Slides 1 - The Investment Environment

1. a. Securities are _____.

   - ○ assets secured by some collateral
   - ○ secure locations to store items of value
   - ◉ tradable financial assets
   - ○ tradable physical assets

   Securities are tradable financial assets. They are issued by companies or governments and represent a financial claim on the resources of the issuer.

2. a. What are types of financial assets (securities)?

   Check all that apply:

   - [x] Bonds
   - [x] Derivatives
   - [ ] Real estate
   - [x] Stocks

   Securities include bonds, stocks and derivatives. Real estate, on the other hand, is an investment in real property.

3. a. _____ assets are used to produce products or services, while _____ assets are claims on real assets or on the cash flows they produce.

   - ○ Financial; real
   - ○ Financial; tangible
   - ◉ Real; financial
   - ○ Tangible; real

   Real assets are used to produce products or services, while financial assets are claims on real assets or on the cash flows they produce.

   Real assets produce real products or services, thus increasing wealth. Financial assets, on the other hand, determine how the additional income or wealth are distributed between investors.

4. a. Which of the following are real assets?

   Check all that apply:

   - [ ] Corporate bond
   - [x] Factory
   - [x] Machine
   - [x] Patent
   - [x] Plot of land

5. a. Which of the following are financial assets?

   Check all that apply:

   - [x] $100 note

- [x] Bank loan
- [ ] Machine
- [ ] Patent
- [x] Share of stock

6. a. A derivative is _____.

   - ○ a call option
   - ○ a copy-cat security
   - ○ a piece of work derived from some other piece of work
   - ◉ any security whose value is derived from the value of some other asset

   A derivative is any security whose value is derived from the value of some other asset. A call option is an example of a derivative, but not all derivatives are call options.

7. a. The problems stemming from a conflict of interest between shareholders and executives are called _____ problems.

   - ◉ agency
   - ○ coordination
   - ○ incompatibility
   - ○ opportunity

   Agency problems are due to a conflict of interest in a principal-agent relationship. The agents (executives) have an incentive to make decisions that are in their own best interest, but not necessarily in the best interest of the principals (shareholders) who hired them.

8. a. Trying to identify mispriced financial assets is an example of _____.

   - ○ asset allocation
   - ○ financial research
   - ○ asset identification
   - ◉ security selection

   Security selection is the choice of specifc securities within a broad asset class. Managers who do security selection try to identify undervalued securities to buy and overvalued securities to sell or short-sell.

9. a. In general, an asset with higher expected return _____.

   - ○ is less expensive
   - ○ is more expensive
   - ○ has lower risk
   - ◉ has higher risk

   The risk-return trade-off implies that a higher expected return goes hand-in-hand with higher risk.

10. a. Which of the following is true about passive vs active management?

   - ○ Active managers usually allocate their capital between one or more index funds.
   - ○ Active managers usually allocate their capital to a fixed risky portfolio and change their allocations only as a result of changes in their risk tolerance.
   - ◉ Active managers usually try to achieve returns higher than commensurate with risk by identifying mispriced

assets.

- ○ Passive managers usually engage in both market timing and security selection.
- ○ Passive managers usually engage in market timing.

Investors who decide to pursue active management try to achieve returns higher than commensurate with risk by identifying mispriced assets (security selection) or asset classes (market timing).

b. ______ refers to the attempt to identify mispriced securities or to predict broad market trends.

- ◉ Active management
- ○ Asset allocation
- ○ Passive management
- ○ Security selection

Active management refers to a type of asset management that tries to achieve superior returns by either identifying mispriced securities (security selection) or predicting broad market trends (market timing).

Passive management, on the other hand, calls for holding a diversified portfolio of securities without trying to time the market or find mispriced securities.

11. a. ______ are markets in which financial securities are issued for the first time, while ______ are markets where already existing securities are traded.

- ○ Issue markets; liquidity markets
- ○ Issue markets; secondary markets
- ○ Primary markets; liquidity markets
- ◉ Primary markets; secondary markets

Primary markets are used by companies to raise new capital. They issue (create) new stocks or bonds and sell them to investors. If these securities are offered to everyone (a public offering), the transaction is called an initial public offering (IPO).

Secondary markets allow investors to trade existing securities with each other. The New York Stock Exchange and NASDAQ are examples of a secondary market. The issuer of the security does not receive any money from secondary market transactions.