Chapter One

The Investment Environment

Chapter Overview

- "Real" versus financial assets
- Risk-return trade-off and efficient pricing of financial assets
- Financial crisis of 2008
  - Illustrated connections between financial system and "real" side of the economy
  - Lessons about systemic risk

Real Assets vs. Financial Assets

Real Assets

- Used to produce goods and services
- **Examples**: Land, buildings, machines, intellectual property

Financial Assets

- Claims to the income generated by real assets or claims on income from the government
- Do not *directly* contribute to the productive capacity of the economy
- **Examples**: Stocks, bonds

Types of Financial Assets

- **Fixed-income / Debt securities**
  - Promises either a fixed stream of income or a stream of income determined by a specified formula (e.g., corporate bond, Treasury bond)
  - The investment performance is least closely related to the financial condition of the issuer
- **Equity**
- **Derivative securities**

Types of Financial Assets

- **Fixed-income / Debt securities**
- **Equity**
  - Represents ownership share in a firm (e.g., common stock)
  - If the firm is successful, the value of equity will increase; otherwise, it will decrease
  - Equity investments tend to be riskier than investments in debt securities
- **Derivative securities**

Types of Financial Assets

- **Fixed-income / Debt securities**
- **Equity**
- **Derivative securities**
  - Payoff depends on the value of other financial variables such as stock prices, interest rates, or exchange rates
  - E.g., call/put option, futures, etc.
  - Derivatives are so named because their values derive from the prices of other assets

Other Types of Financial Markets

- Currency
  - $2 trillion of currency traded each day in London alone
- Commodities
  - E.g., corn, wheat, natural gas

Financial Markets and the Economy

- The Informational Role
  - Stock prices reflect investors’ collective assessment of a firm’s current performance
  - When the market is optimistic about the firm, its share price will rise
  - Thus, stock price play a major role in the allocation of capital in market economies
- Consumption Timing
- Allocation of Risk
- Separation of Ownership and Management
  - **Agency problems**

Financial Markets and the Economy

- The Informational Role
- Consumption Timing
  - Some individuals are earning more than they currently wish to spend
  - Others, e.g., retirees, spend more than they currently earn
  - How can you shift your purchasing power from high-earnings to low-earnings periods of life?
- Allocation of Risk
- Separation of Ownership and Management
  - **Agency problems**

Financial Markets and the Economy

- The Informational Role
- Consumption Timing
- Allocation of Risk
  - Financial markets and the diverse financial instruments allow investors with the greatest taste for risk to bear that risk
- Separation of Ownership and Management
  - **Agency problems**

Financial Markets and the Economy
(Continued)

- Mechanisms to mitigate potential agency problems
  - Compensation plans tie the income of managers to the success of the firm
  - Monitoring from the board of directors
  - Monitoring by large investors and security analysts
  - Threat of takeover for poor performers

Financial Markets and the Economy
(Concluded)

- Corporate Governance and Corporate Ethics
  - Accounting scandals
    - Enron, Rite Aid, HealthSouth
  - Auditing scandals
    - Arthur Andersen (Enron's auditor)
  - Sarbanes-Oxley Act (aka "SOX")
    - Passed in 2002 in response to ethics scandals
    - Focused on corporate governance

The Investment Process

- *Portfolio*: Collection of investment assets

- **Asset allocation**
  - Choice among broad asset classes (e.g., stocks, bonds, real estate, etc.)
- **Security selection**
  - Choice of securities *within* each asset class

The Investment Process
(Continued)

- **Security analysis** involves the valuation of particular securities that might be included in the portfolio
- “Top-down” approach
  - Asset allocation followed by determination of particular securities to be held in each asset class
- “Bottom-up” approach
  - Investment based on attractively priced securities without as much concern for asset allocation

Markets Are Competitive

- Financial markets are highly competitive
- There will almost always be risk associated with investments
- **Risk-return trade-off** - Higher-risk assets are priced to offer higher expected returns than lower-risk assets

Markets Are Competitive
(Continued)

- You should rarely expect to find bargains in the security markets
  - See Ch. 11 for a discussion of the theory and evidence of the efficient market hypothesis
- **Efficient market hypothesis**
  - The prices of securities fully reflect available information
  - If this were true, there would exist neither underpriced nor overpriced securities

Markets Are Competitive
(Concluded)

- **Passive management**
  - Highly diversified portfolio
  - No attempt to improve investment performance by identifying mispriced securities
- **Active management**
  - Focus on improving performance by finding mispriced securities or by timing the performance of broad asset classes

The Players
(1 of 4)

1. Firms
    - Net demanders of capital
    - Raise capital now to pay for investments in plant and equipment
2. Households
    - Typically net suppliers of capital
    - Purchase securities issued by firms that need to raise funds
3. Governments
    - Can function as borrowers or lenders, depending on the relationship between tax revenue and government expenditures

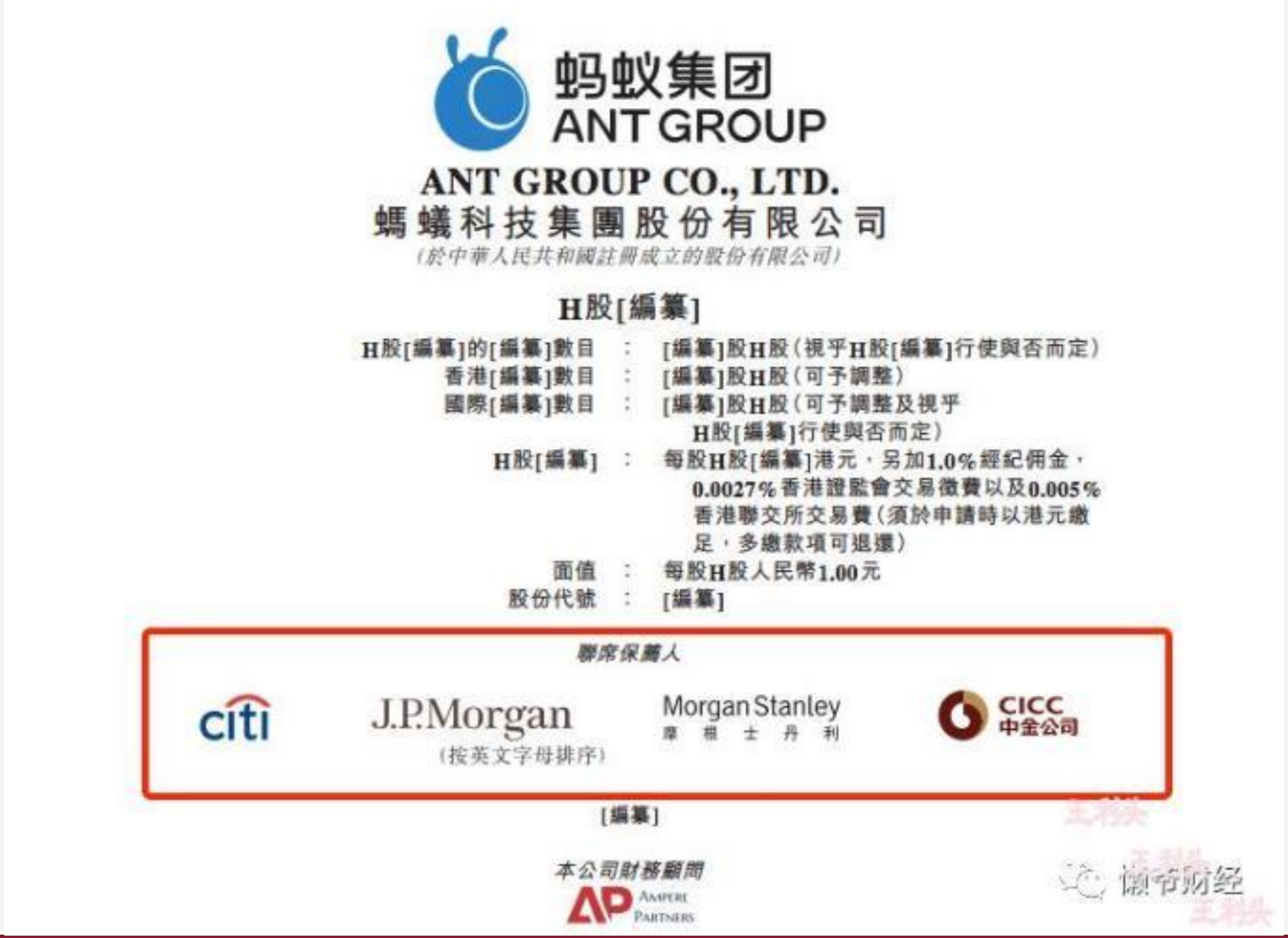
The Players
(2 of 4)

- **Financial intermediaries** bring the suppliers of capital (investors) together with the demanders of capital (primarily corporations and the federal government)
  - Examples
    - Investment companies
    - Banks
    - Insurance companies
    - Credit unions

The Players
(3 of 4)

- **Investment bankers** specialize in the sale of new securities to the public, typically by underwriting the issue
  - Advise the issuing corporation on appropriate price, interest rates, etc.
- New issues of securities are offered to the public in the **primary market**
- Investors trade previously issued securities amongst themselves in the **secondary market**

The Players



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(按英文字母排序)

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本公司財務顧問

AP Ampere Partners

The Players
(4 of 4)

- **Venture capital (VC)** refers to money invested to finance a new, not yet publicly traded firm
  - VC investors commonly take an active role in the management of a start-up firm
- **Private equity** refers to investments in companies whose shares are not publicly traded in a stock market