

30.7: Reading- Investments and Markets- A Brief Overview

Investments and Markets: A Brief Overview

Investing is primarily about using the capital markets to invest surplus cash for long-term growth of wealth.

The following video, “Electronic Trading,” will give you an idea of what trading stocks, bonds, mutual funds, and other investments looks like and how it impacts the financial wealth of the world economy.



What you saw in the video was an example of how “capital markets” work. The capital markets developed as a way for buyers to buy liquidity. In Western Europe, where many of our ideas of modern finance began, those early buyers were usually monarchs or members of the nobility, raising capital to finance armies and navies to conquer or defend territories or resources. Many devices and markets were used to raise capital, but the two primary methods that have evolved into modern times are the **bond** and **stock** markets. These bonds and stocks are traded on the exchanges mentioned earlier (NYSE, OTC, NASDAQ). So, what are stocks and bonds?

Bonds and Bond Markets

Bonds are **debt**. The bond issuer borrows by selling a bond, promising the buyer regular interest payments and then repayment of the principal at maturity. If a company wants to borrow, it could just go to one lender and borrow. But if the company wants to borrow a lot, it may be difficult to find any one investor with the capital and the inclination to make large a loan, taking a large risk on only one borrower. In this case the company may need to find a lot of lenders who will each lend a little money, and this is done through selling bonds.

A bond is a formal contract to repay borrowed money with interest (often referred to as the coupon) at fixed intervals. Corporations and (e.g., federal, state, municipal, and foreign) governments borrow by issuing bonds. The interest rate on the bond may be a fixed interest rate or a floating interest rate that changes as underlying interest rates—rates on debt of comparable companies—change. (Underlying interest rates include the prime rate that banks charge their most trustworthy borrowers and the target rates set by the Federal Reserve Bank.)

There are many features of bonds other than the principal and interest, such as the issue price (the price you pay to buy the bond when it is first issued) and the maturity date (when the issuer of the bond has to repay you). Bonds may also be “callable”: redeemable before maturity (paid off early). Bonds may also be issued with various covenants or conditions that the borrower must meet to protect the bondholders, the lenders. For example, the borrower, the bond issuer, may be required to keep a certain level of cash on hand, relative to its short-term debts, or may not be allowed to issue more debt until this bond is paid off.

Because of the diversity and flexibility of bond features, the bond markets are not as transparent as the stock markets; that is, the relationship between the bond and its price is harder to determine. The U.S. bond market is now more than twice the size (in dollars

of capitalization) of all the U.S. stock exchanges combined, with debt of more than \$27 trillion by the end of 2007. Financial Industry Regulatory Authority (FINRA), (accessed May 20, 2009).

U.S. Treasury bonds are auctioned regularly to banks and large institutional investors by the Treasury Department, but individuals can buy [U.S. Treasury bonds](#) directly from the U.S. government. To trade any other kind of bond, you have to go through a broker. The brokerage firm acts as a principal or dealer, buying from or selling to investors, or as an agent for another buyer or seller.

Stocks and Stock Markets

Stocks or equity securities are shares of **ownership**. When you buy a share of stock, you buy a share of the corporation. The size of your share of the corporation is proportional to the size of your stock holding. Since corporations exist to create profit for the owners, when you buy a share of the corporation, you buy a share of its future profits. You are literally sharing in the fortunes of the company.

Unlike bonds, however, shares do not promise you any returns at all. If the company does create a profit, some of that profit may be paid out to owners as a dividend, usually in cash but sometimes in additional shares of stock. The company may pay no dividend at all, however, in which case the value of your shares should rise as the company's profits rise. But even if the company is profitable, the value of its shares may not rise, for a variety of reasons having to do more with the markets or the larger economy than with the company itself. Likewise, when you invest in stocks, you share the company's losses, which may decrease the value of your shares.

Corporations issue shares to raise capital. When shares are issued and traded in a public market such as a stock exchange, the corporation is "publicly traded." There are many stock exchanges in the United States and around the world. The two best known in the United States are the New York Stock Exchange (now NYSE Euronext), founded in 1792, and the NASDAQ, a computerized trading system managed by the National Association of Securities Dealers (the "AQ" stands for "Automated Quotations").

Only members of an exchange may trade on the exchange, so to buy or sell stocks you must go through a broker who is a member of the exchange. Brokers also manage your account and offer varying levels of advice and access to research. Most brokers have Web-based trading systems. Some discount brokers offer minimal advice and research along with minimal trading commissions and fees.

The Shanghai Stock Exchange (SSE), one of three exchanges in China, is not open to foreign investors. It is the sixth largest stock exchange in the world. The other exchanges in China are the Shenzhen Stock Exchange (SZSE) and the Hong Kong Stock Exchange (HKE). The Hang Seng is an index of Asian stocks on the HKE that is popular with investors interested in investing in Asian companies.

Commodities

Commodities are resources or raw materials, including the following:

- Agricultural products (food and fibers), such as soybeans, pork bellies, and cotton
- Energy resources such as oil, coal, and natural gas
- Precious metals such as gold, silver, and copper
- Currencies, such as the dollar, yen, and euro

Commodity trading was formalized because of the risks inherent in producing commodities—raising and harvesting agricultural products or natural resources—and the resulting volatility of commodity prices. As farming and food production became mechanized and required a larger investment of capital, commodity producers and users wanted a way to reduce volatility by locking in prices over the longer term.

For example, suppose it is now July 2013. If you know that you will want to have wheat in May of 2015, you could wait until May 2015 and buy the wheat at the market price, which is unknown in July 2013. Or you could buy it now, paying today's price, and store the wheat until May 2015. Doing so would remove your future price uncertainty, but you would incur the cost of storing the wheat.

Alternatively, you could buy a futures **contract** for May 2015 wheat in July 2013. You would be buying May 2015 wheat at a price that is now known to you (as stated in the futures contract), but you will not take delivery of the wheat until May 2015. The *value* of the futures contract to you is that you are removing the future price uncertainty without incurring any storage costs. In July 2013 the value of a contract to buy May 2015 wheat depends on what the price of wheat actually turns out to be in May 2015. Investors

are hoping it will be substantially higher, allowing them to sell the contract, make a profit and never actually take possession of the wheat!

Mutual Funds, Index Funds, and Exchange-Traded Funds

A mutual fund is an investment **portfolio** consisting of securities that an individual investor can invest in all at once without having to buy each investment individually. The fund thus allows you to own the performance of many investments while actually buying—and paying the transaction cost for buying—only one investment. Mutual funds have become popular because they can provide diverse investments with a minimum of transaction costs. In theory, they also provide good returns through the performance of professional portfolio managers.

An index fund is a mutual fund designed to mimic the performance of an index, a particular collection of stocks or bonds whose performance is tracked as an indicator of the performance of an entire class or type of security. For example, the Standard & Poor's (S&P) 500 is an index of the five hundred largest publicly traded corporations, and the famous Dow Jones Industrial Average is an index of thirty stocks of major industrial corporations. An index fund is a mutual fund invested in the same securities as the index and so requires minimal management and should have minimal management fees or costs.

Mutual funds are created and managed by mutual fund companies or by brokerages or even banks. To trade shares of a mutual fund you must have an account with the company, brokerage, or bank. Mutual funds are a large component of individual retirement accounts and of defined contribution plans.

Mutual fund shares are valued at the close of trading each day and orders placed the next day are executed at that price until it closes. An exchange-traded fund (ETF) is a mutual fund that trades like a share of stock in that it is valued continuously throughout the day, and trades are executed at the market price.

The ways that capital can be bought and sold is limited only by the imagination. When corporations or governments need financing, they invent ways to entice investors and promise them a return. The last thirty years has seen an explosion in financial engineering, the innovation of new financial instruments through mathematical pricing models. This explosion has coincided with the ever-expanding powers of the computer, allowing professional investors to run the millions of calculations involved in sophisticated pricing models. The Internet also gives amateurs instantaneous access to information and accounts.

For individual investors, investing is a process of balancing the demands and desires of returns with the costs of risk, before time runs out.

KEY TAKEAWAYS

- Bonds are
 - a way to raise capital through borrowing, used by corporations and governments;
 - an investment for the bondholder that creates return through regular, fixed or floating interest payments on the debt and the repayment of principal at maturity;
 - traded on bond exchanges through brokers.
- Stocks are
 - a way to raise capital through selling ownership or equity;
 - an investment for shareholders that creates return through the distribution of corporate profits as dividends or through gains (losses) in corporate value;
 - traded on stock exchanges through member brokers.
- Commodities are
 - natural or cultivated resources;
 - traded to hedge revenue or production needs or to speculate on resources' prices;
 - traded on commodities exchanges through brokers.
- Mutual funds are portfolios of investments designed to achieve maximum diversification with minimal cost through economies of scale.
 - An index fund is a mutual fund designed to replicate the performance of an asset class or selection of investments listed on an index.
 - An exchange-traded fund is a mutual fund whose shares are traded on an exchange.

- Institutional and individual investors differ in the use of different investment instruments and in using them to create appropriate portfolios.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

<https://assessments.lumenlearning.com/assessments/172>

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