



# Chapter 2

## The Financial Environment: Financial Markets and Institutions

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- Capital Allocation Process
- Financial markets
- Financial institutions
- Markets Returns & Efficiency



# The Capital Allocation Process

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- 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.



# Transferring Capital

## See Figure in Textbook

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- Direct transfers - company sells securities directly to investors
- Investment banking - middleman facilitates the sale of securities
- Financial intermediary
  - receives deposits
  - uses deposits to buy securities or make loans
  - creates new forms of capital

# What is a Financial market

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- Mechanism for exchange of financial assets and services
  - Economic Function of financial markets-- Transfer or facilitates the transfer of real economic resources to their highest and best use
  - Financial Function--to provide borrowers with funds (purchasing power) and lenders with earning assets.



# Markets

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- Real vs Financial (non-consumable)
- Spot vs Forward (Futures)
- Money vs Capital
- Public vs. Private
- Mortgage vs Consumer Credit
- Primary vs Secondary
- Direct vs Indirect
- Derivatives
- Geographic



# Investment Banking Functions

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- Aid in security design and registration
- Buy securities directly from company and resell to individual or institutional investors
- Promotes sale of the securities, but will not actually purchase them from the company
- Provides advice
- Earns fees, commissions, spread
- These are primary market transactions



# Financial Market Importance

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- A “place” where individuals and organizations wanting funds are brought together with those having a surplus of funds.
- Importance
  - Well-functioning markets promote economic growth.
  - Economies with well-developed markets perform better than economies with poorly-functioning markets.



# Financial Institutions and Intermediaries

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- Commercial Banks
- Investment Banks
- Savings and Loans & Mutual Savings Banks
- Credit Unions
- Pension Funds
- Life Insurance Companies
- Mutual Funds
- Exchange Traded Funds
- Hedge Funds
- Private Equity Funds



# Changing Role of Financial Intermediaries

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- Historically, highly specialized as to products and geographic area
- Deregulation and technological innovations have altered the operating environment
- Result, creation of large diversified financial service organizations
- Change of financial landscape in 2008-2009 – Elimination of Investment Banks



# Why do Financial Intermediaries Exist?

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- Reduce search costs
- Risk intermediation management
- Denomination intermediation
- Maturity intermediation
- portfolio diversification
- Economies of scale in credit collection and processing and monitoring
- Liquidity
- Convenience costs



# Economic Functions of Financial Intermediaries

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- Provide payment mechanisms
- Money creators
- Wealth Storage and saving facilitators
- Enhanced Economic Efficiency through increased mobility of assets
- Provide Information Market



## Key characteristics for financial intermediaries

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- Highly liquid
- low operating leverage
- high financial leverage TA/TE
- typically most liabilities are short-term
- low market to book value

# Equity/Stock Markets (Physical location vs. Electronic dealer-based markets)

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- Secondary market transactions
- Exchanges (NYSE-Euronext-AMEX (merged 10/1/2008) & Regional)
  - physical marketplace
  - brokerage houses own “seats”
  - Specialists
  - Auction Market
- Over-the-counter - NASDAQ
  - dealers market- hold inventories and “make a market”
  - brokers bring dealers and investors together
- Electronic Markets ECNs (ISLAND)



# What is an IPO?

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- 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.

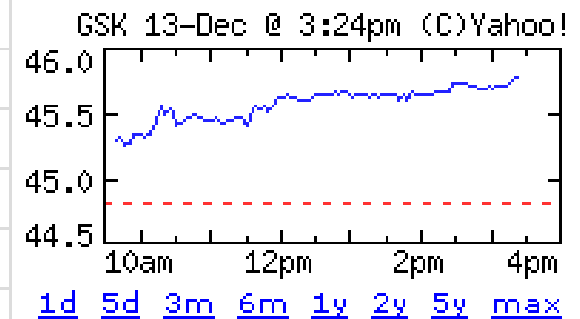
# Where can you find a stock quote, and what does one look like?

- Stock quotes can be found in a variety of print sources (*Wall Street Journal* or the local newspaper) and online sources (Yahoo!Finance, CNNMoney, or MSN MoneyCentral).

GLAXOSMITHKLINE (NYSE:GSK) Delayed quote data by Reuters

Edit

Last Trade:	<b>45.79</b>	Day's Range:	45.27 - 45.83
Trade Time:	3:24PM ET	52wk Range:	38.80 - 47.25
Change:	<b>↑ 0.97 (2.16%)</b>	Volume:	1,533,100
Prev Close:	44.82	Avg Vol (3m):	1,319,227
Open:	45.29	Market Cap:	130.78B
Bid:	N/A	P/E (ttm):	17.25
Ask:	N/A	EPS (ttm):	2.655
1y Target Est:	46.72	Div & Yield:	1.4608 (3.26%)



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# What is the Efficient Market Hypothesis (EMH)?

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- Securities are normally in equilibrium and are “fairly priced.”
- Investors cannot “beat the market” except through good luck or better information.
- Levels of market efficiency
  - Weak-form efficiency
  - Semistrong-form efficiency
  - Strong-form efficiency



## Conclusions about market efficiency

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- 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.