Chapter 1.
Investments: Background and Issues

Definition of Investment

- Investment
  - Trading present resources for future payoff
    - Bank deposit, stock purchase, education
- Real v.s. Financial Assets
  - Real asset: assets for generating goods and services
    - Factory, farm, gas station, restaurant, house
    - Knowledge; education; human capital
  - Financial assets: a claim on real asset
    - Bank loans, stocks, bonds, options, etc.
      - Zero net position in the economy
Financial Assets

- Money and Capital Markets

  - Fixed-income Securities (Debt Instruments)
    - Maturity < 1
      - Money Market
    - Maturity ≥ 1
  - Derivative Securities
  - Equity (Common & Preferred Stock)
    - Capital Market

Players in the Financial Market

- Companies
- Financial Intermediaries
  - Commercial Bank
    - Taking deposit and making loans
  - Investment Bank
    - Selling securities to investors
  - Investment companies
    - Pool and manage money for many investors
- Consumers/Investors
- Government
Why Do We Need Financial Assets?

- Consumption smoothing
  - Saving for the rainy days
  - e.g. College loans; retirement account; self-insurance

- Allocation of risks
  - Diversification over a larger ownership basis
  - Repackaging risk to match investor’s risk appetite

- Separation of ownership & management
  - Corporation can grow to a very large size
  - Owner can hire manager for daily operation
    - Potential agency problem

Investment Process – Two Strategies

- Asset allocation
  - Choice among broad asset classes
    - Stock, bond, real estate, etc.

- Security selection
  - Which particular securities to hold within each asset class

- “Top-down” vs. “bottom-up” approach
Investment Principles

- No Free Lunches
  - Risk-return trade-off
    - How to measure risk? CAPM, Factor Model
  - No arbitrage
    - Bond pricing; APT; Option pricing

- Financial market is (nearly) efficient
  - Financial markets process information quickly and efficiently
    - i.e. most information is priced
    - Passive vs. active management

Recent Trends – What is Hot?

- Globalization
  - International portfolio diversification
    - US market down, Asia markets up, average out
  - Cross border trading
    - ADRs, WEBS (World Equity Benchmark Shares)
  - Foreign exchange risk
    - Exchange rate fluctuation affects returns to foreign stock measured in domestic currency
    - Can be hedged away to eliminate non-company specific factors
Recent Trends

- Securitization - Pass-through securities
  - Mortgage-backed securities (MBS)
    - Pooling loans/mortgages/debts to create standardized securities
    - Banks still service the loan at a fee
    - GSEs (Fannie and Freddie offer credit guarantee)
  - Asset-backed securities (ABS)
  - Efficiency gain
    - Diversification; risk specialization
    - Reduce cost for originator and borrower
- Exchange-traded funds (ETFs)

Wrap-up

- What is investment?
- Differences between financial and real assets
- Why do we need financial assets?
- Two approaches to portfolio construction
- Recent trends in investment