INTRODUCTION OF MARKET PLACE

Capital markets are the hallmark of the capitalized system. With the collapse of the Soviet Union, hundreds of delegations from the former communist bloc countries have visited the United States to learn about our markets and to facilitate the development of markets in Eastern Europe. Stock markets are one of humankind’s greatest inventions; they raise everyone’s standard of living. Capital growth promotes job creation, increases disposable income, and increases charitable giving. The capital markets enable better use of the resources we have, allowing us to alter our consumption pattern over time.

Despite these benefits, many Americans are ignorant of how markets work. For them, the nightly newscast is largely incomprehensible when the talk turns to the day’s activity on Wall Street. This chapter serves as a primer on our markets, how they work, and why we have them. More detail follows in subsequent chapters.

This chapter also introduces the Association for Investment Management and Research (AIMR), and the Chartered Financial Analyst (CFA) program. The CFA is a prestigious credential for those involved in the investment business. Many firms require participation in the CFA program as a condition of employment. Sections of this book and end-of-chapter problems related to the CFA program are marked with the symbol shown in the margin.

THE ROLE OF THE CAPITAL MARKETS:

Why is there a New York stock Exchange, or a Chicago Board of Trade, or a Chicago Board option Exchange? An exchange serves three principal functions: an economic function, a continuous pricing function, and a fair pricing function. Although exchange function is a topic in macroeconomics, the concept is sufficiently important to warrant discussion in an investments text.

ECONOMIC FUNCTION:

The most important function is the economic function. This mechanism facilitates the transfer of money from savers to borrowers. As an example, consider the secondary market for home mortgages. Many small communities in the United States contain middle-class residents with modest savings. Still, the houses they buy are expensive, and virtually everyone needs to borrow money to buy a house. A town’s residents usually have a bank relationship because of the convenience checking and savings accounts offer. People also look to banks for home mortgages suppose one person goes to the local bank and is able to get a $100000 loan. Three other families do the same thing shortly thereafter. Very quickly, the entire saving of the town is loaned out. The bank cannot loan money it does not have. Does this mean that no one else in the town can buy a house? Fortunately, it does not. Elsewhere in the United States, individual investors want to lend money rather than borrow it. The key is to match up the would-be borrowers with the available savers. The local banks holding the mortgage certificates can sell these mortgages to someone else, and routinely do so. Government agencies like the Government National Mortgage Association and the Federal National Mortgage Association help facilitate these sales. Once the local bank sells a mortgage, it receives an inflow of money that can be used to finance someone else’s home mortgage. These mortgages can be sold, too, and the cycle goes on.
Similarly, corporations periodically need to raise money and often sell stocks and bonds to the public. The U.S government never has enough money, it seems, and sells treasury bonds to buyers all over the world. Investors with surplus cash buy these securities. Individual who already own stock and suddenly need to raise cash can sell their shares to someone else.

These are all the examples of the economic function of the capital markets: Facilitating the flow of capital from those who have it and wish to invest it to those who need it and want to borrow it. When a firm sells securities to the public for the first time, it does so in the primary market. The firm receives cash in the exchange for the creditor position. After their initial sale, securities trade in the secondary market, also known as the used of securities market.

After selling shares in the primary market, the issuing firm receives cash. Concurrently, the shareholders equity portion of the corporate balance sheets changes. Trading in the secondary market, however, does not affect the firm’s financial statements. If X buys 100 shares of the Intel common stock for $64, he pays $6400 to the seller of the shares. Intel receives nothing from the trade. Similarly, if y sells her Saturn automobile, the sale has not impact on the automobile company's financial statements. When people talk about what happened on the stock market, they usually mean the secondary market.

**The economic functions of the capital markets: facilitating the flow of capital from savers to borrowers.**

**Continuous Price Function:**

A second function of the capital markets is the continuous pricing function. It means precisely what the name indicates – prices are available moment by moment – and provides a tremendous advantage to the security investors. Consider the case of alternative investments: How much is an antique grandfather’s clock worth? How about Chinese porcelain, or 50 acres of southern pine timberland? Determining the value of these items is not always easy, nor can the task always be accomplished quickly. First, an appraiser checks authenticity and condition. Having established this, we may need to check recent sales of comparable items. This could involve researching catalogs and auction reports or making numerous telephone calls. The necessary activities in this process can be time consuming and even nuisance.

These problems are not an issue with financial assets as sticks and bonds. In most cases, anyone can discover the prices of the various financial assets instantly during the business day. People routinely call their broker and ask, “How’s IBM? How about Texaco?” they fully expect and have come to take for granted an instant reply. Alternatively, one can always check the wall street journal or other newspaper with a business section or pull prices off the internet.

Some securities seldom trade, and we would be less confident in our ability to get a quick notation of a firm that is too small to be carried in the electronic price reporting system. Still, we could probably get a good estimate more quickly than we could for an attic full of uncategorized art or shoebox full of old coins.

**The continuous price function enables market participants to get accurate, up-to-date price information.**
Fair Pricing Function:

Fair pricing is the third function of the capital markets. Some people consider it the most important because it means that we can trust the system. You can tell you broker to sell your stock at the going price and be assured of getting a fair price.

This assistance is not there with most things that sell outside an organized trading ground. You would not, for instance, go to the automobile classified advertisements in the newspaper and automatically pay what someone wanted for a car that interested you if you did; you would likely pay considerably more than necessary.

A main reason capital markets prices are fair is the high number of players in the game. Many people are competing for the same business, in a sense. If you have stock to sell, thousands of people are willing to bid on it. The market ensures that you sell it to the highest bidder. Conversely, buyers confronted with numerous potential sellers can rely on the system to match their order with the best price, which from the buyer’s perspective is the lowest price. The greater number of participants and the more formal the marketplace, the more assurance you have, that you are getting a good price.

Consider a well established local grocery store that is part of a national chain. Are you comfortable shopping there, or do you worry about not getting a good deal? Changes are the prevailing prices are competitive, because so many people pass through the store (and through others in the area) that stores with unreasonably high prices will simply not survive.

As another example, you might own an old coin you know to be valuable. One way to sell the coin would be to go a regional coin show, taking it to various dealers’ tables and getting individual offers on it. An alternative is to offer it for sale at a coin auction. The latter choice will almost certainly result in a higher price. When many dealers look simultaneously look at a particular coin, the market is much more efficient than when the dealers individually look at the coin.

An old joke among academic people describes a business professor who was asked what is daily consulting fee was. He replied, “$2500 per day”. When asked how much consulting he did, he replied, “none, but that is my rate”. You can set any price you like, but when comparable services are available, the highest price is not likely to get any action from the buyers.

The fair price function removes the fear of buying or selling at rip off price. The greater number of participants and the more formal the marketplace, the greater is the likelihood that you are getting a fair price.

THE EXCHANGES:

Exchanges are not a new invention. The oldest stock market is probably the Amsterdam bourse, where shares of the East Indies trading company changed hands. Future contracts traded at the Osaka rice exchange as far back as 1754. What makes the US exchanges to respected are the member of securities traded, the quality of the trading and the oversight of the trading mechanism.
National Exchanges:

The two national exchanges in the United States were historically the New York stock exchange on Wall Street and the American stock exchange on trinity place, one block from the NYSE. In early 1999 the AMEX merged with the NASDAQ stock market. The NYSE dates back to 1792, when 24 merchants began gathering daily to exchange shares of stock. Legend has it that these people met under a buttonwood tree where they traded shares among themselves. The NYSE recognizes the bank of New York as the first corporate stock to have traded on the exchange.

The NYSE officially opened in 1817 in tontine’s coffeehouse. A membership cost $25. In 1825 only 70 stocks were listed. As the capital markets grew, the need to limit the number of exchange members became obvious. Trading continued outside near the buttonwood tree, however, in the area knows as the curb exchange. The curb exchange moved indoors in 1921. It adopted the name AMEX in 1950s.

Only exchange members may trade on the floor of an exchange. A membership is commonly called a seat. Most people are not members and, in order to buy securities, must normally hire someone who is a member to make a desired trade. That person is a broker. The broker is paid commission for his or her efforts. In early 2000, discussions were underway regarding the feasibility of taking NYSE public. Instead of buying or selling seats like any other asset, the current owners of the seats would receive common stock shares. In theory, anyone could then own a piece of the NYSE simply by acquiring one or more shares.

Today, during an average day, over $40 billion worth of stock trades at the NYSE. The NYSE is colloquially called the big board. NYSE employees still sometimes refer to the AMEX as the curb exchange.

Regional Exchanges:

The NYSE is not the oldest US exchange; that distinction belongs to the Philadelphia stock exchange, organized two years before the star of NYSE. Investors call the Philly and 13 other smaller exchanges regional exchanges. Many securities are dual listed, which means they trade on both a national exchange and on one or more of the regional exchanges. Coca cola for instance, trades on the New York, Boston, Cincinnati, Chicago, pacific, and Philly stock exchanges. It also trades on the Frankfurt, Germany, and Zurich, Switzerland exchanges. Worldwide, there are approximately 150 stock exchanges throughout more than 50 countries. The oldest continuously running exchange is the London stock exchange, in business since 1773.

TRADING SYSTEMS:

People buy and sell securities through different mechanisms via the specialist system, via the matchmaker system or electronically.

The Specialist System:

The specialist system is a distinctive feature of the NYSE and the AMEX. At the exchanges, trades in a particular security are subject to the oversight of an exchange member called the specialist. The specialist is charges with making a fair and orderly market in one or more
assigned securities. There are about 460 specialties, most of who handle between 5 and 10 stocks. A specialist is one of the more active stocks will likely handle only that security. A specialist is one of the more active stocks will likely handle only that security.

Suppose an individual investor has a brokerage account with Paine Webber and places an order to buy 100 share of IBM common stock. The individual’s stock-broker wires the order to the floor of the NYSE, where Paine Webber employee receives it and tasks it to the specialist’s post. The post is the specific location on the exchange floor where IBM stock trades. By exchange rules, IBM may only trade at the IBM trading post. The NYSE has 17 trading posts.

At the specialist’s post, three prices for IBM are shown on the computer screen: the bid price, the offer price, and the price at which the last trade occurred. The bid price is the highest price anyone has expressed a willingness to pay for IBM stock. The offer price is the lowest price at which anyone is willing to sell. The computer screen might show IBM bid at 55, offered at 55 1/4, with the last trade at 55 1/8. The specialist’s is job to keep the difference between the bid price and the offer price small. This difference is the bid spread. At the NYSE, 90% of all trades take place within 1/16th of the previous price, and 98% take place within 1/8th. The specialist also ensures that sellers will always find a buyer for their shares, and that buyers will always find shares for sale.

The specialist can get fined for failure to perform his or her duties properly. In 1999 the NYSE fined one specialist firm $200,000 for allegedly failing to maintain a fair and orderly market in six assigned stocks on eight occasions from October 1996 to September 1998. In one instance, on October 27, 1991, the Dow Jones industrial average was down 554.20 points because of the Asian crisis. The following day city corporation opened at $113, down more than $10 from the previous day’s close. The stock then rallied to $127.50 by the end of the day. Some market participants felt the specialist failed to set the opening price properly and then failed to deal with its rapid rise. The NYSE alleged that the specialist failed to participate adequately as a dealer against a market trend doing certain periods of significant price movement.

The specialist is charged with making a fair and orderly market in one or more assigned securities.

SuperDot:

SuperDot is an electronic system enabling NYSE member firms to send certain orders directly to the specialists’ posts on the floor of the exchange without using a human runner to deliver the order. Specialists, in turn, use SuperDot to confirm trades back to the member firms. The NYSE reports that on a given day more than 75% of its trading volume is via SuperDot.

Any NYSE security may be traded via this system, prior to the opening of the trading day; investors may place orders for immediate execution of up to 30000 shares. Once the day’s trading begins, the maximum order size drops to 2100 shares. Orders to buy sell at a set price or better for up to 100000 shares may be placed at any time. About 85% of all orders reach the specialists via the SuperDot system. These orders comprise about 38% of total volume.
Marketmakers:

The market maker system differs from the specialist system in that a group of competing individuals (rather than a single person) maintains the fair and orderly market. Futures exchanges and the Chicago board options exchange use the market maker system.

The visitor to a market maker exchange will be impressed with the activity on the trading floor. Rather than a post, the market maker system uses trading pits. In these sunken areas on the exchange floor, groups of market makers trade by open outcry, calling out their offers to buy and sell and eliminating any standing in line or computerized order entry. The collection of market makers in any trading pit is called the crowd.