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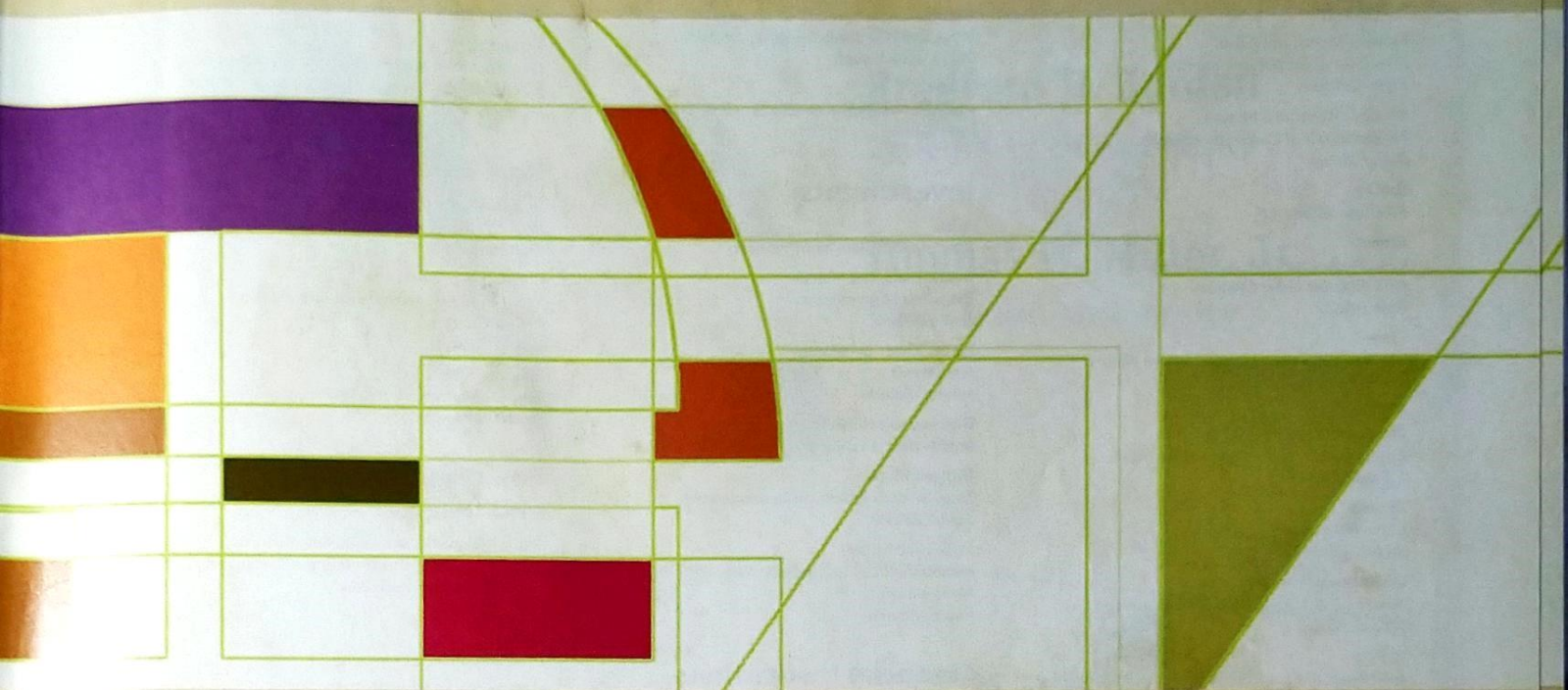
FUNDAMENTALS OF
Investments
VALUATION AND MANAGEMENT

4th Edition



Fundamentals of Investments

Valuation and Management



The McGraw-Hill/Irwin Series in Finance, Insurance, and Real Estate

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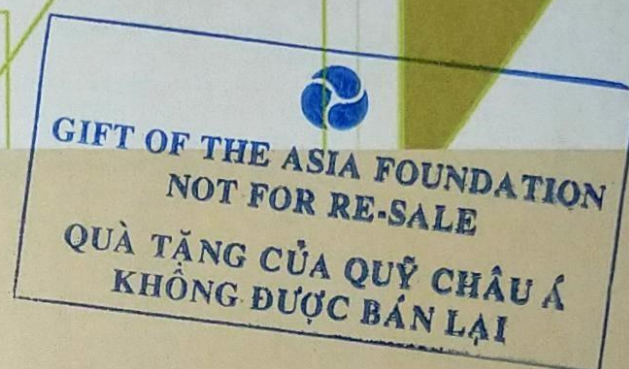
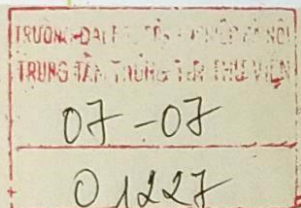
Fundamentals of Investments

Valuation and Management

Fourth Edition

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To my late father, S. Kelly Jordan Sr., a great stock picker.

BDJ

To my parents, Tom and Kathy Miller, my wife Carolyn, and #21—Thomas W. Miller, III.

TWM, Jr.

About the Authors

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Bradford D. Jordan is Professor of Finance and holder of the Richard W. and Janis H. Furst Endowed Chair in Finance at the University of Kentucky. He has a long-standing interest in both applied and theoretical issues in investments, and he has extensive experience teaching all levels of investments. Professor Jordan has published numerous research articles on issues such as valuation of fixed-income securities, tax effects in investments analysis, the behavior of security prices, IPO valuation, and pricing of exotic options. He is co-author of *Fundamentals of Corporate Finance* and *Essentials of Corporate Finance*, two of the most widely used finance textbooks in the world.

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Preface

So why *did* we write this book?

As we toiled away, we asked ourselves this question many times, and the answer was always the same: *Our students made us.*

Traditionally, investments textbooks tend to fall into one of two camps. The first type has a greater focus on portfolio management and covers a significant amount of portfolio theory. The second type is more concerned with security analysis and generally contains fairly detailed coverage of fundamental analysis as a tool for equity valuation. Today, most texts try to cover all the bases by including some chapters drawn from one camp and some from another.

The result of trying to cover everything is either a very long book or one that forces the instructor to bounce back and forth between chapters. This frequently leads to a noticeable lack of consistency in treatment. Different chapters have completely different approaches: Some are computational, some are theoretical, and some are descriptive. Some do macro-economic forecasting, some do mean-variance portfolio theory and beta estimation, and some do financial statements analysis. Options and futures are often essentially tacked on the back to round out this disconnected assortment.

The goal of these books is different from the goal of our students. Our students told us they come into an investments course wanting to learn how to make investment decisions. As time went by, we found ourselves supplying more and more supplemental materials to the texts we were using and constantly varying chapter sequences while chasing this elusive goal. We finally came to realize that the financial world had changed tremendously, and investments textbooks had fallen far behind in content and relevance.

What we really wanted, and what our students really needed, was a book that would do several key things:

- Focus on the students as investment managers by giving them information they can act on instead of concentrating on theories and research without the proper context.
- Offer strong, consistent pedagogy, including a balanced, unified treatment of the main types of financial investments as mirrored in the investment world.
- Organize topics in a way that would make them easy to apply—whether to a portfolio simulation or to real life—and support these topics with hands-on activities.

We made these three goals the guiding principles in writing this book. The next several sections explain our approach to each and why we think they are so important.

Who Is This Book For?

This book is aimed at introductory investments classes with students who have relatively little familiarity with investments. A typical student may have taken a principles of finance class and had some exposure to stocks and bonds, but not much beyond the basics. The introductory investments class is often a required course for finance majors, but students from other areas often take it as an elective. One fact of which we are acutely aware is that this may be the only investments class many students will ever take.

We intentionally wrote this book in a relaxed, informal style that engages the student and treats him or her as an active participant rather than a passive information absorber. We think the world of investments is exciting and fascinating, and we hope to share our considerable enthusiasm for investing with the student. We appeal to intuition and basic principles whenever possible because we have found that this approach effectively promotes understanding. We also make extensive use of examples throughout, drawing on “real world” material and familiar companies wherever appropriate.

By design, the text is not encyclopedic. As the table of contents indicates, we have a total of 20 chapters. Chapter length is about 30 to 40 pages, so the text is aimed at a single-term course; most of the book can be covered in a typical quarter or semester.

Aiming the book at a one-semester course necessarily means some picking and choosing, with regard to both topics and depth of coverage. Throughout, we strike a balance by introducing and covering the essentials while leaving some of the details to follow-up courses in security analysis, portfolio management, and options and futures.

How Does the Fourth Edition of This Book Expand upon the Goals Described Above?

Based on user feedback, we have made numerous improvements and refinements in the fourth edition of *Fundamentals of Investments: Valuation and Management*. We updated every chapter to reflect current market practices and conditions, and we significantly expanded and improved the end-of-chapter material. Also, in a notable change, we now have a chapter devoted to market efficiency and a chapter devoted to behavioral finance.

To give some examples of our additional new content:

- Chapter 3 introduces a detailed presentation of the NASD’s new TRACE system and methods to obtain futures contract and option contract price quotes using the Internet.
- Chapter 6 contains a new section covering the residual income model (RIM).
- Chapter 7 has been expanded to include event studies, informed traders, insider trading, and illegal insider trading. New material includes the performance of professional money managers and stock market anomalies.
- Chapter 8 contains a substantial amount of new material on behavioral finance. In addition to a greatly expanded section on technical analysis, new material in this chapter includes prospect theory, overconfidence, misperceiving randomness, overreacting to chance events, sentiment-based risk, and limits to arbitrage.
- Chapter 10 discusses bond risk measures based on duration.
- Chapter 11 now illustrates the importance of asset allocation using three securities.
- Chapter 12 extends the CAPM with a discussion of the Fama-French three-factor model.
- Chapter 14 contains a new example of how to change the beta of a stock portfolio using stock index futures.
- Chapter 15 now includes a discussion of option “moneyness.”
- Chapter 16 covers using an online calculator to value stock options and it now has a section about hedging stock with stock options.
- Chapter 17 (which was Chapter 7) now includes a section about financial statement forecasting using the percentage of sales approach with a detailed case study that values Starbucks Corporation.
- Chapter 18 covers make-whole call provisions.
- Chapter 19 has some enhanced material on U.S. Savings Bonds and updated material on the size of bid-ask spreads in municipal bond markets.