Course Learning Outcomes for Unit I

Upon completion of this unit, students should be able to:

1. Explain foundational finance theories.
   1.1 Explain the structure and five basic financial principles applicable to financial markets.
   1.2 Differentiate between basic organizational forms.
   1.3 Distinguish between stakeholder and shareholder goals.

Reading Assignment

Chapter 1:
Getting Started - Principles of Finance

Chapter 2:
Firms and the Financial Market

Unit Lesson

Students often ask why finance is an important topic to study. Finance is a foundational topic because many routine decisions depend on a basic understanding of it. Consider the case of Geoffrey Lewis. Lewis faces what seems like a simple decision.

Geoffrey Lewis just finished college and started a job with a major company. Lewis's father gave him a large sum of money as a graduation gift, which Lewis wants to invest for the future. Lewis also has considered starting a small business on the side and hiring a friend to manage it for him. Lewis remembers his father also preaching to him about investing money wisely so when he would need money, he would have it without having to borrow.

Besides starting a business on the side, Lewis has considered investing his money in the market. Although Lewis graduated college, he has never studied finance. Lewis wants to understand some of the main ideas involved, so he will invest his money wisely. Because he never studied finance, Lewis has considered hiring an investment adviser to help him with his decisions.

Considering his choices, Lewis is torn between starting a business and hiring an investment adviser. Lewis is skeptical about hiring someone he does not know. To complicate matters, Lewis heard the market has reacted with great volatility to the government's actions to recover from a recession. Lewis wonders about what risk he will have if he decides to invest in the market.

Because of his unfamiliarity with business, Lewis has enrolled in night classes at a local community college to learn more about finance and investing. By day, Lewis's professor works for a major financial services firm, which is close to where he lives. Lewis's professor encouraged him not to fear investing in the market. The professor explained to Lewis that the firms' main goal is to make money for its shareholders.

As an alternative, Lewis has considered investing in his firm's 401K, which he qualifies for after his first 30-day probation period with his new employer. Lewis's employer gave him a plan summary and brochure showing some alternatives available for him to invest in. After looking at a plan summary, Lewis had difficulty understanding all investment alternatives available and any risks involved in selecting different choices. Lewis's company also offers stock he can buy at a discount. Lewis's employer advises employees to seek help about selecting different plans with different investment objectives but explained it cannot offer any investment advice. The only alternative his boss suggested is to take advantage of the company's stock purchase plan.

Considering these alternatives, Lewis has 30 days to decide what he wants to do because his benefits will begin then. Lewis has considered asking his dad for advice but wants to show him he has learned how to invest wisely. Lewis can start a side business, invest the money independently, or add the money to his 401K. Another alternative is to do some combination of these strategies. For example, Lewis can put some seed money into a start-up company and put the rest in investments either on his own or in his 401K from work. Lewis will have to pay a penalty for any early withdrawals from his 401K, but if he invests independently, then he will have to pay tax on his income. The 401K contributions Lewis can make from his earnings are from pretax income.

Another question Lewis must ponder is what happens if he starts a side business and it needs more money later. Lewis cannot rely on his 401K money because withdrawals before retirement result in stiff tax penalties. Lewis can use money he invests on his own, but he might have to take losses on what he invests in doing so. As an alternative, Lewis can consider borrowing from a local bank but will incur significant interest payments if he does. The company will also have to repay the principal of the loan, which may strain its cash flow.

Besides possibly needing more cash later, Lewis needs to consider any dilution of his ownership interest in a side business. Lewis has to consider how to organize a side business to best suit both company and his personal needs. Lewis will have to decide on an organizational form that will fit with long-term goals and plans.

Although starting a side business has drawbacks, it might diversify Lewis's risk. Diversification benefits an investment portfolio because of variations in risk between investments mitigate certain types of risk. Lewis has to weigh the benefits and risks involved by starting a side business. For example, depending on how Lewis organizes the business, he can expose himself to more risk than his original investment or only to the risk of what he puts into the business.

Lewis should also consider if the money he invests is worth considering alternative investments. A dollar today is worth more than a dollar at some time in the future because of inflation or its erosion in the future. Money held today also has the ability to earn a return at some future time. Timing of investments and when they produce returns is critical. Lewis should also consider the highest and best use of money invested.

Besides timing of investments, Lewis should consider how cash flows will affect the value of the side business should he want to sell it in the future. Timing of cash flows are important because they affect value. Similarly, Lewis has to consider the value of securities he will invest in to decide if these investments are worth the price he can buy them at and how they compare with alternative investments.

Aside from deciding the value of securities, Lewis has to consider what he pays for securities he invests in to decide what the price says about the investment. For example, the market can anticipate information about a company's securities and cause prices to rise or fall because of it. Investors might expect prices to rise in a pharmaceutical company because it discovers a new drug or treatment. Investors want to get in early because knowing about a discovery early results in potentially higher returns the earlier an investor can buy such a security. Similarly, a lawsuit can signal a decline in security prices.

A related issue arises, when insiders in a company have certain information first because it may give them an advantage over outsiders. Lewis should consider how much time it will take to evaluate information so he can invest wisely. Information and timing make a difference.

To complicate matters further, Lewis should consider that managers inside a company work for shareholders, but they sometimes act in their own self-interest first. As a security holder, Lewis may not have much control over managers who act in their own best interest. Likely, Lewis would not even have an awareness of such a problem until after it happens. According to agency theory, shareholders hire directors who hire management to run a business, but often shareholders' interests are not put first. As a shareholder with no management influence, Lewis will lose control unless he owns a significant share of a company in which he invests. Companies often try to find ways to align managers' interests with those of shareholders, but Lewis should understand he may have little ability on his own to control agency issues.

In summary, what seemingly started as a simple decision has become overwhelmingly complex. Lewis has a major decision to consider, one on which his future depends. A solid understanding of core financial principles will help Lewis gather what he needs to decide his future. Consider that most lottery winners end up broke because they only pondered short-term decisions without a long-term strategy. A person, like an army, should not enter a battle without a strategy.

Suggested Reading

In order to access the resources below, you must first log into the myCSU Student Portal and access the ABI/Inform database within the CSU Online Library.

These articles will provide further insight into stocks, trading, and market forces.

Baim, D. V., Goukasian, L., & Misch, M. B. (2015). Olympic sponsorships, stock prices, and trading activity. *International Journal of Sport Finance, 10*(2), 175-195.

Hu, M. (2014). The efficient market hypothesis and corporate event waves: Part II. *Corporate Finance Review, 18*(6), 20-26.