Intermediate Financial Theory
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The market for financial textbooks is crowded at both the introductory and doctoral levels, but much thinner at the intermediate level. Teaching opportunities at this level, however, have greatly increased with the advent of masters of science programs in finance (master in computational finance, in mathematical finance, and the like) and the strengthening demand for higher-level courses in MBA programs.

The Master in Banking and Finance Program at the University of Lausanne admitted its first class in the fall of 1993. One of the first such programs of its kind in Europe, its objective was to provide advanced training to finance specialists in the context of a one-year theory-based degree program. In designing the curriculum, it was felt that students should be exposed to an integrated course that would introduce the range of topics typically covered in financial economics courses at the doctoral level. Such exposure could, however, ignore the detailed proofs and arguments and concentrate on the larger set of issues and concepts to which any advanced practitioner should be exposed.

Our ambition in this text is, accordingly, first to review rigorously and concisely the main themes of financial economics (those that students should have encountered in prior courses) and, second, to introduce a number of frontier ideas of importance for the evolution of the discipline and of relevance from a practitioner’s perspective. We want our readers not only to be at ease with the main concepts of standard finance (MPT, CAPM, etc.) but also to be aware of the principal new ideas that have marked the recent evolution of the discipline. Contrary to introductory texts, we aim at depth and rigor; contrary to higher-level texts, we do not emphasize generality. Whenever an idea can be conveyed through an example, this is the approach we chose. We have, similarly, ignored proofs and detailed technical matters unless a reasonable understanding of the related concept mandated their inclusion.
Intermediate Financial Theory is intended primarily for master level students with a professional orientation, a good quantitative background, and a preliminary education in business and finance. As such, the book is targeted for masters students in finance, but it is also appropriate for an advanced MBA class in financial economics, one with the objective of introducing students to the precise modeling of many of the concepts discussed in their capital markets and corporate finance classes. In addition, we believe the book will be a useful reference for entering doctoral candidates in finance whose lack of prior background might prevent them from drawing the full benefits of the very abstract material typically covered at that level. Finally, it is a useful refresher for well-trained practitioners.

As far as prerequisites go, we take the view that our readers will have completed at least one introductory course in Finance (or have read the corresponding text) and will not be intimidated by mathematical formalism. Although the mathematical requirements of the book are not large, some confidence in the use of calculus as well as matrix algebra is helpful.

In preparing the second edition of this text, we have emphasized the overriding concern of modern finance for the valuation of risky cash flows: Intermediate Financial Theory’s main focus is thus on asset pricing. (In addition, we exclusively consider discrete time methodologies.) The new Chapter 2 makes clear this emphasis while simultaneously stressing that asset pricing does not represent the totality of modern finance. This discussion then leads to a new structuring of the book into five parts, and a new ordering of the various chapters. Our goal here is to make a sharper distinction between valuation approaches that rely on equilibrium principles and those based on arbitrage considerations. We have also reorganized the treatment of Arrow–Debreu pricing to make clear how it accommodates both perspectives. Finally, a new chapter entitled “Portfolio Management in the Long Run” is included that covers recent developments that we view as especially relevant for the contemporary portfolio manager. The two appendices providing brief overviews of option pricing and continuous time valuation methods are now assigned to the text website.

Over the years, we have benefited from numerous discussions with colleagues over issues related to the material included in this book. We are especially grateful to Rajnish Mehra, U. of California at Santa Barbara; Elmar Mertens, Study Center, Gerzensee; Paolo Siconolfi, Columbia University, and Erwan Morellec, University of Lausanne, the latter for his contribution to the corporate finance review of Chapter 2. We are also indebted to several generations of teaching assistants François Christen, Philippe Gilliard, Tomas Hricko, Aydin Akgun, Paul Ehling, Oleksandra Hubal, and Lukas Schmid — and of MBF students at the University of Lausanne who have participated in the shaping-up of this material. Their questions, corrections, and comments have lead to a continuous questioning of the approach we have adopted and have dramatically increased the usefulness of this text. Finally, we reiterate our thanks to the Fondation du 450ème of the University of Lausanne for providing “seed financing” for this project.

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N’estime l’argent ni plus ni moins qu’il ne vaut :
c’est un bon serviteur et un mauvais maître

(Value money neither more nor less than it is worth:
It is a good servant and a bad master)

Alexandre Dumas, fils, *La Dame aux Camélias* (Préface)