## Contents

**PART I  THE THEORY OF FINANCE**  

<table>
<thead>
<tr>
<th>1 Introduction: Capital Markets, Consumption, and Investment</th>
<th>3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Introduction 3</td>
<td>Transactions Costs and the Breakdown of Separation 14</td>
</tr>
<tr>
<td>Consumption and Investment without Capital Markets 4</td>
<td>Summary 15</td>
</tr>
<tr>
<td>Consumption and Investment with Capital Markets 9</td>
<td>Problem Set 15</td>
</tr>
<tr>
<td>Marketplaces and Transactions Costs 13</td>
<td>References 16</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>2 Investment Decisions: The Certainty Case</th>
<th>17</th>
</tr>
</thead>
<tbody>
<tr>
<td>Introduction 17</td>
<td>Cash Flows for Capital Budgeting Purposes 36</td>
</tr>
<tr>
<td>Fisher Separation 18</td>
<td>Summary and Conclusion 41</td>
</tr>
<tr>
<td>The Agency Problem 20</td>
<td>Problem Set 41</td>
</tr>
<tr>
<td>Maximization of Shareholders’ Wealth 20</td>
<td>References 44</td>
</tr>
<tr>
<td>Techniques for Capital Budgeting 25</td>
<td></td>
</tr>
<tr>
<td>Comparison of Net Present Value with Internal Rate of Return 31</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>3 More Advanced Capital Budgeting Topics</th>
<th>46</th>
</tr>
</thead>
<tbody>
<tr>
<td>Introduction 46</td>
<td>The Term Structure of Interest Rates 65</td>
</tr>
<tr>
<td>Capital Budgeting Techniques in Practice 47</td>
<td>Summary and Conclusions 71</td>
</tr>
<tr>
<td>Projects with Different Lives 49</td>
<td>Problem Set 72</td>
</tr>
<tr>
<td>Constrained Capital Budgeting Problems 55</td>
<td>References 74</td>
</tr>
<tr>
<td>Capital Budgeting Procedures under Inflation 61</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>4 The Theory of Choice: Utility Theory Given Uncertainty</th>
<th>77</th>
</tr>
</thead>
<tbody>
<tr>
<td>Five Axioms of Choice under Uncertainty 79</td>
<td>Comparison of Risk Aversion in the Small and in the Large 90</td>
</tr>
<tr>
<td>Developing Utility Functions 80</td>
<td>Stochastic Dominance 92</td>
</tr>
<tr>
<td>Establishing a Definition of Risk Aversion 85</td>
<td>Using Mean and Variance as Choice Criteria 96</td>
</tr>
</tbody>
</table>
5 State-Preference Theory

Uncertainty and Alternative Future States 110
Definition of Pure Securities 111
Complete Capital Market 111
Derivation of Pure Security Prices 113
No Arbitrage Profit Condition 115
Economic Determinants of Security Prices 116
Optimal Portfolio Decisions 119
Portfolio Optimality Conditions and Portfolio Separation 122
Firm Valuation, the Fisher Separation Principle, and Optimal Investment Decisions 124

6 Objects of Choice: Mean-Variance Uncertainty

Measuring Risk and Return for a Single Asset 146
Measuring Portfolio Risk and Return 153
Optimal Portfolio Choice: The Efficient Set with Two Risky Assets (and No Risk-Free Asset) 166
The Efficient Set with One Risky and One Risk-Free Asset 171

7 Market Equilibrium: CAPM and APT

Introduction 193
The Efficiency of the Market Portfolio 194
Derivation of the CAPM 195
Properties of the CAPM 198
Use of the CAPM for Valuation: Single-Period Models, Uncertainty 202
Applications of the CAPM for Corporate Policy 204
Extensions of the CAPM 205

8 Pricing Contingent Claims: Option Pricing Theory and Evidence

Introduction 240
A Description of the Factors That Affect Prices of European Options 241

Appendix A to Chapter 5: Forming a Portfolio of Pure Securities 133
Appendix B to Chapter 5: Use of Prices for State-Contingent Claims in Capital Budgeting 135
Appendix C to Chapter 5: Application of the SPM in Capital Structure Decisions 140
Put-Call Parity 249
Some Dominance Theorems That Bound the Value of a Call Option 251
Derivation of the Option Pricing Formula—The Binomial Approach 256
Valuation of an American Call with No Dividend Payments 269
Pricing American Put Options 277
Extensions of the Option Pricing Model 280

9 Futures Contracts and Markets 300
Introduction 300
General Characteristics of Futures Contracts 300
The Theory of Futures Markets and Futures Contract Pricing 308
Empirical Evidence 319

10 Efficient Capital Markets: Theory 330
Defining Capital Market Efficiency 330
A Formal Definition of the Value of Information 332
The Relationship between the Value of Information and Efficient Capital Markets 338
Rational Expectations and Market Efficiency 339
Market Efficiency with Costly Information 343

PART II CORPORATE POLICY: THEORY, EVIDENCE, AND APPLICATIONS 357

11 Efficient Capital Markets: Evidence 361
Empirical Models Used for Residual Analysis 361
Accounting Information 362
Block Trades 370
Insider Trading 376
New Issues 377

Empirical Evidence on the Option Pricing Model 283
Summary 289
Problem Set 290
References 292
Appendix to Chapter 8: Derivation of the Black-Scholes Option Pricing Model 296

Synthetic Futures and Options on Futures 322
Summary 325
Problem Set 325
References 326

Statistical Tests Unadjusted for Risk 346
The Joint Hypothesis of Market Efficiency and the CAPM 350
Summary 352
Problem Set 353
References 355

Stock Splits 380
Performance of Managed Portfolios 383
Weekend and Year-End Effects 390
Summary 392
Problem Set 393
References 395
12 Capital Budgeting under Uncertainty: The Multiperiod Case

Introduction 401
Multiperiod Capital Budgeting with “Imperfect” Markets for Physical Capital 402
An Examination of Admissible Uncertainty in a Multiperiod Capital Asset Pricing World 406

Using the Arbitrage Pricing Theory for Multiperiod Capital Budgeting 411
Comparing Risky Cost Structures 414
Abandonment Value 419
Summary 430
Problem Set 431
References 435

13 Capital Structure and the Cost of Capital: Theory

The Value of the Firm Given Corporate Taxes Only 439
The Value of the Firm in a World with Both Personal and Corporate Taxes 451
Introducing Risk—A Synthesis of M-M and CAPM 455
The Cost of Capital with Risky Debt 462
The Maturity Structure of Debt 471
The Effect of Other Financial Instruments on the Cost of Capital 472

Summary 481
Problem Set 481
References 485
Appendix to Chapter 13: Duration and Optimal Maturity Structure of the Balance Sheet 489
Duration 489
Immunization 492
Application of Duration to Debt Maturity Structure 494
References to Appendix 495

14 Capital Structure: Empirical Evidence and Applications

Introduction 497
Possible Reasons for an “Optimal” Mix of Debt and Equity 498
Empirical Evidence on Capital Structure 516

Cost of Capital: Applications 523
Summary 536
Problem Set 536
References 539

15 Dividend Policy: Theory

The Irrelevance of Dividend Policy in a World without Taxes 545
Valuation, Growth, and Dividend Policy 548
Dividend Policy in a World with Personal and Corporate Taxes 556

Toward a Theory of Optimal Dividend Policy 561
Other Dividend Policy Issues 569
Summary 571
Problem Set 572
References 573

16 Dividend Policy: Empirical Evidence and Applications

Behavioral Models of Dividend Policy 577
Clientele Effects and Ex Date Effects 578
Dividend Announcement Effects on the Value of the Firm: The Signaling Hypothesis 584
The Relationship between Dividends and Value 588

Corporate Equity Repurchases via Tender Offer 596
Overview of Empirical Evidence 600
Valuation and Corporate Policy 601
Problem Set 608
References 609
### Appendix A  Discounting

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Introduction</td>
<td>841</td>
</tr>
<tr>
<td>The Time Value of Money: Discrete Compounding</td>
<td>841</td>
</tr>
<tr>
<td>The Time Value of Money: Continuous Compounding</td>
<td>851</td>
</tr>
<tr>
<td>Summary</td>
<td>854</td>
</tr>
</tbody>
</table>

### Appendix B  Matrix Algebra

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Matrices and Vectors</td>
<td>861</td>
</tr>
<tr>
<td>The Operations of Matrices</td>
<td>862</td>
</tr>
<tr>
<td>Linear Equations in Matrix Form</td>
<td>864</td>
</tr>
<tr>
<td>Special Matrices</td>
<td>865</td>
</tr>
<tr>
<td>Matrix Inversion Defined</td>
<td>865</td>
</tr>
<tr>
<td>Matrix Transposition</td>
<td>866</td>
</tr>
<tr>
<td>Determinants</td>
<td>866</td>
</tr>
<tr>
<td>The Inverse of a Square Matrix</td>
<td>869</td>
</tr>
<tr>
<td>Solving Linear Equation Systems</td>
<td>870</td>
</tr>
<tr>
<td>Cramer's Rule</td>
<td>870</td>
</tr>
<tr>
<td>Applications</td>
<td>871</td>
</tr>
</tbody>
</table>

### Appendix C  An Introduction to Multiple Regression

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ordinary Least Squares Linear Estimation</td>
<td>877</td>
</tr>
<tr>
<td>Simple Hypothesis Testing of the Linear Regression Estimates</td>
<td>881</td>
</tr>
<tr>
<td>Bias and Efficiency</td>
<td>886</td>
</tr>
<tr>
<td>Summary</td>
<td>892</td>
</tr>
<tr>
<td>References</td>
<td>893</td>
</tr>
</tbody>
</table>

### Appendix D  Calculus and Optimization

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Functions</td>
<td>894</td>
</tr>
<tr>
<td>Differential Calculus</td>
<td>901</td>
</tr>
<tr>
<td>Optimization</td>
<td>911</td>
</tr>
<tr>
<td>Taylor and MacLaurin Series</td>
<td>916</td>
</tr>
<tr>
<td>Integral Calculus</td>
<td>921</td>
</tr>
<tr>
<td>Reference</td>
<td>925</td>
</tr>
</tbody>
</table>

### Author Index

<table>
<thead>
<tr>
<th>Index</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>927</td>
</tr>
</tbody>
</table>

### Subject Index

<table>
<thead>
<tr>
<th>Index</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>933</td>
</tr>
</tbody>
</table>