Investments is a fascinating and lucrative field of study. Like most worthwhile endeavors it takes study, skill, and flair. The field has powerful analytic tools but no universally accepted answers to key questions such as how to value securities or why market prices behave as they do. Actually, academicians do have theoretical answers to these questions but they do not often apply in practice. A gulf, therefore, exists between academics and practitioners. This class has a determined bias towards practice. At the same time the academic controversies are enlightening and worthy of our consideration.

Teaching Philosophy
Learning is a joint venture. You will bring your interest, skills, and knowledge. I will do the same. My main role is to filter the immense amount of material we could cover down to a manageable sample. To operate this way we need a framework. A portion of our first class is devoted to establishing a philosophical frame. In the rest of our time together we will develop an operational frame. If our joint venture is successful you will leave this class with a solid understanding of what investment professionals do and why they do it. We will resist the temptation to go too far. Our goal is not to make you an investment analyst or portfolio manager but to bring the perspectives of the profession to bear in the context of a general management education.

Learning Philosophy
MBA graduates are distinguished by (1) their ability to solve new problems by reasoning from the specific to the general and (2) their advanced skill set. This class is designed to help you reason as an investment professional might. The skills you learn here apply across a broad set of management situations. To learn these skills and improve our reasoning ability the class incorporates group work, class discussion, and both in class and homework exercises. To assess our learning we will have two major exams as well as two papers. Your communication skills should be sharp as your abilities to express your ideas orally and in writing are important skills in this class and in your career.

Learning Styles
Research in educational psychology has established that each individual has a preferred learning style for each separate task. You probably approach reading a novel differently than a finance text. The difference expresses your preferred style for these tasks. The styles we prefer help us understand how we learn so that we can focus our energies appropriately. Be respectful of others’ learning styles and accept that some of the approaches we use work better for others than they do for you.
Learning Objectives
The broad objective of this class is to help you develop your own opinions about major issues in the field (e.g., market efficiency, the price of risk, value and growth styles) and to apply your knowledge to the study and practice of management. More specific learning objectives are outlined below. The learning objectives and learning outcomes constitute our joint expectations for this class.

Learning Framework
In the first section of the course you will be assigned a company to value. Your task is to decide and defend whether this company would be a good investment. You may present whichever techniques seem most compelling from the set of tools presented in the Merck case and our class discussion. The logic of your analysis, the strength of your defense, and the clarity of your writing will determine your grade. We will work through the Merck case in class to provide some examples. The result of your research will be a company analysis report in the style of a Wall Street analyst. In the second section of the class you will pick two mutual funds to compare. You will analyze the strengths and weaknesses of these funds and recommend one or the other as a suitable long-term investment for your own retirement savings. You will also work exercises and build spreadsheets to solve investment-related problems. All of these activities will focus on practical applications.

Role of the Textbooks
We use selected chapters from Investment Analysis and Portfolio Management – a classic textbook in the field – in the first half of the course. Use this book to fill in gaps in your knowledge. Because our class discussions are limited you should read this text before we discuss the topics in class. Raise questions about the text material at any time. For the second half of the course we are using Pioneering Portfolio Management by David F. Swensen, a prominent practitioner. Because this book is not a textbook your approach will need to be flexible. The learning outcomes and exams will address only those topics we have covered in class.

Blackboard
I use Blackboard extensively. Please check it regularly. I would appreciate it if you would report any difficulties to me immediately.

Merck Case
We work through the Merck case together in class. The purpose is to familiarize you with equity valuation techniques and to prepare you to write an analysis of your own. Please skim through the case and the suggested solutions before the first class. We will discuss the case in depth over several classes.

Assigned Papers
In most classes with a paper assignment you have to work on the paper before you learn enough to write a good paper. In this course we are fortunate in that the company analysis report will be due in the second half of the course after we will learn what we need to write the report. The mutual fund report will be due at the end of the term. The assignments themselves are described in Blackboard.

Class Participation
Research has shown that group discussions are a key learning process. You will learn more if you come to class prepared. On rare occasions, however, circumstances intervene and you would prefer not to participate that day. My style is to pose rapid-fire questions and solicit your opinions. If you do not want to be called on during a particular class session, please do not display your nameplate. If you habitually do not display your nameplate, your class participation grade will suffer.
**Intellectual Honesty**

Business succeeds based on trust and ethical behavior by all parties. Consequently I expect you to be ethical in your relationships with me and your colleagues. As a reminder the Crummer School Academic Integrity Policy defines the use, in any form, of the work of another without attribution as plagiarism and a form of academic dishonesty that will result in an automatic failing grade. By the act of submitting written work to satisfy the requirements of this course you claim the work as your own original work and, unless previously agreed with me, that the submission has been prepared originally for this course. The Policy notwithstanding, you have my permission (and encouragement) to consult with the Rollins TJ Writing Center for proofreading and grammar in all written assignments. If you have questions, please see me.

**Assessment**

Your success in this class will be determined largely by the amount of effort you exert. Points will be awarded on the following basis:

- Company Analysis report: 25%
- Merck update: 5%
- Midterm: 20%
- Class participation and In-Class Cases: 5%
- Final exam: 20%
- Mutual Fund Analysis report: 25%

Total: 100%

The grading scale is:

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Letter grades earn the highest point value in the range. Students who receive less than 60 points will be counseled individually.

**Bloomberg**

Bloomberg is an important tool for many investment professionals. You can earn ½ letter grade bonus in this course by becoming Bloomberg certified in equity. The qualification is all on line and access is available by arrangement. We will talk more about Bloomberg in our first class session.

**Learning Objectives for Security Analysis and Portfolio Management**

Investment professionals, like all managers, face many uncertainties in deciding what assets to buy and how to manage those assets to best meet their own and their clients' needs. Three major questions that will continue to preoccupy both practitioners and academics in the future are: how efficient is the market in reflecting relevant information, how should securities be priced, and what is the best way to assemble and manage a portfolio. Fortunately for us these questions are related. While we cannot hope to settle all the issues involved, increasing our intuitive understanding will help us make informed judgments and become better managers.

Along the way we will explore the world of the financial analyst and portfolio manager. You will learn practical skills by doing some investment analysis. You will also learn by investigating what real portfolio managers do.

**Learning Objectives for Security Analysis**

**Capital Markets**

Understanding market history helps us develop reasonable expectations for future markets. Much of the theory in this area addresses the nature of the evolution of market prices (efficient markets) or how securities should be priced (CAPM). You will need a thorough understanding of the strengths and weaknesses of these models and how they are used in practice. Data exercises will allow us to explore relationships that provide a foundation for our
valuation modeling. Our ultimate learning outcomes are (1) to intuitively understand the relationship between risk and return through a study of historical returns and (2) to form an opinion about the efficiency of markets. We will return to the study of efficient markets in the second half of the class.

**Equity Valuation**
Equity valuation is an inexact science that relies for its value added on an innate sense of the business underlying a company’s various securities. This section of the class will introduce you to a wide variety of models which we work together in class. We will look at the published analysis to see how practicing analysts do their work. At the end of this section you should be able to choose the valuation models that will be the most helpful in comparing your companies.

**Bond Valuation**
Bond valuation is far more complicated than it appears in most textbooks. You will investigate various term structure models and apply one to value bonds. You will also investigate a bond’s risk by calculating duration and convexity. The key learning outcomes are (1) an appreciation for simple models of the term structure of interest rates and (2) familiarity with the strengths and weaknesses of the popular measures of bond risk.

**Learning Objectives for Portfolio Management**

**Portfolio Theory**
While a portfolio manager might find him or her self in a variety of environments (asset-liability, e.g., pension plans; or pure return, e.g., mutual funds), we will focus on the pure return environment and look particularly at mutual funds. This analysis begins with a review of portfolio theory. To enhance our intuition we will work through the mathematics of mean-variance optimization together.

**Active and Passive Management**
One of the key controversies in the profession is the value-added from active management. We will concentrate on the question of equity style (large and small, growth and value).

**Practical Portfolios**
Mutual funds are an excellent place to watch portfolio management at work. We will observe how mutual funds are managed and evaluated. We will also investigate hedge funds – the main alternative to mutual funds – and explore whether they add value.

**Investor Psychology**
Only in the last few years has this branch of academic finance gained recognition. The Nobel prize for economics in 2002 was shared by Daniel Kahneman – one of the founders of this field. We will look at the basic tenets of behavioral finance and explore how they effect our assessment of market efficiency and portfolio management techniques.

**A Note on Exams**
This course uses progressive rolling exams – you will receive questions each week. Your midterm exam score is calculated from the first six weeks and your final exam from the last six. Previous exams are available on Blackboard—including a sample of the weekly questions. I recommend you consult these exams early in the term to help you understand the depth of knowledge that is required to be successful in this course. Exams in this course may be unlike others you have taken. I expect you to integrate and synthesize material covered in class. Your opinion matters but how you defend your opinion is how you earn points.

If you earn a score that is less than you think represents your command of the material on any week’s exam you may replace your grade by taking another exam. The purpose is to let your grades accurately reflect what you have learned. The questions on the replacement exam will be similar but not identical to the original. In all fairness my expectations for performance on
the replacement exam will be higher than on the
original.

You must declare your intention to me by e-
mail to take the replacement exam no later than
one week after the exam is returned. The exam
will be administered at a mutually agreed time
and place.

The replacement score, whether higher or
lower, will stand. I strongly encourage you to
meet with me before you decide to take a
replacement exam to clear up any
misunderstandings about the material,
assessment standards, or the like.

This policy does not apply to assigned papers,
group problems, or Excel exercises.

Papers

You have two individual papers to prepare in
each part of the course. Details on the paper
assignments can be found elsewhere in
Blackboard.

Business writing is not great literature but does
expect the writer to be clear, to bring evidence
to bear, and to be direct. Also important is your
reader’s impression that you care about
accuracy. Readers assume that if you did not
proofread your text you probably did not proof
your calculations or your logic either. To
reinforce this important point each typo will
result in a one-half letter grade deduction from
your score.

A professional’s written work looks professional.
Your time at Crummer offers you a low-risk
opportunity to experiment with making your
papers look professional. Oftentimes your
report’s physical appearance helps establish your
work as serious and compelling. You can also
use the structure of your work (titles, side
headings, etc.) to guide your readers through
your presentation.

You will find helpful guidance on grammar and
presentation in “A Few Notes on Making Your
Writing More Effective.” Read the instructions
carefully as they provide requirements for your
paper’s structure and coverage.

Occasionally life intervenes and you cannot
complete a paper by the due date. I would much
prefer that you take your time with these
assignments as they contain the most important
learning outcomes in the class. The penalty for a
late paper is one-half a letter grade—regardless
of how late it is.

Please check with me if you are planning on
submitting your paper after the deadline.

Rollins College is committed to equal access
and does not discriminate unlawfully against
persons with disabilities in its policies,
procedures, programs or employment
processes. The College recognizes its
obligations under the Rehabilitation Act of 1973
and the Americans with Disabilities Act of 1990
to provide an environment that does not
discriminate against persons with disabilities.

Students with Disabilities

If you are a person with a disability on this
campus and anticipate needing any type of
academic/medical accommodations in order to
participate in your classes, please make timely
arrangements by disclosing this disability in
writing to the Disability Services Office at (Box
2613) - Thomas P. Johnson Student Resource
Center, 1000 Holt Ave., Winter Park, FL,
37289. Appointments can be scheduled by
calling 407-646-2354 or by emailing:
gridgeway@rollins.edu
Class Schedule--Security Analysis and Portfolio Management

**Class 1: September 11—The Efficient Market is Dead—Long Live Market Efficiency**

**Discussion Topics:** Philosophy of Learning: Class organization, objectives, and philosophy; Learning Styles; The Role of Theory; Efficient Market Hypothesis

**Sidebar:** The CFA program; Bloomberg certification

**Read Before Class:**¹


When you reach this point in your study of finance you are beyond simple textbook explanations and ready for the uncertainties of the real world. Stories (more formally, theories and hypotheses) are our best guide to this uncertain world. Postman helps us understand the role of stories in learning. We will return to this theme in the second part of this course with more elaborate treatment of stories in economics and finance.

*Life in Danbury* by James M. Bailey (1873)

*Merck & Company: A Comprehensive Equity Valuation Analysis*, Billingsley (1996) (skim before coming to class)


Reilly Brown Chapter 6 – Efficient Capital Markets

*Efficiency and Beyond*, The Economist, July 12, 2009. The efficient-markets hypothesis has underpinned many of the financial industry’s models for years. Some people think EMH caused the financial crisis. Is that true and does anyone still believe markets are efficient?

**Background Reading:** (Skim and decide how for yourself much you need to read carefully)

Reilly Brown, Chapter 3 – Selecting Investments in a Global Market, Chapter 4 – Organization and Functioning of Securities Markets

**In Class Discussion:** *Learning By Story* by Neil Postman (1989) and *Life in Danbury* by James M. Bailey (1873)

**Presentations:** Why We Sometimes Study Theory; Market Efficiency

**In Class Exercise:** Morningstar Ibbotson EnCorr software

**Supplemental Reading:**² *Wall Street: The Speed Traders*, CBS 60 Minutes video, October 10, 2010,


**Learning Objectives:** philosophy of learning and teaching, overview of security analysis, the role of theory in business, efficient markets hypothesis

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¹ All readings are available on Blackboard except Swensen and the Reilly-Brown text

² You are not responsible for any supplemental readings. They are provided only for students who want additional information about a topic.
Learning Outcomes: understand some of the major philosophical and practical issues in the investment profession

Class 2: September 18—Tracking Capital Market Behavior
Discussion Topics: History of capital markets – returns and risks by asset class; The market price of risk; The probability distribution generating security prices; Anomalies, Introduction to security analysis
Reading Assignment: Reilly Brown Chapter 11 – An Introduction to Security Valuation, Merck & Company: A Comprehensive Equity Valuation Analysis.

Background Reading: (Skim and decide how for yourself much you need to read carefully) Reilly Brown Chapter 1 – The Investment Setting, Chapter 5 – Security Market Indicator Series, Chapter 10 – Analysis of Financial Statements

Group Assignment Due: Capital Market Behavior. See Assignment tab on Blackboard. No written report need be prepared.

Videos to review on your own: Capital Market Indexes and Nonsynchronous Trading. You are responsible for the content of these videos on the exams.

In Class Case: Merck & Company: A Comprehensive Equity Valuation Analysis (a brief and preliminary class discussion – read but do not prepare this case)

In Class Exercise: Research Insight

Learning Objectives: intuitive understanding of the history of capital market behavior and the relationship between risk and return, price behavior in an efficient market
Learning Outcomes: be able to distinguish between the history of a variety of asset classes, empirical tests of efficient markets

Class 3: September 25—Fundamental Equity Valuation from the Bottom-up
Discussion Topics: Bottom-up equity valuation techniques

Reading Assignment:

Group Assignment Due: Merck & Company: A Comprehensive Equity Valuation Analysis: We will discuss your group’s analysis of the published solutions to questions 1-14 on pages 13-15. No written report need be prepared.

Individual Assignment Due: Financial Data Exercise (See Blackboard Assignment tab for details). Your written summary will be collected during class.

In Class Case: Security Analysis: How to Analyze a Company
In Class Case Discussion:
Dividend Discount Models and the Role of Treasury Stock in Valuation
H-Models and 3-Stage DDM
Free Cash Flows

Background Reading: (Skim and decide how for yourself much you need to read carefully)
Chapter 15 – Company Analysis and Stock Valuation


Learning Objectives: fundamental bottom-up analysis focused on ratios and financial statement relationships; valuation models applied

Learning Outcomes: understand how a professional analyzes the relationships exhibited in a company’s accounts and how they arrive at a bottom-up valuation

Class 4: October 2—Equity Valuation—Top-down
Discussion Topics: Top Down (macroeconomic) analysis using the example of monetary policy

This chapter is a basic guide to how the Fed sets and implements monetary policy.


Individual Assignment Due: Fed Policy research project

In Class Case Discussion: Fed Policy research project—we will discuss your research findings

Group Assignment Due: Merck Update Case (see Assignment tab on Blackboard)

Learning Objectives: relative equity valuation; macroeconomic analysis and how it leads to company valuation with a special emphasis on the impact of monetary policy
Learning Outcomes: understand the strengths and weaknesses of relative equity valuation; understand how macro-economic analysis influences company valuations

Class 5: October 9—Equity Valuation—Sector and Industry Analysis
Discussion Topics: Alternatives to the Bottom Up Approach

³ You are not responsible for any supplemental readings. They are provided only for students who want additional information about a topic.
**Reading Assignment:** Chapter 13 – Stock Market Analysis, Chapter 14 – Industry Analysis; *Understanding Sectors*, Standard & Poor’s, December 31, 2008. A short fact sheet on how S&P classifies companies into sectors that are widely followed by investment professionals.

**Individual Cases Due:** P/E Valuation, ROE and Return—These research projects are detailed in the Class Day Schedule. Although there is nothing to submit, you are responsible for this material on the exams.

**Learning Objectives:** perspective of a public company on security analysts; analysis of sector and industry dynamics and influence on company valuation

**Learning Outcomes:** understand a company’s view of security analysis and one of the alternatives to bottom up equity valuation

**Class 6: October 16—Bonds**

**Discussion Topics:** Bond Fundamentals; Term Structure of Interest Rate Models

**Reading Assignment:** Reilly Brown Chapter 18 – Bond Fundamentals, Chapter 19 – The Analysis and Valuation of Bonds

**In Class Case:** Using the current term structure of interest rates to price a coupon bond.

**Learning Objectives:** mechanics of how bond pricing reflects the term structure of interest rates, how models are applied to price bonds, how to calculate duration and convexity and explore shortcomings

**Learning Outcomes:** understand how to use the information reflected in the structure of interest rates to value bonds, and how to evaluate bond risk measures

**Draft Case Due:** Company Analysis report draft

**Project Period October 22 through October 30—Analytical Writing Sessions**

No formal class meeting – individual editing sessions

**Students meet one-on-one with Professor and Analytical Writing Coach to review their company analysis drafts**

**Learning Objectives:** improve company analysis report with techniques of analytical writing

**Learning Outcomes:** enhance analytical writing skills

**Class 7: November 6—Classical and Modern Portfolio Theory**

**Discussion Topics:** Philosophy of Learning, Review of Portfolio Theory, Mean-Variance Optimal Portfolios
**Reading Assignment:** Swensen, Chapters 1-6. Read Chapters 1-4 for general knowledge and skim 5 and 6 for overview.4

*The Big Short: Inside the Doomsday Machine* by Michael Lewis 2010. **Finish reading by December 4.**


**Supplemental Reading:** *The Methodology of Positive Economics,* from Essays in Positive Economics (1935), Milton Friedman and *A Critique of Friedman’s Critics,* Journal of Economic Literature (June, 1970), Lawrence A. Boland. Friedman’s essay is a classic and marks a turning point in thinking about how to study economics. Before Friedman most economics was normative – what should be, rather than positive – what is. Friedman’s emphasis on verifying hypotheses (stories) by analyzing empirical data, although it sounds obvious today, has shaped all economics since. Boland gives a formal interpretation of Friedman’s influence. Friedman’s essential message for us is that for us to choose from among competing hypotheses, all of which are logical and consistent with the facts, we need some rules. With Boland’s help Friedman provides those rules.

**In Class Group Exercises:** MVO spreadsheet, Morningstar, EnCorr

**Individual Case Due:** Submit Company Analysis report electronically before the beginning of class (see Blackboard assignment)

**Learning Objectives:** overview of portfolio management, philosophy of economics

**Learning Outcomes:** understand the major philosophical and practical issues in portfolio management

**Class 8: November 13—Asset Allocation Strategies and Ethics in The Investment Business**

**Discussion Topics:** basics of asset allocation, the importance of asset allocation, implementation techniques, style analysis; structure of the mutual fund industry

**Reading Assignment:** Swensen, Chapters 5 and 6.


*Asset-Allocation Heavyweights Square Off,* Morningstar Advisor, February/March 2010, pp. 43-49. Opinions from two experts on asset allocation strategy.


*What Went Wrong in Mutual Fund America?*, John C. Bogle, 2006. Observations from one of the mutual fund industry’s pioneers about the current state of affairs.

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4 Swensen’s book is a memoir and we do not discuss the chapters the way we might a textbook. Read this book for the practical experience of a well-known portfolio manager. Most important is Swensen’s underlying recipe for success. Chapters are listed here only to keep you on track to finish the book by the end of the term.
Edward Jones fee disclosure statement, June 2011.


In Class Case Discussion: Fiduciary Duty versus Suitability


Edward Jones mutual fund revenue sharing disclosure, June 2011. This disclosure reveals rebates of 12b-1 fees to brokers.

These readings provide perspectives on the mutual fund industry


Read these two articles to learn how to find hidden risks in your mutual funds.


**In Class Exercises:** Returns-based Style Analysis

**Learning Objectives:** review the research on the importance of asset allocation; explore how mutual funds have operated

**Learning Outcomes:** understand the difficulties of determining the source of portfolio returns, the commonalities among various strategies

**Class 9: November 20—Active and Passive Management**

**Discussion Topics:** Core-Satellite approach, growth and value styles, performance measurement

**Reading Assignment:** Swensen, Chapters 7, 8, and 9.

*For Yale’s Money Man, a Higher Calling*, New York Times, February 18, 2007. Note the date of this laudatory article.


Yale may not have the key: When diversification doesn’t work, The Economist, Mar 10th 2011. The title says it all.


Finding Value in Small Stocks, Gary G. Schlarbaum and Bradley S. Daniels in Core Satellite Portfolio Management, J. Clay Singleton, 2005. These authors contribute to the style debate by outlining their successful small cap investment style.


Stock Pickers are No Longer the Stars, New York Times, April 9, 2011.

A Master's Skill, or Just Luck, New York Times, October 8, 2011

Rich Managers, Poor Clients, The Economist, January 7, 2012. Hedge fund managers are investment rock stars but their clients don’t seem to benefit.

In Class Cases: Identifying growth and value stocks; Mutual fund performance persistence

Learning Objectives: explore contemporary approaches to portfolio management including combining active and passive management with alternative asset classes and growth and value styles

Learning Outcomes: form an opinion about the potential for value-added from equity style-based portfolio management techniques

Class 10: November 27—Bond Portfolio Management

Discussion Topics: Bond portfolio management through asset-liability matching; Fund manager selection process

Reading Assignment: Swensen, Chapter 9
Fabozzi, Bond Markets, Analysis and Strategies, Chapter 4.

Fund Manager Selection: Watch video interviews on Blackboard with fund manager selection consultants from the Bogdahn Group and the Newport Group and be prepared to discuss.

In Class Case: Building a Better Mousetrap—Bond Portfolio Management

Supplemental Reading: Exchange Traded Funds: visit the American Stock Exchange website: www.amex.com for information on ETFs. ETFs are covered only briefly in class. Read about exchange traded funds under ETFs for Education, Individual Investor and Institutional Investor. Explore the listed ETFs to see the range of indexes they track.

How Leveraged ETF's Compound the Misery, by Paul Justice, Morningstar Advisor, April/May 2009.


The Hidden Fees in the 401(K), Darrell Preston, Bloomberg Markets, March 2008. Skullduggery with 401(K) fees.

Learning Objectives: explore how a bond portfolio can be constructed to immunize a liability; understand how investment consultants evaluate fund managers

Learning Outcomes: a deeper understanding of bonds; be able to apply the immunization technique of bond portfolio management, the manager selection process
Class 11: December 4—Behavioral Finance
Discussion Topics: Psychology applied to investments

Reading Assignment: Swensen, Chapters 10 and 11. 
The Psychology of Risk, Amos Tversky, Quantifying the Market Risk Premium Phenomenon for Investment Decision Making (AIMR 1990). Classic introduction to behavioral finance by someone who would have shared the 2002 Nobel Prize with Daniel Kahneman, if he had lived. 

David Swensen on Investing (video) David Swensen, Yale's Chief Investment Officer and manager of the University's endowment, guest lectures in a class at Yale, discussing the tactics and tools that Yale and other endowments use to create long-term, positive investment returns.

You're on Autopilot, but Check the Speedometer, Mary Williams Walsh, The New York Times, July 13, 2008. Comments on target date funds, one of the Qualified Default Investment Alternatives under the Pension Protection Act of 2006.

Learning Objectives: the characterization of individual investor behavior and its potential to explain market behavior
Learning Outcomes: form an opinion as to the fairness of the market in the presence of irrational individual behavior

Class 12: December 11—Asset Allocation Using Options

Reading Assignment: Options for Asset Allocation Read this short piece to see the equivalency between asset allocation and options positions.

In Class Exercise: Options and Asset Allocation

Individual Case Due: Submit Mutual Fund paper electronically before beginning of class (see Blackboard assignment)