## Key Concepts and Summary

### 17.1 How Businesses Raise Financial Capital

Companies can raise early-stage financial capital in several ways: from their owners’ or managers’ personal savings, or credit cards and from private investors like angel investors and venture capital firms.

A bond is a financial contract through which a borrower agrees to repay the amount that it borrowed. A bond specifies an amount that one will borrow, the amounts that one will repay over time based on the interest rate when the bond is issued, and the time until repayment. Corporate bonds are issued by firms; municipal bonds are issued by cities, state bonds by U.S. states, and Treasury bonds by the federal government through the U.S. Department of the Treasury.

Stock represents firm ownership. A company's stock is divided into shares. A firm receives financial capital when it sells stock to the public. We call a company’s first stock sale to the public the initial public offering (IPO). However, a firm does not receive any funds when one shareholder sells stock in the firm to another investor. One receives the rate of return on stock in two forms: dividends and capital gains.

A private company is usually owned by the people who run it on a day-to-day basis, although hired managers can run it. We call a private company owned and run by an individual a sole proprietorship, while a firm owned and run by a group is a partnership. When a firm decides to sell stock that financial investors can buy and sell, then the firm is owned by its shareholders—who in turn elect a board of directors to hire top day-to-day management. We call this a public company. Corporate governance is the name economists give to the institutions that are supposed to watch over top executives, though it does not always work.

### 17.2 How Households Supply Financial Capital

We can categorize all investments according to three key characteristics: average expected return, degree of risk, and liquidity. To obtain a higher rate of return, an investor must typically accept either more risk or less liquidity. Banks are an example of a financial intermediary, an institution that operates to coordinate supply and demand in the financial capital market. Banks offer a range of accounts, including checking accounts, savings accounts, and certificates of deposit. Under the Federal Deposit Insurance Corporation (FDIC), banks purchase insurance against the risk of a bank failure.

A typical bond promises the financial investor a series of payments over time, based on the interest rate at the time the financial institution issues the bond, and when the borrower repays it. Bonds that offer a high rate of return but also a relatively high chance of defaulting on the payments are called high-yield or junk bonds. The bond yield is the rate of return that a bond promises to pay at the time of purchase. Even when bonds make payments based on a fixed interest rate, they are somewhat risky, because if interest rates rise for the economy as a whole, an investor who owns bonds issued at lower interest rates is now locked into the low rate and suffers a loss.

Changes in the stock price depend on changes in expectations about future profits. Investing in any individual firm is somewhat risky, so investors are wise to practice diversification, which means investing in a range of companies. A mutual fund purchases an array of stocks and/or bonds. An investor in the mutual fund then receives a return depending on the fund's overall performance as a whole. A mutual fund that seeks to imitate the overall behavior of the stock market is called an index fund.

We can also regard housing and other tangible assets as forms of financial investment, which pay a rate of return in the form of capital gains. Housing can also offer a nonfinancial return—specifically, you can live in it.

### 17.3 How to Accumulate Personal Wealth

It is extremely difficult, even for financial professionals, to predict changes in future expectations and thus to choose the stocks whose price will rise in the future. Most Americans can accumulate considerable financial wealth if they follow two rules: complete significant additional education and training after graduating from high school and start saving money early in life.