## Chapter 13: Structure of the Investment Industry

### How the Investment Industry Promotes Successful Investing

1. The investment industry provides services to investors to aid them in doing the following:
   a. Determine their financial goals
   b. Identify potential investments
   c. Evaluate the risk and return prospects of potential investments
   d. Trade securities and assets
   e. Hold, manage, and account for securities and assets during the periods of the investments
   f. Evaluate the performance of their investments
2. Achieving each of these activities require a degree of information, expertise, and systems that few individual or institutional investors have on their own. Firms in the investment industry provide services to aid investors in all or some of these activities.

### Financial Planning Services

1. Financial Planners help clients understand their current and future financial needs, determine their risks and risk tolerance, and preferences for capital growth versus capital preservation. FPs create saving and investment plans for their clients, which often require complex analyses of projected returns and risks of the clients' assets and investments.
2. FPs' clients include individuals/households and various kinds of organizations including foundations and endowment funds. Payout Policies is a term used to describe how much money can be taken from long-term funds to use for current spending.

### Investment Management Services

1. Introduction
   a. After determining their financial status, needs, and goals, individual and institutional investors turn to investment management services to do so (which include asset allocation, investment analysis, and portfolio construction.) The services that are available to any single investor can be dependent upon their net worth.
2. Services for High-Net-Worth and Institutional Clients
   a. Investment Management Activities
      i. The three major activities that investment managers provide clients are:
         1. Asset Allocation: relates to the proportions of a portfolio that should be invested in various asset classes. To determine this allocation, the risk and return characteristics of investments should be analyzed.
         2. Investment Analysis: involves the estimation of the fundamental values of investments. An investment becomes a good option when it fits a client's needs and estimated to be priced below is fundamental value.
         3. Portfolio Construction: involves the building and maintaining of client portfolios done by managers
      ii. The majority of these managers work for investment firms and charge fees relative to assets under management, as well as potentially performance fees.

b. Passive and Active Investment Management
    i. Passive Investment Managers seek to match the return and risk of an appropriate benchmark, which include market indices. These are typically the strategies with lowest implementation costs.
    ii. Active Investment Managers try to predict which securities and assets will outperform or underperform comparable securities and assets. These strategies are typically more expensive to implement.

3. Services for Retail Clients
    a. Retail clients typically do not have access to the same level of services as high-net-worth and institutional investors. Retail clients obtain assistance and advice on investment management activities, including asset allocation, investment analysis, and portfolio construction from investment professionals who work for financial institutions of brokers.

**Investment Information Services**

1. Investment Research Providers
    a. Investors can use the services of investment research providers to make more informed decisions. The research and analysis provided by these firms is typically beyond what the investor themselves would be able to accomplish. This research can include estimations of the effects of economic phenomena or the fundamental value of an asset. It is typically useful to base this research on publicly available information, in order to avoid lengthy disclosures.
2. Credit Rating Agencies
    a. Credit Rating Agencies provide opinions on the credit quality of securities and of their issuers. These agencies are paid by companies to rate their products, investors do not typically pay credit rating agencies unless they are obtaining reports of how the credit ratings were determined.
3. Data Vendors
    a. Data Vendors provide data on companies and market conditions for companies to use in their investment and trading processes. Two forms of important real-time data used by investment professionals are news feeds and market data feeds. Technological advancements have improved availability of data.

**Trading Services**

1. Brokers
    a. Brokerage services include execution, advice, and research. Brokers are agents of firms that assist clients in the execution of trades. Highly liquid securities tend to require less work to facilitate, whereas highly illiquid investments may require the sourcing and facilitation of deals.
    b. Block Brokers are brokers who assist clients in buying and selling blocks of securities. Buying blocks usually provides a discount relative to market price, and selling usually requires a premium to market price.
    c. Prime Brokerage refers to a bundle of services that brokers provide to some of their clients, usually investment professionals engaged in trading. This also includes the

financing of positions, clearing and settling transactions, lowering overall costs to the client.

2. Dealers
    a. Dealers are people of firms that allow their clients to trade without having to find a counterparty. They both buy and sell securities, while profiting off the spread. Dealers provide market participants liquidity.
    b. Market Maker is a term used to describe dealers, because they voluntarily make financial markets, at the specific bid and ask prices of market participants. Dealers can be part of hedge funds, investment banks, etc… almost all investment banks have dealing arms. Many dealers also broker transactions on behalf of their clients.
    c. Internalisation: when broker fill their clients' orders by acting as proprietary traders rather than agents - they trade directly with their clients rather than by arranging trades with others on behalf of their clients.
    d. Due to the overlapping functions of brokers and dealers, some people use the two terms to mean the same thing.
    e. Brokers and dealers face a conflict of interest with respect to how they fill their clients' orders. Brokers want to get the best price for their clients, while dealers want to get the largest possible spread on the trade. Thus, some clients ask that their trades not be internalized.
    f. Primary Dealers: are the dealers with which central banks trade when conducting monetary policy.
        i. Central banks sell bonds to primary dealers to decrease the money supply, and buy them back to increase the money supply.
3. Clearing Houses and Settlement Agents
    a. Clearing Houses and Settlement Agents settle trades after they have been arranged. Clearing refers to all activities that occur from the arrangement of the trade to its settlement, and settlement consists of the final exchange of cash for the security.
    b. Clearing Houses arrange for the final settlement of trades. Clearing houses will only settle trades for their traders, so brokers and dealers who are not part of clearing houses must obtain the services of a clearing house.
    c. Settlement Risk: the risk that a counterparty does not settle their trade. This is reduced by having reliable settlement of trades, improving liquidity. The existence of clearing houses also increases the number of counterparties that a trader cna safely trade with.
4. Custodians and Depositories
    a. Custodians: firms, typically investment banks and brokerage firms, that hold money and securities for safekeeping on behalf of their clients.
    b. Depositories: firms that can act as custodians, as well as monitors. Their role is to:
        i. Prevent the loss of securities and payments through fraud, deficient oversight, or natural disaster
        ii. Ensure that securities cannot be pledged more than once by the same borrower as collateral for loans
        iii. Ensure that securities said to be purchased are actually purchased.

**Organization of Firms in the Investment Industry**

1. Buy-Side and Sell-Side Firms

    a. Sell-Side Firms provide investment products and services. They typically include investment banks, brokers, and dealers.
    b. Buy-Side Firms purchase investment products and services from sell-side firms. They typically manage portfolios for clients and/or themselves.
2. Front, Middle, and Back Offices
    a. Front Office: consists of client-facing activities that provide direct revenue generation. This includes sales, marketing, and customer service. Some consider both trading and research to be front office.
    b. Middle Office: consists of core activities of the firm. This includes risk management, information technology, corporate finance, portfolio management, and research.
    c. Back Office: consists of the administrative and support functions necessary to firms. This includes accounting, human resources, payroll, and operations.