Preface

The purpose of this book is to provide students with a realistic view of the role and activities of an equity security analyst within the investment process by building a construct of how capital markets function and teaching the "thought process" involved with securities analysis. The book will focus on three aspects of securities analysis: (1) understanding the process of analyzing companies; (2) understanding the valuation process; and (3) understanding the challenges of achieving success in a highly competitive capital market.

The focus of this book is on the financial theory and empirical evidence that are useful for investment decisions. The topics covered in this book can be broadly categorized into five groups:

- *Financial Theories*: This includes portfolio theory, the capital asset pricing model, and the arbitrage pricing theory, all of which have become an integrated part of the decision-making in investments.
- *Empirical Evidence in the Equity Market*: This includes patterns in cross sections of stock returns and the time series behavior of stock returns.
- *Introduction to Fixed-Income and Credit Sensitive Instruments*: This includes default-free as well as defaultable bonds; yield curve analysis; fixed-income derivatives such as swaps, caps, floors, and swaptions; models of default and ratings transitions; and more recent development of credit derivatives.
- *Market Efficiency and "Active" Investments*: We start with the efficient market hypothesis, which is a useful framework for modeling financial markets. Like any model, the efficient market hypothesis is not a perfect description of reality: some prices are almost certainly "wrong." Hence there are reasons to believe that active management can have effective results. Topics in active investments include security analysis, active portfolio management, hedge funds, and risk management issues.
- *Introduction to Behavioral Finance*: While traditional finance assumes investors act rationally to maximize a well-defined utility function, behavioral finance tries to use other theories of behavior, from psychology, sociology, and anthropology,

to explain financial markets. This topic will be covered by just one chapter, the main purpose of which is to get you exposed to this active and fast growing field in Finance.

Book Objectives

A sound investment decision requires in-depth knowledge of the financial markets and rigorous analytical thinking. The main objective of this book is to teach you these three elements:

- *Analytical Tools*: Among others, an important analytical skill you should acquire from reading this book is the ability to transform a real life investment problem into an analytical model. This modeling skill is an important aspect of this book.
- *Quantitative Skills*: Modern finance has its quantitative aspect. Powerful mathematical techniques such as optimization, dynamic programming, probability theory, and statistical analysis pave way for many complex investment problems. In this book, you will be exposed to this quantitative aspect.
- *Empirical Knowledge*: Essential to any investment decision is the knowledge of the investment environment. Broadly speaking, the financial instruments can be categorized into equity, debt, and derivatives. Important empirical evidence from all three types of financial markets will be examined in this book.

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