FIN 366: INVESTMENTS BRIEFING

Chapter 1: Investments Background and Issues

An **investment** is foregoing current consumption in expectation of a future benefit. **Real assets** directly contribute to the creation of goods and services (land, buildings) while **financial assets** indirectly contribute (stocks, bonds). **Equity** represents an ownership interest in a company while **fixed income,** including debt and bonds, represents borrowing and a fixed stream of repayment. Financial assets play four key roles: (1) **Informational**: stocks reflect how investors feel about a company, (2) **Consumption timing**: allows us to save for later, (3) **Risk allocation**: there are opportunities to invest regardless of whether we want to take greater risks or be more conservative, and (4) **Separation of ownership and management**: shareholders can contribute capital and hire managers to run the firm. For these roles to be satisfied, there must be **market transparency**. With the separation of ownership and management, **agency problems**, whereby managers pursue their own goals at the expense of shareholders, can arise. **Asset allocation** involves constructing the portfolio by deciding which broad categories to choose, while **security selection** is the choice of specific securities. Markets are competitive: investors rush to react to news when it becomes available. This is known as **market efficiency**. Investors balance **return requirements** (what they wish to earn) and their **risk tolerance** (what they can afford to lose) when constructing their portfolios. We learn from the **Financial Crisis of 2008** and the stock market reaction to the **COVID-19 Pandemic** as we begin our course.