Securities Markets

Chapter 4
Charles P. Jones, Investments: Analysis and Management,
Ninth Edition, John Wiley & Sons
The Role of Financial Markets

- Help firms and governments raise cash by selling claims against themselves
- Provide a place where investors can act on their beliefs
- Help allocate cash to where it is most productive
- Help lower the cost of exchange
Markets in New Securities

• New securities are issued in a primary market
  – Initial public offerings versus seasoned new issues

• Issue facilitated by investment banker
  – Specialists in advice, design, and sales
  – Intermediaries between issuer and investor
Investment Banking

- Client advice includes type and features of security, offer price, and timing of sale
- Underwriting services: Risk of selling to investors assumed from issuer
- Coordinates marketing by helping issuer register securities, issue prospectus, and sell securities
Investment Banking

• Rule 415 (shelf rule) allows certain issuers to sell new securities over time after filing a single registration
  – Reduces issuance cost

• A private placement means new securities are sold directly to investors, bypassing the open market
  – Registration not required
Secondary Markets

• Markets where investors trade previously issued securities

• Auction markets involve bidding in a specific physical location
  – Brokers represent investors for a fee
  – Others trade for their own account

• Negotiated markets consist of decentralized dealer network
Stock Exchanges

• NYSE is a secondary, auction market in equity shares
  – Not-for-profit organization of members
  – Listing requirements for traded firms
  – “Specialists” assigned to each traded equity to make a market in that stock

• AMEX and regional exchanges list smaller firms, have less volume than NYSE
NASDAQ

- Network of competing dealers trading listed securities
- Automated quotation system with no fixed number of participants
  - NASDAQ National Market
  - NASDAQ SmallCap Market
- More firms listed than NYSE
- Network connects to other trading systems
Over-the-Counter Markets

• Network of dealers standing ready to either buy or sell securities at specified prices
  – Dealers profit from spread between buy and sell prices
  – Handle unlisted securities
• OTC Bulletin Board
• ECNs: Additional trading mechanism, especially after exchanges close
Foreign Markets

• US equity markets account for a third of world’s stock market capitalization
  – Many different equity markets exist

• Emerging market: Stable political system, low regulation, low standardization in trading activity
  – Risks: Illiquidity, lack of information, political uncertainty
Equity Market Indicators

• Provide a composite report of market behavior on a given day

• Dow Jones Industrial Average
  – Composed of 30 “blue-chip” stocks
  – Price-weighted index: Essentially adds the prices of 30 stocks, divides by 30
    • Adjusted for stock splits, stock dividends
  – Oldest, most well-known measure
Equity Market Indicators

• Standard & Poor’s Composite Index
  – Composed of 500 “large” firm stocks
  – Expressed as index number relative to a base index value of 10 (1941-43)
  – Value-weighted index: Prices and shares outstanding considered
  • Indicates how much the average equity value of the 500 firms in the index has increased relative to the base period
Equity Market Indicators

- NYSE and NASDAQ Composite Indices
  - Value-weighted indices of broad markets
- Nikkei 225 Average
  - Price-weighted index of 225 actively-traded stocks on the Tokyo Stock Exchange
Bond Markets

- Secondary bond market is primarily an over-the-counter network of dealers
  - NYSE features an automated bond system to execute orders.
    - Mostly corporate bonds, thinly traded
  - Treasury and agency bonds actively trade in dealer markets
    - Municipal bonds less actively traded
Market Developments

• Growth of institutional trading associated with:
  – Block trading of stocks (transactions of at least 10,000 shares)
    • Affects market structure and operation
  – Negotiated, not fixed, commissions

• Evolution of National Market System
  – Centralized system for price and activity reporting, order routing and sequencing
END