INTRODUCTION OF INVESTMENT

Investment is a topic in which virtually everyone has some native interest. At a college campus, a number of students from astronomy to zoology seek to gain admission to an elective investments class in the College of Business Administration. Evening adult education classes with titles such as “Fundamentals of Stock Market” are common.

Most readers of this book are enrolled in a college-level investment course. For many students, this course will be the only time they ever formally study investments in a classroom sitting. The success of an individual investment program has lifelong ramifications, so soaking up as much of this material as possible can be advantageous. Aristotle said, “The educated differ from the uneducated as much as the living from the dead”. This idea is especially true with regards to investment education.

DEFINITION OF INVESTING:

An economist says when people earn a dollar; they do one of two things with it: they either consume it or save it. A person consumes a dollar by spending it on something like a car, clothing, or food. People also consume some of their money involuntarily because they must pay tax; a person saves a dollar by somehow putting it aside for consumption at a later time.

A distinction can be made between saving and investing. Saving involves putting money away with little, if any, risk saving dollars. Putting money in a bank certificate of deposit or a passbook account is saving. A saver knows the future return, and the account is probably insured by the Federal deposit Insurance Corporation (FDIC), a government agency that protects depositors against bank failure. In the short-run, saving involves few worries.

Investing also involves putting money away, but in a risky endeavor. Buying shares of stock in a New York Stock Exchange listed company is investing. If an investor choose to let a broker hold the shares and just send an account statement each month, his or her investment is protected against theft, loss, or brokerage firm failure by the Securities Investor Protection Corporation (SIPC), but not against a decline in value. Depending on the particular stock purchased and other holdings, an investor may have plenty to worry about.

Both saving and investing amount to consumption shifting through time. By not spending a dollar today, a person is able to spend more lately, assuming of course, the person saved or invested wisely.

Investing is risky but saving is not.

INVESTMENT ALTERNATIVES:

Assets:

Assets are things that people own. The two kinds of assets are financial assets and real assets. The distinction between these terms is easiest to see from an accounting viewpoint. A financial asset carries a corresponding liability somewhere. If an investor buys shares of stock, they are an asset to the investor but show up on the right side of the corporation’s
A financial asset, therefore, is on the left-hand side of the owner’s balance sheet and the right-hand side of the issuer’s balance sheet.

**A real asset does not have a corresponding liability associated with it, although one might be created to finance the real asset.**

**Financial assets have a corresponding liability but real assets do not.**

**Securities:**

A security is a legal document that shows an ownership interest. Securities have historically been associated with financial assets such as stocks and bonds, but in recent years have also been used with real assets. Securitization is the process of converting an asset or collection of assets into a more marketable forum.

**Security Groupings:**

Securities are placed in one of three categories: equity securities, fixed income securities, or derivative assets.

1. **Equity Securities:**

The most important equity security is common stock. Stock represents ownership interest in a corporation. Equity securities may pay dividends from the company’s earnings, although the company has no legal obligation to do so. Most companies do pay dividends, and most companies try to increase these dividends on a regular basis.

2. **Fixed Income Securities:**

A fixed income security usually provides a known cash flow with no growth in the income stream. Bonds are the most important fixed income securities. A bond is a legal obligation to repay a loan’s principal and interest, but carries no obligation to pay more than this. Interest is the cost of borrowing money. Although accountants classify preferred stock as an equity security, the investment characteristics of preferred stock are more like those of a fixed income security. Most preferred stocks pay a fixed annual dividend that does not change overtime consequently. An investment manager will usually lump preferred shares with bonds rather than with common stocks.

Conversely, a convertible bond is a debt security paying a fixed interest rate. It has the added feature of being convertible into shares of common stocks by the bond holders. If the terms of the conversion feature are not particularly attractive at a given moment, the bonds behave like a bond and are classified as fixed income securities. On the other hand, rising stock prices make the bond act more like the underlying stock, in which case the bond might be classified as an equity security.

The point is that one cannot generalize and group all stock issues as equity securities and all bonds as fixed income securities. Their investment characteristics determine how they are treated.

**For investment purposes, preferred stock is considered a fixed income security.**
3. **Derivative Assets:**

Derivative assts have received a great deal of attention in the 1990s. A derivative asset is probably impossible to define universally. In general, the value of such an asset derives from the value of some other asset or the relationship between several other assets.

Future and options contracts are the most familiar derivative assets. These building blocks of risk management programs are used by all large investment houses and commercial banks.

The three broad categories of securities are equities, fixed income securities, and derivative asset.

**THREE REASONS FOR INVESTING:**

People choose to invest to supplement their income, to earn gains, and to experience the excitement of the investment process.

1. **Income:**

   Some people invest in order to provide or supplement their income. Investments provide income through the payment of dividends or interest.

2. **Appreciation:**

   Other individuals, especially those in their peak working years, may be more interested in seeing the value of their investments grow rather than in receiving any income from investment. Appreciation is an increase in the value of an investment.

3. **Excitement:**

   Investing is frequently someone’s hobby. Investing is not inherently an end in itself; it is a means to an end. Ultimately, the investment objective involves improved financial standing. If an active investor makes frequent trades but only breaks even in the process, only the stockbroker will benefit materially.

   **Investing is not an end in itself; it is a means to an end.**

**THE ACADEMICS STUDY OF INVESTMENTS:**

Some things about the markets and investor behavior are clear. Many other things remain a puzzle. One objective of any investments course should be to distinguish between what we do and don’t know. Let’s look briefly at the two types of market research in which both professors and Wall Street professionals engage: theoretical and empirical research.

One objective of any investment course should be to distinguish between what we do and don’t know.
Theoretical Research:

Theoretical research builds mathematical models and proposes pricing relationships rather than studying actual market data. Arbitrage is the presence of a risk less profit. Much of theoretical research is the study of arbitrage relationships.

Similarly, dividends must be paid from the firm’s checkbook, and once the checks are sent, the firm’s total assets decline. With reduced assets, the firm is worth less and the stock price declines. Both these points can be demonstrated with theoretical models, but that does not mean people will believe them.

Arbitrage is a presence of a risk less profit.

Empirical Research:

Empirical research uses actual market data rather than mathematical models. Financial theory might suggest a relationship that should hold, and research might then the hypothesis using real numbers. Relatively arbitrary accounting decisions within the firms should not affect the value of the firm. The theoretical underpinnings of firm value show that if management could increase the value of the firm by a simple management action all rational management teams would do so. An empirical research project might be to investigate all stock splits over the past 60 months and see if the evidence is consistent with the “no change in firm value” thesis.

The financial press is particularly interested in empirical research, especially research dealing with anomalies. An anomaly is an observed result that defies explanation within the known theoretical framework.