CHAPTER 1

AN INTRODUCTION TO INVESTMENTS

TEACHING GUIDES FOR QUESTIONS IN THE TEXT

Since the primary purpose of the first chapter is to set several themes that will reappear throughout the text, there are no questions, problems, or cases at the end of the chapter.

THE INVESTMENT ASSIGNMENT (PART 1)

I do little trading, so investment games are inconsistent with my investment philosophy and strategy. Although I do not discourage students from participating in a game, I also do nothing to encourage their use. I, however, have included two investment assignments at the end of the first chapter. The subject of the first reappears throughout the text, but the second one could also be used throughout the semester. Both request the student to track stock prices (i.e., set up a watch account). During the semester, additional material is added such as beta coefficients in Chapter 5.

Since there is no trading in the individual securities, the assignment is essentially a passive instructional tool. An instructor, however, may use the assignments as the basis for a more active assignment if he or she prefers. (I have thought about dividing the class into two groups and have the members of one group trade every week or two and compare their results to the students who had to hold their initial selections for the entire semester.)

SUPPLEMENTAL QUESTIONS

The following are questions that were used in prior editions. These questions may be used to establish themes that reappear throughout the semester.

1. What is the distinction between liquidity and marketability?

Answer: While the two terms may be used interchangeably, they often imply different characteristics. "Liquidity" in the academic literature on finance generally refers to the ease of converting an asset into cash with little risk of loss of principal. "Liquidity" in the professional investment community is generally used to mean the ease with which an asset may be sold at the current market price. With this definition, liquidity refers to the depth of the market. Which definition is being used can generally be determined by context.

Marketability (in finance) refers to the ability to sell an asset in the secondary markets. Be certain to point out that the terms liquidity and marketability are not synonymous and that some assets may be liquid but not marketable (e.g., savings accounts) while others are marketable but not necessarily liquid (e.g., rental property).

2. What is risk?

Answer: Risk refers to the possibility of loss. It is the uncertainty that the expected future will not occur. While the word "risk" has a negative connotation, uncertainty works both ways as events can turn out better than expected. Illustrate "uncertainty" by suggesting an investor expects a return of 10 percent on an investment in a particular stock. If the company fails, then the return will be less than 10 percent. However, if the firm does well and its earnings and dividends rise rapidly, the stock's price may correspondingly rise more rapidly. In this case the realized return may exceed the expected 10 percent return.

3. What is the relationship between risk and expected return?

Answer: To earn more, the investor must bear more risk. Higher expected returns must be associated with more risk. Point out that lower returns are not necessarily inferior or that higher returns are not necessarily superior when you consider the risk necessary to earn the return. The instructor may ask a student to identify a relatively safe asset and compare it to a perceptibly riskier asset. Certainly an investor would only acquire the riskier asset if the anticipated return is sufficient to justify taking the additional risk.

4. A significant part of this text is devoted to valuation. What causes an asset to have value today?

Answer: This question offers the opportunity to discuss the importance of future cash flows (and not historical cash flows) properly discounted for determining present values. Ask the students why they would buy a stock. The answers should revolve around dividends and price appreciation. Use these answers to stress future dividends and future price appreciation (capital gains), all properly discounted at the appropriate risk‑adjusted rate. While Chapter 1 is too early in the text to develop these ideas, their introduction in the first class defines one of the most important themes to reappear through the text.

5. What is the implication of an efficient securities market for the return an investor will earn over a period of time?

Answer: If investments are made in efficient financial markets, the investor should not expect to make consistently superior investments that earn excess returns. Students need to realize that large returns in the securities markets should not occur consistently. (You can use Madoff’s consistent returns as an illustration of a “red flag.”) If a student has earned a large return on a specific investment, use it as an illustration, but then balance the large return with a big loss. You may also point out that if large and consistent returns could be achieved, brokers would not have to buy and sell for customers, textbook authors would not have to write, and teachers of investments could retire.

If a student asks why he or she should take the course if financial markets are efficient and the course will not generate higher returns, the instructor is given an excellent opportunity to discuss why markets are efficient and the advantages offered by such efficiency. Point out the rapid dissemination of information, the investor's need to be informed, and that without information financial markets would not be efficient. Investors need to be informed so that they will not be victimized.

While students may be disappointed when they realize that they will not learn secrets that will permit them to earn large returns, the course will teach them the available options, and the risks/rewards associated with individual assets, and the management of portfolios. All this information will help individuals construct better portfolios given their financial objectives. Then these investors should earn a return over time that is consistent with the amount of risk they bear.