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Chapter 01 - The Investment Environment

## CHAPTER 1: THE INVESTMENT ENVIRONMENT

### PROBLEM SETS

1. Ultimately, it is true that real assets determine the material well-being of an economy. Nevertheless, individuals can benefit when financial engineering creates new products that allow them to manage their portfolios of financial assets more efficiently. Because bundling and unbundling creates financial products with new properties and sensitivities to various sources of risk, it allows investors to hedge particular sources of risk more efficiently.
2. Securitization requires access to a large number of potential investors. To attract these investors, the capital market needs:
  - (1) a safe system of business laws and low probability of confiscatory taxation/regulation;
  - (2) a well-developed investment banking industry;
  - (3) a well-developed system of brokerage and financial transactions; and,
  - (4) well-developed media, particularly financial reporting.These characteristics are found in (indeed make for) a well-developed financial market.
3. Securitization leads to disintermediation; that is, securitization provides a means for market participants to bypass intermediaries. For example, mortgage-backed securities channel funds to the housing market without requiring that banks or thrift institutions make loans from their own portfolios. As securitization progresses, financial intermediaries must increase other activities such as providing short-term liquidity to consumers and small business, and financial services.
4. Financial assets make it easy for large firms to raise the capital needed to finance their investments in real assets. If General Motors, for example, could not issue stocks or bonds to the general public, it would have a far more difficult time raising capital. Contraction of the supply of financial assets would make financing more difficult, thereby increasing the cost of capital. A higher cost of capital results in less investment and lower real growth.

