

INVESTMENT PRINCIPLES

Second Edition

TIMOTHY E. JOHNSON

Professor of Finance, University of Cincinnati To my wife, Janet and our children, Paul, Sarah, Susan, and Linnea

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Preface

The study of investments is of growing importance to every individual, for almost all Americans are investing in the securities market either directly or indirectly. This text is for the person who wants to understand what investing is all about. The material begins at a basic level and works toward a comprehensive description of how the securities markets work and how an investor can approach the markets systematically and prudently in order to achieve his or her investment goals.

In recent years, the field of investments has seen a variety of new approaches and philosophies. While these new approaches have aroused considerable debate among the members of the investment community, and have added a much needed quantitative aspect to investment management, some are nevertheless too hypothetical and unrealistic to be of much aid to a sound investment management program. Those of us who are actively involved in both the academic and the investment management professions know perfectly well that investing still remains primarily an art and not a science and cannot be reduced totally to a buy, hold, sell, statistical equation, or technical chart pattern. The strong fixation for quantitative approaches to security analysis and portfolio management has left a gap in the coverage of more traditional investment principles. The purpose of this book is to fill the gap created by the swing toward highly quantitative texts for the intro-

ductory investments course. This book will ground students in basic investment principles through a proper integration of practical descriptive material and relevant theoretical applications. Thus prepared, the student will be able to move to more advanced courses in security analysis and portfolio management.

This second edition has revised a large amount of the text by updating the material to relate the principles of investing to all the changes that have taken place in the field over the past five years. A large part of the book has been reorganized to improve the flow of the material covered. The redundancy among several chapters has been consolidated and a more workable relationship between security descriptions and security analysis has resulted.

Investment Principles, second edition, retains the widely accepted level of presentation of the first edition with emphasis on the descriptive approach to the sound understanding of investment principles. A new chapter on Traditional Portfolio Management has been included so as to give a more realistic balance to the chapter on Modern Portfolio Management. The entire text is updated to include the significant changes included in the Economic Recovery Act of 1981. Also, the impact of inflation is dealt with where appropriate.

The second edition has been reorganized into a more workable sequence. It begins with an introduction to the investment environment with steps involved in the analytical process. A description of the securities industry follows, leading up to a discussion of both traditional and modern portfolio theory.

Chapter One introduces the student to the topics that he or she will be confronting in the study of investments. Chapter Two covers investing from the perspective of the individual and includes the calculations necessary for a proper understanding of various investments. Although many students may have been exposed to these mathematical concepts in previous studies, a review is usually helpful.

Chapters Three and Five describe fixed and variable return securities with Chapters Four and Six outlining the process by which these securities are analyzed. Some students may have encountered part of the security description before, but it is unlikely that the exposure has been as comprehensive and accompanied by the analysis of securities.

Chapter Seven is an introduction to more speculative investment opportunities in options, warrants, rights, and the commodity market. The investor will have to decide whether to participate in these vehicles in his or her investment planning, so he or she should be aware of the nature of these investment media and their advantages and disadvantages. Although most of these items can be considered speculative, the more conservative side of options and an analytical section on convertibles is also included.

Chapters Eight and Nine describe the securities markets and how they

function as well as the mechanics of the brokerage business and the execution of a security order.

Chapter Ten is devoted to a discussion of investment companies. Many investors, after dealing with securities markets, recognize that they do not have the time or talent or proper emotions to manage their own investment portfolios. This chapter should help them to choose investment companies in accordance with their long-term goals, desired diversification, and professional management needs.

Chapter Eleven discusses the regulatory bodies which oversee the securities industry. These topics, which are a necessary foundation for the analysis of investments, are generally of great interest to students.

Chapter Twelve provides an overview of the analysis of the economy and industries. Sources of information for this analysis is provided along with the general approach to an understanding of these areas. Chapter Thirteen moves to the technical approach, by which technicians use analysis of security prices and other market data as primary indicators for investment decisions.

Chapters Fourteen and Fifteen provide an overview for the investor in both the traditional and modern approaches to portfolio management. The investor who understands the securities markets and has a reasonable grasp on the analysis of the economy, industries, and securities, may nevertheless find difficulty in creating an appropriate portfolio to meet his or her overall goals. These chapters complete the investment process by showing investors how to properly construct and manage the overall portfolio.

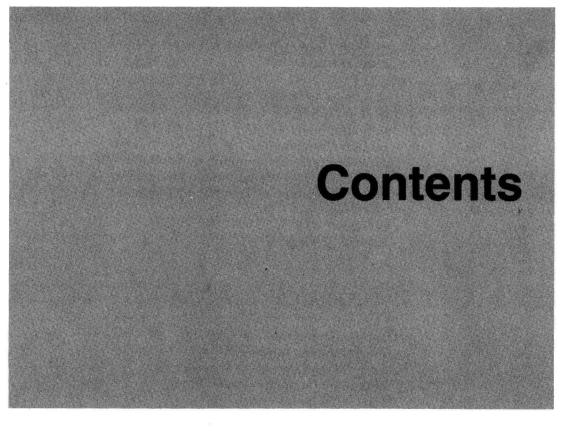
Although the majority of the text is devoted to security investing, Chapter Sixteen, dealing with real estate investment, has been included since this is one of the most common forms of investment that may confront the individual.

Chapter Seventeen covers the important aspects of taxation and estate planning, which are of growing concern to individual investors as they reach higher tax brackets and as they attempt to plan their estates so as to properly provide the necessary assets for their families. The importance of determining the best possible means of passing the estate after death with the least tax impact is covered. Many investors have spent a considerable amount of time investing and building their assets without the proper consideration of the tax and estate implications. The text emphasizes the need for the individual to integrate his total financial planning with the investment decision process.

I am indeed grateful to a large number of people who have helped make this text possible, both from the academic community and the professional investment community. An enormous amount of assistance was provided by the wide range of reviewers who made significant contributions in their critique of the manuscript: Professor Gary G. Schlarbaum (Purdue University), Professor Richard W. McEnally (University of North Carolina), Professor H. Russell Fogler (University of Florida), Professor Glenn A. Wilt, Jr. (Arizona State University), Professor J. Ronald Hoffmeister (University of Missouri), Professor Edward A. Dyl (University of Wyoming), Professor Michael F. Dunn (California State University), Professor Donald A. Nast (Florida State University), Professor Edwin Grossnickle (Western Michigan University), Professor David E. Risch (Florissant Valley Community College), Professor Peter Goulet (University of Northern Iowa), Professor Joe Grissom (Tarrant County Junior College), Professor Ronald Charvonia (Glendale Community College), Professor Thomas J. McKenna (Fresno City College), and Professor Gary Cain (St. Mary's College). It would be impossible to give thanks here to the many individuals within the investment community and others who were of great help; however, special thanks goes to James Roetenberger, Robert Knecht, Greg Ambro, Geoffrey Strauss, Dixie Mills, Mona Gardner, Lew Melnyk, and Al Simone.

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Timothy E. Johnson Cincinnati, Ohio



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The Investment Environment

Investments can be a fascinating and stimulating field of study for those who are interested in gaining knowledge and expertise in investment decision making. The same basic investment principles and procedures apply to both the individual and institutional investor. The study of investments prepares individuals to operate in the securities markets either on their own behalf or on behalf of an institution employing their services. Institutions invest funds on behalf of other investors through pension funds, mutual funds, trust departments of banks, insurance companies, or other indirect investing by the individual. The majority of the emphasis and examples in this text will be from the viewpoint of the individual investor operating in the securities market, although for most investment principles no distinction is necessary.

The study of investments presupposes specific objectives. If we assume that the individual is rational and has an aversion to risk, we can assume that this person starts putting together an investment portfolio only after he or she has established the essential elements of a personal financial plan, for example, cash reserves and a life insurance program. The desire to participate in any investment program presupposes that a person wants to accumulate assets and expand net worth. However, the financial goals of an

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investment program differ widely among individual investors, depending upon the investors' financial needs and, to a significant extent, on social, family, and moral views on the use of money. For example, some investors participate in investment programs to accumulate money for the sake of accumulation and have no special need or goal. They derive satisfaction from the experience of successful investing. Some view investment as a means of providing a fund for their children's college education, supplementing retirement income, or fulfilling other financially related needs. Others view investment as a means of increasing their net worth in order to be able to provide increasing sources of funds for future family members, for religious organizations that need expanding funds to better serve their objectives, and for community-related organizations and programs that need private funding. Whatever the goal of the investor, the purpose of the study of investments is to equip the individual for making intelligent investment decisions.

Successful investing can be a difficult task even for professionals. Although this text presents the objective evidence of the data and the principles necessary for the correct approach to successful investing, there can be no assurance of an easy road to successful investing. Nevertheless, a prudent and informed approach to investment should allow realistic and objective investors to achieve their goals.

The study of investments is of growing importance to every individual. Almost all American workers are investing in the securities market either directly or indirectly. If an individual participates in a company pension program, purchases a life insurance policy, or deposits money in a bank or savings and loan institution, he or she is participating in the securities market. All these financial institutions are continually dealing in the securities market. When they invest the funds made available to them, they try to receive a reasonable rate of return in relation to the expected risk level assumed.

This text is for the individual who wants to understand what investing is all about. The material works toward a general understanding of how the securities markets work and how an investor might approach them systematically and prudently to achieve personal goals. The basic question facing every investor is which securities to buy. The answer depends upon many factors. Successful security investing requires careful study of the economic forces bearing upon each investment decision, the industry being investigated, and the company and security involved in the analysis. Any successful investment strategy must begin with the individual. One must be able to evaluate personal financial circumstances objectively and determine how they relate to a total financial plan lasting throughout a lifetime.

This text outlines the investment principles that are the bases of any investment program followed by a conservative and prudent investor. Unfortunately, many individuals who participate in the securities markets have very little understanding or knowledge of what they are doing, and the risks

they assume result more from a gambling instinct than a prudent approach to long term investing. Many small investors have not accepted the responsibility of accumulating good basic securities. Instead, they have engaged in the most hazardous, unorthodox ventures imaginable in an attempt to gain wealth quickly. They fail to realize that investing and building a solid, well-diversified portfolio is a gradual process. Only after the basic foundation has been prepared should investors begin to accept higher levels of risk.

A major point of this text is to expose the reader to the large number of available investments in which one can participate. Some of these tend to be very speculative (see Chapter 7 in which options and the futures markets are discussed). The investor must have a working knowledge of many of the alternatives so as to be able to recognize and analyze them whenever one confronts them.

INVESTMENT, SPECULATION, AND GAMBLING

It is important to distinguish among investment, speculation, and gambling because they have a tendency to overlap. Many investors think that they are investing, when actually they are either speculating or gambling. An investment involves some positive rate of return that can be reasonably expected after sufficient analysis has been made. Speculation involves a higher level of risk and a more uncertain expectation of returns. In many cases, it is difficult to distinguish between an investment and a speculation. The distinction revolves around the investor's ability to determine the future probability of a return and the ability to make a thorough analysis of the situation. In addition, the length of time the investor plans to hold a security often determines whether it is an investment or a speculation. The same stock can be purchased as an investment or as a speculation, depending upon the purchaser's motivation. For example, an investor may attempt to make a short-term gain on a high-quality stock that other investors have been holding for many years for a combination of appreciation and dividend yield. Traditionally, investment involves a known degree of risk, which dictates that the principal and future income values be relatively certain. Speculation involves taking higher risks with a lesser degree of certainty and safety.

A difficulty with the distinction is that the degree of uncertainty must be measured differently for different types of investments. On one hand, for many corporate bonds and real estate mortgages, the probability of receiving the future stream of income payments and the principal at maturity may be appraised accurately and an appropriate yield may be received that will adequately reward the investor for the risk assumed. On the other hand, variable securities can recover only principal in the marketplace; any income is a distribution of potential profit at the discretion of management. It is,