12.7: Financial Markets and Assets

Learning Outcomes

- Describe financial markets and assets, including securities

In earlier modules, we observed that individuals can either consume or save their income. We also noted that business investment in physical capital is the primary way they grow. Where do individuals put their savings, and where do businesses obtain the funding for investment expenditure? The answer to both of these questions is **financial markets**.

United States' households and businesses saved almost $2.9 trillion in 2012. Where did that savings go and what was it used for? Some of the savings ended up in banks, which in turn loaned the money to individuals or businesses that wanted to borrow money. Some was invested in private companies or loaned to government agencies that wanted to borrow money to raise funds for purposes like building roads or mass transit. Some firms reinvested their savings in their own businesses.

Financial markets include the banking system, equity markets like the New York Stock Exchange, or the NASDAQ Stock Market, bond markets, commodity markets and more. In the 21st Century, financial markets are global, Americans put their savings into foreign as well as domestic bank accounts, foreign and domestic stocks and foreign and domestic bonds. All financial assets are called **securities**. Equities (i.e. stocks) give savers ownership in a company in return for dividends (a regular payment from the company) and/or capital gains (e.g. when you sell the stock at a profit). Bonds are a type of debt. All forms of debt are IOUs, where a saver lends money to a borrower in return for an interest payment.

Borrowing: Banks and Bonds

Businesses need money to operate and to grow. When a firm has a record of earning revenues, or better yet, of earning profits, it becomes possible for the firm to borrow money. Firms have two main borrowing methods: banks and bonds.

A bank loan for a firm works in much the same way as a loan for an individual who is buying a car or a house. The firm borrows an amount of money and then promises to repay it, including some rate of interest, over a predetermined period of time. If the firm fails to make its loan payments, the bank (or banks) can take the firm to court and require it to sell its buildings or equipment to pay its debt.

Another source of financial capital is a bond. A **bond** is a financial contract like a loan, but with two additional properties: typically, bond interest rates are lower than loan interest rates, and there are organized secondary markets for bonds, making them more liquid to bondholders than loans. Bonds are issued by major corporations and also by various levels of government. For example, cities borrow money by issuing municipal bonds, states borrow money by issuing state bonds, and the federal government borrows money when the U.S. Department of the Treasury issues Treasury bonds.

Watch IT

Watch the clip from this video to see an explanation of how the government could sell bonds in order to raise funds to build a new stadium.

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A large company, for example, might issue bonds for $10 million. The firm promises to make interest payments at an annual rate of 8%, or $800,000 per year and then, after 10 years, will repay the $10 million it originally borrowed.

Treasury Bills, Notes and Bonds

When the U.S. federal government runs a deficit, it borrows the money from financial markets. The U.S. Treasury sells three types of debt: Treasury Bills, Treasury Notes and Treasury Bonds. Each of these debt instruments represents an IOU from the federal government. The difference between bills, notes and bonds is in their maturities: Bills are the shortest term debt with maturities less than one year. Notes have maturities between one and ten years. Bonds have maturities longer than ten years.

Corporate Stock

A **corporation** is a business that "incorporates"—that is owned by shareholders that have limited liability for the company's debt but share in its profits (and losses). Corporations may be private or public, and may or may not have publicly traded stock. They may raise funds to finance their operations or new investments by raising capital through selling stock or issuing bonds.

Those who buy the stock become the firm's owners, or shareholders. **Stock** represents firm ownership; that is, a person who owns 100% of a company's stock, by definition, owns the entire company. The company's stock is divided into **shares**. Corporate giants like IBM, AT&T, Ford, General Electric, Microsoft, Merck, and Exxon all have millions of stock shares. In most large and well-known firms, no individual owns a majority of the stock shares. Instead, large numbers of shareholders—even those who hold thousands of shares—each have only a small slice of the firm's overall ownership.

When a large number of shareholders own a company, there are three questions to ask:

1. How and when does the company obtain money from its sale?
2. What rate of return does the company promise to pay when it sells stock?
3. Who makes decisions in a company owned by a large number of shareholders?

First, a firm receives money from the stock sale only when the company sells its own stock to the public (the public includes individuals, **mutual funds**, insurance companies, and pension funds). We call a firm's first stock sale to the public an **initial public offering (IPO)**. The IPO is important for two reasons. For one, the IPO, and any stock issued thereafter, such as stock held as treasury stock (shares that a company keeps in their own treasury) or new stock issued later as a secondary offering, provides the funds to repay the early-stage investors, like the angel investors and the venture capital firms. A venture capital firm may have a 40% ownership in the firm. When the firm sells stock, the venture capital firm sells its part ownership of the firm to the public. A second reason for the importance of the IPO is that it provides the established company with financial capital for substantially expanding its operations.

However, most of the time when one buys and sells corporate stock the firm receives no financial return at all. If you buy General Motors stock, you almost certainly buy them from the current share owner, and General Motors does not receive any of your money. This pattern should not seem particularly odd. After all, if you buy a house, the current owner receives your money, not the original house builder. Similarly, when you buy stock shares, you are buying a small slice of the firm's ownership from the existing owner—and the firm that originally issued the stock is not a part of this transaction.

Second, when a firm decides to issue stock, it must recognize that investors will expect to receive a rate of return. That rate of return can come in two forms. A firm can make a direct payment to its shareholders, called a **dividend**. Alternatively, a financial investor might buy a share of stock in Wal-Mart for $45 and then later sell it to someone else for $60, for $15 gain. We call the increase in the stock value (or of any asset) between when one buys and sells it a **capital gain**. Note that it is also possible that a stockholder can suffer a capital loss, if the price of the stock when sold is less than the price when it was purchased. Thus, while the potential benefits of stock ownership are unlimited, there is a risk of losing some or all of what was invested.

Third: Who makes the decisions about when a firm will issue stock, or pay dividends, or re-invest profits? To understand the answers to these questions, it is useful to separate firms into two groups: private and public.

A **private company** is owned by the people who run it on a day-to-day basis. Individuals can run a private company. We call this a **sole proprietorship**. If a group runs it, we call it a partnership. A private company can also be a corporation, but with no publicly issued stock. A small law firm run by one person, even if it employs some other lawyers, would be a sole proprietorship. Partners may jointly own a larger law firm. Most private companies are relatively small, but there are some large private corporations, with tens of billions of dollars in annual sales, that do not have publicly issued stock, such as farm products dealer Cargill, the Mars candy company, and the Bechtel engineering and construction firm.

When a firm decides to sell stock, which financial investors can buy and sell, we call it a public company. Shareholders own a public company. Since the shareholders are a very broad group, often consisting of thousands or even millions of investors, the shareholders vote for a board of directors, who in turn hire top executives to run the firm on a day-to-day basis. The more stock a shareholder owns, the more votes that shareholder is entitled to cast for the company's board of directors.

In theory, the board of directors helps to ensure that the firm runs in the interests of the true owners—the shareholders. However, the top executives who run the firm have a strong voice in choosing the candidates who will serve on their board of directors. After all, few shareholders are knowledgeable enough or have enough personal incentive to spend energy and money nominating alternative board members.

Watch It

Watch the clip for a brief introduction and explanation of stock markets.

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Glossary

[glossary-page]
[glossary-term]bills:[/glossary-term]
[glossary-definition]short term (less than one year) debt instruments[/glossary-definition]
[glossary-term]bond:[/glossary-term]
[glossary-definition]a financial contract through which a borrower like a corporation, a city or state, or the federal government agrees to repay the amount that it borrowed and also a rate of interest over a period of time in the future; usually long-term (greater than 10 year) debt instruments[/glossary-definition]

[glossary-term]bondholder:[/glossary-term]
[glossary-definition]someone who owns bonds and receives the interest payments[/glossary-definition]

[glossary-term]capital gain:[/glossary-term]
[glossary-definition]a financial gain from buying an asset, like a share of stock or a house, and later selling it at a higher price[/glossary-definition]

[glossary-term]corporation:[/glossary-term]
[glossary-definition]a business owned by shareholders who have limited liability for the company's debt yet a share of the company's profits; may be private or public and may or may not have publicly-traded stock[/glossary-definition]
[glossary-term]debt instruments:[/glossary-term]
[glossary-definition]IOUs[/glossary-definition]

[glossary-term]dividend:[/glossary-term]
[glossary-definition]a direct payment from a firm to its shareholders[/glossary-definition]
[glossary-term]equities or stocks:[/glossary-term]
[glossary-definition]ownership in a private company (unlike debt which conveys no ownership)[/glossary-definition]
[glossary-term]financial markets:[/glossary-term]
[glossary-definition]marketplace where money is invested and borrowed, or in other words, where securities are traded[/glossary-definition]
[glossary-term]initial public offering (IPO):[/glossary-term]
[glossary-definition]original sale of stock by a corporation[/glossary-definition]

[glossary-term]mutual funds:[/glossary-term]
[glossary-definition]funds that buy a range of stocks or bonds from different companies, thus allowing an investor an easy way to diversify[/glossary-definition]
[glossary-term]notes:[/glossary-term]
[glossary-definition]intermediate term (1-10 year) debt instruments[/glossary-definition]

[glossary-term]private company:[/glossary-term]
[glossary-definition]a firm owned by the people who run it on a day-to-day basis[/glossary-definition]

[glossary-term]public company:[/glossary-term]
[glossary-definition]a firm that has sold stock to the public, which in turn investors then can buy and sell[/glossary-definition]
[glossary-term]securities:[/glossary-term]
[glossary-definition]synonym for financial assets, or a certificate or other financial instrument that has monetary value and can be traded. These can be debt securities like bonds or equity securities like stocks. [/glossary-definition]

[glossary-term]shareholders:[/glossary-term]
[glossary-definition]people who own at least some shares of stock in a firm[/glossary-definition]

[glossary-term]shares:[/glossary-term]
[glossary-definition]a firm's stock, divided into individual portions[/glossary-definition]

[glossary-term]sole proprietorship:[/glossary-term]
[glossary-definition]a company run by an individual as opposed to a group[/glossary-definition]

[glossary-term]stock:[/glossary-term]
[glossary-definition]a specific firm's claim on partial ownership[/glossary-definition]

[glossary-term]Treasury bond:[/glossary-term]
[glossary-definition]a bond issued by the federal government through the U.S. Department of the Treasury[/glossary-definition]

[glossary-term]venture capital:[/glossary-term]
[glossary-definition]financial investments in new companies that are still relatively small in size, but that have potential to grow substantially[/glossary-definition]
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