Business Finance Reviewer: Investment, Financial Planning, and Financial Institutions

1. Investment Basics

Investment is the act of placing money in assets or financial instruments with the expectation of earning returns in the future.

People invest to:

• Grow wealth

• Prepare for future expenses

• Protect money against inflation

Common investment assets:

• Stocks

• Bonds

• Mutual funds

• Real estate

• Bank deposits

Risk and Return

Risk – the possibility that an investment may lose value.

Return – the profit or income generated from an investment.

General rule:

Higher Risk → Higher Possible Return

Lower Risk → Lower Expected Return

Examples:

Savings account – very low risk, low return

Bonds – low to moderate risk, moderate return

Stocks – higher risk, higher potential return

Liquidity

Liquidity refers to how quickly an investmnt can be converted into cash without losing value.

High Liquidity:

• Cash

• Savings accounts

Low Liquidity:

• Land

• Buildings

• Real estate

Diversification

Diversification means spreading investments across different assets to reduce risk.

Example:

Instead of investing all money in one asset, an investor divides funds among stocks, bonds, and savings.

Purpose:

• Reduce losses if one investment performs poorly.

2. Types of Investments

Equity Investments:

Represent ownership in a company.

Example: Stocks or shares.

Investors earn through dividends and capital gains.

Debt Investments:

Involve lending money to governments or corporations.

Examples: Bonds and treasury securities.

Investors earn through interest payments.

Mutual Funds and UITF

Mutual Funds:

• Managed by investment companies

• Pool money from many investors

• Professionally managed

UITF (Unit Investment Trust Fund):

• Managed by banks

• Pools funds from multiple investors

• Allows diversification

Benefits:

• Professional management

• Diversification

• Accessible to small investors

3. Financial Planning

Financial planning is the process of managing financial resources to achieve goals.

It involves:

• Identifying financial goals

• Estimating financial needs

• Allocating resources

• Monitoring results

Importance:

• Prepares individuals and businesses for future expenses

• Improves financial decision-making

• Ensures long-term financial stability

Budgeting

Budgets are financial plans used by businesses.

Examples:

Sales Budget – forecasts expected sales.

Production Budget – determines production quantity.

Cash Budget – shows expected cash inflows and outflows.

Capital Budget – used for large investments such as equipment or expansion.

4. Financial Institutions

Financial institutions help manage money, investments, and financial transactions.

Depository Institutions

These institutions accept deposits from the public.

Examples:

- Commercial banks
- Savings banks
- Credit unions

Services include deposits, loans, and payment services.

Non-Bank Financial Institutions

These institutions provide financial services but do not accept regular deposits.

Examples:

- Insurance companies
- Investment houses
- Pawnshops
- Pension funds

Insurance Companies

Insurance companies operate through risk pooling.

Policyholders pay premiums and the company provides financial protection against losses.

Examples include life insurance, property insurance, and health insurance.

Pawnshops

Pawnshops provide short-term loans secured by personal property.

Examples of collateral:

- Jewelry
- Gadgets
- Watches

If the borrower cannot repay the loan, the pawnshop may sell the collateral.

5. Bonds and Interest

A bond is a debt instrument where an investor lends money to a borrower.

Key parts:

Face Value – amount paid at maturity

Interest Rate (Coupon Rate) – percentage paid as interest

Maturity Date – date when the bond must be fully repaid

Bond Pricing

Bonds may be priced:

At Par – market rate equals stated rate

At Discount – market rate higher than stated rate

At Premium – market rate lower than stated rate

6. Time Value of Money

Money today is worth more than the same amount in the future because it can earn interest.

Return on Investment (ROI)

ROI measures the profitability of an investment.

Formula:

ROI = Gain ÷ Investment × 100

Example:

Investment = ₱6,000

Profit = ₱2,250

ROI = 37.5%

7. Capital Budgeting

Businesses evaluate investment projects using different methods.

Payback Period

Measures how long it takes to recover the initial investment.

Formula:

Payback Period = Initial Investment ÷ Annual Cash Flow

Internal Rate of Return (IRR)

IRR is the discount rate that makes the Net Present Value (NPV) equal to zero.

Decision Rule:

If IRR > Cost of Capital → Accept the project

If IRR < Cost of Capital → Reject the project