FN221 Assignment 5

Why do corporations issue stock? Why do investors buy that stock?

The optimal goal for corporation is to maximise profit. In order to do so, it has to invest in specific resources according to the type of business. They need money to invest. Generally, there are two sources of funds to finance the project, debt and equity financing.

Both have advantages and disadvantages. However, corporates issue stock because of the following reasons. First, there is no obligation for the firms to pay the money back within the specific time. In other words, it is less risky than loan financing. Second, it is suitable for start up businesses since those firms have not had reputation and credibility to ask for a loan from bank yet. Third, firms have choices to retain some profit without paying dividend, so that they can use that money for reinvestment.

Investors buy the stock because of the higher rate of return comparing to buying debt instruments. Moreover, they officially the owner of the company, they might have a long-term view about the growth of the company and want to have long term investment. They also have a say in running businesses if they have large percentage of shares.

How do interest rates in the economy affect the price of corporate bond?

Theoretically, price of bond depends significantly on interest rate, coupon payment, risk and time to maturity. Interest in the market is called the discount rate, which we use to discount future cash flow to get the present value (fair price) of the bond.

When the new bond is issued, it states a fixed rate of interest (prevailing market interest rate), coupon. After the bond is sold, investor will face with interest rate risk, a fluctuation in interest rate, which affects the bond price. For example, if the current rate is greater than the coupon rate, bond will be sold below its face value because investors can gain more interest from buying a new bond instead of the low coupon rate one, vice versa.

How important is the investment objectives as stated in the fund's prospectus?

Setting investment objective is one of the most important aspects in fund management since it will determine which and how many assets will be in the portfolio regarding the risk preference of investors. It affects the decision making of fund manager to buy or sell assets. Moreover, investors can choose the fund according to their risk preference. With the objective stated, investors who have the same objective in their mindset can purchase the fund accordingly.

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