



FINANSIAL MARKETS

D. Kostova – Pickett

University of California

ABSTRACT

A major part of a financial executive's job is to raise money to finance current operation and future growth. To do this effectively requires knowledge of financial instrument to the issuing company. In this paper, we consider financial markets. Financial markets in the United States and other well-developed financial markets are quite efficient. To earn above-average returns, an investor in these markets must have access to private information, or accept above-average risk.

Key words: financial, market, efficient, price

Private Placement or Public Issue?

Companies raise money in two broad ways: through private negotiations with banks, insurance companies, pension funds, or other financial institutions or by selling securities to the public. The former is known as a *private placement*; the latter is a *public issue*. Although private placements of equity are rather rare except among small businesses, private placements of debt account for a significant fraction of total corporate debt.

To sell securities to the public, a company must register the issue with the Securities and Exchange Commission. This has traditionally been an expensive, time-consuming, cumbersome task, but unless registered securities may not trade on public markets. This is a valuable privilege. It means the owner of registered securities can sell them simply by calling a stockbroker and placing an order. In contrast, when a financial institution wants to liquidate some of its holdings of private placements, it must sell them to other institutions.

A company's choice of whether to raise money via private placement or public issue comes down to this: Private placements are simpler, are quicker, and can be tailored more closely to the particular needs of the issuer, but because buyers find them difficult to resell, private placements carry somewhat higher interest rates than public issues.

Exchanges and Over-the-Counter Markets

Public issues trade on two types of markets: organized exchanges and over-the-counter markets. Organized exchanges, such as the New York Stock Exchange and the American Stock Exchange, are centralized trading locations that maintain active markets in hundreds of stocks and bonds. Stockbroker members of the exchange, who attempt to match buyers with sellers. Specialists may buy or sell securities for their own accounts, but more often they act as agents, pairing buyers with sellers.

Over-the-counter (OTC) markets are much more informal. Any brokerage house anywhere in the country can create an OTC market for a stock or a bond by quoting a *bid* price at which it will buy the security and a higher *asked* price at which it will sell it. The spread between the bid and asked price is the broker's revenue. In return, the broker must keep an inventory of the security and must frequently trade for her own account to maintain an active market. At the other end of the OTC spectrum is the NASDAQ, a national electronic trading system on which many high-technology companies, such as Microsoft and Intel, trade. Although computerized trading is rapidly blurring the distinction between organized exchanges and OTC markets, it is still safe to say that most well-known companies trade on organized exchanges while the shares of smaller, regional companies and organized exchanges while the shares of

smaller, regional companies and a great many bonds trade over the counter.

International Financial Markets

From a global perspective, companies can raise money on any of three types of markets: *domestic, foreign, or international*. A domestic financial market is the market in the company's home country, while foreign markets are the domestic markets of other countries.

Companies find it attractive to raise money in foreign markets for a variety of reasons. When the domestic is small or poorly developed, a company may find that only foreign markets are large enough to absorb the contemplated issue. Companies may also want liabilities denominated in the foreign currency instead of their own. Finally, issuers may believe foreign-denominated liabilities will prove cheaper than domestic ones in view of anticipated exchange rate changes.

Access to foreign financial markets has historically been a sometime thing. The Swiss and Japanese governments have frequently restricted access to their markets by limiting the aggregate amount of money foreigners may raise in a given time period or imposing firm size and credit quality constraints on foreign issuers. Even U.S. markets in the world, have not always offered unrestricted access to foreigners.

The third type of market on which companies can raise money, international markets, is best viewed as a free market response to the regulatory constraints endemic in domestic and foreign markets. A transaction is said to occur in the international financial market whenever the currency employed is outside the control of the issuing monetary authority. A dollar-denominated loan to an American company in London, a German mark loan to a Japanese company in Singapore, and a French franc bond issue by a Dutch company underwritten in Frankfurt are all examples of international financial market transactions. In each instance, the transaction occurs in a locale that is beyond the direct regulatory authority. Thus, the U.S. Federal Reserve has trouble regulating banking activities involving American companies and are denominated in dollars. Similarly, the Bundesbank has difficulty regulating German mark activities in Singapore.

International financial markets got their start in London shortly after World War II and were originally limited to dollar transactions in Europe. From this beginning, the markets have grown enormously to encompass most major currencies and trading centers around the globe. Today international financial markets give companies access to large pools of capital, at very competitive prices, with minimal regulatory or reporting requirements.

Two important reasons international markets have often been able to offer lower-cost financing than domestic markets are the absence of reserve requirements on international banks and the fact that international banks must abide by deposit in a special, often non-interest-bearing account at the central bank. Because these reserves tie up resources without yielding a competitive return, domestic loans must carry a higher interest rate than international loans to yield the same profit.

The chief appeal of bearer bonds is that they make it easier for investors to avoid paying taxes on interest income.

The ability of international financial markets to draw business away from domestic markets has sharply accelerated the deregulation of domestic financial markets.

Not all regulations are bad, of course. Regulatory oversight of financial markets and the willingness of governments to combat financial panics have greatly stabilized markets and economies for over 50 years. The ongoing question is whether the deregulatory pressures created by international financial markets are improving efficiency by stripping away unwarranted restraints or dangerously destabilizing the world economy.

Investment Banking

Investment bankers are the grease that keeps financial markets running smoothly. They are finance specialists who assist companies in raising money. Other activities include stock and bond brokerage, investment counseling, merger and acquisition analysis, and corporate consulting.

When a company is about to raise new capital, an investment banker's responsibilities are not unlike his fees: many and varied. (Capital-raising techniques vary from one country to another depending on custom and law). In a private placement, the investment banker

customarily acts as an agent, bringing issuer and potential buyer together and helping them negotiate an agreement. In a public issue, the investment banker's responsibilities are much broader and vary depending on whether the company registers the securities with the SEC in the traditional manner or uses what is a shelf registration.

Traditional Registration

In a traditional registration, the investment banker begins working with the issuing company very early in the decision process. In most instances, the banker will have worked closely with management for some years and built up a working rapport. The first task is to help the company decide what type of security to sell. Then, if it is to be a public issue, the banker will help the company register the issue with the SEC. This usually takes 30 to 90 days and includes public disclosure of detailed information about the company's finances, offices, compensation, plans, and so on – information some managements would prefer to keep confidential.

While a traditional registration wends its way toward approval, the investment banker puts together a selling and an underwriting syndicate. A syndicate is a team of as many as 100 or more investment banking houses that join forces for a brief time to sell the new securities. Each member of the selling syndicate accepts responsibility for selling a specified portion of the new securities to investors. Members of the underwriting syndicate in effect act as wholesalers, purchasing all of the securities from the company at a higher price. The "Rules of Fair Practice" of the National Association of Securities Dealers prohibit underwriters offer price quoted to the company. If necessary, however, the syndicate may sell them at a lower price.

Given the volatility of security prices and the length of time required to go through registration, it may appear that underwriters bear significant risks when they guarantee the company a fixed price. This is not the way the world works, however. Underwriters do not commit themselves to a firm price on a new security until just hours before the sale, and if all goes as planned, the entire issue will be sold to the public on the first day of offer. It is the company, not the underwriters, that bears

the risk that the terms on which the securities can be sold will change during registration.

The life of a syndicate is brief. Syndicates form several months prior to an issue for the purpose of preselling and disband as soon as the securities are sold. Even on successful issues, the syndicate breaks up several weeks after the issue date, leaving the underwriters to dispose of their unsold shares on their own.

Shelf Registration

First authorized in 1982, a shelf registration allows frequent security issuers to file a general-purpose registration, good for up to two years, indicating in broad terms the securities the company may issue. Once the registration is approved by the SEC, and provided it is updated periodically, the company can put the registration on the "shelf", ready for use as desired. A shelf registration cuts the time lag between the decision to issue a security and receipt of the proceeds from several months to as little as 48 hours.

Because 48 hours is far too little time in which to throw a syndicate together, shelf registrations tend to be "bought deals" in which a single investment house buys the entire issue in the hope of reselling it piecemeal at a profit. Also, because it is just as easy for the issuer to get price quotes from two investment houses as from one, shelf registrations increase the likelihood of competitive bidding among investment banks. As a result, issue costs for shelf registrations are as 10 to 50 percent lower than for traditional registrations, depending on the type of security and other factors.

Issue Costs

Financial securities impose two kinds of costs on the issuer: annual costs, such as interest expense, and issue costs. We will consider the more important annual costs later. Issue costs are the costs the issuer and its shareholders incur on initial sale. For a private placement, the only substantive cost is the fee charged by the investment banker in his or her capacity as agent. On a public issue, there are legal, accounting, and printing fees, plus those paid to the investment banker. The investment banker states his fee in the form of a spread. To illustrate, suppose ABC Corporation wants to sell 1 million new shares of common stock using traditional registration procedures and its

shares presently trade at \$20 on the Stock Exchange. A few hours prior to public sale, the lead investment banker might inform ABC management that “Given the present tone of the markets, we can sell the new shares at an issue price of \$19.00 and a spread of \$1.50, for a net to the company of \$17,50”. This means the investment banker intends to underprice the issue \$ 1.00 per share (\$20 market price less \$19 issue price) and is charging a fee be split among the managing underwriter, or lead bank, and the syndicate members by prior arrangement according to each bank’s, importance in the syndicates.

To underprice an issue means to offer the new shares at a price below that of existing shares. Investment bankers often underprice on the theory that the price of the new shares must be below that of existing shares to induce investors to hold more and because underpricing makes their own job easier. Selling something worth \$20 for \$19 is a lot easier than selling it for \$20. Underpricing is not an out-of-pocket cost to the more new shares a company must issue to raise a given amount of money. And as the number of shares issued up, the percentage ownership of existing shareholders goes down.

Empirical studies of issue costs confirm two prominent patterns. First, equity is much more costly than debt. Representative costs of raising capital in public markets, ignoring underpricing, average about 2,2 percent of proceeds for straight debt, 3,8 percent for convertible bonds, and 7,1 percent for offerings of equity is 11,0 percent. Second, issue costs as a percentage of gross proceeds for equity are as low as 3 percent for issues larger than \$100 million but rise to over 20 percent for issues under \$500000. Comparable figures for debt financing are from below 0,9 percent for large issues to over 10 percent for very small ones.

Regulatory Changes

Financial market deregulation has ignited a revolution among American financial institutions. In part, deregulation has been the outgrowth of a changing regulatory philosophy, but at least as important has been a wide array of technological and competitive innovations that have made regulation increasingly ineffective.

Prior to the Great Depression, U.S. banks were allowed to engage in commercial and

investment banking. In 1933, Congress passed the Glass-Steagall Act to eliminate perceived conflicts of interest between the two activities. Since then, commercial banks have been prohibited from engaging in most securities-trading activity, while investment banks have been prohibited from accepting deposits and making loans. However, it has become increasingly difficult to clearly separate what constitutes commercial banking versus investment banking; so today distinctions between the two types of banking have become almost meaningless. In many other countries, banks, including U.S. multinational banks, have long been free to engage in investment and commercial banking activities.

Efficient Markets

A recurring issue in raising new capital is timing. Companies are naturally anxious to sell new securities when prices are high. Toward this end, managers routinely devote considerable time and money to predicting future price trends in financial markets.

Concern for proper timing of security issues is natural, but there is a perception among many academicians and market professionals that attempts to forecast future prices in financial markets will be successful only in exceptional circumstances and that unless these circumstances exist, nothing is to be gained by forecasting. Such pessimism follows from the notion of efficient markets, a much-debated and controversial topic in recent decades.

Market efficiency is controversial in large part because many proponents have overstated the evidence supporting efficiency and have misrepresented its implications. To avoid this, let us agree on two things right now. First, market efficiency is a question not of black or white but of shades of gray. A market is not efficient or inefficient but more or less efficient. Moreover, the degree of efficiency is an empirical question that can be answered only by studying the particular market under consideration. Second, market efficiency is a matter of perspective.

What is an Efficient Market?

Market efficiency describes how prices in competitive markets respond to new information.

How long does this price adjustment process take? Louis Ederington and Jae Ha Lee at the University of Oklahoma provide an answer in

their study of market responses to scheduled news releases. Looking at prices in various interest rate and foreign exchange markets on a trade-by-trade basis, they find that price changes begin within 10 seconds of the news release and are basically completed within 40 seconds.

An efficient market, then, is one in which prices adjust rapidly to new information and current prices fully reflect available information about the assets traded. “Fully reflect” means investors rapidly pounce on new information, analyze it, revise their expectations, and buy or sell securities accordingly. They continue to buy or sell securities until price changes eliminate the incentive for further trades. In such an environment, current prices reflect the cumulative judgment of investors. They fully reflect available information.

The degree of efficiency a particular market displays depends on the speed with which prices adjust to news and the type of news to which they respond. It is common to speak of three levels of information efficiency:

1. A market is weak-form efficient if current prices fully reflect all information about past prices.
2. A market is semistrong-form efficient if prices fully reflect all publicly available information.
3. A market is strong-form efficient if prices fully reflect all information public or private.

Extensive tests of many financial markets suggest that with limited exceptions, most financial markets are semistrong-form efficient but not strong-form efficient. In other words, you generally cannot make money trading on public information; insider trading, however, based on private information, can be lucrative. This statement needs to be qualified in two respects. First, there is the issue of perspective. The preceding statement applies to the typical investor, who is subject to brokerage fees and lacks special information-gathering equipment. It does not apply to market makers. Second, it is impossible to test every conceivable type and combination of public information for efficiency. All we can say is that the most plausible types of information tested with the most sophisticated techniques available indicate efficiency. This does not preclude the possibility that a market will be inefficient

with respect to some as yet untested information source.

Implication of Efficiency

If financial markets are semistrong-form efficient, the following statements are true:

- Publicly available information is not helpful in forecasting future prices.
- In the absence of private information, the best forecast of future price is current price, perhaps adjusted for a long-run trend.
- Without private information, a company cannot improve the terms on which it sells securities by trying to select the optimal time to sell.
- Without private information, or the willingness to accept above-average risk, investors should not expect to consistently earn above the market-average rate of return.

Individuals without private information have two choices: They can admit that markets are efficient and quit trying to forecast security prices, or they can attempt to make the market inefficient from their perspective. This involves acquiring the best available information-gathering system in the hope of learning about events before others do. A variation on this strategy, usually illegal, is to seek inside information. A third gambit used by some investors is to purchase the forecasts of prestigious consulting firms. The chief virtue of this approach appears to be that there will be someone to blame if things go wrong. After all, if the forecasts were really any good, the consulting firms could make money by trading, thereby eliminating the need to be nice to nice to potential customers.

As the preceding comments suggest, market efficiency is a subtle and provocative notion with a number of important implications for investors as well as companies. Our treatment of the topic here has been necessarily brief, but it should be sufficient to suggest that unless executives have inside information or superior information-gathering and analysis systems, they may have little to gain from trying to forecast prices in financial markets. This conclusion applies to many markets in which companies participate, including those for government and corporate securities, foreign currencies, and commodities.

There is, however, one important caveat to this conclusion. Because managers clearly possess

private information about their own companies, they should have some ability to predict future prices of their own securities. This means managers' efforts to time new security issues based on inside knowledge of their company and its prospects may in fact be appropriate. But notice the distinction. The decision to postpone an equity issue because the president believes the company will significantly outperform analysts' expectations

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in the coming year in fully defensible in postpone an issue because the treasurer believes stocks in general will soon rise is not. The former decision is based on inside information; the latter is not.

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