

FIN 394.II - INVESTMENT THEORY

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Objective: The focus of this course is on the examination and valuation of the major investment vehicles and strategies popular today. In particular, we will consider how investors allocate their financial assets by forming, managing, and evaluating portfolios containing instruments such as stocks, bonds, futures and option contracts, and mutual funds. Although the ultimate objective will be to develop a conceptual and theoretical background upon which the student can expand his or her knowledge of the field of investments, the topical treatment will be rather practically oriented. This course will follow the general approach used in the Chartered Financial Analyst (CFA) candidate training program. No prior investment experience beyond successful completion of the prerequisite course material covered in the core classes is assumed.

Texts: Required - *Investment Analysis and Portfolio Management, 8e* by F. Reilly and K. Brown (Thomson South-Western, 2006)

Packet of Supplemental Readings & Case Studies

Grades: There will be three sources of evaluation in this course:

Examination I	45%
Examination II	45%
Class Participation	<u>10%</u>
	100%

The first examination will be given as a take-home test immediately following the completion of the class session on the weekend of November 3-4. Written answers to the exam will be due before the beginning of the next class session on the weekend of November 17-18. The test will cover all of the material discussed in the first two class sessions.

The second examination will be given in class on the weekend of December 8-9. It will be a two-hour test that will be given immediately following the regularly scheduled class session on that day. It will cover all of the material discussed in the third and fourth class sessions. No makeup examinations will be given without the prior consent of the instructor. Such consent will only be given in extreme circumstances and only with the proper documentation.

Although they do not constitute a "formal" (i.e., submitted and graded) assignment, preparation of solutions to the assigned end-of-chapter discussion problems and in-class case studies listed in the course outline will be an important focus of this class. The analysis of the conceptual material that will take place during class are linked closely with these exercises and so it is vital that you consider them *before* each class meeting. You will be responsible for being prepared to discuss answers to all of the questions pertaining to a particular topic, even if some of the questions are not eventually covered in class. The class participation component of your grade will largely be determined by your contributions to these discussions, along with other factors such as attendance, promptness, respect for the educational process, and general classroom decorum.

Structure: The course is divided into the following sessions:

- I - Investment Overview: Asset Allocation, Capital Markets, and Trading
- II - Risk, Return, and Portfolio Construction
- III - Investment Instruments: Equity Valuation & Strategy
- IV - Investment Instruments: Fixed-Income Valuation & Strategy
- V - Investment Performance Evaluation

The course outline gives a specific session-by-session breakdown of the topics we will cover in class. Throughout the semester, I may announce in class additional details of the precise assignment for subsequent sessions; this information will also be posted in the appropriate location on the course home page. If you have any questions about what is to be covered in any class, please consult the website or ask me directly before the class session.

Policies: - The grading scheme described above pertains to just this portion of the FIN 394 course. Your overall grade for the semester will be determined by an unweighted average of your respective class rankings for Part I (Advanced Corporate Finance) and Part II (Investment Theory) of the class.

- Although attendance will never be taken, you will be held responsible for everything covered or assigned in class. It is important that you keep up with the material assigned for each session inasmuch as the lectures will, at times, depart significantly from the material contained in the textbook and articles. Further, your general conduct in class (including your attendance and promptness) will be a factor in the assignment of the class participation portion of your final grade.

- The course home page (which can be located by accessing the web address listed on the first page of this syllabus) will serve as an important mechanism for communicating course-related information. However, anything crucial to your class performance that is posted online will also be available through either more traditional outlets (e.g., e-mail, class handouts) or upon request. In addition to electronic versions of many of the materials used in class, the website will contain a file that summarizes the material covered in previous classes as well as one that contains additional details of the next session. These files will be updated—assuming there are no network problems—no later than 1:00 pm two days prior to a class session.

- PowerPoint files containing the class lecture notes will also be posted no later than 1:00 pm two days before a class session. As a rule, these notes will not be distributed in class; if you would like to have them available during the lecture, you should download them (in either hard copy or electronic form) and bring them with you to class.

- The use of computers and other electronic devices in class is permitted only for the purposes of note-taking and discussion of the homework problems *and* when authorized in advance by the instructor; *accessing the internet, recreational programs, or e-mail and messaging accounts without prior consent of the instructor is strictly forbidden.*

- Academic dishonesty (as defined by the Policy Statement on Scholastic Dishonesty for the McCombs School of Business) will not be tolerated and will be dealt with in the most severe manner possible. I assume that all students in this course will act as if bound by this policy and you can expect the same from me. In particular, I will expect that on every assignment or examination the work you submit will be entirely your own. Failure to do so may result in failure on the specific assignment or in the course. The McCombs School Policy Statement offers this message on the subject:

Students who violate University rules on scholastic dishonesty are subject to disciplinary penalties, including the possibility of failure in the course and/or dismissal from the University. Since dishonesty harms the individual, all students, and the integrity of the University, policies on scholastic dishonesty are strictly enforced.

COURSE OUTLINE

The following outline lists the topic coverage and reading requirements for the semester. The "Discussion Problems" listings refer to the end-of-chapter problems that can be found in the Reilly and Brown's (RB) *Investment Analysis and Portfolio Management* textbook. For the RB assignments, the question and problem numbering system refers to the relevant chapter and question or problem (e.g., Problem Q1.2 refers to the second *question* in Chapter 1, P2.3 refers to the third *problem* in Chapter 2). The supplementary readings can be downloaded in pdf format from the course website.

Session I (October 20-21) - Investment Overview: Asset Allocation, Capital Markets, and Trading

Topic I.1: The Global Investment Setting: Background and Review

Reading: RB - Chapter 1, Appendix 1

M. Statman, "A Century of Investors," *Financial Analysts Journal*, May-June 2003.

Discussion Problems: Q1.11, P1.5, P1A.2, P1A.3

Topic I.2: The Asset Allocation and Style Allocation Decisions

Reading: RB Chapter 2 (pp. 37-63), Appendix 2A

Chapter 16 (pp. 625-640)

R. Ibbotson and P. Kaplan, "Does Asset Allocation Policy Explain 40, 90, or 100 Percent of Performance," *Financial Analysts Journal*, January-February 2000

L. Chan and J. Lakonishok, "Value and Growth Investing: Review and Update," *Financial Analysts Journal*, January-February 2004

Discussion Problems: Q2.1, Q2.6, Q2.9, P2.5, Q16.8, P16.5, P16.6

Topic I.3: Global Capital Markets & Security Types

Reading: RB Chapter 3, Appendix 3

Chapter 16 (pp. 606-615)

Discussion Problems: Q3.1, Q3.4, Q3.16, P3.4, P3.5, P3A.1, P3A.2, Q16.1, Q16.2, P16.8

Topic I.4: Security Markets and Trading

Reading: RB Chapter 4, Appendix 4

Discussion Problems: Q4.3, Q4.13, P4.2, P4.4, P4.7

Session II (November 3-4): Risk, Return, and Portfolio Construction

Topic II.1: Risk and Diversification: Fundamental Concepts

Reading: RB Chapter 7 (pp. 200-218)

Discussion Problems: Q7.3, Q7.6, Q7.12, P7.5, P7.6, P7.7

Topic II.2: Risk and Diversification: Efficient Frontier Formation

Reading: RB Chapter 7 (pp. 218-222)

K. Brown, "A Brief Review of the Portfolio Formation Process," Lecture Notes, August 2006

Discussion Problems: Q7.11

Topic II.3: Risk and Expected Return: CAPM & Multi-Factor Models

Reading: RB Chapter 8 (pp. 229-247, 257-261)

Chapter 9 (pp. 269-274, 279-291)

R. Arnott and P. Bernstein, "What Risk Premium is 'Normal'?", *Financial Analysts Journal*, March-April 2002

K. Brown, "Some Useful Facts About Beta," Lecture Notes, August 2006

Discussion Problems: Q8.7, Q8.15, P8.1, P8.11, P8.14, Q9.5, Q9.7, P9.2, P9.6, P9.7

Topic II.4: Altering Portfolio Risk and Return with Derivatives

Reading: RB Chapter 20 (pp. 805-824, 832-838)

Chapter 22 (pp. 925-935)

Discussion Problems: Q20.3, Q20.8, P20.1, P20.2, P20.3, P20.7a, P22.10, P22.11

Session III (November 17-18) – Investment Instruments: Equity Valuation and Strategy

Topic III.1: Market Efficiency and Behavioral Finance

Reading: RB Chapter 6

R. Thaler, "The End of Behavioral Finance," *Financial Analysts Journal*, November-December 1999

Discussion Problems: None

Topic III.2: Equity Valuation Analysis: Company Analysis and DCF Techniques

Reading: RB Chapter 11 (pp. 359-380)

Chapter 14 (pp. 513-533)

K. Brown, "The Foundations of Stock Valuation," Lecture Notes, August 2006

K. Brown, "Some Thoughts on Cash Flow," Lecture Notes, August 2006

Discussion Problems: Q11.1, Q11.8, P11.4, P11.6, P11.15, Q14.8, P14.8, P14.14, P14.15

Topic III.3: Equity Valuation Analysis: Comparable Firm Techniques

Reading: RB Chapter 11 (pp. 380-385)

Chapter 14 (pp. 533-553)

E. Lie and H. Lie, "Multiples Used to Estimate Corporate Value," *Financial Analysts Journal*, March-April 2002

K. Brown, "The Conceptual Relationship Between DCF and Relative Valuation Techniques," Lecture Notes, August 2006

Discussion Problems: Q14.10, Q14.11, Q14.21, P14.16, P14.18a

Topic III.4: Active Equity Portfolio Strategies

Reading: RB Chapter 16 (pp. 615-625)

Discussion Problems: Q16.9, Harbor Capital Appreciation Fund Case Study

Session IV (December 1-2) – Investment Instruments: Fixed-Income Valuation and Strategy

Topic IV.1: Bond Fundamentals: Yield Curve Analysis, Instruments, and Valuation

Reading: RB Chapter 17 (pp. 649-657)

Chapter 18 (pp. 682-691, 700-708)

K. Brown, “The Fundamentals of Bond Valuation,” Lecture Notes, August 2006

Discussion Problems: Q17.8, P17.4, Q18.1, Q18.5, Q18.6, P18.2

Topic IV.2: Bond Risk Measurement

Reading: RB Chapter 18 (pp. 716-737), Appendix 18

Discussion Problems: Q18.7, Q18.8, Q18.18, P18.3, P18.7

Topic IV.3: Fixed-Income Portfolio Strategies: Passive and Dedicated

Reading: RB Chapter 19 (pp. 757-759, 773-788)

K. Brown, “The Mechanics of Bond Immunization,” Lecture Notes, August 2006

Discussion Problems: Q19.14, Q19.16, Q19.17, P19.3

Topic IV.4: Fixed-Income Portfolio Strategies: Active

Reading: RB Chapter 19 (pp. 759-773)

Discussion Problems: P19.6, Greydanus, Boeckh Case Study

Session V (December 8-9) – Investment Performance Evaluation

Topic V.1: Traditional Evaluation Measures: Peer Comparisons and Basic Risk-Adjusted Measures

Reading: RB Chapter 25 (pp. 1040-1061)

Discussion Problems: Q25.3, Q25.6, P25.1, P25.2, P25.3

Topic V.2: Advanced Risk-Adjusted Performance Measures & Attribution Analysis

Reading: RB Chapter 25 (pp. 1064-1079)

Discussion Problems: Q25.4, Q25.5, Q25.7, Q25.8, P25.4, P25.7, P25.8

THIS OUTLINE SHOULD BE CONSIDERED REPRESENTATIVE OF THE MATERIAL WE WILL COVER DURING THE CLASS; IT IS SUBJECT TO CHANGE UPON PROPER NOTIFICATION