THE FINANCIAL ENVIRONMENT

Basic Terminologies of Investment

- **Investment:**
- The commitment of funds to one or more assets that will be held over some future time period is called investment.
- **Investments:**
- The study of the investment process is called investments.
- **Financial Assets:**
- Pieces of paper evidencing a claim on some issuer is called financial assets.
- Or
- A paper (or electronic) claim on some issuer is called financial assets.

Basic Terminologies of Investment

- **Real Assets:**
- The physical/tangible assets such as gold, silver, diamond and real estate etc are called real assets.
- **Marketable Securities:**
- Financial assets that are easily traded in organized market is called marketable securities.

Basic Terminologies of Investment

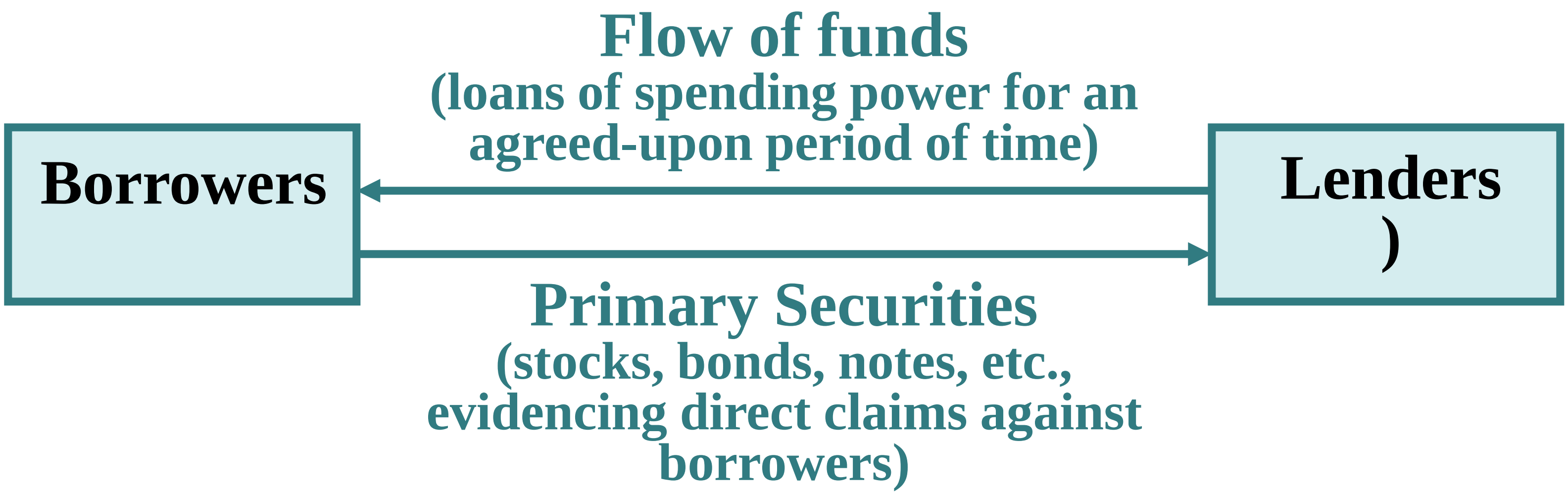
- **Liquidity:**
- The ease with in which an asset can be bought or sold with relatively low price change is called liquidity.
- There are two conditions for the liquid assts;
- 1. Easily convertible into cash
- 2. With relatively low price change

Basic Terminologies of Investment

- **Direct Investing:**
- When investors by themselves buy and sells shares it is known as a direct investing.

Direct Investing:

- *Direct Finance* – Direct lending gives rise to direct claims against borrowers.

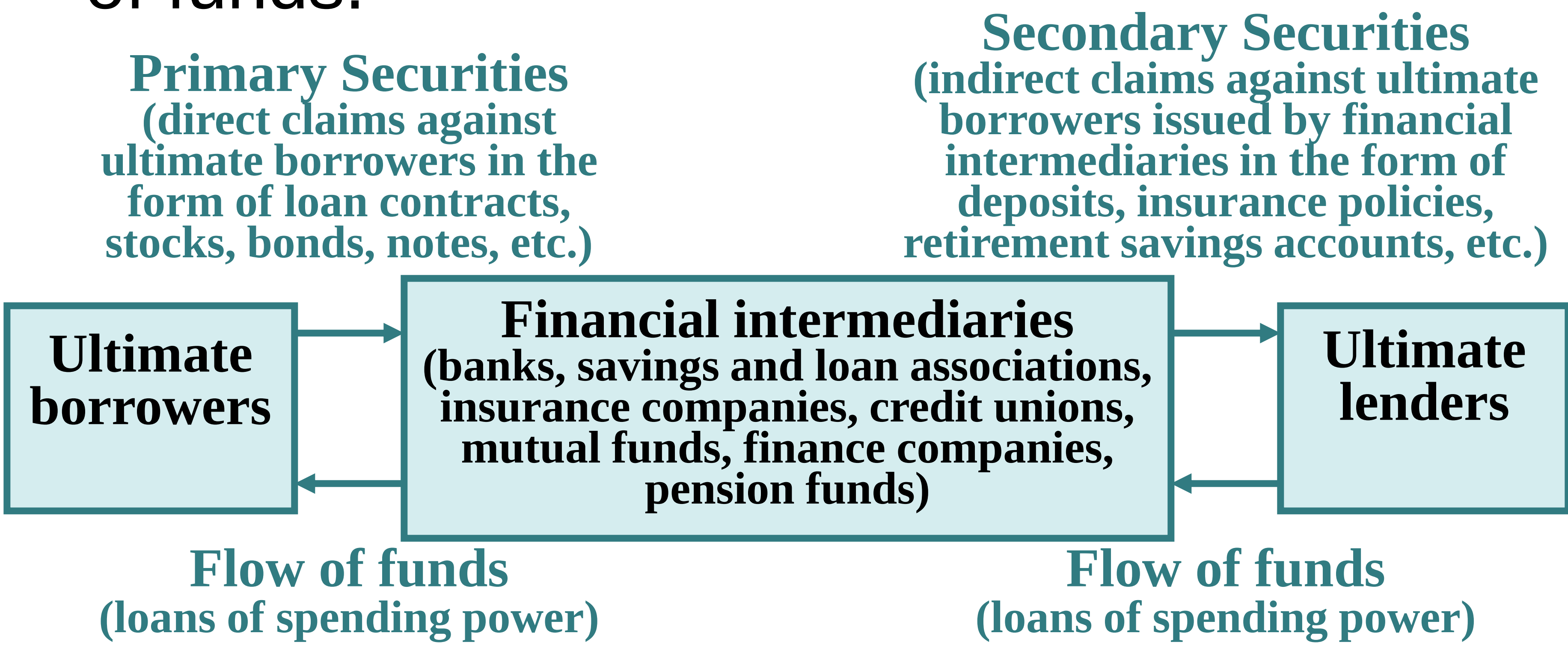


Indirect Investing:

- When investors buy and sells shares through others (Financial intermediaries) it is known as a indirect investing.

Indirect Investing:

- *Indirect Finance* – Financial intermediation of funds.



Basic Terminologies of Investment

- **Treasury Bill:**
- A short term money market instrument sold at discount by the government is called treasury bill.
- **Fixed Income Securities:**
- Securities with specified payment dates and amounts primarily bonds is called fixed income securities.
- **Bonds:**
- Long term debts instruments representing the issuer’s contractual obligation is called bonds.

Basic Terminologies of Investment

- **Investment Companies:**
- A financial company that sells shares in itself to the public and uses these funds to invest in other financial assets is called Investment companies.
- **Closed end Investment companies:**
- An investment company with a fixed capitalization whose shares are bought and sold in secondary market is called Closed end Investment companies.

Basic Terminologies of Investment

- **Open end Investment company (Mutual funds):**
- An investment company whose capitalization constantly changes as new shares are sold and outstanding shares are redeemed (buy back) is called open end investment company or mutual funds.

Basic Terminologies of Investment

- **Corporate Bonds:**
- Long term debt securities of various types sold by corporation.
- **Common Stock:**
- An equity security representing the ownership interest in a company is called common stock.
- Or
- Common stock represents the ownership interest of corporations, or the equity of the stockholders.

Basic Terminologies of Investment

- **Preferred stock:**
- An equity security with an intermediate claim (between the bondholders and stockholders) on a firms assets and earnings.

What is Financial Market?

- All institutions and procedures for bringing buyers and sellers of financial instruments together is called financial market.

The Purpose of Financial Markets

- Financial assets exist in an economy because the savings of various individuals, corporation and government during a period of time differ from their investment in real assets.
- By “Real Assets” we mean houses, buildings, equipments and inventories etc
- If savings equaled investment in real assets for all economic units in an economy over all period of time, there would be no external financing no financial assets and no money or capital market. Each economic unit would be self sufficient.

The Purpose of Financial Markets

- A financial asset is created only when the investment of an economic unit in real assets exceeds its savings and it finances this excess by borrowing or issuing stocks.
- Of course another economic unit must be willing to lend. This interaction of borrowers with lenders determine interest rates.
- In the economy as a whole, saving surplus units (those whose savings exceeds their investments in real assets) provide funds to savings deficit units (those whose investments in real assets exceed their savings).

The Purpose of Financial Markets

- This exchange of funds is evidence by investment instruments, or securities representing financial assets to the holders and financial liabilities to the issuers.
- The purpose of financial markets in an economy is to allocate savings efficiently to ultimate users.

Financial Markets

- “All institutions and procedures for bringing buyers and sellers of financial instruments together is called financial market”.
- Financial markets can be broken into two classes.
- 1. Money Market
- 2. Capital Market

Money and Capital Markets

- **1. Money Market:**
- The market concerned with buying and selling of short term (less than one year original maturity) government and corporate debt securities is called money market.
- **2. Capital Market:**
- The market concerned with relatively long term (greater than one year original maturity) debt and equity instruments (e.g bonds and stocks) is called capital market.

Primary and Secondary Markets

- With in Capital and Money markets there exist both primary and secondary markets.
- **1. Primary Market:**
- A market where new securities are bought and sold for the 1st time (a “new issues” market) is called primary market.
- **2. Secondary Market:**
- A market where existing (used) securities are bought and sold rather than new issues are called secondary market.

Primary and Secondary Markets

- A primary market is a “new issues” market. Here funds raised through the sales of new securities flow from the ultimate savers to the ultimate investors in real assts.
- In a secondary market, existing securities are bought and sold. Transaction in these already existing securities do not provide additional funds to the business.

Primary and Secondary Markets

- The sale of new cars provide cash to the auto manufacturers, but the sale of used cars in the used car market does not.
- In a real sense, a secondary market is a “used car lot” for securities.
- The existence of “used car markets” makes it easier for you to consider buying a new car because you have a mechanism at hand to sell the car when you no longer want it.

Primary and Secondary Markets

- In a similar fashion the existence of secondary market encourages the purchase of new securities by individuals and institutions.
- Because if a seller need to sell a security in the future, he or she will be able to do so in the presence of secondary market.

Financial Intermediaries

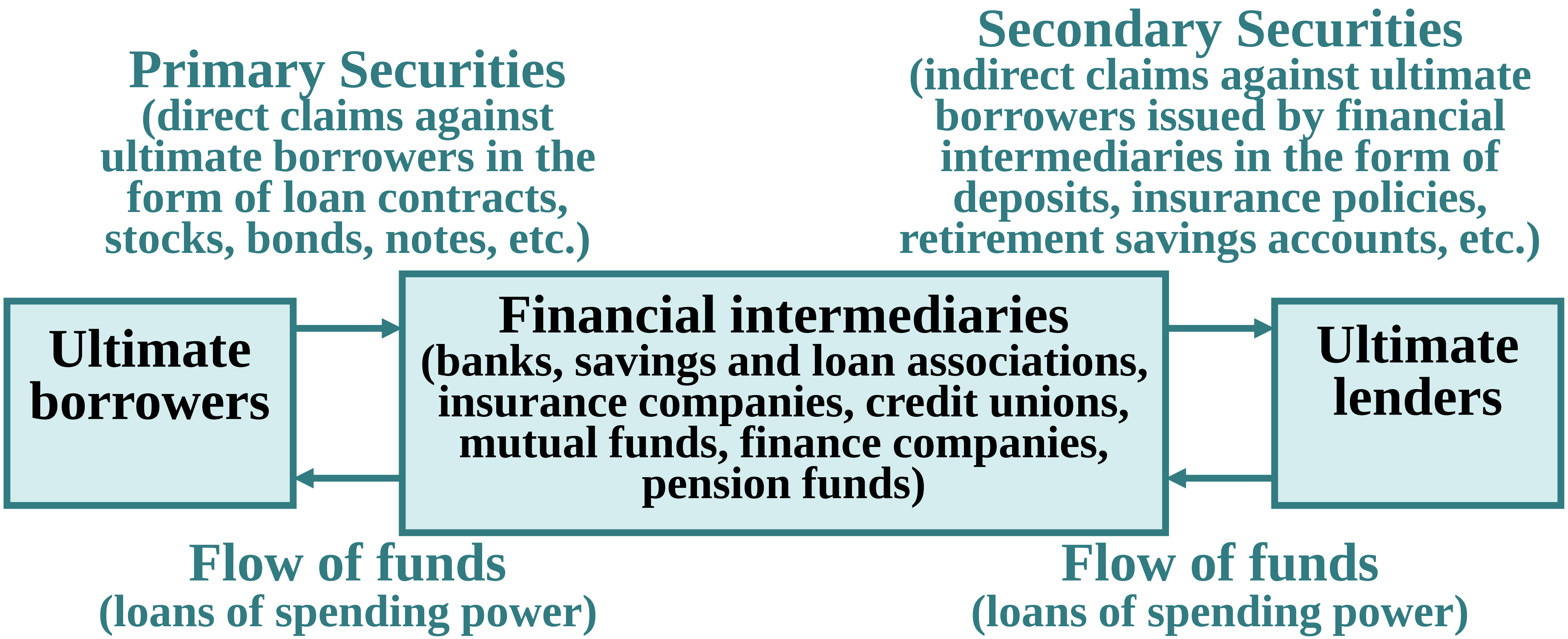
- “Financial institutions that accept money from savers and use that funds to make loans and other financial investments in their own name are called Financial Intermediaries”.
- They include commercial banks, savings institutions, Insurance companies, pension funds, finance companies and mutual funds.

Financial Intermediaries

- The flow of funds from savers to investors in real assets can be direct; if there are financial intermediaries in an economy the flow can also be indirect.
- These intermediaries come between ultimate borrowers and lenders by transforming direct claims into indirect claims.
- Financial intermediaries purchase direct (or primary) securities and in turn issue their own indirect (or secondary) securities to the public.
- For example, A life insurance company purchase corporate bonds (primary securities) and issue life insurance policies (secondary securities) to the public.

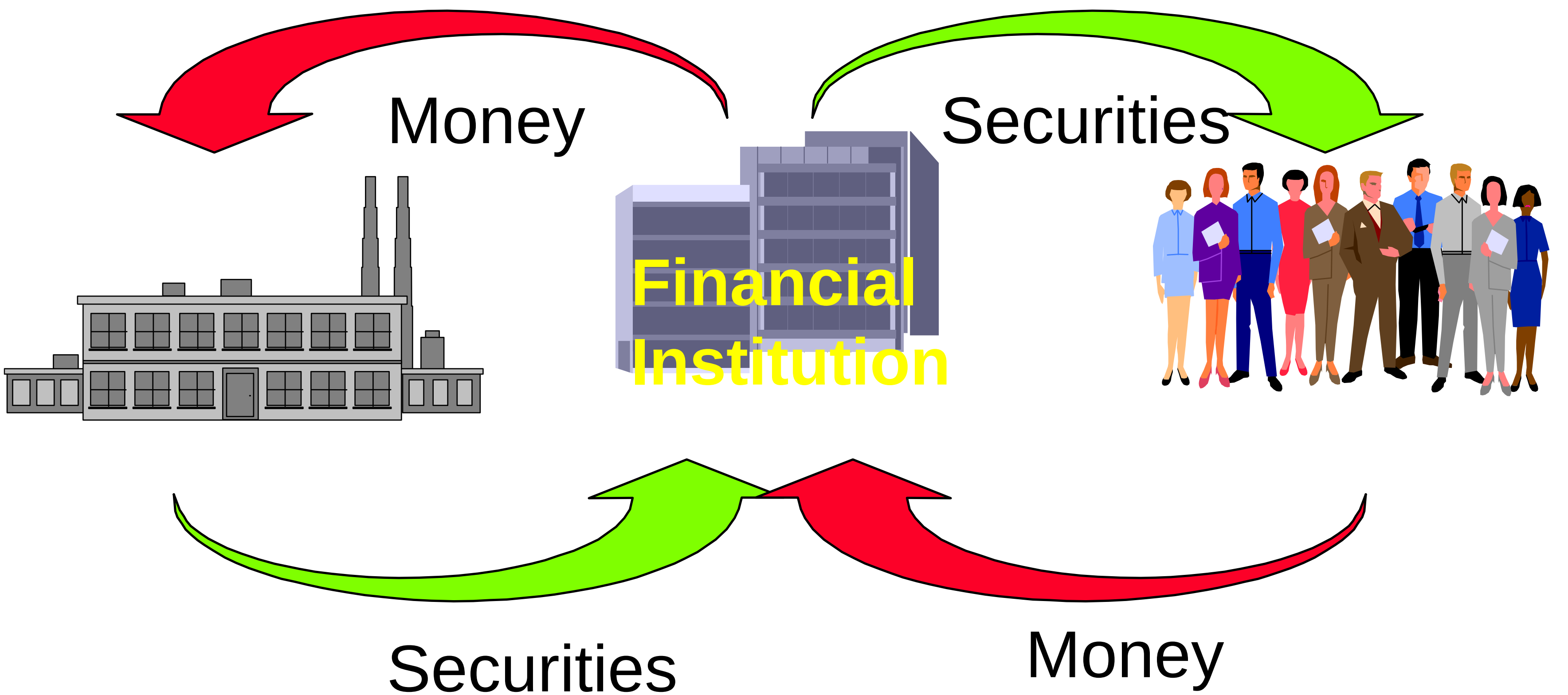
Financial intermediation of funds.

- ③ *Indirect Finance* – Financial intermediation of funds.



Services offered by Financial Institutions

- **Intermediaries help to facilitate the flow of funds in the financial marketplace.**



Types of Financial Institutions

- Commercial Banks
- The primary purpose of commercial banks

  is to take in business deposits and to lend

  funds to businesses.

  Commercial banks are the most important source of funds for business firms in aggregate.

  Banks acquire deposits from individuals, companies and government and in turn makes loan and investments.

  Besides performing a banking function, commercial banks also invest in corporate bonds and stocks.

Types of Financial Institutions

- Savings and Loans

  Savings and loans' primary purpose is to take in deposits from households and to lend funds for home and consumer loans.

Types of Financial Institutions

- Credit Unions

Credit Unions are owned by depositors (actually share owners) who are individuals, not businesses. Credit Unions take in funds and primarily make personal loans.

Types of Financial Institutions

- Commercial Banks
- Savings and Loans
- Credit Unions

Depository Institutions

- **Take in deposits**
- **Make loans**

Types of Financial Institutions

- Finance Companies

Non-bank firms that borrow funds to make short and medium term loans to higher risk borrowers. These companies raise capital through stock issues as well as through borrowing some of which are long term but most of it comes from commercial banks, in turn financial companies makes loans.

Types of Financial Institutions

- Insurance Companies

Receive premiums for insurance policies.
This pool of funds is used to reimburse policyholders who incur losses that are covered under the policy .

Life Insurers: Insure against financial hardship caused by death.

Property and Casualty: Insure against damage to person and property (health, autos, homes, theft, earthquake, etc.)

Property and casualty insurance companies invest municipal bonds which offer tax exempt interest income, to a lesser extent they also invest in stocks and bonds.
Life insurance companies invest in long term securities.

Types of Financial Institutions

- Pension Funds

Workers and/or employers contribute funds for the pension fund to invest. The accumulated funds are used to pay benefits at retirement.
Because of the long nature of the liabilities pension funds are able to invest in long term securities.
As a result they invest heavily in corporate bonds and stock.

Types of Financial Institutions

- Finance Companies
- Insurance Companies
- Pension Funds

Non-Depository Institutions or Contractual Institutions

•Funds come from borrowing, selling insurance policies, and other claims.
•Funds used to buy securities and make loans.

Financial Brokers

- **Broker:**
- An intermediary who represents buyers and sellers in security transactions and receive a commission is called broker.
- **Investment Bankers:**
- A financial institution that underwrites (purchase at a fixed price on a fixed date) new securities for resale is called investment banker.
- **Underwriting:**
- The process by which investment bankers purchases an issue of securities from a firm and resell it to the public.