

## LECTURE 2

### Chapter 3

## SECURITIES MARKETS

#### IPO Required Docs:

- Amendment to the certificate of incorporation
- Corporate Governance (Private are far less formal – responsibility)
- Recruit Independent Board Members / new board committees.
- Registration statements. – SOX (Sarbanes-Oxley Act)

- Primary Markets – First time Companies Issue securities (IPO) to raise capital – sell or float securities (Seasonal Issuers)
  - Underwriters (I Banks)– market the securities – SEC / prospectus (Red Hearing) – Prospectus – Shelf Registration – SEC approved – Rule 415 - regulated for 2 years to come into the market to raise capital
  - Private Placement – Cheaper – Rule 144A (with registration rights) – sophisticated investors
  - IPO Process – Road Shows / Book Building / Allocation / Valuation based on Supply and Demand / Valuation methods to justify stock price recommendation
- Secondary Markets - Not affecting each other stock – simply a transfer between investors
  - How securities are traded – 4 types of markets:
    - Direct Search Markets - Not Organized – seek each other (buyers and sellers)
    - Broker Markets – Pay the broker to find the seller or the buyer
    - Dealer Markets – Purchase on their own – Inventory and markets them to retail (OTC)
    - Auction Markets – Bid and Ask – search across Dealers inventory for best price (NYSE)
  - Types of Orders – 2 types:
    - Market Orders [Buy and sell (executed immediately) – Ask the broker to buy or sell in the market]
    - Price contingency orders (Limit buy order/ sell order / stop loss – instruction on price and time.
  - Trading Mechanics (3 trading systems in the U.S.)

- OTC Dealer market (Broker registration – Quote willing to buy / sell)
  - ECN (Electronic Communication Networks) – Participants post market and limit orders – and they are crossed match.
  - Formal Exchange / Specialist Markets – (i.e. NYSE)
- MARKETS – NYSE / NASDAQ
- Specialists – buy / sell on behalf of their clients “Maintain a Fair and Orderly Market” / “Price continuity”
  - NASDAQ – 3,200 firms listed – 3 different tiers – table 3.1 page 61
    - NASDAQ Select Global (larger)
    - NASDAQ Global
    - NASDAQ Capital (Smaller)
  - NYSE – 2,800 firms listed / \$15 trillion of capital – Listing requirements table 3.2 page 63
  - Block sales – 10,000 shares or more
  - Super Dot or Electronic Trading – a program trade that coordinates purchase or sell of each portfolio settlement
  - T+3 clearing house
  - ECN – List buyer & Sellers and match orders – all 9 exchanges are in the program (including Chicago Mercantile) and bond trading
  - Broker and Trading Costs – Full service brokers can decide to trade on their own (discretionary) /or recommend the stock and buy on their own inventory (Advise)
  - Discount brokers – Price quotation only
- BUYING ON MARGIN – Borrow to return higher – 50%
- Trigger margin Call – at margin level – at trigger it requires:
    - Equity injection
    - Sell of security
  - IRR higher when on Margin

**BUYING ON MARGIN**

One Year (Holding Period) - Assuming No Dividends

		Per		Total	Margin		Interest	Interest		
		Share	Shares		Borrow	Borrow	Rate	Pmt	NW	HPR
No Margin	Buy stock	20	1,000	20,000	0%	-			20,000	
	Sell Stock	25	1,000	25,000					25,000	
	Profit			5,000					<u>5,000</u>	<u>25.0%</u>
With Margin	Buy stock	20	1,000	20,000	50%	10,000	5.0%	500	10,000	
	Sell Stock	25	1,000	25,000		10,000		500	14,500	5.0%
				5,000					<u>4,500</u>	<u>45.0%</u>

- SHORT SELLING – First you sell and then you buy shares
  - An investor borrows a share of stock from broker and sells it. Later, the stock seller must purchase the stock in order to replace the stock that they borrow – betting on going down for the profit. THIS is COVERING THE SHORT POSITION
    - Exchanges permit short selling only when the last change of price is positive
    - Also require that the proceeds for the stock sale must be kept with the broker.

**SHORT SELLING**

Current Price		20					Margin		Interest	Interest		
		Per		Total			Borrow	Borrow	Rate	Pmt	NW	HPR
		Share	Shares									
Borrow shares		20	1,000	20,000	Cr		0%	-			20,000	Cr
Buy Shares		15	1,000	15,000							15,000	
				5,000							<u>5,000</u>	<u>25.0%</u>

- CIRCUIT BREAKERS – October 19, 1987 – 508 points – this prompt several suggestions –
  - First 10% DJIA in an hour – for an hour
  - 20% in 2 hours – for 2 hours
  - 30% - close for the day

## Chapter 4

### Investment Companies: Financial Intermediaries

Funds – set for purpose – profit measurement – NAV (Equity)

$\text{NAV} = \text{MV} - \text{Liabilities or per share (MV - Liabilities) / Shares outstanding}$
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Types:

#### 1. Unit Investment Trusts:

Pools of money in a portfolio – fixed for life of the fund (Unmanaged). To form a unit investment trust, a sponsor, typically a brokerage firm buys a portfolio of securities.

Then sells to the public shares (units in the trust), called Redeemable trust certificates (municipal, corporate).

#### 2. Managed Investment Companies

Board of Directors hires management company to manage the fund – paying an annual fee (.2 – 1.5%)

- a. **Closed-end:** ready to redeem or issue shares at the NAV price.

#### Closed-End Funds

	NAV	Market Price	Premium/Disc (Liquidity)	52-week
Adams Express	15.96	13.85	-13.22	13.84

Selling at a discount

$(\text{Price} - \text{NAV}) / \text{NAV}$
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- b. **Open-end:** Do not redeem or issue shares - exchange within owners – it’s usually traded at the NAV level  
Sales Charge (Load)

### 3. Other Investment Organization

- a. Commingled Funds – partnership of investments that pool their funds (insurance, partnerships, banks)
- b. REIT (closed end funds) – invest in RE with leverage (70%) - Raise the Capital
- c. Hedge Funds (structured as a private partnership)

#### HEDGE FUNDS

- Require the investor to have an initial “lock-up” agreement for withdrawals distributions. – This will allow the Hedge Fund Manager to invest in illiquid assets.
- Since they are not SEC regulated (private – sophisticated investors) the manager invests in other types of investments such as Derivatives, short selling and leverage.
- Compensation fee + share of profit ( 1.5% + 20% of profit)
- Hedge funds are designed to invest in various funds – focus on derivatives, distress firms, currency speculation, convertible bonds, emerging markets, mega arbitrages.
- Section of growth – Fund of Funds

#### MUTUAL FUNDS

- Each fund has an INVESTMENT POLICY - Discussed in the prospectus – allocation (short / Low / Risk – Fidelity, Vanguard, Dreyfus)
  - Money Markets (CD, CP, Deposits – one month average)
  - Equity Funds (Stock – 95% of stock, 5% Money market)
    - Income Funds (high dividends)
    - Growth Funds (capital gain, No dividends)
  - Specialized Section Funds (specific Industry – i.e. Healthcare)
  - Bond Funds (Corporate Funds, Municipal Funds)
  - Investment Funds (Global funds)
  - Balanced Funds (Equity, Bonds)
    - Life-cycle funds (aggressive for young investor) – (Conservative for older)

Targeted Maturity funds – targeted to change as you get older

- Asset Allocation flexible fund (market timing between equity and bonds depending of economic environment)
- Index Funds
  - Vanguard 500
  - S&P 500
  - FEES: front-end load / back-end load / operating expenses

**FEES AND EXPENSES**

Before Fees - NAV

$(NAV_1 - NAV_0 + \text{Income} + \text{Capital Gain}) / NAV_0 = \text{Rate of Return}$
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$NAV = \text{Value of the Funds} - \text{Debt (leverage)}$
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Front-end Load	Back-end Load	12b-1 Charges
Commission or sale charge paid when you purchase the securities	Redemptions % exit fee when you sell the security	SEC allows managers of 12b-1 funds to pay for advertising/marketing – fees from investors.
No more than 8.5%	5-6% and reduces it by 1% from every year the fund are left invested – contingent –or deferred sales charge	
Using 3.0% \$1,000 paid for fund 6% Load = 94 price $60/940 = 0.064$ 6.4%		

Expenses – referred to as “soft dollars”

Taxation – “pass-through states” – U.S. Tax code

If the fund is held at IRA / 401K – No taxes – retirement accounts

EXCHANGED-TRADED FUNDS (ETF) - trades like a stock

Allow investors to trade Index portfolios

SPIDER (SPDR) or S&P Depository receipt - daily trades – unlike Mutual funds, the NAV is calculated at the end of the day.

DIAMONDS (DIA) – DJIA 30

QUBES (QQQ) – NASDAQ 100

WEBS – World Equity benchmark shares – foreign indices

Mutual end performance – compared to the Index / stock market

INFORMATION ON FUNDS – SEC required – Prospectus

- a. Statement on Investment Objective
- b. Investment Policies and Risks
- c. Fund Advisory and Management Bios
- d. Cost Structure (Expense Loads)
- e. Statement of Additional Information (“SAI”) – part B of the prospectus.