
بسم الله الرحمن الرحيم

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يرفع الله الذين آمنوا منكم والذين أوتوا العلم درجات

صدق الله العظيم

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CHAPTER (1)
Introduction to Investment Management

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1.1 Concept of Investment:

- In general terms, investment means the use of money in the hope of making more money.
- In finance, investment means the purchase of a financial product or other item of value with an expectation of favorable future returns.
- Investment of hard-earned money is a crucial activity of every human being.
- Investment is the commitment of funds which have been saved from current consumption with the hope that some benefits will be received in future.
- Investment refers to the concept of deferred consumption, which involves purchasing an asset, giving a loan or keeping funds in a bank account with the aim of generating future returns.
- Various investment options are available, offering differing risk-reward tradeoffs.
- An understanding of the core concepts and a whole analysis of the options can help an investor create a portfolio that maximizes returns while minimizing risk exposure.

Two concepts of Investment:

1) Economic Investment:

- ✓ means addition to the capital stock of the society.
- ✓ The capital stock of the society is the goods which are used in the production of other goods.
- Examples: building, equipment, and inventory.

2) Financial Investment:

- ✓ is an allocation of monetary resources to assets that are expected to yield some gain or return over a given period of time.
- ✓ It means an exchange of financial claims such as shares and bonds, real estate, etc.
- ✓ In their view, investment is a commitment of funds to derive future income in the form of interest, dividends, rent, premiums, pension benefits and the appreciation of the value of their principal capital.
- ✓ In old economies most investments are of the real variety, whereas in a modern economy much investment is of the financial variety.

- The economic and financial concepts of investment are related to each other, because investment is a part of the savings of individuals which flow into the capital market either directly or through institutions.
- Thus, investment decisions and financial decisions interact with each other.
- Financial decisions are primarily concerned with the sources of money where as investment decisions are traditionally concerned with uses or budgeting of money.
- Going to shopping for clothing materials Vs. Investing in a company
- In the next two points, we are going to study returns on the investment you make and the risks associated with investments.

1.2 Investment Returns:

- We will now distinguish between return in the form of current income and return gained through capital appreciation.

- Under some circumstances, current income is either necessary or highly desirable.
- A retired individual often needs a high level of current income to supplement income from Social Security or other pension plans.
- Current income is often desirable when an individual or institutional investor is in a very low or zero marginal tax bracket.
- A marginal tax bracket is the tax rate that applies to the last dollar earned by the taxpayer.
- The need for current income for an individual varies greatly depending on such factors as the age, wealth, and non-investment income of that investor.
- When current consumption needs are satisfied by salary income, growth of principal in the form of capital appreciation often becomes an important investment objective.
- Similarly, institutional investors balance the need for current income with the desire for growth in the market value of the investments over time.

1.3 Investment Risks:

1. Definition of Investment Risk:

- ✓ Investment risk can be defined as the probability or likelihood of occurrence of losses relative to the expected return on any particular investment.
- ✓ Stating simply, it is a measure of the level of uncertainty of achieving the returns as per the expectations of the investor.
- ✓ It is the extent of unexpected results to be realized.
- ✓ The thumb rule is the higher the risk, the better the return.

2. Types of Investment Risks:

- ✓ Risk in an investment may be categorized as either systematic or unsystematic, as outlined in Table 1-1. We will also discuss other traditional risk classifications.
- ❖ **Systematic or Non-Diversifiable:** results from being involved with the market. If an investor invests in common stocks, that investor accepts the possibility that the market may go down or that the economy will do poorly. There is no way to diversify away this risk by adding more stocks.
- ❖ **Unsystematic or Diversifiable:** is risk that is associated with a particular firm or industry. An investor need not accept this type of risk.

Hint: A portfolio of sufficient size will be subject only to systematic risk.

Table 1-1	Two Methods of Risk Classification	
	1. Systematic (Non-Diversifiable)	Unsystematic (Diversified)
	Risks associated with economy and security market	Risks that are unique to an industry or a company.
	2. a. Interest Rate Risk. b. Business Risk. c. Credit Risk. d. Taxability Risk. e. Call Risk. f. Purchasing Power (Inflationary) Risk. g. Liquidity Risk. h. Market Risk. i. Reinvestment Risk. j. Social/ Political/ legislative Risk. k. Currency/ Exchange Rate Risk. l. Psychological Risk. m. Fraud Risk.	

- **Interest Rate Risk:** is the potential for loss of principal owing to changes in the general level of interest rates.

* **Example**: Suppose an investment promises to pay $105 at the end of a one-year period. If the interest rate in the market for this quality of investment is 5 percent, the price of the investment is $100. If the market interest rate changes to 10 percent, the price of the investment should fall to $95.45.

- **Business Risk:** is the measure of risk associated with a particular security. It is also known as unsystematic risk and refers to the risk associated with a specific issuer of a security. Generally speaking, all businesses in the same industry have similar types of business risk. But used more specifically, business risk refers to the possibility that the issuer of a stock or a bond may go bankrupt or be unable to pay the interest or principal in the case of bonds. A common way to avoid unsystematic risk is to diversify.

- **Credit Risk:** refers to the possibility that a particular bond issuer will not be able to make expected interest rate payments and/or principal repayment. Typically, the higher the credit risk, the higher the interest rate on the bond.

- **Taxability Risk:** refers to the risk that a security that was issued with tax-exempt status could potentially lose that status prior to maturity.
- **Call Risk:** is specific to bond issues and refers to the possibility that a debt security will be called prior to maturity
- **Purchasing power (Inflationary) Risk:** is the possibility that future earnings will not command goods and services possible with current dollars. With an uncertain inflation rate, any investment contains risk even if the investment's monetary return is certain.

* **Example**: **A 10 percent investment return during a period when the inflation rate is 10 percent results in the investor being no better off than before in terms of the use of the earnings. The real earnings in this case are zero.**

- **Liquidity Risk:** refers to the possibility that an investor may not be able to buy or sell an investment as and when desired or in sufficient quantities because opportunities are limited.

* **Example**: **selling real estate.**

- **Market Risk:** also called systematic risk, is a risk that will affect all securities in the same manner. In other words, it is caused by some factor that cannot be controlled by diversification.
- **Reinvestment Risk:** In a declining interest rate environment, bondholders who have bonds coming due or being called face the difficult task of investing the proceeds in bond issues with equal or greater interest rates than the redeemed bonds. It is the risk that falling interest rates will lead to a decline in cash flow from an investment when its principal and interest payments are reinvested at lower rates.
- **Social/ Political/ legislative Risk:** associated with the possibility of nationalization, unfavorable government action or social changes resulting in a loss of value. Political risk may arise from either domestic or foreign sources. Changes in domestic tax laws, such as the elimination of preferential treatment on certain capital gains on investments, are always possible and may have an impact on investments.

- **Currency/ Exchange Rate Risk:** is a form of risk that arises from the change in price of one currency against another. If the dollar is strong, the value of a foreign stock or bond purchased on a foreign exchange will decline and vise versa. currency risk is greater for shorter term investments, which do not have time to level off like longer term foreign investments.
- **Psychological Risk:** Success in making investments may be related to an investor's personality. One writer listed the following qualities as being associated with repeated losers in the market: "intellectually lazy, gullible ساذج, greedy طماع, irrational غير رشيد, indecisive متردد, prone to extremes of optimism and pessimism, and readily infected by the emotions of the crowd القطيع". they must be overcome by education and experience if one wishes to achieve investment success.
- **Fraud مخادع Risk:** "A fool and his money are soon parted“. Fortunately, they are uncommon, but when they occur, huge sums of money are often involved. Can investors avoid possible frauds? Whether a particular investment is an honest venture is difficult to know with certainty, but investors can keep several indicators in mind. Any investment that is being promoted heavily and that appears to promise returns substantially above what one would expect to be reasonable should be seriously questioned by the investor. Additionally, mixing heavy doses of religion or politics with investment decisions may open the door to fraudulent schemes.

1.4 Investors:

1. Who is an Investor?

- ✓ is a person that allocates capital with the expectation of a future financial return.

2. Types of Investors:

A. Two Categories of Investors: Active and Passive:

- ❖ **Active نشيط investors** have often achieved their own wealth. They run their own firms, and are self-employed. They like to be in control of their investments, as they are in control of their professional lives.
- ❖ **Passive كسول investors** are people who gained their wealth by inheriting it or by entering into a remunerative professional career. They work in large firms. They often started out with student debt or at a lower salary and worked their way up.

B. Two Categories of Investors: Individual and Institutional:

- ❖ **Individual investors** manage their own funds to achieve their financial goals.
- ❖ Individuals who lack the time or expertise to make investment decisions often employ **institutional investors** - investment professionals who earn their living by managing other people's money.

* **Examples**: banks, life insurance companies, mutual funds, pension funds, and hedge funds.

C. Six Types of Investors and Some Related Personality Characteristics:

1. Busy investors: They follow the ups and downs of equity, gold, or real estate prices. As a result, they tend to buy and sell frequently, often based on what they see others doing. They are active investors.

2. Casual investors: They are the opposite of the busy investor. They are passive investors. They typically prefer safe investments that have proved their value in the past.

3. Cautious حذر investors: They tend to be the most risk-averse, putting financial security first. Afraid of making mistakes, their pursuit of the perfect decision can mean making no decision at all. They are passive investors.

4. Emotional investors: They put their heart into their investment decisions, not their head. They can be a blend of active and passive in their approach, eager to make investments they feel committed to, but unwilling to let go of those that have outlived their value

5. Informed investors: They tend to take a well-rounded approach. They are careful to stay up to date, using a variety of sources to fill in their understanding. While confident of their own financial acumen فطنة, they also are willing to listen to the advice of experts, and to act decisively بحسم. Often high achievers in their professional lives, they typically have a strong work ethic and may seek the same sense of control and accomplishment in their investments.

6. **Technical investors**: They share some characteristics with busy investors, but they tend to analyze the numbers and read the pundits rather than reacting to every market move. They may spend a lot of time on their computer screens, but feel that their diligence is rewarded if they spot a trend earlier than others. These active investors are very involved with the management and choice of their investments.

1.5 Major Characteristics of Investments:

1.Return:

- ✓ All investments are characterized by the expectation of a return.
- ✓ In fact, investments are made with the primary objective of deriving a return.
- ✓ The return may be received in the form of yield plus capital appreciation.
- ✓ The difference between the sale price & the purchase price is capital appreciation.
- ✓ The dividend or interest received from the investment is the yield.
- ✓ The return from an investment depends upon the nature of investment, the maturity period & a host of other factors.

2. Risk:

- ✓ The risk may relate to loss of capital, delay in repayment of capital, nonpayment of interest, or variability of returns.
- ✓ The risk of an investment depends on the following factors:
- The longer the maturity period, the longer is the risk.
- The lower the credit worthiness of the borrower, the higher is the risk.
- ✓ Investments in ownership securities like equity shares carry higher risk compared to investments in debt instrument like bonds.

3. Safety:

- ✓ It implies the certainty of return of capital without loss of money or time.
- ✓ Every investor expects to get back his capital on maturity without loss & without delay.

4. Liquidity:

- ✓ An investment, which is easily saleable, or marketable without loss of money & without loss of time is said to possess liquidity.
- ✓ Equity shares of companies listed on stock exchanges are easily marketable through the stock exchanges.
- ➢ An investor generally prefers liquidity for his investment, safety of his funds, a good return with minimum risk or minimization of risk & maximization of return.

1.6 Types of Investment:

- In this chapter, we will look at the three basic types of investment:

1. Ownership Investments:

- ✓ They are what comes to mind for most people when the word "investment" is batted around.
- ✓ They are the most volatile and profitable class of investment.

Stocks + Business + Real Estate + Precious objects and collectibles

2. Lending Investments:

- ✓ They allow you to be the bank.
- ✓ They tend to be lower risk than ownership investments and return less as a result.

Your savings account + Bonds

3. Cash Equivalents:

- ✓ These are investments that are "as good as cash," which means they're easy to convert back into cash.

Money market funds

1.7 Classifying Investment Alternatives:

- The investment alternatives facing investors can be classified in four different ways:

1) Nature of Assets:

- In finance, an asset is any resource owned or controlled by a business or an economic entity.
- It is anything (tangible or intangible) that can be used to produce positive economic value.
- Assets represent value of ownership that can be converted into cash (although cash itself is also considered an asset).
- The balance sheet of a firm records the monetary value of the assets owned by that firm.
- Assets can be grouped into two major classes: tangible assets and intangible assets.

1) Tangible assets contain various subclasses, including current assets and fixed assets. Current assets include cash, inventory, accounts receivable, while fixed assets include land, buildings and equipment.
2) Intangible assets are non-physical resources and rights that have a value to the firm because they give the firm an advantage in the marketplace. It includes goodwill, copyrights, trademarks, computer programs, and financial assets, including financial investments, bonds, and stocks.

- According to our course, assets can be classified into two broad categories, namely real Vs. financial assets, as follows:

A) Real Assets:

- It provides the framework and resources to facilitate everyday activity in the world economy.

1. **Real estate**: Land and commercial properties including apartments, offices, warehouses, malls, etc.
2. **Infrastructure**: Assets and networks used to transport, store and distribute goods, energy, people and information, such as toll roads, pipelines, airports and cellphone towers.
3. **Commodities**: Basic goods such as oil, natural gas, precious metals, gold, corn and soybeans.
4. **Collectibles**: including antiques, art masterpieces, coins, stamps, etc.

B) Financial Assets:

- is a non-physical asset whose value is derived from a contractual claim, which may be equity or creditor claim.
- Financial assets are usually more liquid than other tangible assets, such as commodities or real estate.

B.1 Equity Claims:

- Equity claims are perhaps most important in the event of the company's liquidation.
- Equity claims are also called residual claims.

1) Direct:

1. Common stock:

- is an equity investment that represents ownership in a corporation.
- Each share out common stock represents a fractional ownership interest in the firm.
- The return on investment in common stock comes from two sources; changeable dividends and capital gains.

- **Example: Suppose you purchased a single share of a Corporation common stock for $155 on January 2. 2021, the first day that the stock market was open for trading that year. During 2021 you received $2.87 in cash dividends. At the end of the year, you sold the stock for $195. You earned $2.87 in dividends and you *realized* a $40 capital gain ($195 sale price - $155 purchase price) for a total dollar return of $42.87. On a percentage basis, the return on this corporation shares in 2021 is calculated as $42.87/ $155 = 0.277 or 27.7%. If you continued to hold the stock rather than sell it, at the end of the year you would have earned the same return but your capital gain would have been *unrealized*.**

2. Preferred stock:

- **Unlike common stock, preferred stock has a fixed dividend rate.**
- **Firms are generally required to pay dividends on preferred shares before they are allowed to pay dividends on their common shares.**
- **Furthermore, if a firm is having financial difficulties and decides to stop paying preferred dividends, it must usually make up all of the dividend payments that it skipped before paying dividends on common shares.**
- **Investors typically purchase preferred stock for the dividends they pay, but preferred shares may also provide capital gains.**

3. Derivatives: Chapter (6)

2. Indirect:

- **The major example of indirect equity claims is *investment company* which is an organization, trust, or entity that collects capital from various investors to reinvest it in financial securities such as equity, debt, and a wide range of money market instruments.**
- **The three investment company types are:**

1 Open-end:

- Commonly known as mutual funds.
- These companies sell shares constantly.
- They are always ready to purchase their shares from investors at net asset value.
- Therefore, the shares of open-end companies are redeemable.
- A mutual fund is a portfolio of stocks, bonds, or other assets that were purchased with a pool of funds contributed by many different investors and that are managed by an investment company on behalf of its clients.
- Investors in a mutual fund own an interest in the fund's collection of securities.
- Mutual funds allow investors to construct well-diversified portfolios without having to invest a large sum of money.
- Most mutual managers follow one of two broad approaches when selecting specific securities for their funds:

1) an actively managed fund, managers try to identify and purchase securities that are undervalued and are therefore likely to perform particularly well in the future. The goal of an actively managed fund is typically to earn a higher return than some sort of benchmark.
2) a passively managed fund, managers make no attempt to identify under or overvalued securities. Instead, they buy a diversified portfolio of stocks and try to mimic or match the return on a market index. Because these funds try to provide returns that are as close as possible to the returns on a market index, they usually referred to as index funds.

- In return for the services that they provide, mutual funds (or rather the investment companies that run the mutual funds) charge investors fees, and some of those fees are rolled together in figure known as the expense ratio, which is a fee charged to investors based on a percentage of the assets invested in a fund.

2. Closed-end:

- These investment companies **list a fixed number of shares** traded in the stock market.
- They do not generally buy back their shares from investors.

3. Unit investment trusts:

- This is an investment company that holds a **static** portfolio containing a fixed set of **not actively** traded securities.
- The UIT will dissolve on a particular date when its portfolio gets liquidated and the proceeds handed over to investors.
- The shares of a UIT can therefore be called **redeemable**.

B.2 Creditor's Claims:

1. **Provided by financial institutions:**

1. Savings accounts:

- SA is an interest-bearing deposit account held at a bank or other financial institution.
- Though these accounts typically pay a modest interest rate, their **safety** and **reliability** make them a great option for parking cash you want available for short-term needs.

2. Certificates of deposit (nonnegotiable):

- are investments between an investor and a financial institution.
- Investors must first select a certain amount of money to invest, terms, and interest rates.
- Once these factors are selected, investors open the CD account according to the agreement.
- The one difference is that non-negotiable CDs **cannot** be transferred, sold, bought, or exchanged.
- Investors are able to withdraw the money early from non-negotiable CDs, but they have to pay **penalties** to do so.

2. Provided by the financial market:

2.1 money market securities: high-quality investments of one year or less in maturity.

a) **Banker's acceptance (BA):** is a negotiable piece of paper that functions like a post-dated check. A bank, rather than an account holder, guarantees the payment. Banker's acceptances (also known as **bills of exchange**) are used by companies as a relatively **safe** form of payment for large transactions.

b) **Certificates of deposit (negotiable):** Investors who invest money in negotiable CDs do **have the right** to transfer, sell, buy, or exchange the CDs.

c) **Commercial paper:** is an **unsecured**, short-term debt instrument issued by corporations. It's typically used to finance short-term liabilities such as payroll, accounts payable, and inventories. Commercial paper is usually issued at a discount from face value. It reflects prevailing market interest rates. Commercial paper involves a specific amount of money that is to be repaid by a specific date. Commercial paper is **not backed by any form of collateral**, making it unsecured debt. Commercial paper is only issued by firms with **high ratings** from credit rating agencies.

d) **Treasury bills:** is a short-term **government** debt obligation backed by the Treasury Department with a maturity of one year or less. They are widely regarded as **low-risk** and **secure** investments.

2.2 capital market securities: fixed-income securities having a maturity of more than one year.

a) **Notes:** A note is a legal document that serves as an **I Owe You** (**IOU**) from a borrower to a creditor or an investor.

b) Bonds: Bonds are long-term debt instruments issued by corporations and governments. A bondholder has a contractual right to receive periodic interest payments plus return of the bond's face, or par, value (the stated value given on the certificate) at maturity (typically 10 to 30 years from the date issued).

- **Example**: If you purchased a \$1,000 bond paying 9% interest semiannual installments, you would receive an interest payment equal to \$1,000 × 9% × ½ year = \$45 every six months. At maturity you would also receive the bond's \$1,000 face value. Bonds vary a great deal in terms of liquidity, so they may or may not be easy to sell prior to maturity.

2. Nature of Income Stream:

- ✓ An important method of classifying investment alternatives is to sort them according to whether the anticipated current income is fixed or variable.
- ✓ Investors often tend think of equity claims such as common stock as variable return securities because the current income cannot always be determined with certainty and the capital appreciation is especially unpredictable.
- ✓ Likewise, investors tend to think of money market securities and bonds as fixed-income securities because their rate of interest is fixed at the time of issuance.

3. Nature of Collateral:

- ✓ The essential distinction here is between an investment alternative secured by the pledge of an asset and an alternative lacking this pledge.
- ✓ An ownership position, such as holding common stock, is an unsecured position to the extent that no pledge of specific assets exists.
- ✓ Creditor claims may be secured by a pledge of specific assets, or they may by unsecured.

4. Nature of Marketability:

- ✓ Investment decision makers are often interested in how easily investments may be liquidated.
- ✓ In the context of marketability, we can make two distinctions.
- ✓ We should note whether the investment is negotiable or nonnegotiable.
- ✓ A negotiable investment is one in which title representing ownership of the investment can be legally transferred from one party to another party.
- ✓ Title cannot be legally transferred to another owner in the case of a nonnegotiable investment.

1.8 Importance of Investment Decisions:

- Investment decisions are important for many reasons, both for individuals and institutions.
- A major reason is simply that the assets held by individuals and institutions often represent enormous sums of money.
- These assets may include the savings of individuals that will provide financial security both during the working years and, more importantly, during the nonworking years of retirement.

1.9 Investment Management:

1) What is "Investment Management"?

- ✓ It refers to portfolio management and the trading of securities to achieve a specific investment objective.

2) Objectives of Investment Management:

- ✓ The objective of portfolio management is to invest in securities is securities in such a way that one maximizes one's returns and minimizes risks in order to achieve one's investment objective.
- ✓ Presented below are some important objectives of portfolio management:

- Stable Current Return
- Marketability
- Tax Planning
- Appreciation in the value of capital
- Liquidity
- Ease of Management
- Collateral Value
- Safety of the investment principal

3) Steps of Investment Management Process:

1- Setting the Investment Objectives:- The major objective is usually optimizing the rate of return.

2- Establishing Investment Policy:- It refers to the allocation of asset amongst the major allocated assets in the capital market. The range of allocated asset is from equities, debt, fixed income securities, real estate, foreign securities to currencies.

3- Selecting the Portfolio Strategy:- The portfolio strategy selected should be in accordance and in conformity with the investment objectives and investment policies.

4- Selecting the Assets:- That asset will be selected which will give best return in available resources and which involves lowest risk. The assets can be shares, stocks, art objects, securities, gold, property etc.

5- Measuring and Evaluating Performance:- the performance of the portfolio will be measured in comparison to the realistic benchmark or the standard set by the investor. Risk and return will be evaluated by the manager.

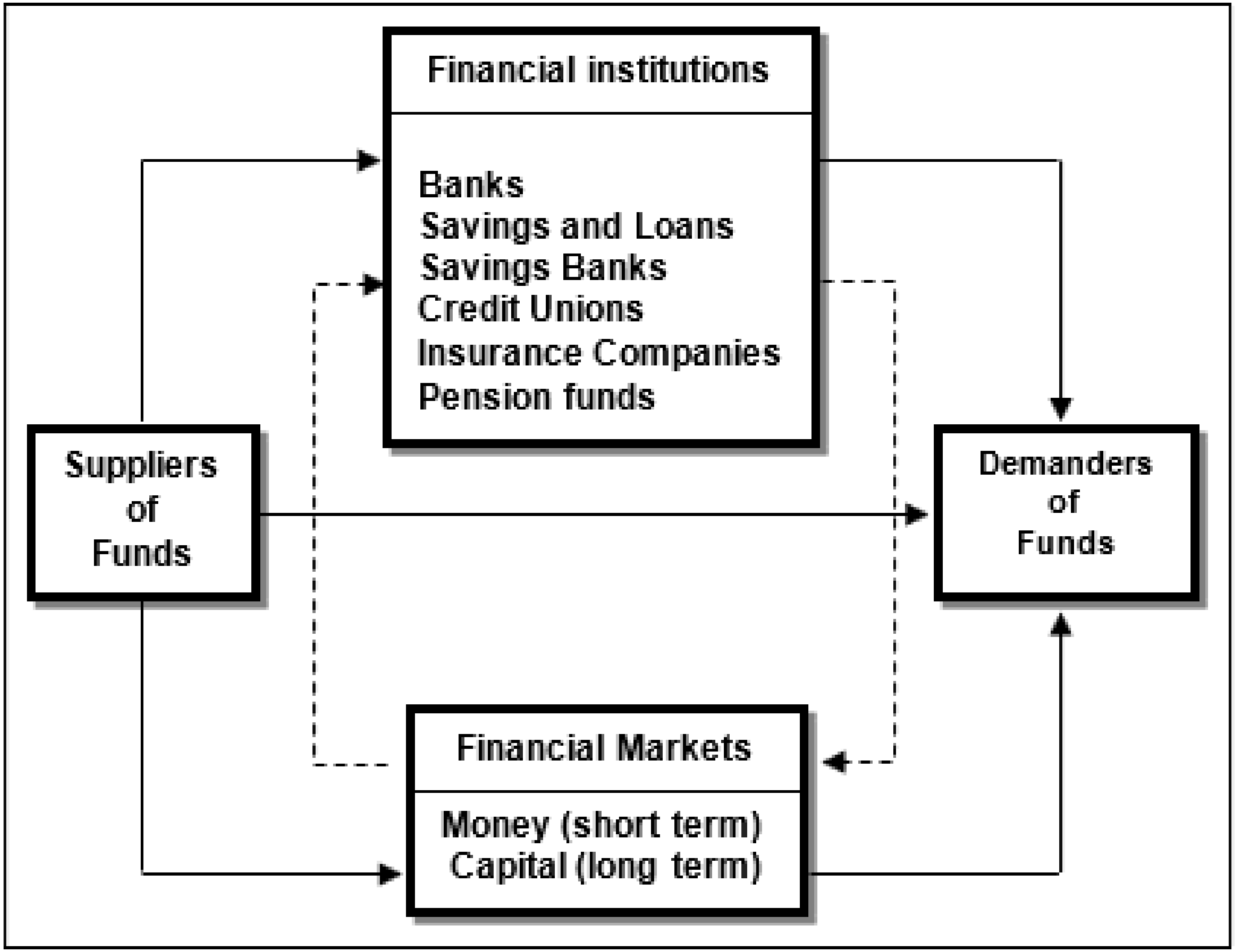
4) The Structure of the Investment Process:

Figure 1–1 is a diagram of the investment process:

Figure 1–1

The Investment Process

Financial institutions participate in the financial markets as well as transfer funds between suppliers and demanders. Although the arrows go only from suppliers to demanders, for some transactions (e.g., the sale of a bond or a college loan), the principal amount borrowed by the demander from the supplier (the lender) is eventually returned.



- Note that the suppliers of funds may transfer their resources to the demanders through financial institutions, through financial markets, or in direct transactions.
- As the broken lines show, financial institutions can participate in financial markets as either suppliers or demanders of funds.
- For the economy to grow and prosper, funds must flow to those with attractive investment opportunities.
- If individuals began suddenly hoarding their excess funds rather than putting them to work in financial institutions and markets, then organizations in need of funds would have difficulty obtaining them.
- As a result, government spending, business expansion, and consumer purchases would decline, and economic activity would slow.
- Both individual and institutional investors apply similar fundamental principles when deciding how to invest money.
- However, institutional investors generally control larger sums of money and have more sophisticated analytical skills than do most individual investors.
- The information presented in this text is aimed primarily at you–the individual investor.
- Mastering this material represents only the first step that you need to take to develop the expertise to become an institutional investor.

1.10 Important Terms: (Read)


Thank you