Topic 1: Investment Environment and Financial Instruments

Finance is different to economics in that finance addresses not only how resources are allocated (what economics does), but also issues such as the terms and which channels the resources are allocated through.

Note: This subject focuses only on equities and investments, therefore we only focus on shares rather than any types of debt or derivatives including futures, forwards, swaps etc.

Real Assets v Financial Assets

Real Assets are assets used directly to produce goods and services. They are mostly tangible in nature. For example, buildings, machines, land, plant, inventory etc.

Real assets differ in 3 ways:

- Variance in what you wish to own (e.g. land or food);
- The accepted level of risk; and
- Consumption time (when you want to use the real assets).

In contrast, financial assets are claims to income. The value of financial assets is derived from real assets and are mostly intangible. That is, financial assets such as bonds are based on real assets which involve what people's expectations of the economy are. Key examples of financial assets are stocks and bonds.

Financial assets are used to overcome the 3 differences in real assets. This is because things like shares allow you to be an owner of the business without having a management role, which allows specialists to focus on areas they excel at, whilst allowing investors to have a diversified portfolio.

Note: In some instances, goods may be tangible yet be financial assets, and in others be intangible yet a real asset (exceptions to the general rules). For example, money is tangible however it is a financial asset as it is currency and isn't used to directly produce goods and services. In contrast, human knowledge is intangible yet it is a real asset as it is used to directly produce goods and services.

As indicated, having a mix of financial and real assets enables us to manage the 3 key differences shown below:

- Consumption Timing – The use of financial assets enables the postponement of consumption. In considering whether someone wishes to postpone consumption, we must consider that they should be reimbursed for the time value of money.
- Risk Allocation – Financial assets can assist with risk allocation as with shares you can use derivatives such as futures, options etc. to minimise the risk. Furthermore, you can use investment techniques such as diversification to minimise your risk. As such, in effect there is a repackaging of business risk and spreading it across to others.
- Separation of Ownership & Management – The ability to buy financial assets such as shares facilitates diversification, liquidity and professional business management

Clients of the Financial System

There are 3 key clients in the financial system. A table on these clients of the financial system is shown below:

- Household Sector
- Business Sector
- Government Sector

- Surplus Spending Unit
  - Income > consumption + investment on real assets
- Deficit Spending Unit
  - Income < consumption + investment on real assets

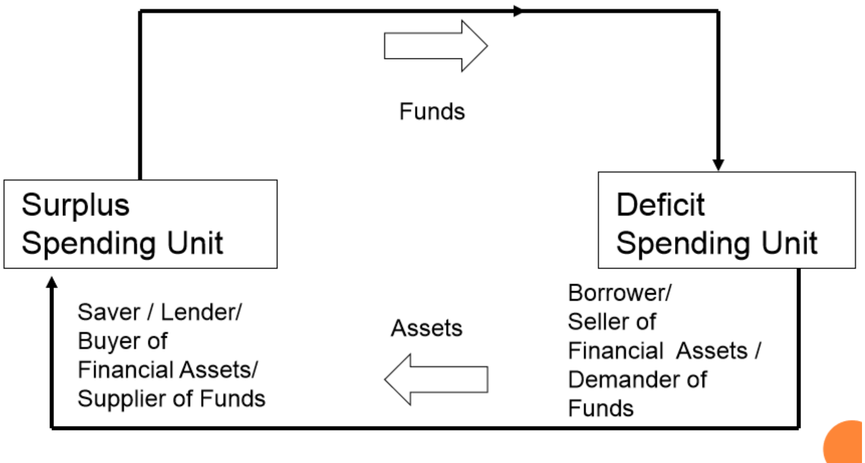
As this demonstrates, the 3 main clients in the financial system are:

- The household sector;
- The business sector; and
- The government sector.

Within these clients, all parties are either surplus spending units who have income greater than consumption and investment in real assets (positive bank balance), or deficit spending units who have income less than consumption and investment in real assets (negative bank balance).

Flow of Funds between Surplus and Deficit Units

The flow of funds between these surplus and deficit units is shown below:

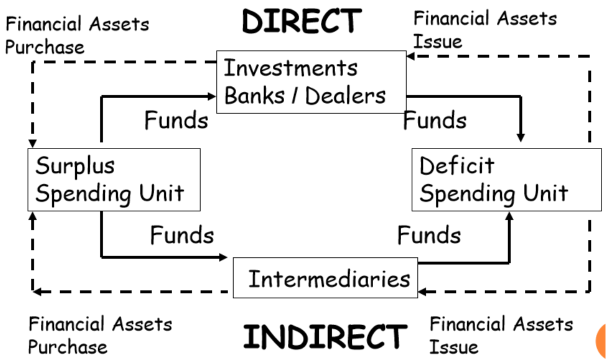


Financial Assets = Financial Claims

As the table above demonstrates, funds flow from surplus units to deficit units in return for assets. That is, the saver will lend money to deficit units and in return they will be provided with assets that recognise the ownership of the surplus spending unit (whether that be physical assets or financial assets which are claims to income e.g. record them as debtors, shares etc.).

Direct v Intermediated Investing

Funds may be invested either directly or indirectly. The table below discusses the differences between direct and indirect investing:



As this shows, direct investments are where funds go from surplus units through investment banks/dealers before flowing to deficit units. In contrast, indirect investing is where funds go from surplus units through intermediaries before flowing to deficit units.

Note that today almost all investing is done indirectly through intermediaries such as managed funds, commercial banks, credit unions etc.

Financial Institutions

Financial institutions may be split into the following categories:

- Financial Intermediaries (commercial banks, investment banks, credit unions) – Financial intermediaries channelize the surplus funds of the household sector to the deficit funds of the business sector. They enjoy economies of scale & specialization (reducing costs), minimise search and negotiation cost, improve liquidity of investments (liquidity means it is easy to transfer to cash with no or little reduction in value), diversify risk and earns spread, and they also charge service fees.
- Investment Banks – Investment banks help businesses to raise capital by selling financial securities to the public. Effectively investment banks sit between companies seeking to raise capital where they may help them in complying with the prospectus and raising funds or even carrying out or defending themselves from a takeover, and individuals who are looking to invest in profitable companies on the stock exchange. They manage the public issues of stocks and bonds, and provide a cost-effective service, certification and charge service fees.

Financial Markets

There are several financial markets including (main 3 are the first 3):

- Money Market – Involves trade in short-term loans between banks and other financial institutions. It is a short term, highly liquid debt market. This is primarily for the Government & Business Sector. For example, treasury notes.
- Bond Market – A longer term debt market, typically issuing bonds but they may also come in the form of bills or notes. For example, Treasury Bonds.
- Equity / Stock Market – A market for business ownership shares, where parties can buy and sell shares. This is a long-term market.
- Derivative Market – A market for futures, options and other derivatives (also long-term).