Homework 1

Chapter 1

1. What are the six (6) principles of finance?
    1. Money has a time value
        - 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. Higher returns are expected for taking on more risk
        - 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 can reduce risk
        - 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. Financial markets are efficient in pricing securities
        - 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. Manager and stockholder objectives may differ
        - 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
2. What are the four (4) main types of financial markets?
    1. Policy makers: President, Congress & U.S. Treasury Federal Reserve Board

       Role: Pass laws & set fiscal & monetary policies
    2. Monetary System: Federal Reserve Central Bank Commercial Banking System

       Role: Create & transfer money
    3. Financial Institutions: Depository Institutions, Contractual Savings organizations, Securities Firms, and Finance Firms

Role: Accumulate & lend/invest savings

4. Financial Markets: Securities Markets, Mortgage Markets, Derivatives Markets, and Currency Exchange Markets

   Role: Market & facilitate transfer of financial assets

3. Financial markets may be categorized as: (1) debt securities markets, (2) equity securities markets, (3) derivative securities markets, and (4) foreign exchange markets. Indicate in which of these markets the following securities trade:

   > - Mortgages
   > - Bonds
   > - Common stocks
   > - Interest rate swaps
   > - Currencies

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Debt Securities Markets	**Derivative Securities Markets**	**Equity Securities Markets**	**Foreign Exchange Markets**
Bonds	Interest rate swaps	Common stocks	Currencies
Mortgages			

Chapter 2

1. Match the following money market securities with their issuers.

Securities	**Issuers**
Treasury bills	Depository institutions
Negotiable CDs	US government
Commercial paper	Banks
Banker’s acceptances	Business firms and institutions

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2. Determine the size of the M1 money supply using the following information.

> - Currency plus Traveler’s checks $25 million
> - Negotiable CDs $10 million
> - Demand deposits $13 million
> - Other checkable deposits $12 million

- $25000000 + 13000000 + 12000000 = 50,000,000$