Chapter 9. Financial Markets and Institutions

**Chapter Objectives**
- To identify the basic investment alternatives
- To understand the nature of securities market, distinguishing between organized exchanges and over-the-counter market
- To recognize important legislations that protect investors
- To learn how to select a stockbroker and how to choose an investment account
- To know how to take an investment position and how to place investment orders

**Why invest?**
- Current enjoyment
  - Home or jewelry
- Current income
  - Interest or Dividends
- Future needs
  - Down payment for a home
  - Educating children
  - Retirement
  - Bequest

**What are the two major classes of investment alternatives?**
- Tangible
  - Provide enjoyment in use as well as an investment return
  - Examples: houses, antiques, land, jewelry
- Intangibles (financial assets or paper assets)
  - Provide claims to tangible assets or the earnings they provide
  - Examples: stocks, bonds

**What are the major factors to consider with any investment?**
- Do You Want Current or Future Return?
  - Current return: Dividends, interest, or other types of asset income received on a regular basis.
  - Future return: A return expected in the future resulting from the potential sale of an asset that has appreciated in value.
  - Total return: Sum of current and future return
- What Is Your Income Tax Situation?
- What Is Your Attitude Towards Risk?
  - Risk Averse (Low Tolerance for Risk)
  - Risk Seeking (High Tolerance for Risk)

**What are the basic investment alternatives?**
- Investments Held for Liquidity
- Securities with Long or No Maturities
- Pooling Arrangements
- Contractual Claims
- Tangible Assets
**What are investment held for liquidity?**

**Types**
- Bank Accounts
- Money Market Mutual Funds
- Series EE and Series HH Bonds

**Characteristics**
- Low risk, low return

**What are the securities with long or no maturities?**

**Types**
- Bonds and Notes by Different Issuers
- Preferred Stock Issued by Corporations
- Common Stock Issued by Corporations

**Characteristics**
- Bonds tend to have lower risks than common stocks. Preferred stocks are in between.

**What are pooling arrangements?**

**Types**
- Mutual Funds
- Investment Trusts
- Limited Partnerships

**Characteristics**
- Risk will depend on the objective of the pooling instrument.

**What are contractual claims?**

**Types**
- Warrants and Rights
- Put and Call Options
- Commodity and Financial Futures

**Characteristics**
- High risk investments

**What are tangible assets?**

**Types**
- Real Estate
  - Personal Residence
  - Others (Rental Properties)
- Gold and Other Metals/Minerals
- Jewelry and Collectibles

**Characteristics**
- Other than personal residence, investment in this category is rather risky

**What are organized exchanges?**

**A Physical Place Where Buyers and Sellers Meet to Trade Securities**

**Examples:**
- New York Stock Exchange (NYSE)
  - The largest exchange in the world - "Big Board"
- The American Stock Exchange
  - Smaller, now affiliated with NASDAQ
- 14 regional stock exchanges
**How does the NYSE work?**
- Securities Traded at “Posts”
- You Must Have a “Seat” To Trade on the Floor
  - Commission Brokers
  - Floor Brokers
  - Floor Traders
  - Specialists
- Trade: investor -> broker -> specialist (auction)

**What is the over-the-counter market?**
- Largest Exchange (Number of Issues Traded)
- Through a Communication System Called NASDAQ
- Small Companies and High-Tech Companies
  - Intel
  - Microsoft

**What are organized options and futures exchanges?**
- Five options exchanges
  - Chicago Board Options Exchange
  - American Options Exchange
  - Philadelphia Options Exchange
  - Pacific Coast Exchange
  - New York Stock Exchange
- Over a dozen commodities exchanges in the U.S. and Canada

**What are the major regulations regarding security exchanges?**
- The Securities Act of 1933
- The Securities Exchange Act of 1934
- The Securities Investor Protection Act of 1970 (SIPC)
- Other Regulation
  - State and local
  - Self-regulation

**What is the Securities Act of 1933?**
- First Federal Law Regulating the Securities Industry
- Applies to New Issues
- Requires a Securities Issuer to Provide A Prospectus - A Very Detailed Document Describing All Material Information Related to the Issue

**What is the Securities Exchange Act of 1934?**
- Much Broader than the 1933 Act
- Outlaws Fraud and Misrepresentation by Anyone, Including Insiders
- Established the Annual Report (10-K) and the Quarterly Report (10-Q)
- Created an Enforcement Agency (SEC)
What are the federal acts requiring registration with the SEC?

- Act
  - The Maloney Act of 1938
  - The Investment Company Act of 1940
  - The Investment Advisors Act of 1940

Group Regulated
- Trade Associations
- Investment Companies
- Investment Advisors

What is the Securities Investor Protection Act of 1970 (SIPC)?

- Protects investors if their stockbrokers have financial problems
- Account insured to $500,000 of securities and $100,000 in cash
- Guarantees only that your securities (not prices) eventually will be delivered to you or another broker.

What are some other regulations?

- States Have “Blue Sky” Laws
  - Similar to the Federal Laws
  - Apply to Intrastate Security Sales
- Self Regulation Is Provided by the National Association of Securities Dealers (NASD) Through:
  - Dealers Rules of Fair Practice
  - Code of Procedure
  - Uniform Practice Code

How to select a stockbroker?

- Full-service vs. discount brokers:
  - Full-service brokers
    - Features: Research, representatives to help with portfolio planning, access to new stock offerings, personal contact with customers, high commissions
    - Visit a full-service broker Website: Merrill Lynch at http://www.ml.com/
  - Discount Brokers
    - Features: Possibly no personal contact, 800 number or the Internet, low commissions
    - Visit a discount broker Website: Ameritrade at http://www.ameritrade.com/
- If you are experienced, choose discount brokers to save commission.

What kinds of accounts are available?

- Cash Account
  - Similar to a Bank’s Charge Account
  - Must Pay for Purchases in 3 Days
  - Can Receive Share Certificates
- Margin Account
  - Allows You to Borrow $ from Your Broker to Buy Securities
  - Interest is Charged on Such Loans
  - If such leverage is used, risk is increased

What are investment positions?

- Long--You buy securities – most common
  - You think the price of a security will fall
  - The Broker loans shares to you so you can sell them at the current high price
- Short--You sell securities that you do not own
  - You can buy these shares back at lower prices and return the borrowed shares to the broker.
  - A short can be risky since long-run trend in prices is up.
What are the different kinds of orders?
- Market Order - Buys/Sells at Best Available Price
- Limit Order - Sets the Highest/Lowest Price You Will Accept
- Stop Order - An Order That Is Triggered by a Security Reaching a Certain Price; Often Used to Protect a Profit in a Stock

Where to find investment information?
- Company Sources
  - The Annual (10-K) and Quarterly (10-Q) Reports from SEC site
  - An example of 10-k report: http://www.sec.gov/Archives/edgar/data/354950/000095014402004155/g75478a10-k.txt

Investment Advisory Services
- Value Line, Moody’s, Standard & Poor’s
- Newspapers and Magazines
  - Wall Street Journal, Barron’s, Investor’s Business Daily
- Internet Data Sources
  - Yahoo: http://finance.yahoo.com/

Chapter 10. Investment Basics

Chapter Objectives
- To grasp the nature of risk and its sources, and to relate risk to investment return
- To see the importance of diversification, and to understand how it reduces investment risk
- To understand how to accomplish adequate diversification, both among asset groups and within an asset group
- To become familiar with methods and issues in establishing a portfolio and changing it over time

What is risk? - Return variability as a measure
- Investment A: no return variation, no risk
- Investment B: some return variation, some risk
- Investment C: wide return variation, much risk
What are the sources of risk?
- Changing Economic Conditions
  - Inflation Risk
  - Business Cycle Risk
  - Interest-Rate Risk
- Changing Conditions of the Security Issuer
  - Management Risk
  - Business Risk
  - Financial Risk

What’s the relationship between risk and return?
- The higher the risk, the higher the expected return (no guarantee) in the long run.
- Example: Annual return from 1970 to 2003
  - Risk:
    - Common Stocks – high risk
      • Highest 37.4% (1995), lowest -26.5% (1974), range 63.9%
    - 90-Day U.S. Treasury Bills – low risk
      • Highest 14.1% (1981), lowest 1.0% (2003), range 13.1%
  - Average annual return:
    - Common stocks – higher average return
      • 11.30% ($1000 in 1970 becomes $38,078 in 2003)
    - 90-Day U.S. Treasury Bills – lower average return
      • 7.23% ($1000 invested in 1970 becomes $10,739 in 2003)

What is investment risk premium?
- Risk Premium:
  - The difference between an investment’s return and the return on U.S. T-Bill
- Market Risk Premium:
  - Using 1970-2003 Historical Data, this Premium is 4.07% (11.30% - 7.23%)
  - Using long-term data, the premium is close to 8%
  - Controversy Exists over Value for the Premium

What is an investment’s required return?
- An investment’s required return is the return it must earn to compensate investors for undertaking its inherent risks.
- Riskier investments have higher required return than less risky investments

What are the two types of risks?
- Random Risks
  - Associated with specific companies
  - Can be reduced by holding more stocks (About 20 at least)
- Market Risk
  - Associated with the Overall Market
  - Cannot be reduced by holding more stocks

What is a portfolio?
- A Portfolio is Simply a Group of Assets Held at the Same Time

What is investment risk premium?
What are the benefits of diversification?
- Diversification means holding a variety of investment assets
- Diversification lowers random risk when asset returns are poorly correlated
- Because the return correlations among stocks, bonds, and bills are low, holding these investments in a portfolio is effective

What are guidelines for diversification?
- Diversify Among Intangibles and Tangibles
  - Remember a house is a major tangible
- Diversify Globally
  - Think about international investments
- Diversify within Asset Groups
  - For example, within stocks, invest in a variety of stocks

What approach to use when acquiring securities?
- Dollar Cost Averaging
  - Make Equal $ Investments At Regular Time Intervals
  - Over Time, You Invest at an Average Cost
- Routine Investment Plans
  - Dividend Reinvestment Plans (DRIPS)
  - Choosing to Reinvest Dividends with Your Mutual Fund

When to sell securities?
- If the Security Becomes Over-Valued
- To Gain Certain Tax Advantages, Such as Capital Losses
- Your Investment Objectives Change
  - You Need to Be More Conservative, or
  - You Need More Current Income

What is market timing?
- As Economic Conditions Change, You Can:
  - Ignore Such Changes--This is a *Buy-and-Hold Strategy*
  - Try to Exploit Such Changes to Enhance Your Return--This is Called a *Market Timing Approach*

Is market timing a good idea?
- In general, no.
- Because
  - Timing is Very Difficult
  - Timing Can Add to Investment Risk
- Bottom Line: Construct a Sound Portfolio and Stick With It!
Assignment for Chapters 9 and 10

- Pretend to invest $1,000
- Pick 5 publicly traded stocks
  - Pretend to pick an brokerage firm on the Web so you have some commission figures
- Find information about them
- Keep honest records till the end of the week before last week of class
- Calculate portfolio high, low, total return at the end