

CHAPTER 1: THE CAPITAL MARKETS AND FINANCIAL SERVICES

Exam weighting
Chapter 1 comprises
between 8-12% of
the exam.



Know for the Exam

- ✓ Glossary of terms in the Canadian Securities Institute text
 - ✓ Investment capital characteristics, suppliers, and users
 - ✓ The roles of financial instruments and financial markets
 - ✓ Auction markets
 - ✓ Dealer (over-the-counter) markets
 - ✓ Dealer and principal transactions
 - ✓ Financial intermediaries
 - ✓ Regulatory organizations
 - ✓ Canadian Investor Protection Fund (CIPF)
 - ✓ Ombudsman for banking services (OBSI)
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INVESTMENT CAPITAL

- When individuals, governments, corporations and organizations take in more money (revenue) than they spend (expenses), they have savings (capital) to invest.
- To be economically effective, capital must be invested *directly* or *indirectly*.
 - *Direct* investments see capital invested directly into brick-and-mortar assets, such as a new company or building.
 - *Indirect* investments see capital invested in items that represent capital, like stocks and bonds issued by governments and corporations. Indirect investments are then used by governments or corporations to make direct investments, such as buying a new piece of equipment. The *indirect investment* process is the focus of this course.
- Indirect investments are usually made by an intermediary who invests the funds of the investor and tries to attain a profit for the investor.

- Non-contractual commitments are indirect investments from which funds may be withdrawn on short notice.
- Contractual commitments are usually intended to lock-in funds for longer periods.

Characteristics

- Investment capital is mobile, sensitive, and scarce. Investors are selective about where capital will be invested and look for countries or locations that are stable, have a good investment climate, present opportunities for growth, and in which risk is minimized.
- Risk analysis of a country determines the flow of capital into or out of the country. The risk analysis usually includes an evaluation of:
 - The political environment including the country's likelihood of involvement in conflict.
 - Fiscal and monetary policies of the government including taxes, government spending, the government's encouragement to save and invest, the management of the growth of the nation's money supply and the promotion of price and foreign exchange stability.
 - Economic trends.
 - Opportunities for adequate *return* considering the risk.
 - The characteristics of the labour force.

Return

The gain or loss of a security over a period of time, usually expressed as a percentage.

Purpose of Investment Capital

- A lack of investment capital in a country will result in lower living standards, declining productivity, rising unemployment, decreasing competitiveness, and rising inflation.

Source of Investment Capital

- The source of capital is savings; savings are the result of a non-financial corporation, an individual, a government or a non-resident of a country having revenues or income that exceed expenses.

Suppliers of Capital

- Principal suppliers of investment capital include:

- Individuals called retail investors who provide investment capital through:
 - savings at chartered banks and other financial institutions such as trust companies, and credit unions
 - Canada Savings Bonds
 - Securities investments
 - Equity in homes and business
 - Cash values of life insurance
- Institutional investors such as pension funds that provide large amounts of investment capital.
- Financial institutions that take deposits or investment capital from individuals and corporations.
- Foreign investors who may invest directly in assets in Canada, purchase Canadian securities on a Canadian market either through a broker in Canada or the foreign office of a Canadian broker, or purchase instruments in foreign capital markets (e.g., a **foreign bond** or a **eurobond**).

Investor Objectives

- Three primary objectives of investors:
 - *Safety of principal*: the desire to ensure the principal will not decrease. Usually investments with a higher rate of safety come with a lower rate of return and less opportunity for capital growth.
 - *Income*: the desire to get the best rate of return.
 - *Growth of capital*: the desire to increase the investment.
- Two secondary objectives of investors:
 - *Liquidity and marketability*: the ability to sell the investment and/or the presence of interested buyers at a given time is important to those who may need to access their money on short notice.
 - *Tax minimization*: the desire to reduce taxes. Tax treatment of an investment depends whether the investment returns dividends, interest, or **capital gains**.

Foreign bond

A bond issued and denominated in a foreign (to the borrower) currency and sold in the same foreign country.

Eurobond

An international bond issued in markets outside the domestic market of the insurer in the currency of the issuer. For example, a eurobond denominated in Canadian dollars is not sold in Canada. Eurobonds have nothing to do with the euro or Europe.

Capital gains

An increase in the value of capital property above its purchase price. Capital property includes real estate, stocks, art, etc.

- Reconciling the objectives of safety, income, growth, and liquidity is best accomplished through **diversification**.

Diversification

To spread out investments among asset classes.

- Diversification is a means of reducing the risk of serious loss by distributing capital over a number of investments. When investments are correctly diversified over the various classes of **assets**, an investor has a balanced portfolio.

Assets

An item of monetary value that is owned by a firm or an individual. Assets are listed on a firm's balance sheet and include tangible items such as inventories, equipment, and real estate as well as intangible items such as property rights or goodwill. Individual assets include real estate, savings, or investments.

- The rule-of-thumb for a balanced portfolio is that no more than 10% of the value of the portfolio should be invested in any one security. As the portfolio grows, no more than 5% of a single security should be held

Comparison of Major Securities and Investor Objectives

Security	SAFETY	INCOME	GROWTH
Short-term Bonds	safest	very steady	most limited
Long-term Bonds	safer	very steady	variable
Preferred Stocks	safe	steady	variable
Common Stocks	least safe	variable	in many cases, most growth

USERS OF CAPITAL

- Canadian and foreign individuals, businesses, and governments use capital.
- Individuals:
 - Use capital to buy houses, cars, appliances, etc.
- Businesses:
 - Use capital to finance:
 - daily operations
 - maintenance of plants and equipment
 - expansion
 - diversification

- Generate much of their capital internally, borrow some from financial intermediaries like the chartered banks, and raise the rest in securities.
- Foreign users:
 - Comprised mainly of governments and businesses.
 - Borrow from Canadian banks or make their securities available to the Canadian market.
 - Are attracted to Canadian capital when it can be accessed at a less expensive rate than the foreign user's own currency.

Federal Government Finance

- To finance debt, the federal government issues **treasury bills (T-bills)**, marketable short and long-term bonds, Canada Savings Bonds (CSBs) and Canada Premium Bonds (CPBs). Government bonds are actually debentures, since physical assets are not pledged as collateral the bonds are secured by the government's ability to tax.
- The highest quality rating is assigned to federal government bonds.
- For foreign investors, the risk of investing in another country's government bonds is reflected in the yield of the bonds. These yields fluctuate in response to the country's political and economic climate.

Treasury bills or T-bills

Government of Canada T-bills are issued in denominations ranging from \$1,000 to \$1 million. New issues are sold by public tender at a discount. The difference between the purchase price and the face amount represents the return to the investor.

Provincial Government Finance

- The provinces raise capital by issuing non-marketable bonds to the federal government, borrowing from the Canada Pension Plan, or selling bonds to institutional or retail investors. They also issue provincial T-bills as well as bonds in foreign currencies and in international markets.
- The provinces also guarantee securities issued by provincially-owned corporations.
- The provinces need to issue government debt to finance road construction and maintenance, public education, health services, to control and develop natural resources and distribute electric power.

- Like federal bonds, provincial bonds are actually debentures.
- Provincial bonds are second in quality to federal bonds.
- The price of each issue is determined by the credit-worthiness of the province and its economic climate.
- The credit-worthiness depends on:
 - The current debt levels of the province.
 - The transfer payments that the province will receive from the federal government.
 - The philosophy and stability of the government.
 - The wealth of the province.

Municipal Finance

- Municipalities finance their operations by issuing instalment or serial debentures. Most municipal debentures are classified as "trustee investments".
- Borrowing by municipalities is regulated by provincial statute which requires the municipality to be conservative with funds entrusted to them.
- The credit-worthiness of a municipality depends on its tax base, population, industrial growth, various types and number of industries, transportation facilities, and repayment track record.

THE ROLE OF FINANCIAL INSTRUMENTS

Debt and Equity

- The securities industry is comprised of financial products (also called instruments), financial markets, and financial intermediaries. Financial instruments connect suppliers and users of capital in the financial markets through financial intermediaries.
- The two categories of financial products are *debt* and *equity*.

Investment Funds

- Investment funds are pools of money whose shares or units are distributed in proportion to each investor's contribution.
- A mutual fund is an open-ended investment fund in which units are continually issued and redeemed.
- Closed-end funds trade like stocks on an exchange; they are issued once.
- Both types of fund provide the investor with professional management and diversification.

Derivatives

- Derivatives options and futures are a financial product whose value is derived from the value of an underlying security, asset or market index.
- Options and futures can be bought or sold at a specific price and time regardless of the market price at that time.
- Mainly for experienced investors.
- Described in detail in chapter seven.

Other Investment Products

- Financial engineering has created products like income trusts and exchange-traded funds which combine different characteristics of **debt**, **equity** and investment funds.

THE ROLE OF FINANCIAL MARKETS

- Financial markets allow buyers and sellers to trade securities in an organized and regulated environment. Stockbrokers and bond dealers serve as intermediaries between buyers and sellers.
- Securities markets can be physical (e.g., the New York Stock Exchange) or take place over a computer or telephone network.

Debt

Debt products are discussed in detail in chapter 5.

Equity

Equities are discussed in detail in chapter 6.