

University of Melbourne

FNCE 10002

**PRINCIPLES OF
FINANCE**

LECTURE NOTES

TABLE OF CONTENTS

Topic 1: Financial Mathematics

1.1 Principles of Finance Pages 1 - 5

- 1.11 Overview of corporate finance
- 1.12 Capital market efficiency
- 1.13 Time value of money (valuation principle, risk free interest rates)
- 1.14 Riskless arbitrage
- 1.15 Law of One Price

1.2 Cash Flows Pages 5 - 14

- 1.21 Simple interest
- 1.22 Compound interest
- 1.23 Valuing a series of cash flows (value additivity principle)
- 1.24 Brief overview of net present value
- 1.25 Types of firms (sole proprietorship, partnership, corporation, LLC)
- 1.26 Perpetuities (ordinary, deferred and growing perpetuity)
- 1.27 Annuities (ordinary, annuity due, growing annuity)
- 1.28 Loan payments and amortisation (amortisation schedule)
- 1.29 Effective annual interest rates

1.3 Debt Securities Pages 14 - 18

- 1.31 Short and long term debt instruments
- 1.32 Overview of discount securities (yield to maturity, coupon rates)
- 1.33 Coupon paying bonds (ex-coupons, internal rate of return, default risk)
- 1.34 Bonds (par, premium and discount bonds)
- 1.35 Price sensitivity to interest rate changes

1.4 Ordinary Shares Pages 18 - 24

- 1.41 Overview of primary and secondary markets
- 1.42 Pricing ordinary shares (share price and return on equity)
- 1.43 Constant dividend growth model (retention rate)
- 1.44 Variable dividend growth model
- 1.45 Pricing of preference shares
- 1.46 P/E ratio (present value of growth opportunities)

Topic 2: Modern Portfolio Theory & Asset Pricing

2.1 Modern Portfolio Theory Pages 25 - 34

- 2.11 Risk and return of financial securities (geometric average return)
- 2.12 Variance and standard deviation of returns
- 2.13 Probability distribution (calculating expected return and variance)
- 2.14 Portfolio risk and return (risk averse investors, covariance, correlation)
- 2.15 Minimum variance portfolio
- 2.16 Portfolio leveraging
- 2.17 Short selling
- 2.18 Limits to diversification benefits

2.2 Capital Asset Pricing Model

Pages 34 - 39

- 2.21 CAPM and systematic risk
- 2.22 Efficient frontier and market portfolio
- 2.23 Capital market line (CML)
- 2.24 Security market line and measuring beta
- 2.25 Estimating and interpreting betas (market model, market risk premium)
- 2.26 Application of CAPM (Sharpe ratio, Treynor ratio, Jensen's alpha)
- 2.27 Photorespiration (C4 photosynthesis and Kranz anatomy)
- 2.28 Security selection

Topic 3: Capital Budgeting and Capital Structure

3.1 Capital Budgeting Process

Pages 39 - 46

- 3.11 Net present value method (incremental cash flows)
- 3.12 Internal rate of return
- 3.13 Problems with the IRR method
- 3.14 Comparison of independent and mutually exclusive projects
- 3.15 Analysing projects with resource constraints (caveats, profitability index)
- 3.16 Calculating the payback period

3.2 Issues in Cash Flow Estimation

Pages 47 - 53

- 3.21 Issues in cash flow estimation (sunk costs, net working capital)
- 3.22 Tax effects (depreciation tax shield, corporate taxes)
- 3.23 Breakeven and sensitivity analysis
- 3.24 Inflation (Fisher relationship)
- 3.25 Constant chain of replacement assumption
- 3.26 Weighted average cost of capital (WACC)

3.3 Capital Structure

Pages 54 - 61

- 3.31 Modigliani and Miller Analysis propositions
- 3.32 Overview of financial leverage (homemade leverage)
- 3.33 Significance of interest tax shield
- 3.34 Miller and Modigliani with taxes in the real world
- 3.35 Financial distress (bankruptcy)
- 3.36 Optimal capital structure

3.4 Payout Policies

Pages 61 - 66

- 3.41 Summary of payout policies
- 3.42 Dividend irrelevance theory
- 3.43 Dividend policy in classical tax system (imputation tax system)
- 3.44 Overview of dividend signalling hypothesis

Topic 4: Introduction to Options

4.1 Derivative Markets

Pages 66 - 74

- 4.11 Overview of derivative contracts (forward, futures and swap contracts)
- 4.12 Introduction to option markets (option contracts)
- 4.13 Comparison of call and put options
- 4.14 Option trading strategies
- 4.15 Hedging with call and put options
- 4.16 Put-call parity and synthetic positions
- 4.17 Factors affecting option prices

Probability Distribution Approach

- One assumes that investors can specify the possible outcomes (C_1 through C_n) and associate probabilities or likelihoods (p_1 through p_n) with these outcomes).
- For each state, convert the cash flows into rate of returns using the initial investment of C .

<i>State</i>	<i>Probability</i>	<i>Cash Flows</i>	<i>Rate of Return</i>
1	p_1	C_1	$R_1 = (C_1 - C)/C$
2	p_2	C_2	$R_2 = (C_2 - C)/C$
3	p_3	C_3	$R_3 = (C_3 - C)/C$
:	:	:	:
n	p_n	C_n	$R_n = (C_n - C)/C$

- Note that $p_1 + p_2 + \dots + p_n = 1$ because one of these states of the world will actually occur.
- The **EXPECTED RETURN** is the expected outcome measured as the weighted average of the individual outcomes, given by:

$$E(r) = p_1R_1 + p_2R_2 + \dots + p_nR_n$$

- The **VARIANCE** or **STANDARD DEVIATION** of returns is the measure of dispersion around the expected return.
- The greater the dispersion, the higher the uncertainty and risk, given by:

$$\text{Var}(r) \text{ or } \sigma^2 = p_1[R_1 - E(r)]^2 + p_2[R_2 - E(r)]^2 + \dots + p_n[R_n - E(r)]^2$$

$$\text{SD}(r) = \sigma$$

- Note that the variance and standard deviation take into account returns above and below the expected return.
- Investors are typically concerned with returns below the expected return (that is, **DOWNSIDE RISK**).

Example: The current price of Stock X is \$10 and market analysts expect the following three states to occur one year from now. What is the expected return and standard deviation of return for this investment?

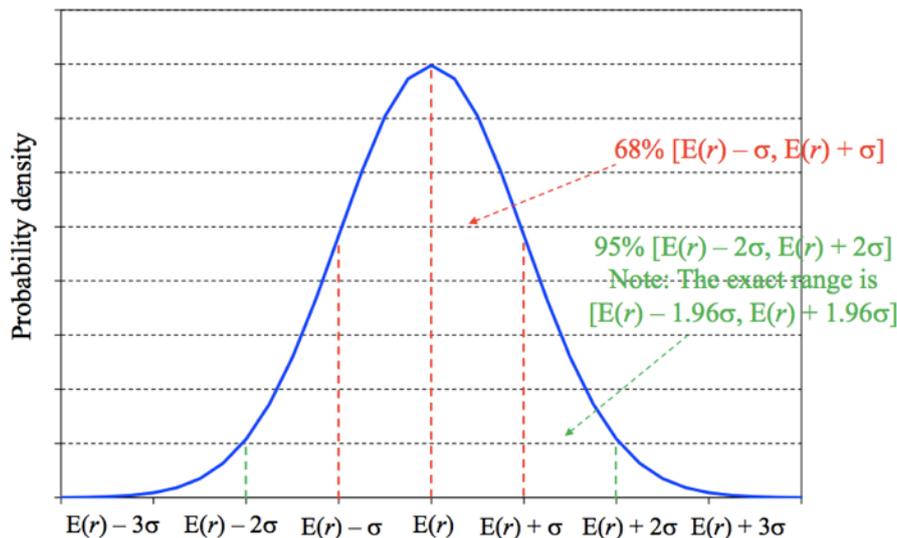
<i>State of the Market</i>	<i>Probability</i>	<i>Dividend</i>	<i>Price</i>
Sucks	0.3	\$0.50	\$8.50
Good	0.4	\$1.00	\$10.00
Awesome	0.3	\$1.50	\$10.50

- ❖ We first convert the cash flows into rates of return for each state
- ❖ The return distribution for Stock X is as follows

<i>State</i>	<i>Probability</i>	<i>Rate of Return, R</i>
Sucks	0.3	$(0.50 + 8.50 - 10.00)/10.00 = -10.0\%$
Good	0.4	$(1.00 + 10.00 - 10.00)/10.00 = 10.0\%$
Awesome	0.3	$(1.50 + 10.50 - 10.00)/10.00 = 20.0\%$

- ❖ $E(r) = 0.3(-0.1) + 0.4(0.1) + 0.3(0.2) = 7.0\%$
- ❖ $\text{Var}(r) = 0.3(-0.1 - 0.07)^2 + 0.4(0.1 - 0.07)^2 + 0.3(0.2 - 0.07)^2$
- ❖ $\text{Var}(r) = 0.0141$
- ❖ $\text{SD}(r) = (0.0141)^{1/2} = 0.1187$ or 11.9%

- A more general interpretation of the expected return and standard deviation of return requires assuming returns are continuous and normally distributed.
- Properties of a **NORMAL DISTRIBUTION** include:
 1. It is a bell-shaped distribution and requires only the expected (or mean) return and standard deviation of return to fully describe it.
 2. It is symmetric around its mean.
 3. It implies an unlimited downside loss potential.



- ❖ In the previous example for stock X, $E(r) = 7\%$ and $\sigma = 11.9\%$
- ❖ Assume you purchased 100 shares of Stock X, investing \$1,000
- ❖ The expected value of your investment next period is...
 - ❖ $1000[1 + E(r)] = 1000(1.07) = \$1,070$
- ❖ There is a 95% probability that the *realized* return will lie in the range $[E(r) - 2\sigma, E(r) + 2\sigma]$ or $(-16.8\%, 30.8\%)$
- ❖ So, there is a 95% probability that a \$1,000 investment in this security will be worth between $1000(1 - 0.168) = \$832$ and $1000(1 + 0.308) = \$1,308$ next period

Portfolio Risk and Return

- Investors are assumed to be risk averse; hence, the higher the variance or standard deviation of returns the worse off the investor.
- A **RISK AVERSE** investor's objective is to minimise the risk of portfolio of investments, given a desired level of expected return or to maximise the expected return of portfolio of investments, given a desired level of risk.
- The simplest way to minimise risk is to diversify across different securities by forming a portfolio of securities.
- Portfolio risk falls as the number of securities in the portfolio increases, but portfolio risk cannot be entirely eliminated using this method.
- The risk that cannot be eliminated is called **SYSTEMATIC RISK**.
- A portfolio's **EXPECTED RETURN** is the weighted average of the expected returns of its component securities.
- Note that the weights are percentages of the investor's original wealth invested in each security.
- It is assumed that all the available funds are invested in the two securities. given by:

$$E(r_p) = x_1E(r_1) + x_2E(r_2)$$

- ❖ x_j = Amount invested in security j / Total amount invested

- ❖ *Note:* $x_1 + x_2 = 1$ and $x_1 = 1 - x_2$ (or $x_2 = 1 - x_1$)

- A portfolio's **VARIANCE** is the weighed average of the variance of its component securities and the covariance between the securities' returns.

$$\text{Var}(r_p) \text{ or } \sigma_p^2 = x_1^2 \sigma_1^2 + x_2^2 \sigma_2^2 + 2x_1x_2\sigma_{12}$$

❖ σ_{12} or $\text{Cov}(r_1, r_2)$ = Covariance between securities 1 and 2

- The standard deviation of the portfolio is hence:

$$\text{SD}(r_p) \text{ or } \sigma_p = [x_1^2 \sigma_1^2 + x_2^2 \sigma_2^2 + 2x_1x_2\sigma_{12}]^{1/2}$$

- The **COVARIANCE OF RETURNS** measures the level of complement between security returns.

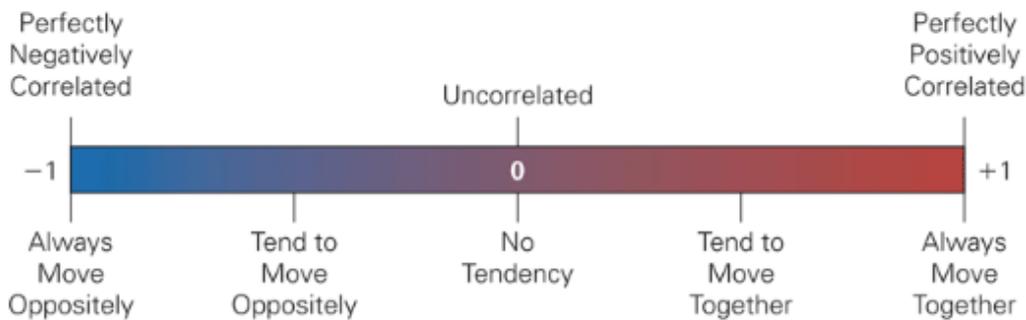
$$\sigma_{12} = p_1[r_{11} - E(r_1)][r_{21} - E(r_2)] + \dots + p_n[r_{1n} - E(r_1)][r_{2n} - E(r_2)]$$

r_{jk} = Return on security $j = 1, 2$ in state $k = 1, 2, \dots, n$

- If $\sigma > 0$, then above (below) average returns on security 1 tend to coincidence with above (below) average returns on security 2.
- If $\sigma < 0$ then above (below) average returns on security 1 tend to coincide with below (above) average returns on security 2.
- If $\sigma = 0$ then security 1's return tends to move independently of security 2's return.
- Note that the magnitude of covariance changes depending on how returns are measured - percentages versus decimals.
- The **CORRELATION OF RETURNS** is a standardised measure of co-movement between two securities, given by:

$$\rho_{12} = \sigma_{12} / \sigma_1 \sigma_2$$

- Note that the sign of the return correlation is the same as the sign of the return covariance and that its value is between -1 and 1.



- The covariance of returns can be rewritten as: $\sigma_{12} = \sigma_1 \sigma_2 \rho_{12}$

