Is financial know-how in your toolkit?

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In *The Essential Financial Toolkit*, IESE Prof. Javier Estrada provides an easy-to-digest and entertaining guide to fundamental financial concepts and indicators.

When should risk be assessed with standard deviation and when with beta? What's the role of the correlation coefficient in the concept of diversification? How do you evaluate performance by taking into account not just return, as most commercial rankings do, but also risk?

For most financial managers and analysts, these are fairly bread-and-butter questions. But for many of us who have not been schooled in financial issues, such questions can be incredibly difficult, if not downright impossible. And yet financial forces are at the heart of industry and commerce, and frequently impact both our professional and personal lives.

IESE Prof. Javier Estrada's book helps to fill in some of these gaps in the layperson's knowledge of financial processes. As implied by the title, *The Essential Financial Toolkit: Everything You Always Wanted to Know About Finance but Were Afraid to Ask*, the book dispels the myth that finance is, by nature, frighteningly complex.

The 10 chapters are presented in the form of a dialogue between a "witty professor" and an "insightful student." The student asks all the questions a reader might have, and the professor's straightforward answers provide a guided tour of the most important financial tools and indicators.

What's more, the book includes an appendix of some useful Excel commands for many of the tools and concepts covered.

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More of the finance, less of the math

No prior knowledge of finance is needed to enjoy and benefit from the book: intuition and application take the front seat, mathematics and models the back. As the professor tells the student in the book's first chapter, "Finance does use a lot of math, but the truth is that in order to master many essential and widely used concepts, you don't need more than high-school math and a few interesting examples."

When it comes to interesting real-life examples, Estrada's book is packed with them. In the first three chapters — on returns, mean returns and risk, respectively — the professor contrasts the wildly divergent stock performance of General Motors, Sun Microsystems and Johnson & Johnson between 1997 and 2007.

Diversification: Balancing risk and return

Chapter four teaches how to build diversified investment portfolios, a process in which the correlation between the assets plays a critical role. Using examples, Estrada shows that the lower the correlation between two assets, the more you stand to gain by combining them. As the "student" realizes, the goal of diversification is to achieve the best balance between risk and return.

Successive chapters discuss such topics as the capital asset pricing model (CAPM), the cost of capital, downside risk and different ways of calculating risk-adjusted returns.

Later, the book underscores the difficulty of beating the market: "Although we often hear that this or that fund manager beat the market last quarter or last year, that means very little. What really counts is whether we can beat the market on a risk-adjusted basis consistently over the long term. The evidence on our ability to pull that off is damning."

Indispensible bonds

The book's final three chapters look at:

- NPV and IRR, the two most widely used tools for project evaluation.
- The benefits and pitfalls of using relative valuation ratios, typically referred to as multiples, in stock evaluation.
- Bonds, a financial instrument that governments, companies and investors could hardly live without.

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Regarding bonds, the book considers the difference between yields and interest rates, the role of credit-rating agencies in assessing a bond's default risk, and the impact of price volatility and liquidity on the risk, and hence, on the required return of bonds.

As the fictional professor states in his closing remarks, by the end of the 10 lessons, readers should have gained a well-grounded understanding "of some financial tools that will help you understand better what you read or hear in the financial press, and hopefully to participate more intelligently in financial discussions."

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