PROJECT APPRAISAL AND INVESTMENT ANALYSIS

LECTURE 14

PORTFOLIO THEORY AND INVESTMENT ANALYSIS

FINANCING THE INDUSTRIAL SECTOR; LARGE SCALE AND SMALL SCALE

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INVESTMENT:

"Investment the *current* commitment of money or other resources in the expectation of reaping *future* benefits."

REAL ASSETS VERSUS FINANCIAL ASSETS

- **Real Assets:**

Real assets are physical assets that have an intrinsic worth due to their substance and properties. Real assets include precious metals, commodities, real estate, land, equipment, and natural resources.

- **Financial Assets:**

In contrast to real assets are financial assets such as stocks and bonds. Such securities are no more than sheets of paper.

THE INVESTMENT PROCESS

Portfolio Investment:

- An investor's *portfolio* is simply his collection of investment assets.
- We invest in portfolio to diversify risk without losing much return.
- Investment assets can be categorized into broad asset classes, such as stocks, bonds, real estate, commodities, and so on.

PORTFOLIO DECISION

Two types of decision an investor makes when investing in a portfolio

- **Asset allocation decision**

  How much to invest in each security?

- **Security selection**

  In which securities to invest?

THE RISK–RETURN TRADE-OFF

- Naturally, if all else could be held equal, investors would prefer investments with the highest expected return.
- But If you want higher expected returns, you will have to pay a price in terms of accepting higher investment risk

EFFICIENT AND EFFICIENT MARKETS

A **Financial market** is a market in which people trade financial securities and derivatives at low transaction costs while **Efficient Market** refers to the degree to which market prices reflect all available, relevant information.

PORTFOLIO MANAGEMENT

- **Passive management** is the opposite of active management, in which a manager selects stocks and other securities to include in a portfolio.
- **Active management** is the attempt to improve performance security analysis. Active management is the use of a human element, such as a single manager, co-managers or a team of managers, to actively manage a fund's portfolio.

  e.g. By identifying mispriced securities.

THE PLAYERS IN FINANCIAL MARKETS

- Firms are net demanders of capital.
- Households typically are net suppliers of capital.
- Governments can be borrowers or lenders, depending on the relationship between tax revenue and government expenditures.

FINANCIAL INTERMEDIARIES

- Financial intermediaries have evolved to bring the suppliers of capital (investors) together with the demanders of capital (corporations and the government).
- Include banks, investment companies, insurance companies, and credit unions.
- Financial intermediaries issue their own securities to raise funds to purchase the securities of other corporations.

CHARACTERISTICS OF COMMON STOCK

- **Residual claim**

In liquidation, shareholders have a claim to what is left after all other claimants such as the tax authorities, employees, suppliers, bondholders, and other creditors have been paid.

- **Limited liability**

Limited liability means that the most shareholders can lose in the event of failure of the corporation is their original investment.

CHARACTERISTICS OF PREFERRED STOCK

- Preferred stock has features similar to both equity and debt.
- Like a bond, it promises to pay to its holder a fixed amount of income each year.
- Preferred stock holders are given priority in payment of dividends and in case of liquidation but have no voting rights.

Note: The difference between preferred and common stock is that preferred stock gives no voting rights to shareholders while common stock does.

INVESTMENT ISSUES

- **Systematic Vs Unsystematic Risk:**

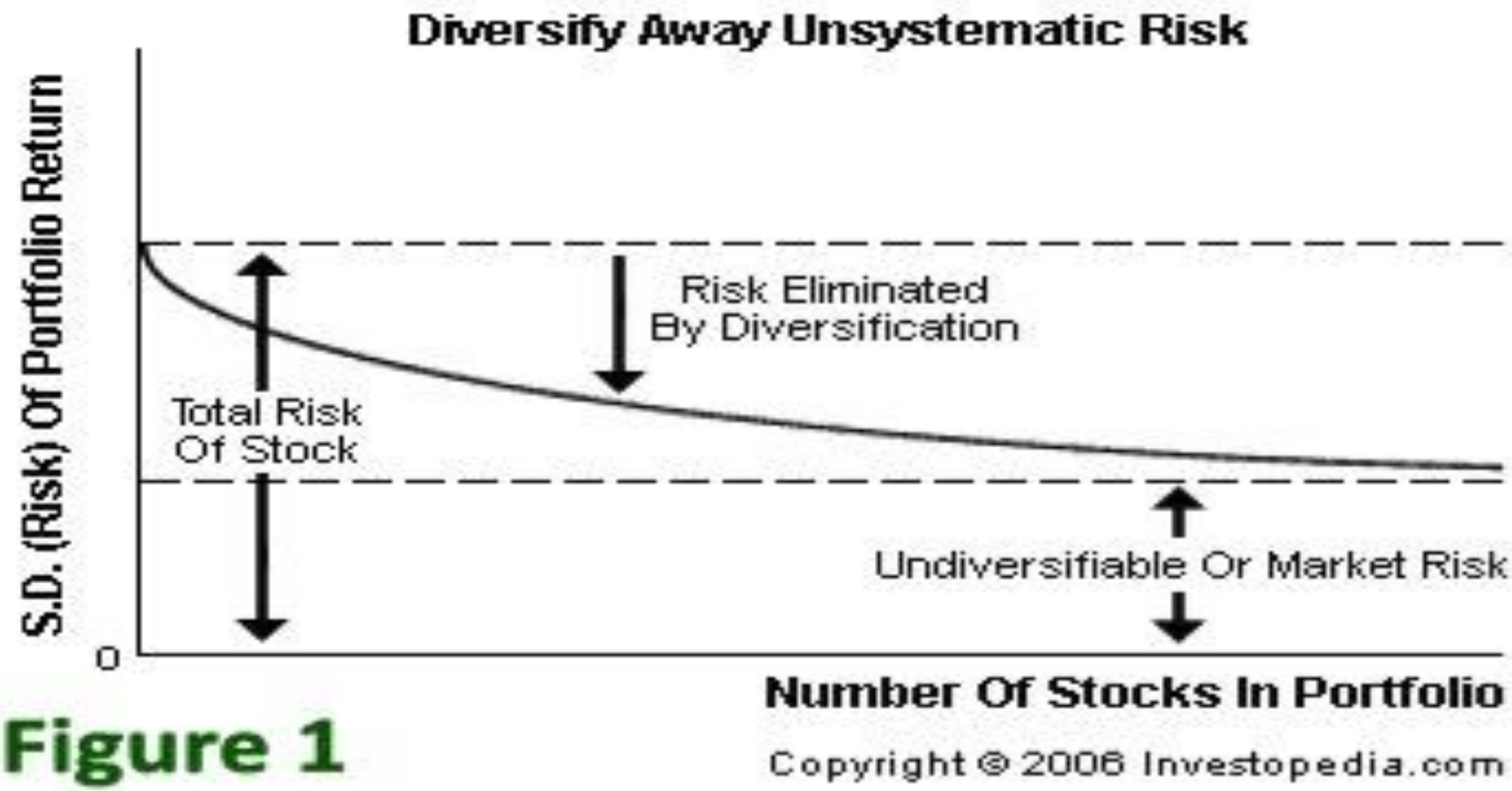

Figure 1

SYSTEMATIC RISK VS. UNSYSTEMATIC RISK

While systematic risk can be thought of as the probability of a loss that is associated with the entire market or a segment therefore, unsystematic risk refers to the probability of a loss within a specific industry or security.

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Financial crisis:

Financial crisis are mainly caused by information asymmetry that results in two main problems

- ✓Adverse selection
- ✓Moral hazard

CONT…

Insider Trading

- Insider trading is the trading of a public company's stock or other securities (such as bonds or stock options) by individuals with access to nonpublic information about the company.
- In various countries, trading based on insider information is illegal.