

Managing Business Finances

chapter # 17

Introduction

- **In this chapter we**
 - examine the activities of the world’s financial markets.
 - describe how organizations seek funds that can be used to finance their endeavors and pay off their debts.
 - discuss how individual investors look to make their money “work” for them by profitably trading commodities, stocks, and bonds

learning objectives

1. **Explain** the concept of the time value of money and the principle of compound growth, and discuss the characteristics of common stock.
2. **Identify** reasons for investing and the investment opportunities offered by mutual funds and exchange-traded funds.
3. **Describe** the role of securities markets and identify the major stock exchanges and stock markets.

learning objectives

4. **Describe** the risk–return relationship and discuss the use of diversification and asset allocation for investments.
5. **Describe** the various ways that firms raise capital and identify the pros and cons of each method.
6. **Identify** the reasons a company might make an initial public offering of its stock, explain how stock value is determined, and discuss the significance of market capitalization.
7. **Explain** how securities markets are regulated.

The Time Value of Money and Compound Growth

- **Time Value Of Money**

- principle that invested money grows, over time, by earning interest or some other form of return

- **Compound Growth**

- compounding of interest over time—with each additional time period, interest returns accumulate

The Rule of 72

- You can find the number of years needed to double your money by dividing the annual interest rate (in percent) into 72.
- The Rule of 72 can also calculate how much interest you must get if you want to double your money in a given number of years: Simply divide 72 by the desired number of years.

Amount to Which an Initial \$10,000 Investment Grows

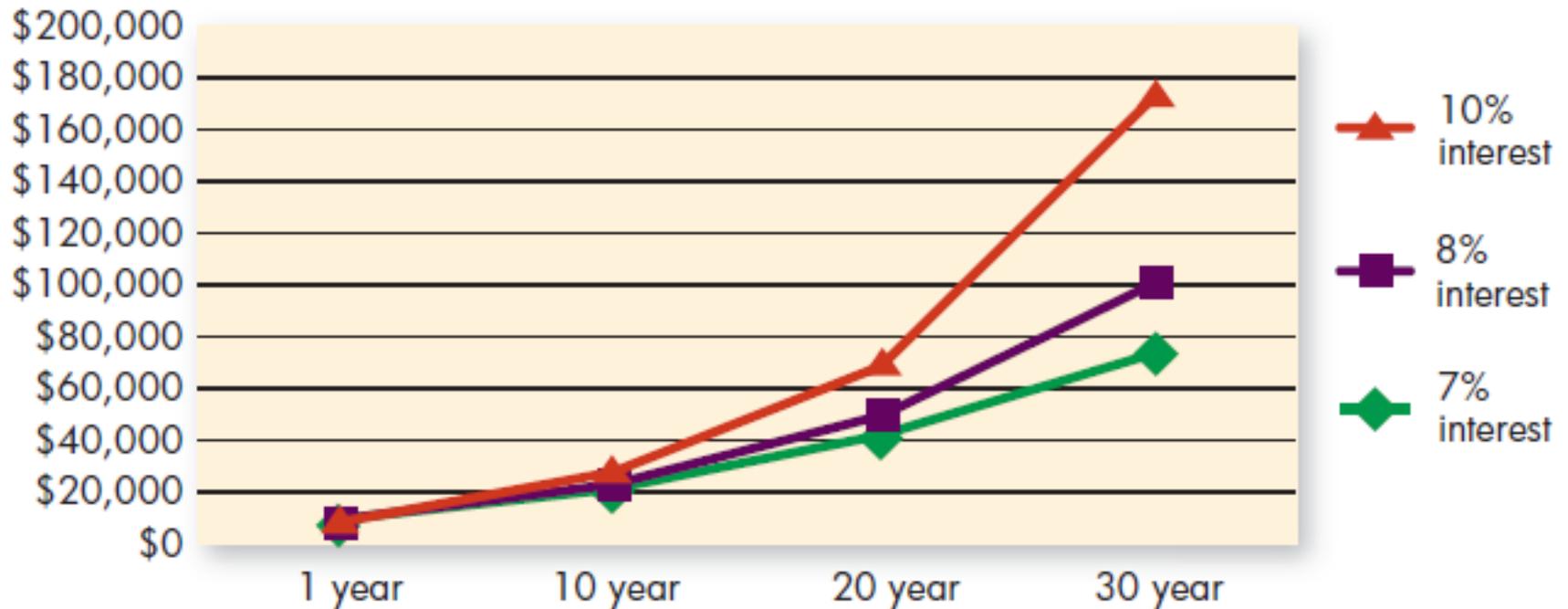


FIGURE 17.1 Amount to Which an Initial \$10,000 Investment Grows

Common Stock Investments

- **Stock**

- portion of ownership of a corporation

- **Common Stock**

- most basic form of ownership, including voting rights on major issues, in a company

Stock Values

- **Market Value**

- current price of a share of stock in the stock market

- **Book Value**

- value of a common stock expressed as the firm's owners' equity divided by the number of common shares

Dividends

- **Dividend**

- payment to shareholders, on a per-share basis, out of the company's earnings

- **Blue-Chip Stock**

- common stock issued by a well-established and respected company with a sound financial history and a stable pattern of dividend payouts

Investing to Fulfill Financial Objectives

- **Mutual Fund**

- company that pools cash investments from individuals and organizations to purchase a portfolio of stocks, bonds, and other securities
- No-load fund, load fund

Reasons for Investing

Stability and Safety

Conservative Capital Growth

Aggressive Growth

Exchange-Traded Funds

- **Exchange-Traded Fund (ETF)**
 - bundle of stocks or bonds that are in an index that tracks the overall movement of a market but, unlike a mutual fund, can be traded like a stock

Advantages of ETFs

- can be traded throughout the day like stocks
- have lower operating costs than mutual funds
- offer ease of entry for investors getting started without much money

The Business of Trading Securities

- **Securities**

- stocks, bonds, and mutual funds representing secured, or asset-based, claims by investors against issuers

- **Securities Markets**

- markets in which stocks and bonds are sold

The Business of Trading Securities *(cont.)*

- **Primary Securities Market**
 - market in which new stocks and bonds are bought and sold by firms and governments
- **Secondary Securities Market**
 - market in which existing (not new) stocks and bonds are sold to the public

The Business of Trading Securities *(cont.)*

- **Securities and Exchange Commission (SEC)**

- government agency that regulates U.S. securities markets

- **Investment Bank**

- financial institution that specializes in issuing and reselling new securities

Stock

- **Stock Exchange**
 - an organization of individuals to provide an institutional auction setting in which stocks can be bought and sold
- **National Association Of Securities Dealers Automated Quotation (NASDAQ) System**
 - world's oldest electronic stock market consisting of dealers who buy and sell securities over a network of electronic communications

Selected Global Stock Exchanges and Markets

table 17.1 Selected Global Stock Exchanges and Markets

Country/Region	Stock Exchange	Total Value of Trades, Year Ended 31 December 2011 (billions of U.S. dollars)
Australia	Australian Securities Exchange	1,197
Brazil	Sao Paulo (BM&F) Stock Exchange	931
Canada	Toronto Stock Exchange	1,542
China	Shanghai Stock Exchange	3,658
Hong Kong	Hong Kong Stock Exchange	1,447
Japan	Tokyo Stock Exchange	3,972
United Kingdom	London Stock Exchange	2,871
United States/Europe	NYSE/Euronext	20,161

Source: "List of Stock Exchanges," based on www.world-stock-exchanges.net/top10.html, accessed on June 4, 2013.

Non-Exchange Trading: Electronic Communication Networks

- **Electronic Communication Network (ECN)**
 - electronic trading system that brings buyers and sellers together outside traditional stock exchanges

Individual Investor Trading

- **Stock Broker**

- individual or organization that receives and executes buy and sell orders on behalf of outside customers in return for commissions

- **Book-Entry Ownership**

- procedure that holds investors' shares in book-entry form, rather than issuing a physical paper certificate of ownership

Individual Investor Trading

- **Market Index**

- statistical indicator designed to measure the performance of a large group of stocks or track the price changes of a stock market

Tracking the Market Using Stock Indexes

- **Bull Market**

- period of rising stock prices, lasting 12 months or longer, featuring investor confidence for future gains and motivation to buy

- **Bear Market**

- period of falling stock prices marked by negative investor sentiments with motivation to sell ahead of anticipated losses

Bull and Bear Markets

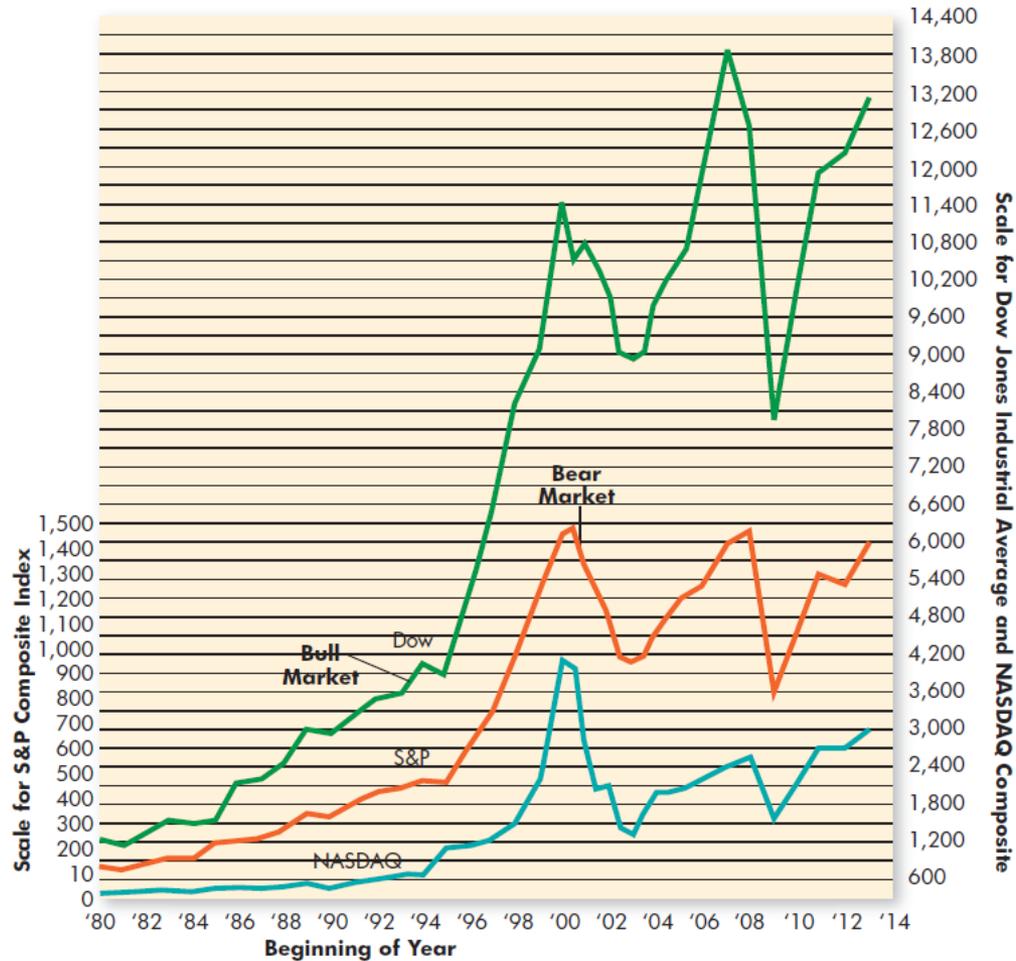


FIGURE 17.2 Bull and Bear Markets

Tracking the Market Using Stock Indexes

- **Dow Jones Industrial Average (DJIA)**
 - oldest and most widely cited market index based on the prices of 30 blue-chip, large-cap industrial firms on the NYSE
- **S&P 500**
 - market index of U.S. equities based on the performance of 500 large-cap stocks representing various sectors of the overall equities market

Tracking the Market Using Stock Indexes (cont.)

- **Nasdaq Composite Index**
 - market index that includes all NASDAQ-listed companies, both domestic and foreign, with a high proportion of technology companies and small-cap stocks
- **Russell 2000 Index**
 - specialty index that uses 2,000 stocks to measure the performance of the smallest U.S. companies

The Risk–Return Relationship

- **Risk-Return (Risk-Reward) Relationship**
 - principle that safer investments tend to offer lower returns, whereas riskier investments tend to offer higher returns (rewards)

Potential Financial Returns Rise with Riskier Investments

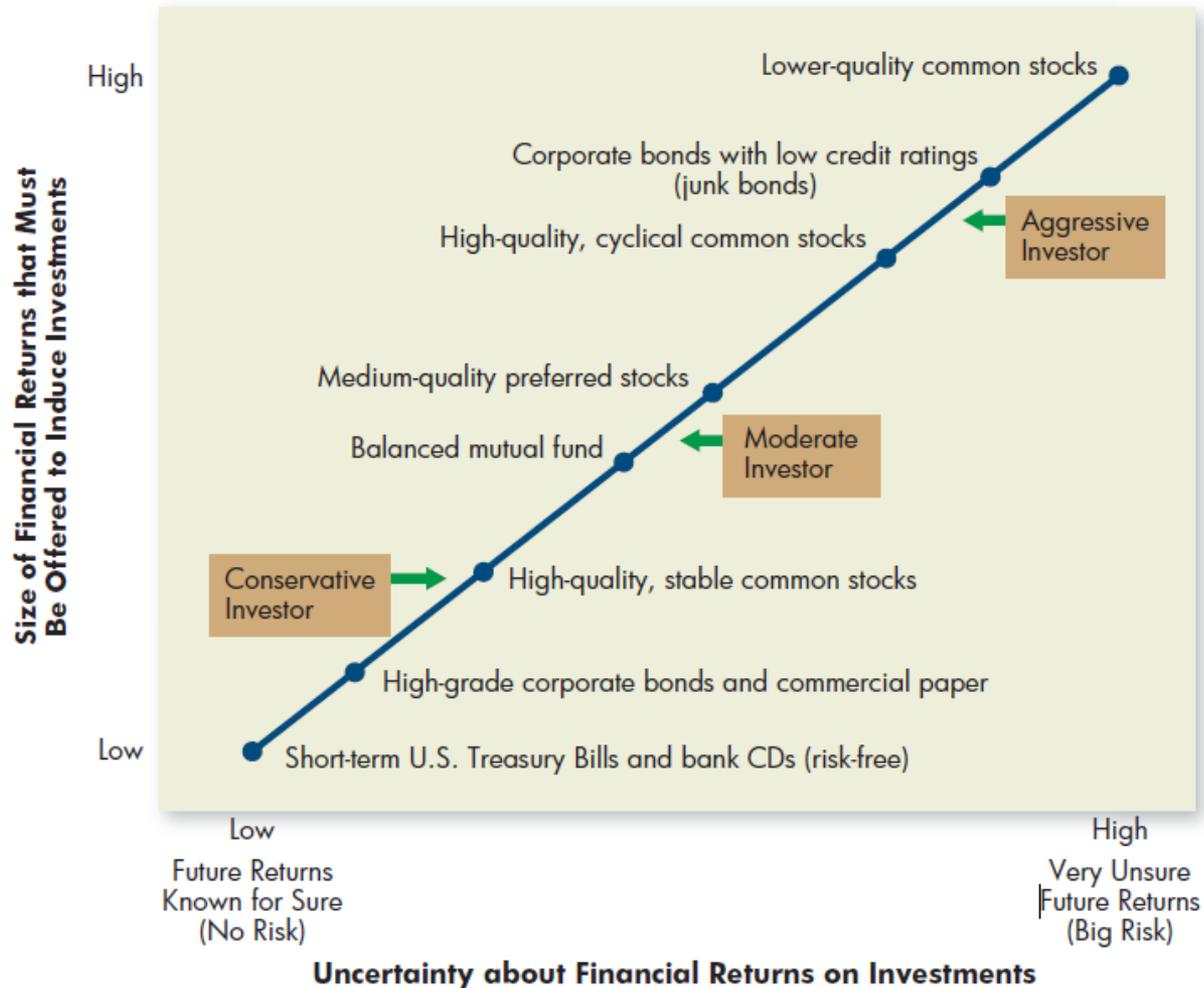


FIGURE 17.3 Potential Financial Returns Rise with Riskier Investments.

Investment Dividends (or Interest), Appreciation, and Total Return

- **Current/Interest Dividend Yield**
 - yearly dollar amount of income divided by the investment's current market value, expressed as a percentage
- **Price Appreciation**
 - increase in the dollar value of an investment at two points in time (the amount by which the price of a security increases)

Investment Dividends (or Interest), Appreciation, and Total Return (cont.)

- **Capital Gain**

- profit realized from the increased value of an investment

- **Total Return**

- the sum of an investment's current dividend (interest) yield and capital gain

Managing Risk with Diversification and Asset Allocation

- **Diversification**
 - purchase of several different kinds of investments rather than just one
- **Asset Allocation**
 - relative amount of funds invested in (or allocated to) each of several investment alternatives
- **Portfolio**
 - combined holdings of all the financial investments of any company or individual

Financing the Business Firm

- **Secured Loan (Asset-Backed Loan)**
 - loan to finance an asset, backed by the borrower pledging the asset as collateral to the lender
- **Collateral**
 - asset pledged for the fulfillment of repaying a loan

Financing the Business Firm (cont.)

- **Loan Principal**

- amount of money that is loaned and must be repaid

- **Unsecured Loan**

- loan for which collateral is not required

Angel Investors and Venture Capital

- **Angel Investors**

- outside investors who provide new capital for firms in return for a share of equity ownership

- **Venture Capital**

- private funds from wealthy individuals seeking investment opportunities in new growth companies

Sale of Corporate Bonds

- **Corporate Bond**

- formal pledge obligating the issuer (the company) to pay interest periodically and repay the principal at maturity

- **Bond Indenture**

- legal document containing complete details of a bond issue

- **Maturity Date (Due Date)**

- future date when repayment of a bond is due from the bond issuer (borrower)

Sale of Corporate Bonds (cont.)

- **Face Value (Par Value)**
 - amount of money that the bond buyer (lender) lent the issuer and that the lender will receive on repayment
- **Default**
 - failure of a borrower to make payment when due to a lender
- **Bondholders' Claim**
 - request for court enforcement of a bond's terms of payment

Sale of Corporate Bonds (cont.)

- **Mortgage-Backed Security (MBS)**
 - mortgages pooled together to form a debt obligation—a bond—that entitles the holder (investor) to cash that flows in from the bundled mortgages
- **Bankruptcy**
 - court-granted permission for a company to not pay some or all debts

Bond Rating Systems

table 17.2 Bond Rating Systems

Rating System	High Grades	Medium Grades (Investment Grades)	Speculative	Poor Grades
Moody's	Aaa, Aa	A, Baa	Ba, B	Caa to C
Standard & Poor's	AAA, AA	A, BBB	BB, B	CCC to D

Becoming a Public Corporation

- **Initial Public Offering (IPO)**
 - First sale of a company's stock to the general public
- **Corporate Raider**
 - investor conducting a type of hostile corporate takeover against the wishes of the company

Stock Valuation

- **Stock Split**

- stock dividend paid in additional shares to shareholders, thus increasing the number of outstanding shares

Financial Comparison: Coca-Cola and PepsiCo

table 17.3 Financial Comparison:
Coca-Cola and PepsiCo

	Coca-Cola	PepsiCo
Recent price	\$40.74	\$81.04
EPS	\$1.91	\$3.90
Dividend yield	2.75%	2.80%

*Source: Yahoo!Finance, June 5, 2013 at <http://finance.yahoo.com/q?s=PEP&q1=1>;
Yahoo!Finance, June 5, 2013 at <http://finance.yahoo.com/q?s=KO&q1=0>.*

Market Capitalization

- **Market Capitalization (Market Cap)**
 - total dollar value of all the company's outstanding shares
- **Debt Financing**
 - long-term borrowing from sources outside a company
- **Equity Financing**
 - using the owners' funds from inside the company as the source for long-term funding

Corporation Sizes Based on Capitalization

table 17.4 Corporation Sizes Based on Capitalization

Capitalization Category	Range of Capitalization
Micro-Cap	below \$250 million
Small-Cap	\$250 million–\$2 billion
Mid-Cap	\$2 billion–\$10 billion
Large-Cap	over \$10 billion

Regulating Securities Markets

- **Prospectus**

- registration statement filed with the SEC, containing information for prospective investors about a security to be offered and the issuing company

- **Insider Trading**

- illegal practice of using special knowledge about a firm for profit or gain

Applying What You've Learned

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Applying What You've Learned (cont.)

- 4. Describe** the risk–return relationship and discuss the use of diversification and asset allocation for investments.
- 5. Describe** the various ways that firms raise capital and identify the pros and cons of each method.
- 6. Identify** the reasons a company might make an initial public offering of its stock, explain how stock value is determined, and discuss the significance of market capitalization.
- 7. Explain** how securities markets are regulated.



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