

## CHAPTER 1: THE INVESTMENT ENVIRONMENT

### PROBLEM SETS

1. While it is ultimately true that real assets determine the material well-being of an economy, financial innovation in the form of bundling and unbundling securities creates opportunities for investors to form more efficient portfolios. Both institutional and individual investors can benefit when financial engineering creates new products that allow them to manage their portfolios of financial assets more efficiently. Bundling and unbundling create financial products with new properties and sensitivities to various sources of risk that allows investors to reduce volatility by hedging particular sources of risk more efficiently.
2. Securitization requires access to a large number of potential investors. To attract these investors, the capital market needs:
  1. a safe system of business laws and low probability of confiscatory taxation/regulation;
  2. a well-developed investment banking industry;
  3. a well-developed system of brokerage and financial transactions; and
  4. well-developed media, particularly financial reporting.

These characteristics are found in (indeed make for) a well-developed financial market.

3. Securitization leads to disintermediation; that is, securitization provides a means for market participants to bypass intermediaries. For example, mortgage-backed securities channel funds to the housing market without requiring that banks or thrift institutions make loans from their own portfolios. Securitization works well and can benefit many, but only if the market for these securities is highly liquid. As securitization progresses, however, and financial intermediaries lose opportunities, they must increase other revenue-generating activities such as providing short-term liquidity to consumers and small business and financial services.
4. The existence of efficient capital markets and the liquid trading of financial assets make it easy for large firms to raise the capital needed to finance their investments in real assets. If Ford, for example, could not issue stocks or bonds to the general public, it would have a far more difficult time raising capital. Contraction of the supply of financial assets would make financing more difficult, thereby increasing the cost of capital. A higher cost of capital results in less investment and lower real growth.

5. Even if the firm does not need to issue stock in any particular year, the stock market is still important to the financial manager. The stock price provides important information about how the market values the firm's investment projects. For example, if the stock price rises considerably, managers might conclude that the market believes the firm's future prospects are bright. This might be a useful signal to the firm to proceed with an investment such as an expansion of the firm's business.

In addition, shares that can be traded in the secondary market are more attractive to initial investors since they know that they will be able to sell their shares. This in turn makes investors more willing to buy shares in a primary offering and thus improves the terms on which firms can raise money in the equity market.

Remember that stock exchanges like those in New York, London, and Paris are the heart of capitalism, in which firms can raise capital quickly in primary markets because investors know there are liquid secondary markets.

6. a. No. The increase in price did not add to the productive capacity of the economy.
- b. Yes, the value of the equity held in these assets has increased.
- c. Future homeowners as a whole are worse off, since mortgage liabilities have also increased. In addition, this housing price bubble will eventually burst and society as a whole (and most likely taxpayers) will suffer the damage.
7. a. The bank loan is a financial liability for Lanni, and a financial asset for the bank. The cash Lanni receives is a financial asset. The new financial asset created is Lanni's promissory note to repay the loan.
- b. Lanni transfers financial assets (cash) to the software developers. In return, Lanni receives the completed software package, which is a real asset. No financial assets are created or destroyed; cash is simply transferred from one party to another.
- c. Lanni exchanges the real asset (the software) for a financial asset, which is 1,250 shares of Microsoft stock. If Microsoft issues new shares in order to pay Lanni, then this would represent the creation of new financial assets.
- d. By selling its shares in Microsoft, Lanni exchanges one financial asset (1,250 shares of stock) for another (\$125,000 in cash). Lanni uses the financial asset of \$50,000 in cash to repay the bank and retire its promissory note. The bank must return its financial asset to Lanni. The loan is "destroyed" in the transaction, since it is retired when paid off and no longer exists.

8. a.

<i>Assets</i>		<i>Liabilities &amp; Shareholders' Equity</i>	
Cash	\$ 70,000	Bank loan	\$ 50,000
Computers	<u>30,000</u>	Shareholders' equity	<u>50,000</u>
Total	\$100,000	Total	\$100,000

Ratio of real assets to total assets =  $\$30,000/\$100,000 = 0.30$

b.

<i>Assets</i>		<i>Liabilities &amp; Shareholders' Equity</i>	
Software product*	\$ 70,000	Bank loan	\$ 50,000
Computers	<u>30,000</u>	Shareholders' equity	<u>50,000</u>
Total	\$100,000	Total	\$100,000

\*Valued at cost

Ratio of real assets to total assets =  $\$100,000/\$100,000 = 1.0$

c.

<i>Assets</i>		<i>Liabilities &amp; Shareholders' Equity</i>	
Microsoft shares	\$125,000	Bank loan	\$ 50,000
Computers	<u>30,000</u>	Shareholders' equity	<u>105,000</u>
Total	\$155,000	Total	\$155,000

Ratio of real assets to total assets =  $\$30,000/\$155,000 = 0.19$

Conclusion: when the firm starts up and raises working capital, it is characterized by a low ratio of real assets to total assets. When it is in full production, it has a high ratio of real assets to total assets. When the project "shuts down" and the firm sells it off for cash, financial assets once again replace real assets.

9. a. For commercial banks, the ratio is:  $\$134.3/\$17,532.8 = 0.0077$

b. For nonfinancial firms, the ratio is:  $\$23,678/\$45,464 = 0.5208$

c. The difference should be expected primarily because the bulk of the business of financial institutions is to make loans and the bulk of the business of non-financial corporations is to invest in equipment, manufacturing plants, and property. The loans are financial assets for financial institutions, but the investments of non-financial corporations are real assets.

10. a. Primary-market transaction in which gold certificates are being offered to public investors for the first time by an underwriting syndicate led by JW Korth Capital.

- b. The certificates are derivative assets because they represent an investment in physical gold, but each investor receives a certificate and no gold. Note that investors can convert the certificate into gold during the four-year period.
11. a. A fixed salary means that compensation is (at least in the short run) independent of the firm's success. This salary structure does not tie the manager's immediate compensation to the success of the firm, so a manager might not feel too compelled to work hard to maximize firm value. However, the manager might view this as the safest compensation structure and therefore value it more highly.
- b. A salary that is paid in the form of stock in the firm means that the manager earns the most when the shareholders' wealth is maximized. Five years of vesting helps align the interests of the employee with the long-term performance of the firm. This structure is therefore most likely to align the interests of managers and shareholders. If stock compensation is overdone, however, the manager might view it as overly risky since the manager's career is already linked to the firm, and this undiversified exposure would be exacerbated with a large stock position in the firm.
- c. A profit-linked salary creates great incentives for managers to contribute to the firm's success. However, a manager whose salary is tied to short-term profits will be risk seeking, especially if these short-term profits determine salary or if the compensation structure does not bear the full cost of the project's risks. Shareholders, in contrast, bear the losses as well as the gains on the project and might be less willing to assume that risk.
12. Even if an individual shareholder could monitor and improve managers' performance and thereby increase the value of the firm, the payoff would be small, since the ownership share in a large corporation would be very small. For example, if you own \$10,000 of Ford stock and can increase the value of the firm by 5%, a very ambitious goal, you benefit by only:  $0.05 \times \$10,000 = \$500$ . The cost, both personal and financial to an individual investor, is likely to be prohibitive and would typically easily exceed any accrued benefits, in this case \$500.
- In contrast, a creditor, such as a bank, that has a multimillion-dollar loan outstanding to the firm has a big stake in making sure that the firm can repay the loan. It is clearly worthwhile for the bank to spend considerable resources to monitor the firm.
13. Mutual funds accept funds from small investors and invest, on behalf of these investors, in the domestic and international securities markets.
- Pension funds accept funds and then invest in a wide range of financial securities, on behalf of current and future retirees, thereby channeling funds from one sector of the economy to another.

Venture capital firms pool the funds of private investors and invest in start-up firms. Banks accept deposits from customers and loan those funds to businesses or use the funds to buy securities of large corporations.

14. Treasury bills serve a purpose for investors who prefer a low-risk investment. The lower average rate of return compared to stocks is the price investors pay for predictability of investment performance and portfolio value.
15. With a top-down investing style, you focus on asset allocation or the broad composition of the entire portfolio, which is the major determinant of overall performance. Moreover, top-down management is the natural way to establish a portfolio with a level of risk consistent with your risk tolerance. The disadvantage of an *exclusive* emphasis on top-down issues is that you may forfeit the potential high returns that could result from identifying and concentrating in undervalued securities or sectors of the market.

With a bottom-up investing style, you try to benefit from identifying undervalued securities. The disadvantage is that investors might tend to overlook the overall composition of your portfolio, which may result in a non-diversified portfolio or a portfolio with a risk level inconsistent with the appropriate level of risk tolerance. In addition, this technique tends to require more active management, thus generating more transaction costs. Finally, the bottom-up analysis may be incorrect, in which case there will be a fruitlessly expended effort and money attempting to beat a simple buy-and-hold strategy.

16. You should be skeptical. If the author actually knows how to achieve such returns, one must question why the author would then be so ready to sell the secret to others. Financial markets are very competitive; one of the implications of this fact is that riches do not come easily. High expected returns require bearing some risk, and obvious bargains are few and far between. Odds are that the only one getting rich from the book is its author.
17. Financial assets provide for a means to acquire real assets as well as an expansion of these real assets. Financial assets provide a measure of liquidity to real assets and allow for investors to more effectively reduce risk through diversification.
18. Allowing traders to share in the profits increases the traders' willingness to assume risk. Traders will share in the upside potential directly in the form of higher compensation but only in the downside indirectly in the form of potential job loss if performance is bad enough. This scenario creates a form of agency conflict known as moral hazard, in which the owners of the financial institution share in both the total profits and losses, while the traders will tend to share more of the gains than the losses.

19. Answers may vary, however, students should touch on the following: increased transparency, regulations to promote capital adequacy by increasing the frequency of gain or loss settlement, incentives to discourage excessive risk taking, and the promotion of more accurate and unbiased risk assessment.