

FIN2010 Financial Management

The Role of Financial Management



Agenda

- What is finance?
 - Investors and borrowers
 - Financial institutions
- Plan for the semester

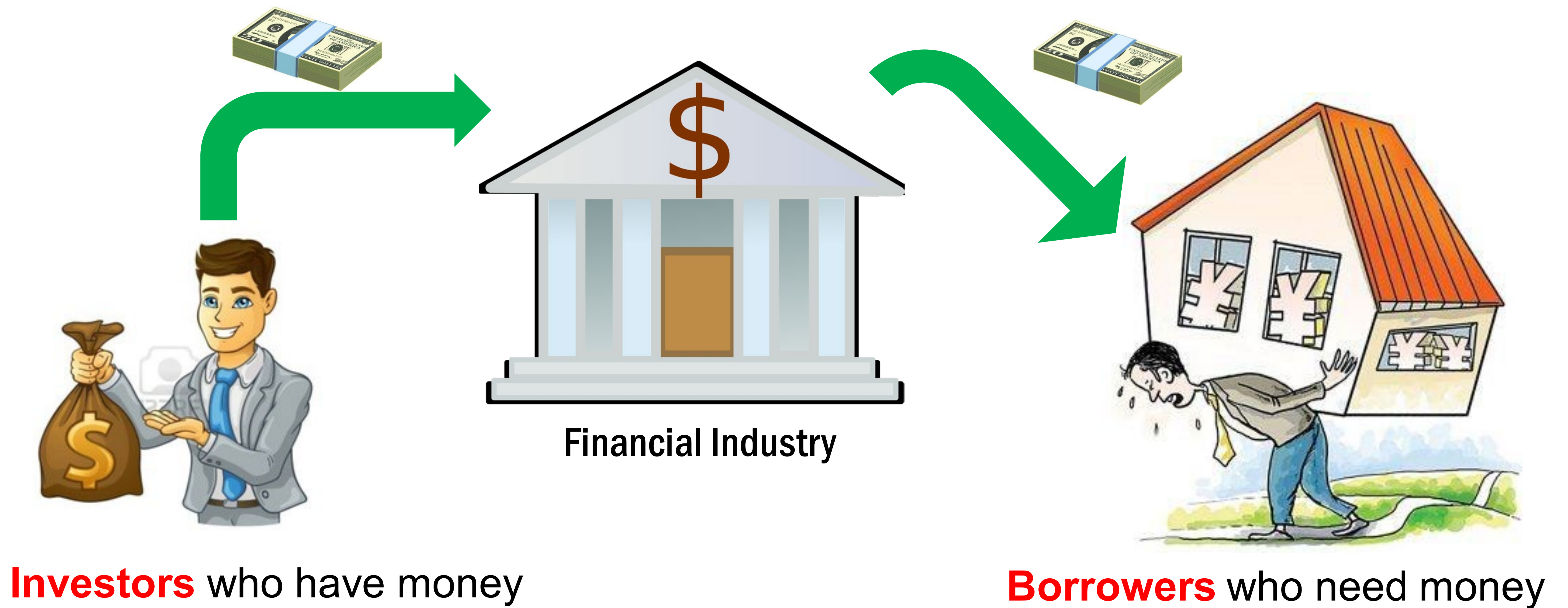


Agenda

- What is finance?
 - Investors and borrowers
 - Financial institutions
- Plan for the semester



What is Finance?

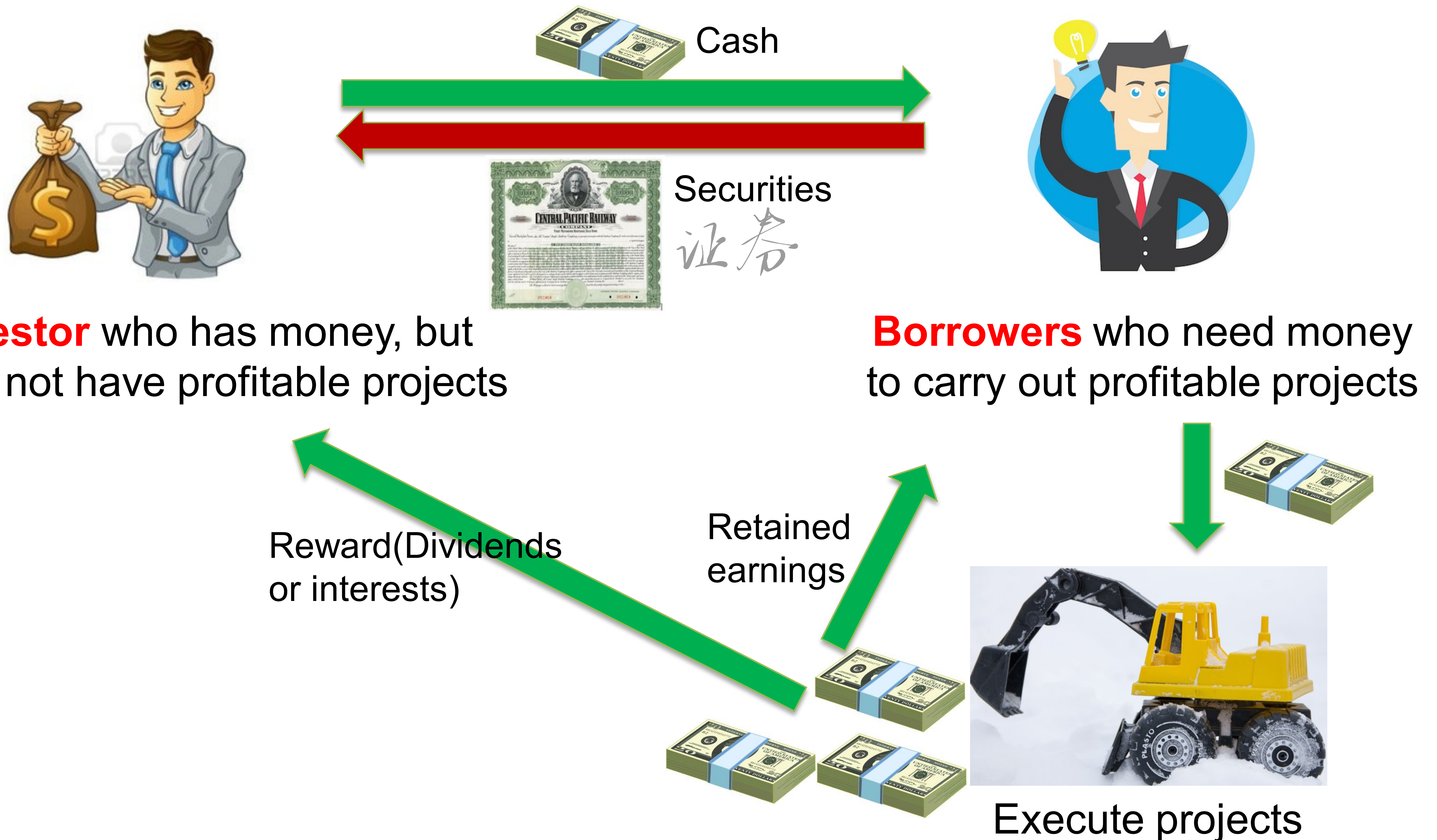


Does Financial Industry Create Value?

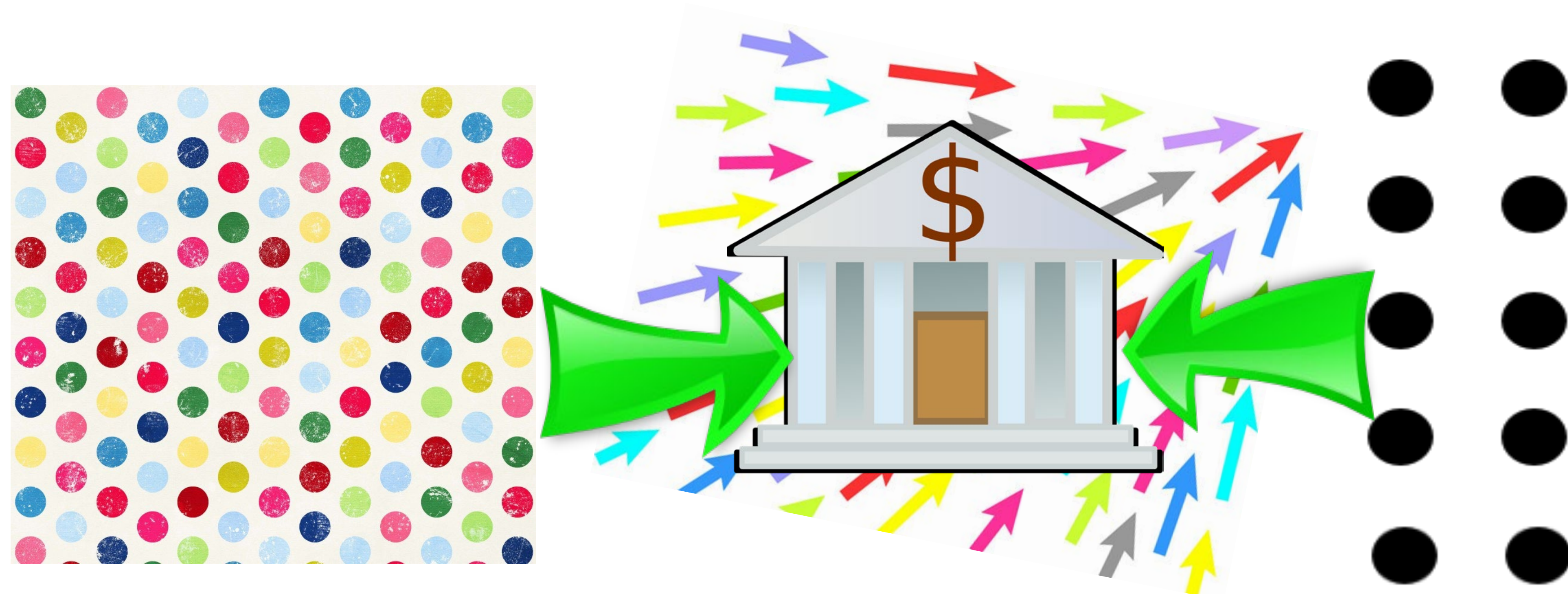
- It seems the financial industry only transfers wealth but does not create wealth. Is this true?
 - **No! Efficient allocation of resource is in itself value-creating**
 - Suppose there are two firms:
 - Firm A can turn \$1 to \$2 in a year
 - Firm B can turn \$1 to \$1.1 in a year
 - If we have \$100 to allocate to the two firms.
 1. An economy with efficient financial industry will allocate all \$100 to firm A. A year later the society has \$200
 2. An economy with *inefficient* financial industry may allocate \$50 to each firm. A year later the society has \$155



How does Finance Create Value?



Why do We Need the Middleman?



100 Investors

10 Borrowers

- Without a middleman, # of negotiations: 1000
With a middleman, # of negotiations: 110 — reduces search costs!
- The middleman provides useful service
 - Due diligence (collect info on borrowers)
 - Risk sharing, diversification, liquidity
 - Advisory
 - Monitoring



Who are the Investors?

Anyone or any institutions that have extra money!



Individuals

Invest directly



Pension Funds



Insurance

Others:

Endowments

Sovereign Funds

Firms

...



主权基金



Money Managers

- Mutual funds
- Hedge funds
- Venture capitals
- Private equities



Invest through managers



Pension Funds

Country	Fund	Assets (in billions)
United States	Federal Old-age and Survivors Insurance Trust Fund (Social Security)	\$2,619
Australia	Australian National Superannuation Scheme	\$2,568
Japan	Government Pension Investment Fund	\$1,790
Norway	Government Pension Fund of Norway	\$1,356
United States	Military Retirement Fund	\$1,178
United States	Civil Service Retirement and Disability Fund	\$1,003
United States	Thrift Savings Plan (TSP)	\$822
Canada	Canada Pension Plan and CPP Investment Board(CPPIB)	\$570
Netherlands	Stichting Pensioenfond ABP (ABP)	\$498
South Korea	National Pension Service (NPS)	\$462
China	National Social Security Fund	\$405

[Source: Wikipedia, National Council for Social Security Fund, as of 2022](#)

Model: Take monthly contribution from young people; pay back (more) when they get old

Investment Goal: (1) Meet future obligations (2) Maximize return



Global Money Management Firms

Rank	Company	Country of Origin	AUM (US\$ Billion)
1	BlackRock	United States	9,090
2	Vanguard Group	United States	7,600
3	Fidelity Investments	United States	4,240
4	UBS Group	Switzerland	3,960
5	State Street Global Advisers	United States	3,600
6	Morgan Stanley	United States	3,131
7	JPMorgan Chase	United States	3,006
8	Goldman Sachs	United States	2,672
9	Credit Agricole	France	2,660
10	Allianz Group	Germany	2,364

[Source: ADV RATINGS](#), as of 2023

Model: Invest other people's money and earn management fees (typically 0.1 to 1% of AUM).

Investment Goal: Maximize AUM by delivering what investors want and outperforming competitors

AUM: asset under management.



Who are the Borrowers?

Anyone or any institutions that need money!

- Government

	Central Gov.	Local Gov.	GDP
US	<u>\$33.2 T</u>	<u>\$4.0 T</u>	<u>\$25.5 T</u>
China	<u>\$25.8 T</u>	<u>\$35.0 T</u>	<u>\$18.0 T</u>

- Business

	Equity	Bond
US	<u>\$46.2 T</u>	<u>\$10.4 T</u>
China	<u>\$10.7 T</u>	<u>\$29.8 T</u>

- Household

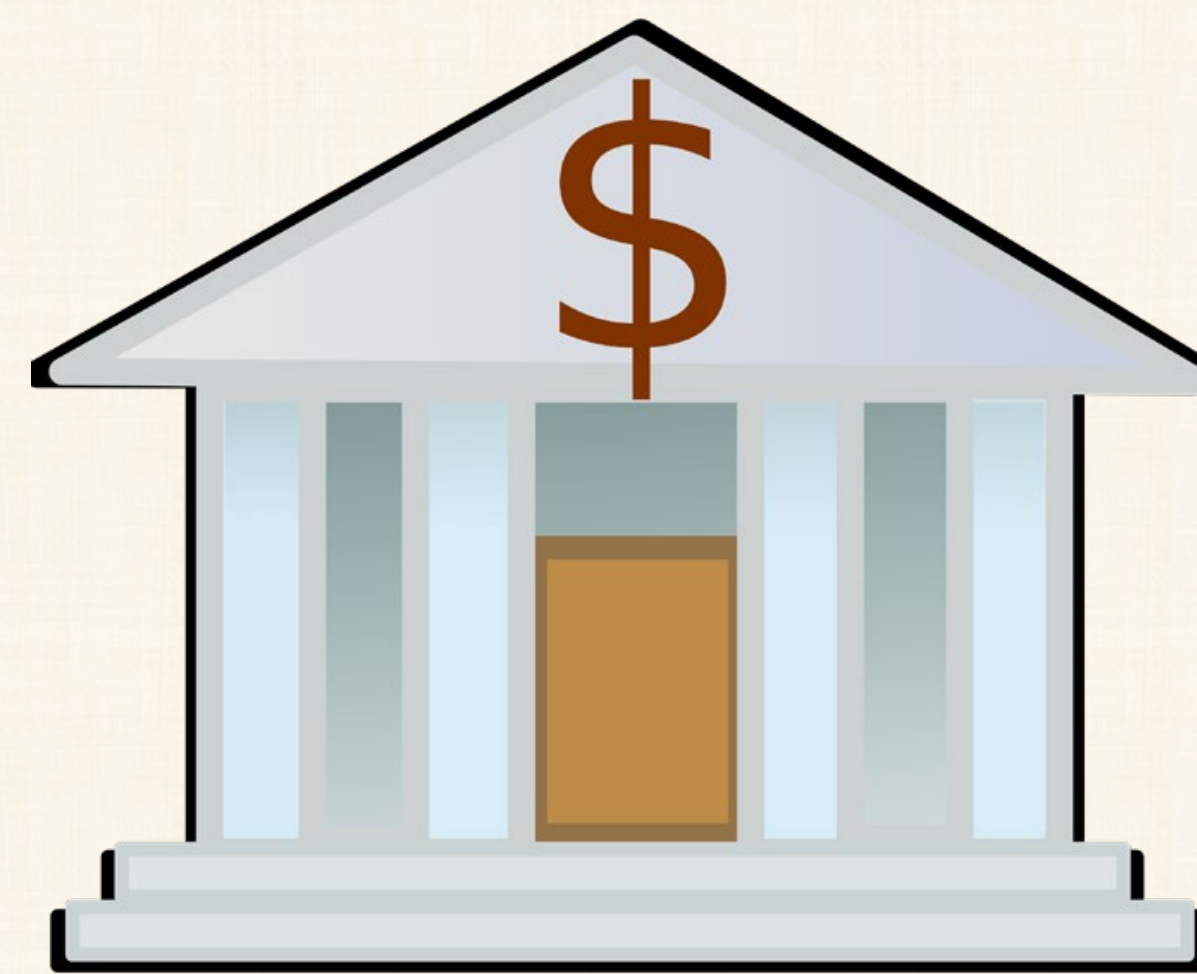
	Home Loan	Auto Loan
US	<u>\$17.3 T</u>	<u>\$1.6T</u>
China	<u>\$7.5 T</u>	<u>\$0.03T</u>

* As of the end of 2022.



Who are the Middlemen?

Investors

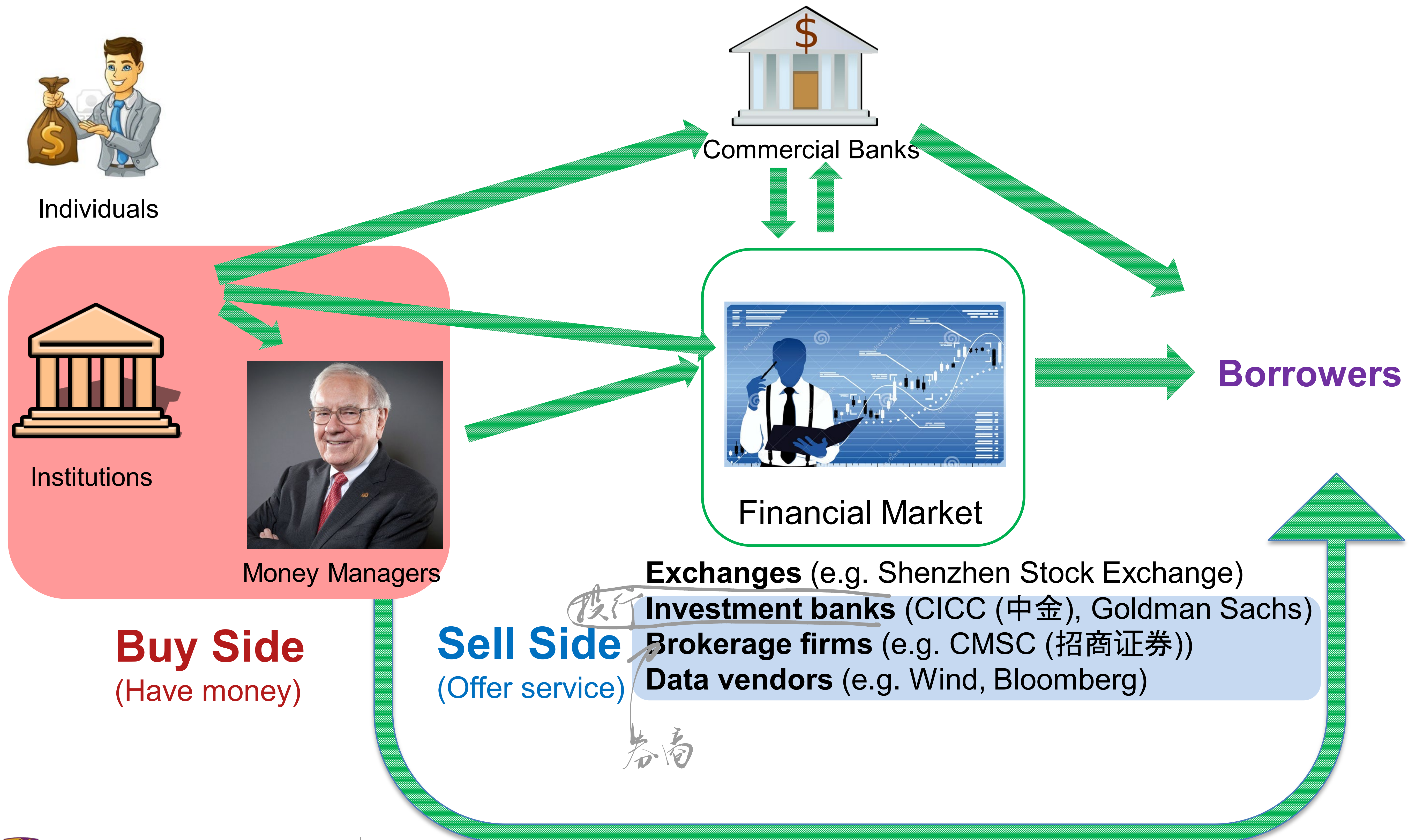


Financial Industry

Borrowers



Who are the Middlemen?



What Securities do They Play with?

Products in the financial markets are called securities.

- Equity instrument
 - Stock 权益产品, 股票
- Simple Debt Instruments
 - Bond
 - Mortgage
- Derivatives 衍生品
 - Forward and Future (transaction to be made in the future)
 - Option (right to execute a transaction in the future)
 - Swap (exchange of two cash flows)



Jobs—Buy Side Institutions



Individuals



Institutions

Tasks

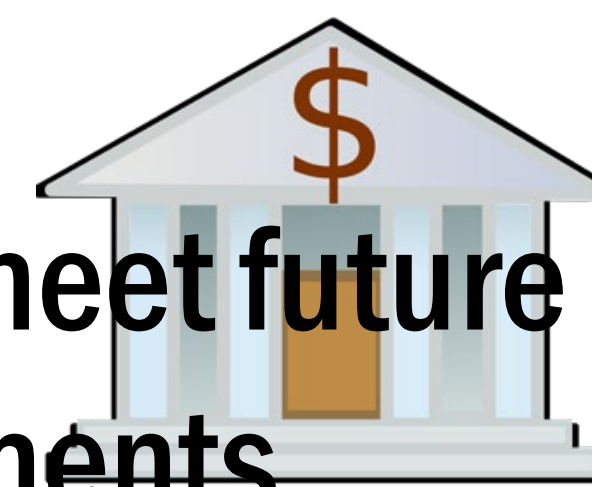
- Manage cash flows to meet future obligations
- Manage risks of investments
- Identify good money managers to delegate the investments to

Good

- Light workload/working hours
- Have power so everyone respects you



Money Managers



Banks



Financial Markets

Borrowers

usually not as high as sell side institutions and limited
to grow
to get in (may require connection)

Jobs—Money Managers



Individuals



Institutions



Money Managers

Tasks

- Generate superior investment performance
 - Quantitative models
 - Fundamental analysis
- Convince investors to put money into your fund (build trust)

Good

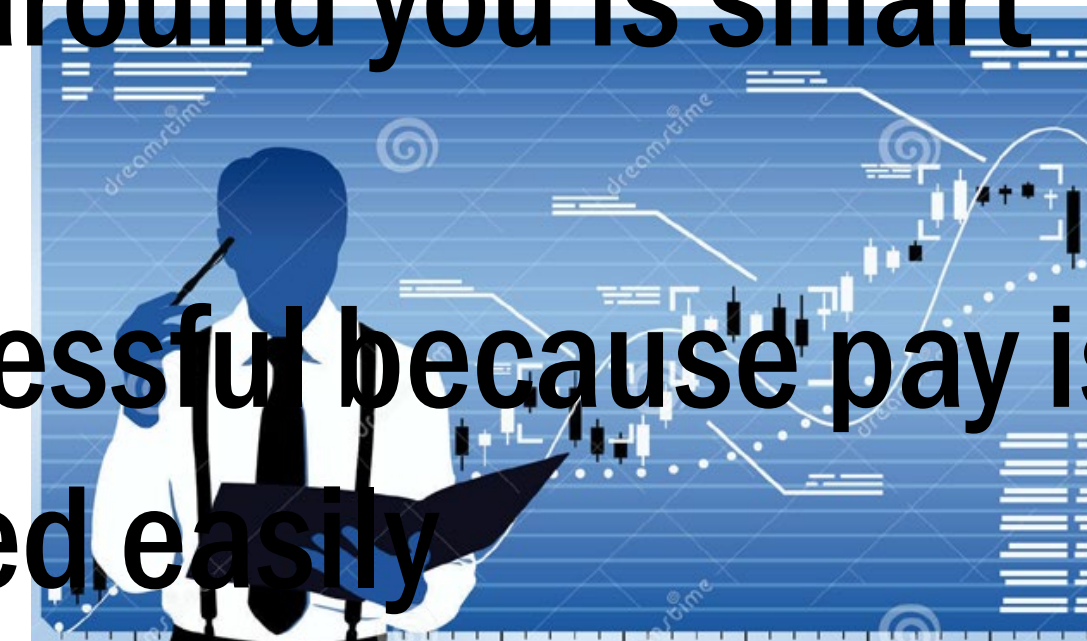
- Extremely high pay (if you perform well)
- Everyone around you is smart

Bad

- Can be stressful because pay is usually tied to performance
- Can be fired easily



Banks



Financial Markets




Borrowers



Jobs—Banks

Commercial Banking

Tasks

-  depositors
-  loans to borrowers
-  Sell investment products to investors to earn incentive fees

Manage risk

Good

-  Hard to
- Have many different Institutions
- switch jobs

Bad

- Pay is usually not high
- Can be boring



Money Managers



Banks

Investment Banking

Tasks

- Primary market: help companies finance (IPO, merger, acquisition)
- Trading

Good

- Very high pay (a large portion is bonus)
- Able to meet with important people
- Good exit options

Bad

- Extremely long working hours
- Sometimes toxic working environment

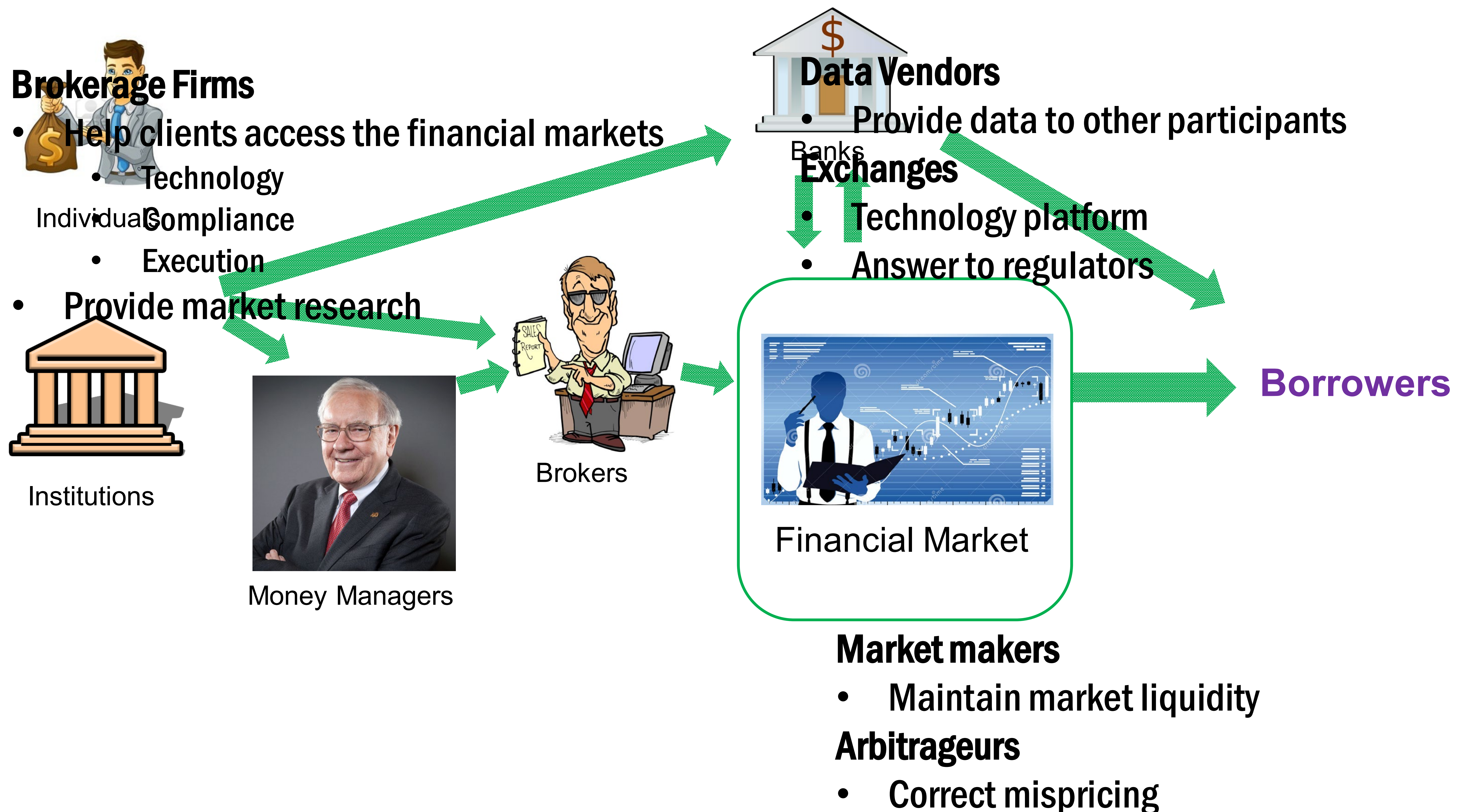


Financial Market

Borrowers



Jobs—Other Institutions



Do you now understand what is going on in these news?

- <https://www.ft.com/content/ab3067cf-c885-4c7c-81bb-30ead3bb94d6>
- <https://www.ft.com/content/3b567d41-e940-4524-8277-8e3ac14edc31>
- <https://www.ft.com/content/994e592c-adcc-4c6b-b45a-18056cb548c0>



Agenda

- What is finance?
 - Investors and borrowers
 - Financial institutions
- Plan for the semester



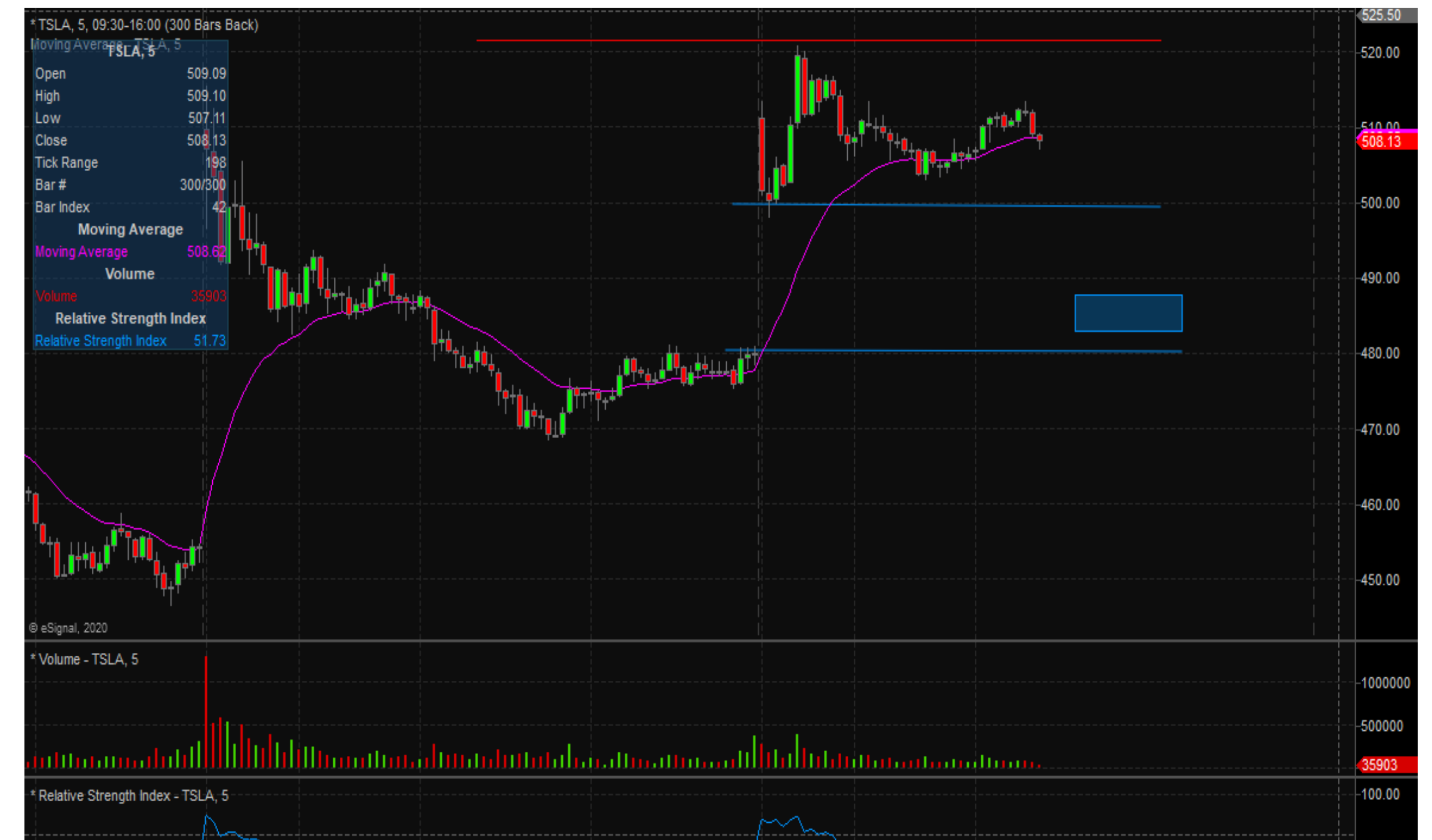
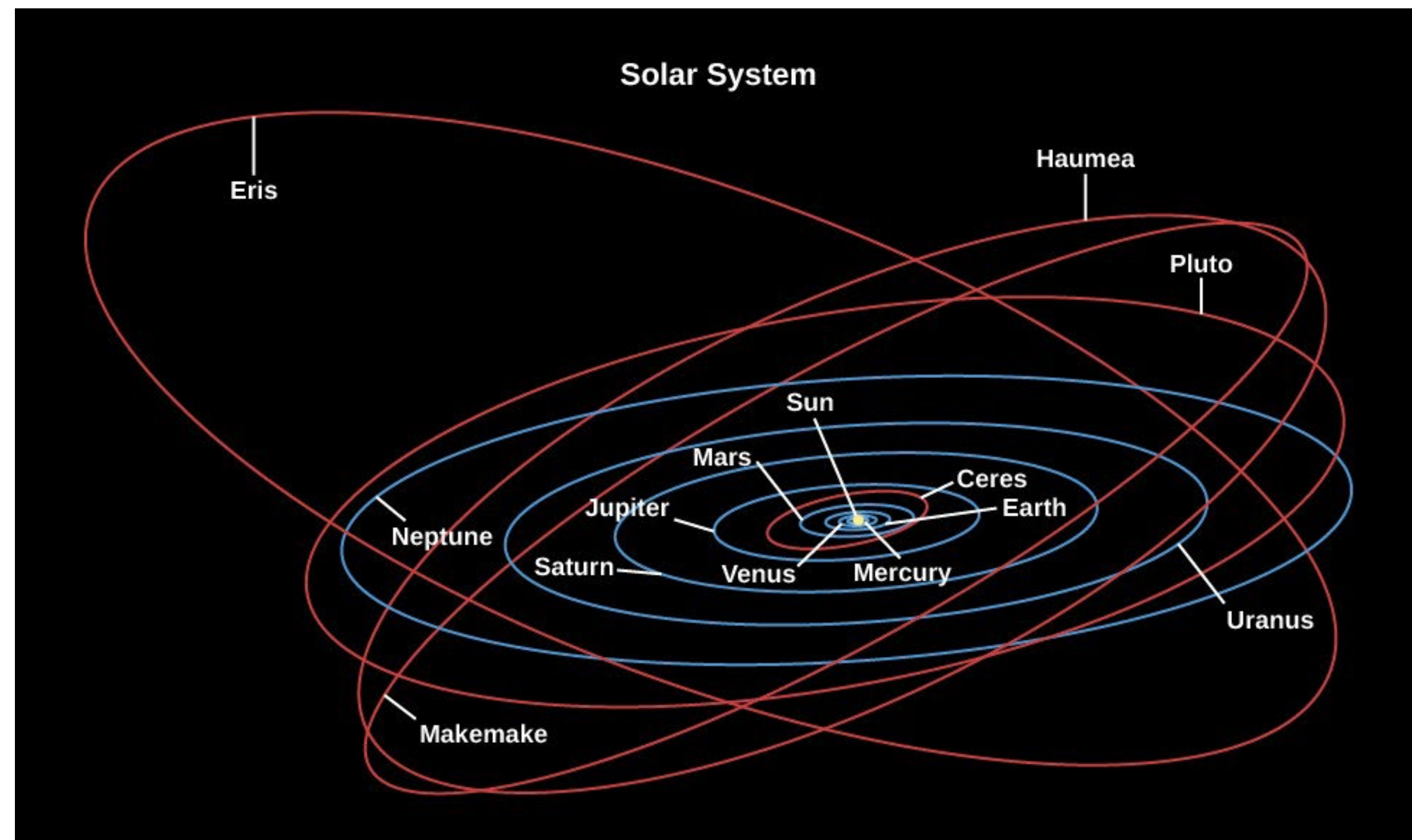
Plan for this Semester

- Basic tools
 - Time value of money, institutional knowledge
- Investors' problems
 - Asset valuation
 - Risk and Return
- Optional topics
 - Personal investment
 - Financial Derivatives
- Midterm
- Corporates' problems
 - Project valuation
 - Raising capital
- Optional topics
- Final



Setting the Correct Expectation

Social science, unlike natural science, cannot accurately describe the world.



Then why do we learn this?

- It is vastly better than pure guess.
- You need to learn the primitive models first so that you can develop more advanced models in the future.



Summary

- What is finance?
- Who are the investors and borrowers?
 - Investors: individuals and institutions
 - Borrowers: government, corporate, individual
- What value does the financial industry create?
 - Help allocate resource efficiently
 - Reduce searching and provide services
- What does the industry consist of?
 - Commercial banks
 - Buy side institutions and money managers
 - Brokers, investment banks, data vendors, exchanges, and many others

