

The Investment Manager's Handbook

Edited by

SUMNER N. LEVINE

State University of New York
Stony Brook, New York

TECHNISCHE HOCHSCHULE DARMSTADT	
Fachbereich 1	
<u>Gesamtbibliothek</u>	
<u>Betriebswirtschaftslehre</u>	
Inventar-Nr.:	33.563
Abstell-Nr.:	A 06/290
Sachgebiete:	0.3.5.2



DOW JONES-IRWIN
Homewood, Illinois 60430

Contents

PART ONE

BASIC ASPECTS

1. **Overview of Investment Management, W. Scott Bauman 3**
The Objectives and Requirements of the Investor. The Environment for Investments. Portfolio Plans or Policies. Control of the Investment Programs. Professional Qualifications for Investment Managers: *The C.F.A. Competency Standards*. Types of Portfolios or Investment Accounts: *Individual/Family-Type Investors. Formal Retirement Funds. Insurance Companies.*
2. **Structures of Investment Management Organizations, W. Scott Bauman 32**
Operational Functions of the Organization: *Economic and Capital Market Research. Industry and Security Research. Statistical Research Systems. Account Management. Transactions and Records Management.* The Decision-Making Structure. General Characteristics of the Organizational Structure: *Scope and Diversity of Functions. Structure of the Organization. Size of the Organization.* Types of Institutions: *Investment Counsel Firm. Investment Companies. Bank Trust Investment Division. Insurance Company Investment Operation. Brokerage Firm Investment Advisory Department. Pension Fund Portfolio Management. Published Investment Advisory Services.*
3. **Setting Investment Objectives, Charles D. Ellis 61**
Investment Counseling. Controlling Risk: *Evaluating Policy and Operations.*
4. **The Efficient Market-Random Walk Debate, Charles D. Kuehner and Fred B. Renwick 70**
Introduction. Requirements for an Efficient Market: *1. Effective Information Flow. 2. Fully Rational Investors. 3. Rapid Price Change to New Information. 4. Low Transaction Cost. 5. Continuous Trading.* Situation Prior to Emergence of the Efficient Market Concept: *Technical Analysis. Fundamental Analysis.* Three Forms of the Efficient Market-Random Walk Hypotheses: *1. The Weak Form. 2. The Semistrong Form.*

3. *The Strong Form. The Weak Form of the Efficient Market-Random Walk Hypotheses: Survey of Evidence: Overview. Analysis of Studies. The Semistrong Form of the Efficient Market-Random Walk Hypotheses: Survey of Evidence: Overview. Analysis of Studies. The Strong Form of the Efficient Market-Random Walk Hypotheses: Survey of Evidence: Overview. Analysis of Studies. Implications, Challenge, and Conclusion: Implications. Challenge to Security Analysis. Conclusion.*

5. Modern Portfolio Theory, Edwin J. Elton and Martin J. Gruber 160

Overview. The Portfolio Choice Problem. Mean Return and Risk: *The Mean Return. A Measure of Risk. Variance of Combinations of Assets. Characteristics of Portfolios.* The Efficient Frontier with Riskless Lending and Borrowing. Implementation of Theory: *The Inputs to Portfolio Analysis. Single Index Models—An Overview. Other Models of Why Stocks Move Together. Simple Portfolio Selection Criteria.* Conclusion.

6. Portfolio Beta Prediction, Vinay V. Marathe 202

Overview. The Capital Asset Pricing Model. The Traditional Method of Estimating Betas. Estimation Error and Bayesian Adjustment. A Multiple-Factor Model of Security Returns: *Common Factors of Security Returns. Implications for Predicting Portfolio Betas. Implications for Predicting Portfolio Residual Risk. Implications for Performance Attribution and Analysis.* Improved Prediction of Beta from Investment Fundamentals. Conclusion. Appendix.

PART TWO

MANAGEMENT STRATEGIES

7. Active Equity Management Strategies, Arthur Zeikel 225

Active Investment Tactics. Security Analysis and Common Stock Evaluation. Evaluation Models. Business Cycles and Investment Timing. Timing and Technical Analysis. Dow Theory and Price Charts: *Price Chart Patterns. Bar Charts. Moving Averages.* Critique of Technical Analysis: *Coping Better.*

8. Passive Equity Management Strategies, James R. Vertin 282

Passive versus Active Management: *Some Issues. The Question of Market Efficiency. Transaction Costs. Management Fees. Risk-Return Considerations. Passive Management Performance.* Managing Passive Portfolios: *Choosing an Index. Portfolio Construction—Duplication or Sampling? Trading Strategies. Pooled versus Individual Portfolios.* Passive Equity Management Strategies: *Core-Noncore (Passive-Active) Portfolios. How Much Passive Management? Asset Allocation Assistance. Market Inventory Fund. Other Passive Possibilities.*

9. Management of Bond Portfolios, H. Russell Fogler 305

Evolution and the Multiperiod Problem—An Overview. Management Strategies: *The Benchmark Yield Curve. The Expected Return—The Start-*

- ing Point. Interest Rate Anticipation. Sector-Quality-Coupon (SQC) Selection. Swapping. Economic and Credit Analysis. Maturity Structure Strategies. Objectives and Risk: A Balance Sheet Approach. Price Volatility. Interest Rate Cycle Risk. Yield Volatility. Call Risk. Default Risk. Reinvestment Risk. Price versus Reinvestment Risk—Offsetting Forces and Immunization: Portfolio Immunization. Duration and Immunization. Caveats on Immunization and Duration. Summary on Immunization. Empirical Studies: Return Functions. Dumbbells versus Laddered Portfolios. The Search for a “Bond Beta”—and the Nonlinearity Dilemma. Immunization Studies. Procedures for Detecting Bankruptcy. Summary. Appendix: Duration and Immunization Mathematically.*
- 10. Management of Real Estate Portfolios, Paul Sack 345**
- Why Invest in Real Estate? The Liquidity of Real Estate Investments. Incremental Value in Real Estate. Characteristics of High Quality Properties. Characteristics of Higher Risk Properties. Determining Intrinsic Value. Leverage. How to Invest in Real Estate: Commingled Funds: Open-End versus Closed-End. Selecting a Real Estate Manager, Fund Manager, or Consultant. Evaluating Performance. Summary.*
- 11. International Diversification, Donald R. Lessard 359**
- Introduction. The Potential Advantages of International Diversification: Expected Returns and Gains from International Diversification. Obstacles to International Investment: Currency Risk. Political or Sovereign Risk. Limited Size and Depth of Foreign Markets. Relative Efficiency of Foreign Markets. Taxes, Restrictions on Ownership, and other Institutional Obstacles. Conclusions Regarding Obstacles to International Investment.*
- 12. Option Strategies, Eugene D. Brody 384**
- The Language of Options. Strategy and Technique: Accumulation of a Position. Using Options as an Extension of Investment Policy. Buy Call and Treasury Bill. Buy and Write. Overriding. Selling Puts. Conversion.*
- 13. Techniques of Portfolio Adjustments, Edmund A. Mennis 399**
- Changes in Portfolio Objectives: Statement of Objectives. Investment Results Expected. Risk Tolerance. Investment Time Horizon. Changes in Portfolio Objectives. Changes in Asset Mix: Asset Mix Defined. Causes of Changes in Asset Mix. Factors Affecting Expected Returns. Predicting Expected Returns. Determination of Asset Mix. Changes in the Composition of Fixed-Income Portfolios: Maturity. Quality. Coupon. Sector. Techniques Contrasted. Changes in the Equity Portfolio: Alternative Styles of Equity Management. Industry Portfolios. Determination of Industry Weights. Company Selection. Sector Portfolios.*
- 14. Investment Returns on Stocks, Bonds, and Bills, Roger G. Ibbotson 420**
- The Risks and Rewards. Measurement of the Five Series: Common Stocks. Long-Term Corporate Bonds. Long-Term Government Bonds. U.S. Treasury Bills. Consumer Price Index.*

- 15. Historical Returns of Real Estate Equity Portfolios, Keith V. Smith 426**
 Index Trends. Real Estate Investment Trusts. Index Appreciation. Comparisons of Samples. Traditional Performance Evaluation. Risk-Adjusted Performance Evaluation.

PART THREE

MEASURING AND MONITORING PERFORMANCE

- 16. Equity Portfolio Performance, Dennis A. Tito and Lawrence Zamos 445**
 The History of Performance Measurement. Examining Performance: *Why Monitor Performance? Who Is Concerned? Meeting Sponsor Objectives. Subdivision of Funds. Period of Performance. The Analyst.* Basic Measurements of Performance: *Return. Risk. Other Important Measures of Performance.* Evaluating Performance: *Achieving Objectives. Benchmarks for Comparative Analysis. Comparative Analysis of Returns. Risk and Return—Using the Capital Market Line. Return and Diversification Relationship. Management Trends.* Correcting Performance: *Trade-off Analysis. Simulation. Optimization. Control.*
- 17. Trends in Bond Portfolio Management, Martin L. Leibowitz . . . 474**
 The Evolution of Active Bond Management: *The Scope of Bond Management Activity. Prospective Problems in Rate Anticipation.* The Baseline Method for Relating Short-Term Performance to Long-Term Goals: *The Yardstick of Total Return. The Baseline Portfolio. Management Activity Relative to the Baseline Portfolio. Evaluating Proposed Departures from the Baseline. Sources of Return. Communication between Sponsor and Manager.*
- 18. Monitoring Executions, Wayne H. Wagner . . . 507**
 Why Monitor Execution Costs? Explicit and Implicit Trading Costs. A Simple Model for Execution Evaluation. Pitfalls in Measuring Execution Costs. Reducing the Cost of Transacting. Conclusion. Appendix.
- 19. Evaluating the Quality of Research Information, Keith P. Ambachtsheer . . . 521**
 What is Research Information? *Why Does this Question Deserve an Answer? Key Factors in Predictive Ability Measurement: The Diefenbach Study. The Korschot Study. The Value Line Method.* Information Coefficient Analysis. Case Studies Using Information Coefficient Analysis. Using Information Coefficient Analysis in Portfolio Management. Information Coefficient Analysis: Is It Ideal? Concluding Comments.
- 20. Measuring and Reporting on Performance, Philip W. Bell . . . 543**
 Concepts and Measures Needed for the Evaluation of Performance: *Objectives: Comparability and Necessary Conditions for Comparability in Performance Measures. Formulating the Data: A Basic Worksheet Tabulation. Current Value Income and Comparative Position Statements, Reconcilia-*

tion with Historical Cost Statements, and Weaknesses of the AICPA Recommendation. Changes in the General Price Level, Inflation Accounting, and Performance Evaluation. Tax Considerations, the Timing Problem, and Interpretation of the Data: Tax Considerations and Performance Reporting. The Timing Problem and Interpretation of the Data.

**PART FOUR
REGULATORY ASPECTS**

21. An Overview of Fiduciary Law, James L. Walters 567

The Standard of Reasonable Care. The Duty of Loyalty. The Effect of Public Interest on Fiduciary Duty. Preventive Steps for the Fiduciary: Knowledge of Specific Laws or Rules affecting the Client. Exculpatory Clauses. Investment Objectives. Disclosure and Consent. Documentation.

22. ERISA and the Portfolio Manager, William J. Chadwick 583

Introduction. Fiduciary Responsibility: Coverage. Structure and Content. Fiduciary Duties. Liability for Fiduciary Breaches. Exculpatory Provisions. Prohibited Transactions: Overview. Prohibited Transaction Restrictions. Statutory Exemptions. Transitional Rules. Administrative Exemptions. Conclusion: Transactional Analysis.

23. Regulation of Investment Managers under Federal Securities Laws, John G. Gillis 603

Introduction. Investment Advisers Act: Background. Who Is an Investment Adviser. Registration and Qualifications. Books and Records: Required by Section 204. Other Requirements—ERISA. Institutional Investment and Beneficial Ownership Disclosure. Investment Advisory Contracts: Topics Covered. Investment Objectives and Restrictions. Fees for Investment Advisory Services. Marketing Investment Advisory Services—Disclosure: Advertising, Brochure Rule and Revised Form ADV. Requirement to Revise Form ADV. Disclosure of Brokerage Placement Practices. Relationships with Brokers: Broker Referrals and Continuing Relationships. Cash Payments for Referrals. Prohibited Transactions—Fraud: General. Dealing with a Client as Principal or Broker. Custody or Possession of Clients' Funds or Securities. Adviser and Personal Securities Transactions. Inside Information. Corporate Projections. Liability: Implied Private Actions under the Investment Advisers Act. SEC Administrative Powers.

24. Legal Limits on Investing: with Reference to State Regulations, John L. Casey 650

Approaching a Common Type of Trust: What is a Trust? Making the Review. The Base Case: What are the Investment Powers? Balance, Diversification, Concentration: A Balanced Portfolio. Diversification. Concentration and Indexing. Individual Security Selection and Portfolio Construc-



tion. When Trustees Retain a Professional Investment Manager. Family Objectives and the Investment Vehicles in the Cosmo Trust: Family Objectives. Reserves. Long-Term Municipals. Discriminating between Issues of Securities; Mutual Funds. Stocks Generally. The Local Business. Deliberate Retention or Sale. Investment Recommendations. Broker Selection. Advisory Fees or a Small Business. Deferred Compensation. Real Property as a Trust Investment. Specific Investment Restrictions for Other Funds Including Institutions: New York Trustees. Public Retirement Funds and Investment Companies. Insurance Companies and other Savings Institutions. Dividend Limits. Foreign Investments. Retention of Securities which Do Not Meet Standards for New Investments: Unrealistic Assumptions. New Restrictions: Social-Impact Investing: Background. Current Issues. Corporate Responses. Shareholder Response. The Investment Manager's Response.

25. **Professional Self-Regulation, W. Scott Bauman 687**
 Educational Standards. Standards of Professional Conduct: *Code of Ethics. Standards of Professional Conduct.* Enforcement of Standards. Continuing Education.

PART FIVE

MANAGEMENT BY TYPE OF ACCOUNT

26. **Management of Pension Fund Portfolios, Patrick J. Regan 697**
 The Size and Growth of Pension Assets. Questions for the Investment Manager: *1. Is the Plan Sponsor a Government Entity, a Labor Union or a Corporation? 2. Is It a Defined Benefit or a Defined Contribution Plan? 3. How Mature Is the Plan and How Will This Change in the Coming Years? 4. How Conservative Are the Funding Methods and Actuarial Assumptions Used to Compute the Pension Costs and Liabilities?* Summary. Appendix.
27. **Municipal and State Pension Plans, Thomas P. Bleakney 709**
 Funding. Investments Held by Public Systems. Investment Trends. Investment Powers. Political Considerations. Socially Useful Investing.
28. **Life Insurance Company Investments, J. Robert Ferrari 725**
 Life Insurance and Savings. Sources of Funds for Investment. Investment Objectives: *Distribution of Assets and Liabilities. Basic Investment Characteristics. The Risk-Return Trade-Off.* Investment Risk: *Insolvency Risk. Liquidity Risk. The Special Problems of Inflation.* Company Organization. Regulation of Life Insurance Investments: *Qualitative Restrictions. Quantitative Restrictions.* Life Insurance Company Taxation. Special Features of Life Insurance Investments: *Forward Commitments. Private Placements.* Historical Investment Behavior: *General Account Investments. Separate Account Investments.*

- 29. Fire and Casualty Portfolios, Karl Zerfoss, Jr.** 750
 The Environment. General Approach. Investment Objectives. The Mix of Assets. Investment Principles: *Bonds Should Be Actively Managed. Tax Management. Realize Common Stock Gains. Diversification and Quality.* Organizing the Investment Function.
- 30. Portfolio Management—Guidelines for a Commercial Bank, Edward M. Roob and Thomas A. Vaughn** 761
 Investment Objectives and the Constraints: *Assess the Bank's Overall Risk Position. Study Liquidity Requirements versus Income Needs. Analyze the Pledging Requirements to Secure Public Funds. Evaluate the Bank's Overall Tax Position, Both Current and Future.* Portfolio Strategies: *"Three-Part" Portfolio Strategy. Type of Investment, Diversification, and Quality. Portfolio Maturity Structure. The "Dumbbell" or "Hour-glass" Portfolio. The "Cyclical" Portfolio.* Swapping: *Yield Pick-Up Swap. The Substitution Swap or Replacement Swap. The Intermarket Swap. The Yield Anticipation Swap. Tax-Loss Trading. Gain Trading. Open-Ending.* Improving Returns on Government Securities Portfolios: *Repurchase Agreements ("Repos"). Resale Agreements ("Resales"). Lending of Government Securities. Liability Management.* Authority and Control Procedures: *Reasons for Having a Written Policy. The Elements of an Investment Policy.*
- 31. Interest Rate Futures and the Management of Bank Portfolios, Morton Lane** 777
 Existing and Planned Financial Instrument Futures—How the Contract Markets Work: *Chicago Mercantile Exchange (International Monetary Market—IMM—subdivision). Chicago Board of Trade (CBOT). American Commodity Exchange at the Amex (American Commodities Exchange or ACE).* Examples of Hedging Situations for Commercial Banks: *Asset Portfolio. Liability Portfolio. A Numerical Example; Asset Portfolio. A Numerical Example; Liability Portfolio.* Arbitrage.
- 32. Personal Trust Management, John R. Boyd** 789
 Trust Institutions. Types of Personal Trust. Organizational Structure of Trust Departments: *1. The Trust Administrator. 2. The Portfolio Manager. 3. The Security Analyst. 4. The Securities Trader.* Investment Standards for Trustees. Custodial and Record Keeping Services. Case Studies: *Case 1. Case 2.*
- 33. Managing Investment Company Portfolios, Norton H. Reamer** 801
What is an Investment Company? Variety of Objectives and Types. Features and Services of Investment Companies. Legal, Tax, and Regulatory Issues. Investment Management of Investment Companies. Types of Organizations. Investment Styles. Risk Control and Modern Investment Techniques. Selecting an Investment Company.



34. **Educational Endowment Funds, J. Peter Williamson and Hazel A. D. Sanger 827**

Introduction. Organization and Decision Making. Setting Investment Objectives: *Real Total Return. Spending. Gifts. Educational Inflation Premium. Spending Policy. Asset Structure.*

PART SIX MONEY MARKET PORTFOLIOS

35. **The Mathematics of Interest Rates, Swaps, and Futures, Sumner N. Levine 853**

Expressions for Rates: *Interest as a Discount. Interest Paid on Maturity. Relationship between Discount Rate and Rate at Maturity. Compound Rates. Converting a Discount Rate into a Compound Rate (Bond Equivalent Yields).* Bond Rates: *Return when Coupon Payments are Not Reinvested. Return when Coupon Payments are Reinvested. Yield to Maturity.* Analysis of Money Market Investments: *Break Even Analysis.* Analysis of Bond Swaps. Interest Rate Futures.

36. **Managing a Liquidity Portfolio, Marcia Stigum 867**

Part 1—The Instruments in Brief: *Dealers and Brokers. U.S. Treasury Securities. T-Bill Futures Market. Federal Agency Securities. Federal Funds. Eurodollars. Certificates of Deposit. Eurodollar Certificates of Deposit. Commercial Paper. Bankers' Acceptances. Repurchases and Reverses. Municipal Notes.* Part 2—The Market Makers: Dealers and Others: *The Dealers. Dealer Financing. Interest Rate Predictions. Confidence Level in Positioning. The Maturity Choice. Strategies to Earn Position Profits. Arbitrages. The Clearing Banks. The Brokers. Communications.* Part 3—The Investors: *Running a Short-Term Portfolio: Contrast of a Portfolio Manager with a Dealer. The Parameters. Managing a Liquidity Portfolio. The Way It's Done.*

PART SEVEN COMPUTER TECHNIQUES

37. **Computer Construction of Optimal Portfolios, Paul R. Samuelson 921**

The Construction of an Optimal Portfolio at a Single Point in Time. The Revisions of an Optimal Portfolio through Time.

38. **Commercially Available Computer Services, Arthur Williams III 939**

Organization: *Economics. Portfolio Strategy. Common Stock Analysis and Management. Fixed Income. International. Accounting. Performance Measurement and Portfolio Audit. News and General Business Information Services. Real Estate.* List of Commercially Available Computer Services: *I. Economics. II. Portfolio Strategy and Simulation. III. Common Stock Analysis and Management. IV. Fixed Income Securities Analysis*

and Management. V. International Information. VI. Accounting. VII. Performance Measurement and Portfolio Audit. VIII. News & General Business Information Services. IX. Real Estate. List of Firms and Services.

PART EIGHT

STOCK MARKET INDEXES

39. Stock Market Indexes, *Sumner N. Levine* 979

GLOSSARY 991

Index 1025