

SECURITY VALUATION AND PORTFOLIO THEORY

[ECON-156]
SPRING 2009

Instructor: Professor Ludwig Chincarini, CFA, Ph.D.

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Website: <http://pages.pomona.edu/~lbc04747/> [Course Materials and other fun stuff]

Office Hours: Carnegie 208 (Mon & Wed 4:15 – 5:30 PM or by request).

Class Hours & Location: Mon & Wed, 2:45 – 4:00 PM, CA 107 (regular classes)

Prerequisites: Econ 101 and 102.

Course Description: The course is intended to provide an understanding of the investment process. Topics include a study of securities markets and functions; securities legislation; sources of investment information; evaluation of alternative investments; valuation of bonds and stocks; risk-return analysis; and portfolio strategies.

Course Objective: To be familiar with investment analysis for ease of understanding concepts produced in the financial press, for a background that would allow a basic intuitive and mathematical understanding of their behavior for work in the financial markets, and to understand how to manage portfolios for investors.

Required Text:

Reilly, Frank K. and Keith C. Brown, *Investment Analysis and Portfolio Management*, 9th Edition, (Fort Worth: The Dryden Press), 2003.

Chincarini, Ludwig B. and Daehwan Kim. *Quantitative Equity Portfolio Management*. New York, McGraw-Hill, 2009, 1st Edition.

Reader (Soft Copy): A compilation of articles relevant to the course will be provided on my website in electronic form.

Other Reading: Students are **must order a subscription** to read the **Wall St. Journal**. Students can sign up for a subscription with me. **Barrons** is another interesting journal that students should consider.

Handouts: Depending on current news topics, handouts relevant to the material will be distributed to students throughout the semester. It will be the students' responsibility to obtain any missed handouts due to absence at a particular class.

A Note on Academic Honesty: Cheating is against the implicit honor code of Pomona College. Thus, projects, exams, quizzes, and homework should be done with complete integrity. **If a case of cheating is detected, it will result in my reporting the act to the university administration.** It can also lead to a failing grade in the course. Any act of plagiarism is a serious break of academic standards and a deliberate case can lead to suspension or expulsion. Any quotation from another source, whether written or spoken, must be bound by quotation marks and footnoted. Paraphrases must be footnoted as well. Generally, cite the use of words or work by others.

Summer Reading Books

1. Malkiel, Burton. *A Random Walk Down Wall Street*. [A classic book and an easy read.]
2. Bernstein, Peter. *Capital Ideas*. [A book that explains the history of modern portfolio theory, including all of the major players from Markowitz to Fischer Black. A fun read.]
3. Lewis, Anthony. *Liar's Poker*. [A fantastic book that discusses, among other things, the great Salomon arbitrage traders of Meriwether & Co., including their love for the game of Liar's Poker.]
4. Bruck, Connie. *Predator's Ball*. [A fun book describing the history of Michael Milken and how the junk bond market was created. A fun read in a major movement in Wall St. history.]

Software Needs May Accompany this Course:

1. STATA. *A statistical programmable software package*.
2. MATLAB. *A programming language with lots of built in tools*.

Note: Students who find clever ways to accomplish our exercises and share their programs and ideas with the class will receive bonus points.

Industry Licenses:

Some of you may wish to enroll in the CFA program (www.aimr.org) or in the MTA program (www.mta.org). The first program is the Certified Financial Analyst pedigree, while the second is a Chartered Market Technician's pedigree. These are credentials that are increasingly being attained by people in the financial industry. Some of the material in this course will be on the CFA exam.

Course Requirements and Grading:

Class Participation:	10%
Mid-Term:	25%
Portfolio Project:	20%
Final Exam:	40%
Assignments:	5%

Further Notes:

- **Class participation** consists of attendance, making comments, answering questions, and or posing questions during class. I may randomly call on people. Please come to class on time for consideration of your professor and fellow students.
- The **Final Exam** will cover all material covered after the mid-term.
- **Portfolio Projects** will consist of group projects (2-3 per group) in which students prepare a document related to constructing and managing “real” portfolios or stocks. These studies should use concepts learned in the class to manage the portfolios. The project will be split up into several parts. The due dates for each part have not been set, but as soon as they are, students shall be given the dates.
- **Assignments** will be given so that students can practice answering questions over the material studied, but *will not be graded*. I will keep track of people who do homework in order to determine borderline grades. Students are encouraged to pay attention to **financial news** as some questions may be linked to current financial market events.
- **Writing improvement** is given by the Pomona Writing Center at Smith Campus Center 216. The website is <http://writing.pomona.edu/writingcenter>. It is a complimentary service to help you with writing.

Organization and Course Outline¹²

Key: * - required reader article

** - optional reader article

Session 1: January 21, 2009³

1. Intro to course
2. Overview of the Course
3. The Investment Setting
Reading: Chapters 1. RB.⁴

Session 2: January 26, 2009

4. Asset Allocation (a.k.a. Investor Preferences)
Reading: Chapter 2 . RB.
5. Selecting Investments (a.k.a. Opportunity Set)
Reading: Chapter 3, RB.
In-Class Workshop: Preparing an IPS
In-Class Workshop: Choosing an investment

Session 3: January 28, 2009

6. Selecting Investments (a.k.a. Opportunity Set)
Reading: Chapter 3, RB.
Pojarliev, Montchill. "Do Professional Currency Managers Beat the Benchmark?" EReader.
In-Class Workshop: Preparing an IPS
In-Class Workshop: Choosing an investment
In-Class Workshop: Setting up a brokerage account

¹ In all cases, dates are the most probable, but again this could change as the semester evolves.

² We will not have class on the following days: February 18, March 16, 18, and March 27.

³ In all cases, dates are the most probable, but again this could change as the semester evolves.

⁴ RB refers to the required textbook, Reilly & Brown. QEPM refers to Chincarini & Kim.

Sessions 4: February 2, 2009

7. **The Structure of Securities Markets**
Reading: Chapter 4, RB.
Chincarini, Ludwig. "The Effectiveness of Global Currency Hedging After the Asian Crisis" *Journal of Asset Management*, May, 2007. EReader.
In-Class Workshop: Computing Risk and Return w/ World Indices.

Sessions 5: February 4, 2009

8. **Understanding Stock Market Indicators**
Reading: Chapter 5. RB.
Chincarini, Ludwig et al. "Beware of Funds Bearing Taxable Gains." EReader.
9. **Efficient Markets and Anomalies**
Reading:
Chapter 1 & 2. QEPM
McClellan, Stephen. "Measuring Managers' Mettle: A Revealing Gauge." EReader.
Byrne, Alistair and Mike Brooks. "Behavioral Finance: Theories and Evidence." EReader.
In-Class Workshop: Testing market efficiency.

Sessions 6: February 9, 2009

10. **Portfolio Theory**
Reading: Chapter 7, RB.
Appendix A on CD: QEPM
Markowitz, Harry. "Portfolio Selection." EReader.
11. **The CAPM**
Reading: Chapter 8, RB.
Chincarini, Ludwig (& Foliofn Research). "Part 1: Diversification," *Handbook of Folio Investing*. EReader.
Foliofn Research, "Beta Folios." EReader.

Session 7: February 11, 2009

12. APT

Reading: Chapter 6. QEPM.

Appendix B on CD: QEPM

Palmon et al. "The Accruals Anomaly and Company Size."
EReader.

In-Class Workshop: Purchasing a stock, an ETF, and an option

In-Class Workshop: Random sampling to show ideas of diversification.

In-Class Workshop: Mean-Variance Optimization with Real Data

Session 8: February 16, 2009

13. APT

Reading: Chapter 6. QEPM.

Appendix B on CD: QEPM

In-Class Workshop: Purchasing a stock, an ETF, and an option

In-Class Workshop: Random sampling to show ideas of diversification.

In-Class Workshop: Mean-Variance Optimization with Real Data

*** No Class on February 18, 2009 ****

Session 9: February 23, 2009

14. Financial Statement Analysis (The Nuts & Bolts of FA)

Reading: Chapter 10, RB.

Chapter 4. QEPM

Thorp, Wayne. "2008 AAI Stock Screen Roundup: Piotroski Strategy Defeats the Bear." EReader.

In-Class Workshop: Computing financial ratios for a company.

In-Class Workshop: Stock Screening

Session 10: February 25, 2009

15. **Security Valuation (The Holy Grail)**
Reading: Chapter 11 & 15, RB.
Appendix B on CD: QEPM.
Citi Group. “Macy’s Report”. EReader.
In-Class Workshop: Valuation of the Current Housing Market

Session 11: March 2, 2009

16. **Industry Analysis**
Reading: Chapter 14, RB.
Group Portfolio Project 1 Due: Report on Investments
Class Discussion

Session 12: March 4, 2009

17. **Stock Market Valuation**
Reading: Chapter 13, RB.
Dornian and Reichenstein. Stocks for the Long-Term: Why Prospects are Rosy.
Wilcox, Stephen. Market Valuation Measures: Does the Fed Model Really Work?“ EReader.
Shiller, Robert and John Campbell. “Valuation Ratios and the Long-Run Stock Market Outlook.” EReader.
In-Class Workshop: Computing current CS for Stock Market

Session 13: March 9, 2009

18. **Technical Analysis**
Reading: Chapter 16. RB.
Chapter 4. QEPM
Handouts: Interviews with Technical Traders.
In-Class Workshop: Building Technical Indicators

Session 14: March 11, 2009**19. Mid-Term Examination**

*** March 12, 2009: Last Day to Drop the Course ***

*** Spring Recess: No Class March 16 and March 18 ***

Session 15: March 23, 2009**20. Portfolio Management Styles**

Reading: Chapter 17, RB.

Chapter 15, Appendix 15A. QEPM.

Chincarini, Ludwig. (w/ Daehwan Kim). "The Advantages of Tax Managed Investing." *Journal of Portfolio Management* 28.1 (2001): 56-72. EReader.

In-Class Workshop: Style Analysis

21. Professional Asset Management

Reading: Chapter 25, RB.

Kochard, Larry. "Best Approaches for Foundation and Endowment Investing." EReader.

Session 16: March 25, 2009**22. Quantitative Equity Portfolio Management**

Reading:

Asness, Cliff. "The Past and Future of Quantitative Asset Management." EReader.

In-Class Workshop: Building a simple portfolio w/ screens and optimization

Session 17: March 30, 2009**23. Performance Attribution**

Reading: Chapter 26, RB.

Chapter 15. QEPM.

In-Class Workshop: Analyzing the performance of real-world mutual funds

Session 18: April 1, 2009

24. Performance Attribution

Reading: Chapter 26, RB.

Chapter 15. QEPM.

In-Class Workshop: Analyzing the performance of real-world mutual funds

*** April 1, 2009: Last day to decide if P/NP or for letter grade. ***

Session 19: April 6, 2009

25. Bonds Basics and Valuation

Reading: Chapter 18, 19. RB.

Session 20: April 8, 2009

26. Bonds Basics and Valuation

Reading: Chapter 18, 19. RB.

Thau, Annette. "The Muni Market Turmoil Continues: What's Going On and How to Respond?" EReader.

Session 21: April 13, 2009

27. Bond Portfolio Management

Reading: Chapter 20, RB.

Chincarini, Ludwig. (w/ David Bieri). "Riding the Yield Curve: A Variety of Strategies." *Journal of Fixed Income* (September, 2005). EReader.

Session 22: April 15, 2009

28. Bond Portfolio Management

Reading: Chapter 20, RB.

Bearely, Srithar. "The SubPrime Crisis: How did we get here? Where are we going?" EReader.

Session 23: April 20, 2009

29. Hedge Funds

Reading: Merrill Lynch, Introduction to Hedge Funds. EReader.
Froland, Charles. "The Fortunes of Private Equity: What drives Success?" EReader.
Seides, Ted. "Understanding Hedge Funds and Trends." EReader.

Session 24: April 22, 2009

30. Hedge Funds

Reading: Merrill Lynch, Introduction to Hedge Funds. EReader.
Chincarini, Ludwig. "A Case Study on Risk Management: Lessons from the Collapse of Amaranth Advisors, L.L.C." *Journal of Applied Finance*, Spring/Summer, 2008. EReader.
Chincarini, Ludwig. "The Failure of LTCM," *BIS Working Paper*, 1998. EReader.

Session 25: April 20, 2009

31. Forwards and Futures

Reading: Chapter 22, RB.
Chincarini, Ludwig. "Managing Cash Flows in Sector Portfolios." *Derivatives Uses, Trading, and Regulation* 10.1 (2004): 27-45. EReader.
Chincarini, Ludwig. "Overreaction in the Weather Derivatives Market," *Pomona College Working Paper*, 2009. EReader.

Session 26: April 22, 2009

32. Forwards and Futures

Reading: Chapter 22, RB.
Chapter 12. QEPM.
In-Class Workshop: Computing the Desired Leverage

*** No Class on April 27, 2009 due to school holiday. ***

Session 27: April 29, 2009

33. Options

Reading: Chapter 23, RB.

Chincarini, Ludwig. "Flexible Insurance for Separate Accounts."

ICFAI Journal of Risk and Insurance, July, 2008. EReader.

Session 28: May 4, 2009

34. Options

Reading: Chapter 23, RB.

Chincarini, Ludwig. "Flexible Insurance for Separate Accounts."

ICFAI Journal of Risk and Insurance, July, 2008. EReader.

Session 29: May 6, 2009

35. Words of Wisdom for Life and the Street

36. Review for Final Exam

*** Reading Days Begin – Study Hard ***

Session 31: May 15, 2009

37. Final Exam: 2:00 PM – 5:00 PM

Guest Speakers⁵

1. Guest Speaker 1: TBA
2. Guest Speaker 2: TBA

We may have one or two guest speakers of significant status in the money management arena to speak to us on real-world portfolio management.

⁵ None of the guest speakers are confirmed.