Chapter 1
The Concept of Investing

OUTLINE

Introduction
Investing Defined
Investment Alternatives
- Assets
- Securities
- Security Groupings

Three Reasons for Investing
- Income
- Appreciation
- Excitement

The Academic Study of Investments
- Theoretical Research
- Empirical Research
- Professors vs. Practitioners

SUMMARY

Even in this short introductory chapter some of the terminology was probably unfamiliar: stock splits, preferred stock, stop order, buying power, and so on. A substantial vocabulary is specific to the investment field, and these terms need to become second nature to anyone involved in investing and investment management. Each chapter begins with a list of the Key Terms covered within that chapter. A good study technique is to focus on them.

The theoretical discussions presented in this book deal generally with fundamental relationships we know absolutely. This background—coupled with coverage of market mechanics, folklore, and institutional detail—should help to develop an ability to speak intelligently about the investment business and to influence future financial decisions.

ANSWERS TO END OF CHAPTER QUESTIONS AND PROBLEMS

1. Saving is a short or long term activity associated with little chance of loss of principal. *Investing* is a long-term activity in a risky venture. The risk can be modest or substantial depending on the characteristics of the investment.

2. The SIPC provides investors who have accounts at a brokerage firm with protection against failure of the brokerage firm, loss by theft or fire, or fraud of a firm employee. It does not provide protection against a loss in market value from making poor investments

3. A financial asset on one person's personal balance sheet also appears on someone else's balance sheet as a liability. Stocks and bonds are financial assets that appear on the right hand side of the corporate balance sheet. A real asset (such as land or gold) does not have a corresponding liability.

Visit TestBankDeal.com to get complete for all chapters

Practical Investment Management 4th Edition Strong Solutions Manual

4. The three categories are equity securities, fixed income securities, and derivative assets. (Note: Futures contracts, a type of derivative, are technically not securities, and are not under the jurisdiction of the Securities and Exchange Commission. There is little practical importance to this distinction.)

5. Three motivations for investing are to generate income, to realize capital appreciation, and for the fun-of-the-chase, or excitement.

6. Suppose a foreign currency dealer sells 100 units of currency A for 1 unit of currency B, sells 50 units of currency C for 1 unit of currency B, and sells 1.8 units of currency A for 1 unit of currency C. Assume the spread is zero: buying and selling prices are the same. In equilibrium, two units of currency A should equal one unit of currency C. Because the dealer sells 1.8 A (instead of 2.0) for each 1.0 C, currency A is overpriced relative to currency C. This presents an arbitrage opportunity. You want to exchange currency A for C. Suppose you begin with 100 B and you exchange them for 10,000 A. Next you exchange the 10,000 A for 5,555.55 C. Now convert the 5,555.55 C into 111.11 B. This is an 11.11% gain with no risk.

7. Theoretical research begins with assumptions about investor behavior, generally assuming they behave rationally. Mathematical logic then leads to relationships among security prices that should hold in a rational world. Empirical researchers look at actual market prices and seek to find statistically significant relationships in the data. Theoretical models are often tested empirically using market data.

8. An anomaly is an empirical result that is inexplicable by financial theory.

9. Because there is no risk of loss with a U.S. Treasury Bill, many people would consider such an activity saving rather than investing.

Visit TestBankDeal.com to get complete for all chapters