Chapter 2: Why Corporations Need Financial Markets & Institutions

INTRODUCTION

In the course of conducting their normal business, firms interact with different markets.

- Product market
- Labor market
- Raw materials market
- Capital goods market
- Financial markets

The Financial markets are where firms raise additional funds and invest their access funds. Financial managers are required to interact with the financial markets.

FINANCIAL MARKETS

Financial markets are places where securities are bought and sold Examples: stock market, bond market, commodity markets, foreign exchange market. Firms raise needed capital in the financial market.

THE FLOW OF SAVINGS TO CORPORATIONS

The primary market role is to channel funds from savers to borrowers for some return.

Savings units ==➔ Channel funds to ==➔ Borrowing units

Households		
Businesses		**Businesses**
Government		**Government**

Two Market Classes:

1- **Primary:** *New* securities or primary claims are issued, resulting on cash inflow to issuer.
2- **Secondary:** *Already existing* financial securities are bought and sold between investors, with no resulting cash inflow to the issuer of the claim.

A- Direct Flow of Funds to Borrowers

Firms issue primary claims directly to investors (savers) through the help of Investment bankers who Assist firms in the issuance process (size, price, and time of the issue and may also underwrite (buy the whole issue and sell for a higher price) the issue through Syndication

B- Indirect Flow of Funds to Borrowers

Funds flow from savers to borrowers indirectly through financial intermediaries. Savers invest in financial intermediaries, which in turn invest in primary claims of the borrowers. **Examples, saving account at a bank, mutual fund shares, life insurance policy, pension fund plan. Secondary claims are claims issued by financial intermediaries.**

Financial intermediaries:
Commercial banks
Pension funds
Insurance company
Mutual funds

Potential Benefits of Financial Markets and Financial Intermediaries:

- **Diversification:** pooling of money allow diversifying investments
- **Expertise**
- **Liquidity:** less or no transaction cost.
- **Convenience:** less time and effort to make sound investments.
- **Risk management:** you are insured against many losses (insurance, futures, bank lending, fore example).
- **Transporting Cash Across Time:** In debt markets, the borrower is able to consume or invest today using the money he will earn in the future. Also, the lender is able to postpone his consumption until the future with higher purchasing power.

Classify markets based on the maturity of its securities:

- **Money markets**
    - **Short-term securities (less than or 1 year maturity)**
    T-bills, Commercial papers, CDs.

- **Capital markets**
    - **Long-term securities (more than 1 year maturity)**
    T-bonds, corp. bonds, stocks, mortgage, municipal bonds.

Classify markets based on the method of trading:

- **Organized**
  - **Auction process** (sellers seek out highest bid and buyers seek out lowest ask)
  - **Specialists:** cover any shortage in the supply or demand on the stock to ensure liquidity and less volatility.
  - **NYSE, AMEX, Other regional stock exchanges.** Brokers have to own seats in the exchange.
  - Sound businesses firms are listed in NYSE

- **Over-the-counter market**
  - **NASDAQ**
  - **Dealers (market makers)**: buy and sell stocks for their own account and post bid and ask prices. They profit from the spread (ask-bid). Ask is the selling price and bid is the buying price.
  - Small firms get listed in NASDAQ. Some large firms also are listed in NASDAQ, like Microsoft, Intel and Apple computers.

<u>Secondary Markets</u>

Benefits of Secondary Markets

- **Liquidity :** Bring sellers and buyers together and facilitate trades with less transaction cost.

- **Efficient pricing and information disclosure:** Money managers, brokerage houses and specialized firms like S&P's, Moody's, and value line.

- **Efficient allocation of capital:** With secondary efficient market, money goes to viable businesses and taken from unsuccessful ones.

The Opportunity Cost of Capital:

Opportunity cost is the cost of something in terms of an opportunity forgone (and the benefits that could be received from that opportunity), or the most valuable forgone alternative, i.e. the second best alternative.

Opportunity cost helps us assign certain value for assets based on the valu of the best alternative forgone. Assets with the same Risk class should have the same return.

Financial markets help us evaluate non-traded assets based on other traded assets with similar risk class.