

Theory of Finance I – FINA 385
Summer 2015
LEC AA and, AB

Chapter 1: The Investment Objective

Chapter 1 Summary
The Investment Objective

- **Objective:** To provide a general overview of the investment environment
 - Short History of Investing
 - The Investment Objective
 - Real vs. Financial Assets
 - Financial System Clients and their Needs
 - The Agency Theory

Chapter 1

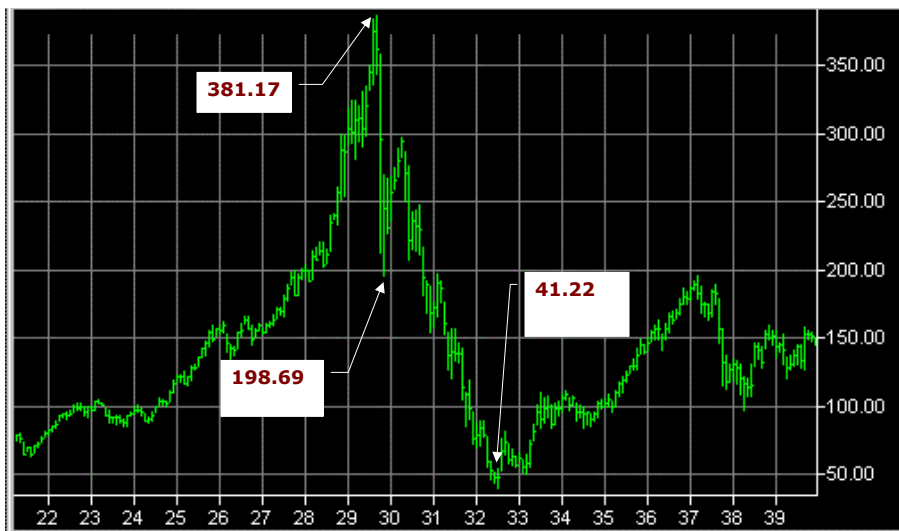
The Investment Objective

Short (Recent) History of Investing

- ◆ The Crash of 1929 and the Great Depression
- ◆ One-day panic in 1987
- ◆ The 'technology bubble' in the nineties and
- ◆ The 'bear market' of the new millennium

The Crash of 1929

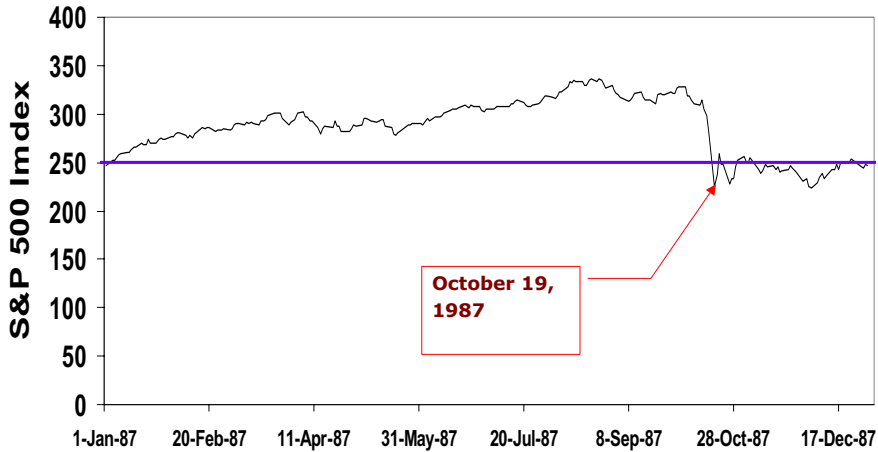
Dow Jones Industrial Average (1921-1940)



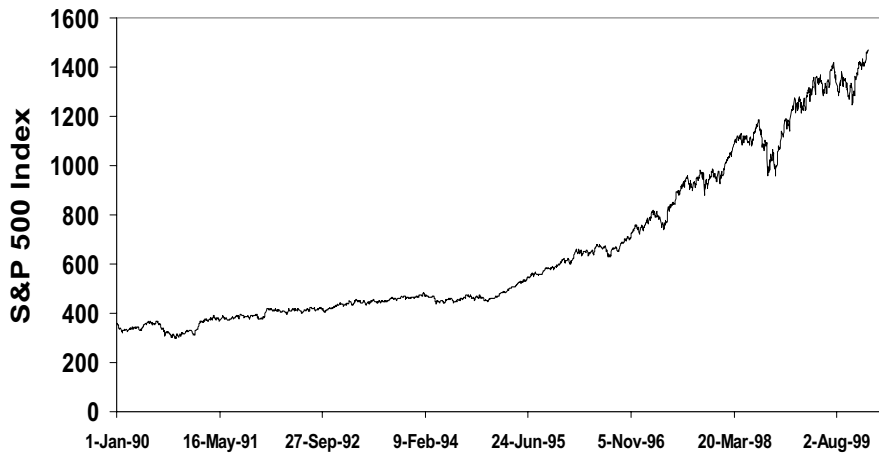
The Recovery Dow Jones Industrial Average (1897-1999)



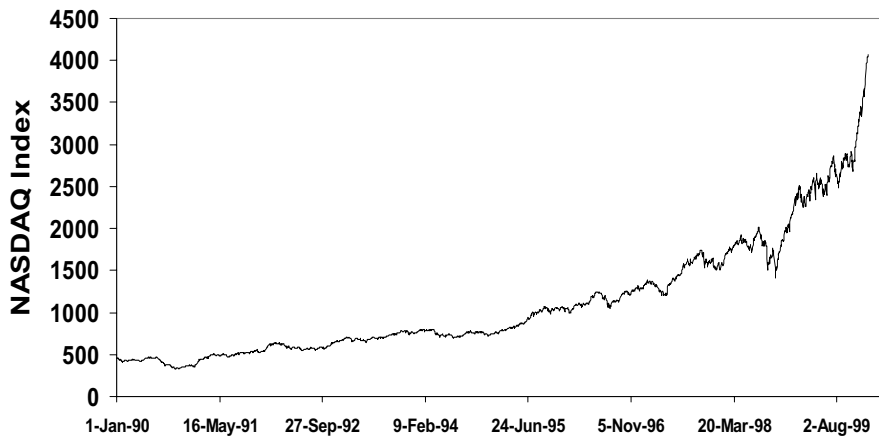
"Black Monday" Crash of October 19, 1987



S&P 500 Index Performance in the 1990s

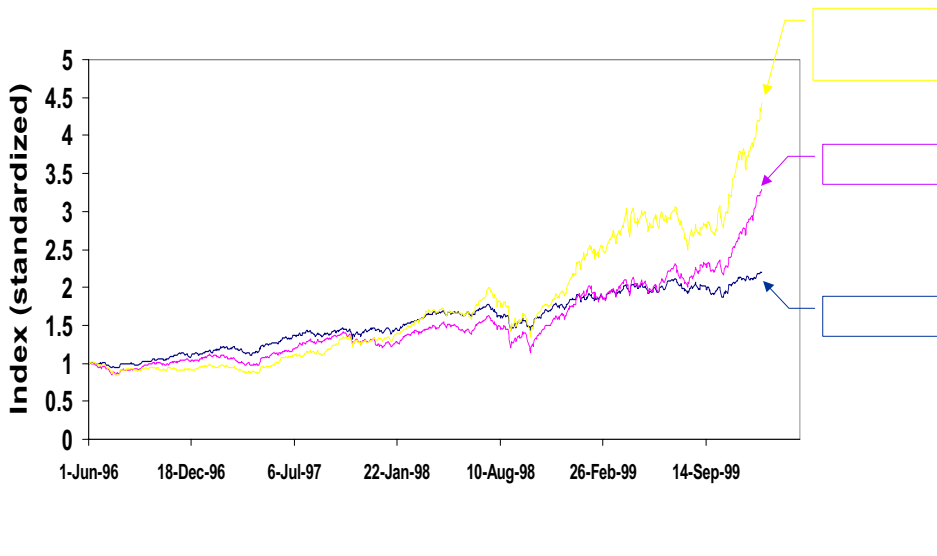


NASDAQ Performance in the 1990s



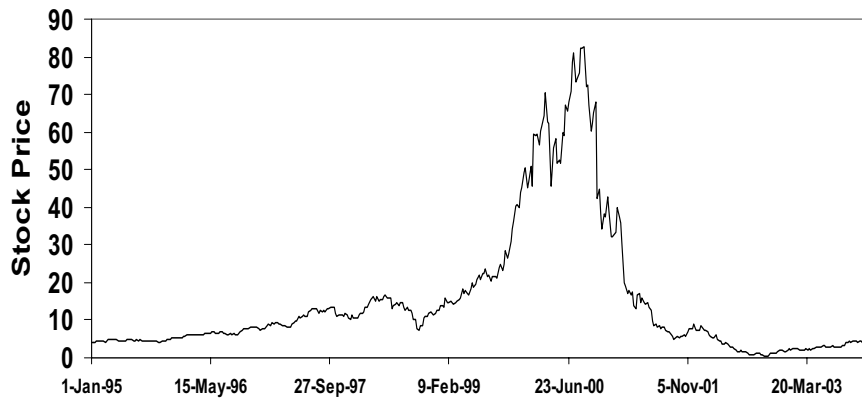
Market Performance 06:1996 - 12:1999

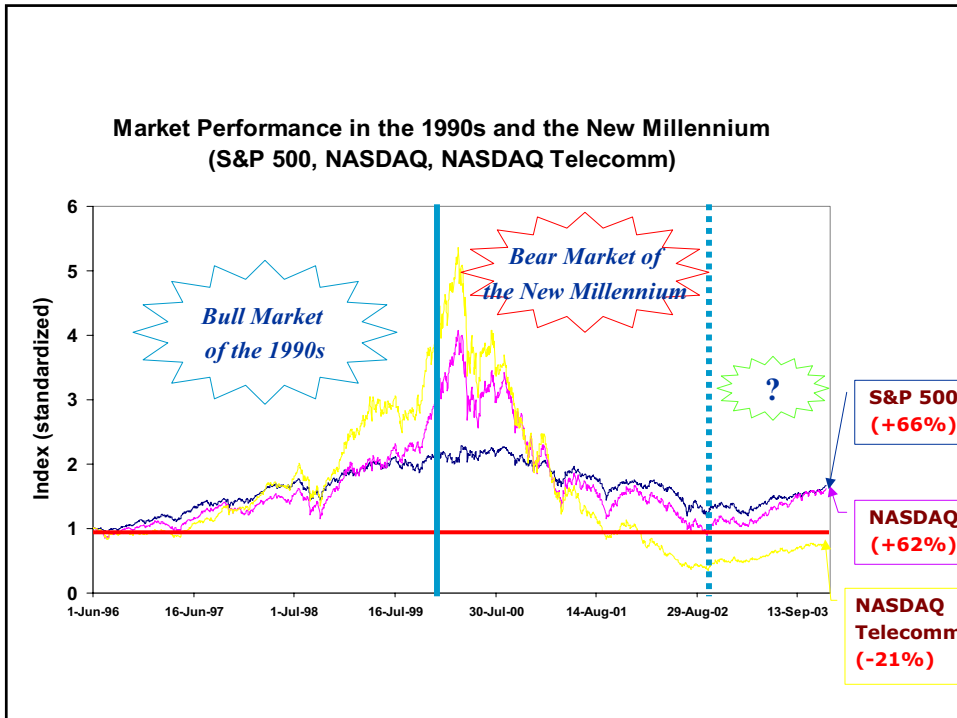
(S&P 500, NASDAQ, NASDAQ Telecomm)



Nortel's Performance (\$U.S)

01:1995 - 12:2003





Investments & Financial Assets

- ◆ Essential Nature of Investment
 - postpone current consumption (save for:)
 - future consumption

- ◆ Real Assets
 - Productive assets (goods and services)

 - Real investment - corporation invests in real assets

- ◆ Financial Assets
 - Claims on income-generating real assets
 - e.g.
 - Stocks -
 - Bonds -

Financial System Clients and Their Needs

- ◆ Household Sector
 - Primary Need:
- ◆ Business Sector
 - Primary Need:
 - Issue new equity (take in new partners) or debt (bank loans or bonds)
- ◆ Government Sector
 - Primary Need:
 - Can only issue (riskless) debt
 - Alternative sources:
- ◆ Foreign Sector
 - Primary Need in Canada: Invest Funds

Role of Financial Assets and Markets

- ◆ Consumption Timing
- ◆ Tax Planning
 - Tax Clienteles – investors in different tax brackets invest in different assets to minimize taxes
- ◆ Allocation of Risk
 - Investors with different attitudes towards risk invest in assets with different risk-return combinations
 - Risk aversion creates demand for financial assets that allow to diversify risk
- ◆ Separation of Ownership and Management

Financial Markets and the Agency Problem

- ◆ **Principal-Agent Relationship**

A situation where one person (agent) is assigned to act on behalf of another person (principal)

- ◆ **The Agency Problem**

Conflicts of interest among principals (shareholders) and agents (managers, directors, auditors, and analysts)

- ◆ **Some Devices for Reducing Agency Costs**

- ◆ Monitoring
- ◆ Aligning preferences of agents with principals

Principal-Agent Relationships in the Financial Market

- ◆ **Shareholders** (principals)

Goal –

- ◆ **Management** (agents)

Duty - maximize shareholders' wealth

Problems -

- ◆ tend to maximize their personal and corporate wealth
- ◆ have best information, but communications to investors may not be credible
- ◆ compensation plans may induce executives to present information in the most favorable light

Principal-Agent Relationships in the Financial Market (Continued)

- ◆ **Board of directors** (agents)

Duty - protect shareholders' interests

Problems -

- ◆ The director's seat on the board depends on good working relation with executives

- ◆ **Auditors** (agents)

Duty - ensure that all relevant information supplied by the management to shareholders is credible

Problems -

- ◆ Auditing firms also provide consulting services

Principal-Agent Relationships in the Financial Market (Continued)

- ◆ **Analysts** (agents)

Duty - study companies and provide investors with advice on stock selection

Problems -

- ◆ The analyst's employer provides investment banking activities to studied companies

- ◆ **Accusations of inadequate disclosure**

- Investment dealers
- Accounting audits
- Managers

The "Right" Approach

- ◆ Diversification
 - Across sectors
 - Across asset classes
 - Across countries
- ◆ Information and patience Across sectors
 - Make informed decisions
 - Diversify
 - Be patient

Diversification Across Sectors

Market Performance in the 1990s and the New Millennium
(S&P 500, NASDAQ, NASDAQ Telecomm)

