

SECOND EDITION

CONTEMPORARY INVESTMENTS

Security and Portfolio Analysis

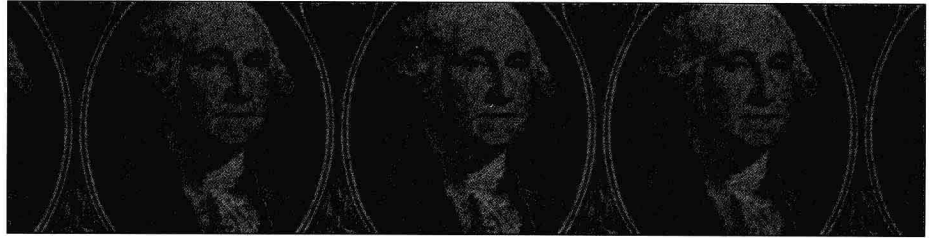
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Douglas Hearth Janis K. Zaima



CONTEMPORARY INVESTMENTS

Security and Portfolio Analysis

SECOND EDITION

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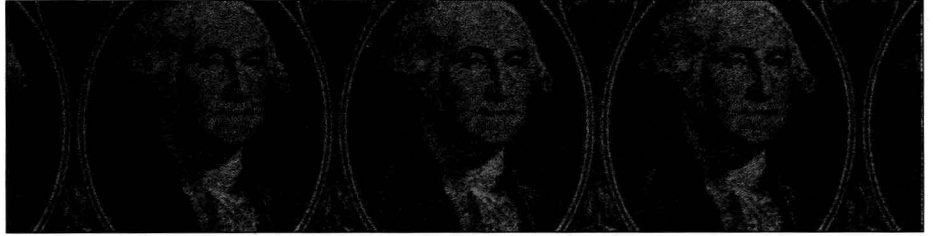
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CONTEMPORARY INVESTMENTS

Security and Portfolio Analysis

SECOND EDITION



This book is dedicated to our parents.

*Donald and Joan Hearth
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PREFACE

When we started writing the first edition of *Contemporary Investments* our overall objective was to create a comprehensive investments textbook, which, while covering much the same material as other texts, would have a much different writing style and focus. Years of teaching experience tells us that investments is often a course many students look forward to taking, only to be disappointed. The textbook is the usual suspect. Why?

Well, we believe that the fundamental problem with most investments texts is that they appear to students to be detached from the real world of investments. Much of the material in existing texts seems to readers to be cloaked in mysterious economic theory coupled with lots of statistics and mathematics. Too little time is devoted to discussing how *real* investors actually make decisions, whether these decisions are right or wrong. That's really too bad; we believe students want to learn more about the practice of investments, not just the theory.

What do we do differently than most investment texts? That's a fair question. For one thing, we've written *Contemporary Investments* in a more informal, conversational style. Let's face it, many textbooks, while sincere and technically correct, are just plain boring. Further, we place more emphasis on investing in common stocks than do most texts. Stocks are arguably the most complicated but also the most interesting investment instrument. The text is also replete with real companies and real investment situations. Whenever possible, we use real world examples to illustrate key points. We don't summarily dismiss successful investors as mere flukes, but rather try to understand why they're successful. Perhaps its mainly luck, but perhaps it's also superior investment skill.

Investment theory is presented in a more lucid, less intimidating manner. You wouldn't need a degree in higher mathematics to understand the material. We show how investment theory can help investors better understand the world of investments and help them make better investment decisions. It's not that we don't feel theory is important; we do. In fact, we believe you need to solid foundation in investment theory in order to know how to properly apply it to real investment situations.

Investing can be fun. You can get a great deal of satisfaction from watching what you felt was a great investment exceed your expectations. At the same time, we never lose sight of the fact investing is serious and important work. Many students aspire to a career in the investments field, and we accommodate them. But even if you don't want a career in investments, more likely than not you're going to be an investor. In fact, you may already be. Improving your standard of living in the future, we believe, will require more astute investment planning today. Consequently, we don't neglect issues that apply mainly to the individual investor.

Finally, throughout the text, we never forget the historical context of investments. While, by its nature, investing is forward looking, we believe you often have to look to the past while looking toward the future. Sure the past is never a guarantee of the future, yet you can learn a great deal by studying past investment successes and failures.

In short then, we've tried to create an investments text written in a more user-friendly, proactive manner, while still being complete and current. We

hope this text not only gives you an operational knowledge of the current field of investments, but provides the stimulation for a lifetime of further study. It is our hope that you will find our text to be both interesting and understandable, and perhaps consider your reading assignments to be more joy than drudgery. You, the reader, will be the ultimate judge as to how well *Contemporary Investments* accomplishes this goal.

Intended Market and Use

We believe this text can be used in the first investments class at either the undergraduate or MBA level. The entire text can be covered in one semester (or quarter). At the same time, given the depth of the in-text examples and end-of-chapter problems, the text can easily fit into a two semester (or two quarter) sequence.

With more than 30 years of combined teaching experience, we know just how difficult it can be to cover all the material you want and need to cover. It often seems like there's never enough time to cover everything. We've tried to help by structuring the text material in such a way that topics can be covered generally, or in more depth, depending on the needs and preferences of instructors and their students. So, instructors can easily emphasize some topics and de-emphasize others.

The text is designed to be read in what we would call, for lack of a better term, a linear fashion, meaning the chapters in the order presented. On the other hand, when designed and writing the text we've tried to allow for some flexibility depending on instructor preferences. Comparing notes with some instructors tells us that some prefer to cover modern portfolio theory in class earlier than we do in the text. This presents no problem; after all, *Contemporary Investments* isn't a novel! One can read the chapters on modern portfolio theory (Chapters 12 through 15), before the chapters on security analysis (Chapters 8 through 11), without much loss in continuity. We know of other instructors who prefer to cover bonds before common stocks. Again, one can read the two chapters devoted to bonds (Chapters 16 and 17), before Chapters 8 through 11, without becoming hopelessly confused.

Changes to the Second Edition

Our overriding goal while the writing the second edition of *Contemporary Investments* was to maintain our emphasis upon applications as the main "theme" behind the book. In other words, we haven't changed our basic philosophy. Rather, in the second edition we concentrated on shortening the text, updating the extensive real-world data and examples, adding more computational problems, integrating the Internet in appropriate chapters and exercises, highlighting the applications features, and providing more instructional and ideas materials to professors in the supplements. We believe we accomplished all of our goals.

Features and Pedagogy

Contemporary Investments offers a number of unique and important features, some of which are new to the second edition, designed to aid in student learning and perk up student interest. A sampling of these features are:

- More emphasis on common stock investing and traditional security analysis (sometimes referred to as the Graham and Dodd approach). Not only have common stocks proven to be superior investments, they are also, in our

view, the most interesting, albeit complicated, investment instrument. The Graham and Dodd approach for valuing common stocks was first published more than 60 years ago, at the height of the Great Depression. It has easily withstood the test of time.

- The qualitative, as well as the quantitative, factors that may determine common stock values and prices are examined in depth, something most texts overlook. While it may be difficult to define what is meant by the *quality of management*, it is too important a topic to ignore, or even downplay. A company can appear to have good looking financial statements, but still be poorly managed.
- Modern portfolio theory (MPT) is presented in a more intuitive and realistic manner, compared to most texts, with a minimum of mathematics. We continually show how MPT can contribute to a better understanding of how the investment markets function. At the same time, we discuss how, when combined with traditional security analysis, MPT can help all types of investors make better investment decisions. If you can see how MPT relates to the real world, we believe you will take it more seriously and it will be easier to learn.
- A more balanced treatment of how professional investors make their investment decisions (technical and fundamental analysis). We recognize, and point out, that professionals are often wrong. However, they've made more than their share of correct calls as well. Some professionals have excellent track records. Why professionals are right is as important as why they are wrong.
- An entire chapter is specifically devoted to a study of speculative bubbles and other past investment follies. One can, after all, argue that investments is often the study of mistakes in retrospect. These stories serve to reinforce important truisms in investments, that price and value can diverge substantially in the short run, but in the long run, investments tend to sell for their intrinsic values. Further, speculative bubbles help to illustrate the human, emotional side of investing.
- A chapter is devoted to mutual fund investing. Mutual funds is one of the most phenomenal success stories in the investments area over the last 20 years. Many people today rely solely on mutual funds when making investments. The mutual fund industry is also a growing source of employment for investment professionals.
- The globalization of the financial markets and investing has been one of the most significant trends in recent years. Virtually all texts recognize this but address the globalization of investing by adding a chapter at the end. The international chapter then becomes a logical candidate for omission when time runs short. We've addressed globalization by attempting to integrate it throughout the text so international issues become a natural part of the material. Where appropriate, a global icon is used so specific international examples can be quickly identified.
- Investing raises a number of ethical situations (such as those involving the use of inside or privileged information). Throughout the text there are numerous opportunities for class discussion involving ethical issues and investing. These are in the form of everything from boxes to end of chapter questions.
- Each chapter begins with a set of learning objectives—phrased as questions—designed to guide the student's reading. The chapter summary then repeats each learning objective individually and summarizes the chapter material that applies to it.

- At the beginning of each chapter is a new feature called *linkages*. This feature consists of three parts—where we've been, what we're doing now, and where we're going in the future.
- Another new feature is use of a marginal glossary. Key terms are defined in the margin near where the reader first encounters them.
- Throughout each chapter there is extensive use of real companies and real investment situations to illustrate key points. Students will run into such well known companies as Disney, General Electric, General Motors, Intel, Microsoft, Nike, Sara Lee, and Southwest Airlines.
- Most chapters contain at least one *Investments Insights* box. These are current articles reprinted from the business and financial press. They help to reinforce key points and show practical applications of the material presented. Unlike many texts, these articles are actually integrated into the body of the chapter.
- Each figure or graph. The notes explain what the figure, or graph, is showing and the point (or points) it is illustrating. This will make the figures clearer and easier to understand.
- In selected chapters, a brief one paragraph summary (Recap) follows difficult, complicated material. Practice questions are also given—the answers appear in an appendix to the text. These recap sections give the reader a chance to catch his or her breath and review what was covered before pushing ahead.
- The most complicated, demanding material, whether it be mathematical or conceptual, has been placed in separate sections (indicated with a *). Readers can skip these sections without any loss of continuity. Instructors have the flexibility of covering or not covering this material.
- At the end of each chapter, there are extensive questions and problems. Most chapters have one or more mini-cases. These comprehensive problems are designed to test student comprehension over large portions of material. All chapters have 15 to 20 discussion questions and problems designed to test knowledge over more specific points. Finally, each chapter has at least one critical thinking exercise (most have more). Critical thinking exercises require Internet searches, library research, computer work, or all three. Not only are these exercises designed to see how well students comprehend the chapter material, they are also designed to give students some hands-on practice with real data and investment situations. We give students lots of opportunities to practice and improve their computer skills. Improved computer skills, by the way, is something potential employers are looking for today.

Supplements

A number of excellent supplements have been developed and accompany *Contemporary Investments*. Our basic philosophy with the ancillary package is to enhance the learning experience by providing a wealth of material that can be used as examples, projects, and presentations. The ancillary package consists of:

- ***Instructor's Resource Manual (IRM)***. The IRM provides an outline of each chapter, a list of points to emphasize, and identifies areas where students often get confused. In addition, the IRM provides a list of possible student projects, worked out computational examples, integration of the lecture slides, mini-case solutions (on separate pages so they can be easily

reproduced for distribution to students), and classroom information on the Investment Insight boxes (such as a summary of the issues raised and questions for discussion or testing). The IRM also contains a section on individual information handouts. These include a time value of money review, a list of AIMR's standards for ethical behavior, a discussion of security price indexes, and a review of convexity. Finally, the IRM contains a complete set of transparency masters.

- **Test Bank.** A thorough, comprehensive test bank is available, both in paper and computerized versions. The test bank contains around 1,500 objective questions, short answer essay questions, and problems along with several sample tests.
- **Data Disk.** A data disk is included with each book. It contains a set of Microsoft Excel worksheets designed to accompany many of the critical thinking exercises. The data disk also includes an entire security analysis report—in Microsoft Word format—and a file listing finance-oriented Web sites. This file can be used in conjunction with popular web browsers such as Netscape and Microsoft Internet Explorer.
- **Investment Wizard (new supplement).** Investment Wizard is a Microsoft Excel workbook and consists of a set of pre-built worksheets. Students enter data or information where indicated on the worksheet. The worksheet performs predetermined calculations—such as finding the duration of a bond or the standard deviation of a portfolio of stocks.
- **Lecture Presentation Slides (new supplement).** Professor Thomas Potter at the University of North Dakota has prepared an outstanding set of computerized lecture slides for each individual chapter. These slides are in Microsoft Power Point format and are designed to be used in class lectures. They provide a dynamic, multimedia lecture experience.
- **Study Guide.** An excellent study guide written by Professor Thommajean Johnsen at the University of Denver is available for purchase by students. The guide contains a detailed chapter outline, and additional questions and problems for student practice and mastery.
- **Web Page.** Contact our Web site at www.dryden.com to access information on up-to-date teaching and learning aids.

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Douglas Hearth
Janis K. Zaima

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