FINA 4320: Investment Management
Chapter 1
Investments: Background and Issues

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Real versus Financial Assets

- Nature of Investment: Reduce current consumption for greater future consumption
- Real Assets
  - Used to produce goods and services: Property, plants and equipment, human capital, etc.
  - Determine the productive capacity and net income of the economy
- Financial Assets
  - Claims on real assets or real asset income

Real versus Financial Assets

- All financial assets (owner of the claim) are offset by a financial liability (issuer of the claim)
- When we aggregate over all balance sheets, only real assets remain
- Hence the net wealth of an economy is the sum of its real assets

Types of Financial Assets

1. Debt (Fixed Income Securities)
   - Payments are fixed or determined by a formula
   - Can be short term or long term, safe or risky
2. Equity
   - Common stock is an ownership share in the corporation.
   - Payments to stockholders are not fixed, but depend on the success of the firm
3. Derivatives
   - Value derives from prices of other assets such as bond or stock prices
   - Used to hedge risks or transfer them to other parties

Financial Markets and the Economy

- Informational Role
  - Do market prices equal the fair value estimate of a security's expected future risky cash flows?
  - Can we rely on markets to allocate capital to the best uses?
- Consumption Timing
  - When current basic needs are met, shift consumption through time by investing surplus
- Allocation of Risk
  - Catering to investors based on their risk-return appetite

Investment Process

- Asset Allocation
  - Choosing the percentage of funds in asset classes
- Security Selection
  - Choosing which particular securities to hold within each asset class
- The asset allocation decision is the primary determinant of a portfolio's return

Markets Are Competitive

- Risk-Return Trade-Off
    - Assets with higher expected returns have higher risk
    - How do we measure risk?
    - How does diversification affect risk?
- Market Efficiency and Implications
    - Securities should be neither underpriced nor overpriced on average
    - Security prices should reflect all information available to investors
    - Whether we believe markets are efficient affects our choice of appropriate investment-management style

Active vs. Passive Management

	Active Management	Passive Management
Markets are…	Inefficient	Efficient
Security Selection:	Actively Seeking Undervalued Stocks	No Attempt to Find Undervalued Securities
Asset Allocation	Market Timing	No Attempt to Time Market

The Players

- Business Firms (net borrowers)
- Households (net savers)
- Governments (can be both borrowers and savers)
- Financial Intermediaries (connectors of borrowers and lenders)
  - Commercial banks
  - Investment companies
  - Pension funds
  - Hedge funds

Investment Bankers, Venture Capital and Private Equity

- Investment Bankers: Firms that specialise in primary market transactions
- Primary Market: A market where newly issued securities are offered to the public
- Secondary market: A market where previously issued securities are traded among investors
- Venture Capital: Money invested to finance a new firm
- Private Equity: Investments in a company that are not traded on a stock exchange

The Rise of Systemic Risk During the Financial Crisis

- Systemic Risk is the risk of breakdown in the financial system, particularly due to spillover effects from one market into others
- By 2007, many banks were highly leveraged and had little capital as a buffer against losses
- They borrowed at low interest for short term, and invested in long-term, illiquid, high-yielding securities
- They needed to constantly refinance their positions to pay back the loan, or else quickly sell off their less liquid asset portfolios
- Even a small portfolio loss could cause the bank's net worth to become negative, making it difficult to refinance the loans
- In such a situation, banks may stop lending to prevent further losses, thus exacerbating funding problems for their customary borrowers