

University of Macau
Faculty of Business Administration

FINC 361 – Theory of Finance
Fall 2006 / 07

Instructor: Dr. Lewis Tam (譚漢強)

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Office hours: 10:30 – 12:30 on Tuesday; 16:00 – 18:00 on Thursday

Section	Time	Room
001	12:30 – 13:50 (Mon, Thur)	JM11
002	14:00 – 15:20 (Mon, Thur)	TP120

Course outline

This course provides an in-depth analysis of modern finance theory and serves as a building block for all the upper-level finance courses. Topics include equilibrium models of asset pricing, the efficient market hypothesis (EMH), option pricing and various theories of corporate finance.

Learning objectives

By the end of the course, students should be able to understand:

- i) driving forces of expected stock returns (or cost of equity);
- ii) market efficiency and their implications to investors;
- iii) binomial-tree model and Black-Scholes model of option pricing;
- iv) the relation between financial leverage and cost of capital;
- v) agency problems in merger decisions and their implications to firm value;
- vi) the economics of mergers and acquisitions.

Readings

Textbook:

1. Copeland, T.E., Weston, J.F., and Shastri, K. (CWS), *Financial Theory and Corporate Policy*, 4th edition, Pearson.

Reference books:

1. Bodie, Z., Kane, A., and Marcus A.J. (BKM), *Investment*, 5th edition, McGraw Hill.
2. Ross, S.A., Westerfield, R.W., and Jaffe, J.F. (RWJ), *Corporate Finance*, 7th edition, McGraw Hill.
3. Brealey, R.A., Myers, S.C., and Allen, F. (BMA), *Corporate Finance*, 8th edition, McGraw Hill.
4. Brealey, R.A., Myers, S.C., and Marcus, A.J. (BMM), *Fundamentals of Corporate Finance*, 5th edition, McGraw Hill.

Grading policies

Your course grade will be determined by your performance in a group presentation (15%), homework assignments (15%), mid-term examination (30%) and final examination (35%), as well as your class participation (5%). Students are required to form a group of three to five students by Sept. 15, 2005.

Presentation. Each group will be required to present ONE assigned article in front of your classmates in the class. You should prepare your PowerPoint slides, with suitable diagrams if necessary, for your presentation. You will have 15 to 20 minutes to present (1) the main idea, (2) the question of interest and (3) the relation of the article to our textbook and other course materials. Everyone of the group has to present at least three minutes. The presentation will be followed by a question-and-answer section. Your performance will be evaluated on individual basis and group basis.

Mid-term and final examinations. The mid-term and the final examinations will last for 2 hours each. You will be required to answer 4 to 5 numerical/essay questions. You may bring along with you a calculator and dictionary to the examinations. **Important:** There will be **NO** make-up for the examination, unless your absence is caused by an accident or illness and you can provide me with a certification from a medical doctor. Please arrange your schedule properly.

Class policies and course schedule

You should show your consideration to other students. Please come to class on time. As a general rule, if you are late for more than 10 minutes, you should not enter the classroom. Switch off your mobile phones before class. During the class, you can raise your hand to ask me questions or answer my questions. However, you should not chat with your classmates in the class.

	Date and Event	Topic
1.	Sept 7	<p><u>Capital Markets, Consumption and Investment</u></p> <ul style="list-style-type: none"> • Time preference of consumption • Consumption and investment with capital markets • Fisher separation theorem and its limitations • Separation of ownership and management <p><i>Required readings:</i></p> <ul style="list-style-type: none"> • Chapter 1 of CWS, "Introduction: Capital markets, consumption, and investment"
2.	Sept 11, 14, 18, 21, 25, 28	<p><u>Capital Market Theory</u></p> <ul style="list-style-type: none"> • Expected return, variance and covariance • Efficient frontier and definition of market portfolio • The relationship between risk and return based on Capital-Asset-Pricing Model (CAPM) <p><i>Required readings:</i></p> <p>CWS</p> <ul style="list-style-type: none"> • Chapter 5 "Objects of choices: Mean-variance portfolio theory" • Chapter 6 "Market equilibrium: CAPM and APT" <p>or BKM</p> <ul style="list-style-type: none"> • Chapter 6 "Risk and risk aversion" • Chapter 7 "Capital allocation between the risky asset and the risk-free asset" • Chapter 8 "Optimal risky portfolios" • Chapter 9 "The Capital Asset Pricing Model"
3.	Oct 5, 9, 16	<p><u>Efficiency Market Hypothesis (EMH): Theory and Evidence</u></p> <ul style="list-style-type: none"> • Forms of EMH and their implications to decision makers • Empirical tests on market efficiency • Fama's (1998) critics on market efficiency tests <p><i>Required readings:</i></p> <ul style="list-style-type: none"> • Chapter 10 of CWS, "Efficient capital markets: Theory" • Chapter 11 of CWS, "Efficient capital markets: Evidence" • Fama, E.F., 1998. "Market efficiency, long-term returns and behavioral finance", <i>Journal of Financial Economics</i> 49, 283-306. <p><i>Presentations:</i></p> <ul style="list-style-type: none"> • Brown, G.W. and Hartzell, J.C., 2001. "Market reaction to public information: the atypical case of the Boston Celtics", <i>Journal of Financial Economics</i> 60, 333-370. • Chan, K., Hameed, A. and Lau, S.T., 2003. "What if trading location is different from business location? Evidence from the Jardine Group", <i>Journal of Finance</i> 58, 1221-1246. • Froot, K.A. and Dabora, E.M., 1999. "How are stock prices affected by the location of trade?", <i>Journal of Financial Economics</i> 53, 189-216.

	Date and Event	Topic
4.	Oct 19, 23, 26 Nov 6	<p><u>Option Pricing</u></p> <ul style="list-style-type: none"> • Understanding options • Valuation of options by binomial approach • Black-Scholes option pricing model • Real options <p><i>Required readings:</i></p> <ul style="list-style-type: none"> • Chapter 23 of BMM, “Options” • Chapter 7 of CWS, “Pricing contingent claims: Option pricing theory and evidence” • Chapter 8 of RWJ, “Risk analysis, real options and capital budgeting” • Chapter 22 of RWJ, “Options and corporate finance” • Chapter 23 of RWJ, “Options and corporate finance: extensions and applications”
	Nov 8	Mid-term Examination
5.	Nov 9, 13, 16, 20, 23	<p><u>Capital Structure</u></p> <ul style="list-style-type: none"> • Modigliani and Miller’s Propositions I & II of capital structure decision • Relationship between financial leverage and beta • Agency problems and cost of financial distress • Theory and evidence on capital structure <p><i>Required readings:</i></p> <ul style="list-style-type: none"> • Chapter 15 of RWJ, “Capital structure: basic concepts” • Chapter 17 of RWJ, “Valuation and capital budgeting for the levered firm” • Chapter 15 of CWS, “Capital structure and the cost of capital: theory and evidence” • Daniel, K. and Titman, S., 1995. “Issuing equity under asymmetric information,” in <i>North Holland Handbook of Finance</i>, Jarrow, Maksimovic and Ziemba editors, North-Holland: Amsterdam. <p><i>Presentations:</i></p> <ul style="list-style-type: none"> • DeAngelo, H., DeAngelo, L. and Wruck, K.H., 2002. “Asset liquidity, debt coveants, and managerial discretion in financial distress: the collapse of L.A. Gear”, <i>Journal of Financial Economics</i> 64, 3-34. • Goyal, V.K., Lehn, K. and Racic, S., 2002. “Growth opportunities and corporate debt policy: the case of the U.S. defense industry”, <i>Journal of Financial Economics</i> 64, 35-59. • Weiss, L.A. and Wruck, K.H., 1998. “Information problems, conflicts of interest, and asset stripping: Chapter 11’s failure in the case of Eastern Airlines”, <i>Journal of Financial Economics</i> 48, 55-97.

	Date and Event	Topic
6.	Nov 27, 30 Dec 4, 7	<p><u>Mergers and Acquisitions</u></p> <ul style="list-style-type: none"> • Theory of firm and motivations for mergers • Agency costs of free-cash-flow • Vertical, horizontal and conglomerate mergers • Estimating merger gains and losses • Spin-offs and equity carve-outs <p><i>Required readings:</i></p> <ul style="list-style-type: none"> • Jensen, M.C., 1986. "Agency costs of free cash flow, corporate finance and takeovers", American Economic Review 76, 323-329. • Bruner, M., 2004. "Where M&A strays and where it pays". • Chapter 20 of Bruner, "Choosing the form of payment and financing" • Chapter 18 of CWS "Acquisitions, divestitures, restructuring, and corporate governance" or Chapter 32 of BMA "Mergers" <p><i>Presentations:</i></p> <ul style="list-style-type: none"> • Allen, J.W., 1998. "Capital markets and corporate structure: the equity carve-outs of Thermo Electron", Journal of Financial Economics 48, 99-124. • Gillan, S.L., Kensinger, J.W. and Martin, J.D., 2000. "Value creation and corporate diversification: the case of Sears, Roebuck & Co.", Journal of Financial Economics 55, 103-137. • Parrino, R., 1997. "Spinoffs and wealth transfers: the Marriott case", Journal of Financial Economics 43, 241-274.
	Nov 11	Review for Final Examination
	To be announced	Final Examination