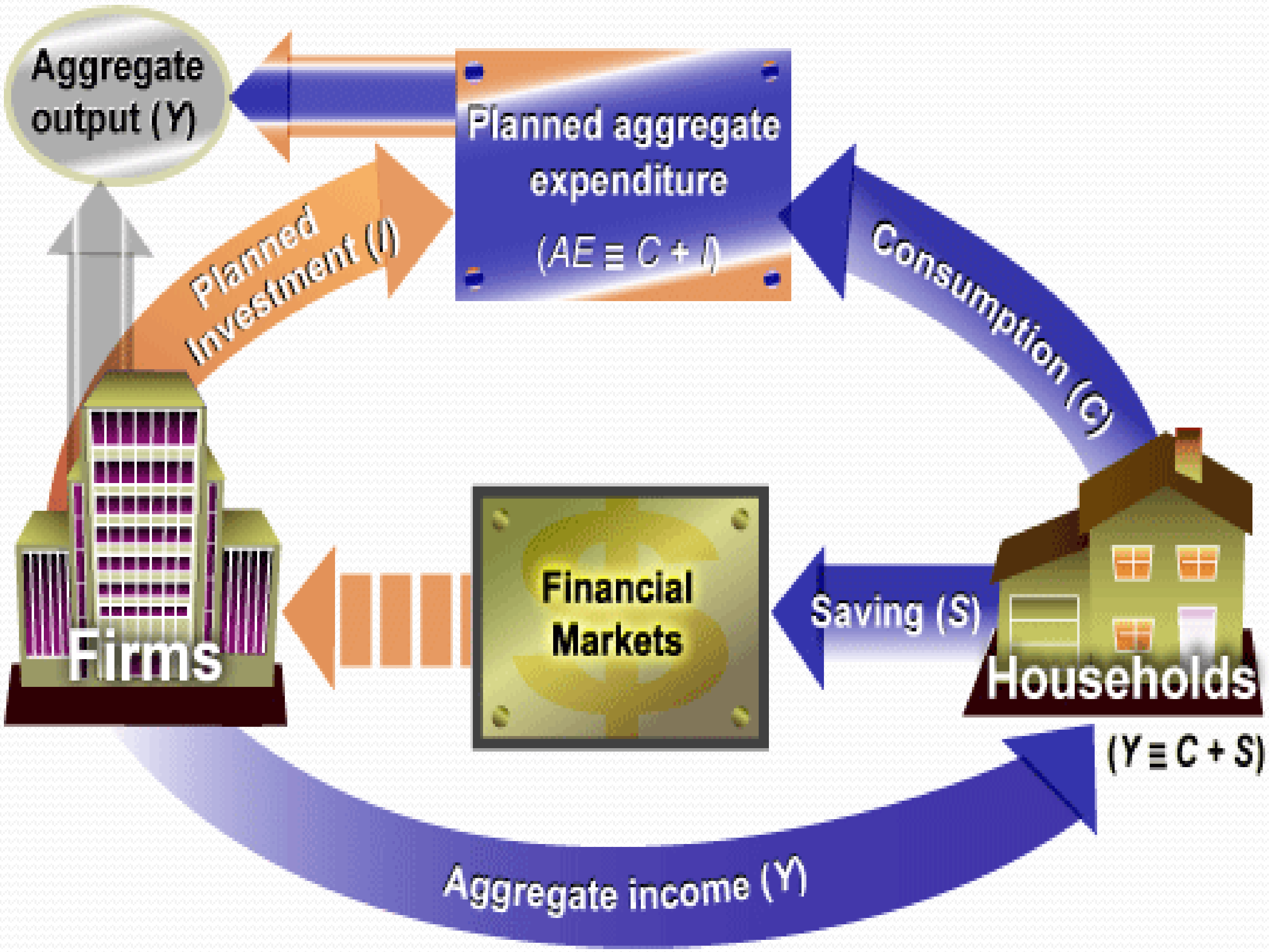
Financial environment

Financial institutions

Financial markets

Private placement

Circular flow of money



Financial institutions

An intermediary that channels the savings of individuals, businesses and governments into loans or investments

- Investment banks: underwrites and distributes new investment securities and helps businesses obtain financing
- Commercial banks: the traditional department store of finance serving a variety of savers and borrowers
- Financial services corporations: conglomerate that offers financial services including investment banking, brokerage operations, insurance and commercial banking

- Credit unions – members have a common bond, savings are loaned to other members, cheap source of finance
- Pension funds – retirement plans funded by corporations for their workers and administered by the trust departments of commercial banks/life insurance companies
- LIC take savings in the forms of annual premiums and invest in stocks, bonds, real estate; make payments to beneficiaries of insured parties, also offer tax deferred savings plans for retirement
- Mutual funds: An investment vehicle that is made up of a pool of funds collected from many investors for the purpose of investing in securities such as stocks, bonds, money market instruments and similar assets. It is operated by money managers, who invest the fund's capital and attempt to produce capital gains and income for the fund's investors.
- Exchange traded funds: A security that tracks an index, a commodity or a basket of assets like an index fund, but trades like a stock on an exchange.

- http://www.sebi.gov.in/mfsid/utigoldexchange.pdf
- Hedge funds: An aggressively managed portfolio of investments that uses advanced investment strategies such as leveraged, long, short and derivative positions in both domestic and international markets with the goal of generating high returns
- Private equity consists of investors and funds that make investments directly into private companies or conduct buyouts of public companies that result in a delisting of public equity.

Types of financial markets

Financial markets are forums in which suppliers of funds and demanders of funds can transact business directly

- Physical asset vs. financial asset market
- Spot vs. future markets SPOT vs. FUTURES MARKET.docx
- Money vs. capital markets Differences between Money Markets and Capital Markets.docx
- Primary vs. secondary markets

Eurocurrency market

- International equivalent of domestic money market
- Market for short term bank deposits denominated in US dollars or other easily convertible currencies
- Eurocurrency deposits arise when a corporation or individual makes a bank deposit in a currency other than the local currency of the country where the bank is located.
- They are mostly time deposits
- The bank lends to corporate or government borrowers or to another international bank
- The rate charge on these interbank loans is called the London Interbank Offered Rate (LIBOR) and is the base rate used to price all Eurocurrency loans

Functions of financial markets

- Facilitate price discovery
  - Market forces fix the price
- Provide liquidity to investor in financial assets
  - Negotiability and transferability
- Reduce the cost of transacting
  - Search costs
  - Information costs

Physical asset vs. Financial asset markets

- Physical asset markets (tangible or real asset markets) are for products such as wheat, autos, real estate, computers and machinery
- Financial asset markets deal with stocks, bonds, notes and mortgage

Primary vs Secondary markets

- Primary markets are where corporations raise capital by issuing new securities
- Secondary markets are those in which securities are traded by investors after they have been issued by corporations

Private vs. Public markets

- Private markets - transactions are negotiated and worked out directly between two parties
- Public markets – organized exchanges where securities that have fairly standardized features are traded.

GlaxoSmithKline PLC (GSK.L)
-LSE Ticker: 925288/ISIN: GB0009252882
1,419.50 26.00(1.80%) 12:27PM GMT+01:00

Prev Close:	**1,445.50**	Day's Range:	**1,415.50 - 1,463.69**
		52wk Range:	**556.50 - 2,076.00**
Open:	**1,451.00**	Volume:	**2,929,946**
Bid:	**1,420.00**	Avg Vol (3m):	**8,105,480**
Ask:	**1,420.50**	Market Cap:	**68.22bn**
1y Target Est:	**N/A**	P/E (ttm):	**1,358.51**
Beta:	**N/A**	EPS (ttm):	**1.05**
Next Earnings Date:	**N/A**	Div & Yield:	**N/A (N/A**

Financial market returns

- **Interest rates** depends on
  - Depreciation of Unit of account
  - Length of maturity period of a loan
  - Default risk regarding repayment
- **ROR on risky assets consist of** dividend yield and capital yield

FINANCIAL MARKET RETURNS

- Interest Rates: An interest rate is a rate of return promised by the borrower to the lender. Different interest rates apply to different kinds of borrowing and lending.
- For example, the mortgage rate applies to a home loan whereas the term lending rate applies to a term loan for an industrial project.
- The interest rate on any type of loan (or fixed income security) depends on several factors, the most important being the unit of account, the maturity, and the default risk.

- The unit of account is the medium such as rupees, dollars, pounds, yen, or gold in which payments are denominated. The 'maturity' of a loan is the period over which it is paid back. Default risk is the possibility that the borrower may not honor his commitment to pay interest and principal as promised.
- Generally, the interest rate is low when the unit of account depreciates very little due to inflation, the maturity period is short, and the default risk is negligible. On the other hand, the interest rate is high when the unit of account depreciates due to inflation, the maturity period is long, and the default risk is high.

Rates of Return on Equity

Interest rates present promised returns on debt instruments. However, many assets (equity instruments) do not promise a given return.
For example, if you invest in equity shares or real estate or a piece of art or for that matter any risky asset does not earn an assured return.
How should one measure the rate of return on a risky asset like equity stock?
The return from such an asset comes from two sources: cash dividend and capital gain or loss.

You buy a company's equity stock at a price of Rs. 100. After one year you get a dividend of Rs. 5 and the share price rises to Rs. 115. Your one year return r is:

$$R = \frac{\text{Cash dividend}}{\text{Beginning price}} + \frac{\text{Ending price} - \text{Beginning price}}{\text{Beginning price}}$$

$$= \frac{5}{100} + \frac{115-100}{100} = 5\% + 15\%$$

The first component is called dividend income component (or dividend yield) and the second component is called capital change component (or capital yield).

Regulatory infrastructure

- Central Bank (RBI): The entity responsible for overseeing the monetary system for a nation.
- Central banks have a wide range of responsibilities, from overseeing monetary policy to implementing specific goals such as currency stability, low inflation and full employment.
- Central banks also generally issue currency, function as the bank of the government, regulate the credit system, oversee commercial banks, manage exchange reserves and act as a lender of last resort.

Securities and Exchange Board of India (SEBI)

- The **Securities and Exchange Board of India** (**SEBI**) is the regulator for the securities market in India.
- Established in the year 1988 and given statutory powers on 12 April 1992 through the SEBI Act 1992.
- SEBI has to be responsive to the needs of three groups, which constitute the market:
  - the issuers of securities
  - the investors
  - the market intermediaries.
- SEBI is credited for quick movement towards making the markets electronic and paperless
- SEBI did away with physical certificates that were prone to postal delays, theft and forgery, apart from making the settlement process slow and cumbersome by passing Depositories Act, 1996.
- SEBI has also been instrumental in taking quick and effective steps in light of the global meltdown and the Satyam fiasco.
- In October 2011, it increased the extent and quantity of disclosures to be made by Indian corporate promoters.
- In light of the global meltdown, it liberalized the takeover code to facilitate investments by removing regulatory structures.
- In one such move, SEBI has increased the application limit for retail investors to Rs 2 lakh, from Rs 1 lakh at present

Credit Rating Agencies

- Providing independent, objective assessments of the credit worthiness of companies and countries, a credit ratings company helps investors decide how risky it is to invest money in a certain country and/or security.
- The **Big Three** credit rating agencies are Moody’s, Standard & Poor’s (S&P's) and Fitch Group. S&P and Moody's are based in the US, while Fitch is dual-headquartered in New York City and London and is controlled by the France-based FIMILAC.
- **Credit Rating Information Services of India Limited (CRISIL)** is a global analytical company providing ratings, research, and risk and policy advisory services.
- CRISIL’s majority shareholder is Standard & Poor’s, a division of McGraw-Hill Financial and provider of financial market intelligence.