

Investment Alternatives

Chapter 2

**Charles P. Jones, Investments: Analysis and
Management,
Tenth Edition, John Wiley & Sons**

Prepared by

G.D. Koppenhaver, Iowa State University

Nonmarketable Financial Assets

- Commonly owned by individuals
- Represent direct exchange of claims between issuer and investor
- Usually very liquid or easy to convert to cash without loss of value
- Examples: Savings accounts and bonds, certificates of deposit, money market deposit accounts

Money Market Securities

- Marketable: claims are negotiable or salable in the marketplace
- Short-term, liquid, relatively low risk debt instruments
- Issued by governments and private firms
- Examples: Money market mutual funds, T-Bills, Commercial paper

Capital Market Securities

- Marketable debt with maturity greater than one year and ownership shares
- More risky than money market securities
- Fixed-income securities have a specified payment schedule
 - Dates and amount of interest and principal payments known in advance

Bond Characteristics

- Buyer of a newly issued coupon bond is lending money to the issuer who agrees to repay principal and interest
- Bonds are fixed-income securities
 - Buyer knows future cash flows
 - Known interest and principal payments
- If sold before maturity price will depend on interest rates at that time

Bond Characteristics

- Prices quoted as a % of par value
- Bond buyer must pay the price of the bond plus accrued interest since last semiannual interest payment
 - Prices quoted without accrued interest
- Premium: amount above par value
- Discount: amount below par value

Innovation in Bond Features

- Zero-coupon bond
 - Sold at a discount and redeemed for face value at maturity
 - Locks in a fixed rate of return, eliminating reinvestment rate risk
 - Responds sharply to interest rate changes
 - Not popular with taxable investors
 - May have call feature

Major Bond Types

- Federal government securities (eg., T-bonds)
- Federal agency securities (eg., GNMMAs)
- Federally sponsored credit agency securities (eg., FNMMAs, SLMAs)
- Municipal securities: General obligation bonds, Revenue bonds
 - Tax implications for investors

Corporate Bonds

- Usually unsecured debt maturing in 20-40 years, paying semi-annual interest, callable, with par value of \$1,000
 - Callable bonds gives the issuer the right to repay the debt prior to maturity
 - Convertible bonds may be exchanged for another asset at the owner's discretion
 - Risk that issuer may default on payments

Bond Ratings

- Rate relative probability of default
- Rating organizations
 - Standard and Poors Corporation (S&P)
 - Moody's Investors Service Inc
- Rating firms perform the credit analysis for the investor
- Emphasis on the issuer's relative probability of default

Bond Ratings

- Investment grade securities
 - Rated AAA, AA, A, BBB
 - Typically, institutional investors are confined to bonds in these four categories
- Speculative securities
 - Rated BB, B, CCC, C
 - Significant uncertainties
 - C rated bonds are not paying interest

Securitization

- Transformation of illiquid, risky individual loans into asset-backed securities
 - GNMMAs
 - Marketable securities backed by auto loans, credit-card receivables, small-business loans, leases
- High yields, short maturities, investment-grade ratings

Equity Securities

- Denote an ownership interest in a corporation
- Denote control over management, at least in principle
 - Voting rights important
- Denote limited liability
 - Investor cannot lose more than their investment should the corporation fail

Preferred Stocks

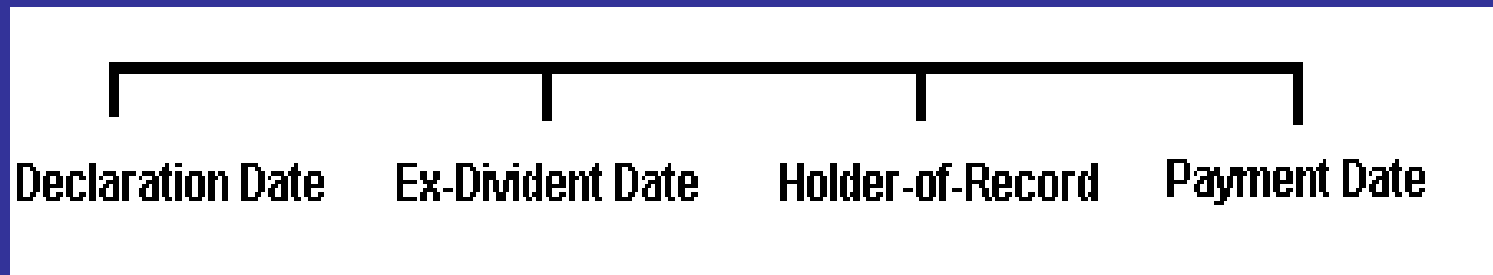
- Hybrid security because features of both debt and equity
- Preferred stockholders paid after debt but before common stockholders
 - Dividend known, fixed in advance
 - May be cumulative if dividend omitted
- Often convertible into common stock
- May carry variable dividend rate

Common Stocks

- Common stockholders are residual claimants on income and assets
- Par value is face value of a share
 - Usually economically insignificant
- Book value is accounting value of a share
- Market value is current market price of a share

Common Stocks

- Dividends are cash payments to shareholders
 - Dividend yield is income component of return = D/P
 - Payout Ratio is ratio of dividends to earnings



Common Stocks

- Stock dividend is payment to owners in stock
- Stock split is the issuance of additional shares in proportion to the shares outstanding
 - The book and par values are changed
- P/E ratio is the ratio of current market price of equity to the firm's earnings

Investing Internationally

- Direct investing
 - US stockbrokers can buy and sell securities on foreign stock exchanges
 - Foreign firms may list their securities on a US exchange or on Nasdaq
 - Purchase ADR's
 - Issued by depositories having physical possession of foreign securities
 - Investors isolated from currency fluctuations

Derivative Securities

- Securities whose value is derived from another security
- Futures and options contracts are standardized and performance is guaranteed by a third party
 - Risk management tools
- Warrants are options issued by firms

Options

- Exchange-traded options are created by investors, not corporations
- Call (Put): Buyer has the right but not the obligation to purchase (sell) a fixed quantity from (to) the seller at a fixed price before a certain date
 - Right is sold in the market at a price
- Increases return possibilities

Futures

- Futures contract: A standardized agreement between a buyer and seller to make future delivery of a fixed asset at a fixed price
 - A “good faith deposit,” called margin, is required of both the buyer and seller to reduce default risk
 - Used to hedge the risk of price changes

Copyright 2006 John Wiley & Sons, Inc. All rights reserved. Reproduction or translation of this work beyond that permitted in Section 117 of the 1976 United States Copyright Act without the express written permission of the copyright owner is unlawful. Request for further information should be addressed to the Permissions department, John Wiley & Sons, Inc. The purchaser may make back-up copies for his/her own use only and not for distribution or resale. The Publisher assumes no responsibility for errors, omissions, or damages, caused by the use of these programs or from the use of the information contained herein.