



CFA Institute

CFA INSTITUTE INVESTMENT SERIES

QUANTITATIVE INVESTMENT ANALYSIS

Third Edition



Richard A. DeFusco, CFA ■ Dennis W. McLeavey, CFA
Jerald E. Pinto, CFA ■ David E. Runkle, CFA

Foreword by Mark J. P. Anson, PhD, CFA

QUANTITATIVE INVESTMENT ANALYSIS

CFA Institute is the premier association for investment professionals around the world, with over 130,000 members in 151 countries and territories. Since 1963 the organization has developed and administered the renowned Chartered Financial Analyst® Program. With a rich history of leading the investment profession, CFA Institute has set the highest standards in ethics, education, and professional excellence within the global investment community and is the foremost authority on investment profession conduct and practice. Each book in the CFA Institute Investment Series is geared toward industry practitioners along with graduate-level finance students and covers the most important topics in the industry. The authors of these cutting-edge books are themselves industry professionals and academics and bring their wealth of knowledge and expertise to this series.

QUANTITATIVE INVESTMENT ANALYSIS

Third Edition

Richard A. DeFusco, CFA

Dennis W. McLeavey, CFA

Jerald E. Pinto, CFA

David E. Runkle, CFA

WILEY

Cover image: © r.nagy/Shutterstock
Cover design: Wiley

Copyright © 2004, 2007, 2015 by CFA Institute. All rights reserved.

Published by John Wiley & Sons, Inc., Hoboken, New Jersey.
Published simultaneously in Canada.

No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording, scanning, or otherwise, except as permitted under Section 107 or 108 of the 1976 United States Copyright Act, without either the prior written permission of the Publisher, or authorization through payment of the appropriate per-copy fee to the Copyright Clearance Center, Inc., 222 Rosewood Drive, Danvers, MA 01923, (978) 750-8400, fax (978) 646-8600, or on the Web at www.copyright.com. Requests to the Publisher for permission should be addressed to the Permissions Department, John Wiley & Sons, Inc., 111 River Street, Hoboken, NJ 07030, (201) 748-6011, fax (201) 748-6008, or online at <http://www.wiley.com/go/permissions>.

Limit of Liability/Disclaimer of Warranty: While the publisher and author have used their best efforts in preparing this book, they make no representations or warranties with respect to the accuracy or completeness of the contents of this book and specifically disclaim any implied warranties of merchantability or fitness for a particular purpose. No warranty may be created or extended by sales representatives or written sales materials. The advice and strategies contained herein may not be suitable for your situation. You should consult with a professional where appropriate. Neither the publisher nor author shall be liable for any loss of profit or any other commercial damages, including but not limited to special, incidental, consequential, or other damages.

For general information on our other products and services or for technical support, please contact our Customer Care Department within the United States at (800) 762-2974, outside the United States at (317) 572-3993, or fax (317) 572-4002.

Wiley publishes in a variety of print and electronic formats and by print-on-demand. Some material included with standard print versions of this book may not be included in e-books or in print-on-demand. If this book refers to media such as a CD or DVD that is not included in the version you purchased, you may download this material at <http://booksupport.wiley.com>. For more information about Wiley products, visit www.wiley.com.

ISBN 978-1-119-10422-3 (Hardcover)
ISBN 978-1-119-10459-9 (ePDF)
ISBN 978-1-119-10460-5 (ePub)

Printed in the United States of America.

10 9 8 7 6 5 4 3 2 1

CONTENTS

Foreword	xiii
Preface	xv
Acknowledgments	xvii
About the CFA Institute Investment Series	xix
CHAPTER 1	
The Time Value of Money	1
Learning Outcomes	1
1. Introduction	1
2. Interest Rates: Interpretation	2
3. The Future Value of a Single Cash Flow	4
3.1. The Frequency of Compounding	9
3.2. Continuous Compounding	11
3.3. Stated and Effective Rates	12
4. The Future Value of a Series of Cash Flows	13
4.1. Equal Cash Flows—Ordinary Annuity	14
4.2. Unequal Cash Flows	15
5. The Present Value of a Single Cash Flow	16
5.1. Finding the Present Value of a Single Cash Flow	16
5.2. The Frequency of Compounding	18
6. The Present Value of a Series of Cash Flows	19
6.1. The Present Value of a Series of Equal Cash Flows	19
6.2. The Present Value of an Infinite Series of Equal Cash Flows—Perpetuity	24
6.3. Present Values Indexed at Times Other than $t = 0$	25
6.4. The Present Value of a Series of Unequal Cash Flows	26
7. Solving for Rates, Number of Periods, or Size of Annuity Payments	27
7.1. Solving for Interest Rates and Growth Rates	27
7.2. Solving for the Number of Periods	30
7.3. Solving for the Size of Annuity Payments	31
7.4. Review of Present and Future Value Equivalence	35
7.5. The Cash Flow Additivity Principle	37

8. Summary	38
Problems	38

CHAPTER 2

Discounted Cash Flow Applications 43

Learning Outcomes	43
1. Introduction	43
2. Net Present Value and Internal Rate of Return	44
2.1. Net Present Value and the Net Present Value Rule	44
2.2. The Internal Rate of Return and the Internal Rate of Return Rule	46
2.3. Problems with the IRR Rule	49
3. Portfolio Return Measurement	51
3.1. Money-Weighted Rate of Return	52
3.2. Time-Weighted Rate of Return	53
4. Money Market Yields	59
5. Summary	64
References	65
Problems	65

CHAPTER 3

Statistical Concepts and Market Returns 69

Learning Outcomes	69
1. Introduction	70
2. Some Fundamental Concepts	70
2.1. The Nature of Statistics	70
2.2. Populations and Samples	71
2.3. Measurement Scales	72
3. Summarizing Data Using Frequency Distributions	73
4. The Graphic Presentation of Data	81
4.1. The Histogram	82
4.2. The Frequency Polygon and the Cumulative Frequency Distribution	83
5. Measures of Central Tendency	86
5.1. The Arithmetic Mean	86
5.2. The Median	90
5.3. The Mode	93
5.4. Other Concepts of Mean	94
6. Other Measures of Location: Quantiles	103
6.1. Quartiles, Quintiles, Deciles, and Percentiles	103
6.2. Quantiles in Investment Practice	108
7. Measures of Dispersion	110
7.1. The Range	111
7.2. The Mean Absolute Deviation	111
7.3. Population Variance and Population Standard Deviation	113
7.4. Sample Variance and Sample Standard Deviation	116
7.5. Semivariance, Semideviation, and Related Concepts	120

7.6. Chebyshev's Inequality	121
7.7. Coefficient of Variation	123
7.8. The Sharpe Ratio	125
8. Symmetry and Skewness in Return Distributions	129
9. Kurtosis in Return Distributions	134
10. Using Geometric and Arithmetic Means	138
11. Summary	140
References	141
Problems	142
 CHAPTER 4	
Probability Concepts	151
Learning Outcomes	151
1. Introduction	152
2. Probability, Expected Value, and Variance	152
3. Portfolio Expected Return and Variance of Return	175
4. Topics in Probability	184
4.1. Bayes' Formula	184
4.2. Principles of Counting	188
5. Summary	192
References	194
Problems	194
 CHAPTER 5	
Common Probability Distributions	199
Learning Outcomes	199
1. Introduction to Common Probability Distributions	200
2. Discrete Random Variables	200
2.1. The Discrete Uniform Distribution	202
2.2. The Binomial Distribution	204
3. Continuous Random Variables	214
3.1. Continuous Uniform Distribution	214
3.2. The Normal Distribution	218
3.3. Applications of the Normal Distribution	224
3.4. The Lognormal Distribution	226
4. Monte Carlo Simulation	232
5. Summary	239
References	240
Problems	241
 CHAPTER 6	
Sampling and Estimation	247
Learning Outcomes	247
1. Introduction	248
2. Sampling	248

2.1.	Simple Random Sampling	248
2.2.	Stratified Random Sampling	250
2.3.	Time-Series and Cross-Sectional Data	251
3.	Distribution of the Sample Mean	254
3.1.	The Central Limit Theorem	254
4.	Point and Interval Estimates of the Population Mean	258
4.1.	Point Estimators	258
4.2.	Confidence Intervals for the Population Mean	260
4.3.	Selection of Sample Size	266
5.	More on Sampling	268
5.1.	Data-Mining Bias	268
5.2.	Sample Selection Bias	271
5.3.	Look-Ahead Bias	272
5.4.	Time-Period Bias	272
6.	Summary	274
	References	276
	Problems	276

CHAPTER 7

Hypothesis Testing 281

	Learning Outcomes	281
1.	Introduction	282
2.	Hypothesis Testing	282
3.	Hypothesis Tests Concerning the Mean	292
3.1.	Tests Concerning a Single Mean	292
3.2.	Tests Concerning Differences between Means	300
3.3.	Tests Concerning Mean Differences	304
4.	Hypothesis Tests Concerning Variance	308
4.1.	Tests Concerning a Single Variance	308
4.2.	Tests Concerning the Equality (Inequality) of Two Variances	310
5.	Other Issues: Nonparametric Inference	314
5.1.	Tests Concerning Correlation: The Spearman Rank Correlation Coefficient	315
5.2.	Nonparametric Inference: Summary	317
6.	Summary	318
	References	320
	Problems	320

CHAPTER 8

Correlation and Regression 327

	Learning Outcomes	327
1.	Introduction	328
2.	Correlation Analysis	328
2.1.	Scatter Plots	328
2.2.	Correlation Analysis	329

2.3.	Calculating and Interpreting the Correlation Coefficient	332
2.4.	Limitations of Correlation Analysis	334
2.5.	Uses of Correlation Analysis	337
2.6.	Testing the Significance of the Correlation Coefficient	345
3.	Linear Regression	348
3.1.	Linear Regression with One Independent Variable	348
3.2.	Assumptions of the Linear Regression Model	352
3.3.	The Standard Error of Estimate	354
3.4.	The Coefficient of Determination	357
3.5.	Hypothesis Testing	359
3.6.	Analysis of Variance in a Regression with One Independent Variable	367
3.7.	Prediction Intervals	370
3.8.	Limitations of Regression Analysis	373
4.	Summary	373
	Problems	375

CHAPTER 9

Multiple Regression and Issues in Regression Analysis 385

	Learning Outcomes	385
1.	Introduction	386
2.	Multiple Linear Regression	386
2.1.	Assumptions of the Multiple Linear Regression Model	392
2.2.	Predicting the Dependent Variable in a Multiple Regression Model	398
2.3.	Testing whether All Population Regression Coefficients Equal Zero	399
2.4.	Adjusted R^2	402
3.	Using Dummy Variables in Regressions	403
4.	Violations of Regression Assumptions	408
4.1.	Heteroskedasticity	408
4.2.	Serial Correlation	415
4.3.	Multicollinearity	419
4.4.	Heteroskedasticity, Serial Correlation, Multicollinearity: Summarizing the Issues	422
5.	Model Specification and Errors in Specification	422
5.1.	Principles of Model Specification	422
5.2.	Misspecified Functional Form	423
5.3.	Time-Series Misspecification (Independent Variables Correlated with Errors)	431
5.4.	Other Types of Time-Series Misspecification	435
6.	Models with Qualitative Dependent Variables	435
7.	Summary	438
	References	440
	Problems	441

CHAPTER 10	
Time-Series Analysis	459
Learning Outcomes	459
1. Introduction to Time-Series Analysis	460
2. Challenges of Working with Time Series	462
3. Trend Models	462
3.1. Linear Trend Models	463
3.2. Log-Linear Trend Models	466
3.3. Trend Models and Testing for Correlated Errors	471
4. Autoregressive (AR) Time-Series Models	472
4.1. Covariance-Stationary Series	472
4.2. Detecting Serially Correlated Errors in an Autoregressive Model	474
4.3. Mean Reversion	477
4.4. Multiperiod Forecasts and the Chain Rule of Forecasting	477
4.5. Comparing Forecast Model Performance	481
4.6. Instability of Regression Coefficients	482
5. Random Walks and Unit Roots	485
5.1. Random Walks	485
5.2. The Unit Root Test of Nonstationarity	489
6. Moving-Average Time-Series Models	494
6.1. Smoothing Past Values with an n -Period Moving Average	494
6.2. Moving-Average Time-Series Models for Forecasting	496
7. Seasonality in Time-Series Models	499
8. Autoregressive Moving-Average Models	504
9. Autoregressive Conditional Heteroskedasticity Models	504
10. Regressions with More than One Time Series	507
11. Other Issues in Time Series	512
12. Suggested Steps in Time-Series Forecasting	512
13. Summary	514
Problems	516
 CHAPTER 11	
Introduction to Multifactor Models	525
Learning Outcomes	525
1. Introduction	525
2. Multifactor Models and Modern Portfolio Theory	526
3. Arbitrage Pricing Theory	527
4. Multifactor Models: Types	533
4.1. Factors and Types of Multifactor Models	533
4.2. The Structure of Macroeconomic Factor Models	534
4.3. The Structure of Fundamental Factor Models	537
5. Multifactor Models: Selected Applications	541
5.1. Factor Models in Return Attribution	542
5.2. Factor Models in Risk Attribution	545

5.3. Factor Models in Portfolio Construction	549
5.4. How Factor Considerations Can Be Useful in Strategic Portfolio Decisions	551
6. Summary	552
References	554
Problems	554
Appendices	557
Glossary	567
About the Editors and Authors	579
About the CFA Program	581
Index	583

FOREWORD

“Central limits,” “probability distributions,” “hypothesis test” — investors have a bit of trouble generating enthusiasm for such terms. Yet, they should be enthusiastic because every investor needs these tools to analyze, compete, and succeed in today’s economic environment. The financial markets and the participants in them become increasingly sophisticated every year. So, at times, it seems like you need a PhD in mathematics just to keep up with the markets.

Fortunately, a PhD is not necessary to succeed. In fact, the financial market battlefield is littered with the credentials of highly educated individuals who have failed spectacularly despite their intense education. Nonetheless, the better equipped you are with the basic tools of financial calculus, the better your chance of success.

Quantitative Investment Analysis provides the necessary utensils for success. In this volume, you will find all the statistical gadgets you need to be a confident and knowledgeable investor. Math need not be a four letter word. It can make your wealth analysis sharper, your investment theme more precise, your portfolio construction more successful.

Furthermore, this book is chock full of examples, practice problems (with answers!), charts, tables, and graphs that bring home in clear detail the concepts and tools of financial calculus. Whether you are a novice investor or an experienced practitioner, this book has something for you. In fact, as I read the book in preparation for writing this foreword, I kept getting unconsciously pulled into the examples; unwittingly, I became engaged in the book before I knew it. But that effect is part of the beauty of this book: It is an easy-to-read and easy-to-use handbook. I wanted to know more with each example I read. I know that you, too, will find that this book stimulates your curiosity while having the same ease of use that I found. Enjoy!

MARK J. P. ANSON, PhD, CFA, CAIA, CPA
President & Chief Investment Officer
Acadia Capital
Bass Family Office

PREFACE

We are pleased to bring you *Quantitative Investment Analysis, Third Edition*, which focuses on key tools that are needed for today's professional investor. In addition to classic time value of money, discounted cash flow applications, and probability material, the text covers advanced concepts such as correlation and regression that ultimately figure into the formation of hypotheses for purposes of testing. The text teaches critical skills that challenge many professionals, including the ability to distinguish useful information from the overwhelming quantity of available data.

The content was developed in partnership by a team of distinguished academics and practitioners, chosen for their acknowledged expertise in the field, and guided by CFA Institute. It is written specifically with the investment practitioner in mind and is replete with examples and practice problems that reinforce the learning outcomes and demonstrate real-world applicability.

The CFA Program Curriculum, from which the content of this book was drawn, is subjected to a rigorous review process to assure that it is:

- Faithful to the findings of our ongoing industry practice analysis
- Valuable to members, employers, and investors
- Globally relevant
- Generalist (as opposed to specialist) in nature
- Replete with sufficient examples and practice opportunities
- Pedagogically sound

The accompanying workbook is a useful reference that provides Learning Outcome Statements, which describe exactly what readers will learn and be able to demonstrate after mastering the accompanying material. Additionally, the workbook has summary overviews and practice problems for each chapter.

We hope you will find this and other books in the CFA Institute Investment Series helpful in your efforts to grow your investment knowledge, whether you are a relatively new entrant or an experienced veteran striving to keep up to date in the ever-changing market environment. CFA Institute, as a long-term committed participant in the investment profession and a not-for-profit global membership association, is pleased to provide you with this opportunity.

ACKNOWLEDGMENTS

We would like to thank Eugene L. Podkaminer, CFA, for his contribution to revising coverage of multifactor models. We are indebted to Professor Sanjiv Sabherwal for his painstaking work in updating self-test examples in all chapters except the chapter on multifactor models. His contribution was essential to the fresh look of this third edition.

We are indebted to Wendy L. Pirie, CFA, Gregory Siegel, CFA, and Stephen E. Wilcox, CFA, for their help in verifying the accuracy of the text. Margaret Hill, Wanda Lauziere, and Julia MacKesson and the production team at CFA Institute provided essential support through the various stages of production. We thank Robert E. Lamy, CFA, and Christopher B. Wiese, CFA, for their encouragement and oversight of the production of a third edition.

ABOUT THE CFA INSTITUTE INVESTMENT SERIES

CFA Institute is pleased to provide you with the CFA Institute Investment Series, which covers major areas in the field of investments. We provide this best-in-class series for the same reason we have been chartering investment professionals for more than 45 years: to lead the investment profession globally by setting the highest standards of ethics, education, and professional excellence.

The books in the CFA Institute Investment Series contain practical, globally relevant material. They are intended both for those contemplating entry into the extremely competitive field of investment management as well as for those seeking a means of keeping their knowledge fresh and up to date. This series was designed to be user friendly and highly relevant.

We hope you find this series helpful in your efforts to grow your investment knowledge, whether you are a relatively new entrant or an experienced veteran ethically bound to keep up to date in the ever-changing market environment. As a long-term, committed participant in the investment profession and a not-for-profit global membership association, CFA Institute is pleased to provide you with this opportunity.

THE TEXTS

Corporate Finance: A Practical Approach is a solid foundation for those looking to achieve lasting business growth. In today's competitive business environment, companies must find innovative ways to enable rapid and sustainable growth. This text equips readers with the foundational knowledge and tools for making smart business decisions and formulating strategies to maximize company value. It covers everything from managing relationships between stakeholders to evaluating merger and acquisition bids, as well as the companies behind them. Through extensive use of real-world examples, readers will gain critical perspective into interpreting corporate financial data, evaluating projects, and allocating funds in ways that increase corporate value. Readers will gain insights into the tools and strategies used in modern corporate financial management.

Equity Asset Valuation is a particularly cogent and important resource for anyone involved in estimating the value of securities and understanding security pricing. A well-informed professional knows that the common forms of equity valuation—dividend discount modeling, free cash flow modeling, price/earnings modeling, and residual income modeling—can all be reconciled with one another under certain assumptions. With a deep understanding of the underlying assumptions, the professional investor can better understand what other investors assume when calculating their valuation estimates. This text has a global orientation, including emerging markets.

Fixed Income Analysis has been at the forefront of new concepts in recent years, and this particular text offers some of the most recent material for the seasoned professional who is not a fixed-income specialist. The application of option and derivative technology to the once staid province of fixed income has helped contribute to an explosion of thought in this area. Professionals have been challenged to stay up to speed with credit derivatives, swaptions, collateralized mortgage securities, mortgage-backed securities, and other vehicles, and this explosion of products has strained the world's financial markets and tested central banks to provide sufficient oversight. Armed with a thorough grasp of the new exposures, the professional investor is much better able to anticipate and understand the challenges our central bankers and markets face.

International Financial Statement Analysis is designed to address the ever-increasing need for investment professionals and students to think about financial statement analysis from a global perspective. The text is a practically oriented introduction to financial statement analysis that is distinguished by its combination of a true international orientation, a structured presentation style, and abundant illustrations and tools covering concepts as they are introduced in the text. The authors cover this discipline comprehensively and with an eye to ensuring the reader's success at all levels in the complex world of financial statement analysis.

Investments: Principles of Portfolio and Equity Analysis provides an accessible yet rigorous introduction to portfolio and equity analysis. Portfolio planning and portfolio management are presented within a context of up-to-date, global coverage of security markets, trading, and market-related concepts and products. The essentials of equity analysis and valuation are explained in detail and profusely illustrated. The book includes coverage of practitioner-important but often neglected topics, such as industry analysis. Throughout, the focus is on the practical application of key concepts with examples drawn from both emerging and developed markets. Each chapter affords the reader many opportunities to self-check his or her understanding of topics.

One of the most prominent texts over the years in the investment management industry has been Maginn and Tuttle's *Managing Investment Portfolios: A Dynamic Process*. The third edition updates key concepts from the 1990 second edition. Some of the more experienced members of our community own the prior two editions and will add the third edition to their libraries. Not only does this seminal work take the concepts from the other readings and put them in a portfolio context, but it also updates the concepts of alternative investments, performance presentation standards, portfolio execution, and, very importantly, individual investor portfolio management. Focusing attention away from institutional portfolios and toward the individual investor makes this edition an important and timely work.

The New Wealth Management: The Financial Advisor's Guide to Managing and Investing Client Assets is an updated version of Harold Evensky's mainstay reference guide for wealth managers. Harold Evensky, Stephen Horan, and Thomas Robinson have updated the core text of the 1997 first edition and added an abundance of new material to fully reflect today's investment challenges. The text provides authoritative coverage across the full spectrum of wealth management and serves as a comprehensive guide for financial advisors. The book expertly blends investment theory and real-world applications and is written in the same thorough but highly accessible style as the first edition.

All books in the CFA Institute Investment Series are available through all major booksellers. And, all titles are available on the Wiley Custom Select platform at <http://customselect.wiley.com/> where individual chapters for all the books may be mixed and matched to create custom textbooks for the classroom.

CHAPTER 1

THE TIME VALUE OF MONEY

Richard A. DeFusco, CFA
Dennis W. McLeavey, CFA
Jerald E. Pinto, PhD, CFA
David E. Runkle, PhD, CFA

LEARNING OUTCOMES

After completing this chapter, you will be able to do the following:

- interpret interest rates as required rates of return, discount rates, or opportunity costs;
- explain an interest rate as the sum of a real risk-free rate and premiums that compensate investors for bearing distinct types of risk;
- calculate and interpret the effective annual rate, given the stated annual interest rate and the frequency of compounding;
- solve time value of money problems for different frequencies of compounding;
- calculate and interpret the future value (FV) and present value (PV) of a single sum of money, an ordinary annuity, an annuity due, a perpetuity (PV only), and a series of unequal cash flows;
- demonstrate the use of a time line in modeling and solving time value of money problems.

1. INTRODUCTION

As individuals, we often face decisions that involve saving money for a future use, or borrowing money for current consumption. We then need to determine the amount we need to invest, if we are saving, or the cost of borrowing, if we are shopping for a loan. As investment analysts, much of our work also involves evaluating transactions with present and future cash flows.

Quantitative Methods for Investment Analysis, Second Edition, by Richard A. DeFusco, CFA, Dennis W. McLeavey, CFA, Jerald E. Pinto, CFA, and David E. Runkle, CFA. Copyright © 2004 by CFA Institute.

When we place a value on any security, for example, we are attempting to determine the worth of a stream of future cash flows. To carry out all the above tasks accurately, we must understand the mathematics of time value of money problems. Money has time value in that individuals value a given amount of money more highly the earlier it is received. Therefore, a smaller amount of money now may be equivalent in value to a larger amount received at a future date. The **time value of money** as a topic in investment mathematics deals with equivalence relationships between cash flows with different dates. Mastery of time value of money concepts and techniques is essential for investment analysts.

The reading¹ is organized as follows: Section 2 introduces some terminology used throughout the reading and supplies some economic intuition for the variables we will discuss. Section 3 tackles the problem of determining the worth at a future point in time of an amount invested today. Section 4 addresses the future worth of a series of cash flows. These two sections provide the tools for calculating the equivalent value at a future date of a single cash flow or series of cash flows. Sections 5 and 6 discuss the equivalent value today of a single future cash flow and a series of future cash flows, respectively. In Section 7, we explore how to determine other quantities of interest in time value of money problems.

2. INTEREST RATES: INTERPRETATION

In this reading, we will continually refer to interest rates. In some cases, we assume a particular value for the interest rate; in other cases, the interest rate will be the unknown quantity we seek to determine. Before turning to the mechanics of time value of money problems, we must illustrate the underlying economic concepts. In this section, we briefly explain the meaning and interpretation of interest rates.

Time value of money concerns equivalence relationships between cash flows occurring on different dates. The idea of equivalence relationships is relatively simple. Consider the following exchange: You pay \$10,000 today and in return receive \$9,500 today. Would you accept this arrangement? Not likely. But what if you received the \$9,500 today and paid the \$10,000 one year from now? Can these amounts be considered equivalent? Possibly, because a payment of \$10,000 a year from now would probably be worth less to you than a payment of \$10,000 today. It would be fair, therefore, to **discount** the \$10,000 received in one year; that is, to cut its value based on how much time passes before the money is paid. An **interest rate**, denoted r , is a rate of return that reflects the relationship between differently dated cash flows. If \$9,500 today and \$10,000 in one year are equivalent in value, then $\$10,000 - \$9,500 = \$500$ is the required compensation for receiving \$10,000 in one year rather than now. The interest rate—the required compensation stated as a rate of return—is $\$500/\$9,500 = 0.0526$ or 5.26 percent.

Interest rates can be thought of in three ways. First, they can be considered required rates of return—that is, the minimum rate of return an investor must receive in order to accept the investment. Second, interest rates can be considered discount rates. In the example above, 5.26 percent is that rate at which we discounted the \$10,000 future amount to find its value today. Thus, we use the terms “interest rate” and “discount rate” almost interchangeably. Third, interest rates can be considered opportunity costs. An **opportunity cost** is the value that investors forgo by choosing a particular course of action. In the example, if the party who supplied

¹Examples in this reading and other readings in quantitative methods at Level I were updated in 2013 by Professor Sanjiv Sabherwal of the University of Texas, Arlington.

\$9,500 had instead decided to spend it today, he would have forgone earning 5.26 percent on the money. So we can view 5.26 percent as the opportunity cost of current consumption.

Economics tells us that interest rates are set in the marketplace by the forces of supply and demand, where investors are suppliers of funds and borrowers are demanders of funds. Taking the perspective of investors in analyzing market-determined interest rates, we can view an interest rate r as being composed of a real risk-free interest rate plus a set of four premiums that are required returns or compensation for bearing distinct types of risk:

$$r = \text{Real risk-free interest rate} + \text{Inflation premium} + \text{Default risk premium} \\ + \text{Liquidity premium} + \text{Maturity premium}$$

- The **real risk-free interest rate** is the single-period interest rate for a completely risk-free security if no inflation were expected. In economic theory, the real risk-free rate reflects the time preferences of individuals for current versus future real consumption.
- The **inflation premium** compensates investors for expected inflation and reflects the average inflation rate expected over the maturity of the debt. Inflation reduces the purchasing power of a unit of currency—the amount of goods and services one can buy with it. The sum of the real risk-free interest rate and the inflation premium is the **nominal risk-free interest rate**.² Many countries have governmental short-term debt whose interest rate can be considered to represent the nominal risk-free interest rate in that country. The interest rate on a 90-day US Treasury bill (T-bill), for example, represents the nominal risk-free interest rate over that time horizon.³ US T-bills can be bought and sold in large quantities with minimal transaction costs and are backed by the full faith and credit of the US government.
- The **default risk premium** compensates investors for the possibility that the borrower will fail to make a promised payment at the contracted time and in the contracted amount.
- The **liquidity premium** compensates investors for the risk of loss relative to an investment's fair value if the investment needs to be converted to cash quickly. US T-bills, for example, do not bear a liquidity premium because large amounts can be bought and sold without affecting their market price. Many bonds of small issuers, by contrast, trade infrequently after they are issued; the interest rate on such bonds includes a liquidity premium reflecting the relatively high costs (including the impact on price) of selling a position.
- The **maturity premium** compensates investors for the increased sensitivity of the market value of debt to a change in market interest rates as maturity is extended, in general (holding all else equal). The difference between the interest rate on longer-maturity, liquid Treasury debt and that on short-term Treasury debt reflects a positive maturity premium for the longer-term debt (and possibly different inflation premiums as well).

²Technically, 1 plus the nominal rate equals the product of 1 plus the real rate and 1 plus the inflation rate. As a quick approximation, however, the nominal rate is equal to the real rate plus an inflation premium. In this discussion we focus on approximate additive relationships to highlight the underlying concepts.

³Other developed countries issue securities similar to US Treasury bills. The French government issues BTFs or negotiable fixed-rate discount Treasury bills (*Bons du Trésor à taux fixe et à intérêts précomptés*) with maturities of up to one year. The Japanese government issues a short-term Treasury bill with maturities of 6 and 12 months. The German government issues at discount both Treasury financing paper (*Finanzierungsschätze des Bundes* or, for short, *Schätze*) and Treasury discount paper (*Bubills*) with maturities up to 24 months. In the United Kingdom, the British government issues gilt-edged Treasury bills with maturities ranging from 1 to 364 days. The Canadian government bond market is closely related to the US market; Canadian Treasury bills have maturities of 3, 6, and 12 months.

Using this insight into the economic meaning of interest rates, we now turn to a discussion of solving time value of money problems, starting with the future value of a single cash flow.

3. THE FUTURE VALUE OF A SINGLE CASH FLOW

In this section, we introduce time value associated with a single cash flow or lump-sum investment. We describe the relationship between an initial investment or **present value (PV)**, which earns a rate of return (the interest rate per period) denoted as r , and its **future value (FV)**, which will be received N years or periods from today.

The following example illustrates this concept. Suppose you invest \$100 ($PV = \100) in an interest-bearing bank account paying 5 percent annually. At the end of the first year, you will have the \$100 plus the interest earned, $0.05 \times \$100 = \5 , for a total of \$105. To formalize this one-period example, we define the following terms:

$$\begin{aligned} PV &= \text{present value of the investment} \\ FV_N &= \text{future value of the investment } N \text{ periods from today} \\ r &= \text{rate of interest per period} \end{aligned}$$

For $N = 1$, the expression for the future value of amount PV is

$$FV_1 = PV(1 + r) \quad (1)$$

For this example, we calculate the future value one year from today as $FV_1 = \$100(1.05) = \105 .

Now suppose you decide to invest the initial \$100 for two years with interest earned and credited to your account annually (annual compounding). At the end of the first year (the beginning of the second year), your account will have \$105, which you will leave in the bank for another year. Thus, with a beginning amount of \$105 ($PV = \105), the amount at the end of the second year will be $\$105(1.05) = \110.25 . Note that the \$5.25 interest earned during the second year is 5 percent of the amount invested at the beginning of Year 2.

Another way to understand this example is to note that the amount invested at the beginning of Year 2 is composed of the original \$100 that you invested plus the \$5 interest earned during the first year. During the second year, the original principal again earns interest, as does the interest that was earned during Year 1. You can see how the original investment grows:

Original investment	\$100.00
Interest for the first year ($\$100 \times 0.05$)	5.00
Interest for the second year based on original investment ($\$100 \times 0.05$)	5.00
Interest for the second year based on interest earned in the first year ($0.05 \times \$5.00$ interest on interest)	0.25
Total	\$110.25

The \$5 interest that you earned each period on the \$100 original investment is known as **simple interest** (the interest rate times the principal). **Principal** is the amount of funds originally invested. During the two-year period, you earn \$10 of simple interest. The extra \$0.25 that you have at the end of Year 2 is the interest you earned on the Year 1 interest of \$5 that you reinvested.

The interest earned on interest provides the first glimpse of the phenomenon known as **compounding**. Although the interest earned on the initial investment is important, for a given interest rate it is fixed in size from period to period. The compounded interest earned on reinvested interest is a far more powerful force because, for a given interest rate, it grows in size each period. The importance of compounding increases with the magnitude of the interest rate. For example, \$100 invested today would be worth about \$13,150 after 100 years if compounded annually at 5 percent, but worth more than \$20 million if compounded annually over the same time period at a rate of 13 percent.

To verify the \$20 million figure, we need a general formula to handle compounding for any number of periods. The following general formula relates the present value of an initial investment to its future value after N periods:

$$FV_N = PV(1 + r)^N \quad (2)$$

where r is the stated interest rate per period and N is the number of compounding periods. In the bank example, $FV_2 = \$100(1 + 0.05)^2 = \110.25 . In the 13 percent investment example, $FV_{100} = \$100(1.13)^{100} = \$20,316,287.42$.

The most important point to remember about using the future value equation is that the stated interest rate, r , and the number of compounding periods, N , must be compatible. Both variables must be defined in the same time units. For example, if N is stated in months, then r should be the one-month interest rate, unannualized.

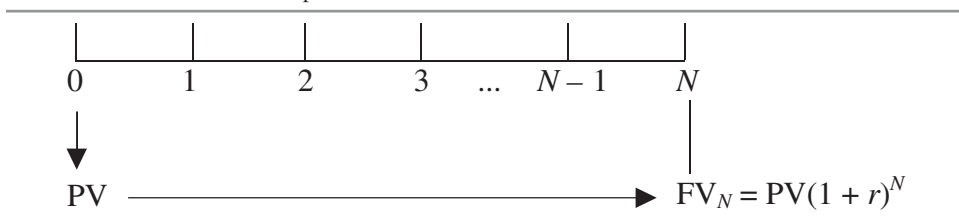
A time line helps us to keep track of the compatibility of time units and the interest rate per time period. In the time line, we use the time index t to represent a point in time a stated number of periods from today. Thus the present value is the amount available for investment today, indexed as $t = 0$. We can now refer to a time N periods from today as $t = N$. The time line in Figure 1 shows this relationship.

In Figure 1, we have positioned the initial investment, PV , at $t = 0$. Using Equation 2, we move the present value, PV , forward to $t = N$ by the factor $(1 + r)^N$. This factor is called a future value factor. We denote the future value on the time line as FV and position it at $t = N$. Suppose the future value is to be received exactly 10 periods from today's date ($N = 10$). The present value, PV , and the future value, FV , are separated in time through the factor $(1 + r)^{10}$.

The fact that the present value and the future value are separated in time has important consequences:

- We can add amounts of money only if they are indexed at the same point in time.
- For a given interest rate, the future value increases with the number of periods.
- For a given number of periods, the future value increases with the interest rate.

FIGURE 1 The Relationship between an Initial Investment, PV , and Its Future Value, FV



To better understand these concepts, consider three examples that illustrate how to apply the future value formula.

EXAMPLE 1 The Future Value of a Lump Sum with Interim Cash Reinvested at the Same Rate

You are the lucky winner of your state's lottery of \$5 million after taxes. You invest your winnings in a five-year certificate of deposit (CD) at a local financial institution. The CD promises to pay 7 percent per year compounded annually. This institution also lets you reinvest the interest at that rate for the duration of the CD. How much will you have at the end of five years if your money remains invested at 7 percent for five years with no withdrawals?

Solution: To solve this problem, compute the future value of the \$5 million investment using the following values in Equation 2:

$$\begin{aligned}
 PV &= \$5,000,000 \\
 r &= 7\% = 0.07 \\
 N &= 5 \\
 FV_N &= PV(1+r)^N \\
 &= \$5,000,000(1.07)^5 \\
 &= \$5,000,000(1.402552) \\
 &= \$7,012,758.65
 \end{aligned}$$

At the end of five years, you will have \$7,012,758.65 if your money remains invested at 7 percent with no withdrawals.

In this and most examples in this reading, note that the factors are reported at six decimal places but the calculations may actually reflect greater precision. For example, the reported 1.402552 has been rounded up from 1.40255173 (the calculation is actually carried out with more than eight decimal places of precision by the calculator or spreadsheet). Our final result reflects the higher number of decimal places carried by the calculator or spreadsheet.⁴

⁴We could also solve time value of money problems using tables of interest rate factors. Solutions using tabled values of interest rate factors are generally less accurate than solutions obtained using calculators or spreadsheets, so practitioners prefer calculators or spreadsheets.

EXAMPLE 2 The Future Value of a Lump Sum with No Interim Cash

An institution offers you the following terms for a contract: For an investment of ¥2,500,000, the institution promises to pay you a lump sum six years from now at an 8 percent annual interest rate. What future amount can you expect?

Solution: Use the following data in Equation 2 to find the future value:

$$\begin{aligned}PV &= ¥2,500,000 \\r &= 8\% = 0.08 \\N &= 6 \\FV_N &= PV(1+r)^N \\&= ¥2,500,000(1.08)^6 \\&= ¥2,500,000(1.586874) \\&= ¥3,967,186\end{aligned}$$

You can expect to receive ¥3,967,186 six years from now.

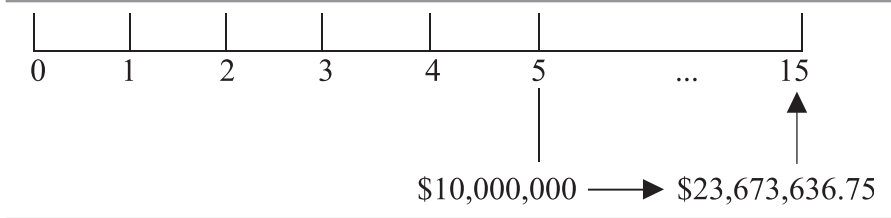
Our third example is a more complicated future value problem that illustrates the importance of keeping track of actual calendar time.

EXAMPLE 3 The Future Value of a Lump Sum

A pension fund manager estimates that his corporate sponsor will make a \$10 million contribution five years from now. The rate of return on plan assets has been estimated at 9 percent per year. The pension fund manager wants to calculate the future value of this contribution 15 years from now, which is the date at which the funds will be distributed to retirees. What is that future value?

Solution: By positioning the initial investment, PV, at $t = 5$, we can calculate the future value of the contribution using the following data in Equation 2:

$$\begin{aligned}PV &= \$10 \text{ million} \\r &= 9\% = 0.09 \\N &= 10 \\FV_N &= PV(1+r)^N \\&= \$10,000,000(1.09)^{10} \\&= \$10,000,000(2.367364) \\&= \$23,673,636.75\end{aligned}$$

FIGURE 2 The Future Value of a Lump Sum, Initial Investment Not at $t = 0$ 

This problem looks much like the previous two, but it differs in one important respect: its timing. From the standpoint of today ($t = 0$), the future amount of \$23,673,636.75 is 15 years into the future. Although the future value is 10 years from its present value, the present value of \$10 million will not be received for another five years.

As Figure 2 shows, we have followed the convention of indexing today as $t = 0$ and indexing subsequent times by adding 1 for each period. The additional contribution of \$10 million is to be received in five years, so it is indexed as $t = 5$ and appears as such in the figure. The future value of the investment in 10 years is then indexed at $t = 15$; that is, 10 years following the receipt of the \$10 million contribution at $t = 5$. Time lines like this one can be extremely useful when dealing with more complicated problems, especially those involving more than one cash flow.

In a later section of this reading, we will discuss how to calculate the value today of the \$10 million to be received five years from now. For the moment, we can use Equation 2. Suppose the pension fund manager in Example 3 above were to receive \$6,499,313.86 today from the corporate sponsor. How much will that sum be worth at the end of five years? How much will it be worth at the end of 15 years?

$$PV = \$6,499,313.86$$

$$r = 9\% = 0.09$$

$$N = 5$$

$$\begin{aligned} FV_N &= PV(1+r)^N \\ &= \$6,499,313.86(1.09)^5 \\ &= \$6,499,313.86(1.538624) \\ &= \$10,000,000 \text{ at the five-year mark} \end{aligned}$$

and

$$PV = \$6,499,313.86$$

$$r = 9\% = 0.09$$

$$N = 15$$

$$\begin{aligned} FV_N &= PV(1+r)^N \\ &= \$6,499,313.86(1.09)^{15} \\ &= \$6,499,313.86(3.642482) \\ &= \$23,673,636.74 \text{ at the 15-year mark} \end{aligned}$$