

CHAPTER 5

Financial Markets and Institutions

- The Capital Allocation Process
- Financial markets
- Financial institutions
- Stock Markets and Returns
- Stock Market Efficiency

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The Capital Allocation Process

- In a well-functioning economy, capital flows efficiently from those who supply capital to those who demand it.
- Suppliers of capital – individuals and institutions with “excess funds”. These groups are saving money and looking for a rate of return on their investment.
- Demanders or users of capital – individuals and institutions who need to raise funds to finance their investment opportunities. These groups are willing to pay a rate of return on the capital they borrow.

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How is capital transferred between savers and borrowers?



- Direct transfers
- Investment banking house
- Financial intermediaries

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What is a market?

- A market is a venue where goods and services are exchanged.
- A financial market is a place where individuals and organizations wanting to borrow funds are brought together with those having a surplus of funds.

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Types of financial markets

- Physical assets vs. Financial assets
- Money vs. Capital
- Primary vs. Secondary
- Spot vs. Futures
- Public vs. Private

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The importance of financial markets

- Well-functioning financial markets facilitate the flow of capital from investors to the users of capital.
 - Markets provide savers with returns on their money saved/invested, which provides them money in the future.
 - Markets provide users of capital with the necessary funds to finance their investment projects.
- Well-functioning markets promote economic growth.
- Economies with well-developed markets perform better than economies with poorly-functioning markets.

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What are derivatives? How can they be used to reduce or increase risk?

- A derivative security's value is "derived" from the price of another security (e.g., options and futures).
- Can be used to "hedge" or reduce risk. For example, an importer, whose profit falls when the dollar loses value, could purchase currency futures that do well when the dollar weakens.
- Also, speculators can use derivatives to bet on the direction of future stock prices, interest rates, exchange rates, and commodity prices. In many cases, these transactions produce high returns if you guess right, but large losses if you guess wrong. Here, derivatives can increase risk.

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Types of financial institutions

- Commercial banks
- Investment banks
- Mutual savings banks
- Credit unions
- Pension funds
- Life insurance companies
- Mutual funds
- Hedge funds

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Physical location stock exchanges vs. Electronic dealer-based markets

- Auction market vs. Dealer market (Exchanges vs. OTC)
- NYSE vs. Nasdaq
- Differences are narrowing



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Stock Market Transactions

- Apple Computer decides to issue additional stock with the assistance of its investment banker. An investor purchases some of the newly issued shares. Is this a primary market transaction or a secondary market transaction?
 - Since new shares of stock are being issued, this is a primary market transaction.
- What if instead an investor buys existing shares of Apple stock in the open market – is this a primary or secondary market transaction?
 - Since no new shares are created, this is a secondary market transaction.

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What is an IPO?

- An initial public offering (IPO) is where a company issues stock in the public market for the first time.
- “Going public” enables a company’s owners to raise capital from a wide variety of outside investors. Once issued, the stock trades in the secondary market.
- Public companies are subject to additional regulations and reporting requirements.

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Historical stock market performance, S&P 500 (1968-2004)



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Semistrong-form efficiency

- All publicly available information is reflected in stock prices, so it doesn't pay to over analyze annual reports looking for undervalued stocks.
- Largely true, but superior analysts can still profit by finding and using new information.

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Strong-form efficiency

- All information, even inside information, is embedded in stock prices.
- Not true--insiders can gain by trading on the basis of insider information, but that's illegal.

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Conclusions about market efficiency

- Empirical studies suggest the stock market is:
 - Highly efficient in the weak form.
 - Reasonably efficient in the semistrong form.
 - Not efficient in the strong form. Insiders have made abnormal (and sometimes illegal) profits.
- Behavioral finance
 - Incorporates elements of cognitive psychology to better understand how individuals and markets respond to different situations.

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Implications of market efficiency

- You hear in the news that a medical research company received FDA approval for one of its products. If the market is semi-strong efficient, can you expect to take advantage of this information by purchasing the stock?
 - No – if the market is semi-strong efficient, this information will already have been incorporated into the company's stock price. So, it's probably too late ...

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Implications of market efficiency

- A small investor has been reading about a “hot” IPO that is scheduled to go public later this week. She wants to buy as many shares as she can get her hands on, and is planning on buying a lot of shares the first day once the stock begins trading. Would you advise her to do this?
 - Probably not. The long-run track record of hot IPOs is not that great, unless you are able to get in on the ground floor and receive an allocation of shares before the stock begins trading. It is usually hard for small investors to receive shares of hot IPOs before the stock begins trading.

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