CHAPTER 1. INVESTMENTS: BACKGROUND AND ISSUES

**Investment** is the current commitment of Money or other resources in the expectation of reaping future benefits.

- Investments lead to a reduction in current consumption patterns
- On the other hand, investments cause a better and planned future consumption patterns.

**Real assets:**
They are the assets to produce goods and services in the economies.
*Example: Land, buildings, machinery, accessories, knowledge, etc.*

**Financial assets:**
They are the assets having claims on or income generated from real assets.
*Example: Stocks, bonds, shares.*

When households buy stocks, bonds and shares, these become financial assets of them, where they become liabilities of the issuers.

Main focus of this course will be on “INVESTMENTS ON FINANCIAL ASSETS”.

**Types of Financial Assets:** *Fixed income securities, equity and derivatives*

1. **Fixed Income Securities**
   These promise either a fixed stream of income or a stream of income that is determined according to a specified formula.

   *Example:*
   Corporate bond promising that bondholder will receive a fixed amount of interest each year.

2. **Equity (Common Stock)**
   Unlike fixed-income securities, common stock or equity represents an ownership share in the corporation. Equity holders are not promised any particular payment. They receive any dividends the firm may pay and have prorated ownership in the real assets of the company.

   If the firm is successful, the value of the equity will increase, otherwise it will decrease. Therefore, equity investments are riskier than fixed income securities.

3. **Derivative Securities**
They are commonly options and futures contracts that provide payoffs which are determined by the prices of other assets such as bond or stock prices.

Derivative securities are so named because their values derive from the prices of other assets.

Example: the value of the call option will depend on the price of Intel Stock.

**Financial Markets and the Economy**

Real assets determine the wealth of the economy while financial assets merely represent claims on real assets. Financial assets allow us to make the most of the economy’s real assets.

*Consumption Timing*
In high-earnings periods, people are likely to invest their savings in financial assets such as stocks and bonds where in low-earnings periods they are likely to sell these assets to provide funds for their consumption needs.

Thus, consumption patterns of people are allocated to periods that provide the greatest satisfaction.

*Allocation of Risk*
Risk can be allocated by people to invest, for example, in alternative ones as well, may be at the same time, just to allocate risk associated with financial assets.

*Separation of Ownership and Management*
Many businesses are owned and managed by the same individual. Small businesses are the most common example to this simple organization that was the most common form of business organization before the Industrial Revolution. However, today, along with global markets and large scale production, it became very difficult to continue the same type of organizations. Therefore, in today’s corporations ownership and management are separated since it also became impossible for an individual to run both duties.

*Agency Problem*
However, one of the results of the separation of ownership and management is the problems faced in agencies (authorized people), that is mainly resulted from the conflicts of interest among parties.
The Investment Process

An investor’s portfolio is simply his/her collection of investment assets. Once the portfolio is established, it is updated or “rebalanced” by selling or buying securities.

Investors make 2 types of decisions in constructing their portfolios:

1. The **Asset Allocation** decision is the choice among broad asset classes such as stocks, bonds, real estates, commodities, etc.

2. The **Security Selection** decision is the choice of which particular securities to hold *within* each asset class.

Security analysis involves the valuation of particular securities that might be included in the portfolio. For example, an investor might ask whether A or B is more attractively priced.

Markets are Competitive

Financial markets are highly competitive. Thus, which alternative for us?

1. **The Risk-Return Trade-Off**
   The risk and return comparison should be made prior to making investment in financial assets. That means that cost-benefit analysis should be done prior to making investment in Money markets.

2. **Efficient Markets**
   Efficient markets simply suggest that all the information about stocks, bonds and shares should be available to investors. This is called “Efficient Market Hypothesis”. Thus, this hypothesis concerns the choice between active and passive investment-management strategies.

   a. **Passive-Management** calls for holding highly diversified portfolios without spending effort or other resources attempting to improve investment performance through security analysis.

   b. **Active-Management** is the attempt to improve performance either by identifying mispriced securities or by timing the performance of broad asset classes.

The Players:

1. Firms: They are net borrowers
2. Households: They are net savers
3. Governments: They can be both borrowers and lenders
4. Investment bankers: They mainly advise corporations on issuing securities. They handle the marketing of the security issuance to the public.

**Key Trends: Globalization**

International and global markets continue to integrate and develop. As a result of globalization, national markets started to integrated with world markets. The following issues have been more important as a result of globalization:

- Managing foreign exchange
- Diversification to improve performance
- Instruments and vehicles continue to develop
- Information and analysis improves

**Securitization**

It is the process of backing up the loans by securities. It is simply pooling the loans into standardized securities.

**Financial Engineering:**

It is the process of creating and designing securities with custom-tailored characteristics.

**Bundling /Unbundling Securities:**

It is the creation of new securities either by combining primitive and derivative securities into one composite hybrid or by separating returns on an asset into classes.