## Chapter 1: The Investment Industry - A Top/Down View

### Introduction

In essence, the financial system connects those who seek money and those with money who are seeking to invest.

### The Financial Services Industry

1. Within the financial system, the financial services industry offers a range of products and services to savers and spenders and helps to channel funds between them.
    a. Savers and spenders both include individuals (households), companies, and governments.
        i. The term saver characterises those who have accumulated savings. These savings are often invested, at which point savers become investors and providers of capital. In the situation of a loan, savers are considered to be lenders.
        ii. The term spender characterises those who need money. When spenders receive money, they become users of capital.
2. Assets
    a. Assets are defined as items that have value. This includes both:
        i. Real Assets: physical assets, such as land and buildings. These are sometimes referred to as physical capital when they are part of a company's means of production.
        ii. Financial Assets: claims on real, or possibly other financial, assets, such as a stock or bond. An investor's total holdings of financial assets is called a Portfolio or Investment Portfolio.
3. Securities
    a. Securities are defined as financial assets that can be traded. The two largest categories of securities are:
        i. Debt Securities: in essence, loans that lenders make to borrowers. Debt Securities are also called Fixed-Income Securities because the loan payments are often fixed. They are also known as Bonds, the investors being called Bondholders.
        ii. Equity Securities: stocks / shares. Stock/share holders have ownership in a company. Companies have no obligation to repay the cost of the stock or to pay dividends to stockholders, but stockholders often do receive them and expect to sell in the long-run for a gain.
4. Markets
    a. Markets are where buyers meet sellers to trade.
    b. Financial Markets are where savers and spenders can buy and sell securities. Investing through this medium is called Direct Financing because providers of capital (savers) have a direct claim on the users of capital (spenders).
    c. Financial Intermediaries are bodies that mediate this exchange. Investment through this medium is called Indirect Finance, because providers of capital do not have a direct claim on the users of capital.

i. Given that identifying and making investments (and subsequently ensuring the viability of that investment) is costly both in terms of time or money, financial intermediaries become a more efficient way of investing compared to direct financing for providers of capital.

**Financial Institutions**

Financial Insitutitions are types of Financial Intermediaries. There are two main types of Financial Institutions:

1. Banks
    a. The purpose of banks is to collect deposits from savers and to transform them into loans to borrowers (indirectly connecting them.) The savers do not have a claim on the lendee, rather they have a claim on the bank through their deposit, and the bank has a claim on the lendee.
        i. Banks are also called Deposit-Taking Institutions. In exchange for savers deposits, banks offer a variety of transactional services such as cash writing, etc…
        ii. Banks can also raise money to make loans by issuing and selling bonds or stocks on financial markets.
    b. There are many different structures that banks take:
        i. Building Societies: (also known as savings and loan associations) specialize in financing long-term residential mortgages.
        ii. Retail Banks: provide banking products and services to individuals and small businesses (checking/saving, debit/credit, loans/mortgages/)
        iii. Commercial Banks: provide a variety of goods and services to companies and other financial institutions.
        iv. Co-operative and Mutual Banks: are financial institutions that their members own and run. This can be advantageous because savers have the potential to earn interest on their savings through the bank's investments/loans.
    c. If borrowers default, banks are still responsible for paying their depositors and lenders. This means that the owners of the bank are ultimately responsible for paying their debts and that banks should loan carefully.

2. Insurance Companies
    a. The purpose of Insurance Companies is to help individuals and companies offset the risks they face. To protect themselves, individuals and companies can enter insurance contracts (policies) that provide payment in the event of a specified loss. Those who purchase these contracts usually pay an up-front premium.
    b. There are two main types of insurance companies:
        i. Property and Casualty Insurers: who insure assets such as homes, cars, and businesses.
        ii. Legal Liability and Life Insurers: who insure the owners of the title in the event of death or legal liability.

c. Insurers act as Financial Intermediaries because they connect the buyers of their insurance contracts with providers of capital that are willing to bear the insured risks.
    i. The buyers benefit because they can transfer risk without having to find someone who is willing to assume the risk.
    ii. The providers of capital benefit because they can earn a return on their investment.
    iii. Insurance Companies manage the relationship between the buyers of the insurance contract and the providers of capital.
d. Insurance Companies also needs to manage:
    i. Fraud: people deliberately causing or falsely claiming losses to collect insurance settlements.
    ii. Moral Hazard: people being less careful about not sustaining losses once they are insured.
    iii. Adverse Selection: occurs when people who are most at risk buy insurance, causing insured losses to be greater than average losses.

**How Economies Benefit From the Existence of the Investment Industry**

The Investment Industry is a subset of the financial services industry and is comprised of the participants that enable savers to invest their money and spenders to raise capital in financial markets.

1. Economic Systems
    a. The investment industry lies within a greater economic system, the goal of which is to enable an efficient allocation of scarce resources.
    b. Capitalism: an economic system that promotes private ownership as the means of production and markets as the means of allocating scarce resources.
        i. In a pure, free market, capitalist economy, there is no central authority and individuals and companies make their own decision regarding the allocation and use of resources.
        ii. When scarce resources are used efficiently, economics are able to grow.
        iii. Pure, free market capitalism only exists in theory. Practically, governments are always involved in some way (whether regulation, oversight, etc..)
2. How the Investment Industry Fosters Economic Growth
    a. The Investment Industry helps foster the efficient allocation of resources that exist within an economy. Without the Investment Industry, the interaction between savers and spenders would be far less efficient.
    b. The Investment Industry also provides and processes information about investments, economies, individuals, companies, and governments. This information is used by spenders to help decide how their money should be invested.
    c. The Investment Industry also provides liquidity, which refers to the ease of buying or selling an asset without affecting its price. The inherent liquidity of assets can vary, for instance real estate versus cash.
        i. Trading a large quantity of shares can affect a share’s price.

        ii. Liquidity is an important part of a well functioning financial market. High liquidity markets allow investors to complete a transaction quickly (and to reverse it quickly) and to have confidence that they are getting a fair price.

**How Investors Benefit From the Existence of the Investment Industry**

1. How the Investment Industry Serves Investors (the following list are characteristics that define a functional investment industry)
    a. An important feature of a well-functioning investment industry is the availability and diversity of investment opportunities. This allows for investors' needs to be met by the market. Investors have the ability to invest in debt and equity securities, derivatives, alternative investments, and pooled investment vehicles.
        i. Investment Industry participants can also repackage claims on a group of real and financial assets to create new financial products that better meet the needs of investors.
    b. Another feature is the availability of a broad range of investment services that help them better make and implement decisions. These services include planning, management, information, and trading services.
    c. Another feature is the competitiveness of financial markets. Competitive markets arise when a market is composed of a large number of players, none of which have undue influence. This promotes market efficiency and reduces prices.
    d. Another feature is high liquidity and low transaction costs, as both of these improve efficiency and help to maximize returns.
    e. Another feature is the availability of relevant and accurate information regarding the economy, as this type of information affects prices. Additionally, prices can fluctuate quickly.
    f. Another feature is the ability to handle risk. Risk refers to the effect of uncertain future events on an organization or the outcome that an organization achieves. The Investment Industry can help both manage and assess risk.
2. Need for Trust, Laws, and Regulation
    a. Trust is an essential component of all markets and industries, and in the Investment Industry in particular. Trust enables investors to have confidence in the investments that they make and in the financial intermediaries that help them make those investments.
    b. Laws and Regulation are required so that participants in the Investment Industry practice fairly. Laws are typically created by governments, while Regulation is typically achieved through agencies.
        i. Laws and Regulation are designed to prevent fraud, protect investment industry participants (particularly individual investors), and promote and maintain the integrity, transparency, and fairness of financial markets.
        ii. Laws and Regulations cannot foresee and prevent all potential occurrences, so it is paramount that investment industry participants conduct themselves legally and according to ethical standards. This is paramount for investor confidence, the viability of the economy, and maintaining the reputation of the investment industry.

**Investment Industry Participants**

1. How Companies and Governments Raise Capital
    a. Investment Banks: also known as merchant banks, are financial intermediaries that have expertise in assisting companies and governments raise capital.
        i. Investment Banks help companies organize equity and debt issuances (hence their involvement in IPO's.)
        ii. Investment Banks are specialists in matching investors with companies and governments seeking capital. Because investment banks are able to design securities that fit the needs and desires of both spenders and savers, both sides are able to attain investment at a lower cost than they would otherwise be able to.
2. How the Investment Industry Helps Savers Invest Their Money
    a. There are, generally speaking, two main types of investors: individual and institutional. Individual investors are as their name suggests, and institutional investors are organizations that invest either for themselves or on the behalf of others.
    b. Within each of these categories are further divisions:
        i. Individual investors are usually classified by their total amount of capital that is investible, typically making them either retail or high net-worth.
        ii. Institutional investors include:
            1. Pension plans
            2. Endowment Funds (long-term funds for non-profit organizations)
            3. Foundations (grant-making institutions funded by financial gifts and the income they produce)
            4. Sovereign Wealth Funds (typically made up of a government's surpluses)
    c. Brokers and Dealers are trading service providers that allow participants in financial markets to make transactions. Brokers are agents who work on the behalf of sellers and buyers to mediate their transactions. Dealers act as principles, meaning that they use their own capital and accounts in their transactions (this is known as Proprietary Trading.) Brokers and Dealers both provide liquidity and help reduce transaction costs.
    d. Other participants that provide trading services include clearing houses and settlement agents, which confirm and settle trades after they have been agreed to. Custodians and depositories hold money and securities on behalf of clients.
    e. Institutional investors can employ buy-side analysts to analyze investment opportunities. Individual investors can employ investment professionals to make investments for them (such as through financial planning.) They can also buy financial products created by financial institutions, such as mutual funds.

**Key Forces Driving the Investment Industry**

- Competition
- Technology
- Globalization
- Regulation