

Investments

Topic 0: Capital Markets

UCLA | Fall 2024

by Mikhail Chernov

Overview of Topic 0

① Capital markets

② Sell side

③ Buy side

1. Capital Markets

Capital Markets

- Big picture: matching projects with sources of financing
- This activity creates the need for intermediaries
 - matching
 - risk transfer after initial funding
- Financial firms are highly specialized creating a larger need for intermediation
 - Different ways to finance a project: debt, equity, many more . . . Each type requires different expertise even if the project is the same
 - Different risk appetites . . . even diversification requires a multitude of expertise types
 - “Quality” of available capital affects the investment profile

Banking

- Commercial banks
 - Accept deposits
 - Lend out money
 - Face lenders and borrowers
 - Subject to heavy regulation making them “safe”
- Investment banks
 - Facilitate lending/borrowing when the parties are facing each other
 - Facilitate trading of claims in the secondary market (risk sharing)

Investors

- Deposit into a bank
- Invest with an asset manager:
 - mutual funds
 - hedge funds
 - venture capital
 - private equity
- DIY
 - [retail](#)/discount broker
 - charge no fee but get rebates from market makers, [PFOF](#)
 - keep track of holdings, facilitate short sales and purchase on the margin
 - full-service broker
 - FinTech: [roboadvising](#)
 - prime brokers do not execute trades

Asset management

- Different flavors depending on the level of regulation and wealth of clients
- Evaluate the universe of financial assets
 - Primarily, secondary markets
- Evaluate risk-return tradeoffs
- Make investment decisions to maximize returns, given the level of risk
- This endeavor is the focus of this class

2. Sell Side

Sell Side

- Usually represented by “bulge bracket” investment banks, such as, BAML, Goldman Sachs, JP Morgan, and Morgan Stanley
- Investment banking division enables primary market transactions
 - IPO/SEO
 - Loans and bond issuance
 - M&A and bankruptcies
- Capital markets division facilitates secondary market transactions
 - Sales & Trading
 - Research / Strategy
 - Structuring
 - Indexing
 - Risk management
- Prime brokerage

Trading

- Every security has two prices
 - Bid – bank/broker buys from the client
 - Ask/offer - banks sells
 - Ask > Bid
- A client may ask to make a market, that is, quote both Bid and Ask
 - Usually there is an order size (small) for which this is guaranteed
- Sometimes a broker acts as a client's agent searching for counterparty
- Sometimes a broker commits capital and takes the other side

Markets

- Exchanges and over-the-counter (OTC)
- Exchanges are *centralized* marketplaces:
 - Orders (market, limit, size) are consolidated in one place
 - Specialists (one per security) manage an auction process
 - Market makers (multiple per security) stand ready to buy or sell as needed
 - Major transformation to electronic trading over the last 15 years:
high-frequency trading
- OTC is a *bilateral* market
 - Useful when markets are new or difficult to standardize, e.g., bonds
 - Give rise to search: contact multiple dealers yourself

3. Buy Side

Buy Side

- Asset managers invest capital
 - raise money from clients (retail, institutional)
 - invest money in the financial markets
 - subject to their investment mandate and regulation
- Investment style
 - passive, or indexing
 - active
- Benchmarking
 - relative performance
 - absolute returns
- Restrictions
 - long only
 - relaxed constraint (130% long, 30% short)
 - market neutral

Investment products

- Mutual funds
 - Open-ended; can trade once a day, can redeem, price=NAV
 - Closed-ended; can trade intraday, cannot redeem, price<NAV
 - Have to disclose their (long) holdings quarterly through 13-F filings (13-D if own >5% of a company)
 - Targeting small retail
- ETFs and ETNs, facilitated by Authorized Participants
 - similar to market makers
 - can buy and re-sell the ETF units, or can convert between a basket of securities and units
 - APs convert when the market value is far from NAV
 - levered and inverse ETFs
- Alternative investments (precludes retail participation)
 - Typically minimal or no regulatory restrictions
 - General partners (managers) charge investors (limited partners) performance fees
 - Capital lock-up

Investors

- Individuals
- Private Wealth Managers / Registered Investment Advisors
- Family Office
- Institutions
 - State pension plans
 - Corporate pension plan
 - Endowments / Foundations
 - Funds of funds
 - (Re) insurance companies
 - Corporate Treasury departments