# Preface

*Investments* by Bodie, Kane, and Marcus is one of the leading textbooks for courses in investment analysis. It is also a reference source for investment professionals and individual investors. It has a comprehensive coverage of investment related topics, and the authors do an excellent job of communicating complex concepts in an easy-to-understand manner.

This Asia Global Edition, adapted from *Investments*, *Ninth Edition*, has been written to address the growing need by Asian users for local and regional content to reflect the financial instruments, markets, trading practices, institutions, and regulatory framework in the Asia-Pacific region with particular emphasis on South-east Asian and East Asian countries. The theoretical and conceptual aspects of investment analysis are not context specific so very few changes were made to such material. As such, readers familiar with the U.S. and Global editions of the book should find the transition to the Asia Global Edition to be relatively smooth.

## NEW IN THE ASIA GLOBAL EDITION

The following is a guide to some of the changes in this edition.

### *Increased Discussion of Asian Content*

The Asia Global Edition includes more Asia relevant content on topics such as the recent global financial crisis and its effects on Asian countries, post-financial crisis changes in hedge fund regulation in the U.S., Europe and Singapore, post-financial crisis changes in the regulation of short-selling in Asia, regulators of Asia-Pacific exchanges, accounting scandals at Asian firms, inflation protected bonds issued by Asia-Pacific countries, Chinese yuan-denominated Dim Sum bonds, global and emerging market bond indexes, Asian stock market indexes, index options traded on Asian exchanges, Asian options and futures exchanges, recent mergers involving Asian exchanges, exchange-rate targeted monetary policy in Singapore, adoption of International Financial Reporting Standards (IFRS) in the Asia-Pacific region, Islamic investment funds, and sovereign wealth funds.

This edition also clarifies that some terms such as unit trusts and (structured) warrants carry a different meaning in the U.S. than what they do in many parts of Asia. Similarly, Time Deposits are referred to as Certificates of Deposit (CDs) in the U.S. but terms such as Fixed Deposits and Term Deposits are more common in Asia.

Several tables and figures were updated to reflect Asian content instead of U.S. content. For example, the balance sheet of U.S. households and the national wealth data of the U.S. were replaced with the balance sheet of Taiwan households and the national wealth data of Taiwan, respectively. Other tables and figures were replaced to reflect updated data on U.S. mutual funds, exchange traded funds, and the market capitalization of stock exchanges in Asia and around the world.

Finally, to keep the text to a reasonable length, the coverage of some detailed U.S.-specific content was reduced in this edition. Some examples of topics with reduction in coverage are tax-exempt municipal bonds, structure of NASDAQ and NYSE stock exchanges, NAICS codes, U.S. fiscal policy and U.S. legislative processes.

### *Words from the Street boxes*

Changes were made to over a dozen *Words from the Street* boxes. A couple of them were removed, some were replaced with newer versions, and some new boxes were introduced. Most of the new boxes contain short articles from business and other periodicals that address issues of real-world relevance with an emphasis on Asia. The topics discussed in these *Words from the Street* boxes include dark pools in Asia, a short squeeze example from Japan, the growth of sovereign wealth funds in Asia and elsewhere and their investment performance during and after the financial crisis, the losses suffered by Asian investors in Lehman CDO-linked minibonds, currency changes in Korea and Japan and their impact on the stock market, rate-rigging of LIBOR and similar benchmark borrowing rates in Asia and around the world, a rethink of political risk by analysts after the recent popular revolutions in the Middle East and North Africa, diversification and asset allocation from investments in emerging markets, behavioral finance issues in the Asia-Pacific region, and the increased scrutiny of fund of (hedge) funds.

### *E-Investments Exercises*

Changes were made to over a dozen *E-Investments Exercises*. In a few cases, the changes were necessitated by the modified layout and content of many websites. The new exercises were designed to provide students with an opportunity to apply what they have learned in class to learn more about financial issues in Asia and elsewhere by using resources on the Internet. The topics examined in these exercises include stock market listing standards in the Singapore Exchange and Hong Kong Exchange, Asian business cycle indicators, inflation rates in developing Asia, Japanese yen foreign currency futures, global funds, equity valuation, and a novel financial derivative called contracts for difference (CFDs), which have become very popular in the Asia-Pacific region.

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# Preface to 9e

We wrote the first edition of this textbook more than two decades ago. The intervening years have been a period of rapid, profound, and ongoing change in the investments industry. This is due in part to an abundance of newly designed securities, in part to the creation of new trading strategies that would have been impossible without concurrent advances in computer technology, in part to rapid advances in the theory of investments that have come out of the academic community, and in part to unprecedented events in the global securities markets. In no other field, perhaps, is the transmission of theory to real-world practice as rapid as is now commonplace in the financial industry. These developments place new burdens on practitioners and teachers of investments far beyond what was required only a short while ago. Of necessity, our text has evolved along with financial markets and their influence on world events.

*Investments,* Ninth Edition, is intended primarily as a textbook for courses in investment analysis. Our guiding principle has been to present the material in a framework that is organized by a central core of consistent fundamental principles. We make every attempt to strip away unnecessary mathematical and technical detail, and we have concentrated on providing the intuition that may guide students and practitioners as they confront new ideas and challenges in their professional lives.

This text will introduce you to major issues currently of concern to all investors. It can give you the skills to conduct a sophisticated assessment of watershed current issues and debates covered by the popular media as well as more-specialized finance journals. Whether you plan to become an investment professional, or simply a sophisticated individual investor, you will find these skills essential, especially in today's ever-changing environment.

Our primary goal is to present material of practical value, but all three of us are active researchers in the science of financial economics and find virtually all of the material in this book to be of great intellectual interest. Fortunately, we think, there is no contradiction in the field of investments between the pursuit of truth and the pursuit of money. Quite the opposite. The capital asset pricing model, the arbitrage pricing model, the efficient markets hypothesis, the option-pricing model, and the other centerpieces of modern financial research are as much intellectually satisfying subjects of scientific inquiry as they are of immense practical importance for the sophisticated investor.

In our effort to link theory to practice, we also have attempted to make our approach consistent with that of the CFA Institute. In addition to fostering research in finance, the CFA Institute administers an education and certification program to candidates seeking the designation of Chartered Financial Analyst (CFA). The CFA curriculum represents the consensus of a committee of distinguished scholars and practitioners regarding the core of knowledge required by the investment professional. This text also is used in many certification programs for the Financial Planning Association and by the Society of Actuaries.

Many features of this text make it consistent with and relevant to the CFA curriculum. Questions from past CFA exams appear at the end of nearly every chapter, and, for students who will be taking the exam, those same questions and the exam from which they've been taken are listed at the end of the book. Chapter 3 includes excerpts from the "Code of Ethics and Standards of Professional Conduct" of the CFA Institute. Chapter 28, which discusses investors and the investment process, presents the

CFA Institute's framework for systematically relating investor objectives and constraints to ultimate investment policy. End-of-chapter problems also include questions from test-prep leader Kaplan Schweser.

In the Ninth Edition, we have continued our systematic collection of Excel spreadsheets that give tools to explore concepts more deeply than was previously possible. These spreadsheets, available on the Web site for this text (**www.mhhe.com/bkm**), provide a taste of the sophisticated analytic tools available to professional investors.

## UNDERLYING PHILOSOPHY

In the Ninth Edition, we address many of the changes in the investment environment, including the unprecedented events surrounding the financial crisis.

At the same time, many basic *principles* remain important. We believe that attention to these few important principles can simplify the study of otherwise difficult material and that fundamental principles should organize and motivate all study. These principles are crucial to understanding the securities traded in financial markets and in understanding new securities that will be introduced in the future, as well as their effects on global markets. For this reason, we have made this book thematic, meaning we never offer rules of thumb without reference to the central tenets of the modern approach to finance.

The common theme unifying this book is that *security markets are nearly efficient,* meaning most securities are usually priced appropriately given their risk and return attributes. Free lunches are rarely found in markets as competitive as the financial market. This simple observation is, nevertheless, remarkably powerful in its implications for the design of investment strategies; as a result, our discussions of strategy are always guided by the implications of the efficient markets hypothesis. While the degree of market efficiency is, and always will be, a matter of debate (in fact we devote a full chapter to the behavioral challenge to the efficient market hypothesis), we hope our discussions throughout the book convey a good dose of healthy criticism concerning much conventional wisdom.

### Distinctive Themes

*Investments* is organized around several important themes:

1. **The central theme** is the near-informational-efficiency of well-developed security markets, such as those in the United States, and the general awareness that competitive markets do not offer "free lunches" to participants.

   A second theme is the risk–return trade-off. This too is a no-free-lunch notion, holding that in competitive security markets, higher expected returns come only at a price: the need to bear greater investment risk. However, this notion leaves several questions unanswered. How should one measure the risk of an asset? What should be the quantitative trade-off between risk (properly measured) and expected return? The approach we present to these issues is known as *modern portfolio theory,* which is another organizing principle of this book. Modern portfolio theory focuses on the techniques and implications of *efficient diversification,* and we devote considerable attention to the effect of diversification on portfolio risk as well as the implications of efficient diversification for the proper measurement of risk and the risk–return relationship.
2. **This text places** greater emphasis on asset allocation than most of its competitors. We prefer this emphasis for two important reasons. First, it corresponds to the procedure that most individuals actually follow. Typically, you start with all of your money in a bank account, only then considering how much to invest in something riskier that might offer a higher expected return. The logical step at this point is to consider risky asset classes, such as stocks, bonds, or real estate. This is an asset allocation decision. Second, in most cases, the asset allocation choice is far more important in determining overall investment performance than is the set of security selection decisions. Asset allocation is the primary determinant of the risk–return profile of the investment portfolio, and so it deserves primary attention in a study of investment policy.
3. **This text offers** a much broader and deeper treatment of futures, options, and other derivative security markets than most investments texts. These markets have become both crucial and integral to the financial universe and are the major drivers in that universe and in some cases, the world at large. Your only choice is to become conversant in these markets—whether you are to be a finance professional or simply a sophisticated individual investor.

## NEW IN THE NINTH EDITION

The following is a guide to changes in the ninth Edition. This is not an exhaustive road map, but instead is meant to provide an overview of substantial additions and changes to coverage from the last edition of the text.

### Chapter 1 The Investment Environment

This chapter has been revised extensively to include a comprehensive section on the financial crisis of 2008 and its causes. Background includes a timeline, and the chapter addresses the now-prevalent idea of systemic risk.

### Chapter 2 Asset Classes and Financial Instruments

Following the financial crisis, the need to shed a bit more light on certain classes of financial instruments became apparent. This chapter does so by including new boxes and other material on the strategies and failures of Fannie Mae and Freddie Mac.

### Chapter 3 How Securities Are Traded

We cover the new restrictions on short selling in the wake of the 2008 crash, and their implications for the markets.

### Chapter 5 Introduction to Risk, Return, and the Historical Record

Discussion of the historical record on risk and return has been thoroughly revised, with considerable new material on tail risk and extreme events.

### Chapter 7 Optimal Risky Portfolios

We added a section on stock risk in the long run and the fallacy of "time diversification."

### Chapter 9 The Capital Asset Pricing Model

We incorporated an expanded treatment of liquidity risk and risk premia.

### Chapter 11 The Efficient Market Hypothesis

This chapter has been expanded to include more complete coverage of possible security price bubbles in the wake of the 2008 crisis.

### Chapter 13 Empirical Evidence on Security Returns

We revised and updated the discussion of the role of liquidity risk in asset pricing, consistent with recent empirical evidence.

### Chapter 14 Bond Prices and Yields

We added a section that discusses credit risk, focusing on credit default swaps and their role in the 2008 crisis.

### Chapter 17 Macroeconomic and Industry Analysis

This chapter incorporates a new look at macro policy following the 2008 crisis, including global stock market dispersion and monetary versus fiscal policy.

### Chapter 19 Financial Statement Analysis

We look closely at the mark-to-market accounting and the new FASB guideline controversy in the context of the crisis.

### Chapter 20 Options Markets

While much about this chapter remains constant, we included a much-needed new box on the role of derivatives in risk management.

### Chapter 25 International Diversification

This chapter underwent a significant revision with fully updated results on the efficacy of international diversification. It also includes an extensive discussion of an international CAPM. Only six pages in the entire chapter escaped any significant changes.

### Chapter 26 Hedge Funds

We have incorporated new treatments of style analysis and liquidity involving hedge fund returns. We also introduced the Madoff scandal and the role that hedge funds played in the situation.

### Chapter 28 Investment Policy and the Framework of the CFA Institute

In this chapter, we update our discussion of investment policy statements, with many examples derived from the suggestions of the CFA Institute.

## ORGANIZATION AND CONTENT

The text is composed of seven sections that are fairly independent and may be studied in a variety of sequences. Because there is enough material in the book for a two-semester course, clearly a one-semester course will require the instructor to decide which parts to include.

**Part One** is introductory and contains important institutional material focusing on the financial environment. We discuss the major players in the financial markets, provide an overview of the types of securities traded in those markets, and explain how and where securities are traded. We also discuss in depth mutual funds and other investment companies, which have become an increasingly important means of investing for individual investors. Perhaps most important, we address how financial markets can influence all aspects of the global economy, as in 2008.

The material presented in Part One should make it possible for instructors to assign term projects early in the course. These projects might require the student to analyze in detail a particular group of securities. Many instructors like to involve their students in some sort of investment game, and the material in these chapters will facilitate this process.

**Parts Two and Three** contain the core of modern portfolio theory. Chapter 5 is a general discussion of risk and return, making the general point that historical returns on broad asset classes are consistent with a risk–return trade-off, and examining the distribution of stock returns. We focus more closely in Chapter 6 on how to describe investors' risk preferences and how they bear on asset allocation. In the next two chapters, we turn to portfolio optimization (Chapter 7) and its implementation using index models (Chapter 8).

After our treatment of modern portfolio theory in Part Two, we investigate in Part Three the implications of that theory for the equilibrium structure of expected rates of return on risky assets. Chapter 9 treats the capital asset pricing model and Chapter 10 covers multifactor descriptions of risk and the arbitrage pricing theory. Chapter 11 covers the efficient market hypothesis, including its rationale as well as evidence that supports the hypothesis and challenges it. Chapter 12 is devoted to the behavioral critique of market rationality. Finally, we conclude Part Three with Chapter 13 on empirical evidence on security pricing. This chapter contains evidence concerning the risk–return relationship, as well as liquidity effects on asset pricing.

**Part Four** is the first of three parts on security valuation. This part treats fixed-income securities—bond pricing (Chapter 14), term structure relationships (Chapter 15), and interest-rate risk management (Chapter 16). **Parts Five and Six** deal with equity securities and derivative securities. For a course emphasizing security analysis and excluding portfolio theory, one may proceed directly from Part One to Part Four with no loss in continuity.

Finally, **Part Seven** considers several topics important for portfolio managers, including performance evaluation, international diversification, active management, and practical issues in the process of portfolio management. This part also contains a chapter on hedge funds.