Chapter 14

Investment Goals and Decision Criteria
The Choice of a Discount Rate

• Choice is critical in selecting between alternative opportunities and deciding what opportunities merit additional considerations
• The Summation technique
• The Risk-adjusted discount rate
Investment Decisions and Decision Rules

• Precise rules for making investment decisions depend on the nature of the problem

• Net present value does not give an unambiguous decision signal when projects require different levels of initial cash outlay
  – Profitability index (PI) is calculated by dividing the present value of expected future cash flows by the amount of the initial cash outlay. The quotient represents present value per dollar of initial cash expenditure
Investment Decisions and Decision Rules

• General decision rule is to accept the project with the greatest profitability index (assuming there is no difference in the risk profile of competing opportunities)
Investment Decisions and Decision Rules

- Investors must select from between investment alternatives, all of which are considered desirable.
  - Investors constantly face mutually exclusive investment decisions.
  - The most appropriate technique for deciding between mutually exclusive alternatives when using the net present value approach is to accept the alternative producing greater (positive) net present value.
  - When using the internal rate of return, the most appropriate approach is to accept the proposal having the higher internal rate of return, providing it is greater than the predetermined rate.
Investment Decisions and Decision Rules—Mutually Dependent Proposals

- Investment proposals are *mutually dependent* if acceptance of one forces the investor to accept the other. Acquisition of more than one property at a time requires consideration of results from alternative combinations.
Investment Decisions and Decision Rules—
Mutually Dependent Proposals

– Group mutually dependent ventures into consolidated units, and treat each unit as a single investment venture
– Accept mutually dependent combination having the highest net present value
– If “packages” differ in amount of initial equity cash expenditure, compare the profitability indexes of the combinations
– If internal rate of return method is being used, accept the combination having the highest calculated return
Investment Value and Investment Strategy

• Investment value is value of an income producing property to a particular investor
• Prospective investors will be motivated to buy if they believe their subjective investment value is greater than the amount they will have to pay for a property
Investment Value and Investment Strategy

• Owners will be motivated to sell if they believe they will receive more than their properties are worth to them as elements in their personal investment portfolios

• The greater the spread between investment value and transaction price for both buyer and seller, the greater the possible increase in both investors’ wealth