

# Section 7: Fundamental of an Investment

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# Today Agenda

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- ▶ Understand your behavior
- ▶ Understand the investment process
- ▶ Tips for the beginners
- ▶ Madoff case study
- ▶ Safe haven discussion

# Understand your behavior

# Topics

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- ▶ Inconsistent attitudes toward risk
- ▶ Mental accounting
- ▶ Prospect theory
- ▶ Loss aversion
- ▶ Avoiding regrets
- ▶ Payment decoupling

# Risk

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- ▶ Samuelson:
  - ▶ I propose the following gamble:
    - ▶ Flip a coin:
      - ▶ If its heads you win 200 baht
      - ▶ It its tails you pay 100 baht
  - ▶ Would you take it?

# Risk

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- ▶ Other people's response:
  - ▶ No !
  - ▶ But if you let me do it 100 times, I will take it

# Inconsistent attitudes toward risk

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- ▶ If an investor would turn down the bet offered above,
- ▶ He would also have to turn down gambles with much higher stakes
- ▶ Traditional utility theory assumes constant “coefficient of risk aversion”
- ▶ Yet investors apply different coefficient

# Mental Accounting

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Decision makers tend to segregate the different types of gambles faced into separate accounts, and then apply prospect theoretic decision rules to each account by ignoring possible interaction

# Prospect theory

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- ▶ Reference point
  - ▶ Gains and losses require a reference point
  - ▶ Reference point is specific to the choice
  - ▶ Investors have discretion in how to frame the reference point

# Reference Point Management

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- ▶ If losses are more painful than gains
- ▶ But gains have diminishing utility, and
- ▶ Losses have diminishing disutility
- ▶ It pays to:
  - ▶ Aggregate losses
  - ▶ Enjoy gains separately
  - ▶ Embed a loss in a gain

# Loss Aversion

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- ▶ The disutility of giving up an object is greater than the utility associated with acquiring it
- ▶ Utility is not over states of wealth so much as over changes relative to a reference point

## Loss Aversion (2)

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- ▶ You are holding stock in xyz corporation and also stock in abc corporation
- ▶ They are both trading for \$100/share
- ▶ You have 100 shares of each
- ▶ You bought xyz for \$50/share and you bought abc for \$150/share
- ▶ You need \$10000 to pay spring tuition. Which do you sell?
- ▶ Conclusion: Investors want to “lock in” their gain and sell too quickly

# Avoiding Regret

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- ▶ Investors postpone regret associated with realizing losses.
- ▶ The asymmetry between the strength of pride and regret leads inaction to be favored over action.

# Payment Decoupling

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- ▶ Separating the purchasing decision and the payment decision alters your willingness to pay
- ▶ Large purchases eliminate transaction disutility (e.g., phone plans, health clubs)
- ▶ Credit card VS Cash

# Summary

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- ▶ Lesson learnt from your personal finance behavior
- ▶ Do's and Don'ts
- ▶ It's all about your acknowledgement and your risk tolerance.

# Understand the investment process

# Important questions

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- ▶ What are investment goals?
- ▶ Am I ready for implementing my investment process?
- ▶ Where is my safety zone? Where is not?
- ▶ What are factors affecting my investment process?
- ▶ What are my investment process?

# Establish your investment goals

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- ▶ Financial goals should be specific and measurable. To develop your goals ask yourself. . .
  - ▶ How much will you need for your goals?
  - ▶ How will you obtain the money?
  - ▶ How long will it take you to obtain the money?
  - ▶ How much risk are you willing to assume in an investment program?
  - ▶ What possible economic or personal conditions could alter your investment goals?
  - ▶ Are you willing to make the sacrifices necessary to meet your investment goals?
  - ▶ What will the consequences be if you don't reach your investment goals?
  - ▶ Given your economic circumstances, are your investment goals reasonable?

# Performing a financial check-up

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- ▶ Work to balance your budget
  - ▶ Do you regularly spend more than you make?
- ▶ Pay off high interest credit card debt first
- ▶ Start an emergency fund you can access quickly
  - ▶ Three to nine months of living expenses
- ▶ Have access to other sources of cash for emergencies
  - ▶ Line of credit is a short-term loan approved before the money is needed
  - ▶ Cash advance on your credit card

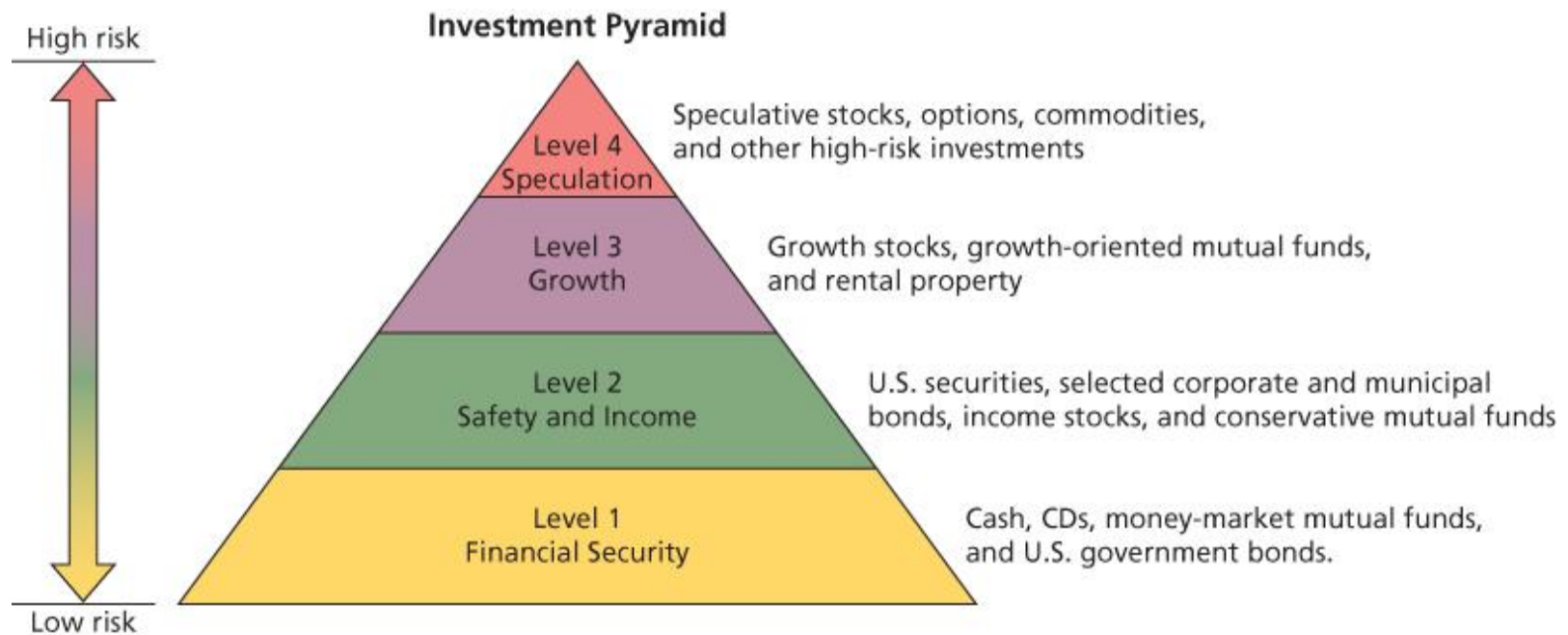
# Assess your safety and risk

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- ▶ Safety in any investment means minimal risk of loss
- ▶ Risk means a measure of uncertainty about the outcome
- ▶ Investments range from very safe to very risky
- ▶ The potential return on any investment should be directly related to the risk the investor assumes
- ▶ Speculative investments are high risk

# Assess your safety and risk (2)

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# What are risk factors?

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- ▶ **Inflation risk** - during periods of high inflation your investment return may not keep pace with the inflation rate
- ▶ **Interest rate risk** - you may invest in a bond at a 6%, rates later go up to 8%; your bond price falls
- ▶ **Business failure risk** - bad management or products affect stocks, municipal or corporate bonds and mutual funds that invest in stock
- ▶ **Market risk** - prices fluctuate because of behaviors of investors
- ▶ **Global investment risk** - changes in currency affect the return on your investment

# Factors affecting choices of investment

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## INVESTMENT INCOME

- ▶ Safest investments – predictable income
  - ▶ Savings accounts and certificates of deposit
  - ▶ government savings bonds
  
- ▶ Higher potential income investments include...
  - ▶ Corporate bonds
  - ▶ Preferred stocks and income common stocks
  - ▶ Income mutual funds
  - ▶ Real estate rental property

# Factors affecting choices of investment (2)

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## INVESTMENT GROWTH

- ▶ Growth means investment will increase in value
  - ▶ Common stock
  - ▶ Growth companies pay little or no dividends, but reinvest in the company
  - ▶ Mutual funds, government and corporate bonds, and real estate offer growth potential

## ▶ INVESTMENT LIQUIDITY

- ▶ Ability to buy or sell an investment quickly without substantially affecting the investment's value; e.g. Real estate is not a very liquid investment

# Investment alternatives

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## Stock or equity financing

- ▶ Equity capital is provided by stockholders who buy shares of a company's stock.
- ▶ Stockholders are owners and share in the success of the company.
- ▶ A corporation is not required to repay the money obtained from the sale of stock.
- ▶ The corporation is under no legal obligation to pay dividends to stockholders: they may instead retain all or part of earnings.

## Investment alternatives (2)

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### CORPORATE AND GOVERNMENT BONDS

- ▶ A bond is a loan to a corporation, the federal government, or a municipality
- ▶ Bondholders receive periodic interest payments, and the principal is repaid at maturity (1-30 years)
- ▶ Bondholders can keep the bond until maturity or sell it to another investor before maturity

# Investment alternatives (3)

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## Mutual funds

- ▶ Investors' money is pooled and invested by a professional fund manager
- ▶ You buy shares in the fund
- ▶ Provides diversification to reduce risk
- ▶ Funds range from conservative to extremely speculative
- ▶ Match your needs with a fund's objective
- ▶ Be aware of fees depending upon different fund chosen

# Investment alternatives (4)

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## REAL ESTATE

- ▶ The goal of a real estate investment is to buy a property and sell it at a profit. Nationally, 3% appreciation in price a year is average. However, decreases in value are also possible.
- ▶ Location, location, location is important.

# Investment alternatives (5)

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- ▶ Speculative investments

- ▶ A speculative investment is a high-risk investment made in the hope of earning a relatively large profit in a short time  
Typical speculative investments include:

- ▶ Antiques and collectibles
- ▶ Call and put options
- ▶ Derivatives
- ▶ Commodities
- ▶ Coins and stamps
- ▶ Precious metals and gemstones

# Asset allocation

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## ▶ **Asset Allocation**

- ▶ The process of placing your assets among several types of investments which lessens your investment risk

## ▶ **Time Factor**

- ▶ The longer that you are invested the better your opportunity for increasing returns

## ▶ **Your Age**

- ▶ The type and style of your investments should change with your age

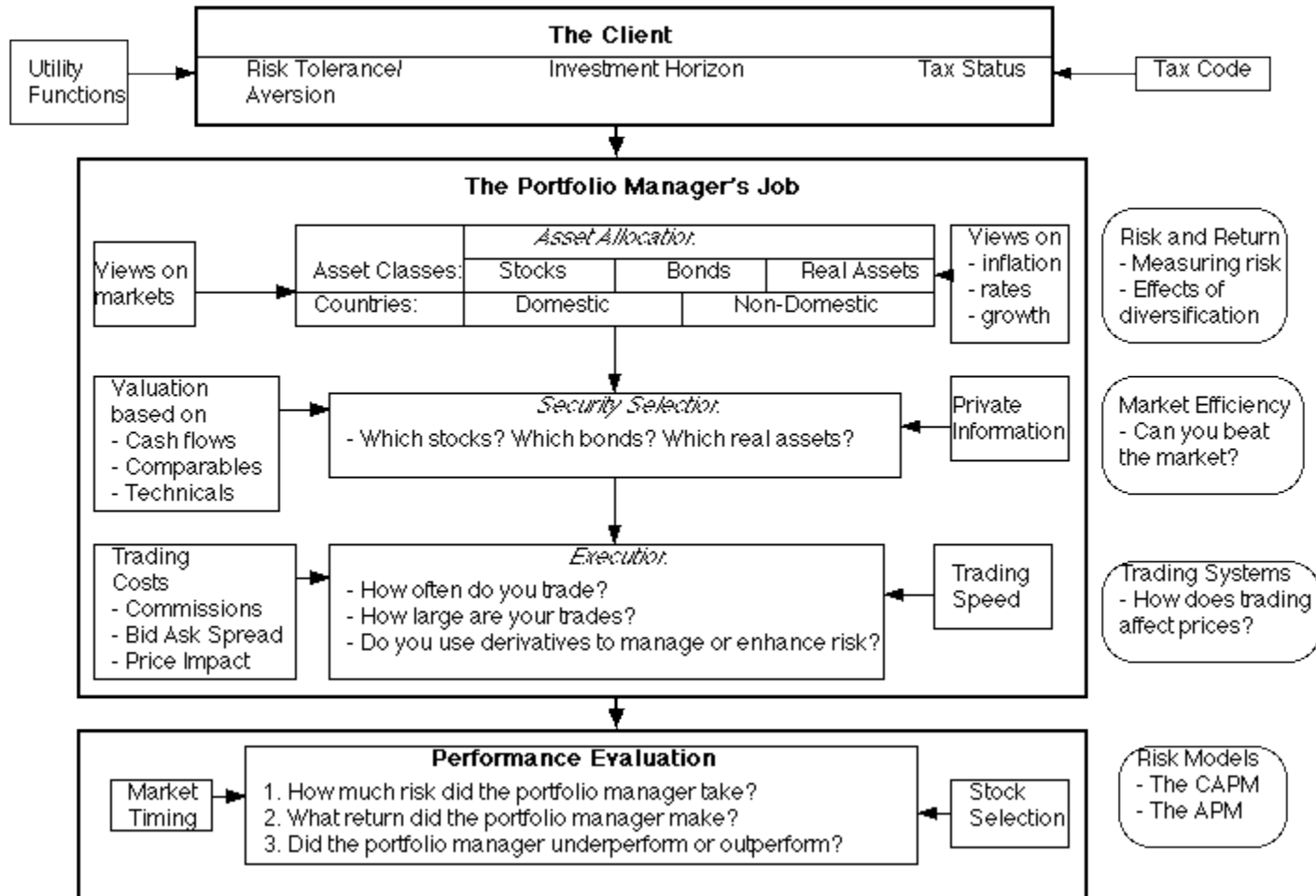
# A personal plan for investing

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1. Establish realistic goals
2. Determine the amount of money needed to meet your goals
3. Specify the amount of money available to fund your investments
4. List different investments you want to evaluate
5. Evaluate risk and potential return for each
6. Reduce possible investments to a reasonable number
7. Choose at least two different investments
8. Continue to evaluate your investment program

# Overall investment process

## The Investment Process



# Your role in the investment process

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- ▶ Evaluate potential investments
- ▶ Monitor the value of your investments
- ▶ Keep accurate and current records
- ▶ Seek the assistance of a financial planner
- ▶ Consider the tax consequences of selling your investments

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# Class Assignment V

## Establish your financial goals

# Establish your investment goals

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- ▶ This class assignment is an individual task, due on Mar 9, 2013 in class.
- ▶ You have to prepare one-paged summary (preferably in excel format) of your investment goals as detailed:
  - ▶ Description of your investment goals (at least two)
  - ▶ Specify either short-term or long-term
  - ▶ Your budget on investment to satisfy each investment goal (proportion to the total budget)
  - ▶ Evaluate level of risks (high/medium/low) and identify sources of risks
  - ▶ Describe some possible investments to achieve each goal

# Role play

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- ▶ Ask for 2 volunteers to demonstrate how to develop your investment process
- ▶ Each group representative will acts as a private wealth manager for the other group
  - ▶ To access investment goals
  - ▶ To access expected return and risk level
  - ▶ To develop a recommendation for investment plan based on their needs

# Tips for beginners

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- ▶ A reliable rule is that returns in excess of the return offered by the government can only be achieved by taking risks
- ▶ Risk is most obvious when an investment is volatile and least obvious when a risky investment has not yet shown any volatility. Be particularly questioning when an adviser recommends a low-volatility investment that offers superior returns.

## Tips for beginners (2)

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- ▶ Do not invest in something you do not understand simply because a group of your peers is doing so. A desire to conform can explain many decisions that we would otherwise not take.
- ▶ Whatever your adviser says, make sure that your investments are either in Treasury bonds, or else are well diversified.
- ▶ Just because an investment firm is regulated by the authorities, do not assume that the regulators have been able to check that everything is all right.

# Madoff Case Study Discussion

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- ▶ What was Madoff's scheme?
- ▶ How can Madoff's scheme be attractive to many investors?
- ▶ What went wrong with Madoff's scheme?
- ▶ Lesson learnt from this fraud

# Safe haven assets

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- ▶ Government bonds
- ▶ Commodities (e.g. gold)
- ▶ Which one is more preferred ?