Chapter 1
Investments: Background and Issues

9. 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.

10. 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. As securitization progresses, financial
intermediaries must increase other activities such as providing short-term liquidity to
consumers and small business, and financial services.

11. Financial assets make it easy for large firms to raise the capital needed to finance their
investments in real assets. If General Motors, 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 means less investment
and lower real growth.
12. Mutual funds accept funds from small investors and invest, on behalf of these investors, in the national and international securities markets.

Pension funds accept funds and then invest, 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.

13. 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, the fact that shares can be traded in the secondary market makes the shares more attractive to investors since investors know that, when they wish to, 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.

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” investment strategy, 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” investment strategy, you try to benefit from identifying undervalued securities. The disadvantage is that you 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 your level of risk tolerance. In addition, this technique tends to require more active management, thus generating more transaction costs. Finally, your analysis may be incorrect, in which case you will have 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.