



FINANCE 397.1 – INVESTMENT THEORY AND PRACTICE

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Professor	Sanford J Leeds
Office	GSB 5.126C
Office Hours	By Appointment
Phone	471-6830
E-Mail	sandy.leeds@mcombs.utexas.edu
Course Web Page	via Blackboard
Teaching Assistants	Mukund Joshi and Erin McCarthy

Course Objectives

This course is designed to teach you the investment process. In particular, you should leave this class understanding the components used to put together a portfolio. This requires you to understand different types of securities (bonds, stocks, mutual funds, derivatives) and how they are combined to form a portfolio. In addition, there is background information which is necessary to understand. This information includes topics such as types of markets, how to place orders, and what stock indexes represent.

The Normal Routine...

Normally, when I teach this class, I start with an introduction to the study of Investments (Unit 1). This introductory unit includes some “personal finance” issues such as planning for retirement. After that, we typically discuss (Unit 2) the cost of capital (cost of debt, cost of preferred stock and cost of equity). We focus on the relationship between risk and return. After Unit 2 is done, we focus on Investment instruments.

Units 3 and 4 cover bonds. Unit 3 examines the basics of bonds (terminology, pricing relationships, etc.) and Unit 4 examines concepts and strategies used in managing bond portfolios. In Unit 4, we focus on the concept of duration and how that translates into certain strategies (such as immunization).

Units 5 – 10 cover stocks. We examine stock market indexes (Unit 5), the relationship between the economy and the stock market (Unit 6), valuation (Unit 7), technical analysis (Unit 8), market efficiency vs. behavioral finance (Unit 9) and placing orders (as well as using margin and selling short) in Unit 10.

Unit 11 covers derivatives. Our focus is on options from both an academic perspective (terminology, pricing, etc.) and a strategic perspective (how to use options to supplement your equity portfolio).

Unit 12 will allow us to study mutual funds. You can think of these as portfolios of stocks and bonds. Finally, Unit 13 examines portfolio performance.

The Routine With Fund Managers...

Unfortunately, I can not proceed in the normal order that I usually follow. The reason is that I feel the need to cover the equity portion of this course first. Obviously, the reason for this is that you will be putting together an equity portfolio for the close of trading on February 28, 2009. In addition, you need to be familiar with this material for interviews in January. You will always be told which portion of the packet to bring with you.

Leadership and this Course

The Texas MBA program is designed to develop influential business leaders. The MBA Program has identified four fundamental and broad pillars of leadership: knowledge and understanding, communication and collaboration, responsibility and integrity, and a worldview of business and society.

In this course, you will enhance your knowledge and understanding of financial markets and investment instruments. Since most of you hope to be asset managers or investment bankers, you must understand how the capital markets work.

Materials

Text

Investment Analysis and Portfolio Management, 9e by F. Reilly and K. Brown
(Thomson-Southwestern, 2009)

Investments / Portfolio Management and Security Selection (Sanford J Leeds, 2008)

Calculator

You will need a business calculator for this class. The calculator should have the following keys: IRR, n, i, PV, PMT, FV, and CF. As long as those keys are present, the calculator is fine. If you may consider taking the CFA exam in the future, I recommend the HP 12c (this calculator is the finance industry standard and one of only two calculators that may be used on the CFA exam). The other calculator which is permissible for the CFA exam is the Texas Instruments BA II Plus. You should bring a financial calculator to every one of our class meetings.

Prerequisite

BA 385T – Financial Management – must be successfully completed prior to taking this class. There are no exceptions to this rule.

Course Requirements and Grading

Your grade in the course will be determined as follows:

Midterm Exam	35%
Final Exam:	45%
Project:	20%

Normally, the average grade point of this elective is within .1 of 3.5. With this select group, I do not follow those standards. I compare your grades to the grades of the students in the “non-Fund” sections (from past semesters). This way, you are not adversely affected by being in a group of students who focus on this subject. With that said, please understand that this cuts both ways – you can get high grades or low grades. I do give Cs and lower grades. This is never my goal, but it is inevitable. I do not think that it is fair for someone to work hard in order to receive a B- and then to find out that someone scored far lower and received the same B-. Finally, please realize that I lower grades based on violations of the Professionalism Policy (described below) and the Honor Code (also described below). It is particularly important to me that you arrive on time, stay for the entire class, keep your laptops closed and respect your peers. As the semester progresses, you will realize that I will hold you to a very high standard, but I will hold myself (and how this class is presented) to an even higher one.

Description of Requirements

Midterm and Final Exam

Your exams will be held outside of class. The Fund managers (as a group) will be allowed to select the exam dates (we will discuss this in class). The exams will be long (approximately three hours). My exams tend to include most of the material that I have taught (rather than just a few big questions). The typical test might have approximately 12 – 15 quantitative problems and five qualitative questions. The qualitative questions are usually short answer or multiple choice. The difficulty level of the multiple choice questions is intended to parallel the level of question that you could face on the CFA® exam. From a point perspective, the average test is 70% quantitative. (This can vary.)

You should realize that I test on what I teach. In order to prepare, you should review your packet notes (including slides), the uncollected homework problems that I have written and the uncollected problems from the back of the chapters. In addition, I will give you a slide deck to help you review for each exam. While I typically list dates in the syllabus, I can not do that with you – you will be setting the exam dates.

I do not release old exams. I 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, I 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.

How to Prepare for Class and the Exams

Prior to class, you should read the pages in the packet which we will be covering. Frequently, you will also have a taped lecture to listen to. These tapes are on Blackboard (in the Documents section). After class, you should use the text if you did not understand what we discussed or if you need more information. (Please understand: I will not hold you responsible for topics covered in the text that are not in the packet or the homework. The packet contains everything that you need to know.) Also realize that while I want you to read the entire packet, I will tell you what you are specifically responsible for when we are in class.

Please NOTE: it is always possible that we will finish a lecture quicker than planned. As a result, you should always bring your packet notes for that day, as well as one lecture ahead.

I will not collect homework. Homework should be done because you want to learn the material, rather than because you want to receive a checkmark. Furthermore, I expect you to have discipline, rather than needing me to “force” you to do your homework.

I am a firm believer that you learn finance by working problems. If you attend class and work the problems in a timely fashion, you will do well. If you don't work the problems in a timely fashion, this will be a very difficult class. Study the course packet consistently.

Since you won't have time to do the homework problems again and again, let me suggest a good way to study. After you work the problems, every few days you should go back and re-read the questions. By doing this, you will trigger the thought process that you had to go through in order to answer the question. And always remember, it's not a matter of whether you are able to answer the question the first time you see it...the issue is whether you can recognize it and answer the question in the future (and whether you can apply these concepts to the real world).

IMPORTANTLY, you will sometimes be given assignments that must be done in anticipation of class. These assignments will be to listen to taped lectures. I will sometimes quiz you on these lectures at the start of the next class to ensure that you have done this.

Underperforming on these quizzes will result in your grade being lowered.

Project

This project is intended to further your Investments education and to help you to realize that you can continue to educate yourself when you graduate. This project must be done alone. You can **choose between any of the following six projects (but I HIGHLY RECOMMEND Project A)**:

Project A

Read and outline “The Essays of Warren Buffett: Lessons for Corporate America” by Warren Buffett and edited by Lawrence Cunningham.

This is the project that the vast majority of people have done over the years. There are two reasons I suggest you select 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.

Project B

Read and outline the first eight chapters of "Valuation: Measuring and Managing the Value of Companies" by McKinsey and Company.

This is a good book for those of you interested in valuation. This is probably slightly harder reading (than Buffett) and the book is more expensive than the other books. I would also recommend "Valuation" by Aswath Damodaran, but this book may be long for this project. With that said, Damodaran is a very clear writer.

Project C

Read and outline "Applied Equity Analysis" by James English.

This is a starter book for people interested in becoming an equity analyst. In my opinion, a more basic book is "Security Analysis on Wall Street" by Jeffrey C. Hooke. You would probably enjoy "Applied Equity Analysis" more.

Project D

Read and outline "Investment Philosophies: Successful Investment Philosophies and the Greatest Investors Who Made Them Work" by Aswath Damodaran.

Damodaran is a very clear writer. This is a relatively easy book for those of you interested in the equity markets.

Project E

Read and outline an investments related book that you are interested in. This **MUST** be approved by me by **February 15th**. Please realize that I often reject books if they are not related to Investments or they are too basic. In addition, you are not permitted to use a book that you have used in any other class or program or that you have previously read.

More Notes About the Project

The project is due on the last day of class. I do not accept late papers. Your paper must be in outline form and can not 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.

The project is (usually) not a grade differentiator. The reality is that the exams will result in grade differentiation. Rather, 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.

Homework Problems

Packet UNIT		Approximate # of Classes	Textbook Chapters	Uncollected Textbook Problems
1	Intro to Investments	3	1 - 3	Chap 2: 4 - 5
2	Cost of Capital	3	1; 7 - 9	Chap 1: 1-12; Chap 1 Appendix: 1 - 3; Chap 3: 4-5; Chap 3 Appendix: 1 - 2; Chap 6: 1- 3; Chap 7: 1-6, 8; Chap 8: 1-3, 11-16; Chap 11: 3; Chap 25: 10a, 10b
3	Bond Basics	3	17 - 18	Chap 11: 1 - 2; Chap 17: 1 - 5; Chap 18: 1b, 1c, 2, 4, 10, 11, 12, 16
4	Managing Fixed Income	2	18 - 19	Chap 18: 3, 5, 7, 9; Chap 19: 1- 5, 8, 9
5	Indexes	2	5	Chap 5: 1-2, 4-6
6	Economy	1	12 - 13	Chap 12: 2, 4
7	Valuation	4	11 - 14	Chap 11: 4 - 10, 14, 15; Chap 12: 5-9; Chap 14: 3, 8-11; 14-16
8	Technical Analysis	1	15	Chap 15: 5-6
9	EMH vs Behavioral Finance	1	6	No HW
10	Trades and Orders	2	4	Chap 4: 1 - 7
11	Derivatives	3	20, 22 - 23	Chap 22: 2, 10, 11, 13
12	Mutual Funds	1.75	24	Chap 24: 1- 8, 10
13	Evaluating Performance	0.25	25	Chap 25: 1-4; 6-8

McCombs Classroom Professionalism Policy

MY COMMENTS ABOUT THE PROFESSIONALISM POLICY: I will expect you to comply with the Professionalism Policy and you should expect me to comply with it. I firmly believe that professional behavior (being on time, staying for the full class, no laptops) is crucial to a culture of learning. Additionally, this simple professionalism will do nothing to stop us from laughing in class and enjoying the learning process.

The 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.

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.

As specific guidance for this course, you should not try to seek guidance about exams or types of questions from students who have previously taken this class. You should not do anything to aid future students in the testing process. Helping fellow students learn is an important part of our culture. I believe that it is easy to distinguish the attempt to help someone learn as opposed to the attempt to pass on information about exams.

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."

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, 471-6441 TTY or via e-mail if you have any questions.