

# CHAPTER ONE

## THE INVESTMENT ENVIRONMENT

### **CHAPTER OVERVIEW**

The student is introduced to the general concept of investing—to forego spending cash today in the hopes of increasing wealth in the future. Real assets are differentiated from financial assets, and the major categories of financial assets are defined. The risk/return tradeoff and the reality that most assets are efficiently priced most of the time are introduced. The role of financial intermediaries is discussed. The chapter also provides presentation of the financial crisis of 2008, its causes and its implications, as well as regulatory attempts to address those consequences

### **LEARNING OBJECTIVES**

After studying this chapter, students should have an understanding of the overall investment process know some of the key elements involved in the investment process. Students should understand differences in financial and real assets and be able to identify the major components of the investment process. Students should be able to describe a derivative security and understand how it is used. Finally, students should understand the causes and effects of the financial crisis of 2008.

### **PRESENTATION OF CHAPTER MATERIAL**

#### **1.1 Real Assets versus Financial Assets**

The main elements of the chapter are presented here. The concept of giving up current consumption to invest in assets that allow greater consumption in the future is the key notion to start discussion of the chapter material. The discussion of real and financial assets can be used to discuss key differences in the assets and their appropriateness as investment vehicles.

The instructor might want to elucidate the material using updated balance sheets and net worth for Canadian households from the Statistics Canada website:

[https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?  
pid=3610058001&pickMembers%5B0%5D=2.4&pickMembers%5B1%5D=3.1](https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?pid=3610058001&pickMembers%5B0%5D=2.4&pickMembers%5B1%5D=3.1)

## 1.2 Financial Assets

Fixed income securities include both long-term and short-term instruments. The essential element of debt securities and the other classes of financial assets is the fixed or fixed formula payments that are associated with these securities. Common stock that features residual payments to the owners can be contrasted with the relatively certain debt claims. A derivative security is a security whose performance is based on or tied to another asset or financial security. The discussion of derivative securities presented here should be brief and used to highlight the discussion of innovation in our markets. Students may find interest in key elements of each derivative and how they relate the properties to debt and equity securities.

## 1.3 Financial Markets and the Economy

Financial assets (and hence markets where they are traded) play a big role in developed economies by allowing to make the most of the economy's real assets. Markets encourage allocation of capital to firms that have the best prospects in the view of the market participants. Markets allow participants to adjust consumption and to choose levels of risk that are appropriate. Financial markets also allow for separation of management and ownership. Current issues related to corporate governance and ethics issues are presented here, which provides students a great opportunity for discussion. Be sure to mention:

- The informational role of financial markets
- Consumption timing
- Allocation of risk
- Separation of ownership and management
- Corporate governance and corporate ethics

## 1.4 The Investment Process

Section 1.4 describes the major components of the investment process. Two of the major elements in the investment process, **asset allocation** and **security selection**, can be used to discuss the content and coverage in the course. Previewing the concept of **risk-return trade-off** is important for the development of portfolio theory and many other concepts developed in the course. The discussion of active and passive management styles is related to the concept of market efficiency.

## 1.5 Markets are Competitive

The two major elements of a competitive market are the risk–return trade-off and market efficiency. Here, efficiency can be introduced in broad terms; however, the conclusion is there

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should be a risk–return trade-off in securities markets. Also, contrast passive management with active management, which combines security selection and timing. Material in later chapters can be previewed in terms of emphasis on elements of active management. On the other hand, the essential element related to passive management is holding an efficient portfolio. Here, efficiency means not only diversification but also appropriate risk levels, cash flow characteristics, and administration costs.

## 1.6 The Players

The major participants in the financial markets are discussed here, Governments, households and businesses can be issuers and investors in securities. Financial intermediaries include many groups who bring issuers and investors together. Investment bankers perform many specialized services for businesses and operate in the primary market. Venture capital provides financial for start-up firms. The instructor can obtain updated aggregate balance sheets for Canadian chartered banks from:

[https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?  
pid=3610058001&pickMembers%5B0%5D=2.13&pickMembers%5B1%5D=3.1](https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?pid=3610058001&pickMembers%5B0%5D=2.13&pickMembers%5B1%5D=3.1)

Canadian nonfinancial corporations balance sheets can be obtained from:

[https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?  
pid=3610058001&pickMembers%5B0%5D=2.7&pickMembers%5B1%5D=3.1](https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?pid=3610058001&pickMembers%5B0%5D=2.7&pickMembers%5B1%5D=3.1)

## 1.7 The Financial Crisis of 2008

Section 1.7 presents the Financial Crisis of 2008, with emphasis on its antecedents and its significance in the future of the financial world. It begins with events leading up to the crisis and introduces the important Case-Shiller Index of U.S. housing prices (of which the students should be familiar). The discussion turns to the mechanics of the mortgage pass-through security (instructors will note that the generalized idea of securitization is presented here as well). The cash flow for these securities is depicted graphically in Figure 1.4. The authors also discuss in detail the role government sponsored entities Fannie Mae and Freddie Mac played in the crisis.

The text introduces mortgage derivatives in this section, focusing on collateralized debt obligations (CDOs) and credit default swaps (CDS). This section ties these derivatives with the all-important concept of systemic risk (where problems in one financial sector spill over to other sectors). Students will need to tie together several disparate concepts here for a strong understanding of how this crisis occurred.

This section then describes the sub-prime housing meltdown, the subsequent credit freeze and the impact these events had on the real economy. The government's response is presented. Students can have great discussions on the effectiveness of the various fiscal and monetary actions during this time.

A brief summary of the Canadian experience over the Financial Crisis is also provided.

## 1.8 Outline of the Text

In this section, the authors divide the text into seven independent learning parts, with several chapters in each part. This can be useful for instructors when developing the course syllabus.

- Part 1 is an introduction to financial markets, instruments, and trading of securities.
- Part 2 starts with a general discussion of risk and return and capital market history and then moves on to investor risk preferences, efficient diversification, and portfolio optimization.
- Part 3 investigates the implications of portfolio theory and introduces the capital asset pricing model.
- Part 4 discusses debt markets and Part 5 equity markets.
- Part 6 covers derivative assets like options and futures.
- Part 7 serves as an introduction to active investment management.

## KEY TERMS

investment	security selection	primary market
real assets	security analysis	secondary market
financial assets	risk-return trade-off	venture capital (VC)
fixed-income (debt) securities	passive management	private equity
equity	active management	securitization
derivative securities	financial intermediaries	systemic risk
agency problem	investment companies	
asset allocation	investment bankers	