Chapter 17: Managing Business Finances

Chapter Outline

Retirement! Now there's something that most students do not think about, yet it is something that we all must strategically plan for. This chapter introduces us to the concept of the time value of money and the principle of compound growth that is central to our creation of wealth—wealth that we will need to fund our retirements!

The chapter introduces the student to the investment opportunities offered by mutual funds and exchange-traded funds. It describes the role of securities markets and identifies the major stock exchanges in the world. The chapter introduces students to the concept of the risk-return relationship and discusses the value of diversifying an investment portfolio. Finally, the chapter examines how a firm can raise funds through equity or debt financing.

Learning Objectives

17-1. Explain the concept of the time value of money and the principle of compound growth, and discuss the characteristics of common stock.

17-2. Identify reasons for investing and the investment opportunities offered by mutual funds and exchange-traded funds.

17-3. Describe the role of securities markets and identify the major stock exchanges and stock markets.

17-4. Describe the risk-return relationship and discuss the use of diversification and asset allocation for investments.

17-5. Describe the various ways that firms raise capital and identify the pros and cons of each method.

17-6. Identify the reasons a company might make an initial public offering of its stock, explain how stock value is determined, and discuss the significance of market capitalization.

17-7. Explain how securities markets are regulated.

CHAPTER OUTLINE

Learning Objective 17-1:

Explain the concept of the time value of money and the principle of compound growth, and discuss the characteristics of common stock.

Maximizing Capital Growth

Wise investment is the key to growing your money, especially if you are seeking to build capital to start your own business or simply as a cushion for a sound financial future. A number of concepts come into play when searching for investment opportunities.

A. The Time Value of Money and Compound Growth

The time value of money is a concept that recognizes that if we invest money, it makes more money over time through the addition of compound interest. **Compound growth** is the cumulative growth from interest paid to the investor over given time periods. With each additional time period, an investment grows as interest payments accumulate and earn more interest, thus multiplying the earning capacity of the investment.

1. **The Rule of 72** is a handy rule of thumb to estimate how long it will take to double an investment. You can find the number of years it will take to double an investment by dividing 72 by the annual interest rate of the investment (in percent). Thus, a 10 percent investment will take 7.2 years to double. Bottom line for investors: seek higher interest rates because money will double more frequently.

2. **Making Better Use of Your Money.** Each year, interest is added to our investments. If we continually reinvest the principal amount and the interest, the growth of our money will become larger each year.

B. Common Stock Investments

A **stock** is a portion of the ownership of a corporation. The company's total ownership is divided into small parts, called *shares*, which can be bought and sold to determine how much of the company (how many shares of stock) is owned by each shareholder.

1. **Common Stock.** A share of common stock is the most basic form of ownership in a company. Individuals and other companies purchase a firm's common stock in the hope that it will increase in value, provide dividend income, and enable shareholders to vote on major issues that are brought before the shareholders.

a. **Market value** is the current share price in the stock market.

b. **Book value** of common stock is stockholders' equity divided by the number of common shares.

2. **Investment Traits of Common Stock.** Common stocks are among the riskiest of all investments, though historically stock values rise over time. Growth prospects in various industries change periodically.

3. **Dividend.** A dividend is a payment to shareholders, on a per-share basis, out of the company's earnings. **Blue chip stocks** are stocks of well-established firms that consistently provide investors with secure income from dividend payouts. Not all strong firms pay dividends, however. Some focus on reinvesting in the company toward future growth.

Learning Objective 17-2:

Identify reasons for investing and the investment opportunities offered by mutual funds and exchange-traded funds.

Investing to Fulfill Financial Objectives

Mutual funds and exchange-traded funds are popular alternatives to stocks because they offer attractive investment opportunities for various financial objectives and often do not require large sums of money for entry.

Mutual Funds

Mutual funds are created by companies such as T. Rowe Price and Vanguard that pool cash investments from individuals and organizations to purchase a portfolio of stocks, bonds, and other securities. The portfolio is expected to increase in value and produce income for the fund and its investors.

A. Reasons for Investing

Mutual funds are flexible in their investment goals. It is relatively easy to open a mutual fund account. The three most common objectives for opening a mutual fund account are:

1. **Stability and Safety.** Funds stressing safety seek only modest growth with little fluctuation in principal value regardless of economic conditions. These funds include money market mutual funds and other funds that preserve the fund holders' capital and reliably pay current income.

2. **Conservative Capital Growth.** Preservation of capital and current income, alongside some capital appreciation, can be gained through balanced funds. These funds invest in a mix of municipal bonds, corporate bonds, and common stocks. A **corporate bond** is debt issued by a company in order for it to raise capital. An investor who buys a corporate bond is effectively lending money to the company in return for a series of interest payments, but these bonds may also actively trade on the secondary market.

3. **Aggressive Growth.** Aggressive growth funds seek maximum long-term capital growth; they sacrifice current income and safety by investing in stocks of new and sometimes troubled companies, firms developing new products and technologies, and other high-risk securities. (security=tradeable financial asset / includes a wide array of investments)

B. Most Mutual Funds Don't Match the Market

Many, but not all, mutual funds are managed by "experts" who select the stocks, bonds, and securities in which the fund will invest. Some estimates indicate that up to 80 percent of mutual funds underperform a market's average return due to ***management expenses and underperforming stocks***. This has led to the development of passively managed or index funds to reduce the management costs of funds.

C. Exchange Traded Funds
An exchange-traded fund (ETF) is a bundle of stocks (or bonds) that are in an index that tracks the overall movement of a market. ETFs can be traded like a stock.

1. **Advantages of ETFs**. ETFs offer three advantages over mutual funds:

a. They can be traded throughout the day like a stock.

b. They have low operating expenses.

c. They do not require high initial investments.

Difference between mutual funds and ETFs? https://www.ramseysolutions.com/retirement/etf-vs-mutual-funds

Learning Objective 17-3:

Describe the role of securities markets and identify the major stock exchanges and stock markets.

The Business of Trading Securities
Stocks and bonds are referred to as **securities** because they represent secured, or financially valuable, claims on the part of investors. Stocks and bonds are sold in securities markets. By facilitating the buying and selling of securities, the securities markets provide the capital that companies rely on for survival.

A. Primary and Secondary Securities Markets
Newly issued stocks and bonds are bought and sold in primary securities markets. To bring a new security to market, the issuing firm must get approval from the **Securities and Exchange Commission (SEC)**—the government agency that regulates U.S. securities markets.

Investment Banks issue and resell new securities, as well as create the distribution networks for selling the securities. Investment banks provide three important services:

1. They advise companies on the timing and financial terms of new issues.

2. They underwrite (buy and assume liability for) new securities, providing an issuing firm with 100 percent of the money (less commission and fees).

3. They create distribution networks to move new securities through groups of banks and brokers to individual investors.

New securities, however, represent only a small portion of traded securities. Existing stocks and bonds are sold in the much larger **secondary securities market**, which is handled by such familiar bodies as the New York Stock Exchange.

B. Stock Exchanges

A stock exchange is an organization of individuals that provides an institutional auction setting in which stock can be bought or sold.

1. **The Trading Floor.** Each exchange governs the places and times when trading occurs. Trading is allowed only on the *trading floor,* which can be a physical location, or an electronic market. Trading floors today are equipped with a vast array of electronic communication equipment to display, buy, and sell data. In addition, a variety of news services provide up-to-the-minute information relevant to the business world. Any change in world events may affect share prices.

2. **The Major Stock Exchanges.** Among the stock exchanges that operate on trading floors in the United States, the New York Stock Exchange is the largest. It faces stiff competition from electronic trading, and large foreign exchanges such as those in London and Tokyo.

a. **The New York Stock Exchange (NYSE).** The NYSE is a hybrid market that utilizes both electronic transfers as well as a trading floor in New York. Many firms list their stocks regionally, as well as on one of the national exchanges.

b. **Global Stock Exchanges.** The value of shares listed on foreign exchanges continues to grow. Major overseas stock exchanges are found in Shanghai, Tokyo, London, and Hong Kong.

c. **The NASDAQ.** The NASDAQ was the first electronic stock market. NASDAQ orders are gathered and executed solely on a worldwide computer network. NASDAQ is working to replace trading floors of traditional exchanges.

d. **International Consolidation and Cross-Border Ownership.** Analysts expect technological advances and regulatory factors to drive together the separate stock markets in various parts of the world. Stock markets that are not able to cope with voluminous electronic trades have merged or partnered with others as competitive pressures intensify. Competition has brought faster transactions and lower transaction fees for investors.

D. Individual Investor Trading.

While many investors rely heavily on the advice they receive from brokers, more experienced and well-informed investors often prefer to invest independently without outside guidance.

1. **Stock Brokers.** Stock brokers receive and execute orders from non-exchange members and earn commissions as a result.

2. **Discount Brokers.** These brokers are fast and low-cost, providing no advice or sales consultations. They do offer online services such as stock research and industry analysis.

3. **Full-Service Brokers.** Consulting advice and personal financial planning are provided.

4. **Online Investing.** This is possible via convenient access to the Internet and is ideal for self-directed investors.

E. Tracking the Market Using Stock Indexes

Investors have used stock indexes to track market performance for decades. Market indexes provide some summaries of overall market price trends.

Bull Markets. Bull markets are periods of rising stock prices in which investors are motivated to buy because they are confident of continuing rising prices. **Bear Markets.** Bear markets are periods of falling stock prices during which investors sell anticipating lower prices in the future. To qualify as a bear market usually means prices are about 20 percent lower than the peak prices.

1. **The Dow Jones. The Dow Jones Industrial Average** (simply referred to as the Dow) is the oldest and most widely used index. It tracks the performance of the U.S. industrial sector by focusing on 30 blue-chip, large-cap companies. It is used as a barometer of the market's overall movement and economic health, though it only considers 30 companies.

2. **The S&P 500.**
The **S&P 500** is a broad index that tracks 500 large-cap companies from a number of sectors including IT, energy, industrials, financials, health care, consumer staples, and telecommunications.

3. **The NASDAQ Composite.**
Unlike the Dow and the S&P 500, the **NASDAQ Composite** includes all NASDAQ companies, totaling some 3,100 in its index. Because of its company roster, it is over-weighted in technology firms.

4. **The Russell 2000. The Russell 2000** is a specialized index that tracks the performance of the smallest U.S. companies based on their market capitalization.

Learning Objective 17-4:

Describe the risk-return relationship and discuss the use of diversification and asset allocation for investments.

The Risk-Return Relationship

Each type of investment has a **risk-return relationship,** which reflects the notion that safer investments tend to offer lower returns, and riskier investments tend to offer higher returns.

A. Investment Dividends (or Interest), Appreciation, and Total Return. Investors invest for different reasons. In evaluating a potential investment, investors examine returns from dividends, price appreciation, and total returns.

1. **Dividends.** The rate of return from stock dividends is known as the **current dividend yield.** This figure is generated by dividing the yearly dollar amount of the dividend income by the investment's current market value. The dividend yield is expressed as a percentage. It can be compared against yields from other investments.

2. **Price Appreciation.** Price appreciation is an increase in the dollar value (share price) of an investment. The profit realized from the increased market value of an investment is a **capital gain.**

3. **Total Return.** Total returns are the sum of the dividend yield plus the stock's capital gain. It is calculated by the formula:
Total Returns (%) = (Current dividend payment + Capital gain) / Original investment X 100

C. Managing Risk with Diversification and Asset Allocation
Most investors select a mixed portfolio of investments that provides an overall level of risk and return that feels comfortable.

1. **Diversification.** Through diversification, investors buy several kinds of investments rather than just one kind; this strategy reduces investor risk by "not having all one's eggs in one basket."

2. **Asset Allocation.** Asset allocation is the proportion of funds invested in each of the investment alternatives. These proportions can be changed at any time.

3. **Performance Difference for Different Portfolios.** A **portfolio** is the combined holdings of all financial investments of any individual or company. These investments include stocks, bonds, mutual funds, and real estate. Investment portfolios have different objectives ranging from aggressive high growth portfolios to stable income/low volatility portfolios.

Learning Objective 17-6:
Identify the reasons a company might make an initial public offering of its stock, explain how stock value is determined, and discuss the significance of market capitalization.

Becoming a Public Corporation
An **Initial Public Offering (IPO)** is a firm's first sale of its stock to the public. Corporations consider various issues before deciding to take the firm public.

A. Going Public Means Selling Part Ownership of the Company
Private owners lose some control when shares are sold to the public. Anyone owning a large proportion of the company's shares gains a powerful position in determining who runs the corporation and how. While an extreme case, this is particularly seen if the stock price falls and another investor **(a corporate raider)** mounts a **hostile takeover.** Corporations are vulnerable to hostile takeovers if their stock prices become undervalued and the firm's assets still have high value.

B. Stock Valuations
Most investors look for long-term value in stocks, rather than their short-term price. In determining long-term value, investors typically examine the company's financial health, its past history of

results and future forecasts, its record for managerial performance, and overall prospects for competing successfully in the coming years.

1. **Why Shares have Different Prices.** Share prices (value of a company stock) can differ substantially from one stock to another for various reasons. These include the supply and demand of the stock and the desire of corporations to have their shares sell within certain price ranges.

2. **Comparing Prices of Different Stocks.** When evaluating the price of Pepsi and Coca-Cola an investor would compare dividends, price-earning ratios (market value price per share by the company's earnings per share (EPS)), and historical performance consistency over a period of several years, along with indicators of each firm's prospects for the future. An investor should not simply compare share prices.

C. Market Capitalization

Market capitalization is the total value of the company's outstanding shares, calculated by the current stock price multiplied by the number of outstanding shares. Firms with larger market caps are considered to be less risky investments than firms with smaller market caps.

D. Choosing Equity versus Debt Capital

Firms can meet their capital needs through equity financing (putting the owners' capital to work) or debt financing (from outside the firm). These both have pros and cons.

1. **Pros and Cons of Debt Financing:**

a. **Long-term Loans.** Long-term loans are attractive because the number of parties involved is limited, they can be arranged quickly, and there is no need for public disclosure to account for how the loan is being used. On the other hand, long-term loans have the disadvantage that borrowers may not easily be able to find lenders and may face some restrictions as a condition for the loan.

b. **Corporate Bonds.** The advantage of bonds is that they can raise large amounts of money when the company needs it. The disadvantage is that they can incur high administration costs and stiff interest payments.

2. **Pros and Cons of Equity Financing.** Equity financing is sometimes a favorable option for companies. Equity financing includes issuing common stock or using the company's retained earnings. Issuing new stock can be expensive when dividend payments need to be made. It may be more costly than paying bond interest. Using retained earnings for capital projects means that this money is not available for dividend payments; this may reduce the stock price and the total market capitalization. However, the firm will not have to borrow money and pay interest.