



Chapter 1

The Role and Scope of Investments



Key Topics

Key topics include:

- investments and the investment process;
- investment vehicles; and
- a summary.



What is an Investment?

- An investment is
 - a commitment of funds
 - for a period of time
 - with the expectation of preserving value and/or earning a positive rate of return.
- Return
 - Income
 - Appreciation



The Investment Process

- The investment process
 - transfers funds from net suppliers (individuals) of funds
 - To net demanders (governments and businesses) of funds

- Vital for economic growth.



Investment Vehicles

- **Short-term**

- those that mature in less than a year.
- T-Bills, CD's and Commercial Paper.
- Used for warehousing & liquidity

- **Stock**

- potential for capital gains and dividends
- Equity Investment

- **Fixed income securities**

- bonds, preferred stock, convertible securities
- offer fixed periodic returns and some capital gains potential.



Investment Vehicles

- **Mutual fund**
 - investment companies
- **Derivative securities**
 - options (puts/calls) and futures that derive their value from the underlying securities or assets.
- **Real estate**
- **Tangible investments.**



Risk

- The chance that Actual Return $< E(r)$
- Speculation
 - purchase of high-risk investment vehicles offering highly uncertain earnings and future value.



Investment Process Steps

1. Meeting Investment Prerequisites.
2. Establishing Investment Goals.
3. Adopting an Investment Plan.
4. Evaluating Investment Vehicles
5. Selecting Suitable Investments
6. Constructing a Diversified Portfolio
7. Managing the Portfolio



1. Investment Prerequisites

- Set overall Financial goals
- Basic Needs are met
 - Necessities
 - Emergency funds
 - Risk Management (death, disability, illness, negligence, property damage)



2. Establish Investment Goals

- Common Investment Goals
 - Retirement Funding
 - Enhance current income
 - Save for major expenditures
 - Shelter income from taxes



3. Adopt Investment Plan

- Written document covering
 - How funds will be invested
 - target date for achieving goal
 - Appropriate amount of risk



4. Evaluate Investments

- Risk – Return Tradeoff
- Asset valuation



5. Select Investments

- Selection should be based on
 - Investor goals
 - Risk/Return considerations
 - Tax considerations



6. Construct Diversified Portfolio

- Use principles of diversification for risk management in the investment process



7. Manage the Portfolio

- Measure actual performance compared to expected performance
- Adjust portfolio weights (buy/sell) to maintain optimal allocation



Taxes

- Individuals should consider income tax consequences of investment decisions.
- Property taxes can impact returns on real estate and property investments.



Types of Income

- **Active**
 - Wages, salaries, bonuses, alimony
- **Portfolio Income**
 - Interest, dividends, and capital gains
- **Passive income**
 - real estate, limited partnerships, other tax-advantaged investments



Tax Planning

- **Shift**
- **Avoid**
- **Defer**

- Before tax return is irrelevant....only what you keep matters.



Life Cycle Investing

- Goals shift as age changes
 - Youth (age 20 to 45)
 - Growth-Oriented
 - Middle-age (age 45 to 60)
 - Consolidation
 - Retirement Years (age 60 to ?)
 - Income-oriented



Different Economic Environments

- Market cycle
 - recovering (expansionary) stage
 - Declining (recessionary) stage
 - Change in Direction
 - Occurs at the top (peak) and the bottom (trough).



Liquidity

- Ability to convert an investment into cash quickly with little or no loss in value
 - Short-term investment vehicles
 - Selection depends on
 - availability
 - safety
 - liquidity
 - yield on average return.



Risk Pyramid

- Volume III, Investments, page 80, Exhibit 15: The Risk Pyramid