

# Global Investments

i\*\*  
! )->

**SIXTH EDITION**

**Bruno Solnik**

HEC PARIS

HONG KONG UNIVERSITY OF SCIENCE & TECHNOLOGY

&

**Dennis McLeave<sup>^</sup>**

CFA INSTITUTE

UNIVERSITY OF VIRGINIA

EMERITUS. UNIVERSITY OF RHODE ISLAND

Boston San Francisco New York;  
London Toronto Sydney Tokyo Singapore Madrid  
Mexico City Munich Paris Cape Town Hong Kong Montreal

# ^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

<i>Undcovered Interest Rate Parity</i>	44
<i>Foreign Exchange Expectations: The Forward Premium (Discount) and the Expected Exchange Rate Movement</i>	46
<i>Combining the Relations</i>	48
<i>International Parity Relations and Global Asset Management</i>	48
Exchange Rate Determination	50
<i>Purchasing Power Parity Revisited</i>	51
<i>Fundamental Value Based on Absolute PPP</i>	51
<i>Fundamental Value Based on Relative PPP</i>	54
<i>The Balance of Payments Approach</i>	56
<i>The Asset Market Approach</i>	61
Summary	68
Problems	70
Bibliography	74

1

## **Chapter 3 Foreign Exchange Determination and Forecasting 75**

Learning Outcomes	75
International Monetary Arrangements	76
<i>A Historical Perspective</i>	76
The Empirical Evidence	83
<i>Interest Rate Parity</i>	83
<i>International Fisher Relation</i>	84
<i>Purchasing Power Parity</i>	85
<i>Foreign Exchange Expectations</i>	88
<i>Practical Implications</i>	90
Exchange Rate Forecasting	91
<i>Is the Market Efficient and Rational?</i>	92
<i>The Econometric Approach</i>	94
<i>Technical Analysis</i>	95
<i>Central Bank Intervention</i>	97
<i>The Use and Performance of Forecasts</i>	99
Summary	102
Problems	103
Bibliography	106
Chapter 3 Appendix: Statistical Supplements on Forecasting Asset Returns	
<i>Some Notations</i>	109
<i>Traditional Statistical Models with Constant Moments</i>	110
<i>Traditional Statistical Models with Time-Varying Moments</i>	111
<i>Nontraditional Models</i>	113
<i>Data Mining, Data Snooping and Model Mining</i>	115

v

## Chapter 4 International Asset Pricing 117

Learning Outcomes	117
International Market Efficiency	118
Asset Pricing Theory	121
<i>The Domestic Capital Asset Pricing Model</i>	121
<i>Asset Returns and Exchange Rate Movements</i>	123
<sup>^</sup> <i>The Domestic CAPM Extended to the International Context</i>	125
<i>International CAPM</i>	126
<i>Market Imperfections and Segmentation</i>	135
Practical Implications	136
<i>A Global Approach to Equilibrium Pricing</i>	136
<i>Estimating Currency Exposures</i>	139
<i>Tests of the ICAPM</i>	146
Summary	148
Problems	151
Bibliography	155

## Chapter 5 Equity: Markets and Instruments 157

Learning Outcomes	157
Market Differences: A Historical Perspective	158
<i>Historical Differences in Market Organization</i>	159
<i>Historical Differences in Trading Procedures</i>	159
<i>Automation on the Major Stock Exchanges</i>	161
Some Statistics	167
<i>Market Size</i>	167
<i>Liquidity</i>	170
<i>Concentration</i>	171
Some Practical Aspects	171
<i>Tax Aspects</i>	172
<i>Stock Market Indexes</i>	172
<i>Information</i>	176
Execution Costs	177
<i>Components of Execution Costs</i>	177
<i>Estimation and Uses of Execution Costs</i>	179
<i>Some Approaches to Reducing Execution Costs</i>	182
Investing in Foreign Shares Listed at Home	185
<i>Global Shares and American Depositary Receipts</i>	185
<i>Motivation for Multiple Listing</i>	186
<i>Foreign Listing and ADRs</i>	186
<i>Closed-End Country Funds</i>	189
<i>Open-End Funds</i>	193
<i>Exchange Traded Funds</i>	193

&

Summary 196  
Problems 197  
Bibliography 202

**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

\$

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

## Chapter 8 Alternative Investments 317

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

T

Distressed Securities/Bankruptcies	568
Commodity Markets and Commodity Derivatives	369
<i>Commodity Futures</i>	369
<i>Motivation and Investment Vehicles</i>	370
<i>Active Investment</i>	371
<i>The Example of Gold</i>	372
<i>Commodity-Linked Securities</i>	373
Summary	575
Problems	578
Bibliography	583

## **Chapter 9 The Case for International Diversification 385**

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

<i>The Principles of a Forward, and a Futures Contract</i>	434
<i>The Different Instruments</i>	437
<i>Forward and Futures Valuation</i>	444
<i>Use of Forward and Futures</i>	447
Swaps	453
<i>The Principles of a Swap</i>	453
<i>The Different Instruments</i>	454
<i>Swaps Valuation</i>	456
<i>Use of Swaps</i>	460
Options	464
<i>Introduction to Options</i>	464
<i>The Different Instruments</i>	466
<i>Option Valuation</i>	468
<i>Use of Options</i>	473
Summary	476
Problems	478
Bibliography	483

## **Chapter 11 Currency Risk Management 485**

Learning Outcomes	485
Hedging with Futures or Forward Currency Contracts	486
<i>The Basic Approach: Hedging the Principal</i>	487
<i>Minimum-Variance Hedge Ratio</i>	490
<i>The Influence of the Basis</i>	494
<i>Implementing Hedging Strategies</i>	496
<i>Hedging Multiple Currencies</i>	497
Insuring and Hedging with Options	499
<i>Insuring with Options</i>	499
<i>Dynamic Hedging with Options</i>	500
<i>Implementation</i>	504
Other Methods for Managing Currency Exposure	505
Strategic and Tactical Currency Management	509
<i>Strategic Hedge Ratio</i>	509
<i>Currency Overlay</i>	512
<i>Currencies as an Asset Class</i>	514
Summary	515
Problems	516
Bibliography	521

## **Chapter 12 Global Performance Evaluation**

Learning Outcomes	523
The Basics	524
<i>Principles and Objectives</i>	524
<i>Calculating a Rate of Return</i>	527



Performance Attribution in Global Performance Evaluation	534
<i>The Mathematics of Multicurrency Returns</i>	535
<i>Total-Return Decomposition</i>	537
<i>Performance Attribution</i>	540
<i>More on Currency Management</i>	545
<i>Multiperiod Attribution Analysis</i>	548
<i>An Example of Output</i>	555
Performance Appraisal in Global Performance Evaluation	557
<i>Risk</i>	557
<i>Risk-Adjusted Performance</i>	559
<i>Risk Allocation and Budgeting</i>	562
<i>Some Potential Biases in Return and Risk</i>	563
Implementation of Performance Evaluation	565
<i>More on Global Benchmarks</i>	565
<i>Global Investment Performance Standards and Other Performance</i>	568
<i>Presentation Standards</i>	568
Summary	570
Problems	571
Bibliography	579

## **Chapter 13 Structuring the Global Investment Process 581**

Learning Outcomes	581
A Tour of the Global Investment Industry	582
<i>Investors</i>	582
<i>Investment Managers</i>	584
<i>Brokers</i>	585
<i>Consultants and Advisers</i>	585
<i>Custodians</i>	587
Global Investment Philosophies	587
<i>The Passive Approach</i>	587
<i>The Active Approach</i>	589
<i>Balanced or Specialized</i>	590
<i>Industry or Country Approach</i>	591
<i>Top-Down or Bottom-Up</i>	591
<i>Style Management</i>	592
<i>Currency</i>	593
<i>Quantitative or Subjective</i>	594
The Investment Policy Statement	595
Capital Market Expectations	600
<i>Defining Asset Classes</i>	603
<i>Long-Term Capital Market Expectations: Historical Returns</i>	603
<i>Long-Term Capital Market Expectations: Forward-Looking Returns</i>	605
<i>Short-Term Capital Market Expectations</i>	608

JN

Global Asset Allocation: From Strategic to Tactical	610	
<i>Strategic Asset Allocation</i>	610	
<i>Tactical Asset Allocation</i>	614	
Global Asset Allocation: Structuring and Quantifying the Process	615	
<i>Research and Market Analysis</i>	617	
<i>Asset Allocation Optimization</i>	619	
<i>Portfolio Construction</i>	620	
<i>Performance and Risk Control</i>	620	
Summary	624	^
Problems	625 <sup>n</sup>	
Bibliography	627	
<i>Glossary</i>	629	
<i>Index</i>	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 International Limited are proud to be one of the most reputable and well-established names in the financial services industry, providing Wealth Management services to over 3,000 clients since 1994. With a keen focus on delivering service excellence, we offer financial planning, private banking and investment management solutions to expatriates, high-net-worth individuals, trusts and family offices across the world. Global Investments Incorporated Reedham House 31 King...Â Global Investments Incorporated. Property investment firm in Manchester, United Kingdom. Closed now. CommunitySee all. 18,868 people like this. 18,879 people follow this. 0 check-ins. AboutSee all.