INTERNATIONAL FINANCIAL MANAGEMENT II
FIN 614
FALL 2018

Purpose:
Finance 612 & 614 are designed to familiarize students with the basic tools and concepts of International Financial Management. The main goal of this sequence is to provide the conceptual and analytical framework required for understanding how international financial conditions influence the decision-making process of modern business leaders in the corporate and capital markets arenas. Within Fin 612, we learned the major characteristics, institutions, and players of the exchange rate markets. We then considered the interaction between cross-border trade, capital flows, interest rates, inflation, monetary and fiscal policies, economic growth, and their impact on financial investment and corporate decision-making. Finally, we used these ideas to explore exchange rate regimes, Central Banks’ intervention policies, and currency crises. In this follow-up course, Fin 614, we will examine various other international financial markets (equities, bonds, swaps, and other derivatives), and the opportunities they present for corporate financial policies, risk management, and portfolio management. We will also attempt to explain and interpret the recent wave of international financial crises affecting the global capital markets. This sequence is tailored to students seeking careers in international banking and portfolio management or in finance and strategy for domestic and multinational corporations. Due to the nature of the material, the course will be taught in the form of lectures using many of the quantitative tools you have learned in previous Finance, Economics, and Statistics courses.

Instructor:

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TA: George Malikov  
Email: gmalikov@umich.edu
Office Hours:

Tuesdays: 2:00 p.m. to 4:00 p.m. (room R4434)

By appointment as needed; see the Canvas website for the TA's office hours and location.

Course Materials:

There is one required textbook for this course:

1. *International Financial Management* by Geert Bekaert and Robert Hodrick, 2nd edition (Pearson-Prentice Hall) [1st edition is fine];

I will provide specific additional readings and lecture notes on the Canvas class website.

Additional textbooks you may be interested in (but are NOT required) are:

2. *International Investments* by Bruno Solnik and Dennis McLeavey, 5th or most recent edition (Pearson Addison-Wesley).

3. *International Financial Markets*, by Richard Levich (McGraw-Hill Irwin);


All of these textbooks are available for consultation at the Kresge Library. Please always check the Canvas class website at least a day prior to each class session: YOU ARE RESPONSIBLE for downloading all class materials, handouts, and readings for a session.

The Canvas class website also contains a discussion board, where I will occasionally post messages with answers to frequently asked questions.

Homework:

Two homework problem sets will be assigned throughout the term. The homework will be posted on the Canvas class website. Due dates for the homework are indicated below.

Homework may be done individually or in groups. Nonetheless, homework assignments must be submitted **individually, on my class desk, prior to class-time on the due date.** You must show how you obtained all your answers. Late homework will not be accepted.

Homework 1: Due at the beginning of LECTURE 7
Homework 2: Due at the beginning of LECTURE 11
Practice Quizzes:

Three ungraded practice quizzes (made of five questions each) will be available throughout the term. The quizzes will be posted on the Canvas class website (in the Modules section). Practice quizzes are for your self-assessment and won't count toward your final grade; however, you are required to try each of them, at least once. Afterwards, the quiz will show you how to work through the solution. I suggest you to work on the questions on your own first, before looking at the solutions. The quizzes provide additional practice for the final exam.

Group Project:

There will be one group project. The purpose of the project is to write a “global asset allocation report.” Asset allocation reports are routinely prepared and distributed by investment banks to clients worldwide. Typically, such a report is focused on a wide range of asset classes (stocks, bonds, cash, commodities, real estate) and countries (developed, emerging). The report includes an analysis of the world business cycle, as well as of relevant economic, financial, and political events taking place in selected markets and regions: Elections, Central Bank interventions, important monetary or fiscal decisions, etc. Finally, the report uses all this and other information to formulate tactical (short-term, e.g., up to 1 year) and strategic (long-term, e.g., up to 5 years) global asset allocation recommendations for investors with different degrees of risk aversion. You will also have to recommend whether and how the potential risk/return trade-off stemming from the foreign exchange exposure of the selected portfolio should be addressed.

Your team has to prepare and submit such report to me. The report itself will have to be of no less than three but no more than four pages in length. Indeed, global investors and CFOs tend to be busy and have little or no time for lengthy dissertations. Hence, your recommendations will have to be prominently placed in the report (for example, with the help of pie charts). Your analysis has to employ the tools and techniques we will discuss in class (for instance, return forecasting), as well as any other economic, financial, or statistical tool you may be comfortable with. In addition, you MUST construct your portfolio
allocation using the portfolio optimization techniques we will discuss in class. I will provide
you with sample allocations you can use to ensure your portfolio engine is generating the
correct numbers. **You do not have to use Excel to construct the portfolio engine. Yet,**
you will have to send me an email with any software code/program you used for the
optimization together with the final report.

Asset allocation reports are generally not too technical in nature, since they strive to be read
by the largest possible number of clients. Therefore, you will attach an **Appendix of no less
than two and no more than four pages in length** in which you describe the analytics and
details of the methodologies you used to prepare the report. **Shorter or longer reports will be penalized.**

**This project is to be completed in groups of three to five members.** You have to submit only one report for the entire group, being careful to note all the names of
group members, via email to me, in PDF format only, by 9:00 am of the due date: **December 16, 2018.** Late reports will not be accepted. The report will be graded based on quality of content, quality of exposition, and the extent to which it feels “professionally” executed.

I cannot stress this enough: Start planning and working on this project early, especially on
the portfolio optimization engine … few hours of work prior to the due date are insufficient
to generate a “passing grade” report.

**Data Collection: The Tozzi Center**

As you will soon notice, one of the most challenging tasks for your project is to collect data.
In the Files section of the Canvas class website, there is a subsection titled **International
Finance Web Resources**; there you will find links to sources for most of your data needs.

In addition, you can look for the data you need in the Tozzi Center. Located in the first floor
of the Executive Residence, the Tozzi Center is a state-of-the-art lab with PCs running the
most important data applications in Finance (Reuters, Bloomberg, Datastream, etc). **Kai
Petainen** is the manager of the Tozzi Center and has kindly agreed to provide data retrieval
help to the students of FIN 614. He has prepared a special folder with all the information you may need to collect data in the Tozzi Center, as well as with the most requested data series. He can also help you find any new data you may be looking for. The Tozzi Center is open all day long; Kai is usually available throughout the day, although he tells me that the best times for him to help you are usually in the mornings and in the late afternoons.

Final Exam:

The final exam will be a 2-hour exam on:

December 12, 2018 from 6:30 pm to 8:30 pm, room R0230.

There will be no makeup exam, unless you miss the exam because of a well-documented, valid written medical excuse (e.g., a doctor's note stating that it would have been impossible for you to be in class by the scheduled day/time). The exam will be closed-book. You are not allowed to use any laptop during the exam but only financial calculator(s). You will be allowed to bring one 8-1/2" x 11" sheet of paper with notes and formulas (both sides are ok) on it. The paper does not have to be handwritten (yet, it cannot contain any of the slides from the lecture notes or any of the solution sheets from the homework) and has to be handed in along with the exam.

Grading Policy:

<table>
<thead>
<tr>
<th>Class Participation / Attendance</th>
<th>10%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Homework</td>
<td>10%</td>
</tr>
<tr>
<td>Group Project</td>
<td>40%</td>
</tr>
<tr>
<td>Final Exam</td>
<td>40%</td>
</tr>
</tbody>
</table>

I will grade graduate students according to the following grading policy set by the Ross School of Business for MBA electives, assigning (roughly):

“Excellent” to 0 – 35% of the students

“Good” to 0 – 40% of the students

“Pass”, “Low Pass”, or “Fail” to 0 – 25% of the students.
Personal integrity and professionalism are fundamental values of the Ross Business School community. This course will be conducted in strict conformity with the Academic Honor Code. The Code and related procedures can be found at the following website: www.bus.umich.edu/Academics/Resources/communityvalues.htm. The site also contains comprehensive information on how to be sure that you have not plagiarized the work of others. Claimed ignorance of the Code and related information appearing on the site will be viewed as irrelevant should a violation take place. Non-Ross Business School students taking the course should also familiarize themselves with the Code as they will be subject to the Code as well while in this course.

Attendance & Seating Policy:

Attendance to class is mandatory. Lectures will stress the most important issues addressed in the course and may go beyond the scope of the textbook for certain topics. You are responsible for announcements in class; consult a colleague if you are absent. Perfect attendance will factor into grading for those on the edge of grade distributions. I will distribute in class a seating chart at the beginning of the second lecture. You will be expected to use the seat you choose that day for the remainder of the term. I will post a copy of the seating chart on the Canvas class website. Please place a name tag with your name in front of your seat at all times and fill the face card form available on the Canvas class website by the beginning of the second class.

Special Accommodations:

The University of Michigan is committed to providing equal opportunity for participation in all programs, services and activities. Students wishing to receive testing accommodations must register with the UM SSD (Services for Students with Disabilities) as soon as possible. Students must then submit their Verified Individualized Services and Accommodations (VISA) form via online web form as early as possible, but no later than two weeks prior to the test or quiz for which accommodations are requested.
Requests must be sent using the Accommodations Request form available at the following website:

https://docs.google.com/forms/d/e/1FAIpQLScqfP5B-bM0rfwyvtOeKXAMPyTrLHZwrPbvd6oMfgE2yNYPQ/viewform

and must include a scanned or photographed copy of the VISA form. This form only needs to be submitted once during your academic career with Ross unless your accommodations eligibility expires. Questions can be directed to the Accommodations Coordinator at RossAccommodationsCoordinator@umich.edu.

In rare cases, the need for an accommodation arises after the two-week deadline has passed (for example, a broken wrist). In these cases, you should still contact SSD and the Ross Accommodations Coordinator. However, due to logistical constraints, the SSD cannot guarantee that an accommodation can be made after the two-week deadline has passed.
Course Content & Class Schedule (tentative):

1. **The International Equity Markets**

1.1. **International Equity Markets and Instruments** (LECTURES 1 & 2)

   Opportunities for investors (diversification, return enhancement) and corporations (additional sources of financing) in international equity markets; global market size, liquidity and concentration; historical differences in market organization and trading procedures; tax aspects; market indexes; execution costs; ADRs; benefits and costs of ADR holdings for investors; benefits and costs of ADR issuance for corporations; open end funds, closed end funds, exchange traded funds, country funds, regional funds.

   **Suggested readings**: Bekaert-Hodrick (Chap. 12); Solnik (Chap. 5); Levich (Chap. 15); Melvin (Chap. 7)

1.2. **International Equity Diversification** (LECTURES 3 & 4)

   The case for international diversification: Risk reduction through attractive correlations; portfolio return performance; currency risk not a barrier to international investment; the mathematics of diversification; the case against international diversification: Increases in correlations during bear markets; barriers to international investments; segmentation; globalization.

   **Suggested readings**: Bekaert-Hodrick (Chap. 13); Solnik (Chap. 4); Levich (Chap. 15, Appendix to Chap. 14); Melvin (Chap. 7)

1.3. **International Asset Pricing** (LECTURES 5 & 6)

   Building and using a portfolio engine: More on the mathematics of diversification; determining the inputs; a review of market efficiency and the domestic capital asset pricing model (CAPM); asset returns and exchange rate movements; the domestic CAPM extended to the international context; international CAPM (ICAPM); the World CAPM; implications for corporations’ cost of equity capital in financially integrated capital markets; assessing the
exposure of corporations’ (cost of) equity capital to currency risk: Translation risk and business currency risk: The Novartis case.

**Suggested readings:** Bekaert-Hodrick (Chap. 13, 16.2); Solnik (Chap. 4); Levich (Chap. 15); Melvin (Chap. 7)

1.4. *Issues in International Asset Pricing* (LECTURE 7)

Alternatives to CAPM, ICAPM, and World CAPM: APT, Fama-French; integration versus segmentation; integration, segmentation, market efficiency, and pricing; further implications for corporations’ risk and cost of capital of (time-varying) financial market integration; the case for and against investing in Emerging markets; risk and opportunities for corporations in Emerging markets; the impact of financial market integration for Emerging market firms (cost of capital, return volatility, net profits); home bias.

**Suggested readings:** Bekaert-Hodrick (Chap. 13); Solnik (Chap. 6, 9); Levich (Chap. 15); Melvin (Chap. 7)

2. *The International Bond Markets*

2.1. **Global Bond Markets, Instruments, and Pricing** (LECTURES 8 & 9)

The various segments; world market size; bond indexes; the Eurobond market; emerging markets and Brady bonds; types of instruments; quotations; global bond markets as additional sources of funding for corporations; costs and benefits of Eurobond markets versus local corporate bond markets as sources of capital for corporations; the Eurobond issuing process; refresher on bond valuation (zero-coupon bonds, bonds with coupons, duration and interest rate sensitivity, credit spreads and the determinants of credit risk); international yield curve comparisons; the return and risk on foreign bond instruments; a multicurrency approach to bond investing; international diversification with bonds.

**Suggested readings:** Bekaert-Hodrick (Chap. 11, 14.3); Solnik (Chap. 7); Levich (Chap. 10, 14); Melvin (Chap. 13)
3. Global Asset and Liability Management

3.1. Issues in Global Portfolio Management (LECTURE 10)

International portfolio diversification: Active versus passive asset allocation; strategic versus tactical asset allocation; determining the inputs: Forecasting international asset returns; prediction regressions; local versus global variables in prediction regressions; time-varying volatility and correlations; sensitivity analysis; reasonable portfolio allocations: Weight constraints; tracking-error optimization; the Black-Litterman approach.

Suggested readings: Solnik (Chap. 13, Appendix to Chap. 3); Levich (Chap. 14, 15)

3.2. Currency Risk Management (LECTURE 11)

Basics of currency forwards, futures, options; a crucial choice for investors and corporations: Hedging foreign exchange risk with currency forwards, futures, or option contracts; insuring and hedging with options; other methods for managing currency exposure; currency overlay.

Suggested readings: Risk management: Bekaert-Hodrick (Chap. 20); Solnik (Chap. 10, 11); Levich (Chap. 11, 12); Melvin (Chap. 4)

4. International Financial Crises (LECTURE 12)

Historical perspective on international financial crises; alternative definitions of financial crises; banking crises; currency crises; bubbles; twin crises; financial contagion; what causes financial crises and why they propagate across countries and markets; implications of financial crises for investors’ portfolio choices and corporations’ financing and capital budgeting decisions; corporations’ cost of capital and currency crises.

Suggested readings: Bekaert-Hodrick (Chap. 10.5, 14.1, 14.3); Levich (Chap. 1, 2, 8); Melvin (Chap. 13)