FINANCIAL MARKETS

Types of U.S. financial markets

- **Primary markets** can be distinguished from **secondary markets**.
  - Securities are first offered for sale in a primary market.
  - For example, the sale of a new bond issue, preferred stock issue, or common stock issue takes place in the primary market.
  - Trading in currently existing securities takes place in the secondary market, such as on the stock exchanges.
- The **money market** can be distinguished from the **capital market**.
  - Short-term securities trade in the money market.
  - Typical examples of money market instruments are (l) U.S. Treasury bills, (2) federal agency securities, (3) bankers' acceptances, (4) negotiable certificates of deposit, and (5) commercial paper.
  - Long-term securities trade in the capital markets. These securities have maturity exceeding one year, e.g., stocks and bonds.
- **Spot markets** can be distinguished from **futures markets**.
  - Cash markets are where something sells today, right now, on the spot; in fact, cash markets are often referred to as "spot" markets.
  - Futures markets are where you can set a price to buy or sell something at some future date.
- **Organized security exchanges** can be distinguished from **over-the-counter markets**.
  - Organized security exchanges are physical places where securities trade.
  - Stock exchanges are organized exchanges.
  - Organized security exchanges provide several benefits to both corporations and investors. They (l) provide a continuous market, (2) establish and publicize fair security prices, and (3) help businesses raise new financial capital.
  - Over-the-counter (OTC) markets include all security markets **except** the organized exchanges. The money market is a prominent example. Most corporate bonds are traded over-the-counter.

Investment Banker

- A financial specialist who acts as an intermediary in the selling of securities.
- Three basic functions of an investment banker:
  - Assumes the risk of selling a new security issue. This is called **underwriting**. Typically, a group of investment banker actually buy the new issue from the corporation that is raising funds. The group then sells the issue to the investing public (hopefully) at a higher price than it paid.
  - Provides for the **distribution** of the securities to the investing public.
  - **Advises** firms on the details of selling securities.

- Several distribution methods used:
  - In a **negotiated purchase,** the price that the investment banker pays for the securities is "negotiated" with the issuing firm.
  - In a **competitive-bid purchase,** the group willing to pay the issuing firm the greatest dollar amount per new security wins the competitive bid.
  - In a **commission** (or **best-efforts**) offering, the investment banker sells the issue in return for a fixed commission.

Registration

- Most new public issues must be registered with the SEC before they can be sold to final investors.
- This involves filing a document called a **registration statement** with the SEC.
- Another document, the **prospectus**, is also filed with the SEC for examination.
- A selling group is formed to distribute the new securities to final investors.
- A due diligence meeting is held prior to taking the offering to the public.

Private placements

- In a private placement, a small number of investors purchase the entire security offering.
- Large financial institutions are the major investors in private placements. These include (l) life insurance firms, (2) state and local retirement funds, and (3) private pension funds.

Flotation costs

- The firm raising long-term capital typically incurs two types of flotation costs:
  - the underwriter's spread, and
  - issuing costs

Regulations

- In July 2002 Congress passed the Public Company Accounting Reform and Investor Protection Act.
- The short name for the act became the Sarbanes-Oxley Act of 2002.
  - The corporate advisors (like accountants, lawyers, company officers, and boards of directors) are accountable for misconduct.

Interest Rate Determinants

- The real rate of interest is the difference in the nominal rate and the anticipated rate of inflation.
- Letting the nominal rate of interest be represented by k_{rf}, the anticipated rate of inflation by IRP, and the real rate of interest by k*, we can express the result by the following equation:
  - real rate = nominal rate + rate of inflation

The term structure of interest rates

- The relationship between a debt security's rate of return and the length of time until the debt matures is known as the **term structure of interest rates.**
- It is called **yield curve**, when shown on a graph.