

# Contents

Preface xvi

## PART I

### Introduction 1

#### Chapter 1

#### The Investment Environment 1

- 1.1 Real Assets versus Financial Assets 2
  - 1.2 Financial Assets 3
  - 1.3 Financial Markets and the Economy 5
    - The Informational Role of Financial Markets / Consumption Timing / Allocation of Risk / Separation of Ownership and Management / Corporate Governance and Corporate Ethics*
  - 1.4 The Investment Process 8
  - 1.5 Markets Are Competitive 9
    - The Risk–Return Trade-Off / Efficient Markets*
  - 1.6 The Players 11
    - Financial Intermediaries / Investment Bankers / Venture Capital and Private Equity*
  - 1.7 The Financial Crisis of 2008 15
    - Antecedents of the Crisis / Changes in Housing Finance / Mortgage Derivatives / Credit Default Swaps / The Rise of Systemic Risk / The Shoe Drops / The Dodd-Frank Reform Act*
  - 1.8 Outline of the Text 23
- End of Chapter Material 23–26

#### Chapter 2

#### Asset Classes and Financial Instruments 27

- 2.1 The Money Market 27
  - Treasury Bills / Certificates of Deposit / Commercial Paper / Bankers' Acceptances / Eurodollars / Repos*

*and Reverses / Federal Funds / Brokers' Calls / The LIBOR Market / Yields on Money Market Instruments*

#### 2.2 The Bond Market 33

*Treasury Notes and Bonds / Inflation-Protected Treasury Bonds / Federal Agency Debt / International Bonds / Municipal Bonds / Corporate Bonds / Mortgages and Mortgage-Backed Securities*

#### 2.3 Equity Securities 40

*Common Stock as Ownership Shares / Characteristics of Common Stock / Stock Market Listings / Preferred Stock / Depositary Receipts*

#### 2.4 Stock and Bond Market Indexes 43

*Stock Market Indexes / Dow Jones Industrial Average / The Standard & Poor's 500 Index / Other U.S. Market-Value Indexes / Equally Weighted Indexes / Foreign and International Stock Market Indexes / Bond Market Indicators*

#### 2.5 Derivative Markets 50

*Options / Futures Contracts*

End of Chapter Material 52–56

#### Chapter 3

#### How Securities Are Traded 57

#### 3.1 How Firms Issue Securities 57

*Privately Held Firms / Publicly Traded Companies / Shelf Registration / Initial Public Offerings*

#### 3.2 How Securities Are Traded 62

*Types of Markets*

*Direct Search Markets / Brokered Markets / Dealer Markets / Auction Markets*

*Types of Orders*

*Market Orders / Price-Contingent Orders*

*Trading Mechanisms*  
*Dealer Markets / Electronic Communication Networks (ECNs) / Specialist Markets*

3.3 **The Rise of Electronic Trading** 66

3.4 **U.S. Markets** 68  
*NASDAQ / The New York Stock Exchange / ECNs*

3.5 **New Trading Strategies** 70  
*Algorithmic Trading / High-Frequency Trading / Dark Pools / Bond Trading*

3.6 **Globalization of Stock Markets** 73

3.7 **Trading Costs** 74

3.8 **Buying on Margin** 75

3.9 **Short Sales** 78

3.10 **Regulation of Securities Markets** 82  
*Self-Regulation / The Sarbanes-Oxley Act / Insider Trading*

**End of Chapter Material** 86–90

Chapter 4

**Mutual Funds and Other Investment Companies** 91

4.1 **Investment Companies** 91

4.2 **Types of Investment Companies** 92  
*Unit Investment Trusts / Managed Investment Companies / Other Investment Organizations*  
*Commingled Funds / Real Estate Investment Trusts (REITs) / Hedge Funds*

4.3 **Mutual Funds** 95  
*Investment Policies*  
*Money Market Funds / Equity Funds / Sector Funds / Bond Funds / International Funds / Balanced Funds / Asset Allocation and Flexible Funds / Index Funds*  
*How Funds Are Sold*

4.4 **Costs of Investing in Mutual Funds** 98  
*Fee Structure*  
*Operating Expenses / Front-End Load / Back-End Load / 12b-1 Charges*  
*Fees and Mutual Fund Returns*

4.5 **Taxation of Mutual Fund Income** 102

4.6 **Exchange-Traded Funds** 103

4.7 **Mutual Fund Investment Performance: A First Look** 106

4.8 **Information on Mutual Funds** 109

**End of Chapter Material** 112–116

PART II

**Portfolio Theory and Practice** 117

Chapter 5

**Risk, Return, and the Historical Record** 117

5.1 **Determinants of the Level of Interest Rates** 118  
*Real and Nominal Rates of Interest / The Equilibrium Real Rate of Interest / The Equilibrium Nominal Rate of Interest / Taxes and the Real Rate of Interest*

5.2 **Comparing Rates of Return for Different Holding Periods** 121  
*Annual Percentage Rates / Continuous Compounding*

5.3 **Bills and Inflation, 1926–2015** 124

5.4 **Risk and Risk Premiums** 126  
*Holding-Period Returns / Expected Return and Standard Deviation / Excess Returns and Risk Premiums*

5.5 **Time Series Analysis of Past Rates of Return** 129  
*Time Series versus Scenario Analysis / Expected Returns and the Arithmetic Average / The Geometric (Time-Weighted) Average Return / Variance and Standard Deviation / Mean and Standard Deviation Estimates from Higher-Frequency Observations / The Reward-to-Volatility (Sharpe) Ratio*

5.6 **The Normal Distribution** 134

5.7 **Deviations from Normality and Alternative Risk Measures** 136  
*Value at Risk / Expected Shortfall / Lower Partial Standard Deviation and the Sortino Ratio / Relative Frequency of Large, Negative 3-Sigma Returns*

5.8 **Historic Returns on Risky Portfolios** 140  
*A Global View of the Historical Record*

5.9 **Normality and Long-Term Investments** 147  
*Short-Run versus Long-Run Risk / Forecasts for the Long Haul*

**End of Chapter Material** 151–156

Chapter 6

**Capital Allocation to Risky Assets** 157

6.1 **Risk and Risk Aversion** 158  
*Risk, Speculation, and Gambling / Risk Aversion and Utility Values / Estimating Risk Aversion*

6.2 **Capital Allocation across Risky and Risk-Free Portfolios** 164

6.3 **The Risk-Free Asset** 166

6.4 **Portfolios of One Risky Asset and a Risk-Free Asset** 167

6.5 **Risk Tolerance and Asset Allocation** 170  
*Non-Normal Returns*

6.6 **Passive Strategies: The Capital Market Line** 176  
**End of Chapter Material** 178–187  
**Appendix A: Risk Aversion, Expected Utility, and the St. Petersburg Paradox** 187  
**Appendix B: Utility Functions and Risk Premiums** 191

Chapter 7

**Optimal Risky Portfolios** 193

7.1 **Diversification and Portfolio Risk** 194

7.2 **Portfolios of Two Risky Assets** 195

7.3 **Asset Allocation with Stocks, Bonds, and Bills** 203  
*Asset Allocation with Two Risky Asset Classes*

7.4 **The Markowitz Portfolio Optimization Model** 208  
*Security Selection / Capital Allocation and the Separation Property / The Power of Diversification / Asset Allocation and Security Selection / Optimal Portfolios and Non-Normal Returns*

7.5 **Risk Pooling, Risk Sharing, and the Risk of Long-Term Investments** 217  
*Risk Pooling and the Insurance Principle / Risk Sharing / Diversification and the Sharpe Ratio / Time Diversification and the Investment Horizon*  
**End of Chapter Material** 222–232  
**Appendix A: A Spreadsheet Model for Efficient Diversification** 232  
**Appendix B: Review of Portfolio Statistics** 237

Chapter 8

**Index Models** 245

8.1 **A Single-Factor Security Market** 246  
*The Input List of the Markowitz Model / Systematic versus Firm-Specific Risk*

8.2 **The Single-Index Model** 248  
*The Regression Equation of the Single-Index Model / The Expected Return–Beta Relationship / Risk and Covariance in the Single-Index Model / The Set of Estimates Needed for the Single-Index Model / The Index Model and Diversification*

8.3 **Estimating the Single-Index Model** 255  
*The Security Characteristic Line for Ford / The Explanatory Power of Ford’s SCL / The Estimate of Alpha / The Estimate of Beta / Firm-Specific Risk*  
*Typical Results from Index Model Regressions*

8.4 **The Industry Version of the Index Model** 259  
*Predicting Betas*

8.5 **Portfolio Construction Using the Single-Index Model** 262  
*Alpha and Security Analysis / The Index Portfolio as an Investment Asset / The Single-Index Model Input List / The Optimal Risky Portfolio in the Single-Index Model / The Information Ratio / Summary of Optimization Procedure / An Example / Correlation and Covariance Matrix*  
*Risk Premium Forecasts / The Optimal Risky Portfolio / Is the Index Model Inferior to the Full-Covariance Model?*  
**End of Chapter Material** 271–276

PART III

**Equilibrium in Capital Markets** 277

Chapter 9

**The Capital Asset Pricing Model** 277

9.1 **The Capital Asset Pricing Model** 277  
*Why Do All Investors Hold the Market Portfolio? / The Passive Strategy Is Efficient / The Risk Premium of the Market Portfolio / Expected Returns on Individual Securities / The Security Market Line / The CAPM and the Single-Index Market*

9.2 **Assumptions and Extensions of the CAPM** 288  
*Identical Input Lists / Risk-Free Borrowing and the Zero-Beta Model / Labor Income and Nontraded Assets / A Multiperiod Model and Hedge Portfolios / A Consumption-Based CAPM / Liquidity and the CAPM*

9.3 **The CAPM and the Academic World** 298

9.4 **The CAPM and the Investment Industry** 299  
**End of Chapter Material** 300–308

Chapter 10

**Arbitrage Pricing Theory and Multifactor Models of Risk and Return** 309

10.1 **Multifactor Models: A Preview** 310  
*Factor Models of Security Returns*

10.2 **Arbitrage Pricing Theory** 312  
*Arbitrage, Risk Arbitrage, and Equilibrium / Well-Diversified Portfolios / The Security Market Line of the APT*  
*Individual Assets and the APT*  
*Well-Diversified Portfolios in Practice*

10.3 **The APT, the CAPM, and the Index Model** 319  
*The APT and the CAPM / The APT and Portfolio Optimization in a Single-Index Market*

- 10.4 A Multifactor APT 321
- 10.5 The Fama-French (FF) Three-Factor Model 324
- End of Chapter Material 326–332

Chapter 11

**The Efficient Market Hypothesis 333**

- 11.1 Random Walks and the Efficient Market Hypothesis 334  
*Competition as the Source of Efficiency / Versions of the Efficient Market Hypothesis*
- 11.2 Implications of the EMH 339  
*Technical Analysis / Fundamental Analysis / Active versus Passive Portfolio Management / The Role of Portfolio Management in an Efficient Market / Resource Allocation*
- 11.3 Event Studies 343
- 11.4 Are Markets Efficient? 347  
*The Issues*  
*The Magnitude Issue / The Selection Bias Issue / The Lucky Event Issue*  
*Weak-Form Tests: Patterns in Stock Returns*  
*Returns over Short Horizons / Returns over Long Horizons*  
*Predictors of Broad Market Returns / Semistrong Tests: Market Anomalies*  
*The Small-Firm Effect / The Neglected-Firm Effect and Liquidity Effects / Book-to-Market Ratios / Post-Earnings-Announcement Price Drift*  
*Strong-Form Tests: Inside Information / Interpreting the Anomalies*  
*Risk Premiums or Inefficiencies? / Anomalies or Data Mining? / Anomalies over Time*  
*Bubbles and Market Efficiency*
- 11.5 Mutual Fund and Analyst Performance 359  
*Stock Market Analysts / Mutual Fund Managers / So, Are Markets Efficient?*
- End of Chapter Material 365–372

Chapter 12

**Behavioral Finance and Technical Analysis 373**

- 12.1 The Behavioral Critique 374  
*Information Processing*  
*Forecasting Errors / Overconfidence / Conservatism / Sample Size Neglect and Representativeness*  
*Behavioral Biases*  
*Framing / Mental Accounting / Regret Avoidance / Affect / Prospect Theory*  
*Limits to Arbitrage*  
*Fundamental Risk / Implementation Costs / Model Risk*

*Limits to Arbitrage and the Law of One Price*  
*“Siamese Twin” Companies / Equity Carve-Outs / Closed-End Funds*

*Bubbles and Behavioral Economics / Evaluating the Behavioral Critique*

**12.2 Technical Analysis and Behavioral Finance 384**

*Trends and Corrections*  
*Momentum and Moving Averages / Relative Strength / Breadth*  
*Sentiment Indicators*  
*Trin Statistic / Confidence Index / Put/Call Ratio*  
*A Warning*  
End of Chapter Material 391–396

Chapter 13

**Empirical Evidence on Security Returns 397**

- 13.1 The Index Model and the Single-Factor SML 398  
*The Expected Return–Beta Relationship*  
*Setting Up the Sample Data / Estimating the SCL / Estimating the SML*  
*Tests of the CAPM / The Market Index / Measurement Error in Beta*
- 13.2 Tests of the Multifactor Models 403  
*Labor Income / Private (Nontraded) Business / Early Tests of the Multifactor CAPM and APT / A Macro Factor Model*
- 13.3 Fama-French-Type Factor Models 407  
*Size and B/M as Risk Factors / Behavioral Explanations / Momentum: A Fourth Factor*
- 13.4 Liquidity and Asset Pricing 414
- 13.5 Consumption-Based Asset Pricing and the Equity Premium Puzzle 416  
*Expected versus Realized Returns / Survivorship Bias / Extensions to the CAPM May Resolve the Equity Premium Puzzle / Liquidity and the Equity Premium Puzzle / Behavioral Explanations of the Equity Premium Puzzle*  
End of Chapter Material 422–424

PART IV

**Fixed-Income Securities 425**

Chapter 14

**Bond Prices and Yields 425**

- 14.1 Bond Characteristics 426  
*Treasury Bonds and Notes*  
*Accrued Interest and Quoted Bond Prices*

*Corporate Bonds*

*Call Provisions on Corporate Bonds / Convertible Bonds / Puttable Bonds / Floating-Rate Bonds*

*Preferred Stock / Other Domestic Issuers / International Bonds / Innovation in the Bond Market*

*Inverse Floaters / Asset-Backed Bonds / Catastrophe Bonds / Indexed Bonds*

**14.2 Bond Pricing 432**

*Bond Pricing between Coupon Dates*

**14.3 Bond Yields 438**

*Yield to Maturity / Yield to Call / Realized Compound Return versus Yield to Maturity*

**14.4 Bond Prices over Time 444**

*Yield to Maturity versus Holding-Period Return / Zero-Coupon Bonds and Treasury Strips / After-Tax Returns*

**14.5 Default Risk and Bond Pricing 449**

*Junk Bonds / Determinants of Bond Safety / Bond Indentures*

*Sinking Funds / Subordination of Further Debt / Dividend Restrictions / Collateral*

*Yield to Maturity and Default Risk / Credit Default Swaps / Credit Risk and Collateralized Debt Obligations*

**End of Chapter Material 460–466**

Chapter 15

**The Term Structure of Interest Rates 467**

**15.1 The Yield Curve 467**

*Bond Pricing*

**15.2 The Yield Curve and Future Interest Rates 470**

*The Yield Curve under Certainty / Holding-Period Returns / Forward Rates*

**15.3 Interest Rate Uncertainty and Forward Rates 475**

**15.4 Theories of the Term Structure 477**

*The Expectations Hypothesis / Liquidity Preference Theory*

**15.5 Interpreting the Term Structure 480**

**15.6 Forward Rates as Forward Contracts 484**

**End of Chapter Material 486–494**

Chapter 16

**Managing Bond Portfolios 495**

**16.1 Interest Rate Risk 496**

*Interest Rate Sensitivity / Duration / What Determines Duration?*

*Rule 1 for Duration / Rule 2 for Duration / Rule 3 for Duration / Rule 4 for Duration / Rule 5 for Duration*

**16.2 Convexity 505**

*Why Do Investors Like Convexity? / Duration and Convexity of Callable Bonds / Duration and Convexity of Mortgage-Backed Securities*

**16.3 Passive Bond Management 513**

*Bond-Index Funds / Immunization / Cash Flow Matching and Dedication / Other Problems with Conventional Immunization*

**16.4 Active Bond Management 522**

*Sources of Potential Profit / Horizon Analysis*

**End of Chapter Material 525–536**

PART V

**Security Analysis 537**

Chapter 17

**Macroeconomic and Industry Analysis 537**

**17.1 The Global Economy 537**

**17.2 The Domestic Macroeconomy 540**

*Key Economic Indicators*

*Gross Domestic Product / Employment / Inflation / Interest Rates / Budget Deficit / Sentiment*

**17.3 Demand and Supply Shocks 542**

**17.4 Federal Government Policy 542**

*Fiscal Policy / Monetary Policy / Supply-Side Policies*

**17.5 Business Cycles 545**

*The Business Cycle / Economic Indicators / Other Indicators*

**17.6 Industry Analysis 550**

*Defining an Industry / Sensitivity to the Business Cycle / Sector Rotation / Industry Life Cycles*

*Start-Up Stage / Consolidation Stage / Maturity Stage / Relative Decline*

*Industry Structure and Performance*

*Threat of Entry / Rivalry between Existing Competitors / Pressure from Substitute Products / Bargaining Power of Buyers / Bargaining Power of Suppliers*

**End of Chapter Material 560–568**

Chapter 18

**Equity Valuation Models 569**

**18.1 Valuation by Comparables 569**

*Limitations of Book Value*

**18.2 Intrinsic Value versus Market Price 571**

**18.3 Dividend Discount Models 573**

*The Constant-Growth DDM / Convergence of Price to Intrinsic Value / Stock Prices and Investment*

*Opportunities / Life Cycles and Multistage Growth Models / Multistage Growth Models*

**18.4 The Price–Earnings Ratio 587**  
*The Price–Earnings Ratio and Growth Opportunities / P/E Ratios and Stock Risk / Pitfalls in P/E Analysis / Combining P/E Analysis and the DDM / Other Comparative Valuation Ratios*  
*Price-to-Book Ratio / Price-to-Cash-Flow Ratio / Price-to-Sales Ratio*

**18.5 Free Cash Flow Valuation Approaches 595**  
*Comparing the Valuation Models / The Problem with DCF Models*

**18.6 The Aggregate Stock Market 599**  
**End of Chapter Material 601–612**

Chapter 19

**Financial Statement Analysis 613**

**19.1 The Major Financial Statements 613**  
*The Income Statement / The Balance Sheet / The Statement of Cash Flows*

**19.2 Measuring Firm Performance 618**

**19.3 Profitability Measures 619**  
*Return on Assets, ROA / Return on Capital, ROC / Return on Equity, ROE / Financial Leverage and ROE / Economic Value Added*

**19.4 Ratio Analysis 623**  
*Decomposition of ROE / Turnover and Other Asset Utilization Ratios / Liquidity Ratios / Market Price Ratios: Growth versus Value / Choosing a Benchmark*

**19.5 An Illustration of Financial Statement Analysis 633**

**19.6 Comparability Problems 636**  
*Inventory Valuation / Depreciation / Inflation and Interest Expense / Fair Value Accounting / Quality of Earnings and Accounting Practices / International Accounting Conventions*

**19.7 Value Investing: The Graham Technique 642**  
**End of Chapter Material 643–656**

PART VI

**Options, Futures, and Other Derivatives 657**

Chapter 20

**Options Markets: Introduction 657**

**20.1 The Option Contract 657**  
*Options Trading / American and European Options / Adjustments in Option Contract Terms / The Options Clearing Corporation / Other Listed Options*

*Index Options / Futures Options / Foreign Currency Options / Interest Rate Options*

**20.2 Values of Options at Expiration 663**  
*Call Options / Put Options / Option versus Stock Investments*

**20.3 Option Strategies 667**  
*Protective Put / Covered Calls / Straddle / Spreads / Collars*

**20.4 The Put-Call Parity Relationship 675**

**20.5 Option-Like Securities 678**  
*Callable Bonds / Convertible Securities / Warrants / Collateralized Loans / Levered Equity and Risky Debt*

**20.6 Financial Engineering 684**

**20.7 Exotic Options 686**  
*Asian Options / Barrier Options / Lookback Options / Currency-Translated Options / Digital Options*  
**End of Chapter Material 687–698**

Chapter 21

**Option Valuation 699**

**21.1 Option Valuation: Introduction 699**  
*Intrinsic and Time Values / Determinants of Option Values*

**21.2 Restrictions on Option Values 703**  
*Restrictions on the Value of a Call Option / Early Exercise and Dividends / Early Exercise of American Puts*

**21.3 Binomial Option Pricing 706**  
*Two-State Option Pricing / Generalizing the Two-State Approach / Making the Valuation Model Practical*

**21.4 Black-Scholes Option Valuation 714**  
*The Black-Scholes Formula / Dividends and Call Option Valuation / Put Option Valuation / Dividends and Put Option Valuation*

**21.5 Using the Black-Scholes Formula 722**  
*Hedge Ratios and the Black-Scholes Formula / Portfolio Insurance / Option Pricing and the Crisis of 2008–2009 / Option Pricing and Portfolio Theory / Hedging Bets on Mispriced Options*

**21.6 Empirical Evidence on Option Pricing 734**  
**End of Chapter Material 735–746**

Chapter 22

**Futures Markets 747**

**22.1 The Futures Contract 747**  
*The Basics of Futures Contracts / Existing Contracts*

**22.2 Trading Mechanics 753**  
*The Clearinghouse and Open Interest / The Margin Account and Marking to Market / Cash versus Actual Delivery / Regulations / Taxation*

**22.3 Futures Markets Strategies 757**  
*Hedging and Speculation / Basis Risk and Hedging*

**22.4 Futures Prices 761**  
*The Spot-Futures Parity Theorem / Spreads / Forward versus Futures Pricing*

**22.5 Futures Prices versus Expected Spot Prices 768**  
*Expectations Hypothesis / Normal Backwardation / Contango / Modern Portfolio Theory*

**End of Chapter Material 770–774**

Chapter 23

**Futures, Swaps, and Risk Management 775**

**23.1 Foreign Exchange Futures 775**  
*The Markets / Interest Rate Parity / Direct versus Indirect Quotes / Using Futures to Manage Exchange Rate Risk*

**23.2 Stock-Index Futures 783**  
*The Contracts / Creating Synthetic Stock Positions: An Asset Allocation Tool / Index Arbitrage / Using Index Futures to Hedge Market Risk*

**23.3 Interest Rate Futures 788**  
*Hedging Interest Rate Risk*

**23.4 Swaps 790**  
*Swaps and Balance Sheet Restructuring / The Swap Dealer / Other Interest Rate Contracts / Swap Pricing / Credit Risk in the Swap Market / Credit Default Swaps*

**23.5 Commodity Futures Pricing 797**  
*Pricing with Storage Costs / Discounted Cash Flow Analysis for Commodity Futures*

**End of Chapter Material 801–810**

PART VII

**Applied Portfolio Management 811**

Chapter 24

**Portfolio Performance Evaluation 811**

**24.1 The Conventional Theory of Performance Evaluation 811**  
*Average Rates of Return / Time-Weighted Returns versus Dollar-Weighted Returns / Adjusting Returns for Risk / The Sharpe Ratio for Overall Portfolios*  
*The M<sup>2</sup> Measure and the Sharpe Ratio*  
*The Treynor Ratio*  
*The Information Ratio*  
*The Role of Alpha in Performance Measures / Implementing Performance Measurement: An Example / Realized Returns versus Expected Returns*

**24.2 Style Analysis 823**

**24.3 Performance Measurement with Changing Portfolio Composition 826**  
*Performance Manipulation and the Morningstar Risk-Adjusted Rating*

**24.4 Market Timing**  
*The Potential Value of Market Timing / Valuing Market Timing as a Call Option / The Value of Imperfect Forecasting*

**24.5 Performance Attribution Procedures 835**  
*Asset Allocation Decisions / Sector and Security Selection Decisions / Summing Up Component Contributions*

**End of Chapter Material 841–852**

Chapter 25

**International Diversification 853**

**25.1 Global Markets for Equities 853**  
*Developed Countries / Emerging Markets / Market Capitalization and GDP / Home-Country Bias*

**25.2 Exchange Rate Risk and International Diversification 857**  
*Exchange Rate Risk / Investment Risk in International Markets / International Diversification / Are Benefits from International Diversification Preserved in Bear Markets?*

**25.3 Political Risk 868**

**25.4 International Investing and Performance Attribution 871**  
*Constructing a Benchmark Portfolio of Foreign Assets / Performance Attribution*

**End of Chapter Material 875–880**

Chapter 26

**Hedge Funds 881**

**26.1 Hedge Funds versus Mutual Funds 882**  
*Transparency / Investors / Investment Strategies / Liquidity / Compensation Structure*

**26.2 Hedge Fund Strategies 883**  
*Directional and Nondirectional Strategies / Statistical Arbitrage*

**26.3 Portable Alpha 886**  
*An Example of a Pure Play*

**26.4 Style Analysis for Hedge Funds 889**

**26.5 Performance Measurement for Hedge Funds 891**  
*Liquidity and Hedge Fund Performance / Hedge Fund Performance and Survivorship Bias / Hedge Fund Performance and Changing Factor Loadings / Tail Events and Hedge Fund Performance*

**26.6 Fee Structure in Hedge Funds 899**  
**End of Chapter Material 902–906**

Chapter 27

**The Theory of Active Portfolio Management 907**

- 27.1 Optimal Portfolios and Alpha Values 907**  
*Forecasts of Alpha Values and Extreme Portfolio Weights / Restriction of Benchmark Risk*
- 27.2 The Treynor-Black Model and Forecast Precision 914**  
*Adjusting Forecasts for the Precision of Alpha / Distribution of Alpha Values / Organizational Structure and Performance*
- 27.3 The Black-Litterman Model 918**  
*Black-Litterman Asset Allocation Decision / Step 1: The Covariance Matrix from Historical Data / Step 2: Determination of a Baseline Forecast / Step 3: Integrating the Manager's Private Views / Step 4: Revised (Posterior) Expectations / Step 5: Portfolio Optimization*
- 27.4 Treynor-Black versus Black-Litterman: Complements, Not Substitutes 923**  
*The BL Model as Icing on the TB Cake / Why Not Replace the Entire TB Cake with the BL Icing?*
- 27.5 The Value of Active Management 925**  
*A Model for the Estimation of Potential Fees / Results from the Distribution of Actual Information Ratios / Results from Distribution of Actual Forecasts*
- 27.6 Concluding Remarks on Active Management 927**  
**End of Chapter Material 927–928**  
**Appendix A: Forecasts and Realizations of Alpha 928**  
**Appendix B: The General Black-Litterman Model 929**

Chapter 28

**Investment Policy and the Framework of the CFA Institute 931**

- 28.1 The Investment Management Process 932**  
*Objectives / Individual Investors / Personal Trusts / Mutual Funds / Pension Funds / Endowment Funds / Life Insurance Companies / Non-Life Insurance Companies / Banks*

- 28.2 Constraints 937**  
*Liquidity / Investment Horizon / Regulations / Tax Considerations / Unique Needs*
- 28.3 Policy Statements 939**  
*Sample Policy Statements for Individual Investors*
- 28.4 Asset Allocation 943**  
*Taxes and Asset Allocation 944*
- 28.5 Managing Portfolios of Individual Investors 945**  
*Human Capital and Insurance / Investment in Residence / Saving for Retirement and the Assumption of Risk / Retirement Planning Models / Manage Your Own Portfolio or Rely on Others? / Tax Sheltering*  
*The Tax-Deferral Option / Tax-Protected Retirement Plans / Deferred Annuities / Variable and Universal Life Insurance*
- 28.6 Pension Funds 951**  
*Defined Contribution Plans / Defined Benefit Plans / Pension Investment Strategies*  
*Investing in Equities / Wrong Reasons to Invest in Equities*
- 28.7 Investments for the Long Run 954**  
*Making Simple Investment Choices / Inflation Risk and Long-Term Investors*  
**End of Chapter Material 956–966**

- REFERENCES TO CFA PROBLEMS 967**
- GLOSSARY G-1**
- NAME INDEX I-1**
- SUBJECT INDEX I-4**
- FORMULAS F-1**