

Applications of Economic Analysis to Portfolio Management

A necessary task in the investment management process is to formulate capital market expectations. These forecasts of risk and return for various asset classes form the basis for constructing portfolios that maximize expected return for given levels of risk.

This study session examines the process of setting capital market expectations and covers major tools of economic analysis. The application of neo-classical growth theory to develop economic forecasts is presented. The discussion includes how economic forecasts can be integrated with equity valuation techniques to value an equity market.

READING ASSIGNMENT

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| Reading 14 | Capital Market Expectations
by John P. Calverley, Alan M. Meder, CPA, CFA, Brian D. Singer, CFA, and Renato Staub, PhD |
| Reading 15 | Equity Market Valuation
by Peter C. Stimes, CFA, and Stephen E. Wilcox, PhD, CFA |

LEARNING OUTCOMES

READING 14. CAPITAL MARKET EXPECTATIONS

The candidate should be able to:

- a** discuss the role of, and a framework for, capital market expectations in the portfolio management process;
- b** discuss challenges in developing capital market forecasts;

- c** demonstrate the application of formal tools for setting capital market expectations, including statistical tools, discounted cash flow models, the risk premium approach, and financial equilibrium models;
- d** explain the use of survey and panel methods and judgment in setting capital market expectations;
- e** discuss the inventory and business cycles and the effects that consumer and business spending and monetary and fiscal policy have on the business cycle;
- f** discuss the effects that the phases of the business cycle have on short-term/long-term capital market returns;
- g** explain the relationship of inflation to the business cycle and the implications of inflation for cash, bonds, equity, and real estate returns;
- h** demonstrate the use of the Taylor rule to predict central bank behavior;
- i** interpret the shape of the yield curve as an economic predictor and discuss the relationship between the yield curve and fiscal and monetary policy;
- j** identify and interpret the components of economic growth trends and demonstrate the application of economic growth trend analysis to the formulation of capital market expectations;
- k** explain how exogenous shocks may affect economic growth trends;
- l** identify and interpret macroeconomic, interest rate, and exchange rate linkages between economies;
- m** discuss the risks faced by investors in emerging-market securities and the country risk analysis techniques used to evaluate emerging market economies;
- n** compare the major approaches to economic forecasting;
- o** demonstrate the use of economic information in forecasting asset class returns;
- p** explain how economic and competitive factors can affect investment markets, sectors, and specific securities;
- q** discuss the relative advantages and limitations of the major approaches to forecasting exchange rates;
- r** recommend and justify changes in the component weights of a global investment portfolio based on trends and expected changes in macroeconomic factors.

READING 15. EQUITY MARKET VALUATION

The candidate should be able to:

- a** explain the terms of the Cobb-Douglas production function and demonstrate how the function can be used to model growth in real output under the assumption of constant returns to scale;
- b** evaluate the relative importance of growth in total factor productivity, in capital stock, and in labor input given relevant historical data;
- c** demonstrate the use of the Cobb-Douglas production function in obtaining a discounted dividend model estimate of the intrinsic value of an equity market;
- d** critique the use of discounted dividend models and macroeconomic forecasts to estimate the intrinsic value of an equity market;
- e** contrast top-down and bottom-up approaches to forecasting the earnings per share of an equity market index;

- f** discuss the strengths and limitations of relative valuation models;
- g** judge whether an equity market is under-, fairly, or over-valued using a relative equity valuation model.