Chapter 35	McConnell, Brue and Flynn 20th

Financial Economics

In this chapter you will learn about the time value of money and about financial assets.

Financial economics studies investor preferences and how they affect the trading and pricing of financial assets like stocks, bonds, and real estate. The two most important investor preferences are a desire for high rates of return and a dislike of risk and uncertainty. This chapter will explain how these preferences interact to produce a strong positive relationship between risk and return: the riskier an investment, the higher its rate of return. This positive relationship compensates investors for bearing risk. And it is enforced by a powerful set of buying and selling pressures known as arbitrage, which ensures consistency across investments so that assets with identical levels of risk generate identical rates of return. As we will demonstrate, this consistency makes it extremely difficult for anyone to “beat the market” by finding a set of investments that can generate high rates of return at low levels of risk. Instead, investors are stuck with a trade-off: if they want higher rates of return, they must accept higher levels of risk. On average, higher risk results in higher returns. But it can also result in large losses, as it did for many investors who held risky assets during the financial crisis of 2007–2008.