



## Chapter 2

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# Investment Markets and Transactions



# Security Markets

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- Forums that allow suppliers and demanders of securities to make financial.
- Types of Securities Markets:
  - Money markets (Short-Term securities)
  - Capital markets (Long-term securities)
    - Primary
    - Secondary



# Primary Markets

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- Going Public
- Process governed by SEC
- Usually assisted by Investment Banker
  - Serves as underwriter



# Secondary Market

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- Handles securities traded among investors after they have been issued
  - Stock exchanges
  - NASDAQ
    - computer based national market
  - Over-the-counter (OTC) markets
    - Include small companies that cannot qualify for listing
    - Most government bonds



# Broker Markets

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- Two parties in transaction are brought together
- Specialists manage auction process
- NYSE, AMEX



# Dealer Market

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- Buyer and seller not brought together
  - No centralized trading floor
- Market Makers
- NASDAQ, OTC
- Bid/Ask Spread



# Third and Fourth Markets

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- **The third market**

- OTC transactions made in exchange-listed securities

- **The fourth market**

- Transactions made directly between large institutional buyers and sellers.



# General Market Conditions

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- **Bull markets**

- favorable markets
- rising prices, investor optimism, economic recovery, and government stimulus.

- **Bear markets**

- unfavorable markets
- falling prices, investor pessimism, economic slowdown, and government constraint.



# Globalization of Securities

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- Facilitates Diversification
  - Wider range of industries & securities
  - Securities traded in larger number of markets
  - Securities denominated in different currencies



# International Investing

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- **Direct investment**

- American Depository Receipts (ADRs)
  - dollar-denominated receipts for the stocks of foreign companies
- Purchase directly on exchange
- American Depository Shares (ADSs)
- Yankee Bonds
  - Dollar denominated debt securities issued by foreign governments and corporations

- **Indirect Investment**

- mutual funds specializing in foreign securities.



# Risk of International Investing

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- Trade policies, labor laws, and taxation may affect operating conditions.
- Foreign economic and political environments
- Accounting differences
- Exchange rate risk



# Review

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- Review problems 69, 91, 92, 93 and 94 in Volume III, Investments



# Regulation of Securities Markets

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- **Purpose:**

- protect investors
- Meet needs of financial marketplace

- **Major Legislation:**

- Securities Act of 1933
- Securities Act of 1934
- Insider Trading and Fraud Act of 1988
- Sarbanes Oxley Act of 2002



# Review

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- Review problems 104, 105 and 106 in Volume III, Investments



# Basic Types of Investment Transactions

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- **Long**

- investors buy securities in the hope that they will increase in value

- **Margin**

- use borrowed funds to purchase securities
- Magnifies returns and losses (use OPM)



# Margin Requirements

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- Set by the Federal Reserve Board.
  - ***Initial margin*** – amount which must be provided by the investor at the time of purchase.
  - ***Maintenance margin*** - minimum amount of equity investors must have in their margin accounts at all times.



# Margin Accounts (3 of 4)

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- Restricted account
  - account whose equity is less than the initial margin requirement
  - investor
    - may not make further margin purchases
    - must bring the margin back to the initial level when securities are sold.
  
- Margin call
  - notification of need to bring the equity of an account up to the maintenance level or have margin holdings sold to reach this point.



# Margin Accounts

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- Margin =  $\frac{\text{value of securities} - \text{debit balance}}{\text{value of securities}}$

$$= \frac{V - D}{V}$$

- value of securities = current market price
- debit balance = amount borrowed.



# Margin Trading

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- Return on invested capital equals:

$$\frac{\text{income rec'd} - \text{loan interest} + \text{value at sale} - \text{value at purchase}}{\text{amount of equity invested}}$$

- This return can be annualized by multiplying it by the equivalent number of periods in a year.



# Uses of Margin Trading

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- Increase transaction returns
  - hope for the price to increase.
- Pyramiding
  - Using margin (equity) in an account in excess of the required margin to purchase additional securities



# Short Selling

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- Selling borrowed securities with the expectation of purchasing the securities back at a lower price.
- Impact
  - make money when prices drop.
  - have no current income as dividends belong to the lender.
  - If prices go up, the losses go up as well.
  - Must meet margin requirements to cover increases in price and/or dividends



# Short Sales Restrictions

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- **Uptick rule**

- short sales can only be executed on an uptick, or a zero tick that follows an uptick

- **Dividends**

- The short seller is responsible to the lender of the security for any dividends paid during the short sale period.
- Theoretically, this should not be an issue, since the price of the security tends to fall by the dividend amount when the stock goes ex-dividend.