Investment Alternatives

Chapter 2
Nonmarketable Financial Assets

- Commonly owned by individuals
- Represent direct exchange of claims between issuer and investor
- Usually very liquid or easy to convert to cash without loss of value
- Examples: Savings accounts and bonds, certificates of deposit, money market deposit accounts
Money Market Securities

- Marketable: claims are negotiable or salable in the marketplace
- Short-term, liquid, relatively low risk debt instruments
- Issued by governments and private firms
- Examples: Money market mutual funds, T-Bills, Commercial paper
Capital Market Securities

- Marketable debt with maturity greater than one year and ownership shares
- More risky than money market securities
- Fixed-income securities have a specified payment schedule
  - Dates and amount of interest and principal payments known in advance
Bond Characteristics

- Buyer of a newly issued coupon bond is lending money to the issuer who agrees to repay principal and interest.
- Bonds are fixed-income securities:
  - Buyer knows future cash flows
  - Known interest and principal payments
- If sold before maturity price will depend on interest rates at that time.
Bond Characteristics

- Prices quoted as a % of par value
- Bond buyer must pay the price of the bond plus accrued interest since last semiannual interest payment
  - Prices quoted without accrued interest
- Premium: amount above par value
- Discount: amount below par value
Innovation in Bond Features

- Zero-coupon bond
  - Sold at a discount and redeemed for face value at maturity
  - Locks in a fixed rate of return, eliminating reinvestment rate risk
  - Responds sharply to interest rate changes
  - Not popular with taxable investors
  - May have call feature
Major Bond Types

- Federal government securities (e.g., T-bonds)
- Federal agency securities (e.g., GNMAAs)
- Federally sponsored credit agency securities (e.g., FNMAAs, SLMAAs)
- Municipal securities: General obligation bonds, Revenue bonds
  - Tax implications for investors
Corporate Bonds

- Usually unsecured debt maturing in 20-40 years, paying semi-annual interest, callable, with par value of $1,000
  - Callable bonds gives the issuer the right to repay the debt prior to maturity
  -Convertible bonds may be exchanged for another asset at the owner’s discretion
  - Risk that issuer may default on payments
Bond Ratings

- Rate relative probability of default
- Rating organizations
  - Standard and Poors Corporation (S&P)
  - Moody’s Investors Service Inc
- Rating firms perform the credit analysis for the investor
- Emphasis on the issuer’s relative probability of default
Bond Ratings

- **Investment grade securities**
  - Rated AAA, AA, A, BBB
  - Typically, institutional investors are confined to bonds in these four categories

- **Speculative securities**
  - Rated BB, B, CCC, C
  - Significant uncertainties
  - C rated bonds are not paying interest
Securitization

- Transformation of illiquid, risky individual loans into asset-backed securities
  - GNMAs
  - Marketable securities backed by auto loans, credit-card receivables, small-business loans, leases
- High yields, short maturities, investment-grade ratings
Equity Securities

- Denote an ownership interest in a corporation
- Denote control over management, at least in principle
  - Voting rights important
- Denote limited liability
  - Investor cannot lose more than their investment should the corporation fail
Preferred Stocks

- Preferred stockholders paid after debt but before common stockholders
  - Dividend known, fixed in advance
  - May be cumulative if dividend omitted
- Often convertible into common stock
- Hybrid security because features of both debt and equity
- May carry variable dividend rate
Common Stocks

- Common stockholders are residual claimants on income and assets.
- Par value is face value of a share.
  - Usually economically insignificant.
- Book value is accounting value of a share.
- Market value is current market price of a share.
Common Stocks

- Dividends are cash payments to shareholders
  - Dividend yield is income component of return
    \[ D/P \]
  - Payout Ratio is ratio of dividends to earnings

- [Diagram: Declaration Date, Ex-Dividend Date, Holder-of-Record, Payment Date]
Common Stocks

- Stock dividend is payment to owners in stock.
- Stock split is the issuance of additional shares in proportion to the shares outstanding.
  - The book and par values are changed.
- P/E ratio is the ratio of current market price of equity to the firm’s earnings.
Investing Internationally

- Direct investing
  - US stockbrokers can buy and sell securities on foreign stock exchanges
  - Foreign firms may list their securities on a US exchange or on Nasdaq
  - Purchase ADR’s
    - Issued by depositories having physical possession of foreign securities
    - Investors isolated from currency fluctuations
Derivative Securities

- Securities whose value is derived from another security
- Futures and options contracts are standardized and performance is guaranteed by a third party
  - Risk management tools
- Warrants are options issued by firms
Options

- Exchange-traded options are created by investors, not corporations
- Call (Put): Buyer has the right but not the obligation to purchase (sell) a fixed quantity from (to) the seller at a fixed price before a certain date
  - Right is sold in the market at a price
- Increases return possibilities
Futures

- Futures contract: A standardized agreement between a buyer and seller to make future delivery of a fixed asset at a fixed price
- A “good faith deposit,” called margin, is required of both the buyer and seller to reduce default risk
  - Used to hedge the risk of price changes
Chapter 2

End