

FUNDAMENTALS *of* INVESTING

SEVENTH EDITION



Lawrence J. Gitman Michael D. Joehnk

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+17.2	D	4.50	1.25	10.67	-0.19	McKIntEq	IL	-2.7	-5.3	+
+21.0	A	4.50	1.42	9.72	-0.07	McKSmCp	..	NA	NA	+
+7.4	B	4.50	1.09	10.52	-0.12	MJI	IL	-1.7	-2.3	+
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NS	..	4.50	1.90	15.47	-0.14	RHJSmCp	SC	-2.0	-3.9	+
NS	..	4.50	0.90	9.49	..	SAMI Pfd	SE	-0.1	+0.8	+
+14.4	B	4.50	1.25	10.84	-0.05	SirBal	BL	-1.4	-1.1	+
NS	..	4.50	1.90	10.24	+0.04	SirBd	..	NA	NA	+
NS	..	4.50	0.75	13.86	-0.14	SirEq	GR	-2.7	-3.1	+
+14.4	B	4.50	1.25	12.57	-0.13	SirGwlh	GR	-3.2	-3.6	+
NS	..	4.50	1.10	12.57	-0.13	SirGtlh p	GR	-3.2	-3.6	+
NS	..	4.50	1.35	11.35	-0.12	SirSEq	SC	-4.0	-5.1	+
+6.9	C	4.50	1.04	12.64	-0.02	SterBl	BL	+0.2	+0.5	+
NS	..	0.00	2.20	16.78	-0.08	SterEq	GI	-0.8	-1.1	+
NS	..	0.00	2.01	13.33	+0.05	SterSCap	SC	-0.5	+1.5	+
NS	..	0.00	2.10	14.28	-0.12	TS&WEq	GI	-2.1	-1.8	+
NS	..	0.00	2.10	10.73	+0.04	TS&WFI	GT	+1.4	+2.6	+

PREFACE

"Market Hits New High." How many times have investors read this headline or heard this market report over the course of the last few years? The performance of the stock market has been *the* major story in the financial press recently and has had a widespread impact on investors, investment vehicles, and the investment environment in general. The golden glow of the stock market has changed the way many people view the activity of investing; some have even suggested that the financial community has overcome the inevitability of dips in the business cycle. Yet many remain wary of the possibility of market tremors, such as that in October 1997, and some even fear the financial equivalent of a seismic "big one." In the midst of the market euphoria on the one hand and prophecies of a market collapse on the other stands the individual investor wondering what to believe and what to do with his or her investment funds.

This textbook, *Fundamentals of Investing*, seventh edition, reflects the realities of today's changing investment environment—from new investment vehicles, techniques, and strategies to regulations and taxes. The book serves investors who wish to develop and monitor their own investment portfolios actively. It meets the needs of professors and students in the first course in investments offered at colleges and universities, junior and community colleges, professional certification programs, and continuing education courses. Focusing both on individual securities and on portfolios of securities, *Fundamentals of Investing* explains how to implement investment goals in light of risk–return tradeoffs. A conversational tone and liberal use of examples guide students through the material and demonstrate important points.

Key Features of the Seventh Edition

Using information gathered from both academicians and practicing investment professionals, plus feedback from adopters, the seventh edition reflects the realities of today's investment environment. At the same time, it provides a structured framework for successful teaching and learning.

Comprehensive and Integrated Learning System

Learning Goals at the beginning of each chapter are the central feature of our proven teaching/learning system. Each Learning Goal is tied by a special icon to the associated first-level head in the text, and these goals are restated and reviewed, point by point, at the chapter's end. To support these Learning Goals, Concepts in Review questions appear at the end of each section of the chapter (positioned before the next first-level head) and allow students to test their understanding of each section before moving on to the next section of the chapter. In addition, each goal is keyed to the end-of-chapter discussion questions, problems, cases, and selected supplements.

By focusing on the Learning Goals, students will know what material they need to learn, where they can find it in the chapter, and whether they've mastered it by the end of the chapter. In addition, instructors can build lectures and assignments around the Learning Goals.


Clear Focus on the Individual Investor

Today, about one out of every three adult Americans owns stock either directly or indirectly (through mutual funds). The focus of *Fundamentals of Investing* has always been on the individual investor. This focus on the individual investor gives students the information they need to plan, implement, and manage a successful investment program. It also provides students with a solid foundation on which subsequent courses can develop an understanding of the advanced concepts, tools, and techniques used by institutional investors and money managers.

Timely Topics

Various issues and developments constantly reshape financial markets and investment vehicles. We have revised virtually all topics to take into account changes in the investment environment that have occurred since the previous edition was published. To retain the text's timeliness, we also expanded coverage of certain topics, including online sources of investment information, derivatives, new forms of IRAs, and international diversification. These discussions provide students with a realistic understanding of the investment arena. In addition, we have added various Internet linkages to guide students to sites that will provide current data, information, and decision models.

Globalization

As a result of the growing globalization of securities markets, *Fundamentals of Investing* continues to stress the global aspects of investing. We initially look at the growing importance of international markets, investing in foreign securities—indirectly or directly, international investment performance, and the risks of investing internationally. In later chapters, popular international investment opportunities and strategies are described as part of the coverage of each specific type of investment vehicle. This integration of international topics helps students understand the importance of maintaining a global focus when planning, building, and managing an investment portfolio. Global topics are highlighted by inclusion of a globe icon .

Comprehensive yet Flexible Organization

The text provides a firm foundation for learning by first describing the overall investment environment, including the concepts of risk and return. It then examines each of the popular investment vehicles—common stocks, bonds, preferred stocks, convertible securities, options, futures, mutual funds, real

estate and other tangibles, and tax-advantaged investments. The final section of the book focuses on investment administration—constructing, managing and controlling portfolios of the popular investment vehicles discussed in earlier chapters. Although the first and last parts of the textbook are best covered at the start and end of the course, respectively, instructors can cover particular investment vehicles in just about any sequence.

We organized each chapter according to a decision-making perspective, and we have been careful always to point out the pros and cons of the various vehicles and strategies that we present. With this information, individual investors can select the investment actions that are most consistent with their objectives. In addition, we've illustrated investment vehicles and strategies in such a way that students learn the decision-making implications and consequences of each investment action they contemplate. The comprehensive yet flexible nature of the book enables instructors to customize it to their own course structure and teaching objectives.

Specific Content Changes by Chapter

- *Chapter 1*, on the role and scope of investments, has been shortened to provide a “quick start out of the blocks.” It retains an overview of types of investments, the investment process, and investment vehicles—essential information that serves as a foundation on which to build understanding in subsequent chapters. Discussion of the steps in investing has been moved to Chapter 3. The overview of the textbook has been omitted. We have inserted marginal annotations that explain the book's pedagogical features to improve students' understanding of these important features as they appear.
- *Chapter 2*, on investment markets and transactions, contains expanded and updated coverage of international investment performance and foreign securities and a significantly updated discussion of stockbrokers that includes online as well as full-service and discount brokers. We also added discussion of the use of alternative dispute resolution processes to reduce conflicts between investors and their brokers.
- *Chapter 3*, on investment planning and information, now begins with a streamlined discussion of investment planning. The chapter reflects tax updates consistent with the Taxpayer Relief Act of 1997. The revised discussion of short-term investments now precedes updated and streamlined discussions of types and sources of investment information and advice and market averages and indexes, which now have a more global focus.
- *Chapter 4*, on measuring investment return and risk, emphasizes the actual rather than the approximate yield—an approach now used throughout the textbook. The chapter includes a boxed discussion of deflation and its risks. The discussions of various aspects of risk, including beta and CAPM, have been clarified and streamlined.
- *Chapter 5*, on common stock investments, contains updated information on market performance through the third quarter of 1997, including a discussion of the 1997 market “stumble,” which triggered the use of the circuit breakers installed after the 1987 crash. The chapter also now contains discussion of stock spin-offs, the effects of currency movements in international

investing, and the Russian stock market. Finally, the chapter has been streamlined, primarily to eliminate duplication of material on buying and selling stocks.

- *Chapter 6*, on analytical dimensions of stock selection, now includes more coverage of the impact that growth in earnings has on share prices, as it introduces the reader to PEG which relates a firm's P/E ratio to its rate of growth in earnings.
- *Chapter 7*, on stock valuation and investment decisions, has been updated throughout and now emphasizes the use of IRR procedures to measure stock returns, rather than approximate yield—which has been dropped.
- *Chapter 8*, on bond investments, includes updated information on market performance through 1997. It also has new material on Treasury inflation-indexed bonds (TIPs), asset-backed bonds, crossover bonds, and taxable munis.
- *Chapter 9*, on bond valuation and analysis, now focuses more clearly on the term structure of interest rates and the pricing of bonds. It also discusses a barbell bond investment strategy.
- *Chapter 10*, on preferred stock and convertible securities, has been thoroughly updated to reflect the latest market trends. An example is new coverage of monthly income preferred stock (MIPS) and convertible bonds.
- *Chapter 11*, on options, now includes more coverage of Dow Jones-linked products, such as the DJ index options, which are some of the hottest vehicles in the market. The chapter also includes discussion of customizing convertible bonds and using index options to protect a portfolio.
- *Chapter 12*, on commodities and financial futures, also introduces the reader to the new Dow Jones futures contracts and notes the difference between these contracts and other traditional equity index contracts, like the S&P 500; also included is discussion of arbitrage trading and the triple-witching day.
- *Chapter 13*, on mutual funds, has been revised and updated to reflect growth in this form of investment in the last few years. Coverage now includes discussion of “funds of funds” and information on reading prospectuses and on single-country index funds (WEBS).
- *Chapter 14*, on real estate and other tangible investments, includes an updated discussion of the state of real estate markets, applies the latest revisions of the tax laws, and demonstrates the calculation of actual yield for real estate investment. The example of real estate valuation has been revised to fully reflect the impact of the Taxpayer Relief Act of 1997 on cash flows. The discussion of other tangible investments is also thoroughly revised and streamlined.
- *Chapter 15*, on tax-advantaged investments, has been thoroughly updated to reflect the latest tax laws, particularly the Taxpayer Relief Act of 1997, and related investment strategies and vehicles. The discussions of 401(k) and Keogh plans have been revised and updated, and the discussion of IRAs has been thoroughly reworked to reflect the impact of the new tax law on them, including the creation of Roth IRAs and Education IRAs.
- *Chapter 16*, on portfolio construction, includes a revised section on the effectiveness, methods, and benefits of international diversification. The

discussion of traditional versus modern portfolio theory is streamlined and improved.

- *Chapter 17*, on portfolio management and control, has been updated to focus more clearly on the evaluation and assessment of portfolio performance and the methods for timing portfolio transactions.

Pedagogical Features

This textbook has long been recognized for its numerous pedagogical features designed to help students focus their study of investments. Among the useful features it includes are Learning Goals, a marginal glossary, *Investing in Action* boxed readings, Concepts in Review questions, Internet linkages, Investor Facts, and varied end-of-chapter materials.

LG 1

Learning Goals

Each chapter begins with six Learning Goals, labeled with numbered icons (noted at left of head), that clearly state the concepts and materials to be covered. The Learning Goal icons are tied to first-level headings, are reviewed point by point at the chapter's end, and are keyed to end-of-chapter discussion question, problems, and cases.

Alongside the chapter's Learning Goals at the beginning of each chapter is a brief vignette that features a real-world company or event and ties it to the chapter topic.

Marginal Glossary

New terms are set in boldface type and defined when first introduced in the text. In addition, each term appears with its definition in the text margin, to facilitate student learning and review. The page numbers on which these entries appear within the text are noted in boldface in the book's index, to make it easy to find these definitions.

Investing in Action

Each chapter features two boxed essays, called *Investing in Action*, that describe real-life investing situations or events. Although we have revised and retained a few of the most popular from the previous edition, the majority are new. These high-interest boxes, which have been written specifically for this textbook, demonstrate concepts introduced in the text and enliven the students' reading at a level consistent with their abilities.

Concepts in Review

Concepts in Review questions appear at the end of each section of the chapter (positioned before the next first-level heading) and are marked with a special design element. As students progress through the chapter, they can test their understanding of each concept, tool, or technique before moving on to the next section within the chapter. In this edition we have added Concepts in Review questions related to the *Investing in Action* boxes. These questions help to integrate the key concepts in the boxes with the text material.

Internet Linkages

The growth of the Internet and its increasing usage in college coursework has impelled us to add several types of Internet linkages in the seventh edition. The first is Internet interlineals—inserts following the Concepts in Review at the ends of key text sections. These inserts refer students to Web sites related to the topic covered in the section. In addition, each chapter ends with Home Page Exercises, which are described under the heading End-of-Chapter Materials later in the Preface. The third Internet linkage is the textbook's Home Page (at hepg.aw.com), which offers a wide variety of informational resources for students and instructors. This resource is described in more detail in the Supplemental Materials section of the Preface.

We feel certain that the inclusion of these rich Internet linkages in the seventh edition of the textbook adds further real-world flavor and a timely source of useful information for both students and instructors.

Investor Facts

Each chapter also contains two to three Investor Facts—brief sidebar items that give an interesting statistic or cite an unusual investment experience. The facts and figures in these boxes are intended to stimulate student interest and motivate further thought. For example, the Investor Fact on page 70 demonstrates the impact of taxes on the amount of money you would accumulate by making annual \$2,000 deposits into an account that earns 8% annual interest over 30 years. The Investor Fact on page 578 uses an example of an item auctioned from Jacqueline Kennedy's estate to demonstrate the impact of celebrity on the value of collectibles.


End-of-Chapter Materials

A number of important elements at the end of each chapter reinforce the concepts, tools, and techniques described in the chapter and help students review and integrate chapter content.

Summary Each summary lists the chapter's key concepts and ideas, which correspond directly to the six numbered Learning Goals presented at the beginning of the chapter. The Learning Goal icons precede each summary item, which begins with a boldfaced restatement of the learning goal.

Discussion Questions A handful of thought-provoking Discussion Questions, keyed to the Learning Goals, are included at the end of each chapter. They guide students to integrate, investigate, and analyze the key concepts presented in the chapter. Many questions require that students apply the tools and techniques presented in the chapter to investment information they have obtained, and then make a recommendation with regard to a specific investment strategy or vehicle. These project-type questions are far broader than the Concepts in Review questions included within the chapter.

Problems A set of 8 to 15 Problems is included at the end of each chapter except Chapter 1. The Problems, keyed to the Learning Goals, vary in complexity and scope and thus ensure professors a wide choice of assignable mate-

rials. A CD-ROM symbol  appears next to the Problems that can be solved using the *Fundamentals of Investing* CD-ROM, described in detail below.

Case Problems Two Case Problems, keyed to the Learning Goals, encourage students to use higher-level critical thinking skills: to apply techniques presented in the chapter, to evaluate alternatives, and to recommend how an investor might solve a specific problem.


Home Page Exercises The Home Page Exercises section—new in the seventh edition—consists of two parts. The first is a brief statement of how and where the chapter topic is covered and where it may be found on the Internet, with additional sites listed as resources for student exploration. Next come the Exercises, which require students to obtain data, information, or computational assistance from particular Web sites in order to answer questions or solve simple problems. These Web sites are linked through our textbook Home Page at hepg.aw.com. Frederick P. Schadler of East Carolina University is the author of this feature.

Supplemental Materials

We recognize the key role of a complete and creative package of materials to supplement a basic textbook. We believe that the following materials, offered with the seventh edition, will enrich the investments course for both students and instructors.



The *Fundamentals of Investing* CD-ROM

Included with each new copy of the book is the *Fundamentals of Investing* CD-ROM, which was revised and improved for this edition by Kathryn E. Coates and David Geis of KDC Software Solutions. The purpose of the CD-ROM is to perform the calculation of virtually all of the formulas, ratios, and valuation procedures presented in the book. The CD-ROM is user-friendly and fully interactive. More than a problem solver, it also enhances the student's understanding of the investment process. The CD-ROM is keyed to all applicable text discussions and end-of-chapter and ancillary materials with a disk symbol . Detailed instructions for using the disk are printed on the back left endpaper and in a help file contained on the CD-ROM.

***Fundamentals of Investing* Home Page**

The textbook's Home Page (at hepg.aw.com) offers a rich variety of informational resources for students and instructors. Visitors to the site will find links to related sites mentioned in the interlineals at the ends of text sections; links to sites mentioned in the Home Page Exercises at the ends of chapters; interviews with investors, who share their investing philosophies and their successes or failures; readings on various topics; additional material beyond the normal scope of the first-level investments course; information on more investors' resources; and a calculator keystrokes manual.

Study Guide

The student review manual, *Study Guide to Accompany Fundamentals of Investing, Seventh Edition*, prepared by Karin B. Bonding, of the McIntire School at the University of Virginia and CFA, President of Capital Markets Institute, Inc., Ivy, Virginia has been completely revised. Each chapter of the *Study Guide* contains a chapter summary, a chapter outline, and a programmed self-test that consists of true-false and multiple-choice questions. Following the self-test are problems with detailed solutions and, where appropriate, calculator key strokes showing use of the calculator to solve certain problems. All elements are similar in form and content to those found in the book.

Instructor's Manual

Written by the text authors, with the assistance of Kumar Venkataraman of Arizona State University, the *Instructor's Manual* contains chapter outlines; a list of major topics discussed in each chapter; detailed chapter reviews; answers to all Concepts in Review questions, Discussion Questions, and Problems; solutions to the Case Problems; and ideas for outside projects. Instructions for outside projects are printed on separate sheets, for ease in duplicating them for classroom distribution.

Test Bank

Revised for the seventh edition by Susan Mason, the *Test Bank* now includes a substantial number of new questions. Each chapter now contains at least 15 true-false questions, at least 40 multiple-choice questions, and several problems and short-essay questions. The *Test Bank* is also available in Test Generator Software (TestGen-EQ with QuizMaster-EQ for Windows). Fully networkable, this software is available for Windows and Macintosh. TestGen-EQ's friendly graphical interface enables instructors to easily view, edit, and add questions; export questions to create tests; and print tests in a variety of fonts and forms. Search and sort features let the instructor quickly locate questions and arrange them in a preferred order. QuizMaster-EQ automatically grades the exams, stores results on disk, and allows the instructor to view or print a variety of reports.

PowerPoint Transparency Slides

To facilitate classroom presentations, PowerPoint slides of key text images are available for Windows and Macintosh. A PowerPoint viewer is provided for use by those who do not have the full software program.

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NS	4.50	1.45	10.23	-0.13	Jacobs	IL	-1.6	-2.7	+
NS	4.50	1.26	15.41	-0.05	MckDmEq	GR	-1.2	-4.2	+
NS	4.50	1.35	10.86	+0.04	MckGov	LG	+1.3	+2.5	+
+18.8	B	4.50	1.25	10.67	-0.19	MckIntEq	IL	-2.7	-5.3
+17.2	D	4.50	1.25	9.72	-0.07	MckSmCp	...	NA	NA
+19.2	B	0.00	0.57	10.52	-0.12	MJI	IL	-1.7	-2.3
+21.0	A	4.50	1.42	14.23	-0.12	NWQBals p	MP	-1.9	-2.3
NS	4.50	0.90	15.47	-0.14	RHJSmCp	SC	-2.0	-3.9	+
+7.4	B	4.50	1.09	9.49	...	SAMI Ptd	SE	-0.1	+0.8
+12.6	A	4.50	1.10	10.84	-0.05	SirBal	BL	-1.4	-1.1
NS	4.50	1.90	10.24	+0.04	SirBd	...	NA	NA	+
NS	4.50	0.75	13.86	-0.14	SirEq	GR	-2.7	-3.1	+
+14.4	B	4.50	1.25	12.57	-0.13	SirGwth	GR	-3.2	-3.6
NS	4.50	1.10	12.57	-0.13	Sir Gths p	GR	-3.2	-3.6	+
NS	4.50	1.35	11.35	-0.12	SirSEq	SC	-4.0	-5.1	+
+6.9	C	4.50	1.04	12.64	-0.02	SterBl	BL	+0.2	+0.5
NS	0.00	2.20	16.78	-0.06	SterEq	GI	-0.8	-1.1	+
NS	0.00	2.01	13.33	+0.05	SterSCap	SC	-0.5	+1.5	+
NS	0.00	2.10	14.28	-0.12	TS&WEq	GI	-2.1	-1.8	+
			10.73	+0.04	TS&WFI	GT	+1.4	+2.6	+

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NS	..	4.50	1.15	10.23	-0.13	Jacobs	IL	-1.6	-2.7
NS	..	4.50	1.26	15.41	-0.05	McKDmEq	GR	-1.2	-4.2
NS	..	4.50	1.35	10.86	+0.04	McKGov	LG	+1.3	+2.5
+18.8	B	4.50	1.25	10.67	-0.19	McKIntEq	IL	-2.7	-5.3
+17.2	D	4.50	1.25	9.72	-0.07	McKSmCp	..	NA	NA
+19.2	B	0.00	0.57	10.52	-0.12	MJI	IL	-1.7	-2.3
+21.0	A	4.50	1.42	14.23	-0.12	NWQBals p	MP	-1.9	-2.3
NS	..	4.50	0.90	15.47	-0.14	RHJSmCp	SC	-2.0	-3.9
+7.4	B	4.50	1.09	9.49	..	SAMI Pfd	SE	-0.1	+0.8
+12.6	A	4.50	1.10	10.84	-0.05	SirBal	BL	-1.4	-1.1
NS	..	4.50	1.90	10.24	+0.04	SirBd	..	NA	NA
NS	..	4.50	0.75	13.86	-0.14	SirEq	GR	-2.7	-3.1
+14.4	B	4.50	1.25	12.57	-0.13	SirGwth	GR	-3.2	-3.6
NS	..	4.50	1.10	12.57	-0.13	SirGthSp	GR	-3.2	-3.6
NS	..	4.50	1.35	11.35	-0.12	SirSEq	SC	-4.0	-5.1
+6.9	C	4.50	1.04	12.64	-0.02	SterBl	BL	+0.2	+0.5
NS	..	0.00	2.20	16.78	-0.08	SterEq	GI	-0.8	-1.1
NS	..	0.00	2.01	13.33	+0.05	SterSCap	SC	-0.5	+1.5
NS	..	0.00	2.10	14.28	-0.12	TS&WEq	GI	-2.1	-1.8
NS	..	0.00	2.10	10.73	+0.04	TS&WFI	GT	+1.4	+2.6

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4.8	B	NS	0.00	2.43	15.94	-0.12	GroEdTr	GR	-2.2	-3.1	NS	NS	NS	0.00	NA	18.07	-0.05	EquityD	GR	-2.5	-3.8	
NS	NS	NS	0.00	NA	22.99	-0.11	RelVal	GI	0.0	0.0	NS	NS	NS	0.00	NA	15.99	-0.15	IndexI	GI	-1.3	-1.8	
NS	NS	NS	0.00	NA	22.99	-0.11	RelVal	fr	0.0	0.0	NS	NS	NS	0.00	NA	16.40	-0.12	TwedyAmerVal	GR	-1.4	-0.4	
NS	NS	NS	0.00	NA	12.97	-0.05	StellarA	MP	-0.9	-0.5	+11.6	D	NA	NS	0.00	1.39	16.40	-0.09	TwedyGIVal	GL	+0.1	+0.1

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