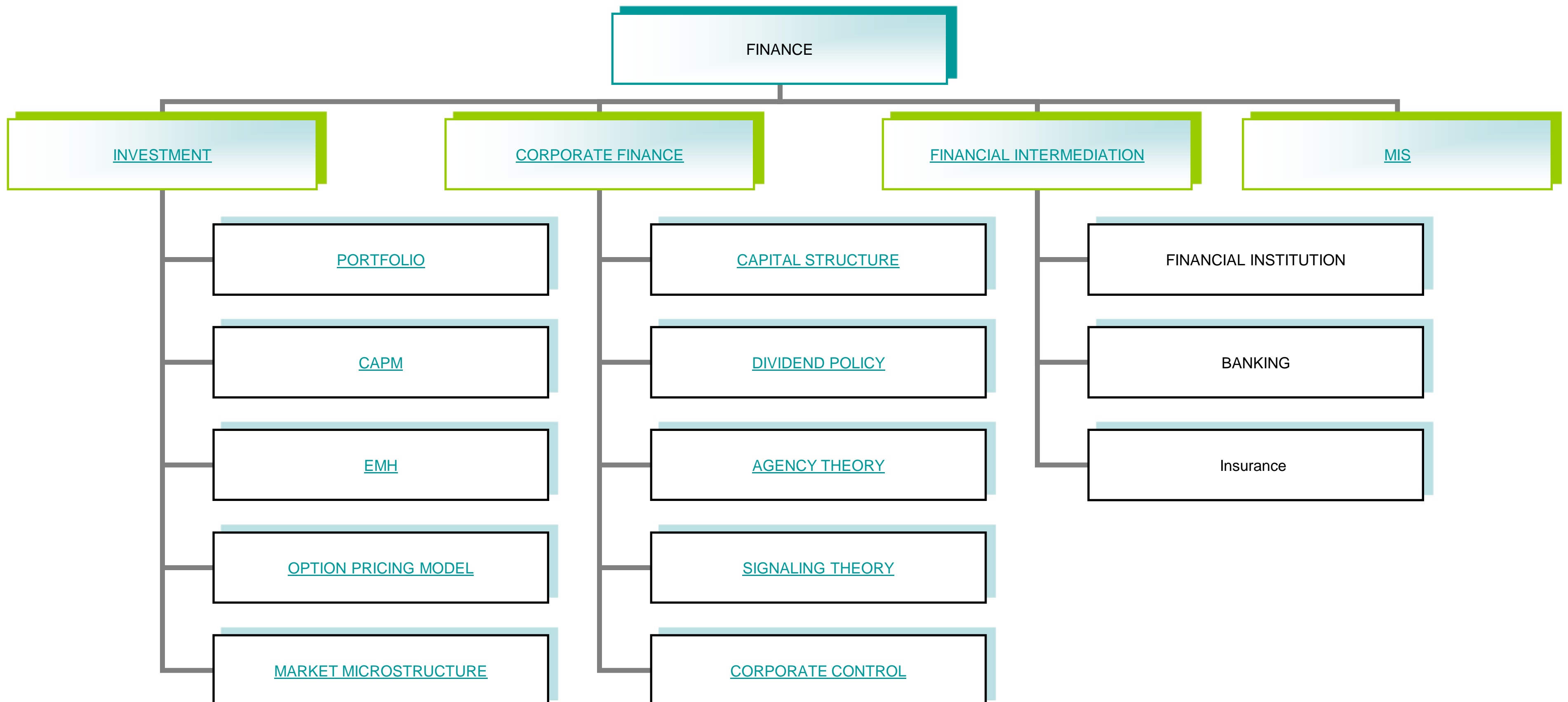
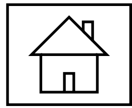
FINANCIAL MANAGEMENT

MODERN FINANCE THEORY (Modified from Megginson, 1997)

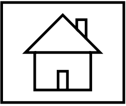




Saving and Investment

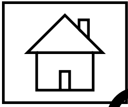
- Fisher (1930): how to earn higher return by lending on the capital market than they could by seeking out individual borrowers, and borrowers can obtain inexpensive financing without incurring search costs.

- Fisher Separation Theorem



Portfolio Theory

- Professor Harry Markowitz (1952): "Don't put all your eggs in one basket".
- Base concept: unsystematic risk and systematic risk → efficient portfolio
- Technique and measuring correlation, covariance, standard deviation, and total variation in portfolio setting.

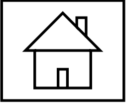


Capital Asset Pricing Model (CAPM)

- Sharpe (1964), Lintner (1965), and Mossin (1966)
- Contributions:

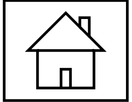
  1. Trade off risk and return: capital market line
  2. Beta (β)

- Ross (1976): Arbitrage Pricing Theory (APT) with more than one factor that influence the expected return of asset such as economic variables.



Efficient Market Hypothesis

- Fama (1970): speed and complete of relevant information incorporated in capital market.
- Degree of efficient:
  1. Weak form
  2. Semi-strong form
  3. Strong form
- Basic concept is investors are rational.



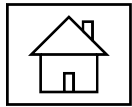
Option Pricing Theory (Black-Scholes Option Pricing Model)

- Black and Scholes (1973)
- 8 Assumptions:

1. Market are friction
2. Short sales are allow
3. No dividend payment or other distribution
4. Market on going (continue)
5. Stock prices random walk
6. Constant variance rate of return
7. The option can be exercised only at maturity
8. The risk less interest rate is known and constant

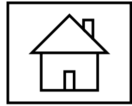
Market Microstructure

- First modern market microstructure study was Ho and Stol (1981) base on Demsetz (1968) and Tinic (1972)
- Market crashed in American capital market in 1987
- Two basic model: spread model and price formation model



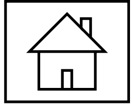
Market Microstructure (continued)

- Using intraday data to study. So, need appropriate application software e.g: SAS
- Some basic empirical model: trade-off between dealer and informed/uninformed trader, evolution of stock prices, trading day vs non trading day, asymmetric information in international capital market, market design, market mechanism, privat vs public information, herding, etc



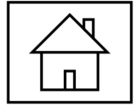
Corporate Finance

- The major study of corporate finance are capital budgeting, capital structure, dividend policy and merger and acquisition to maximize shareholder's wealth.



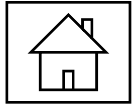
Capital Structure

- Modigliani and Miller (1958): M&M irrelevant propositions, called proposition I and proposition II
- Link of the study is asymmetric information such as signaling model, pecking order hypothesis, agency cost/tax shield trade-off model



Dividend Policy

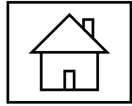
- M & M irrelevant model
- Empirical model to test the dividend policy: agency cost/contracting model and signaling model.



Agency Theory

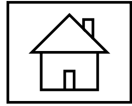
- Jensen and Meckling (1976)
- Contributions:

  1. Agency cost model of the firm
  2. Compensation policy



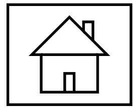
Signaling Theory

- Arkelof (1970) and Spence (1973): the original economics papers on signaling. Leland and Pyle (1977) was the first major financial application of signaling theory.
- Corporate insiders better informed than outside investor



Corporate Control

- Bradley (1980): Merger and acquisition in business world.
- Later empirical study: stock voting rights, the value of concentrate vs dispersed ownership structure, benefit shareholders on the various compensation plans for company manager, etc



Financial Intermediation

- Financial Institution: reksadana
- Banking: investment vs commercial banking
- Banking: national banking vs Universal banking
- Insurance: life, investment, pension, education, etc

Management Information System

- Base idea: unite disparate financial function into a single, integrated system that provide complete visibility into financial system
- MIS functions:

  1. as a management tool: support of management change
  2. provide a wide range of financial and non financial information
  3. as a system: connect, accumulate, process, and then provide information to all parties in the budget system on a continuous basis

MIS (Continued)

- Main steps in introducing MIS:
  1. Preparation
  2. Design
  3. Procurement
  4. Implementation

Summary

- In pricing assets, only systematic risk matter
- Emphasize investment rather than financing
- Emphasize cash flow rather than accounting profits
- Remember that finance is now a global game
- Remember that finance is a quantitative discipline
- All theories are based on the principles of informationally efficient capital markets populated by rational, utility-of-wealth-maximizing investors who can costlessly diversify unsystematic risk and are thus concerned only with pervasive, economy-wide forces. So, where is the behavior finance stand?

Good luck