CHAPTER 1

The Investment Framework

1. As a potential investor, what would be your objective(s) and constraints? What major trade-offs do you face?

The answer depends on the student. In general, all investors face quantitative and qualitative constraints. For example, constraints include resources, age and preferences and objectives include wealth maximization or satisfaction of some future liability. One tradeoff is the balancing between risk and return since higher expected return entails assuming more risk.

2. Why is it inappropriate to say 'I want to make as much money on my investments as possible'? What are you ignoring?

Such talk is meaningless. You ignore the other side of the situation – risk. Remember, that there is a trade off between risk and return and these cannot be separated.

3. Take a look at the cafeteria in your college campus. You and most of other students go there on a daily basis for food and drinks. If the male person working there to serve you is always shirking his work responsibilities, how would you advise him in order to keep his job?

The obvious answer would be to advise him to rise up to his responsibilities. By not doing his part, other co-workers are filling in and thus costs, explicit and implicit, rise. For example, other co-workers may not do his job efficiently and effectively resulting in waste of time, and resources. In addition, customer wait may become a factor which also, indirectly, will contribute to the cost of service and thus a higher price for you, the customer. As a result, you should advise him to take seriously his responsibilities or simply find another job.

4. We discussed the conflicts that arise between a company's manager and its stakeholders. Can you suggest some other ways to align a manager's goals to those of the firm's owners? You might want to scour The Wall Street Journal to find some relevant articles.

The answer is left to the student.

5. Consider the following scenario. Suppose your parents ask their neighbor (who consistently pays attention to the stock market because he is an active investor) for advice on a particular stock. Your parents wish to decide if it makes sense to buy the stock. If the neighbor's opinion on the stock is favorable and says that the company will do fine in the future, is such a statement unethical? Answer the question assuming that your parents thought that your neighbor's opinion was based on a good knowledge of the company.

It depends. For example, if your neighbor had prior knowledge that the company is about to go under and misled you into buying stock from that company, then it would most likely be unethical behavior. If not, then it would not matter. You should also question your neighbor's motives for suggesting such a purchase. What could possibly be his benefit from doing so?

6. We discussed the conflicts that arise between existing and new stockholders when management wishes to undertake new projects financed by equity. Now, consider the following scenario. The management of the firm has no other means of financing a new risky project but to sell bonds. If bondholders knew of the project's riskiness (which might be greater that they would be willing to bear), they would outright refuse to provide the funds. Explain the outcome of such behavior by the bondholders. Do we have an instance of market failure? What if the bondholders did not know of the project's risk? What impact would that have on the bondholders' wealth (relative to that of the stockholders)?

Bondholders would pursue this action because they know that more debt lowers the value of existing debt. Thus, creditors, old and new alike, will be put at risk. Moreover, if the project is successful, the benefits would exclusively accrue to shareholders but not to bondholders because they only get a fixed return. On the other hand, if the project goes sour, then creditors might also share the loss. From the shareholders' point of view, this situation is 'heads I win, tails you lose' game, which may not be viewed well by creditors.

The agent-principal conflict is relevant in this case. This conflict arises because the stockholders know that if the project goes sour they will lose but the creditors will still be paid.

7. We discussed social responsibility in the text. Can you advance an argument for the mandatory and for the non-voluntary requirement of such behavior for firms by government law?

It will, in general, be difficult (if not politically possible) for the government to impose mandatory restrictions on social responsibility actions of firms. Firms typically find it beneficial to engage in socially desirable actions because their profitability is enhanced in the long run.

8. Would you be willing to accept more risk if you expected to earn higher return? If so, which attitude toward risk would you have?

Yes, I would because of the expectation for higher return. This means that I am a risk-averse investor.

9. How do you understand the term 'efficiency' when applied to the financial markets?

Efficiency can be describes as the effective allocation of scarce resources among competing (alternative) uses towards the production of goods and services.

10. Classify the following assets as real or financial: factory, stock, option, pencil, knowledge, education.

Real, financial, financial, real, real, real.

11. Which business has more or less financial and/or real assets, a bank or IBM? What is each business' social function?

A bank has more financial than real assets while IBM has the opposite. The bank's social function is to efficiently transfer funds from savers to investors. IBM's social function is to provide safe products.

12. What are the social functions of financial intermediaries? Can you give some examples?

Financial intermediaries accept funds from savers and lend funds to investors and some can issue their own securities to finance purchases of other institutions' securities. Financial intermediaries differ from other companies in the sense that their business is in financial assets. For instance, if we compare Ford Motor company to a commercial bank we will see that Ford has more of real assets (like plant and equipment) and less of financial assets, whereas the opposite is true for the bank. This is so because a commercial bank simply channels funds from households to the business sector. That is the social function of such intermediaries. Another example of a financial intermediary is an investment company, commonly known as mutual fund. A mutual fund simply pools the funds of small investors and invests the resulting big sum in a variety of financial assets on their behalf.

13. What is the objective of the investment management process?

First of all, recognize that professional portfolio managers get paid for managing other people's money and that their pay is fee-based. This means that the more money is under management, the greater the resulting fees and the manager's salary. The objective of the portfolio manager is to use the inputs (i.e., funds, technology) as efficiently as possible in order to generate the greatest expected return possible for the client, given the constraints. The inputs are spelled out in the investor's investment policy statement and the constraints are the investor's risk tolerance and preferences. Thus, the objective of investment management is to maximize a client's expected return given his risk constraints.

14. Which actions currently exist to suppress future episodes of unethical behavior?

Some mechanisms already in place to deter such wrongdoings are the threat of being cast (forced) out, and consumers' increasing public outcry combined with the threat of activist investors. New laws were enacted in recent years in response to these waves of unethical board practices like the Sarbanes-Oxley Act of 2002, and the Securities and Exchange Commission's Fair Disclosure regulation put forth in 2000. A securities investor has some extra protection coming from the Securities Investor Protection Corporation (SIPC). SIPC is a non-profit corporation that insures customer accounts (for up to $500,000) of brokerage member firms against failure. An investor can seek damages from a brokerage firm (that is, a firm that buys/sells securities on his behalf), if he is not happy with its advice services, via arbitration before a major stock exchange body (the National Association of Securities Dealers, NASD, as we will see in later chapters).

Finally, another way to deter such practices by professional managers and advisers is for the investor to shun such organizations. In other words, investors should reward institutions which apply ethical behavior or social investing and 'punish' those that do not.

CHAPTER 2