



FIN 397.1 – INVESTMENT THEORY AND PRACTICE
FIN 397.2 – PORTFOLIO MANAGEMENT AND SECURITY
ANALYSIS

SPRING 2013

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Course Objectives

The purpose of this course is to combine Investment Theory and Practice (FIN 397.1) and Portfolio Management and Security Analysis (FIN 397.2). FIN 397.1 involves the foundations of the Investment process: fundamental background knowledge (markets, trading, indexes, etc.), fixed income securities, equity securities, derivatives, mutual funds and performance evaluation.

The purpose of FIN 397.2 is to provide a conceptual and theoretical foundation for the activities of student managers involved with the on-going operations of The MBA Investment Fund, LLC. Using a blend of academic- and practitioner-oriented readings, projects, and group analytical sessions, managers will be introduced to both the conventional wisdom and state-of-the-art methods used in performing many of the Fund's functional tasks, including security research, security trading, and organizational coordination. It is assumed that students have completed (or are concurrently enrolled in) the relevant prerequisite courses in finance, accounting, and statistics.

Required Materials

Investment Analysis and Portfolio Management, 10e by F. Reilly and K. Brown
(Cengage-Southwestern, 2012)

Investments (Sanford J Leeds, 2012)

Recommended Materials

A Random Walk Down Wall Street, 10e by B. Malkiel (Norton, 2011)

Pioneering Portfolio Management, 2e by D. Swensen (Free Press, 2009)

Wall Street Journal

Barron's

Institutional Investor

Bloomberg Markets

Economist

Financial Times

Financial Analyst Journal

Journal of Portfolio Management

Journal of Investment Management

Grades (FIN 397.1)

Midterm	45%
Final Exam	45%
Project	10%

Grades (FIN 397.2)

Stock Pitch	35%
Project #1 (Performance Measurement)	25%
Project #2 (Risk-Return Analysis)	25%
Morning Meeting	15%

Description of Requirements

Exams

The exam dates (for FIN 397.1) will be set by the class. We have the flexibility to schedule the exam at a time that does not conflict with your other exams. It is possible that the final exam will be during the University assigned time. Both exams will be closed-book. They will contain a combination of quantitative and qualitative problems.

We do not release old exams. We have found that releasing old exams is problematic because (1) it results in people studying “to the exam” rather than studying to learn; and (2) students inevitably feel that old exams are easier than the current exam. In addition, we do not allow students to keep their exams. This maintains the fairness of exams, since you know that no one has seen old exams. You will have ample opportunity to review your exam. **If you ask any of our past students what our tests look like or what material is tested, we consider this to be a violation of the Honor Code.**

Projects

You will be assigned to teams for any group projects (FIN 397.2). The project to be done in FIN 397.1 is to be done alone as is the Stock Pitch assignment in FIN 397.2. All FIN 397.2 projects (including the Stock Pitch) will be described in class. The FIN 397.1 project is described immediately below.

The FIN 397.1 project is intended to further your Investments education and to help you to realize that you can continue to educate yourself when you graduate. For your project, I want you to read and **OUTLINE** “The Essays of Warren Buffett: Lessons for Corporate America” by Warren Buffett and edited by Lawrence Cunningham.

There are two reasons that I have you do this project: (1) people love this book; and (2) there is probably no better way to learn about the market than by reading Buffett’s letters to his shareholders. This book consolidates key points from letters. All of his letters are available online at www.berkshirehathaway.com.

Your paper must be in outline form and cannot be longer than ten pages plus a cover page. Ten pages is the total (other than the cover) regardless of whether you call something an appendix or anything else. If you want an example of an outline, look at how my packet is written.

The goal of your outline should be to allow someone who has not read this book to fully understand what it is about. A good outline clearly distinguishes thoughts. It is not simply sentences with a letter in front of it. It eliminates unnecessary words and groups ideas together.

The project is usually not a grade differentiator in FIN 397.1. The reality is that the exams will result in grade differentiation. The project is a learning exercise and the grading scale is normally pretty tight (usually 88 - 94). With that said, every so often someone turns in something that results in a significantly lower grade. The fact that the grade range is normally tight is not intended to diminish the importance of this assignment. Normally, I grade your exams (because they have the largest impact on your final grade) and I have my TA grade your outlines. This assignment is to be done alone.

In the past, students have received low grades on this assignment for various reasons. Examples include students who have clearly not read all of the book, students who did this in sentence form and students who collaborated (which is an act of academic dishonesty). The highest grade that you can get if you do this in paragraph form is 80 (which means that you will be in the 70s because I don’t give perfect scores on this assignment). If you have not read the entire book, the highest grade you can receive is 50 (and again, that score isn’t likely). But, if you read the book and outline it and you feel like you have made a good-faith effort, you should not worry. You will know if you fall into one of the “troubled” categories.

Course Outline and Reading List

Friday, December 14

Topic: History of the Fund (KB)

Topic: Jobs and Interviewing (SL)

Saturday, December 15

Topic: Computer Training (John Dowling)

Topics: Modern Portfolio Theory (KB)

Topic: CAPM and FF Three-Factor Model (SL)

Reading: RB Chapters 1, 7 – 9

K. Brown, “A Brief Review of the Portfolio Formation Process”, Lecture Notes, December 2012

J. Estrada, “The Three-Factor Model: A Practitioner’s Guide,” *Journal of Applied Corporate Finance*, Spring 2011

Tapes: Unit 2

Assignment: Chapter 6 – Problems 1-3; Chapter 7 – Problems 4 – 6, 8; Chapter 8 – Problems 1 – 5, 7 - 10; Chapter 9 – Problems, 1, 3 – 5; Chapter 11 – Problem 3; Efficient Portfolio Formation Case Study

Assignment: Read three handouts (Leeds’ outlines on Private Wealth Management, Mutual Funds, Hedge Funds)

Monday, December 16

Topic: Valuation (Focus on DDM, FCFE, Differences Between FCFE and FCFF) (SL)

Topic: American Century Visit

Reading: RB Chapters 11 and 14

Tapes: Unit 7

Assignment: RB Chapter 11 – Problems 4 – 10, 14, 15; Chapter 12 – Problems 4 – 8; Chapter 14 – Problems 3, 8 – 10; Leeds Unit 7 Problems

Guest Speakers: Brad Eixmann and Chad Baumler (from American Century)

Tuesday, December 17

Guest Speaker: Bruce Zimmerman (UTIMCO)

Guest Speaker: Matt Miller (Dimensional Fund Advisors)

Travel to Houston: How to Pick a Stock (Warren Tennant and John Thornton)

Wednesday, December 18

Houston Trip (Goldman Sachs, Fayed Sarofim, UBS, Invesco)

Tuesday, January 8

Two-Minute Pitch Competition

Guest Speaker: Ryan Nixon (Goshawk Global Investments)

Wednesday, January 9 (no class)

Tapes: Top Down Approach; Active vs. Passive Management; Screening

Monday, January 14th (KB)

Teacher Retirement System Trip

Wednesday, January 16 (KB)

Topic: Portfolio Performance Measurement

Reading: RB Chapter 25 (pp. 959-978, 980-985, 990-993)

Assignment: RB Chapter 25 – Questions 3-6, 8, Problems 1-4, 6

Wednesday, January 23 (KB)

Topic: Portfolio Performance Measurement

Reading: RB Chapter 25 (pp. 986-990, 993-996)

V. Harlow and K. Brown, "The Right Answer to the Wrong Question: Identifying Superior Active Portfolio Management," *Journal of Investment Management*, Fourth Quarter 2006

Assignment: RB Chapter 25 – Questions 7, 10, 8, Problems 7-9

Monday, January 28th (SL)

Topic: Stock Market Indexes (Unit 5)

Reading: RB Chapter 5; Leeds “Academic Studies on Index Inclusion” notes

Taped Lectures: Unit 5, Value and Growth; Value and Growth Studies

Problems: Chapter 5 – Problems 1 – 2; 4 – 6; Leeds Unit 5 Problems

Wednesday, January 30th (SL)

Topics: Unit 2 Math; Active vs. Passive Mgt; Top-Down vs. Bottom-Up

Tapes: Listen to Unit 2 Math

Pre-Class Assignment: Work Problems That I Will Assign

Assignment: RB Chapter 1 – Problems 1 – 12; Chapter 1 Appendix Problems 1 – 3; Chapter 3 – Problems 4 – 5; Chapter 3 Appendix – Problems 1 – 2; Chapter 7 – Problems 1 – 3, 7; Chapter 8 – Problem 6; Chapter 25 – Problems 10a and 10b; Leeds Unit 2 Problems

Speaker: Pat Dorsey

Monday, February 4th (SL) – Two Parts to Lecture

Part 1 – *Topics: The Relationship Between the Economy and Stocks*

Reading: RB Chapter 12

Tapes: Unit 6 (Optional); New Tape on Relative Valuation

Assignment: RB Chapter 12 – Problem 2; Leeds Unit 6 Problems

Part 2 – *Topic: Relative Valuation, LBO Valuation, Other Valuation Topics*

Reading: Already done (Chapters 11 and 14)

Wednesday, February 6th – Lecture Broken into Two Parts (SL)

Part 1 – Topics: Global Capital Markets and Security Types (Unit 10, Chapter 1); Efficient Market Hypothesis (Unit 9)

Reading: RB Chapters 3, 4 (pp. 95 – 112) and 6 (pp. 149-169)

B. Malkiel, “The Efficient Market Hypothesis and Its Critics,” *Journal of Economic Perspectives*, 2003

Tapes: Markets (Unit 10 Chapter 1); High Frequency Trading (Algorithmic Trading)

Part 2 -- Topic: What We Should Know About Analysts & Behavioral Finance

Reading: RB Chapter 6 (pp. 169-176)

S. Ramnath, S. Rock and P. Shane, “The Financial Analyst Forecasting Literature: A Taxonomy With Suggestions for Further Research,” *International Journal of Forecasting*, 2008

B. Barber and T. Odean, “The Behavior of Individual Investors,” (2011) (will be chapter in Handbook of the Economics of Finance)

Monday, February 11th (KB)

Topics: Strategic and Tactical Asset Allocation

Reading: RB Chapters 2 (pp. 33-38, 49-55) and 16 (pp. 553-555, 577-583)

K. Brown, L. Garlappi, and C. Tiu, “Asset Allocation and Portfolio Performance: Evidence from University Endowment Funds,” *Journal of Financial Markets*. May 2010

Assignment: RB Chapter 16 – Problems 6, 8

Wednesday, February 13th (KB)

Topics: Advanced Portfolio Risk Analytics

K. Brown, “The Components of Portfolio Risk,” Lecture Notes, January 2013

A. Damodaran, “Value at Risk (VaR),” Chapter 7 from *Strategic Risk Taking* (Wharton Publishing), August 2007

G. He and R. Litterman, “The Intuition Behind Black-Litterman Model Portfolios,” Goldman Sachs Working Paper, December 1999

Assignment: Asset Class Risk Analysis Case Study

Monday, February 18th and Wednesday, February 20th
NO CLASS – EXAM PREP AND PORTFOLIO TRANSITION

Monday, February 25th and Wednesday, February 27th
NO CLASS – EXAMS IN OTHER CLASSES

Monday, March 4th
Make-up class – topic TBD

Wednesday, March 6th (SL)
Topics: Orders (Unit 10); Technical Analysis (Unit 8)

Reading: RB Chapter 4 (pp. 112 – 119) and Chapter 15

Tape: Unit 8; Unit 10 (excluding Chapter 1)

Assignment: RB Chapter 4 – Problems 1 – 7; RB Chapter 15 – Problems 5 – 6; Leeds Unit 8 and 10 Problems

Friday, March 8th (SL)
Advisor Meeting Prep (Morning Meetings)

Monday, March 11th (SL)
Advisor Meeting Prep (Morning Meetings)

Wednesday, March 13th (SL)
Advisor Meeting Prep (Morning Meetings)

Monday, March 18th (SL)
Topic: Bonds Basics (Unit 3)

Reading: RB Chapters 17 – 19

Tape: Unit 3

Assignment: RB Chapter 11 – Problems 1, 2; Chapter 17 – Problems 1 – 5; Chapter 18 – Problems 1b, 1c, 2, 4, 9a, 10 – 12, 14; Leeds Unit 3 HW

Wednesday, March 20th (SL)

Topic: Fixed Income Management (Unit 4)

Reading: RB Chapters 17 – 19

D. Martin, J. Martin and S. Moyer, “A Primer on Distressed Investing: Buying Companies by Acquiring Their Debt,” *Journal of Applied Corporate Finance*, Fall 2012

Tape: Unit 4

Assignment: RB Chapter 18 – Problems 3, 5 and 7; Chapter 19 – Problems 1 – 4, 8; Leeds Unit 4 HW

Monday, March 25th (KB)

Topic: Derivatives – Forwards, Futures, Swaps

Reading: RB Chapters 20 (pp. 741-747, 754-755, 767-768), 21 (pp. 781-796, 800-806), 23 (pp. 867-875, 878-879)

Assignment: RB Chapter 20 - Question 2, Problems 1-3 (a(1)-b(1) only); Chapter 21-Question 7, Problems 4, 8-9; Chapter 23 – Problems 1, 5

Wednesday, March 27th (SL)

Topic: Derivatives – Options

Reading: RB Chapters 20 (pp. 747-750, 755-765, 768-772), 22 (pp. 821-847, 850-859)

Assignment: RB Chapter 20 - Problems 1-3 (a(2)-b(1) only), 4-5; Chapter 22-Questions 4-5, Problems 2-4, 6, 10-11

Monday, April 1st (SL)

Topic: CDOs and Credit Default Swaps

Reading: J. Martin, “A Primer on the Role of Securitization in the Credit Market Crisis of 2007,” (2009)

J. Coval, J. Jurek and E. Stafford, “The Economics of Structured Finance,” *Journal of Economic Perspectives* 23, no. 1 (winter 2009)

Wednesday, April 3rd (SL)

Topic: Mutual Funds

Reading: RB Chapter 24; Leeds “Mutual Funds” notes

Tape: Unit 12

Assignment: RB Chapter 24 – Problems 1 – 8; Leeds Unit 12 Problems

Monday, April 8th (KB)

Topic: Introduction to Alternative Investments & Private Equity

Reading: RB Chapter 24 (pp. 929-931, 938-945)

B. Singer, R. Staub, and K. Terhaar, “Determining the Appropriate Allocation to Alternative Investments,” *CFA Institute Conference Proceedings*, 2002

A. Metrick and A. Yasuda, “The Economics of Private Equity Funds,” *Review of Financial Studies*, June 2010

Assignment: Yale University Investment Office Case Study

Wednesday, April 10th (SL)

Topic: Hedge Funds

Reading: Leeds “Hedge Funds” notes

Monday, April 15th (SL)

Topic: Personal Finance (Unit 1)

Reading: RB Chapter 2

Tape: Unit 1

Assignment: Leeds Unit 1 Problems

Wednesday, April 17th (SL)

Topic: Personal Finance (Unit 1) and PWM

Reading: RB Chapter 2; Leeds “Private Wealth Management” notes

Monday, April 22nd (KB)

Morning Meeting

Wednesday, April 24th (KB)

Morning Meeting

Monday, April 29th

Topics: Discussion of Industry Reports (for Next Semester); Course Evaluations

Reading: None

Assignment: None

Wednesday, May 1st

Make-up Class

Policies:

Enrollment in this course is restricted to the current set of student managers for The MBA Investment Fund. While this exclusivity creates a more collegial atmosphere than you will experience in most classes, it is important to keep in mind that there is a serious academic purpose to this course that is distinct from the day-to-day activities of the Fund. Accordingly, when evaluating the quality of your work and effort at the end of the semester, we will curve together the scores for the entire section to determine the final distribution. In each class, a full range of grades will be considered. In borderline situations, both class participation and your general effort throughout the semester will be determining factors.

You should treat this course as you would any of your other Fund responsibilities; that is, missing a class session is comparable to missing a Fund business meeting. Whether present or not, you will be held responsible for everything covered or assigned in class. Further, your general conduct in class (including your attendance and promptness) will be a part of your class participation grade. Finally, unless we specifically use laptops for an in-class assignment, they should not be open during class.

McCombs Classroom Professionalism Policy

The highest professional standards are expected of all members of the McCombs community. The collective class reputation and the value of the Texas MBA experience hinges on this.

Faculty are expected to be professional and prepared to deliver value for each and every class session. Students are expected to be professional in all respects.

The Texas MBA classroom experience is enhanced when:

- **Students arrive on time.** On time arrival ensures that classes are able to start and finish at the scheduled time. On time arrival shows respect for both fellow students and faculty and it enhances learning by reducing avoidable distractions.
- **Students display their name cards.** This permits fellow students and faculty to learn names, enhancing opportunities for community building and evaluation of in-class contributions.
- **Students minimize unscheduled personal breaks.** The learning environment improves when disruptions are limited.
- **Students are fully prepared for each class.** Much of the learning in the Texas MBA program takes place during classroom discussions. When students are not prepared they cannot contribute to the overall learning process. This affects not only the individual, but their peers who count on them, as well.
- **Students attend the class section to which they are registered.** Learning is enhanced when class sizes are optimized. Limits are set to ensure a quality experience. When section hopping takes place some classes become too large and it becomes difficult to contribute. When they are too small, the breadth of experience and opinion suffers.
- **Students respect the views and opinions of their colleagues.** Disagreement and debate are encouraged. Intolerance for the views of others is unacceptable.
- **Laptops are closed and put away.** When students are surfing the web, responding to e-mail, instant messaging each other, and otherwise not devoting their full attention to the topic at hand they are doing themselves and their peers a major disservice. Those around them face additional distraction. Fellow students cannot benefit from the insights of the students who are not engaged. Faculty office hours are spent going over class material with students who chose not to pay attention, rather than truly adding value by helping students who want a better understanding of the material or want to explore the issues in more depth. Students with real needs may not be able to obtain adequate help if faculty time is spent repeating what was

said in class. There are often cases where learning is enhanced by the use of laptops in class. Faculty will let you know when it is appropriate to use them. In such cases, professional behavior is exhibited when misuse does not take place.

- **Phones and wireless devices are turned off.** We've all heard the annoying ringing in the middle of a meeting. Not only is it not professional, it cuts off the flow of discussion when the search for the offender begins. When a true need to communicate with someone outside of class exists (e.g., for some medical need) please inform the professor prior to class.

Remember, you are competing for the best faculty McCombs has to offer. Your professionalism and activity in class contributes to your success in attracting the best faculty to this program.

Academic Dishonesty

I have no tolerance for acts of academic dishonesty. Such acts damage the reputation of the school and the degree and demean the honest efforts of the majority of students. The minimum penalty for an act of academic dishonesty will be a zero for that assignment or exam.

The responsibilities for both students and faculty with regard to the Honor System are described on <http://mba.mcombs.utexas.edu/students/academics/honor/index.asp> and on the final pages of this syllabus. As the instructor for this course, I agree to observe all the faculty responsibilities described therein. During Orientation, you signed the Honor Code Pledge. In doing so, you agreed to observe all of the student responsibilities of the Honor Code. If the application of the Honor System to this class and its assignments is unclear in any way, it is your responsibility to ask me for clarification.

Students with Disabilities

Upon request, the University of Texas at Austin provides appropriate academic accommodations for qualified students with disabilities. Services for Students with Disabilities (SSD) is housed in the Office of the Dean of Students, located on the fourth floor of the Student Services Building. Information on how to register, downloadable forms, including guidelines for documentation, accommodation request letters, and releases of information are available online at <http://deanofstudents.utexas.edu/ssd/index.php>. Please do not hesitate to contact SSD at (512) 471-6259, VP: (512) 232-2937 or via e-mail if you have any questions.

Honor Code Purpose

Academic honor, trust and integrity are fundamental to The University of Texas at Austin McCombs School of Business community. They contribute directly to the quality of your education and reach far beyond the campus to your overall standing within the business community. The University of Texas at Austin McCombs School of Business Honor System promotes academic honor, trust and integrity throughout the Graduate School of Business. The Honor System relies upon The University of Texas Student Standards of Conduct (Chapter 11 of the Institutional Rules on Student Service and Activities) for enforcement, but promotes ideals that are higher than merely enforceable standards. Every student is responsible for understanding and abiding by the provisions of the Honor System and the University of Texas Student Standards of Conduct. The University expects all students to obey the law, show respect for other members of the university community, perform contractual obligations, maintain absolute integrity and the highest standard of individual honor in scholastic work, and observe the highest standards of conduct. Ignorance of the Honor System or The University of Texas Student Standards of Conduct is not an acceptable excuse for violations under any circumstances.

The effectiveness of the Honor System results solely from the wholehearted and uncompromising support of each member of the Graduate School of Business community. Each member must abide by the Honor System and must be intolerant of any violations. The system is only as effective as you make it.

Faculty Involvement in the Honor System

The University of Texas at Austin McCombs School of Business Faculty's commitment to the Honor System is critical to its success. It is imperative that faculty make their expectations clear to all students. They must also respond to accusations of cheating or other misconduct by students in a timely, discrete and fair manner. We urge faculty members to promote awareness of the importance of integrity through in-class discussions and assignments throughout the semester.

Expectations Under the Honor System

Standards

If a student is uncertain about the standards of conduct in a particular setting, he or she should ask the relevant faculty member for clarification to ensure his or her conduct falls within the expected scope of honor, trust and integrity as promoted by the Honor System. This applies to all tests, papers and group and individual work. Questions about appropriate behavior during the job search should be addressed to a professional member of the Career Services Office. Below are some of the specific examples of violations of the Honor System.

Lying

Lying is any deliberate attempt to deceive another by stating an untruth, or by any direct form of communication to include the telling of a partial truth. Lying includes the use or omission of any information with the intent to deceive or mislead. Examples of lying include, but are not limited to, providing a false excuse for why a test was missed or presenting false information to a recruiter.

Stealing

Stealing is wrongfully taking, obtaining, withholding, defacing or destroying any person's money, personal property, article or service, under any circumstances. Examples of stealing include, but are not limited to, removing course material from the library or hiding it from others, removing material from another person's mail folder, securing for one's self unattended items such as calculators, books, book bags or other personal property. Another form of stealing is the duplication of copyrighted material beyond the reasonable bounds of "fair use." Defacing (e.g., "marking up" or highlighting) library books is also considered stealing, because, through a willful act, the value of another's property is decreased. (See the appendix for a detailed explanation of "fair use.")

Cheating

Cheating is wrongfully and unfairly acting out of self-interest for personal gain by seeking or accepting an unauthorized advantage over one's peers. Examples include, but are not limited to, obtaining questions or answers to tests or quizzes, and getting assistance on case write-ups or other projects beyond what is authorized by the assigning instructor. It is also cheating to accept the benefit(s) of another person's theft(s) even if not actively sought. For instance, if one continues to be attentive to an overhead conversation about a test or case write-up even if initial exposure to such information was accidental and beyond the control of the student in question, one is also cheating. If a student overhears a conversation or any information that any faculty member might reasonably wish to withhold from the student, the student should inform the faculty member(s) of the information and circumstance under which it was overheard.

Actions Required for Responding to Suspected and Known Violations

As stated, everyone must abide by the Honor System and be intolerant of violations. If you suspect a violation has occurred, you should first speak to the suspected violator in an attempt to determine if an infraction has taken place. If, after doing so, you still believe that a violation has occurred, you must tell the suspected violator that he or she must report himself or herself to the course professor or Associate Dean of the Graduate School of Business. If the individual fails to report himself or herself within 48 hours, it then becomes your obligation to report the infraction to the course professor or the Associate Dean of the Graduate School of Business. Remember that although you are not required by regulation to take any action, our Honor System is only as effective as you make it. If you remain silent when you suspect or know of a violation, you are approving of such dishonorable conduct as the community standard. You are thereby precipitating a repetition of such violations.

The Honor Pledge

The University of Texas at Austin McCombs School of Business requires each enrolled student to adopt the Honor System. The Honor Pledge best describes the conduct promoted by the Honor System. It is as follows:

"I affirm that I belong to the honorable community of The University of Texas at Austin Graduate School of Business. I will not lie, cheat or steal, nor will I tolerate those who do."

"I pledge my full support to the Honor System. I agree to be bound at all times by the Honor System and understand that any violation may result in my dismissal from the Graduate School of Business."