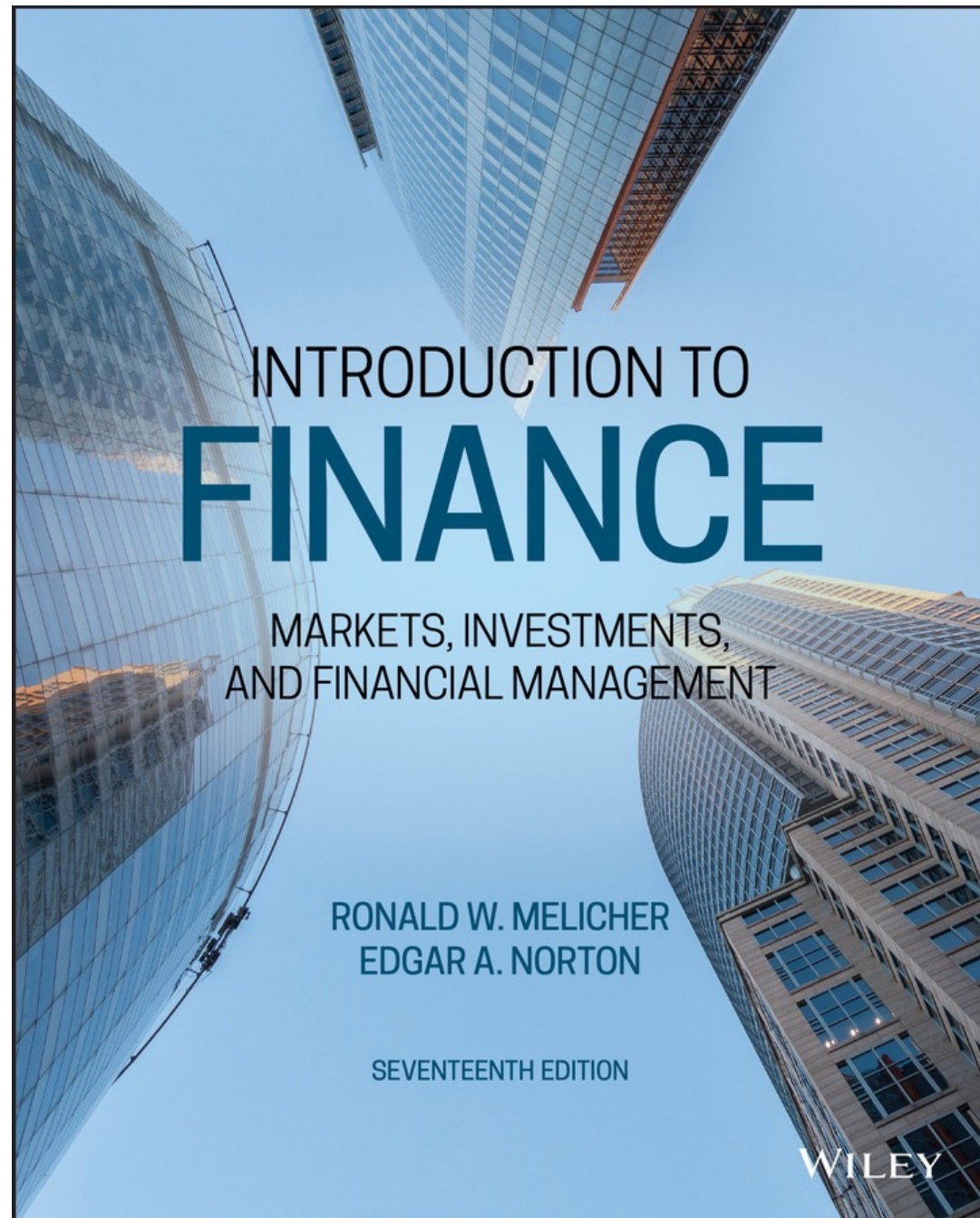


Chapter 1

The Financial Environment





Chapter Learning Objectives

- LO 1.1 Define *finance* and describe the three areas of finance.
- LO 1.2 Explain why finance should be studied.
- LO 1.3 Describe and discuss the six principles of finance.
- LO 1.4 Identify the four components of the financial system and describe their roles.



Chapter Learning Objectives

- LO 1.5 Describe financial markets characteristics and the four types of financial markets.
- LO 1.6 Identify several major career opportunities in finance.
- LO 1.7 Describe this textbook's plan of study.



Section 1.1 What is Finance?

- LO 1.1 Define *finance* and describe the three areas of finance.



Capitalism in the U.S.

- **Capitalism**

An economic system with private ownership of assets, production of goods and services for profit, a price mechanism for allocating resources, and financial markets

The U.S. is a mixed market capitalistic system that combines government formed economic goals and free markets



Two Basic Definitions

- **Finance**

Study of how individuals, institutions, governments, and businesses acquire, spend, and manage money and other financial assets

- **Financial Environment**

Encompasses the financial system, institutions, markets, and individuals that make the economy operate efficiently

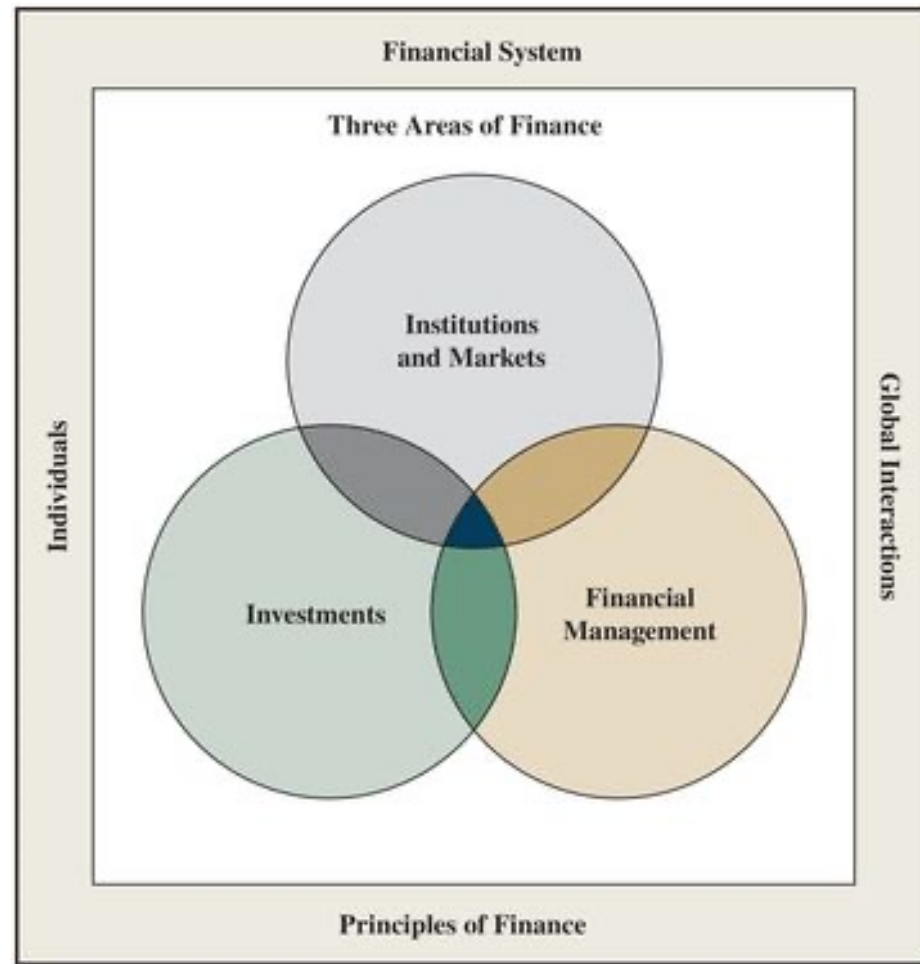


Three Areas of Finance within the Financial System

- Institutions and Markets
- Investments
- Financial Management

[Note: These areas do not operate in isolation but rather interact or intersect with each other. Figure 1.1 provides a graphic illustration.]

Figure 1.1 Graphic Illustration of the Financial Environment





Finance Area Definitions

- **FINANCIAL INSTITUTIONS**

Help the financial system operate efficiently and transfer funds from savers to investors

- **FINANCIAL MARKETS**

Physical locations or electronic forums that facilitate the flow of funds



Finance Area Definitions

- **INVESTMENTS**

Area involves sale or marketing of securities, analysis of securities, and management of investment risk

- **FINANCIAL MANAGEMENT**

Involves financial planning, asset management, and fund raising decisions to enhance firm value



Two Themes within the Finance Topic

- **Entrepreneurial Finance**

Study of how growth-driven, performance-focused, early-stage firms raise funds and manage operations and assets

- **Personal Finance**

Study of how individuals prepare for financial emergencies, protect against premature death and the loss of property, and accumulate wealth



Section 1.2 Why Study Finance?

- LO 1.2 Explain why finance should be studied.



Financial/Economic Background

- First two decades of the twenty-first century was characterized by economic and financial market volatility
- The analysis and understanding of past developments in economic activity and financial markets are useful to businesses, governments, and individuals in planning their futures
- By learning from the past, we may be able to avoid similar problems in the future



Recent Finance and Economic Developments

- Price bubble for technology stocks (including dot.com start-ups) burst in 2000
- 2001 recession was exacerbated by Sept. 11 terrorist attack
- Housing price bubble burst in mid-2006 resulting in steep housing price declines



Recent Finance and Economic Developments

- Securities tied to housing prices also declined causing concern that financial institutions with insufficient equity capital might fail
- The result was the 2007-08 financial crisis followed by the 2008-09 Great Recession
- Economic recovery from the 2007-09 near disaster has turned into more than a decade of economic growth in the U.S.



Reasons for Studying Finance

1. To make informed economic decisions
2. To make informed personal and business investment decisions
3. To make informed career decisions based on a basic understanding of business finance



Section 1.3 Six Principles of Finance

- LO 1.3 Describe and discuss the six principles of finance.



Principles of Finance

1. Money has a time value
2. Higher returns are expected for taking on more risk
3. Diversification of investments can reduce risk



Principles of Finance (Continued)

4. Financial markets are efficient in pricing securities
5. Manager and stockholder objectives may differ
6. Reputation matters



1. Time Value of Money

- Money in hand today is worth more than the promise of receiving the same amount of money in the future
- Time value of money exists because a sum of money today could be invested and “grow” over time



2. Risk-Return Tradeoff

- Risk is the uncertainty about the outcome or payoff of an investment in the future
- Rational investors would choose a riskier investment only if they feel the expected return is high enough to justify the greater risk



3. Diversification of Investments

- All investment risk is not the same
- Some risk can be removed or *diversified* by investing in several different assets or securities
- We will explore the benefits of investment diversification in Part 2 of this text



4. Efficient Financial Markets

- A financial market is “information efficient” if at any point in time the prices of securities reflect all information available to the public
- When new information becomes available, prices quickly change to reflect that information
- Information efficient markets provide liquidity and fair prices



5. Management Vs. Owner Objectives

- Management objectives may differ from owner objectives (called *principal-agent problem*)
- Owners or equity investors want to maximize the returns on their investments
- Managers may seek to emphasize the size of firm sales, assets, or other perks
- Solution: tie manager compensation to performance measures beneficial to owners



6. Reputation Matters!

- Ethical Behavior:
How an individual or organization treats others legally, fairly, and honestly
- High reputation value reflects high quality ethical behavior, so employing high ethical standards is the “right” thing to do



Section 1.4 Overview of the Financial System

- LO 1.4 Identify the four components of the financial system and describe their roles



Democracy in the U.S.

- **Democracy**

A system of government where limited authority and power are granted by law to its people who participate by voting on government goals and actions

The U.S. is a representative democracy where citizens elect representatives from among their peers to participate by voting on government issues



Four U.S. Financial System Components

- **Policy Makers**

President, Congress & U.S. Treasury
Federal Reserve Board

Role: Pass laws & set fiscal & monetary policies

- **Monetary System**

Federal Reserve Central Bank
Commercial Banking System

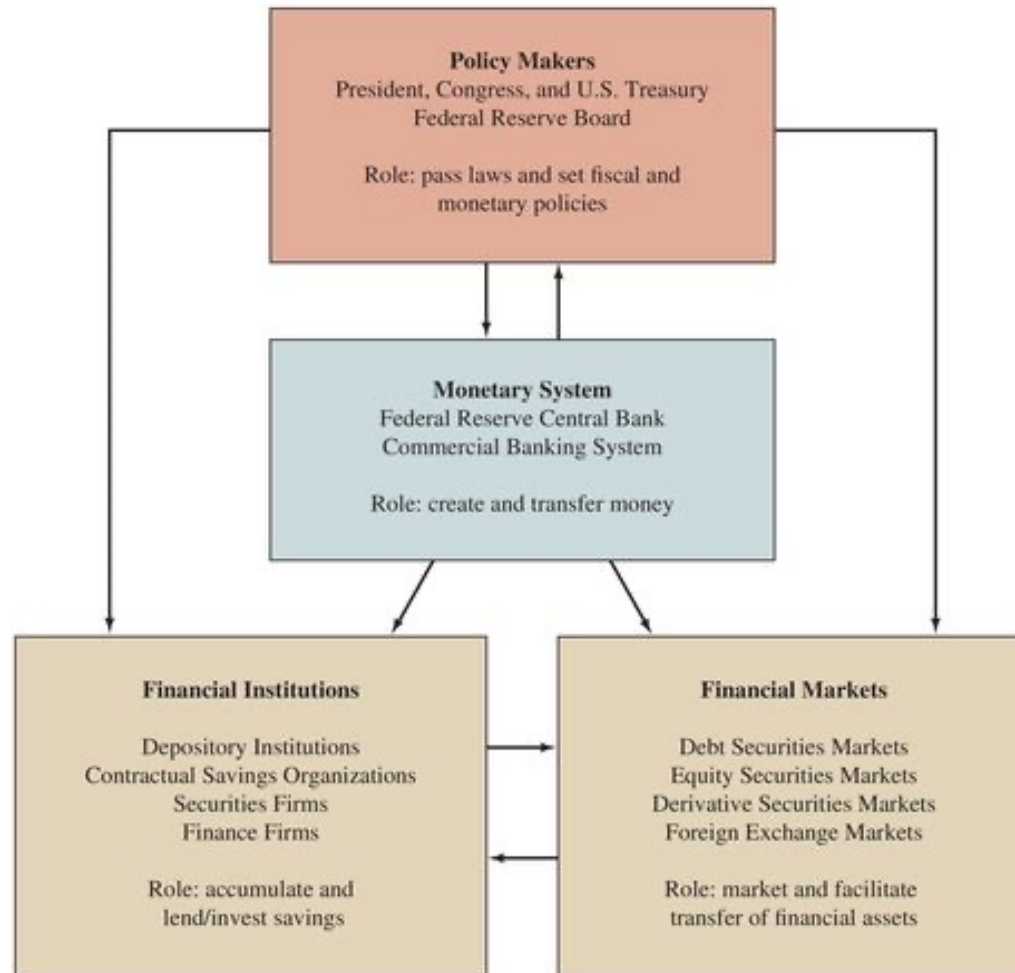
Role: Create & transfer money



Four Financial System Components (Continued)

- **Financial Institutions**
Depository Institutions, Contractual Savings organizations, Securities Firms, and Finance Firms
Role: Accumulate & lend/invest savings
- **Financial Markets**
Securities Markets, Mortgage Markets, Derivatives Markets, and Currency Exchange Markets
Role: Market & facilitate transfer of financial assets

Figure 1.2 Graphical View of the Major Components of the U.S. Financial System





Components and Their Financial Functions

Monetary System

- Creating money
- Transferring money

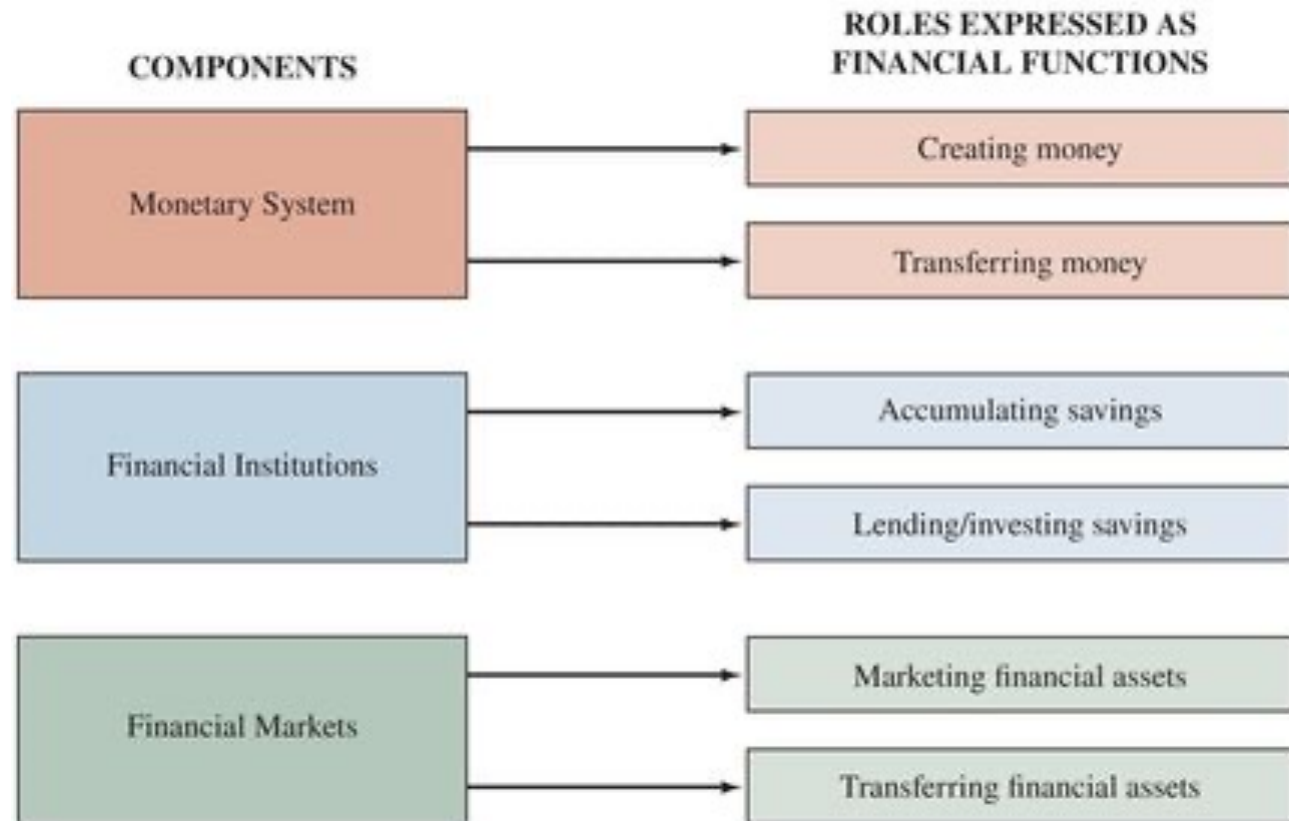
Financial Institutions

- Accumulating savings
- Lending/investing savings

Financial Markets

- Marketing financial assets
- Transferring financial assets

Figure 1.3 Three Financial System Components and the Financial Functions Used to Carry Out Their Roles





Section 1.5 Financial Markets: Characteristics and Types

- LO 1.5 Describe financial markets characteristics and the four types of financial markets



Financial Markets Characteristics

- **Money Markets**

Where debt securities with maturities of one year or less are issued or traded

- **Capital Markets**

Where debt securities with maturities longer than one year and corporate stocks are issued or traded



Financial Markets

Characteristics (Continued)

- **Primary Markets**

Where the initial offering or origination of debt and equity securities takes place

- **Secondary Markets**

Where the transfer of existing debt (bonds and mortgages) and equity securities between investors occurs



Major Types of Financial Markets

- **Debt Securities Markets**

Where money market securities, bonds, and mortgages are originated and traded

- **Equity Securities Markets**

Where corporate ownership shares are initially sold and traded



Major Types of Financial Markets

- **Derivative Securities Markets**

Where financial contracts that derive their values from underlying debt and equity securities are originated and traded

- **Foreign Exchange Markets**

Electronic markets in which banks and institutional traders buy and sell various currencies on behalf of businesses and other clients



Section 1.6 Careers in Finance

- LO 1.6 Identify several major career opportunities in finance



Careers in Finance

- Financial management
- Depository financial institutions
- Contractual savings and real property organizations
- Securities markets and investment firms



Entry-Level Finance Positions

Financial Management

- Cash management analyst
- Capital expenditures analyst
- Credit analyst
- Financial analyst
- Cost analyst
- Tax analyst



Entry-Level Finance Positions

Depository Financial Institutions

- Loan analyst
- Bank teller
- Investments research analyst



Entry-Level Finance Positions

Contractual Savings and Real Property Organizations

- Insurance agent (broker)
- Research analyst
- Real estate agent (broker)
- Mortgage analyst



Entry-Level Finance Positions

Securities Markets and Investment Firms

- Stock broker (account executive)
- Security analyst
- Investment banking analyst
- Financial planner assistant



Section 1.7 The Plan of Study

- LO 1.7 Describe this textbook's plan of study



Textbook: Three Parts

- **PART 1: INSTITUTIONS AND MARKETS**

Focuses on the role financial markets play in the financial system and financial basics that underlie how markets operate

- **PART 2: INVESTMENTS**

Focuses on the characteristics of stocks and bonds, how securities are valued, and the operations of securities markets



Textbook: Three Parts

- **PART 3: FINANCIAL MANAGEMENT**

Focuses on the financial planning, asset management, and fund raising activities that will enhance firm value



Web Links

www.sba.gov

www.sba.gov/advo

www.bloomberg.com/businessweek

www.careerjournal.com

www.monster.com