

**CHAPTER 1**  
Investments - Background  
and Issues

**1.1 REAL ASSETS VERSUS  
FINANCIAL ASSETS**

**Financial Versus Real Assets**

- Essential nature of investment
  - Reduced current consumption
  - Planned later consumption
- Real Assets
  - Assets used to produce goods and services
- Financial Assets
  - Claims on real assets

**Table 1.1. Balance Sheet – U.S. Households, 2006**

**TABLE 1.1**  
Balance sheet U.S. households, 2006

Assets		\$ Billion	% Total	Liabilities and Net Worth		\$ Billion	% Total
<b>Real assets</b>							
Real estate		\$22,177	33.6%	Mortgages		\$ 9,161	13.9%
Consumer durables		3,822	5.8	Consumer credit		2,150	3.3
Other		224	0.3	Bank & other loans		237	0.4
<b>Total real assets</b>		<b>\$26,223</b>	<b>39.7%</b>	Security Credit		249	0.4
				Other		401	0.6
				<b>Total liabilities</b>		<b>\$12,199</b>	<b>18.5%</b>
<b>Financial assets</b>							
Deposits		\$ 6,251	9.5%				
Life insurance reserves		1,097	1.7				
Pension reserves		11,109	16.8				
Corporate equity		5,685	8.6				
Equity in noncorp. business		6,786	10.3				
Mutual fund shares		4,537	6.9				
Debt securities		3,216	4.9				
Other		1,126	1.7				
<b>Total financial assets</b>		<b>39,807</b>	<b>60.3</b>	<b>Net worth</b>		<b>53,831</b>	<b>81.5</b>
<b>Total</b>		<b>\$66,030</b>	<b>100.0%</b>			<b>\$66,030</b>	<b>100.0%</b>

Note: Column sums may differ from totals because of rounding error.  
Source: Flow of Funds Accounts of the United States, Board of Governors of the Federal Reserve System, June 2006.

**Table 1.2 Domestic Net Worth, 2006**

**TABLE 1.2**

Assets	\$ Billion
Domestic net worth	
Nonresidential real estate	\$13,713
Residential real estate	22,198
Equipment and software	3,811
Inventories	1,634
Consumer durables	3,843
<b>Total</b>	<b>\$45,199</b>

Note: Column sums may differ from total because of rounding error.  
Source: Flow of Funds Accounts of the United States, Board of Governors of the Federal Reserve System, September 2006.

**1.2 A TAXONOMY OF FINANCIAL ASSETS**

## Major Classes of Financial Assets or Securities

- Debt
  - Money market instruments
    - Bank certificates of deposit
  - Capital market instruments
    - Bonds
- Common stock
- Preferred stock
- Derivative securities

## 1.3 FINANCIAL MARKETS AND THE ECONOMY

### Financial Markets

- Informational Role of Financials Markets
  - The Google effect
- Consumption Timing
- Allocation of Risk
- Separation of Ownership and Management
  - Agency Issues

### Corporate Governance and Ethics

- Accounting Scandals
  - Examples – Enron and WorldCom
- Misleading research reports
- Auditors watchdogs or consultants
  - Example – Arthur Andersen and Enron
- Sarbanes-Oxley Act
  - Tighten the rules of corporate governance

## 1.4 THE INVESTMENT PROCESS

### The Investor's Portfolio

- Asset allocation
  - Choice among broad asset classes
- Security selection
  - Choice of which securities to hold within asset class
- Security selection

## 1.5 MARKETS ARE COMPETITIVE

### Risk-Return Trade-Off

- How should one measure risk
- Assets with higher expected returns have greater risk
- What role does diversification play

### Efficient Markets Theory

- Should be neither underpriced nor overpriced securities
- Security price should reflect all information available to investors

### Active Versus Passive Management

#### Active Management

- Finding undervalued securities
- Timing the market

#### Passive Management

- No attempt to find undervalued securities
- No attempt to time
- Holding an efficient portfolio

## 1.6 THE PLAYERS

### The Players

- Business Firms – net borrowers
- Households – net savers
- Governments – can be both borrowers and savers
- Financial Intermediaries
  - Banks
  - Investment companies
  - Insurance companies
  - Credit unions
- Investment Bankers

### Table 1.3 Balance Sheet of Commercial Banks

**TABLE 1.3**

Balance sheet of commercial banks

Assets			Liabilities and Net Worth		
	\$ Billion	% Total		\$ Billion	% Total
<b>Real assets</b>					
Equipment and premises	\$ 93.9	1.0%	Deposits	\$6,383.0	66.5%
Other real estate	4.9	0.1	Borrowed funds	798.0	8.3
<b>Total real assets</b>	<b>\$ 98.8</b>	<b>1.0%</b>	Subordinated debt	132.7	1.4
<b>Financial assets</b>					
Cash	\$ 397.6	4.1%	Federal funds and repurchase agreements	750.0	7.8
Investment securities	1,648.7	17.2	Other	566.8	5.9
Loans and Leases	5,589.3	58.2	<b>Total liabilities</b>	<b>\$8,630.5</b>	<b>89.9%</b>
Other financial assets	1,082.4	11.3			
<b>Total financial assets</b>	<b>\$8,718.0</b>	<b>90.8</b>			
<b>Other assets</b>					
Intangible assets	\$ 345.6	3.6			
Other	440.0	4.6			
<b>Total other assets</b>	<b>785.5</b>	<b>8.2</b>	<b>Net worth</b>	<b>971.7</b>	<b>10.1</b>
<b>Total</b>	<b>\$9,602.3</b>	<b>100.0%</b>		<b>\$9,602.3</b>	<b>100.0%</b>

Note: Column sums may differ from totals because of rounding error.  
Source: Federal Deposit Insurance Corporation, www.fdic.gov, September 2005.

### Table 1.4 Balance Sheet of Nonfinancial U.S. Business

**TABLE 1.4**

Balance sheet of nonfinancial U.S. business

Assets			Liabilities and Net Worth		
	\$ Billion	% Total		\$ Billion	% Total
<b>Real assets</b>					
Equipment and software	\$ 3,642	15.8%	Bonds and mortgages	\$ 4,034	17.5%
Real estate	6,769	29.4	Bank loans	651	2.8
Inventories	1,593	6.9	Other loans	772	3.4
<b>Total real assets</b>	<b>\$12,004</b>	<b>52.2%</b>	Trade debt	1,658	7.2
<b>Financial assets</b>					
Deposits and cash	\$ 973	4.2%	Other	3,256	14.1
Marketable securities	438	1.9	<b>Total liabilities</b>	<b>\$10,372</b>	<b>45.1%</b>
Trade and consumer credit	2,077	9.0			
Other	7,525	32.7			
<b>Total financial assets</b>	<b>11,014</b>	<b>47.8</b>	<b>Net worth</b>	<b>12,646</b>	<b>54.9</b>
<b>Total</b>	<b>\$23,018</b>	<b>100.0%</b>		<b>\$23,018</b>	<b>100.0%</b>

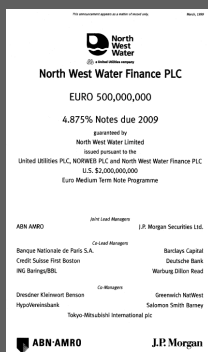
Note: Column sums may differ from totals because of rounding error.  
Source: Flow of Funds Accounts of the United States, Board of Governors of the Federal Reserve System, June 2006.

## 1.7 RECENT TRENDS

## Globalization

- Managing foreign exchange
- Diversification to improve performance
- Instruments and vehicles continue to develop (WEBs)
- Information and analysis improves

### Figure 1.1 Global Debt Issue



## Securitization

- Offers opportunities for investors and originators
- Changes in financial institutions and regulation
- Improvement in information capabilities
- Credit enhancement and its role

