

## Table of Contents

Glossary of Commonly Used Symbols .....	IV
Glossary of Commonly Used Vocabularies .....	VII
1 Investment Analysis under Certainty .....	1
1.1 Arbitrage Theory under Certainty.....	1
1.1.1 Introductory Example.....	1
1.1.2 Arbitrage Theory (under Certainty).....	3
1.1.2.1 Intuition.....	3
1.1.2.2 Definition of No Arbitrage .....	4
1.1.2.3 Consequences Arising from No Arbitrage .....	10
1.1.2.3.1 First Consequence Arising from No Arbitrage: Existence of Steady Asset Prices .....	10
1.1.2.3.2 Second Consequence Arising from No Arbitrage: Asset Prices Coincide with Present Values of Cash Flows.....	11
1.1.2.3.3 Third Consequence Arising from No Arbitrage: Testing Financial Markets with Respect to No Arbitrage.....	13
1.1.2.3.4 Implication of No-Arbitrage: Law of One Price .....	15
1.2 Investment Analysis on Imperfect Markets: Taxes.....	16
1.2.1 Underlying Decision Problem.....	16
1.2.2 Tax Code .....	16
1.2.3 After-Tax Discount Factors.....	17
1.2.4 Real Investment Analysis.....	20
1.2.5 Special Cases of Real Investment Analysis with Taxes .....	22
1.2.5.1 Value of the Depreciation Method.....	22
1.2.5.2 Tax Paradox .....	23
1.2.5.3 Wrong Implementation of After-Tax Discount Factors: the So-called “Standard Model” .....	24
2 Portfolio Selection.....	27
2.1 Bond Portfolio Selection: Duration .....	27
2.1.1 Underlying Decision Problem.....	27
2.1.2 Analysis of the Wealth Change, i.e., Materialization of Interest Rate Risk in the Outcome .....	29
2.1.2.1 Intuitive Analysis of the Wealth Change .....	29
2.1.2.2 (Semi-)Formal Analysis of the Wealth Change.....	30
2.1.2.3 First Application: Measurement of Risk .....	36
2.1.2.4 Second Application: Management of Risk.....	44

2.1.3	Introduction to Duration-Based Bond Portfolio Selection .....	45
2.1.3.1	Immunization of a Portfolio against Interest Rate Changes that Occur Immediately after Time t.....	46
2.1.3.2	Immunization of a Portfolio against Interest Rate Changes that Occur within the First Year, i.e., before the First Cash Flow .....	51
2.1.4	Advanced Duration-Based Bond Portfolio Management.....	53
2.1.4.1	Multi-period Aspects .....	53
2.1.4.1.1	Immunization of a Portfolio against Interest Rate Changes that Occur within the $t + n + 1^{\text{st}}$ year, i.e., before the $n^{\text{th}}$ Cash Flow .....	53
2.1.4.1.2	Immunization of a Portfolio against Repeated Interest Rate Changes/Dynamic Immunization .....	55
2.1.4.2	Contingent Immunization/Speculation on Interest Rates.....	60
2.1.5	Evaluation of Duration-Based Bond Portfolio Management .....	61
2.2	Portfolio Selection Theory for Stocks .....	63
2.2.1	Trade-off between Risk and Opportunities: $\mu$ - $\sigma$ -preferences and Maximum Principle of Efficiency .....	63
2.2.2	$\mu$ - $\sigma$ -efficient Portfolios of Risky Assets (Markowitz Diversification) .....	64
2.2.2.1	Portfolio Holdings in a Special Case: Global Minimum Variance Portfolio .....	64
2.2.2.2	Portfolio Holdings in the General Markowitz Case .....	70
2.2.2.3	Portfolio Weights in a Special Case: Global Minimum Variance Portfolio .....	77
2.2.2.3.1	Preparatory work .....	77
2.2.2.3.2	Determination of Portfolio Weights in a Special case: Global Minimum Variance Portfolio.....	79
2.2.2.4	Portfolio Weights in the General Markowitz Case .....	80
2.2.3	$\mu$ - $\sigma$ -efficient Portfolios of Risky and Riskless Assets (Markowitz/Tobin Diversification) .....	82
2.2.3.1	General Effects of a Riskless Asset .....	82
2.2.3.2	Portfolio Holdings in the General Markowitz/Tobin Case.....	83
2.2.3.3	Portfolio Holdings in a Special Case: Tangency Portfolio .....	89
2.2.3.4	Portfolio Weights in the General Markowitz/Tobin Case .....	92
2.2.3.4.1	Preparatory work .....	92
2.2.3.4.2	Determination of Portfolio Weights in the General Markowitz/Tobin Case.....	92
2.2.3.5	Portfolio weights in a Special Case: Tangency Portfolio .....	94
2.2.4	Summary on $\mu$ - $\sigma$ -efficient Portfolios .....	96
3	Asset Pricing .....	99
3.1	The Capital Asset Pricing Model (CAPM) .....	99
3.1.1	Derivation of the Price Equation .....	99
3.1.2	Return Equation of the CAPM .....	103

3.1.3	Side Aspect of Asset Pricing Results: Variance Decomposition .....	104
3.1.4	Use of the CAPM (in the Industry) .....	109
3.2	Pricing of Options .....	115
3.2.1	Institutional Details .....	115
3.2.2	Pricing of European Options in the Binomial Model.....	118
3.2.2.1	Binomial Model .....	118
3.2.2.2	Pricing in the One-period Binomial Model.....	120
3.2.2.3	Pricing in the Multi-period Binomial Model.....	123
3.2.3	The Transition from the Discrete-time and -state to the Continuous-time and -state Model: the Black/Scholes Formula .....	124
4	Corporate Finance: Hedging .....	133
4.1	Definition of Terms .....	133
4.1.1	Overview of Types of Classical Derivatives .....	133
4.1.2	Further Institutional Details on Selected Derivatives .....	135
4.1.2.1	Forwards.....	135
4.1.2.2	Futures.....	135
4.1.2.3	Options .....	138
4.2	Implementation Hedging.....	139
4.2.1	Perfect Hedge.....	139
4.2.2	Cross Hedge.....	147
4.2.2.1	Need for Cross Hedging.....	147
4.2.2.2	Basic Types of Cross Hedges.....	148
4.2.2.3	Details on the Minimum Variance Hedge .....	149