FINC2011 Notes

Week 1

What is finance?

- The interaction of **providers of funds** and **users of funds**.
- Finance is a study of how to bring the lenders and borrowers together through financial markets.
- Financial markets:
    1. Stocks
    2. Foreign exchange
    3. Debt capital and money
- Corporations face two principal financial decisions:
    1. What investments should the corporation make? → **investing decision** (capital budgeting or capital expenditure (CAPEX))
    2. How should it pay for the investment? → **financing decision**

The role of the financial manager

- Interact firm's operations with financial markets.
- Decisions:
    1. Investment decision (capital budgeting) → what long-term investments should the firm take on?
        - The decision to purchase and sell assets
        - **Real assets**: assets that can be put to productive use to generate a return (e.g. machinery and equipment).
    2. Financing decision (capital structure) → where will we get the long-term financing to pay for the investment? → sale of financial assets
        - **Financial assets:** Assets that represent a claim to a series of cash flows against an economic unit (e.g. corporate bond).
    3. Dividend decision → how are returns distributed to equity holders?
        - Investment decisions involve a trade-off. Decision by companies to pay out net profit after tax or retained earnings to shareholders (as dividends) or alternatively, reinvest these profits (retained earnings).
        - If the firm invests cash rather than paying it out, shareholders don't get the opportunity to investment it themselves in financial markets. The return they give up is called the opportunity cost of capital. If the firm's investments can earn a return higher than the opportunity cost of capital, stock price increases. Vice-versa.

The goal of financial management

- **Maximise the market value of the existing owners' equity**
- Shareholders do not want the maximum possible stock price, but rather the maximum honest share price.
- Can increase the value of the firm by making good investment decisions. Financing decisions can add value, and can destroy value if they are wrong
- Owner wealth is measured by **market capitalisation** of securities.
    1. For shares this is the total market value of all the shares of a company on issue.

2. MCAP = Price x Shares outstanding

Agency problems

- Agency relationship: Principal hires an agent to represent their interest
    1. Shareholders (principals) hire managers (agents) to run the company.
- Agency problem
    1. Conflict of interest between principal and agent
- Why does this conflict exist?
    1. Because there is a separation of ownership and control
- Separation of ownership and control
    1. Shareholders (owners) → the 'Principle'; elect the board of directors
    2. Board of directors → hires and fires management; monitors managers and sets high level strategy to maximise firm value.
    3. Managers → the 'Agent'; responsible for day-to-day management; implements strategy set by the board of directors in order to maximise firm value
- What does each stockholder want?
    1. To be as rich as possible → maximise their current wealth (which is the goal of financial management)
    2. To transform that wealth into the most desirable time pattern of consumption either by borrowing to spend now or investing to spend later.
    3. To manage the risk characteristics of that consumption plan.
- What do the managers want?
    1. Agency costs arise when managers put their own self-interest ahead of the interests of shareholders.
- Agency costs:
    1. How can we align shareholder and management interests?
        - Legal and regulatory requirements
        - Managerial compensation (stock options & performance-based options)
        - Shareholders elect the board of directors, who are responsible for monitoring management
        - Proxy fight to replace existing management
        - Threat of takeover

Introduction to valuation

- Asset valuation
    1. The value of an asset today is not the same as its value in the future, because of the **time value of money**
    2. **The time value of money** is derived from the fact that interest can be earned on an alternative investment opportunity.
        - This interest rate is referred to as the **opportunity cost of buying the asset** or the **opportunity cost of capital**.
- **Arbitrage:** purchase of one security and simultaneous sale of another to give a risk-free profit.
- **Time value of money**: Money has a time value due to the existence of positive rates of interest.

Week 2

➢ Functions of a modern financial system

- A **financial system** comprises a range of financial institutions, financial instruments and financial markets which interact to facilitate the flow of funds.
  - Overseen by a central bank (RBA)
  - Supervised by a prudential regulator (Australian Prudential Authority)
- Key functions:
  - Encourage savings and allocate these savings to the most efficient users of funds
    - Surplus entities can invest their savings through the purchase of financial assets. Assets (real and financial) can be thought of as a package of four main attributes:
      - **Return or yield:** The total financial benefit received (interest and capital) from an investment; expressed as a percentage.
      - **Risk:** The possibility or probability that an actual outcome will vary from the expected outcome; uncertainty.
      - **Liquidity:** Access to cash and other sources of funds to meet day-to-day expenses and commitments.
      - **Time-pattern of cash flows:** The frequency of periodic cash flows (interest and principal) associated with a financial instrument.
    - Financial instruments should possess different combinations of the four attributes to encourage savings.
    - Savings are available for investment capital, which can used to improve the productive capacity of the economy. This results in economic growth.
    - Financial markets should ensure that savings are directed to the most efficient users of funds.
    - Financial institutions like commercial banks, finance companies, insurance companies, superannuation funds and managed funds help bring together those who have money (savers) and those who need money (borrowers).
  - Provide economic and financial information to the markets
    - Information affects price and investment decisions
    - Types of information: Macroeconomic announcements; stock information; company information (e.g. annual reports); etc.
  - Important component of monetary policy
    - **Monetary policy:** Actions of a central bank that influence the level of interest rates in order to achieve economic outcomes → primary target is inflation.

➢ Financial institutions

- **Depository financial institutions** (Commercial banks)
  - Accept deposits and provide loans to customers. E.g. CBA, Westpac
  - Balance-sheet activities: