Lecture 2. The Investment Environment

What is Investment Environment?

When investors take a decision to invest in either stocks or bonds or attempt to make an investment in a portfolio of assets in any market or across markets (i.e. international investing), they make such decisions in an investment environment where higher (lower) returns are associated with higher (lower) risk.

The term "Investment Environment" essentially includes all types of investment opportunities (i.e. varied financial and real assets), investment vehicles or alternatives in the market that are available to an investor, financial markets, investment process, market structure that enables purchasing and selling of investments, regulatory set up that fosters an enabling environment to invest, and market intermediaries.

Investment environment relates to developments in the domestic and international economy, which have an impact (positive or negative) on asset (financial and real) prices or values of asset classes and related risk.

Elements (7) of Investment Environment

There are seven elements of the investment environment that one should be aware of:

Assets and investment vehicles: an investor usually has a plethora of existing types of assets to choose from – which include stocks, corporate bonds, government bonds (for example, US Treasury Bills – usually very safe in terms of default risk), municipal bonds, money market instruments (which are short-term, highly marketable and usually very low risk) derivatives, currencies, real estate and commodities. Further, an investor can choose among varied investment vehicles – mutual funds, hedge funds and Exchange Traded Funds (ETF's) among others.

Financial markets: it is a market where buyers and sellers of assets (such as stocks, bonds, currencies and derivatives) trade with each other. A notable feature of such markets is that it is market forces that determine the prices of asset classes. Typically, financial markets are characterized by transparent pricing and certain regulations with reference to trading, costs and fees, and represent a vast array of financial products. Financial markets include stock markets (primary and secondary markets), bond markets, money markets, cash or spot markets, derivatives markets (options, futures, swap agreements etc.), foreign exchange and interbank markets, and over the counter (OTC) markets.

Market structure: the same refers to the structure of the financial markets, which include the equity, debt, foreign exchange, mortgage and the derivatives markets. The most widely followed market in the US is the stock market and from the point of view of economic activity, the debt market is very important as investors and borrowers in this market play a pivotal role in determining interest rates.

Market intermediaries: the same include insurance and pensions companies, investment banks, commercial banks (banks participate in the money and capital markets), primary dealers, brokers, financial advisors and stock exchanges among others.

Investment process: the same essentially outlines the steps required in creating an investment portfolio based on determining an investor's investment objectives and risk profile, asset allocation policy i.e. how an investor's investments are diversified among varied asset classes, which has a major influence on the overall performance of a portfolio, implementing an investment strategy and rebalancing of portfolio (that is consistent with an investor's chosen or desired asset allocation strategy).

Regulation: of securities markets is a very important element of the investment environment. Across countries such as the US, the UK and others, trading in the financial markets is regulated through a plethora of laws, to ensure that investors and traders have adequate information to take well-informed investment-related decisions and to prevent fraudulent activities. For example, in the US, there are two government bodies for general regulatory oversight of financial markets – Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission. In addition, exchanges have their own regulatory groups. Regulation of stock and corporate bond markets are the most prominent examples of financial market regulation.

Economy: developments in the domestic economy and the global economy relating to GDP, inflation, interest rates, fiscal deficit and monetary policy have a major impact on the prices of assets and related volatility (prices of financial assets, particularly stock prices are often very volatile). Further, asset allocation is the most important decision in the realm of asset management and contributes significantly to the performance of portfolios. Moreover, asset allocation and related investment decisions are critically based on analyzing both the global and domestic economy, and constructing various forward looking macroeconomic scenarios.

Consequently, for asset allocation, macroeconomic analysis, incorporating both domestic and international economy assessment, is critical.

What are the features of investment environment?

- Safety of principal. Safety of funds invested is one of the essential ingredients of a good investment programme
- Liquidity and Collateral value
- Stable income
- Capital growth
- Tax implications
- Stability of Purchasing Power
- Legality

What are the investment environment objectives?

Safety, income, and capital gains are the big three objectives of investing.