Global Investments

Bruno Solnik
HEC PARIS
HONG KONG UNIVERSITY OF SCIENCE & TECHNOLOGY

<&

Dennis McLeave
CFA INSTITUTE
UNIVERSITY OF VIRGINIA
EMERITUS. UNIVERSITY OF RHODE ISLAND
Contents

Preface xix

Chapter 1 Currency Exchange Rates 1
Learning Outcomes 1
Currency Exchange Rate Quotations 3
**Direct and Indirect Quotations 4**
Cross-Rate Calculations 5
Forex Market and Quotation Conventions 6
Bid-Ask (Offer) Quotes and Spreads 8
Cross-Rate Calculations with Bid-Ask Spreads 10
No-Arbitrage Conditions with Exchange Rates 12
Forward Quotes 14
 Interest Rate Parity: The Forward Discount and the Interest Rate Differential 15
Forward Exchange Rate Calculations with Bid-Ask Spreads 20
Summary 22
Problems 25

Chapter 2 Foreign Exchange Parity Relations
Learning Outcomes 27
Foreign Exchange Fundamentals 28
 Supply and Demand for Foreign Exchange 28
Balance of Payments 30
Current Account Deficits and Financial Account Surpluses 31
Factors Affecting the Financial Account 33
Government Policies: Monetary and Fiscal 35
Exchange Rate Regimes 36
International Parity Relations 38
 Some Definitions 39
Interest Rate Parity 40
Purchasing Power Parity: The Exchange Rate and the Inflation Differential 40
International Fisher Relation: The Interest Rate and Expected Inflation Rate Differentials 42
Chapter 3 Foreign Exchange Determination and Forecasting 75

Learning Outcomes 75
International Monetary Arrangements 76
A Historical Perspective 76
The Empirical Evidence 83
Interest Rate Parity 83
International Fisher Relation 84
Purchasing Power Parity 85
Foreign Exchange Expectations 88
Practical Implications 90
Exchange Rate Forecasting 91
Is the Market Efficient and Rational? 92
The Econometric Approach 94
Technical Analysis 95
Central Bank Intervention 97
The Use and Performance of Forecasts 99
Summary 102
Problems 103
Bibliography 106

Chapter 3 Appendix: Statistical Supplements on Forecasting Asset Returns
Some Notations 109
Traditional Statistical Models with Constant Moments 110
Traditional Statistical Models with Time-Varying Moments 111
Nontraditional Models 113
Data Mining, Data Snooping and Model Mining 115
Chapter 6  Equity: Concepts and Techniques  203

Learning Outcomes  203  
Approaching International Analysis  204  
  The Information Problem  205  
  A Vision of the World  206  
Differences in National Accounting Standards  207  
  Historical Setting  208  
  International Harmonization of Accounting Practices  209  
  Differences in Global Standards  212  
  The Effects of Accounting Principles on Earnings and Stock Prices  215  
Global Industry Analysis  217  
  Country Analysis  217  
  Industry Analysis: Return Expectation Elements  222  
  Industry Analysis: Risk Elements  227  
Equity Analysis  232  
Global Risk Factors in Security Returns  242  
  Risk-Factor Model: Industry and Country Factors  246  
  Other Risk Factors: Styles  247  
  Other Risk Factors: Macroeconomic  247  
  Practical Use of Factor Models  249  
Summary  251  
Problems  252  
Bibliography  257  

Chapter 7  Global Bond Investing  256  

Learning Outcomes  256  
The Global Bond Market  260  
  The Various Segments  260  
  World Market Size  262  
  Bond Indexes  263  
  The International Bond Market  264  
  Emerging Markets and Brady Bonds  269  
Major Differences Among Bond Markets  271  
  Types of Investments  271  
  Quotations, Day Count, and Frequency of Coupons  272  
  Legal and Fiscal Aspects  274  
A Refresher on Bond Valuation  276  
  Zero-Coupon Bonds  276  
  Bond with Coupons  278
Contents

Duration and Interest Rate Sensitivity 280
Credit Spreads 282
Multicurrency Approach 284
  International Yield Curve Comparisons 284
  The Return and Risk on Foreign Bond Investments 287
  Currency-Hedging Strategies 288
  International Portfolio Strategies 289
Floating-Rate Notes and Structured Notes 293
  Floating-Rates Notes (FRNs) 294
  BuUFRNs 300
  Bear FRNs 302
  Dual-Currency Bonds 302
  Currency-Option Bonds 306
  Collateralized Debt Obligations (CDOs) 307
Summary 310
Problems 312
Bibliography 316

Chapter 8 Alternative Investments 317

Learning Outcomes 317
Investment Companies 319
  Valuing Investment Company Shares 320
  Fund Management Fees 320
  Investment Strategies 320
  Exchange Traded Funds 323
Real Estate 332
  Forms of Real Estate Investment 333
  Valuation Approaches 334
  Real Estate in a Portfolio Context 342
Private Equity 344
  Stages of Venture Capital Investing 346
  Investment Characteristics 347
  Types of Liquidation/Divestment 348
  Valuation and Performance Measurement 349
Hedge Funds and Absolute Return Strategies 351
  Definition of Hedge Funds 351
  Classification 354
  Funds of Funds 357
  Leverage and Unique Risks of Hedge Funds 359
  Hedge Funds Universe and Indexes 360
  The Case for Investing in Hedge Funds 363
Closely Held Companies and Inactively Traded Securities 366
  Legal Environment 366
Valuation Alternatives 367
Bases for Discounts/Premiums 367
Chapter 9  The Case for International Diversification  385

Learning Outcomes  385
The Traditional Case for International Diversification  588  
  Risk Reduction through Attractive Correlations  388 
  Portfolio Return Performance  398 
  Currency Risk Not a Barrier to International Investment  406 
The Case against International Diversification  407  
  Increase in Correlations  407  
  Past Performance Is a Good Indicator of Future Performance  411 
  Barriers to International Investments  411 
The Case for International Diversification Revisited  415  
  Pitfalls in Estimating Correlation During Volatile Periods  415 
  Expanded Investment Universe and Performance Opportunities  417 
  Global Investing Rather Than International Diversification  418 
The Case for Emerging Markets  421  
  The Basic Case  421 
  Volatility, Correlations, and Currency Risk  422 
  Portfolio Return Performance  423 
  Instability of Emerging Markets  424 
  Segmentation versus Integration Issue  425 
Summary  425 
Problems  427 
Bibliography  430

Chapter 10  Derivatives: Risk Management with Speculation, Hedging, and Risk Transfer  433

Learning Outcomes  433 
Forward and Futures  434
Chapter 11  Currency Risk Management  485

Learning Outcomes  485

Hedging with Futures or Forward Currency Contracts  486

The Basic Approach: Hedging the Principal  487
Minimum-Variance Hedge Ratio  490
The Influence of the Basis  494
Implementing Hedging Strategies  496
Hedging Multiple Currencies  497

Insuring and Hedging with Options  499

Insuring with Options  499
Dynamic Hedging with Options  500
Implementation  504

Other Methods for Managing Currency Exposure  505

Strategic and Tactical Currency Management  509
Strategic Hedge Ratio  509
Currency Overlay  512
Currencies as an Asset Class  514

Summary  515

Problems  516

Bibliography  521

Chapter 12  Global Performance Evaluation

Learning Outcomes  523

The Basics  524
Principles and Objectives  524
Calculating a Rate of Return  527
Chapter 13  Structuring the Global Investment Process  581

Learning Outcomes  581
A Tour of the Global Investment Industry  582
   Investors  582
   Investment Managers  584
   Brokers  585
   Consultants and Advisers  585
   Custodians  587
Global Investment Philosophies  587
   The Passive Approach  587
   The Active Approach  589
   Balanced or Specialized  590
   Industry or Country Approach  591
   Top-Down or Bottom-Up  591
   Style Management  592
   Currency  593
   Quantitative or Subjective  594
The Investment Policy Statement  595
Capital Market Expectations  600
   Defining Asset Classes  603
   Long-Term Capital Market Expectations: Historical Returns  603
   Long-Term Capital Market Expectations: Forward-Looking Returns  605
   Short-Term Capital Market Expectations  608
<table>
<thead>
<tr>
<th>Contents</th>
</tr>
</thead>
<tbody>
<tr>
<td>Global Asset Allocation: From Strategic to Tactical 610</td>
</tr>
<tr>
<td>Strategic Asset Allocation 610</td>
</tr>
<tr>
<td>Tactical Asset Allocation 614</td>
</tr>
<tr>
<td>Global Asset Allocation: Structuring and Quantifying the Process 615</td>
</tr>
<tr>
<td>Research and Market Analysis 617</td>
</tr>
<tr>
<td>Asset Allocation Optimization 619</td>
</tr>
<tr>
<td>Portfolio Construction 620</td>
</tr>
<tr>
<td>Performance and Risk Control 620</td>
</tr>
<tr>
<td>Summary 624</td>
</tr>
<tr>
<td>Problems 625</td>
</tr>
<tr>
<td>Bibliography 627</td>
</tr>
</tbody>
</table>

| Glossary 629 |
| Index 643 |
Global Investment Holdings became the leading independent brokerage and investment banking firm in Turkey soon after its establishment in 1990. The Company has played a vital role in the development of Turkish capital markets by paving the way for many of the country’s leading businesses to meet international businesses for the first time. The Company transformed into an investment portfolio company in late 2004 drawing on its appetite for growing investments and its extensive investment banking experience.
Global Investments Group was founded in 2009 by the Chairman and Chief Executive Officer to engage in the significant expansion of Solar Panels in the United Arab Emirates. Global Investments Group offer their services to residential and commercial clients. Therefore, it is our aim to offer and provide you with the most practical and cost effective services using high quality materials as we install on-grid and off-grid roof top systems.