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Stock Market

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Article Reviewed on March 20, 2021
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Updated Mar 20, 2021

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What is the Stock Market?

The stock market refers to the collection of markets and exchanges where regular activities of buying, selling, and issuance of shares of publicly-held companies take place. Such financial activities are conducted through institutionalized formal exchanges or over-the-counter (OTC) marketplaces which operate under a defined set of regulations. There can be multiple stock trading venues in a country or a region which allow transactions in stocks and other forms of securities.

While both terms - stock market and stock exchange - are used interchangeably, the latter term is generally a subset of the former. If one says that she trades in the stock market, it means that she buys and sells shares/equities on one (or more) of the stock exchange(s) that are part of the overall stock market. The leading stock exchanges in the U.S. include the New York Stock Exchange (NYSE), Nasdaq, and the Chicago Board Options Exchange (CBOE). These leading national exchanges, along with several other exchanges operating in the country, form the stock market of the U.S.

Though it is called a stock market or equity market and is primarily known for trading stocks/equities, other financial securities - like exchange traded funds (ETF), corporate bonds and derivatives based on stocks, commodities, currencies, and bonds - are also traded in the stock markets. (For related reading, see "What's the Difference Between the Equity Market and the Stock Market?")

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Stock Market

Understanding the Stock Market

While today it is possible to purchase almost everything online, there is usually a designated market for every commodity. For instance, people drive to city outskirts and farmlands to purchase Christmas trees, visit the local timber market to buy wood and other necessary material for home furniture and renovations, and go to stores like Walmart for their regular grocery supplies.

Such dedicated markets serve as a platform where numerous buyers and sellers meet, interact and transact. Since the number of market participants is huge, one is assured of a fair price. For example, if there is only one seller of Christmas trees in the entire city, he will have the liberty to charge any price he pleases as the buyers won't have anywhere else to go. If the number of tree sellers is large in a common marketplace, they will have to compete against each other to attract buyers. The buyers will be spoiled for choice with low- or optimum-pricing making it a fair market with price transparency. Even while shopping online, buyers compare prices offered by different sellers on the same shopping portal or across different portals to get the best deals, forcing the various online sellers to offer the best price.

A stock market is a similar designated market for trading various kinds of securities in a controlled, secure and managed environment. Since the stock market brings together hundreds of thousands of market participants who wish to buy and sell shares, it ensures fair pricing practices and transparency in transactions. While earlier stock markets used to issue and deal in paper-based physical share certificates, the modern day computer-aided stock markets operate electronically.

How the Stock Market Works

In a nutshell, stock markets provide a secure and regulated environment where market participants can transact in shares and other eligible financial instruments with confidence with zero- to low-operational risk. Operating under the defined rules as stated by the regulator, the stock markets act as primary markets and as secondary markets.

As a primary market, the stock market allows companies to issue and sell their shares to the common public for the first time through the process of initial public offerings (IPO). This activity helps companies raise necessary capital from investors. It essentially means that a company divides itself into a number of shares (say, 20 million shares) and sells a part of those shares (say, 5 million shares) to common public at a price (say, $10 per share).

To facilitate this process, a company needs a marketplace where these shares can be sold. This marketplace is provided by the stock market. If everything goes as per the plans, the company will successfully sell the 5 million shares at a price of $10 per share and collect $50 million worth of funds. Investors will get the company shares which they can expect to hold for their preferred duration, in anticipation of rising in share price and any potential income in the form of dividend payments. The stock exchange acts as a facilitator for this capital raising process and receives a fee for its services from the company and its financial partners.

Following the first-time share issuance IPO exercise called the listing process, the stock exchange also serves as the trading platform that facilitates regular buying and selling of the listed shares. This constitutes the secondary market. The stock exchange earns a fee for every trade that occurs on its platform during the secondary market activity.

The stock exchange shoulders the responsibility of ensuring price transparency, liquidity, price discovery and fair dealings in such trading activities. As almost all major stock markets across the globe now operate electronically, the exchange maintains trading systems that efficiently manage the buy and sell orders from various market participants. They perform the price matching function to facilitate trade execution at a price fair to both buyers and sellers.

A listed company may also offer new, additional shares through other offerings at a later stage, like through rights issue or through follow-on offers. They may even buyback or delist their shares. The stock exchange facilitates such transactions.

The stock exchange often creates and maintains various market-level and sector-specific indicators, like the S&P 500 index or Nasdaq 100 index, which provide a measure to track the movement of the overall market. Other methods include the Stochastic Oscillator and Stochastic Momentum Index.

The stock exchanges also maintain all company news, announcements, and financial reporting, which can be usually accessed on their official websites. A stock exchange also supports various other corporate-level, transaction-related activities. For instance, profitable companies may reward investors by paying dividends which usually comes from a part of the company's earnings. The exchange maintains all such information and may support its processing to a certain extent. (For related reading, see "How Does the Stock Market Work?")

Functions of a Stock Market

A stock market primarily serves the following functions:

Fair Dealing in Securities Transactions: Depending on the standard rules of demand and supply, the stock exchange needs to ensure that all interested market participants have instant access to data for all buy and sell orders thereby helping in the fair and transparent pricing of securities. Additionally, it should also perform efficient matching of appropriate buy and sell orders.

For example, there may be three buyers who have placed orders for buying Microsoft shares at $100, $105 and $110, and there may be four sellers who are willing to sell Microsoft shares at $110, $112, $115 and $120. The exchange (through their computer operated automated trading systems) needs to ensure that the best buy and best sell are matched, which in this case is at $110 for the given quantity of trade.

Efficient Price Discovery: Stock markets need to support an efficient mechanism for price discovery, which refers to the act of deciding the proper price of a security and is usually performed by assessing market supply and demand and other factors associated with the transactions.

Say, a U.S.-based software company is trading at a price of $100 and has a market capitalization of $5 billion. A news item comes in that the EU regulator has imposed a fine of $2 billion on the company which essentially means that 40 percent of the company's value may be wiped out. While the stock market may have imposed a trading price range of $90 and $110 on the company's share price, it should efficiently change the permissible trading price limit to accommodate for the possible changes in the share price, else shareholders may struggle to trade at a fair price.

Liquidity Maintenance: While getting the number of buyers and sellers for a particular financial security are out of control for the stock market, it needs to ensure that whosoever is qualified and willing to trade gets instant access to place orders which should get executed at the fair price.

Security and Validity of Transactions: While more participants are important for efficient working of a market, the same market needs to ensure that all participants are verified and remain compliant with the necessary rules and regulations, leaving no room for default by any of the parties. Additionally, it should ensure that all associated entities operating in the market must also adhere to the rules, and work within the legal framework given by the regulator.

Support All Eligible Types of Participants: A marketplace is made by a variety of participants, which include market makers, investors, traders, speculators, and hedgers. All these participants operate in the stock market with different roles and functions. For instance, an investor may buy stocks and hold them for long term spanning many years, while a trader may enter and exit a position within seconds. A market maker provides necessary liquidity in the market, while a hedger may like to trade in derivatives for mitigating the risk involved in investments. The stock market should ensure that all such participants are able to operate seamlessly fulfilling their desired roles to ensure the market continues to operate efficiently.

Investor Protection: Along with wealthy and institutional investors, a very large number of small investors are also served by the stock market for their small amount of investments. These investors may have limited financial knowledge, and may not be fully aware of the pitfalls of investing in stocks and other listed instruments. The stock exchange must implement necessary measures to offer the necessary protection to such investors to shield them from financial loss and ensure customer trust.

For instance, a stock exchange may categorize stocks in various segments depending on their risk profiles and allow limited or no trading by common investors in high-risk stocks. Exchanges often impose restrictions to prevent individuals with limited income and knowledge from getting into risky bets of derivatives.

Balanced Regulation: Listed companies are largely regulated and their dealings are monitored by market regulators, like the Securities and Exchange Commission (SEC) of the U.S. Additionally, exchanges also mandate certain requirements – like, timely filing of quarterly financial reports and instant reporting of any relevant developments - to ensure all market participants become aware of corporate happenings. Failure to adhere to the regulations can lead to suspension of trading by the exchanges and other disciplinary measures.

Regulating the Stock Market

A local financial regulator or competent monetary authority or institute is assigned the task of regulating the stock market of a country. The Securities and Exchange Commission (SEC) is the regulatory body charged with overseeing the U.S. stock markets. The SEC is a federal agency that works independently of the government and political pressure. The mission of the SEC is stated as: "to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."■■

Stock Market Participants

Along with long-term investors and short term traders, there are many different types of players associated with the stock market. Each has a unique role, but many of the roles are intertwined and depend on each other to make the market run effectively.

- Stockbrokers, also known as registered representatives in the U.S., are the licensed professionals who buy and sell securities on behalf of investors. The brokers act as intermediaries between the stock exchanges and the investors by buying and selling stocks on the investors' behalf. An account with a retail broker is needed to gain access to the markets.
- Portfolio managers are professionals who invest portfolios, or collections of securities, for clients. These managers get recommendations from analysts and make the buy or sell decisions for the portfolio. Mutual fund companies, hedge funds, and pension plans use portfolio managers to make decisions and set the investment strategies for the money they hold.
- Investment bankers represent companies in various capacities, such as private companies that want to go public via an IPO or companies that are involved in pending mergers and acquisitions. They take care of the listing process in compliance with the regulatory requirements of the stock market.
- Custodian and depot service providers, which are institution holding customers' securities for safekeeping so as to minimize the risk of their theft or loss, also operate in sync with the exchange to transfer shares to/from the respective accounts of transacting parties based on trading on the stock market.
- Market maker: A market maker is a broker-dealer who facilitates the trading of shares by posting bid and ask prices along with maintaining an inventory of shares. He ensures sufficient liquidity in the market for a particular (set of) share(s), and profits from the difference between the bid and the ask price he quotes.

How Stock Exchanges Make Money

Stock exchanges operate as for-profit institutes and charge a fee for their services. The primary source of income for these stock exchanges are the revenues from the transaction fees that are charged for each trade carried out on its platform. Additionally, exchanges earn revenue from the listing fee charged to companies during the IPO process and other follow-on offerings.

The exchange also earns from selling market data generated on its platform - like real-time data, historical data, summary data, and reference data – which is vital for equity research and other uses. Many exchanges will also sell technology products, like a trading terminal and dedicated network connection to the exchange, to the interested parties for a suitable fee.

The exchange may offer privileged services like high-frequency trading to larger clients like mutual funds and asset management companies (AMC), and earn money accordingly. There are provisions for regulatory fee and registration fee for different profiles of market participants, like the market maker and broker, which form other sources of income for the stock exchanges.

The exchange also makes profits by licensing their indexes (and their methodology) which are commonly used as a benchmark for launching various products like mutual funds and ETFs by AMCs.

Many exchanges also provide courses and certification on various financial topics to industry participants and earn revenues from such subscriptions.

Competition for Stock Markets

While individual stock exchanges compete against each other to get maximum transaction volume, they are facing threat on two fronts.

Dark Pools: Dark pools, which are private exchanges or forums for securities trading and operate within private groups, are posing a challenge to public stock markets. Though their legal validity is subject to local regulations, they are gaining popularity as participants save big on transaction fees.

Blockchain Ventures: Amid rising popularity of blockchains, many crypto exchanges have emerged. Such exchanges are venues for trading cryptocurrencies and derivatives associated with that asset class. Though their popularity remains limited, they pose a threat to the traditional stock market model by automating a bulk of the work done by various stock market participants and by offering zero- to low-cost services.

Significance of the Stock Market

The stock market is one of the most vital components of a free-market economy.

It allows companies to raise money by offering stock shares and corporate bonds. It lets common investors participate in the financial achievements of the companies, make profits through capital gains, and earn money through dividends, although losses are also possible. While institutional investors and professional money managers do enjoy some privileges owing to their deep pockets, better knowledge and higher risk taking abilities, the stock market attempts to offer a level playing field to common individuals.

The stock market works as a platform through which savings and investments of individuals are channelized into the productive investment proposals. In the long term, it helps in capital formation & economic growth for the country.

Key Takeaways

- Stock markets are vital components of a free-market economy because they enable democratized access to trading and exchange of capital for investors of all kinds.
- They perform several functions in markets, including efficient price discovery and efficient dealing.
- In the US, the stock market is regulated by the SEC and local regulatory bodies.

Examples of Stock Markets

The first stock market in the world was the London stock exchange. It was started in a coffeehouse, where traders used to meet to exchange shares, in 1773. The first stock exchange in the United States of America was started in Philadelphia in 1790. The Buttonwood agreement, so named because it was signed under a buttonwood tree, marked the beginnings of New York's Wall Street in 1792. The agreement was signed by 24 traders and was the first American organization of its kind to trade in securities. The traders renamed their venture as New York Stock and Exchange Board in 1817. (For related reading, see "The Highest Priced Stocks In America")