Money Market Instruments (Cash Instruments)

- Short term debt instruments sold by governments, financial institutions and corporations → vehicles for short term borrowing
    - Treasury Bills (US Gov)
    - Repurchase agreements (Repos)
    - Commercial paper, commercial deposits
    - The London interbank rate (LIBOR), EURIBOR

Capital Market Instruments

- Maturities of greater than one year, or no maturity at all, generally divided into 2 types
- Fixed income or debt
    - Promises either a fixed stream of income or a stream of income determined by a specific formula
- Common stock or equity
    - Presents an ownership share in a company

Fixed Income Instruments (Fixed Income securities/debt instruments/bonds)

- Government bonds, or government agency bonds (backed by sovereign entity)
- Corporate bonds
- Developed market bonds vs emerging market bonds
- Credit rating agencies - Fitch, S&P, Moodys
    - Investment-grade BBB- or above
    - High yield (junk bonds)
- Fixed-rate bonds: Most bonds issued by corporates have a fixed coupon
- Floating rate: Coupon tied to a benchmark rate: eg. prime rate, LIBOR. Treasury rate + spread
- Floating rate can also be tied to the inflation rate:
    - UK - inflation-linked Glits
    - US - treasury inflation protected securities

Equity Instruments

- Common stock or equity
    - Residual claim to earnings, after all, holders of debt claims are paid - the riskiest security
- Hybrid securities
    - Preference shares - a hybrid of debt and equity

How do these instruments rank in terms of risk? What factors affect their risk?

1. The priority of the claims the investment has on income and assets
2. The creditworthiness of the issuer or guarantor
3. The maturity of an instrument - in general, the longer the maturity the more risky it is
4. The liquidity of the instrument and the type of market in which it is traded

Derivatives

- futures/forwards and options
- A forward or future is the delayed purchase or sale of an asset, with an agreed price now
- An option is a contingent claim - like insurance contract you may not use it. The buyer of an option has the right but not the obligation to buy or sell an asset in the future at a certain price

Why are derivatives useful?

- There are a finite number of bonds and stocks, of a particular maturity dates, or of a particular size
    - A derivates is like a side-bet and for the over-the-counter derivatives, can provide any exposure you want
    - They can be written on, for example, the price of electricity or the amount of rainfall in a year
    - They allow a transfer of risk from those who wish to avoid risk to those who are more willing to take it on

Indirect Investing

- Investment funds investing in mixtures of stocks and bonds - managed by a manager, maybe active or passive → regulated
- ETFs- Exchange-traded funds - bought and sold like shares, cheaper than managed funds → regulated
- Hedge Funds - typically invest in more esoteric and risky assets than traditional funds. Not available to retail investors, only to large sophisticated investors → Not regulated

Reasons Not to Invest as an Individual

- An investment fund is a way of investing money alongside other investors in order to benefit from the inherent advantages of working as part of a group. These advantages include an ability to:
    - Hire professional investment managers, which may potentially be able to offer better returns and more adequate risk management
    - Benefit from economies of scale, i.e, lower transaction costs
    - Increase the asset diversification to reduce some unsystematic risk

So then what are Alternatives Investments?

- Anything that is not cash, equity or bonds, a loosely used term, can mean different things to different investors
    - Hedge funds
    - Real assets, eg. Real estate, commodities
    - Currencies
    - Asset-backed securities (securitized debts)

The Role of Financial Markets

- The informational role
    - Capital flows to companies with best prospects
- Consumption timing
    - Use securities to store wealth and transfer consumption to the future
- Allocation of risk
    - Investors can select securities consistent with their tastes for risk, which benefits the firms that need to raise capital