Competitive Advantage in Investing  
B8424-001  
Summer 2015

Professor Steven Abrahams  
sa362@columbia.edu

Course Description

Successful investing almost always depends on operating with some distinct competitive advantage. And nowhere is that clearer than in the competition between institutional investors, where many investment models compete to extract return from debt, equity and other assets. Investment advantage can come from better information or analysis. But advantage also arises more clearly and more sustainably from the amount and quality of a portfolio’s own equity, the cost and structure of its own funding, its tax and accounting framework and its regulatory and political environment.

This course approaches investing from the perspective of institutional portfolio managers trying to capitalize on comparative advantage. It introduces a framework that fits comparative advantage into classical finance theory. It then leads students through the advantages held by money managers and hedge funds, banks and insurers, GSEs, sovereign wealth funds and broker/dealers, among others. Through case studies and industry data, the course examines how those advantages shape the investment behavior of these institutions.

To develop practical appreciation for managing a portfolio, students will use actual fixed income market offering to construct a series of portfolios appropriate to different institutions. Students will come to understand how to build a portfolio appropriate to particular institutions and how the distinct behavior of different institutions can drive pricing, liquidity and other general aspects of capital markets.

This course is excellent preparation for any student considering a career in fixed income or equity investment management at a money manager, bank, insurer or other institution, or for students considering sales, trading or research.

Prerequisites:

• B6300 Corporate Finance  
• B8306 Capital Markets

Recommended:

• B8308 Debt Markets or working knowledge of fixed income markets since most institutional portfolios trade in those markets regularly.
Selected Course Materials and Other Resources


- Handouts, broker/dealer offering sheets, guest speakers

Evaluation

- Attendance and class participation: 20%
- Team and individual weekly assignments: 20%
- Team portfolio management assignments: 30%
- Individual final paper: 30%

Optional Short Workshops (likely scheduled for weekends)

- *Tools for fixed income analysis* including Bloomberg and Deutsche Bank’s MBS Analytics on Bloomberg
- *Constructing relative value trades in fixed income*

Course Outline

A Conceptual Framework for Investing

- The classics of finance: Markowitz and CAPM

- The flaws in CAPM and the alternative Local CAPM

- The key sources of comparative advantage in fixed income and, to a lesser extent, equity investing including funding and liability structures, accounting and tax regimes, regulatory and legal constraints and their impact on asset choice, holding period and other aspects of investment behavior.

Risk, Reward and Portfolio Construction

- Scenario construction: developing expectations about the yield curve, volatility, swap spreads, credit and mortgage spreads and funding markets

- Estimating risk and return: calculating expected returns and volatility in Treasury, agency and corporate debt and MBS; estimating risk and return in funded portfolios
• Hedging components of risk: hedging corporate debt, agency callable debt and MBS

*Portfolio Management for Total Return*

• Sources of comparative advantage for money managers, hedge funds and others: evaluating fund performance; understanding hedge fund performance; growth and future prospects for providers of alpha and beta

*Portfolio Management for Banks*

• Sources of comparative advantage for banks: funding through retail and wholesale deposits, FHLB advances, debentures, government programs; potential for informational advantages; accounting/tax considerations; regulatory and political considerations.

• Portfolio behavior at banks: the conflicting objectives of managing capital, ROE and net interest margin; observed differences in funding structure; observed differences in asset mix; observed differences in trading behavior.

• Case study: hedging a mortgage servicing portfolio on a bank balance sheet: characteristics of the asset; methods to hedge the risk; accommodating the offsetting impact of new mortgage originations; the influence of accounting.

*Portfolio Management for Insurers*

• Sources of comparative advantage for insurers: funding through insurance premiums, annuities and other vehicles; differences between life and P&C liability structures; impact of regulator and rating agency capital charges.

*Portfolio Management for REITs and GSEs*

• Sources of comparative advantage for REITs: regulatory exemptions, source and quality of capital, sources of funds, limits to allowable assets.

• Sources of comparative advantage for GSEs: funding through the agency debt markets; impact of debt issuance process on funding costs; use of derivatives to minimize funding costs; accounting/tax considerations; regulatory and political considerations.

• Portfolio behavior at GSEs: observed differences at FNM and FRE over time; observed differences between FNM/FRE and the FHLBanks.
Portfolio Management for Sovereign Wealth Funds

- The varying investment objectives of sovereign wealth funds: from foreign reserve management to fiscal stability, from monetary policy to wealth preservation
- The varying approaches of sovereign wealth funds: asset allocation and response to financial crisis
- The role of moral hazard in the investment strategies of sovereign wealth funds

Portfolio Management for Broker/Dealers

- Sources of comparative advantage for brokers/dealers: information, liquidity and transaction costs; sources of funding; position flexibility; observable differences over time in the aggregate broker/dealer portfolio

Turning the Tables: The Impact of Market Structure on Asset Value

- Understanding the impact of market structure: case studies of GSE, bank and Fed impact on value in MBS; case studies of GSE and mortgage servicer impact on value in swaptions; case studies of foreign central bank and Fed impact on value in U.S. Treasury debt.

Detailed class schedule

<table>
<thead>
<tr>
<th>Class Date</th>
<th>Topic</th>
<th>Assignment</th>
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</thead>
<tbody>
<tr>
<td>1 Wed, May 27</td>
<td>Introduction, key investment assets and key risks</td>
<td>No assignment</td>
</tr>
<tr>
<td>2 Fri, May 29</td>
<td>CAPM, the challenge to CAPM and local CAPM</td>
<td>Question Set #1</td>
</tr>
<tr>
<td>3 Mon, Jun 1</td>
<td>Sources of return, risk bundles and risk hedging</td>
<td>Start team portfolio</td>
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<tr>
<td>4 Wed, Jun 3</td>
<td>Scenario construction and anticipating asset performance</td>
<td>Question Set #2</td>
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<tr>
<td>5 Mon, Jun 8</td>
<td>General sources of competitive advantage: Part I</td>
<td>No assignment</td>
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<tr>
<td>6 Wed, Jun 10</td>
<td>General sources of competitive advantage: Part II</td>
<td>Question Set #3</td>
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<tr>
<td>7 Mon, Jun 15</td>
<td>Advantage in total return: Mutual Funds Part I</td>
<td>No assignment</td>
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<tr>
<td>8 Wed, Jun 17</td>
<td>Advantage in total return: Mutual Funds Part II*</td>
<td>Question Set #4</td>
</tr>
<tr>
<td>9 Mon, Jun 22</td>
<td>Advantage in total return: Hedge Funds Part I</td>
<td>No assignment</td>
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<tr>
<td>10 Wed, Jun 24</td>
<td>Advantage in total return: Hedge Funds Part II*</td>
<td>Question Set #5</td>
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<tr>
<td>11 Mon, Jun 29</td>
<td>No class</td>
<td>No assignment</td>
</tr>
<tr>
<td>12 Mon, Jul 1</td>
<td>Advantage from liabilities: Banks Part I</td>
<td>Question Set #6</td>
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<tr>
<td>13 Wed, Jul 8</td>
<td>Advantage from liabilities: Insurers Part I</td>
<td>Question Set #7</td>
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<tr>
<td>14 Mon, Jul 13</td>
<td>Advantage from liabilities: Insurers Part II*</td>
<td>No assignment</td>
</tr>
<tr>
<td>15 Wed, Jul 15</td>
<td>Advantage: REITs</td>
<td>Question Set #8</td>
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<tr>
<td>16 Mon, Jul 20</td>
<td>Advantage: Broker/dealers</td>
<td>No assignment</td>
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<tr>
<td>17 Wed, Jul 22</td>
<td>Advantage: Government sponsored enterprises*</td>
<td>Question Set #9</td>
</tr>
<tr>
<td>18 Mon, Jul 27</td>
<td>Advantage: Sovereign wealth funds</td>
<td>No assignment</td>
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<tr>
<td>19 Wed, Jul 29</td>
<td>Turning the tables: investors’ impact on asset values</td>
<td>Question Set #10</td>
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<tr>
<td>20 Mon, Aug 3</td>
<td>Student presentations</td>
<td>No assignment</td>
</tr>
<tr>
<td>21 Wed, Aug 5</td>
<td>Student presentations (if the time is needed)</td>
<td>No assignment</td>
</tr>
<tr>
<td>22 Wed, Aug 12</td>
<td>Final paper due</td>
<td>Turn in final paper</td>
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* Featured speaker from 6 PM – 7 PM
READINGS for SUMMER 2015

Topic 1: Portfolio Theory (Wed, May 27 – Fri, May 29)

Required

Optional


Topic 2: Return, Risk and Portfolio Construction (Mon, Jun 1 – Wed, Jun 3)

Required

Optional


**Topic 3: Comparative Advantage (Mon, Jun 8 – Wed, Jun 10)**

**Required**

**Topic 4: Total Return I (Mon, Jun 15 – Wed, Jun 17)**

**Required**


**Optional**

**Topic 5: Total Return II (Mon, Jun 22 – Wed, Jun 24)**

**Required**

**Optional**

Agarwal, Vikas and Narayan Y. Naik (2005), *Hedge Funds*, now Publishers: Hanover, MA. Full text available online via Columbia University CLIO.

**Topic 6: Advantage from liabilities: banks (Wed, Jul 1 – Mon, Jul 6)**

**Required**

**Optional**

**Topic 7: Advantage from liabilities: insurers (Wed, Jul 8 – Mon, Jul 13)**

**Required**


**Topic 8: REITs (Wed, Jul 15)**

**Required**


**Optional**


**Topic 9: Broker/dealers (Mon, Jul 20)**

**Required**

**Topic 10: Government sponsored enterprises (Wed, Jul 22)**

**Required**
**Topic 10: Sovereign Wealth Funds (Mon, Jul 27)**


**Topic 11: Tables Turn: the Impact of Market Structure on Asset Valuation (Wed, Jul 29)**

**Required**

**Optional**

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