

Topics in Financial Economics: Lecture 1

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The Objectives

- Theories and facts of finance

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- understanding of financial activities of corporations

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- understanding of financial activities of corporations
- understanding of how finance side affects macroeconomic performance

My Hope and the Structure of the Module

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 - Big change from the previous exams. Go to all the lectures and classes please.

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- Ash Demirgiic-Kunt and Ross Levine, "Stock Market Development and Financial Intermediaries: Stylized Facts", THE WORLD BANK ECONOMIC

Asset Pricing: the basic

- Buy an asset today = benefit flow of tomorrow, the day after tomorrow, the day after that,...
- Discount future
 - Financial reasons
 - Psychological reasons
- $P = \sum_{t \geq 1} D_t \cdot B_t$: B_t the (expected) benefit arriving at date t ; D_t discount rate of B_t .
- What affects D_t ?
 - Micro factors: risk (volatility)
 - Macro factors: risk, current level of richness...
 - Q (10 cts): Will the discount rates of China be higher or lower than those of UK?

Asset Pricing: the basic Cont'

- For a simple case, $D_t = (\frac{1}{1+r})^t$ and $B_t = (1+g)^t B_0$, where r is the interest rate and B_0 is the current earning, $P_t = \frac{B_0(1+g)}{r-g}$. So the price/earning ratio is,

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 $g = 7\% \Rightarrow P/E = 21.4$; $P/E = 30 \Rightarrow g = 8.4\%$.
- There are asset bubbles, if P/E ratio is unjustifiable by r and g . (Date S&P 500 P/E; Shanghai Stock Exchange)

Capital Structure

- A typical Balance Sheet:

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- data: the trend of equity and debt values in the US.

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 - c. There are no corporate tax, nor taxes or transaction costs associated with security trading
 - d. There are perfect capital markets for borrowing and lending;
- Then, the total value of a firm is equal to the market value of the total cash flows generated by its assets and is not affected by its choice of capital structure, that is, the value is decided by the asset side only, while independent of the liability side.

The Proof of MM-1

- Suppose two firms have the same cash flow $\{X_t\}_{t \geq 1}$. Firm 1 - equity only, with the market value of S_1 ; Firm 2 leveraged, with equity worth S_2 and debt worth D_2 . To prove: $S_1 = S_2 + D_2$

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- If $S_1 > S_2 + D_2$: the investor with £1 of firm-1 shares sells the shares and invests the proceedings in firm 2: $\frac{S_2}{S_2 + D_2}$ of the pound in its shares; $\frac{D_2}{S_2 + D_2}$ in its debts. The net effect for any future date t is

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- The key of the proof: the individual investors can exactly "undo" any financial policy undertaken by the firm
- Irrelevance of dividend policy: suppose two firms have the same cash flow, but one firm delays dividend payment of today by depositing the cash and paying it tomorrow. The two firms are of the same value.

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- What does it not capture?
- Miller: Showing what *doesn't* matter can also show, by implication, what *does*.