Corporate Finance, Module 2: “How to Calculate Present Values”

Corporate finance module 2: Readings for Eleventh Edition

(The attached PDF file has better formatting.)

The page numbers here are for the *eleventh* edition of Brealey and Myers. You may also use the seventh, eighth, ninth, or tenth editions of this text. The page numbers for earlier editions are in separate postings. The substantive changes in the textbook are slight among these editions, but the final exam problems are based on the eleventh edition.

Read Section 3.1, “Using the present value formula to value bonds” on pages 46- 49. This material is easy for most candidates (you value more complex cash flows for the actuarial exams) but it is the foundation of bond valuation.

Read Section 3.2, “How bond prices vary with interest rates”, on pages 49-53. You have more precise duration formulas on the actuarial exams. For the corporate finance VEE course, the capital structure of the firm changes with interest rates.

Read Section 3.3, “The term structure of interest rates,” on pages 53-57. Know the various terms (spot rate, coupon rate, yield to maturity). Read Section 3.4, “Explaining the Term Structure,” on page 57-59. In later chapters, Brealey and Myers use the CAPM to derive the systematic risk of debt. Other economists assume the CAPM applies to stocks, not to debt. The final exam problems follow the Brealey and Myers presentation, computing CAPM betas for assets, equity, and debt.

Read Section 3.5, “Read and Nominal Interest Rates” on pages 59-61. Know how to derive net present values with both real and nominal interest rates. Some final exam questions give the real interest rate instead of the nominal interest rate. Skip the sub-section on “Indexed bonds and the real rate of interest” on pages 61-63.

The discussion of interest rates and of current vs future consumption is consistent with the Barro’s text on *Macroeconomics* and Landsburg’s text on *Microeconomics*. Brealey and Myers focus on capital markets, whereas economists focus on individual actors. Economists often assume that all consumers have the same preferences. This is not necessary; the capital markets construct a market preference based on the marginal consumer. Barro follows the same theory, but the explanation is better in the Brealey and Myers text.

Read Section 3.6, “The Risk of Default” on pages 64-66; skip the section “Sovereign bonds and default risk” on pages 66-68. Later modules deal with capital structure, default risk, and optimal debt levels.

Most of the material in Module 2 is also on the actuarial exams. These topics are simple for most candidates, but they are used in later corporate finance modules, where the concepts are harder.

The Summary on page 69 is a good review. Review problems 1, 3, 4, and 5 on page 70, problems 6, 9a, 9b, and 10a on page 71, and problem 14a on page 72.