Chapter 1
The Investment Environment

• Outline

Learning Goals

I. Investments and the Investment Process

A. Attributes of Investments
  1. Securities or Property
  2. Direct or Indirect
  3. Debt, Equity, or Derivative Securities
  4. Low- or High-Risk Investments
  5. Short- or Long-Term Investments
  6. Domestic or Foreign

B. The Structure of the Investment Process
  1. Suppliers and Demanders of Funds
     a. Government
     b. Business
     c. Individuals
  2. Types of Investors

Concepts in Review

II. Types of Investments

A. Short-Term Investments

B. Common Stock

C. Fixed-Income Securities
  1. Bonds
  2. Convertible Securities
  3. Preferred Stock

D. Mutual Funds

E. Exchange-Traded Funds

F. Hedge Funds

G. Derivative Securities
   1. Options
   2. Futures

H. Other Popular Investments

Concepts in Review

III. Making Investment Plans

A. Steps in Investing
   1. Step 1: Meet Investment Prerequisites
   2. Step 2: Establish Investment Goals
   3. Step 3: Adopt an Investment Plan
   4. Step 4: Evaluate Investments
   5. Step 5: Select Suitable Investments
   6. Step 6: Construct a Diversified Portfolio
   7. Step 7: Manage the Portfolio

B. Considering Personal Taxes
   1. Basic Sources of Taxation
   2. Types of Income
      a. Ordinary Income
      b. Capital Gains and Losses
   3. Investments and Taxes
   4. Tax-Advantaged Retirement Savings Plans

C. Investing over the Life Cycle

D. Investments and the Business Cycle

Concepts in Review

IV. Meeting Liquidity Needs with Short-Term Investments

A. Role of Short-Term Investments
   1. Interest on Short-Term Investments
   2. Risk Characteristics
   3. Advantages and Disadvantages of Short-Term Investments

B. Common Short-Term Investments

C. Investment Suitability

Concepts in Review

V. Careers in Finance

A. Commercial Banking

B. Corporate Finance

C. Financial Planning

D. Insurance

E. Investment Banking

F. Investment Management

Concepts in Review

Summary

Key Terms

Discussion Questions

Problems

Case Problems

1.1 Investments or Golf?

1.2 Preparing Carolyn Bowen's Investment Plan

Excel with Spreadsheets

Key Concepts

1. The meaning of the term *investment* and the implications it has for individual investors
2. Review the factors used to differentiate between different types of investments
3. The importance of and basic steps involved in the investment process
4. Popular types of investment vehicles, including short-term vehicles, common stock, mutual funds and exchange-traded funds, fixed-income securities such as bonds, preferred stock, and convertibles
5. Derivative securities such as options and futures
6. Other popular investments such as real estate, tangibles, and tax-advantaged investments
7. Investment goals including income, major expenditures, retirement, and sheltering income from taxes; the latter includes analysis of tax-advantaged retirement vehicles
8. Building a diversified portfolio consistent with investment goals
9. Sources of taxation, types of taxable income, and the effect of taxes on the investor
10. Developing an investment program that considers differing economic environments and the life cycle
11. The use of short-term securities in meeting liquidity needs

12. The merits and suitability of various popular short-term investments, including deposit accounts and money market securities

Overview

This chapter provides an overview of the scope and content of the text.

1. The term *investment* is defined, and the alternative investment opportunities available to investors are classified by types.

2. The structure of the investment process is examined. This section explains how the marketplace brings together suppliers and demanders of investment funds.

3. The key participants in the investment process—government, business, and individuals—are described, as are institutional and individual investors.

4. *Returns* are defined as rewards for investing. Returns to an investor take two forms—current income and increased value of the investment over time. In this section, the instructor need only define return, since there will be another opportunity to develop the concept of return in Chapter 4; also, providing information about recent investment returns always engages students' attention.

5. Next, the following investment vehicles available to individual investors are discussed: short-term vehicles, common stock, fixed-income securities, mutual funds, exchange-traded funds, hedge funds, real estate, tangibles, tax-advantaged investments, and options and futures. The text describes their risk-return characteristics in a general way. The instructor may want to expand on the advantages and disadvantages of investing in each, although they will be treated in greater detail in subsequent chapters. It is vital for any investor to establish investment goals that are consistent with his or her overall financial objectives.

6. Once the investment goals have been well specified, the investor can adopt an investment plan consistent with these goals, select suitable investments, and build a diversified portfolio and manage it.

7. Personal taxes are discussed in terms of types of income and tax rates. The investment process is affected by current tax laws. Examples of tax shelters, especially tax-advantaged retirement vehicles, and tax planning are provided.

8. Once investment goals are established, it is important to understand how the investment process is affected by different economic environments. The chapter talks about types of investments such as stocks, bonds, and tangibles as they are affected by business cycles, interest rates, and inflation.

9. Liquidity is defined, and short-term securities that can be used to meet liquidity requirements are described. The discussion includes a look at short-term interest rates and the risk characteristics of various short-term securities.

10. The next section covers the various types of short-term vehicles available to today's investor. The text provides enough detail about everything from passbook accounts to money market funds to commercial paper that students should get a good grasp of the differences between the vehicles. Information on current rates brings realism into the classroom and enhances student perception of the lecturer as a knowledgeable instructor.