



Math Review

CFA L1 Standard

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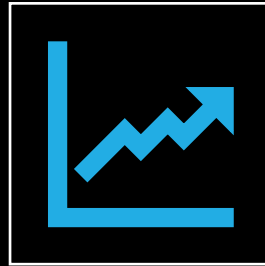
To Begin with

ChatGPT is a good coach if and only if you have a good understanding of what you are asking.

TABLE OF CONTENTS



The Time Value of
Money

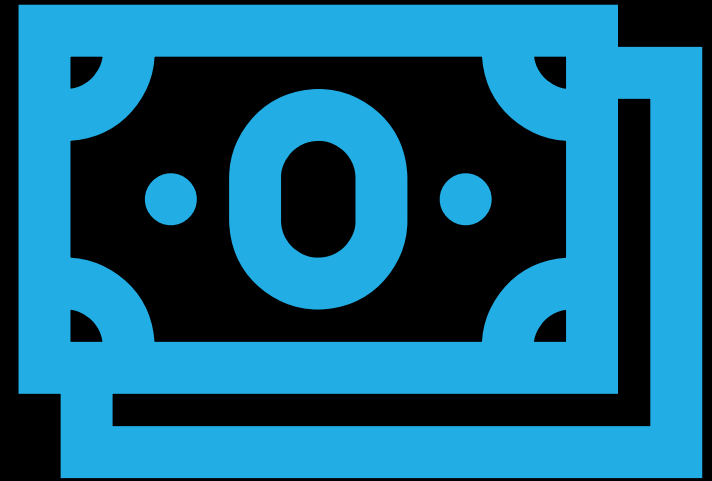


Statistical Concepts
and Market Returns



Probability
Concepts

The Time Value of Money



The Time Value of Money

- Introduction
- FV of a Single Cash Flow
- FV of a Series of Cash Flows
- PV of a Single CF
- PV of a Series of CFs
- Rates, Periods, and Size of Annuity Payments

Introduction

- In short, the calculation of the time value of money involves finding equivalence between cash flows occurring on different dates.
- The real risk-free rate reflects the time preferences of individuals for current versus future real consumption.

interest rate

*= real rate + inflation premium + default risk premium
+ liquidity premium + maturity premium*

FV of a Single Cash Flow

- A single CF or lump-sum investment
- Principle
- Interest
- (Frequency of) Compounding

$$FV_N = PV \left(1 + \frac{r_a}{m} \right)^{mN}$$

Effective Annual Rate (EAR)

- A stated annual interest rate will result in different Effective Annual Rates (EAR) depending on the compounding frequency.

$$EAR_{DT} = \left(1 + \frac{r_a}{m}\right)^m - 1$$

- For continuous-time case:

$$EAR_{CT} = e^{r_a} - 1 > EAR_{DT}$$

FV of a Series of Cash Flows

- Annuity and Perpetuity.
- Equal CFs case:

$$FV_N = A \sum_{t=0}^{N-1} [(1+r)^t]$$

$$FV_N = A \left[\frac{(1+r)^N - 1}{r} \right]$$

FV of a Series of Cash Flows

- Unequal CFs case:

$$FV_N = \sum_{t=1}^T CF_t(1+r)^{T-t}$$

From FV to PV

- Do the opposite.

$$PV_N = A \sum_{t=1}^N \left[\frac{1}{(1+r)^t} \right]$$

$$PV_N = A \left[\frac{1 - \frac{1}{(1+r)^N}}{r} \right]$$

From FV to PV

- Unequal CFs case:

$$PV_N = \sum_{t=1}^T CF_t(1+r)^{-t}$$

$$FV_N = PV(1+r)^N$$

The equation above will yield the same value as the one you calculated two slides earlier.

From FV to PV

- Infinite case (when interest rates are positive):

$$PV = A \sum_{t=1}^{\infty} \left[\frac{1}{(1+r)^t} \right]$$

$$PV = \frac{A}{r}$$

Consol Bond

- There used to be such bond issued by British government that promised to pay a level CF forever. Say the bond paid £100 per year in perpetuity, how would you price the bond if the required rate of return were 5%?

Consol Bond

- What if the first payment starts at $t=5$?

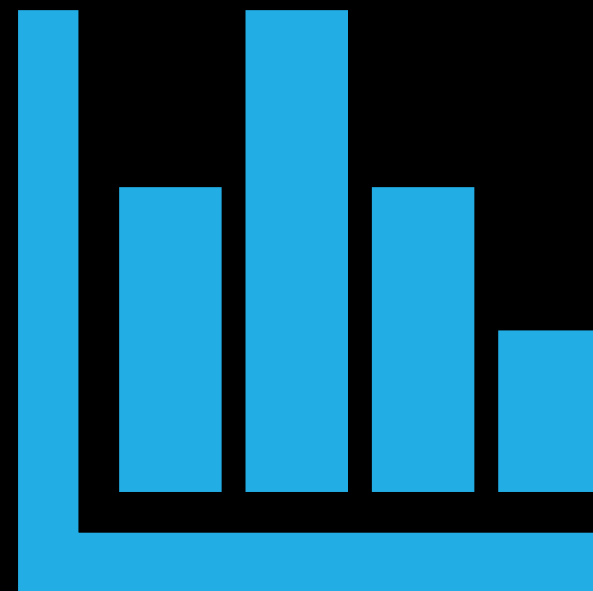
$$PV_4 = 2000$$

$$PV_0 = 2000/(1.05)^4$$

Application

- Now you know all the essential equations in the field of time value of money.
- By now, you should know how to use CF and r to get PV/FV.
- So automatically, you know how to use PV and FV to get r .
- If you know PV, FV, and r , you know N .
- If you know PV, r , and N , you know A .
- ...

Statistical Concepts and Market Returns



Moments

- Mean
- Dispersion A.K.A Spread
- Skewness
- Kurtosis

Data

- Population
- Sample
- Sample Statistics
- Frequency Distribution

$$R_t = \frac{P_t + D_t - P_{t-1}}{P_{t-1}}$$

Measures of Mean

- Arithmetic Mean and Geometric Mean:

$$\bar{X} = \frac{\sum_{i=1}^n x_i}{n}$$

$$G = \sqrt[n]{\prod_{i=1}^n x_i} \Rightarrow \ln G = \frac{\sum_{i=1}^n \ln x_i}{n}$$

Measures of Mean

- Why Geometric? Consider the following: You are holding a stock that worth \$100 at $t=0$. At $t=1$ it worth \$200, but it drops back to \$100 at $t=2$. What's the difference between using arithmetic and geometric?

$$AM = \frac{[1 + (-0.5)]}{2} = 0.25$$

$$GM = ((1 + 1)(1 - 0.5))^{\frac{1}{2}} - 1 = 0$$

Measures of Dispersion

- Range
- Mean Absolute Deviation
- Variance
- Standard Deviation

Measures of Dispersion

$$R = MAX - MIN$$

$$MAD = \frac{\sum |X - \bar{X}|}{n}$$

$$s^2 = \frac{\sum (X - \bar{X})^2}{n - 1}$$

To measure sample variance, we need to consider the degree of freedom, to make it an unbiased estimator of population variance.



Probability Concepts

Risk, Uncertainty, and Probability

- Corporate Finance \cong Risk Management

Probability

- Random Variable - $A(a,b,c)$, $B(x,y,z)$
- Outcomes – a, b, c, x, y, z
- Event – specific set of outcomes

- Unconditional Probability A.K.A Marginal Probability $P(A)$
- Conditional Probability $P(A|B)$
- Joint Probability $P(AB)$

Probability

- Multiplication Rule for Probability:

$$P(AB) = P(A|B)P(B)$$

$$P(AB) = P(A)P(B)$$

- Addition Rule for Probabilities:

$$P(A \text{ or } B) = P(A) + P(B) - P(AB)$$

Expected Value

- Your portfolio:

$$P = c(w_1, w_2, \dots)$$

$$\sum w_i = 1$$

- The expected return of this portfolio:

$$E(R_p) = E(w_1R_1 + w_2R_2 + \dots) = w_1E(R_1) + w_2E(R_2) + \dots$$

Covariance

- Definition:

$$\text{Cov}(R_i, R_j) = E[(R_i - ER_i)(R_j - ER_j)] = \sigma_{ij}$$

- Recall, for sample:

$$\text{Cov}(R_i, R_j) = \sum_{i=1}^N (R_i - \bar{R}_i)(R_j - \bar{R}_j) / (n - 1)$$

Variance of Portfolio

- In general:

$$\sigma^2(R_P) = \sum_{i=1}^N \sum_{j=1}^N w_i w_j \text{Cov}(R_i, R_j)$$

- The simplest case (two assets):

$$\sigma^2(R_P) = w_1^2 \sigma^2(R_1) + w_2^2 \sigma^2(R_2) + 2w_1 w_2 \text{Cov}(R_1, R_2)$$

Correlation

$$\rho(R_1, R_2) = \frac{Cov(R_1, R_2)}{\sigma(R_1)\sigma(R_2)} \in [0,1]$$

*Bayes' Formula

- Recall:

$$P(AB) = P(A|B)P(B)$$

- Financial intuition:

$$P(EVENT|INFO) = \frac{P(INFO|EVENT)}{P(INFO)} P(EVENT)$$

Update prior probability of an event when receiving new information.

*Combination and Permutation

- Combination, pick r out of n :

$$C_n^r = \frac{n!}{(n-r)!r!} = \frac{n \cdot n-1 \cdot \dots \cdot n-r+1}{r \cdot r-1 \cdot \dots \cdot 1} = C_n^{n-r}$$

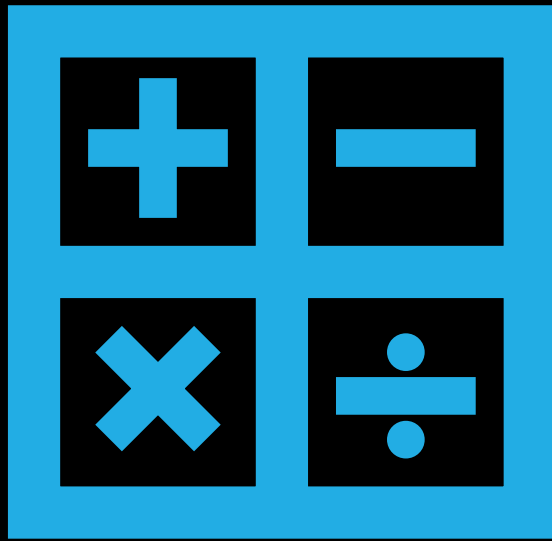
$$C_5^2 = \frac{5 \cdot 4}{2 \cdot 1} = 10 = \frac{5 \cdot 4 \cdot 3}{3 \cdot 2 \cdot 1} = C_5^3$$

*Combination and Permutation

- Permutation, pick r out of n:

$$P_n^r = \frac{n!}{(n-r)!} = n \cdot n-1 \cdot \dots \cdot n-r+1$$

$$P_5^2 = \frac{5 \cdot 4 \cdot 3 \cdot 2 \cdot 1}{3 \cdot 2 \cdot 1} = 5 \cdot 4 = 10$$



**Mathematically,
this is all you
need for the
course.**