

BUS 418-E100 International Financial Management Simon Fraser University

Instructor: Daniel Smith

Office: Segal 3325

Burnaby WMC3329

Phone: (778) 782-4675 (Burnaby)

(778) 782-7714 (Segal)

Fax: (778) 782-4920 (Burnaby)

Email: drsmith@sfu.ca

URL: <http://www.sfu.ca/~drsmith/bus418>

Username:

Password:

Lecture: 5:30-8:20 WMC3535

Office Hours: Monday 3:30-5:30 (Burnaby)

Wednesday 12:30-2:00 Segal.

Description:

This course examines the management of assets and liabilities in a multinational setting. The primary topic to be covered is the evaluation and management of foreign exchange risk. Management topics include the pricing and application of foreign exchange derivatives: swaps, futures and options.

Learning Outcomes:

1. Become familiar with the subtleties and complexities facing investors and firms when operating in an international context.
2. Be able to critically evaluate popular press articles on foreign exchange rate details.
3. Understand the various forces that determine exchange rates.
4. Explain the operation and pricing of foreign exchange rate derivative contracts.
5. Identify potential sources of exchange rate risk for a firm, evaluate whether the risk needs to be hedged, and if so articulate the optimal hedging strategy.
6. Articulate the benefits and costs of international diversification and the relative advantages/disadvantages of various vehicles.

Pedagogy:

A range of different teaching styles will be used which includes lecture, group discussion, case study, and peer learning. You are expected to contribute both to our group discussions and when engaging in group work. I will encourage you to work closely in your groups when preparing for cases and when working on the problem sets. The lectures will not religiously follow the textbook chapters, though you are required to read each chapter. In fact, I will assign pre-reading for each class that I expect you all to have at least perused before the lecture. A large component of your learning will take place in

groups so we will spend some of week 1 discussing group dynamics. However, if your group turns out dysfunctional and despite your diligent endeavors (and you must convince me that you worked at it) you still discover that one group member is not pulling their weight, then after two warnings you may eject that member from your group. Conversely, if you feel that your group as a whole is being less than helpful then also after two warnings you may form your own group. If you are having any concerns with the group work please ensure that you see me as early as possible.

Course Coverage:

1. Background (Chapters 1-3)

The first part of the course introduces the environment in which international firms operate. We will present the major historical developments in foreign exchange markets including the important development of the Euro. The Balance of Payments summarizes all international transactions that involve an economy and has an important influence on the exchange rate determination.

2. Foreign Exchange Markets and Exchange Rate Determination (Chapters 5 and 6)

We will discuss how foreign currency is traded both in the spot and forward markets and consider some important crises that have arisen. The third part of the course considers the underlying no-arbitrage conditions that determine spot and forward exchange rates. We consider interest rate and purchasing power parity and the efficient markets views of exchange rate determination.

3. Currency Derivatives (Chapters 7 and 14 and some of 11)

The third second of the course introduces a range of interest rate and currency derivative contracts, including forwards, futures, options, forward rate agreements, and various swaps. We will focus on understanding how to use them to hedge currency risk and spend a little time on valuation.

4. FX Risk Management (Chapters 8 and 9)

In section 4 we consider why firms may or may not want to hedge currency risk. We will spend some time understanding the sources of currency risk and consider some vehicles available to diversify both transaction and economic exposure.

5. International portfolio theory and asset pricing (Chapter 15, some of 12, 13, and 17)

In this section we consider both the vehicles and motivates for investing internationally. We introduce a range of instruments for investing internationally in both fixed income and equity markets. We will spend some time considering the economic advantages for international diversification and why despite these gains many investors choose not to

invest abroad (the so-called “home bias”). The international CAPM will also be introduced.

Grading:

Midterm Exams [35% each]

Dates: MT1 11 February, 2008

MT2 31 March, 2008

The two exams are not cumulative. The first midterm covers topics one and two while the second midterm covers topics three through five. The best preparation for the exams is to fully understand the homework questions. Many exam questions are directly related to problem set questions, though they may look a little different. You may bring a one page formulae sheet which covers *only* formulae (i.e., no definitions or explanations).

Group Term Paper [25%]

The project focuses on an exchange rate (which your group will choose) over the period September 2007 to Mid-March 2008 and is done in groups of 3 to 4. You will be required to provide a progress report/rough first draft (4 pages roughly) by lecture 10 (17 March, 2008) and all groups will present a short (12 min) presentation in the last class. More details are given below.

Homework [5%]

During the semester I will give four assignments. Much of the midterm exams will be **heavily** based on questions from the problem sets. You are encouraged to work on them in your groups however you *must* submit your *own* work. You are required to submit a **reasonable attempt** by noon on Wednesday before class in the appropriate drop box outside the third floor reception desk. I will look through the papers (they are not graded in detail) and return them in class when we will go over the problems. I am looking for a “reasonable attempt” and not the “right” answer. For each assignment submitted you will earn one percent. If you submit all four assignments you will be given a bonus one percent for a total of five percent.

Class Participation [0%]

I may take into account good class participation when allocating grades to students who are near a border.

Notes:

- Before the first lecture all students must form groups of 4. During some lectures you will be asked to work on problems in small groups so please try to sit near your other group members.
- I will not change the weights on the assessment under any circumstances, so please do not ask.
- You will be permitted to bring a one-page formulae sheet to the exams. Please ensure that your name clearly appears at the top and submit the sheet with each exam. The

formulae sheet may contain **formulae only**, i.e., no definitions. Formulae sheets containing definitions will be confiscated.

- You may bring a *nonprogrammable* calculator into the exams (the sole function must be as a calculator). PDAs, cell phones and similar devices are not allowed. [It is a good idea to bring a spare along too.]
- If, due to some unforeseeable emergency, you must miss either exam, you must advise me with suitable documentation within a day or two of the exam date.
- Although this course is a finance course and the primary focus is therefore on analytical concepts, the ability to express oneself with the written word is still important. Style and grammar will be given some weight when grading.

Required Text:

Cheol S. Eun and Bruce G. Resnick, 2007, *International Financial Management*, Fourth Edition, Irwin McGraw- Hill.

Reference Texts:

Michael H. Moffett, Arthur I. Stonehill and David K. Eiteman, 2003, *Fundamentals of Multinational Finance*, Addison-Wesley

A slightly more advanced and comprehensive treatment.

Bruno Solnik, (Most Recent Version) *International Investments*, Addison-Wesley Publishing Company.

A more advanced treatment focusing primarily on international portfolio theory.

Prerequisites:

BUS 315, BUS 316, BUS 360; 60 credit hours

You will need to be comfortable with many concepts previously studied, including statistics (random variables, mean, variance, correlation, regression), investments (utility functions, portfolio choice, the CAPM), derivatives (arbitrage, options, futures), and perhaps investments (calculating NPVs and costs of capital). You must also be familiar with the Black-Scholes option pricing formulae. We will only need this after the first midterm. If you are at all nervous about any of these concepts then start reading now.

Academic Honesty:

Academic integrity is central to the university and it is expected that all students act honestly on all assessment. Students should be familiar with the definition of academic honesty <http://www2.sfu.ca/policies/teaching/t10-02.htm>. Included in the definition of academic dishonesty is plagiarism which involves the copying of any material without giving explicit credit (reference) to the author. No excuses (including ignorance) will be accepted.

Group Term Paper

You are to write a term paper on the behavior of an exchange rate series that you will choose. This assignment will be done in groups of three or four. You may choose any exchange rate from the following list: USD against Australian Dollar, Canadian Dollar, Euro, GB Pound, Japanese Yen, Swiss Franc, and Pound/Euro. Each group should use a different exchange rate so please give your group name and exchange rate to me ASAP.

The assignment contains two components. The first part is to follow as a group the major exchange rate movements and economic events over the period September 2007 to Mid-March 2008. You will be required to link the major events for this series to economic fundamentals where possible. You may like to discuss any articles you find in newspapers. The second part of the paper is an empirical exercise exploring the effect of some economic variables on your exchange rate. You may gather historical data that extends back several years. Examples may be the effect of gold or oil prices, or interest rate differentials on exchange rate changes. There are some subtle statistical points to keep in mind:

- You cannot regress a random walk on a random walk or you will get large R² but small T-statistics. This is called a spurious regression problem. You CANNOT, for example, run the regression $S_t = a + bOIL_t + e_t$ where S is the exchange rate and OIL is the price of oil. You can, however, study $\Delta S_t = a + b\Delta OIL_t + e_t$ where ΔS_t denotes the CHANGE in the variable (exchange rate) and is given by $\Delta S_t = S_t - S_{t-1}$.
- Don't use overlapping observations. For example if you regress the one-month change in the exchange rate on the one-month interest rate differential don't use weekly data: $\Delta S_{t+1} = a + b(i_t^{\$} - i_t^{\pounds}) + e_t$.

Your written report will be due at 4:30 on Friday April 4, 2008 and must include:

- A one page executive summary
- 10-12 pages of detailed analysis (12 point Times Roman font and 1.5 line spacing with one inch margins)
- An appendix possibly including the raw data, statistical analysis, and any clarifying material you wish to provide.
- Please use only a single staple in the upper right corner. **DO NOT USE** those annoying plastic covers or spiral binding.

Other notes:

- You will need to conduct some quantitative empirical analysis which may include regressions.
- Although this is a finance course and VERY heavily focused on the quantitative/analytical side style is still important. So please note that grammar and style *will* be graded. The better the draft the better the feedback I will be able to provide.
- During the final lecture each group will present their findings in a 12 minute group presentation. You are encouraged to use overheads or computer aids in

your presentation. Please bring a copy of your one-page executive summary for your classmates.

- Twenty marks will be allocated to the written report and the remaining five marks will be for the presentation. The order of the groups will be determined randomly and you will be informed in advance of the presentation order.

An important part of your project will be tracking the major historical events affecting your exchange rate. To that end it is essential that you start *very* early reading news reports. Be sure to save all citations. I cannot stress this advice enough.

Information Sources:

- Google and News papers (especially the WSJ, Globe and Mail and National Post). Some countries major newspapers are also available online.
- <http://finance.yahoo.com/>: contains lots of data and news pieces (see in particular <http://finance.yahoo.com/currency>). You can access historical news reports <http://biz.yahoo.com/n/group/060501.z09.html>.
- Datastream <http://www.datastream.com/> is available on a terminal in the library. Bar none, this is the most useful source of data for the first part of the project.
- <http://www.economagic.com/>: great site for historical exchange rates and other US Macroeconomic variables you will need. Also has links to historical LIBOR data (<http://www.economagic.com/libor/>) and has Marco data from the central banks of Australia, Japan and the Euro.
- <http://www.oanda.com/convert/fxhistory>: historical FX data.
- <http://fx.sauder.ubc.ca/data.html>: really useful site with data, analysis and interesting background material.
- <http://www.futuresguide.com/today.txt> Futures quotes. Cite also has historical data <http://www.futuresguide.com/historical-data.php>
- <http://www.ny.frb.org/xml/fx.html> Historical data including forward rates for the Euro and Yen.
- <http://www.dbresearch.com/> Deutsche Bank website contains some nice background research including country backgrounds.
- <https://www.commerzbank.com/research/index.html> background research
- <http://www.gcitrading.com/fxnews/index.aspx> daily market update (a little too heavy on the technical analysis for my taste though)
- <http://research.stlouisfed.org/fred2/> best site for interest and exchange rates