

Securities Markets (ECON 133)

Instructor: Vladyslav Sushko

MWF 9:30-10:40AM, Stevens Acad. 150

Phone: (831) 459-2647

Email: vsushko@ucsc.edu

Office Hours: Mondays & Wednesday 11am-Noon or by appointment
459 Engineering 2

TA: Ren Wang

Email: rxwang@ucsc.edu

Office Hours: 9:00 am -11: am
403G Engineering 2

Sections:

TUE. 6:00-7:10PM, 372 J. Baskin Engr.

TUE. 7:30-8:40PM, 372 J. Baskin Engr.

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Course Website

Assignments and announcements will be posted on class website:

<http://people.ucsc.edu/~vsushko/econ133.php>

Course Materials

- ***Essentials of Investments (8th Edition)*** by Zvi Bodie, Alex Kane, Alan Marcus. Two books (8th and 7th edition) have been reserved in Science & Engineering Library. For the homework, please use the 8th edition
- ***The Myth of The Rational Market*** by Justin Fox; Publisher: HarperBusiness, First Edition - First Printing edition (June 9, 2009)
- ***The Wall Street Journal***; Publisher Dow Jones & Co., Inc.
75% student discount for a 10-week subscription available in class and online at: <http://student.wsj.com>
- Three **articles** on the class website.

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- **Grading**

- Your grade will be based on homework, class participation (pop quizzes), two midterms, and a final examination. Weekly homework assignments will be posted on class website each Friday of the week prior. The relative weights are: final (40%), 2 midterms (20% each), 6 homework assignments (15%), and 6 pop quizzes (5%). We will drop the lowest homework and the lowest pop quiz score; **late homework will NOT be accepted, NO makeup quizzes will be given.**
- The final exam for this class is scheduled for **Wednesday, December 8, 2010 at 8:00AM**. If you know you cannot take the final at this pre-determined time, **DO NOT TAKE THIS CLASS**. If you take this class, do not make travel plans that conflict with the date and time of the final. **No makeup final exams will be given.**

Chapter 1

Investments: Background and Issues

Real Versus Financial Assets

- **Essential nature of investment**
 - **Reduce current consumption in hopes of greater future consumption**
- **Real Assets**
 - **Used to produce goods and services: Property, plant & equipment, human capital, etc.**
- **Financial Assets**
 - **Claims on real assets or claims on asset income**

Real versus Financial Assets

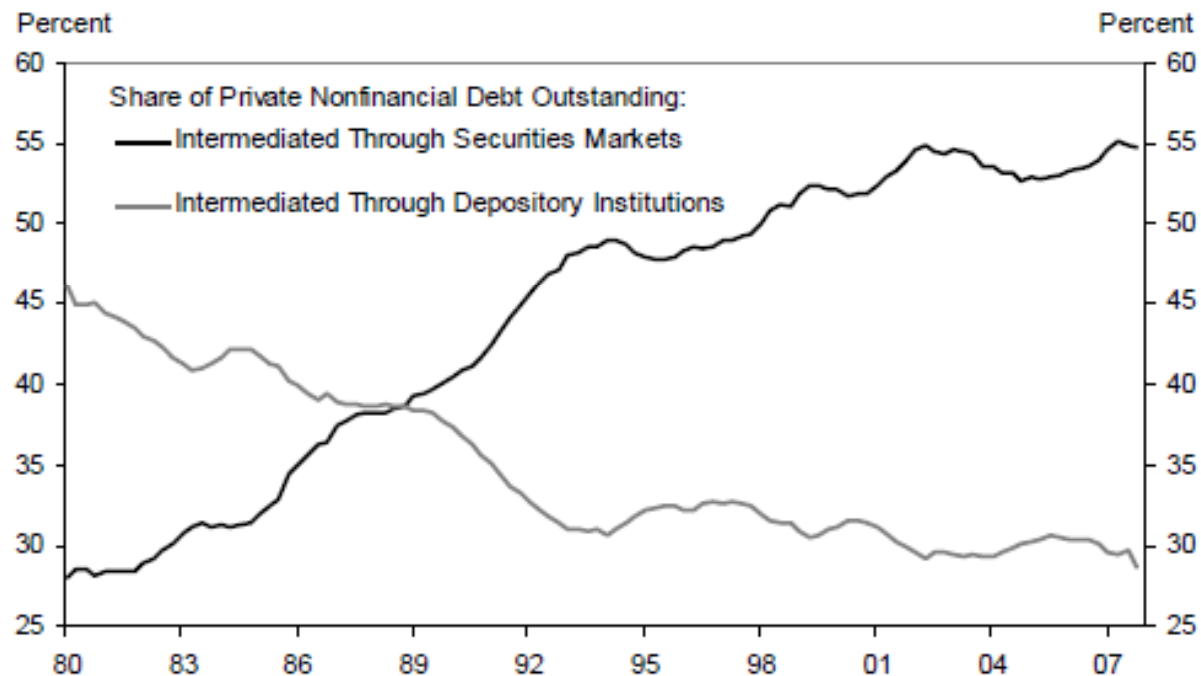
- All financial assets (owner of the claim) are offset by a financial liability (issuer of the claim).
- When we aggregate over all balance sheets, only real assets remain.
- Hence the net wealth of an economy is the sum of its real assets.
- Then why need financial markets?

Roles of Financial Markets

- **Informational Role**
 - **Market prices reflect the estimate of a security's expected future risky cash flows**
- **Allocation of Capital to Productive Activities**
 - **Companies can borrow from banks or issue stocks and bonds**
- **Allocation of Risk**
 - **Bonds versus stock of a given company**
 - **Bank CD versus company bond**
 - **Tradeoff between risk and return**
- **Consumption Smoothing**
 - **Save when income is high, consume when low**

Intermediation through Bank vs. Securities Markets

Exhibit 2.6 Share of Intermediation through Banks and Securities Markets



Source: Morgan Stanley calculations based on Federal Reserve Flow of Funds Accounts.

The Players

- **Business Firms – net borrowers**
- **Households – net savers**
- **Governments – can be both borrowers and savers**
- **Financial Intermediaries “Connectors of borrowers and lenders”**

Commercial Banks

- **Traditional line of business: Make loans funded by deposits**

Investment companies

Insurance companies

Pension funds

Hedge funds

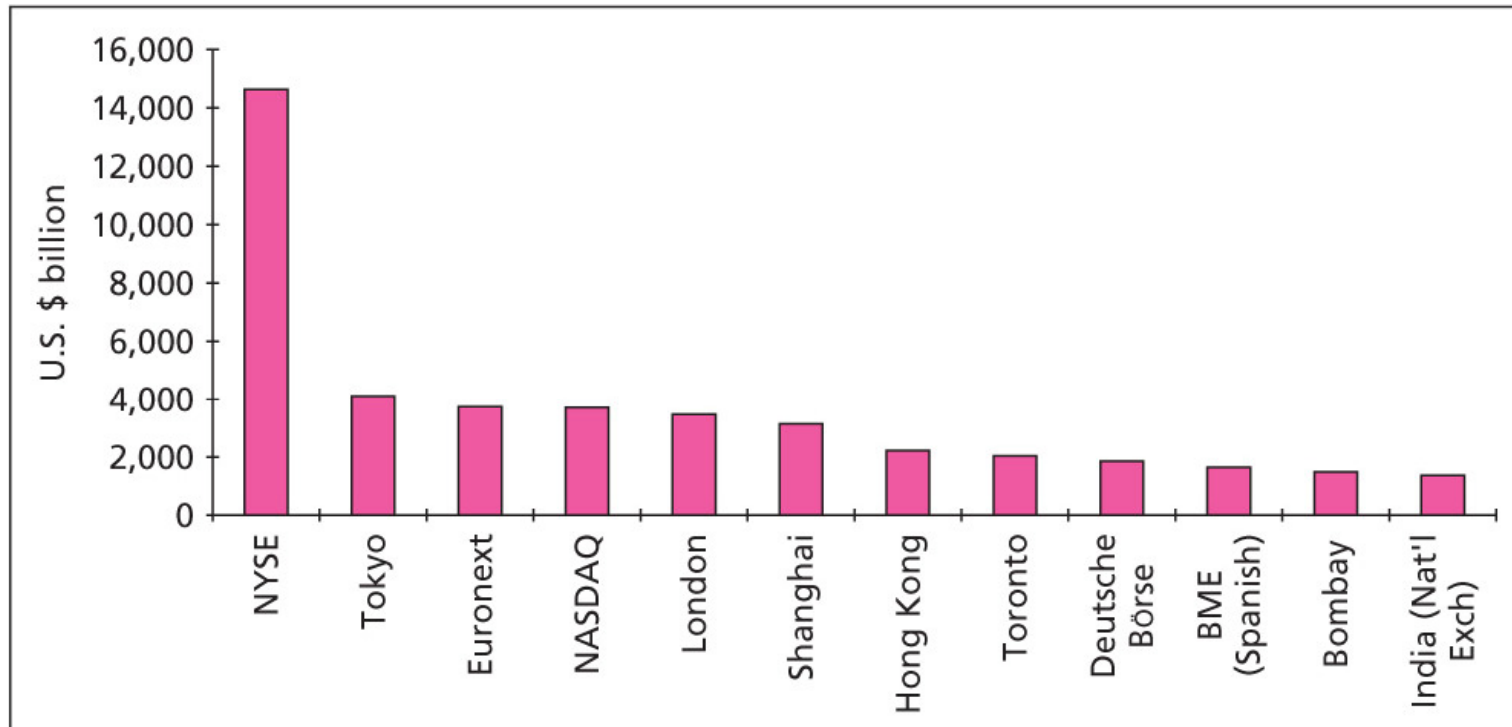
The Players Cont.

- **Investment Bankers**
 - **Firms that specialize in primary market transactions**
 - **Primary market:**
 - A market where newly issued securities are offered to the public.
 - The investment banker typically 'underwrites' the issue.
 - **Secondary market**
 - A market where pre-existing securities are traded among investors.

- **Investment Bankers**

- **Some investment banks chose to become commercial banks to obtain deposit funding and government assistance**
- **All of the major investment banks are now under the much stricter commercial bank regulations.**
 - **What are the implications for innovation and capital issuance resulting from these changes?**

Secondary Markets: Market Cap. of Major World Stock Exchanges, 2007



Secondary Markets

Stock Exchanges:

- **NYSE – 2,800 firms, \$15 trillion (\$87 billion daily)**
 - Auction market, centralized exchange
 - Trade with specialists
- **NASDAQ – 3,200 firms, \$4 trillion**
 - Dealer market, decentralized
 - ECN (for approx 50% of trading)

Derivatives:

- **CME – Stock, Commodity, and Currency Options/Futures**

Complex Derivatives and Bond Markets:

- **OTC, dealer markets; thin compared to stocks, subject to liquidity risk**

Major Classes of Financial Assets or Securities

- **Debt**
 - **Money market instruments**
 - **Bank certificates of deposit, T-bills, commercial paper, etc.**
 - **Bonds**
 - **Preferred stock**
- **Common stock**
 - **Ownership stake in the entity, residual cash flow**
- **Derivative securities**
 - **A contract whose value is derived from some underlying market condition.**

The Investment Process

- **Asset allocation**

Choosing the percentage of funds in asset classes

Stocks	60%
Bonds	30%
Alternative Assets	6%
Money market securities	4%

- **Security selection & analysis**

Choosing specific securities w/in an asset class

- **The asset allocation decision is the primary determinant of a portfolio's return**

Risk-Return Trade- Off

- o Assets with higher expected returns have higher risk.

	Average Annual Return	Minimum (1931)	Maximum (1933)
Stocks	About 12%	-46%	55%

A stock portfolio can be expected to lose money about 1 out of every 4 years.

- o Bonds have a much lower average rate of return (under 6%) and have not lost more than 13% of their value in any one year.

Risk-Return Trade- Off

