# MAJOR PARTICIPANTS IN FINANCIAL MARKETS

## WHAT WILL YOU LEARN?

- Who are the investors and issuers of financial securities?
- Who are the financial intermediaries?
- What role do the financial intermediaries serve?
- What are different types of investment companies?
  - What is the difference between open-end and closed-end fund?
  - What is an ETF?
  - Private equity?
  - Hedge funds?

## WHO ARE THE INVESTORS AND ISSUERS?

- Households, businesses, governments, and their foreign counterparts are all providers and users of capital.
- Savings, earnings, and fiscal policy determine the equilibrium in markets.
- Prices reflect the relative supply and demand for funds.

## WHO ARE THE INVESTORS AND ISSUERS?

- Households

| | | |
|---|---|---|
| **New Households** | ⇨ | **Typically take on debt to make capital goods purchases; net dis-savers.** |
| **Established Households** | ⇨ | **Common to see asset accumulation in multiple asset classes; net savers.** |
| **Retired Households** | ⇨ | **Net asset de-accumulation with falling exposure to risky assets; net dis-savers.** |

## WHO ARE THE INVESTORS AND ISSUERS?

- Firms are net demanders of capital. They issue debt and equity securities to raise capital in order to pay for investments in plant and equipment.
- Corporations with excess cash to invest participate in financial markets by investing those funds on a short-term basis.

## WHO ARE THE INVESTORS AND ISSUERS?

- Governments can be borrower or lender, depending on their tax revenues and expenditures.
- The issuance of Treasury bills, notes, and bonds is the major way the U.S. government borrows from the public.

## FINANCIAL INTERMEDIARIES

- Financial institutions bring together suppliers of capital (investors) with demanders of capital (corporations and government). They therefore act as **financial intermediaries**.
- These include banks, investment companies, insurance companies, and credit unions.

## INVESTMENT COMPANIES

- An **investment company** is essentially an institution that pools funds from investors with the purpose of investing on their behalf.
- Registered investment companies are mutual funds, unit investment trusts, and real estate investment trusts (REITs).
- Investors buy shares in investment companies. The value of each share is called the **net asset value (NAV)**. Net asset value equals assets minus liabilities divided by the number of shares.

## CLOSED-END FUNDS

- Shares of closed-end funds are traded on organized exchanges.

## OPEN-END (MUTUAL) FUNDS

- Money market funds
- Equity funds
- Sector funds
- Bond funds
- International funds
- Balanced funds
- Index funds

# EXCHANGE-TRADED FUNDS (ETFS)

- **Exchange-traded funds (ETFs)** are funds whose shares are traded on exchanges.
- They can be traded throughout the day just like any share of stock.
- Examples are spiders (S&P500), diamonds (Dow Jones Industrials), cubes (NASDAQ 100 index, ticker QQQ)
- i-shares energy (sector ETFs), commodity ETFs

# PRIVATE EQUITY

- Private equity refers to asset managers who make equity investments in companies that are not publicly traded.
- They provide funding for start-up companies, management buyouts, or leveraged buyouts.
- They are exempt from SEC registration requirement.

## HEDGE FUNDS

- Hedge funds are unregistered private funds that allow investors to pool their investment.
- They are open to a small number of high-worth individual and institutional investors.
- Hedge funds typically take a proportion of assets invested (2% norm) and a fraction of profits (20% typical) as compensation.

## SUMMARY

- Households, business, governments, and their foreign counterparts are all providers and users of capital.
- Financial intermediaries include banks, investment companies, insurance companies, and credit unions.
- Explain the difference between open-end and closed-end funds.
- Explain the different between mutual funds and ETFs.
- Examples of unregistered investment companies include private equity and hedge funds.

# PRIMARY AND SECONDARY MARKETS

## WHAT WILL YOU LEARN?

- What is the definition of a primary market?
- What is the definition of a secondary market?
- How do firms issue securities?
  - What is a private placement offering?
  - What is an initial public offering?
  - What is a seasoned equity offering?
- Empirical facts about IPO underpricing

# PRIMARY MARKET

- In January 1996, Larry Page and Sergey Brin started working together on developing a search engine, which they called Blackrub.
- Over the next two years, with funds from private investors, they raised $1 million, and started Google, Inc. in September 1998.
- On April 29, 2004, Google Inc. filed with the Securities Exchange Commission (SEC) an initial public offering.
- On August 19, 2004, shares were sold to the public, making Google a public corporation.

# PRIMARY MARKET

- It is in the **primary market** that companies raise funds through issuing new securities – new issues of equity or debt.
  - **Initial public offering (IPO)**: first issue of shares to the general public
  - **Seasoned equity offering (SEO)**: sale of additional sales by companies that are already publicly traded

## SECONDARY MARKET

- Trades in existing securities take place in the **secondary market**.
  - For example, if you decide to sell your Apple shares to another investor, this transaction takes place in the secondary market and has no impact on the total outstanding number of Apple shares.

## PRIVATE PLACEMENT

- When private firms wish to raise funds, they can sell shares directly to a small number of institutional or wealthy investors in a **private placement**.

# IPO PROCESS

Choosing an investment bank

↓

Filing a preliminary registration statement with the SEC (*red herring*)

↓

Road show / Bookbuilding

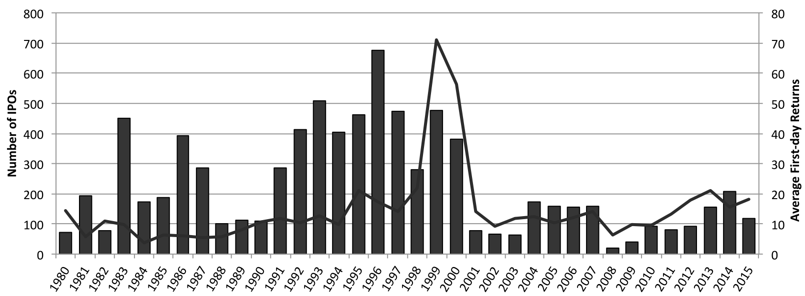
↓

Approval of the final statement by the SEC (*prospectus*)

# IPO PROCESS

- Underwriters purchase the entire offering from the issuing company and then resell them to the public. This is called a **firm commitment**.
- Contrast this with a **best efforts** offering. Sometimes, the syndicate helps the firm to sell the issue to the public, but does not purchase the securities.

## Number of Offerings (bars) and Average First-day Returns (line) on US IPOs (1980-2015)




In 1980-2000, an average of 310 firms went public every year
In 2001-2015, an average of 111 firms went public every year

Source: Jay Ritter, University of Florida

9

## SUMMARY

- Definition of primary and secondary markets
- Learned about how firms issue securities
- Initial public offering process
- IPO underpricing