# Investment Information and Criterions

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In certain instances, investors are faced with competing investment opportunities, however, due to scarcity of capital, they are forced to pursue the most viable investment. This is because capital is a scarce resource, and therefore, investors seek capital projects that will maximize their return on investments. Similarly, investment is a present sacrifice that investors take in order to reap future benefits. Therefore, they will seek to put money in investments or capital projects that promise higher monetary value than the present monetary value. For instance, a corporation has retained earnings with a present value of £2, 000,000; however, investing these funds in, for example, government debt instruments will yield a return of investment of 20% in one year. As a result, the monetary value of the corporation in a year will have increased by 20%.

In the process of investing, investors, individual, firms and governments are required to make the decision of whether to invest or not, and how to invest given a wide array of investment options. Bryoles (2007) observes that investors are faced with numerous investment options; however, due to scarcity of capital, they have to choose among available options. For example, an individual might have to decide whether to invest in stocks, fixed income securities or real estate; a government might have to decide whether to build a road, a school or a dam; a corporation might have to decide whether to replace existing machines, expand the business or launch a new product in the market.

Brigham and Houston (2007) observe that investors undertake analysis to make an investment decision on the best available investment opportunity to pursue. The methods of analysis are based on economic and mathematical principles. Using economic and financial techniques, investors analyse financial information to arrive at the optimal investment decision. Analysis of

financial information on the available investment options helps minimize uncertainty of investment. Fuss and Vermeulen (2004) highlight that investments face the challenge of uncertainty, as it affects timing of investment and the level of investment. It is, therefore, evident that the process of investing is mired with complexity. For this reason, this essay seeks to discuss the information investors need to decide where to invest their capital and then to judge the effectiveness of their investment decisions.

**Information Aids of Making Investment Decisions**

Investors before making an investment decision evaluate critically economic and financial information that pertains to an investment. Evaluation of relevant information to an investment help an investor assess risks and returns on investments. For instance, equity investors analyze economic fundamentals of a company before they invest in the stocks of that company, in what is termed as fundamental analysis. According to Jones (2009), fundamental analysis helps investors evaluate the future financial outlook and investment prospects of the company. Fundamental analysis evaluates three layers of information that directly or indirectly affects investment performance of a company. The first layer of information is macroeconomic information that include inflation, interest rates and economic policies. The second set of information pertains to the industry outlook in which the company operates and include industry specific material information such as regulations in the industry, weather patterns among other factors that affect the sector in which the company operates as a whole. The third level of information that is evaluated by investors during fundamental analysis is company specific material information and includes information such as profits for the company, management expertise of the company, corporate governance, strategies and other material information that affects financial performance of a company. Due to the key role that financial and economic

information plays in the process of making investment decisions, Ogbonna and Ebimobowe (2011) observe that it is for this reason that listed companies are required by law and regulations to prepare and present to the public financial statement and reports that are truthful, complete and unbiased on any material information. Similarly, other investors such as governments and firms rely on financial and economic information in making investment decision. Just like individual in making investment decisions, misrepresentation of material information leads to poor investment decisions.

Investors require projected financial performance of an investment to determine its viability. According to financial practitioners and investors, cash is the king of investments and businesses. This is because cash is what a business reinvests and uses to run the operations of the business. Therefore, Titman, Martin and Keown (2010, p20) opines that the value of an investment is measured by its cash flow, though there are other factors such as accounting profits and liquidity that determine financial performance and outlook of an investment. Titman et al., (2010, p22) further continue to assert that investments are measured by assessment of the projected cash flows or economic profits and not accounting profits. This is because accounting profit, which are prepared using Generally Accepted Accounting Principle, does not reveal the ability of a corporation or investment to meet its financial obligations, as a company can report profit but be unable to honor its financial obligations. Cash flow represents the movement of cash in and out of the coffers and a healthy investment should record higher cash inflows than cash outflows. Investments are characterized by two flows of cash, cash outflow to acquire an investment and cash inflow representing income from the investment. Broyles (2007, p.15) observes that cash flow occurs in two forms, as a single payment/lump sum or as a series, which

may be regular irregular or deferred. Titman et al., (2010, p.24) classifies cash flow into two main classes annuity and perpetuity. Annuity describes a defined stream of cash flow for a defined number of periods; the cash flows are uniform or changing but fall due at regular intervals. In this arrangement, the investor either pays or receives a series of cash flow at regular interval. Perpetuity is a constant stream of cash flow that lasts forever. It is important for an investor to know the type of cash flow his investment falls under in order to ascertain whether the time horizon of the investment matches his goals and needs.

Information on cash flows of an investment is solely not important in evaluating investment decisions. This is because money has a time value and, therefore, the value of cash received today will not be the same a year later due to changes in interest rates. According to Titman et al., (2010, p. 25) cash flows are then discounted using an appropriate discount rate to reflect the present value of future cash flows. Broyles (2007, p.20) proposes that the present value of projected future cash inflows should exceed the present cash flow an investor is spending to acquire an investment. This also represents the value the investment added to the firm. Broyles (2007, p.21) notes that besides discounted cash flows, which investors evaluate to ascertain the viability of an investment, investors analyse incremental cash flow, which is a cash flow that increases or decreases due to decision alternative, marginal cost or marginal revenues. Incremental costs are used in making investment decisions regarding replacement analysis.

Investing involves sacrificing to spend today to gain future benefits. For this reason, investors require high returns as a compensation for foregoing spending their wealth. In addition, the future is uncertain, and therefore, investors should be compensated for assuming the risk to invest in spite the uncertain future of their initial investment. According to Brigham and Houston

(2007), investors evaluate the risk levels to determine the required return on investment; a highly risky investment requires a high reward tradeoff because of high uncertainty of the investment while low risk requires a low reward tradeoff because the investment is safe. Different investors hold differing views in determining risk return trade off. Brigham and Houston (2007) further continue to observe that all investors factor risk into investment decision by increasing the discount rate in calculating the present value of projected cash flows. In the case of firms, managers evaluate the risk return trade off of a capital investment using the firm's cost of capital, which is a rate of return that equals return required by both equity and debt financiers of the firm. An individual investor, on the other hand, uses benchmark rates of the desired investment class as the rate of return for this investment. Unlike required rate of return, determining risk is difficult. Therefore, investors before making the invasion decision should establish risk levels inherent in the investment and whether these levels of risk match their risk tolerance levels. As Broyles (2007) asserts that risk results in deviation of investment performance from the expected outcome. The major sources of investment risk include strategic, financial, operational, contingent, political, and regulatory risks. Strategic risk is a deviation of the expected investment outcome due to strategy such as overcapacity, obsolescence. Financial risk is risk that causes an investment to deviate from expected outcome due to changes in interest rates, credit risk or foreign exchange risk. Contingent risk is a risk that an investment faces if a certain contingent event occurs. Operational risks are risks that an investment is exposed to due to administrative and operational procedures. Regulatory and political risks are risks that an investment faces due to changes in the regulatory framework, political environment or policy alterations. Titman et al., (2010, p.24) observe that investors need tax information to decide where to invest their funds. Different investors hold different tax preference; as a result, they pursue different investments.

An investor with high tax liability would prefer investments that would offset his tax liabilities. Frankfurter, Wood and Wansley (2003) observe that individual investors in Britain prefer low dividend yield stocks to high dividend yield stocks because of tax preferences. Capital gains in the United Kingdom are taxed at a lower tax rate of 20% unlike dividends taxed by up to 39%. Therefore, investors prefer stocks that defer tax payment and invest the money into the business to grow the firm value, increasing stock price and substituting lower taxed capital gain to high taxed dividend income. Once investors are furnished with the material information needed to facilitate investment decision making, the next step is using criterions to choose the optimal investment decision. Scholleova, Fotr and Svecova (2010) state that investment projects are characterized by the following unique features, namely cash flows, real service life and risk of the investment. The authors continue to state that based on the three unique factors criterion of assessing investments can be classified into two groups that include static and dynamic criterions.

**Criterions of Investment Decision Making**

Contemporary business enterprises are faced with numerous investment options, however, finite resources constrict them from pursuing those capital projects at a go. Business managers to circumvent this challenge choose and allocate resources to the most viable project after a thorough evaluation of existing operations and new projects. According to Maroyi and van der Poll (2012) business managers use capital budgeting techniques to evaluate viability of an investment. Shim and Siegel (2008) explain that capital budgeting is a set of investment decision tools that investors use to facilitate investment decision making process. Emery, Finnerty and Stow (2007) observe that the investment decisions pertain to equipment replacement, expansion

and product development. In essence, capital budgeting techniques are investment appraisal tools used by investors to determine profitability and viability of an investment project.

Shim and Siegel (2008) assert that there are two methods of investment appraisal, namely discounting methods and non-discounting methods. Discounting approaches consider the time value of money concept while non-discounting methods do not take into account the time value of money. Emery et al., (2007) highlights that discounting methods include net present value and internal rate of return (IRR) while profit index, accounting rate of return and payback period constitute non-discounting methods. The choice of the method to use depends on management decision and the type of project. Scholleova et al., (2010), on the other hand, refer discounting approaches as dynamic criterions because they take into consideration cash flows, service life and risk.

**Dynamic criterions of making investment decision**

Scholleova et al., (2010) state that net present value is a dynamic criterion that take into consideration timing of cash flows, service life of the investment and the overall risk of the investment. Consequently, NPV is considered a sophisticated investment criterion method. Net present value technique requires projection of cash flow and their timing. Cash flows are then discounted using appropriate discount rate to obtain the net present value of future cash flow. The riskier the project, the higher is the discount rate, conversely, the lower the risky the investment the lower the discount rates. Baker et al., (2008) explain that the obtained present value of future cash flows is subtracted from the cash investment of the project to arrive at an investment decision. If investment required exceeds the present value of future cash flow, the project is abandoned. However, if present value of future cash flow exceeds required

investment, the investor accepts to undertake the investment. Investors use this investment decision criterion because it has the following unique features; it considers timing of cash flow, time value of money, service life of an investment and risks of an investment.

The internal rate of return is an dynamic criterion of investment decision making just like NPV. Similar to NPV, internal rate of return takes into account timing of cash flows, time value of money, service life of an investment and risk of an investment. Baker et al., (2008) explain that the internal rate of return gives investors a discount rate that yield the rate of return on investment for the firm. Therefore, if the internal rate of return is greater than the cost of capital, an investor should undertake the investment. However, if the IRR is less than the investor's required rate of return , the investment is not viable and should be abandoned. Just like the other dynamic criterions, investors use NPV because it utilizes timing of cash flow, service life of an investment and risks of a project in assessing viability of an investment. However, IRR it may be misleading to investors because it is subjective, as it provides multiple rates of return, assumes constant cost of capital and cash flows during the service life of a project, which is not a characteristic of imvestment projects.

Profitability index is another investment criterion that takes into consideration the time value of money, service life of an investment and risks of an investment. Investors use profitability index to select the most profitable project from a number of projects. Investment decision is made based on the comparison of profitability index of many projects. Emery et al., (2007) opine that investors undertake an investment with the highest profitability index among investment projects competing for capital. Profitability index can be misleading to investors because it suffers from

numerous setbacks, such as the cost of capital used to calculate net present value of cash flow is an estimate and profitability index is not a good appraisal tool for mutually exclusive investment projects.

**Static criterions of making investment decisions**

Sometimes investors do not evaluate investment options based on time value of money, service life of an investment or timing of cash flows. Scholleova et al., (2010) term non-discounting approaches to investment decisions as static criterions because they consider cash flow and ignore risk. According to Shim and Siegel (2008), the most commonly used static criterions that are used in investment decision making process are payback period and accounting rate of return. Payback period measures the time it will take an investor to recover fully his investment. According to Emery et al., (2007), the shorter the period, the desirable is the investment. Investors use the payback period because of the following reasons: it is easy to compute and it is a good measure of liquidity. However, payback period can be misleading to investors because of the following setbacks: it does not take into account the time value of money, it does not consider all cash flows because it ignores cash flows after payback period, ot ignores service life of an investment  and it ignores the risks of an investment.

Accounting rate of return, just like the payback period method, is a static criterions that used in investment decision making process. However, unlike the other methods, it uses net income or accounting profits instead of cash flows. Accounting rate of return (ARR) gives investors required rate of return based on annual net income. According to Shim and Siegel (2008), accounting rate of return is simply a ratio of average annual net income to average initial investment. Investors accept investments with an accounting rate of return higher than the their

required rate of return. Conversely, an investor should not underatake an investment that has an accounting rate of return lower than the required rate of return. Accounting rate of return has an advantage that, it is simple to compute. Baker et al., (2008) opine that accounting rate of return can be misleding to inverstors because t ignores the time value of money, risks of an investment and use accounting profits instead of cash.

**Conclusion**

Lack of capital hinders investors, individuals, firms and governments pursuing all available capital projects simultaneously. Therefore, investors resort to choosing the most viable of the competing capital projects. As a result, this makes investment decision making to be part of strategic decision-making as implementation of new projects contributes to economic, financial and investment portfolio growth. Successful selection of a viable investment project among competing projects increases investment value, however, unsuccessful selection of a viable project among competing projects leads to a decline in investment value. The quality of investment decision is affected by the quality of information that is needed to make investment decisions and the type of criterion used in evaluating and selecting investment projects.

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