The Investment Environment

Chapter 1

Real & Financial Assets

- Real assets = assets used to produce goods and services (productive capacity)
  - physical assets (land, buildings, machinery etc.)
  - "human assets" (labor, human capital)
- Financial Assets = claims on real assets
  - stocks and bonds
  - contribute *indirectly* to productive capacity by allowing the transfer of funds to most profitable opportunities
  - define the allocation of income among investors

Real & Financial Assets

- Distinguish between real and financial assets:
  - in balance sheet: real assets are *only* on asset side, while financial assets can be on both sides
  - Summing up balance sheets:
    - financial assets cancel out
    - real assets sum up to the net wealth of the economy
  - financial assets are destroyed during normal operation of business, while real assets only by accident or depreciation

Role of Financial Assets and Markets

1. Consumption timing
   - financial assets allow the transfer of purchasing power from one period to another (shift consumption)
2. Allocation of risk
   - investors can find the assets with the desired level of risk and return
3. Separation of ownership
   - large companies need large investment, hence many investors, but one or few managers

Separation of Ownership – Problems

Separation of ownership causes *principal-agent* (or *agency*) problems – agents (managers) don't always have the best interest of principals (shareholders) in mind

Solutions:

- compensation plans (e.g., stock options)
- board of directors
- outsider monitoring (e.g., large investors, security analysts)
- takeover threat (proxy contest)
- proposed – stock-based compensation

Crisis in Corporate Governance

- Accounting Scandals changes to financial data so as to hide the actual condition of the firm (e.g., Enron, Global Crossing)
- Analyst Scandals = misleading or overly optimistic reports by financial analysts (e.g., Merrill Lynch)
- Allocation of Initial Public Offerings (IPOs) to corporate executives to repay for personal favors (e.g., CSFB)

Financial System Clients and Their Needs

- Household Sector
  - primary need: invest funds
  - different incentives due to taxes, risk tolerance
- Business Sector
  - primary need: raise funds
  - want to get the best price for securities with the lowest issue cost possible → middlemen
- Government Sector
  - primary need: raise funds
  - can only sell bonds, but also regulates financial market

Meeting the Needs of Participants

- Financial Intermediation = channeling funds from investors (savings) to the business sector
  - Examples: banks, insurance companies, credit unions, investment companies (mutual funds)

  Advantages:
  - economies of scale (large sums to be invested)
  - diversification
  - specialization → lower transaction costs
- Investment Banking = firms that specialize in advising on and issuing securities (IPOs)
  - An important asset is *credibility*

Meeting the Needs of Participants

- Financial Innovation & Derivatives
  - due to the need for investment diversity
  - examples: securitization of mortgages
  - *primitive securities* offer returns based on the status of the issuer
  - *derivative securities* offer returns based on additional factors related to the price of other assets (used in general for risk management)
- Responding to Regulation & Taxes

  Examples: Eurodollar market, zero-coupon bonds

Markets and Market Structure

Four types of markets:

- *direct search market* – buyers and sellers look for each other directly (non-standard goods, sporadic participation)
- *brokered market* – if goods are sufficiently active (e.g., primary market, market for large block transactions)
- *dealer market* – dealers trade in their own interest, making profit from the bid-ask spread (e.g., the over-the-counter stock market)
- *auction market* – all economic agents converge to one place (e.g., NYSE)

Investments and Innovation

Ongoing trends:

- Globalization
- Securitization
- Financial engineering
- IT and communications revolution

Key Trends - Globalization

Foreign investment opportunities:

- purchase foreign securities using American Deposit Receipts (ADRs – domestically traded claims to foreign stocks) or WEBS (World Equity Benchmark Shares – claims on portfolios of foreign stocks)
- purchase foreign securities in USD
- buy mutual funds that invest overseas
- buy derivatives that depend on prices in foreign security markets

Key Trends - Securitization

- pools of loans are aggregated into *pass-through securities*
- enables issuers to bypass intermediaries, because of the large volume
- examples: mortgages, collateralized automobile receivables (CARs), credit card debt etc.
- also allowed the “cleansing” of bank balance sheets of loans to developing nations (Brady bonds – partially collateralized with US Treasury bonds)

Key Trends - Financial Engineering

- design and creation of securities with custom-tailored characteristics, in general with regard to exposure to certain types of risk
- deal with bundling or unbundling cash-flows to suit the requirements of traders
- usually involves primitive and derivative securities:
  - common stock combined with options
  - mortgage pass-through certificate split into 2 classes: only principal payment and only interest payment

Key Trends – Computer Networks

- helped introduce some innovations: online trading, online information dissemination etc.
- lowered transaction costs
- allow the bypass of intermediaries like investment bankers (e.g., Spring Street Brewing Company) or the creation of online investment bankers