INVESTMENTS: BACKGROUND AND ISSUES

Physical (Real) Assets vs. Financial Assets

- Real assets—often tangible, physical assets; primarily used to produce goods and services.
- Financial assets—claims on future cash flows generated by real assets.
- Divisibility—financial assets generally have greater divisibility than real assets.
- Marketability (Liquidity)—financial assets generally are more marketable than real assets.
- Holding Period—holding periods vary for both type of assets; even though some financial assets have no specific maturity, they do not have to be held forever.
- Information Availability—in many cases, information concerning financial assets is more readily available than for real assets.

Financial Assets

- Debt—loans; repaid over a specific period.
- Equity—ownership; stock represents ownership in a corporation.
- Fixed-income securities—offer a fairly stable cash flow stream (income) each period; examples are debt and preferred stock.
- Derivatives—based on values of other (underlying) assets.

Financial Markets

- The primary purpose of financial markets is to bring together those who need funds (e.g., borrowers) and those who wish to invest money (e.g., lenders).
- Information role—prices reflect information available in the financial markets.
- Transferring the consumption of income—financial markets allow for the transference of income to different times of your life. For example, by borrowing to purchase a house, you transfer income that you expect to earn in the future to the period when you purchase the house. Saving for retirement transfers income you earn in the current period to a future period when you are retired.
- Agency issues—investors who purchase investment instruments, such as stock, allow managers to act as their "agents" when operating a firm.
    - The owners of a large corporation and the persons who make the day-to-day decisions (the managers) generally are not the same individuals.
    - Investors empower managers of a large corporation to make day-to-day decisions to operate the firm such that the results are in the best interests of the owners.
    - Agency problems arise when managers act in their own best interests and those interests conflict with the best interests of investors. Managers can be encouraged to make decisions that benefit shareholders through:

        - Compensation programs that reward the "right behavior."
        - The threat of firing if investors' goals are not pursued.
        - Takeover threats; often, senior management is fired first when a takeover takes place.
        - Ownership requirements; if managers are also owners of the company, they will tend to act in the best interests of the other owners.

- Governance and Ethics
    - Governance refers to the set of rules the firm adheres to when managing business operations.
    - Ethics refers to the general attitude the company exhibits when conducting business. For example, how are employees and customers treated in the normal course of business?

Investment Process

- Asset allocation—percentage of funds that should be invested in various types of investments; top-down portfolio construction.
- Security selection—evaluation of specific investments to include in a portfolio; bottom-up portfolio construction.

Competition in the Financial Markets

- Risk-return tradeoff—investments with higher returns generally are riskier than investments with lower returns.
- Efficient markets—competition breeds efficiency
    - Passive portfolio management—believe markets are somewhat efficient.
    - Active portfolio management---try to find mispriced investments attempting to earn higher-than-normal returns.

Market Participants (The Players)

- Companies—net users of funds.
- Investors/individuals—net suppliers of funds.
- Governments—can be either net users of funds or net suppliers of funds.
- Financial intermediaries
    - Organizations that bring borrowers and lenders together.
    - Collect deposits and manufacture various financial products, including loans, savings instruments, and so forth.
    - Investment companies—mutual funds.
- Investment bankers—specialize in helping corporations and governments raise funds through new issues of securities.

Financial Crisis of 2008

- Housing finance (mortgages)
    - Securitization—investments backed by combinations (pooling) of loans.
    - Adjustable-rate mortgages (ARM)—interest rates on mortgages adjust based on prevailing market rates.
- Mortgage derivatives—risk management?
    - Collateralized debt obligations (CDOs)—generally two tranches of loans: (1) majority of loans are senior debt with good credit ratings; (2) remainder of the loans consists of junior debt that are considered “junk” loans (lower credit ratings). Good-credit loans absorb (offset) some of the risk of the “junk” loans.
- Credit default swaps—a type of “insurance” against default risk.