Chapter 27: The Basic Tools of Finance
Principles of Economics, 6th Edition
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1. Introduction
    a. *This material is covered in much more detail in your finance class (Mgt 726) and will not be covered in Mgt 704.*
    b. Def: Finance is the field that studies how people make decisions regarding the allocation of resources over time and the handling of risk. P. 578

2. Present Value: Measuring the Time Value of Money
    a. Def: The present value is the amount of money today that would be needed to produce, using prevailing interest rates, a given future amount of money. P. 578
    b. Def: The future value is the amount of money in the future that an amount of money today will yield, given prevailing interest rates. P. 578
    c. Def: Compounding is the accumulation of a sum of money in, say, a bank account, where the interest earned remains in the account to earn additional interest in the future. P. 578
    d. **FYI: The Magic of Compounding and the Rule of 70, P. 580**

3. Managing Risk
    a. Risk Averse
        i. Def: Risk averse is exhibiting a dislike of uncertainty. P. 581
        ii. **Figure 1: The Utility Function, P. 581**
    b. The Markets for Insurance
    a. Diversification of Firm Specific Risk
        i. Def: Diversification is the reduction of risk achieved by replacing a single risk with a larger number of smaller unrelated risks. P. 582
        ii. **Figure 2: Diversification Reduces Risk, P. 583**
        iii. Def: Firm specific risk is risk that affects only a single company. P. 583
        iv. Def: Market risk is the risk that affects all companies in the stock market. P. 583
    b. The Tradeoff Between Risk and Return
        i. **Figure 3: The Tradeoff Between Risk and Return, P. 584**

4. Asset Valuation
    a. Fundamental Analysis
        i. Def: Fundamental analysis is the study of a company's accounting statements and fute prospects to determine its value. P. 585
    b. The Efficient Markets Hypothesis
        i. Def: The efficient markets hypothesis is the theory that asset prices reflect all publicly available information about the value of an asset. P. 585
        ii. In the News: A Cartoonist's Guide to Stock Picking, P. 586
        iii. Def: Informational efficient is reflecting all available information in a rational way. P. 586
        iv. Def: A random walk is the path of a variable whose changes are impossible

to predict. P. 586

v. Case Study: Random Walks and Index Funds, P. 587

vi. **In the News: Is the Efficient Markets Hypothesis Kaput? P. 588**

c. Market Irrationality

5. Conclusion

6. Summary