COURSE: INVESTMENTS |CHAPTER 1

INTRODUCTION TO INVESTMENTS

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Chapter Purpose

This chapter introduces the foundations of investment analysis. It explains:

What investment means	Why we invest	Real and financial assets
Role of financial markets	Risk and return	Asset allocation
Security selection	Active and passive management	The decision process

Learning Objectives

By the end of this chapter, students should be able to:

1. Define investment.
2. Distinguish saving from investing.
3. Explain real and financial assets.
4. Identify major financial asset classes.
5. Explain the economic role of financial markets.
6. Describe the investment process.
7. Explain risk and return.
8. Distinguish asset allocation from security selection.
9. Explain diversification.
10. Compare active and passive strategies.
11. Identify major market participants.
12. Explain the role of investment policy.

What Is an Investment?

An investment is the commitment of resources today with the expectation of receiving future benefits.

Resources Today
Capital committed

→

Investment
Asset acquired

→

Future Cash Flows
Income and value

KEY IDEA Investors sacrifice some current consumption in exchange for expected future benefits.

Why Do People Invest?

Investors commit capital for a range of personal and institutional goals:

Preserve wealth	**Generate income**	**Accumulate capital**
Finance retirement	**Build emergency reserves**	**Fund education**
Purchase property	**Protect against inflation**	**Achieve financial independence**

Saving vs. Investing

Saving

- Safety of principal
- High liquidity
- Short-term needs

Setting aside income for future use.

Investing

- Greater uncertainty
- Longer time horizons
- Higher return potential

Committing money to assets expected to produce future returns.

Saving and Investment Are Connected

Income
Earned by households and firms

↓

Consumption and Saving
Income not consumed becomes saving

↓

Investment
Saving funds productive assets

LINK Savings provide the resources that can be invested in productive assets and financial markets.

Investment as an Intertemporal Choice

Investors choose how to distribute spending power across time.

Consumption Today

Immediate certain benefit from spending current income.

Consumption Tomorrow

Larger expected benefit if funds are invested successfully.

TRADE-OFF Investing means sacrificing some current consumption to potentially increase future consumption opportunities.

The Basic Investment Decision

Every investor must answer six core questions:

How much?
Amount to invest

Which assets?
Asset selection

What return?
Expected outcome

What risk?
Risk accepted

How long?
Time horizon

How liquid?
Access to cash

Two Broad Types of Assets

Assets can broadly be divided into two categories that play different roles in wealth creation and capital allocation.

REAL ASSETS

Productive resources used to create goods and services

FINANCIAL ASSETS

Claims on the income generated by real assets

What Are Real Assets?

Real assets are productive resources used to produce goods and services.

- **Land**
- **Buildings**
- **Machinery**
- **Factories**
- **Technology**
- **Natural resources**
- **Human capital**
- **Infrastructure**

What Are Financial Assets?

Financial assets are claims on the income or resources generated by economic entities.

Shares	**Bonds**	**Treasury securities**
Bank deposits	**Mutual-fund units**	**Derivative contracts**

Real Assets vs. Financial Assets

Real Assets	Financial Assets
Productive resources	Financial claims
Generate goods and services	Allocate claims to income
Land	Shares
Buildings	Bonds
Machinery	Treasury securities
Technology	Investment-fund units

Relationship Between Real and Financial Assets

Financial assets finance the creation of real assets; real assets generate the cash flows that reward investors.

Investors Purchase securities → **Company** Raises funds → **Factory** Real asset created → **Production** Generates cash flows → **Investors** Receive returns

Capital flows out to real investment and returns flow back to investors — a continuous cycle.

Why Financial Assets Matter

Financial assets link savers, firms, governments and markets. They support:

Capital formation	**Transfer of savings**	**Risk sharing**	**Ownership**
Financing	**Consumption timing**	**Economic growth**	**Market liquidity**

Financial Markets Connect Savers and Users of Funds

SAVERS
Households and institutions

↓

FINANCIAL MARKETS
Intermediation, pricing, liquidity

↓

USERS OF FUNDS
Businesses and governments

↓

INVESTMENT AND ECONOMIC ACTIVITY
Output, jobs and growth

Capital Allocation

Financial markets help direct funds toward their most valuable uses:

Productive businesses	**Infrastructure**	**Government activities**
Innovation	**Expansion**	**Entrepreneurship**

KEY PRINCIPLE Capital should flow toward its most productive uses.

Consumption Timing

Financial markets allow individuals to shift purchasing power across time.

Saver

- Current income exceeds current consumption
- Invests the surplus funds
- Moves purchasing power to the future

Borrower

- Current expenditure exceeds available funds
- Borrows against future income
- Moves purchasing power to the present

Allocation of Risk

Investors differ in their willingness and capacity to bear risk:

Risk tolerance	**Wealth**	**Investment horizon**	**Income needs**	**Expectations**

Conservative investors → Aggressive investors

RESULT Financial markets allow risk to be distributed among investors with different preferences.

Separation of Ownership and Management

Modern corporations separate the providers of capital from those who run the business.

Ownership
Shareholders provide capital

→

Board of Directors
Oversight and accountability

→

Management
Operates the business

IMPLICATION This creates economic efficiency, but also potential agency problems.

The Agency Problem

Managers may not always make decisions perfectly aligned with shareholder interests.

Excessive executive benefits

Empire building

Weak accountability

Poor investment decisions

Information asymmetry

Short-term focus

Corporate Governance

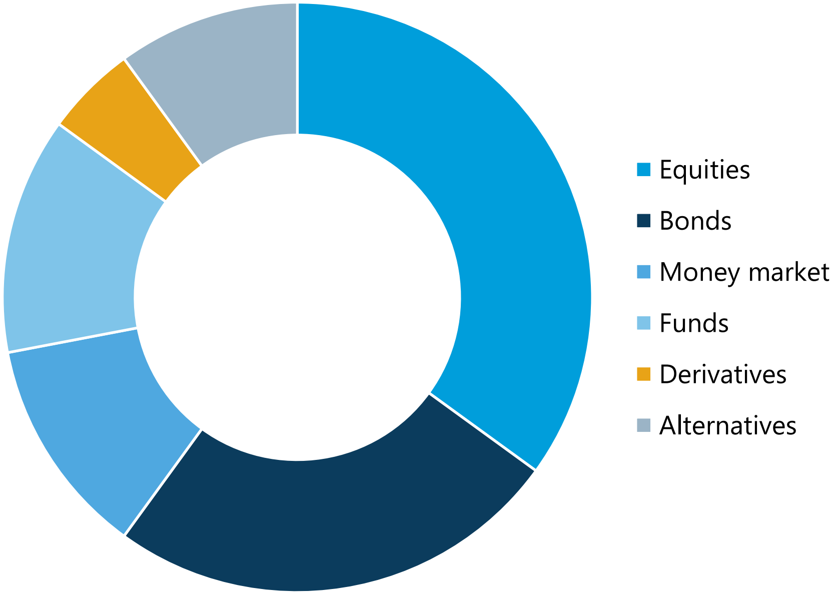
Corporate governance mechanisms help align management with owners.

Board oversight	**External audit**	**Shareholder voting**
Compensation incentives	**Regulation**	**Disclosure**

Major Financial Asset Classes

Investors may allocate capital among several broad classes of financial assets.

- Money-market instruments
- Bonds
- Equities
- Investment funds
- Derivatives
- Alternative investments



Money-Market Instruments

Typical characteristics

- Short maturity
- Highly liquid
- Lower risk than many long-term securities
- Modest expected return

Examples

- Treasury bills
- Commercial paper
- Certificates of deposit
- Repurchase agreements

Bonds

A bond represents a debt claim on the issuer.

Investor
Lends money

→

Issuer
Receives capital

→

Interest + Principal
Repaid to the investor

Typical issuers

- Governments
- Corporations
- Public institutions

Equity Securities

Common stock represents an ownership claim on a company.

Dividends

Cash distributions paid out of company earnings.

Capital Appreciation

Gains from an increase in the market price of the share.

RISK NOTE Equity returns are uncertain and generally involve greater risk than high-quality debt.

Derivatives

Derivatives derive their value from another underlying asset or variable.

Examples

- Options
- Futures
- Forwards
- Swaps

Uses

- Hedging
- Speculation
- Risk management
- Arbitrage

Alternative Investments

Examples

- Real estate
- Commodities
- Private equity
- Hedge funds
- Infrastructure

Common considerations

- Lower liquidity
- Complexity
- Higher minimum investment
- Specialised risks

They may provide diversification benefits, but require careful due diligence.

What Is the Investment Environment?

The investment environment is the ecosystem in which securities are issued, priced and traded.

Investors	**Issuers**	**Financial institutions**	**Securities**
Markets	**Regulation**	**Information**	**Economic conditions**

Major Market Participants

Households
Supply savings

Businesses
Raise and invest capital

Governments
Borrow, invest and regulate

Financial Institutions
Facilitate transactions

Institutional Investors

Institutional investors manage very large pools of capital on behalf of others.

Pension funds

Insurance companies

Mutual funds

Investment companies

Banks

Hedge funds

Sovereign wealth funds

Endowments

Financial Intermediaries

Financial intermediaries stand between savers and the ultimate users of funds.

Savers
Surplus units

→

Intermediaries
Pooling and transformation

→

Users of Funds
Deficit units

Examples

- Banks
- Insurance companies
- Mutual funds
- Pension funds
- Investment companies

Investment Banks

Investment banks assist businesses and governments in raising and deploying capital.

Security issuance

Underwriting

Capital raising

Mergers and acquisitions

Financial advisory

Market transactions

Primary Market

The primary market is where new securities are issued for the first time.

Investors
Provide funds

→

New Security Issue
Primary market

→

Issuer
Receives capital

Examples

- Initial public offering (IPO)
- New bond issue
- New share offering

Secondary Market

The secondary market is where existing securities trade among investors.

Investor A
Sells

→

Market
Price discovery and matching

→

Investor B
Buys

NOTE The issuing organisation usually receives no new capital from a secondary-market trade.

Why Secondary Markets Matter

- **Liquidity**
- **Price discovery**
- **Market information**
- **Portfolio adjustment**
- **Exit opportunities**

CONSEQUENCE Without liquidity, investors may be less willing to buy newly issued securities.

What Is Investment Return?

Return is the financial gain or loss generated by an investment over a period.

Income

- Interest received on debt securities
- Dividends received on equities

Capital Gain or Loss

- Change in the market price of the asset
- Realised on sale or held as unrealised

Holding-Period Return

$$HPR = (P_1 - P_0 + D) \div P_0$$

Where:

P_0
Beginning price

P_1
Ending price

D
Income received during the period

The holding-period return combines income and price change into a single measure of performance.

Return Example

ETB 100
Purchase price (P_0)

ETB 108
Ending price (P_1)

ETB 5
Dividend (D)

$$HPR = (108 - 100 + 5) \div 100 = 13 \div 100$$

13%
Total holding-period return

Return combines the ETB 8 capital gain with the ETB 5 dividend, expressed as a share of the amount invested.

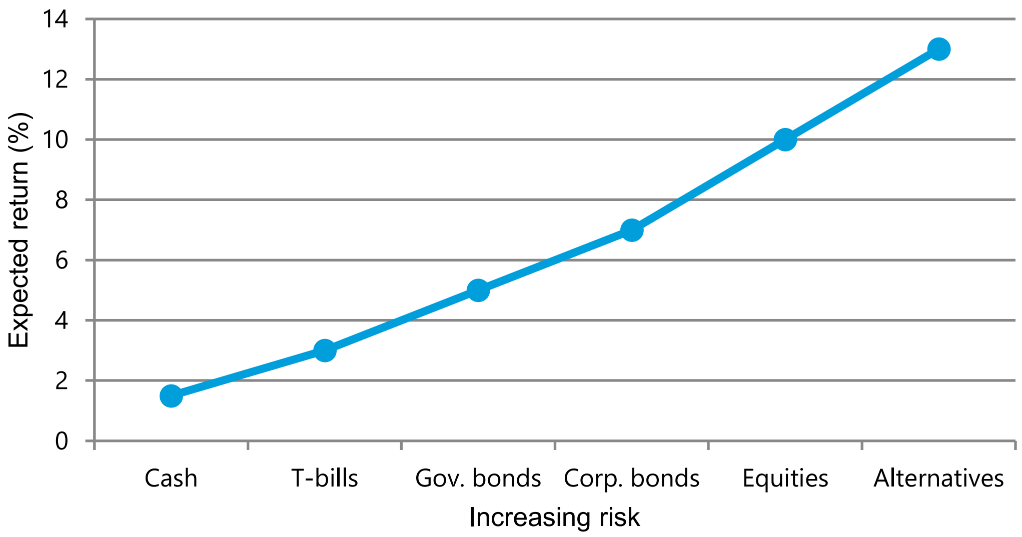
What Is Investment Risk?

Investment risk is uncertainty about future investment outcomes. Sources include:

- **Market movements**
- **Interest rates**
- **Inflation**
- **Business performance**
- **Credit risk**
- **Currency movements**
- **Political events**
- **Liquidity conditions**

Risk–Return Trade-Off

Higher expected returns generally require investors to accept greater risk.



Lower risk

Typically lower expected return.

Higher risk

Typically higher required expected return — but higher risk does not guarantee a higher realised return.

Risk Premium

Expected Return = Risk-Free Rate + Risk Premium

Risk-Free Rate
Compensation for the time value of money

Risk Premium
Compensation for bearing uncertainty

The larger the perceived uncertainty, the larger the premium investors require.

The Investment Process

A disciplined investment process follows a repeating sequence of steps:

Define Objectives → **Identify Constraints** → **Asset Allocation** → **Select Securities**

Construct Portfolio → **Monitor** → **Rebalance** → **Evaluate Performance**

Performance evaluation feeds back into objectives — the process is continuous.

Step 1 — Define Investment Objectives

Objectives state what the portfolio is meant to achieve:

- **Capital preservation**
- **Current income**
- **Capital growth**
- **Retirement funding**
- **Wealth accumulation**
- **Growth plus income**

Step 2 — Identify Constraints

Constraints limit the set of feasible portfolios:

- **Risk tolerance**
- **Investment horizon**
- **Liquidity**
- **Taxes**
- **Legal restrictions**
- **Personal circumstances**
- **Ethical preferences**

Investment Horizon

Short Horizon

- Greater emphasis on liquidity
- Greater emphasis on capital preservation
- Limited capacity to recover losses

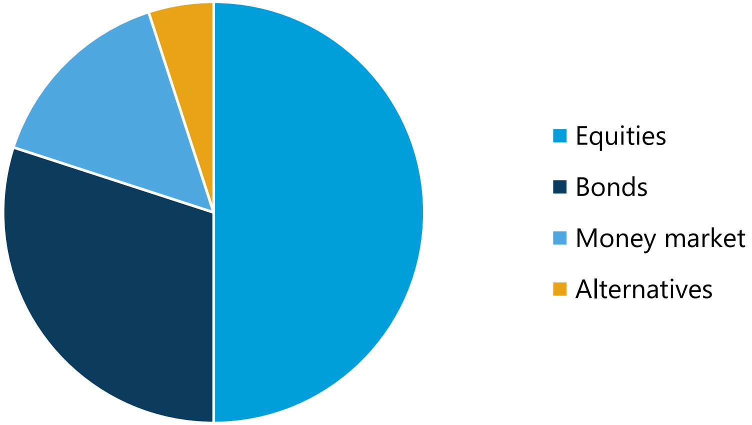
Long Horizon

- Greater ability to tolerate short-term volatility
- Greater ability to absorb temporary market losses
- More scope for growth assets

Asset Allocation

Asset allocation determines how wealth is divided among broad asset classes.

- 50% equities
- 30% bonds
- 15% money market
- 5% alternatives



QUESTION How much should be invested in each asset class?

Security Selection

Security selection determines which individual investments to hold.

Asset Allocation	Security Selection	Portfolio
How much in shares?	Which shares?	Final holdings

RELATIONSHIP These are distinct but complementary decisions within one investment process.

Diversification

Diversification means spreading investments across assets whose returns do not move perfectly together.

Reduce company-specific risk

Stabilise portfolio outcomes

Improve risk-return trade-offs

KEY IDEA Diversification is about interaction between assets — not merely the number of holdings.

Active Investment Management

Active management attempts to outperform a benchmark through:

- **Security analysis**
- **Market timing**
- **Sector rotation**
- **Security selection**
- **Tactical allocation**

OBJECTIVE Generate superior risk-adjusted returns after costs.

Passive Investment Management

Passive investing seeks to track a market benchmark rather than beat it.

Examples

- Index funds
- Index ETFs
- Benchmark-tracking portfolios

Potential advantages

- Lower turnover
- Lower costs
- Broad diversification
- Simpler implementation

Active vs. Passive

Active	Passive
Seeks to outperform a benchmark	Seeks to track a benchmark
More security analysis	Less security selection
More trading possible	Lower turnover
Usually higher costs	Usually lower costs
Skill-dependent	Benchmark-dependent

Investment Policy Statement

An Investment Policy Statement (IPS) provides a structured framework for investment decisions. It may define:

- **Objectives**
- **Risk tolerance**
- **Time horizon**
- **Liquidity needs**
- **Asset-allocation ranges**
- **Constraints**
- **Rebalancing rules**
- **Performance benchmark**

Practical Investment Case

Investor profile

- Investment capital: ETB 1,000,000
- Age 35
- Stable employment
- Long investment horizon
- Moderate risk tolerance
- Long-term growth objective

Student tasks — recommend:

1. Investment objective
2. Liquidity requirement
3. Risk level
4. Asset allocation
5. Diversification approach
6. Active / passive mix
7. Suitable performance benchmark

Justify each recommendation with reference to the investor's objectives, horizon and constraints.

Key Takeaways

- Investment means sacrificing resources today for expected future benefits.
- Saving and investing are related but differ in objectives and risk.
- Real assets create productive capacity; financial assets are claims on it.
- Financial markets channel savings toward productive investment.
- Markets help allocate both capital and risk.
- Major asset classes span money markets, bonds, equities, derivatives and alternatives.
- Return consists of income plus capital gain or loss.
- Higher expected return generally requires accepting greater risk.
- Asset allocation determines broad portfolio structure.
- Security selection determines specific holdings.
- Diversification reduces avoidable concentration risk.
- Active and passive strategies reflect different beliefs about markets.
- A disciplined process begins with clear objectives and constraints.
- Governance and policy keep decisions aligned over time.

Chapter 2 — Asset Classes and Financial Instruments

The next chapter will cover:

- Asset-class classification
- Money-market instruments
- Treasury bills
- Commercial paper
- Certificates of deposit
- Repurchase agreements
- Bonds
- Common stock
- Preferred stock
- Market indexes
- Derivatives
- Alternative investments
- Risk, return and liquidity
- Role in portfolio construction

THANK YOU

Questions and Discussion

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