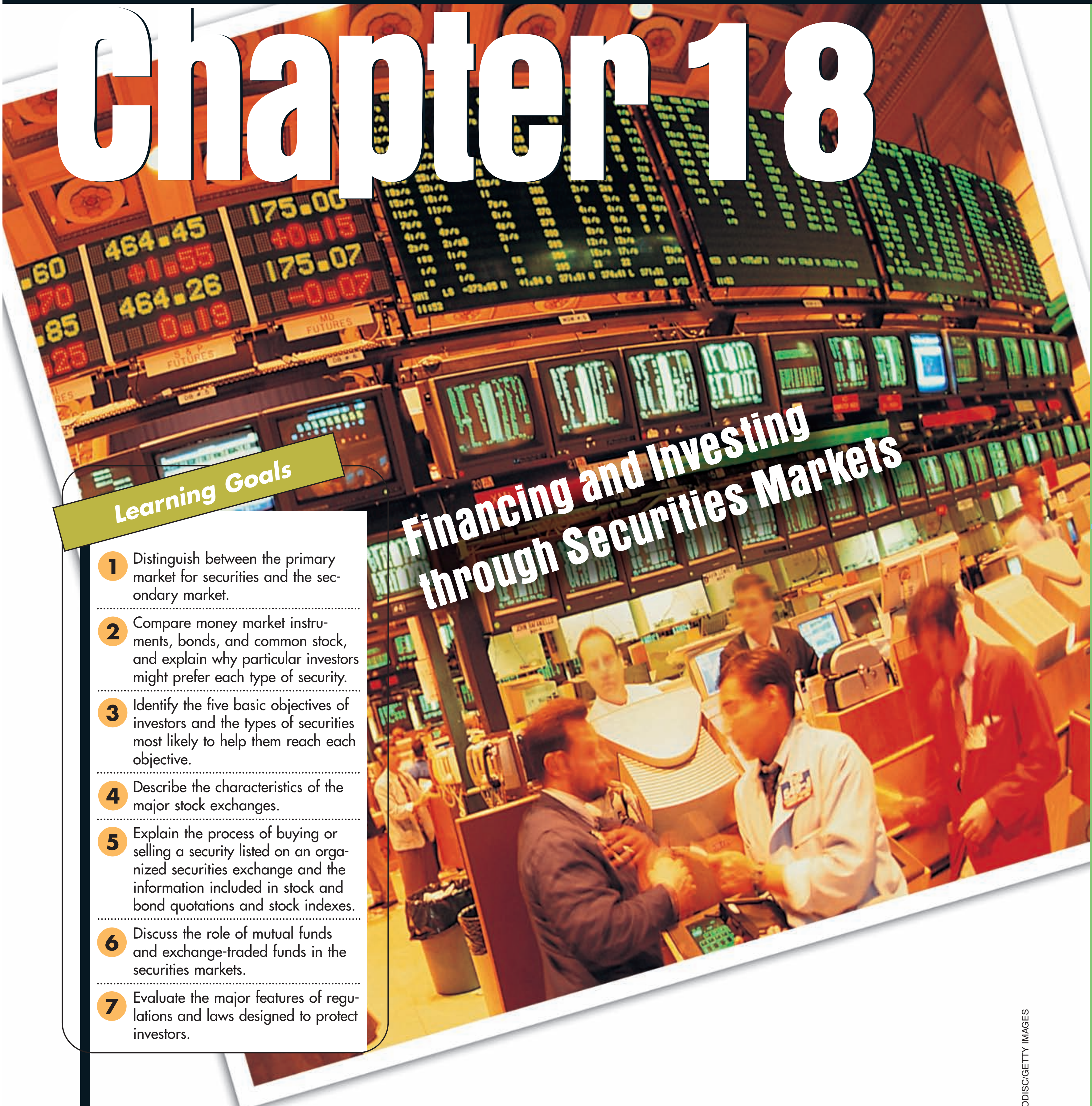
# Chapter 18

## Financing and Investing through Securities Markets



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### Learning Goals

1. Distinguish between the primary market for securities and the secondary market.
2. Compare money market instruments, bonds, and common stock, and explain why particular investors might prefer each type of security.
3. Identify the five basic objectives of investors and the types of securities most likely to help them reach each objective.
4. Describe the characteristics of the major stock exchanges.
5. Explain the process of buying or selling a security listed on an organized securities exchange and the information included in stock and bond quotations and stock indexes.
6. Discuss the role of mutual funds and exchange-traded funds in the securities markets.
7. Evaluate the major features of regulations and laws designed to protect investors.

Every day, companies do exactly what you do as an individual: figure out how much money is needed to cover expenses and still have some left over to invest for the future. Like you, they must determine where and how to obtain any financing to survive and thrive. While you are looking for a job, companies are searching for ways to keep their enterprises operating. One way of finding funds is to take a firm public by selling shares of stock to investors. But recently a number of public corporations have been reversing this trend: they have reverted to private status. Going private has several advantages: the firm no longer has to worry about dips in its stock prices, it no longer has to answer to shareholders or pay out dividends, and it is not required to report financial results.


AP PHOTO/RIC FELD

# Cable Companies Leave Public Life

Two cable television companies—Cablevision and Cox Communications—have decided to privatize. By doing so, they can avoid the intense scrutiny of investors and the public eye and exert more internal control. With money borrowed from such sources as Merrill Lynch and Bank of America, Cablevision plans to buy back its stock from shareholders and then spin off two divisions into one smaller public company—Rainbow Media cable and Madison Square Garden. Cox Communications accomplished its move to private status when its controlling shareholder, Cox Enterprises, paid $8.5 billion for the 38 percent of Cox Communications that it didn't already own—effectively taking it off the stock market. Cox Communications is the third-largest cable television provider in the United States, with 6.3 million basic cable subscribers. The firm also offers digital cable, digital telephone, and high-speed Internet services and is now focused on encouraging subscribers to purchase bundled services. Going private cuts the cost of public financial reporting requirements and takes the firm out of the Wall Street spotlight, where investors often focus on short-term performance.

Rumors continue to circulate that cable companies—and Cablevision in particular—are ripe for acquisition. Some industry experts believe that Cablevision, run by the Dolan family, is open to offers. Cablevision, a smaller company than its larger rivals Comcast and Time Warner, is located in the suburbs of New York. But despite its size, the firm has shown an uncanny ability to dominate its market. It also maintains a steady and substantial flow of cash. With its high profile and solid financial standing, Cablevision could be attractive to buyers. But others believe that taking the firm private makes a potential sale more complicated. "Once private, the lack of a public market trading value for [Cablevision] would appear to make an acquisition more complicated," explains one industry analyst, "with the buyer having far less information." It would probably be more expensive, as well. Either way, cable companies are rewriting the script for their industry, and viewers will need to tune in to see what ultimately happens.[1]

## ChapterOverview

The previous chapter discussed two sources of funds for long-term financial needs: debt capital and equity capital. Long-term debt capital takes the form of U.S. government bonds, municipal bonds, and corporate bonds. Equity capital takes the form of common and preferred stock—ownership shares in corporations. Stocks and bonds are commonly called **securities,** because both represent obligations on the part of issuers to provide purchasers with expected or stated returns on the funds invested or loaned.

This chapter examines how securities are bought and sold in two financial markets—the primary market and the secondary market. The primary market involves the initial sale of new securities to investors, and the secondary market consists of the sale of existing securities between investors. As we discussed in Chapter 17, financial markets are an important part of the overall financial system, the system by which funds are transferred from savers to users. Next, we explore the characteristics of stocks, bonds, and money market instruments (short-term debt securities) and the way investors choose specific securities. We then examine the role of organized securities exchanges, such as the New York Stock Exchange, in the financial sector and outline the information included in reports of securities transactions. This section is followed by a discussion of mutual funds—an especially popular option for individual investors. Finally, we review the laws that regulate the securities markets and protect investors.

**securities** financial instruments such as stocks and bonds.

**primary market** market in which new security issues are first sold to investors; issuers receive the proceeds from the sale.

## PRIMARY VERSUS SECONDARY MARKETS

In the **primary market**, firms and governments issue securities and sell them initially to the public. When a company needs capital to purchase inventory, expand a plant, make major investments, acquire another firm, or pursue other business goals, it may sell a bond or stock issue to the investing public. For example, Wal-Mart Stores recently sold about $800 million in bonds. It used the proceeds to build new stores.[2] Similarly, when Washington State needs capital to build a new highway, to buy a new ferry, or to fulfill other public needs, its leaders may also decide to sell bonds.

A stock offering gives investors the opportunity to purchase ownership shares in a firm such as well-known drug maker Amgen and to participate in its future growth, in exchange for providing current capital. When a company offers stock for sale to the general public for the first time, it is called an **initial public offering (IPO)**. During a recent twelve-month period, around 180 initial public offerings raised a total of more than $30 billion. These companies, on average, had been in existence for seven years prior to going public.[3]

Both profit-seeking corporations and government agencies also rely on primary markets to raise funds by issuing bonds. For example, the federal government sells Treasury bonds to finance part of federal outlays such as interest on outstanding federal debt. State and local governments sell bonds to finance capital projects such as the construction of sewer systems, streets, and fire stations.

Announcements of new stock and bond offerings appear daily in business publications such as the *Wall Street Journal.* These announcements are often in the form of a simple black-and-white ad called a *tombstone.*

Securities are sold to the investment public in two ways: in open auctions and through investment bankers. Virtually all securities sold through open auctions consist of U.S. Treasury securities. A week before an upcoming auction, the Treasury announces the type and number of securities it will be auctioning. Treasury bills are auctioned weekly, whereas longer-term Treasury securities are auctioned once a month or once a quarter. Prospective buyers submit bids to the Treasury. Two types of bids are allowed: competitive and noncompetitive. A competitive bid specifies how much the investor wishes to purchase and the price. The higher the price specified, the lower the return to the investor, and the lower the cost to the

Treasury. In a typical auction the Treasury accepts about half of the competitive bids submitted. An investor submitting a noncompetitive bid only specifies the amount he or she wishes to purchase (up to a limit of $5 million) and agrees to pay a price equal to the average price on accepted competitive bids. Investors may submit bids directly to the Treasury or through banks and investment firms.

Sales of most corporate and municipal securities are made via financial specialists called **investment bankers.** Merrill Lynch, Goldman Sachs, Lehman Brothers, and Crédit Suisse First Boston (CSFB) are examples of well-known investment banking firms. An investment banker is a financial intermediary that purchases the issue from the firm or government and then resells the issue to investors. This process is known as **underwriting.**

Investment bankers underwrite stock and bond issues at a discount, meaning that they pay the issuing firm or government less than the price the investment banker charges investors. This discount is compensation for services rendered, including the risk investment bankers incur whenever they underwrite a new security issue. Although the size of the discount is often negotiable, they usually average around 5 percent for all types of securities. The size of the underwriting discount, however, is generally higher for stock issues than it is for bond issues. For instance, the average underwriting discount for IPOs is close to 7 percent.[4]


AP PHOTO/MARK LENNIHAN

Lehman Brothers is one of the world's largest investment banking firms.

Corporations and governments are willing to pay for the services provided by investment bankers because they are financial market experts. In addition to locating buyers for the issue, the underwriter typically advises the issuer on such details as the general characteristics of the issue, its pricing, and the timing of the offering. Several investment bankers commonly participate in the underwriting process. The issuer selects a lead, or primary, investment banker, which in turn forms a syndicate consisting of other investment banking firms. Each member of the syndicate purchases a portion of the security issue, which it resells to investors.

**secondary market** market in which existing security issues are bought and sold by investors.

Media reports of stock and bond trading are most likely to refer to trading in the **secondary market,** a collection of financial markets in which previously issued securities are traded among investors. The corporations or governments that originally issued the securities being traded are not directly involved in the secondary market. They neither make any payments when securities are sold nor receive any of the proceeds when securities are purchased. The New York Stock Exchange (NYSE) and the Nasdaq stock market are both secondary markets. In terms of the dollar value of securities bought and sold, the secondary market is four to five times as large as the primary market. During a typical trading day, more than $50 billion worth of stock changes hands on the NYSE alone.[5] We describe secondary markets in more depth later in the chapter.

**assessment check**

1. Distinguish between the primary and secondary markets for securities. Is the primary market or secondary market larger?
2. Explain the two ways in which securities are sold in the primary market.

## TYPES OF SECURITIES

Securities can be classified into three categories: money market instruments, bonds, and stock. Money market instruments and bonds are both debt securities, and stocks are units of ownership in corporations like General Electric, Best Buy, 3M, and PepsiCo.

**money market instruments** short-term debt securities issued by corporations, financial institutions, and governments.

"They Said It"

"Look at market fluctuations as your friend rather than your enemy; profit from folly rather than participate in it."
—Warren Buffett (b. 1930)
Investor and philanthropist

"They Said It"

"Don't gamble! Take all your savings and buy some good stock and hold it till it goes up. If it don't go up, don't buy it."
—Will Rogers (1879–1935)
Humorist

## Money Market Instruments

**Money market instruments** are short-term debt securities issued by governments, financial institutions, and corporations. By definition, all money market instruments mature within one year from the date of issue. Investors are paid interest by the issuer for the use of their funds. Money market instruments are generally low-risk securities and are purchased by investors when they have surplus cash. As noted in the prior chapter, financial managers often invest surplus cash in money market instruments because they are low risk and are easily convertible into cash. For example, Microsoft has more than $15 billion currently invested in money market instruments.[6] Examples of money market instruments include U.S. Treasury bills, commercial paper, and bank certificates of deposit. These securities were described in the prior chapter.

## Bonds

Bondholders are creditors of a corporation. By selling bonds, a firm obtains long-term debt capital. Federal, state, and local governments also acquire funds in this way. Bonds are issued in various denominations (face values), usually between $1,000 and $25,000. Each issue indicates a rate of interest to be paid to the bondholder—stated as a percentage of the bond's face value—as well as a maturity date on which the bondholder is paid the bond's face value. Because bondholders are creditors, they have a claim on the firm's assets that must be satisfied before any claims of stockholders in the event of the firm's bankruptcy, reorganization, or liquidation. For example, when California and Bermuda–based Global Crossing emerged from bankruptcy, existing creditors received about 35 percent of the shares of the newly reorganized company to satisfy their claims. Those who owned shares of Global Crossing at the time of its bankruptcy filing, by contrast, received nothing, losing about $50 billion.[7]

***Types of Bonds*** A prospective bond investor can choose among a variety of bonds. Major types of bonds are summarized in Table 18.1.

**Government bonds** are bonds sold by the U.S. Treasury. Because government bonds are backed by the full faith and credit of the U.S. government, they are considered the least risky of all bonds. The Treasury sells bonds that mature in 2, 3, 5, 7, 10, and 30 years from the date of issue. The Treasury stopped selling new 30-year bonds in 2001 but recently reintroduced sales of the so-called *long bond.* The "Hit & Miss" feature on page 580 discusses some of the reasons why the sale of 30-year bonds was resumed.

**Municipal bonds** are bonds issued by state or local governments. There are two types of municipal bonds. A revenue bond is a bond issue whose proceeds are to be used to pay for a project that will produce revenue—such as a toll road or bridge. The Oklahoma Turnpike Authority has issued such bonds. A general obligation bond is a bond whose proceeds are to be used to pay for a project that will not produce any revenue—such as a new Indiana state police post. General obligation bonds can be sold only by states such as Oregon or local governmental units such as Toledo, Ohio, or Bergen County, New Jersey, that have the power to levy taxes. An important feature of municipal bonds is the exemption of interest payments from federal income tax. Because of this attractive feature, municipal bonds generally carry lower interest rates than either corporate or government bonds.

Corporate bonds are a diverse group and often vary based on the collateral backing the bond. A **secured bond** is backed by a specific pledge of company assets. For example, mortgage bonds are backed by real and personal property owned by the firm, such as machinery or furniture, and collateral trust bonds are backed by stocks and bonds of other companies owned by the firm. In the event of default, bondholders may receive the proceeds from selling these

Table 18.1

Types of Bonds

| Issuer | Types of Securities | Risk | Special Features |
|---|---|---|---|
| U.S. Treasury (government bonds) | Notes: Mature in 10 years or fewer from date of issue. | Treasury bonds and notes have virtually no risk. | Interest is exempt from state income taxes. |
| | Bonds: Mature in 30 years from date of issue | | |
| State and local governments (municipal bonds) | General obligation: Issued by state or local governmental units with taxing authority; backed by the full faith and credit of the state where issued. | Risk varies depending on the financial health of the issuer. | Interest is exempt from federal income taxes and may be exempt from state income taxes. |
| | Revenue: Issued to pay for projects that generate revenue—such as water systems or toll roads; revenue from project used to pay principal and interest. | Most large municipal bond issues are rated in terms of credit risk (AAA or Aaa is the highest rating). | |
| Corporations | Secured bonds: Bonds are backed by specific assets. | Risk varies depending on the financial health of the issuer. | A few corporate bonds are convertible into shares of common stock of the issuing company. |
| | Unsecured bonds (debentures): Backed by the financial health and reputation of the issuer. | Most corporate bond issues are rated in terms of credit risk (AAA or Aaa is the highest rating). | |
| Financial institutions (such as Fannie Mae and Freddie Mac) | Mortgage pass-through securities | Generally very low risk. | They pay monthly income consisting of both interest and principal. |

assets. Because bond purchasers want to balance their financial returns with their risks, bonds backed by pledges of specific assets are less risky than those without such collateral. Consequently, a firm can issue secured bonds at lower interest rates than it would have to pay for comparable unsecured bonds. However, many firms do issue unsecured bonds, called **debentures.** These bonds are backed only by the financial reputation of the issuing corporation.

Another popular type of bond is the **mortgage pass-through security.** Mortgage pass-through securities are sold by Fannie Mae, Freddie Mac, and other financial institutions. The securities are backed by a self-liquidating pool of mortgage loans purchased from lenders such as savings banks. As borrowers make their monthly mortgage payments, these payments are "passed through" to the holders of the pass-through securities. Mortgage pass-through securities are popular because they are relatively safe (mortgages have to be insured) and provide monthly income.

***Quality Ratings for Bonds*** Two factors determine the price of a bond: its risk and its interest rate. Bonds vary considerably in terms of risk. One tool used by bond investors to assess the risk of a bond is its so-called **bond rating.** Two investment firms—Standard & Poor's (S&P) and Moody's—rate most corporate and municipal bonds. The bonds with the least risk are assigned a rating of either AAA (S&P) or Aaa (Moody's). The ratings descend as

# HIT & MISS

## An Old Investment Makes a Comeback

Treasury bonds aren't glamorous, especially ones with long-range maturity dates. In fact, the U.S. Treasury put a hold on the sale of 30-year bonds for several years because the federal government had a budget surplus and didn't need to borrow the money. But the Treasury recently announced their return to the marketplace. Who's not yawning about the announcement? In the investment industry, it's the fixed-income specialists who are cheering the comeback. "It's like having an old friend back," explains Clifford A. Gladson, a senior vice president for fixed-income investments at USAA Investment Management.

Thirty-year bonds carry with them a reputation for long-term security in the form of guaranteed rates for mutual funds and pension funds, which tend to make long-range investments. But most individuals don't hang onto the same investments for three decades—they can usually do better with shorter-term, slightly riskier investments. And as interest rates in general climb, the value of a long-term bond may diminish even though it pays a higher fixed interest rate than short-term bonds. Still, the 30-year bond has been a benchmark for many investment professionals. "There's a love affair out there for some people," quips one manager of fixed-income portfolios for Vanguard. The 30-year bond provides a guaranteed rate of return and is free of state income taxes, two features that attract investors. It also gives them one more option they did not have for several years.

Anyone interested in making an investment should do the homework before purchasing. Individuals must consider their own needs and goals. An 80-year-old retiree is unlikely to buy a 30-year bond, but a 45-year-old might want this type of investment as part of his or her retirement portfolio. "I think it's good for [investment] portfolios," notes a financial economist at Wachovia Securities. "It adds to the diversification component." So you make the purchase and then hit the snooze button—several times.

### Questions for Critical Thinking

1. Would you purchase a 30-year Treasury bond during your career? If so, when and why? If not, why not?
2. If you plan to participate in a firm's pension plan or other investments made on your behalf by your employer, what steps might you take to learn about the types of investments being made?

**Sources:** Avrum D. Lank, "30-Year Treasury Bonds May Come Up Short for Individual Investors," *Milwaukee Journal Sentinel,* accessed August 16, 2006, http://www.jsonline.com; Elizabeth Harris, "The 30-Year Bond Is Back, and So Is Romance," *New York Times,* accessed July 28, 2006, http://www.nytimes.com; Kathleen Lynn, "Investors, Take Note: The 30-Year Treasury Bond Is Back," *The Record,* accessed August 4, 2005, http://www.recordnet.com; Mike Meyers, "30-Year's Revival May Help Taxpayer," *(Minneapolis) Star Tribune,* accessed August 4, 2005, http://startribune.com.

risk increases. Table 18.2 lists the S&P and Moody's bond ratings. Bonds with ratings of BBB (or Baa) and above are classified as **investment-grade bonds.** Examples of investment-grade bonds include Royal Dutch Shell (rated AA by Standard and Poor's) and the Illinois State Building Authority (rated AAA by Standard & Poor's). By contrast, bonds with ratings of BB (or Ba) and below are classified as speculative, or so-called **junk bonds.** Junk bonds attract investors by offering high interest rates in exchange for greater risk. Today, junk bonds pay about 50 percent more in interest than do investment-grade corporate bonds. An example of speculative-grade bonds is those issued by Ford Motor Company (rated BB by Standard and Poor's).

The second factor affecting the price of a bond is its interest rate. Other things being equal, the higher the interest rate, the higher the price of a bond. However, everything else usually is not equal; the bonds may not be equally risky, or one may have a longer maturity. Investors must evaluate the trade-offs involved.

Another important influence on bond prices is the market interest rate. Because bonds pay fixed rates of interest, as market interest rates rise, bond prices fall, and vice versa. For instance, the price of a ten-year bond, paying 5 percent per year, would fall by about 8 percent if market interest rates rose from 5 percent to 6 percent.

Table 18.2

Bond Ratings

| | Standard & Poor's Rating | Moody's Rating | |
|---|---|---|---|
| Highest to lowest | AAA | Aaa | Investment-grade bonds |
| | AA | Aa | |
| | A | A | |
| | BBB | Baa | |
| | BB | Ba | Speculative-grade bonds (junk bonds) |
| | B | B | |
| | CCC | Caa | |
| | CC | Ca | |
| | C | C | |

Note: Any bond with a rating below is C is currently in default, meaning it is not paying interest or repaying principal.

***Retiring Bonds*** Because bonds in an issue mature on a specific date, borrowers such as Bed Bath & Beyond or Harris County, Texas, must have the necessary funds available to repay the principal at that time. In some instances, this can create a cash flow problem. To ease the repayment problem, some borrowers issue serial bonds. A serial bond issue consists of bonds that mature on different dates. For example, assume a corporation issues $20 million in serial bonds for a 30-year period. None of the bonds mature during the first 20 years. However, beginning in the 21st year, $2 million in bonds mature each year until all the bonds are repaid at the end of the 30 years.

A variation of the concept of serial bonds is the sinking fund bond, or prerefunded bond. Under this arrangement, the issuer, such as the city of Oakland, California, makes annual deposits to accumulate funds for use in redeeming the bonds when they mature. These deposits are made to the bond's trustee—usually a large bank—who represents bondholders. The deposits must be large enough that their total, plus accrued interest, will be sufficient to redeem the bonds at maturity.

Most corporate and municipal bonds, and some government bonds, are callable. A **call provision** allows the issuer to redeem the bond before its maturity at a prespecified price. Not surprisingly, issuers tend to call bonds when market interest rates are declining. For example, if York County, Pennsylvania, had $50 million in bonds outstanding with a 6 percent annual interest rate, it would pay $3 million annually in interest. If interest rates decline to 4 percent, the county may decide to call the 6 percent bonds, repaying the principal from the proceeds of newly issued 4 percent bonds. Calling the 6 percent bonds, and issuing 4 percent bonds, will save the county $1 million a year in interest payments. The savings in annual interest expense should more than offset the cost of retiring the old bonds and issuing new ones.

## Stock

The basic form of corporate ownership is embodied in **common stock.** Purchasers of common stock are the true owners of a corporation. Holders of common stock vote on major company decisions, such as purchasing another company or electing a board of directors. In return for

**common stock** shares of ownership in a corporation.

the money they invest, they expect to receive some sort of return. This return can come in the form of cash dividend payments and/or expected price appreciation. Dividends vary widely from stock to stock. DuPont, for instance, pays an annual dividend of almost $1.50 per share. By contrast, Starbucks pays no annual dividend to its shareholders. As a general rule, faster-growing companies pay less in dividends because they need more funds to finance their growth. Consequently, investors expect stocks paying little or no cash dividends to show greater price appreciation compared with stocks paying more generous cash dividends.

Common stockholders benefit from company success, and they risk the loss of their investments if the company fails. If a firm dissolves, claims of creditors must be satisfied before stockholders receive anything. Because creditors have a senior claim to assets, holders of common stock are said to have a residual claim on company assets.

Sometimes confusion arises over the difference between the book value and a stock's market value. *Book value* is determined by subtracting the company's liabilities from its assets. When this net figure is divided by the number of shares of common stock outstanding, the book value of each share is known. Recently, Johnson & Johnson had a book value of around $12 per share.

The *market value* of a stock is the price at which the stock is currently selling. Johnson & Johnson had a recent market price of $68 per share. It is easily found by referring to the financial section of daily newspapers or on the Internet and may be more or less than the book value. What determines market value, however, is more complicated. However, while many variables cause stock prices to fluctuate up and down in the short term, in the long run stock prices tend to follow a company's profits. For instance, over the last ten years, both Johnson & Johnson's earnings and stock price have risen by more than 300 percent.

**"They Said It"**

*"October. This is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August, and February."*
*—Mark Twain (1835–1910) Author*

**preferred stock** stock whose holders have priority over common stockholders in the payment of dividends but usually have no voting rights.

***Preferred Stock*** In addition to common stock, a few companies also issue **preferred stock**—stock whose holders receive preference in the payment of dividends. General Motors and Bank of America are examples of firms with preferred stock outstanding. Also, if a company is dissolved, holders of preferred stock have claims on the firm's assets that are ahead of the claims of common stockholders. On the other hand, preferred stockholders rarely have any voting rights, and the dividend they are paid is fixed, regardless of how profitable the firm becomes. Therefore, although preferred stock is legally equity, many investors consider it to be more like a bond than common stock.

***Convertible Securities*** Companies may issue bonds or preferred stock that contains a conversion feature. This feature gives the bondholder or preferred stockholder the right to exchange the bond or preferred stock for a fixed number of shares of common stock. For example, credit card issuer Providian Financial has a convertible bond outstanding that allows its holder to exchange the bond (which has a face value of $1,000) for around 77 shares of Providian common stock. So if Providian's stock was selling for $20 per share, the convertible bond would be worth at least $1,540 (77 × $20). Convertible bonds pay lower interest rates than those lacking conversion features, helping reduce the interest expense of the issuing firms. Investors are willing to accept these lower interest rates because they value the potential for additional gains if the price of the firm's stock increases.

**assessment check**

1. Explain the difference between a money market instrument and a bond.
2. What are the two types of bonds issued by state and local governments? Describe the difference between a secured and unsecured bond.
3. Discuss the major investment characteristics of common stock.

## SECURITIES PURCHASERS

Two general types of investors buy securities: institutions and individuals. An **institutional investor** is an organization that invests its own funds or those it holds in trust for others. Institutional investors include insurance companies such as New York Life, pension funds such as Alabama's state employee pension fund, T. Rowe Price mutual funds, and not-for-profit organizations such as the American Cancer Society. Many institutional investors are huge. As noted in Chapter 17, pension funds have more than $6.5 trillion in assets, and the total assets of life insurance companies exceed $4.2 trillion.[8] Institutional investors buy and sell large quantities of securities, often in blocks of 10,000 or more shares per transaction. Such block trading represents about half of the total daily volume on the major securities exchanges.[9]

The number of individual investors who own shares through mutual funds or their employer's retirement plans is steadily rising, and the firms that manage their funds control more than half of all U.S. equities.[10] More than half of all Americans now own stocks, either directly or by investing in stock mutual funds. By contrast, 30 years ago, less than one-third of American households owned any stocks at all.[11]

## Investment Motivations

Why do individuals and institutions invest? In general, individuals and institutions have five primary motivations for investing: growth in capital, stability of principal, liquidity, current income, and income growth. All investors must rank each motivation in terms of importance, and all investments involve trade-offs. For example, an investment that has the potential for substantial growth in capital may provide no current income. By contrast, an investment that has very stable principal may have little potential for capital growth. The bottom line is this: Some investments are more appropriate for certain investors than for others. Table 18.3 provides a useful guide for evaluating money market instruments, bonds, and stocks.

**"They Said It"**

**"Successful investing is anticipating the anticipations of others."**
*—John Maynard Keynes (1883–1946) Economist*

***Growth in Capital*** When it comes to potential growth in capital over time, especially over long periods of time, common stocks are the clear winner. For example, over a recent 20-year period, $10,000 invested in common stocks would have grown to more than $64,000. A similar investment in bonds made during the same period would have grown to less than $35,000. This example does not imply, however, that the prices of all common stocks go up all the time, nor do they go up by the same amount. Not surprisingly, stock performance varies considerably. For instance, over the past decade $10,000 invested in Procter & Gamble's common stock would have grown to more than $37,000. By contrast, over the same period, a $10,000 investment in Ford's common stock would have grown to less than $13,500.

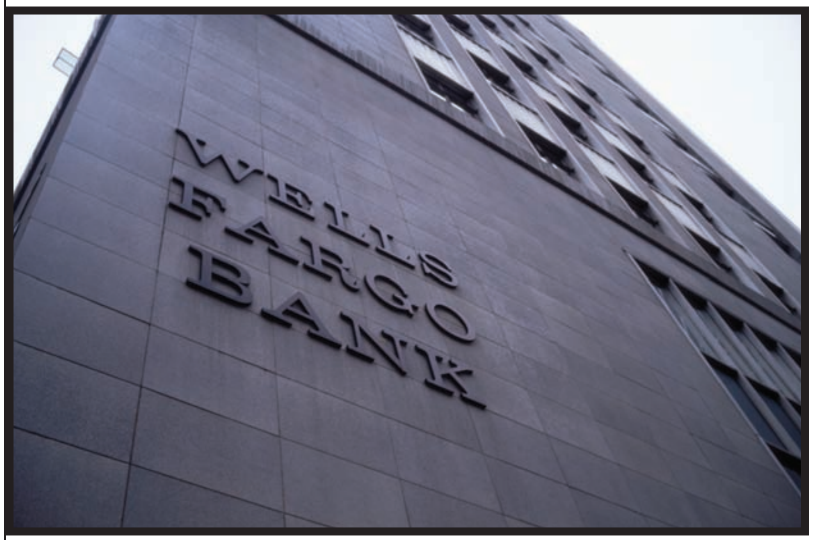
***Stability of Principal*** Treasury bills and other money market instruments are the clear winner when it comes to stability of principal. The odds that the price of a money market

**Table 18.3**

Comparing Investment Alternatives

| Investment Motivation | Money Market Instruments | Bonds | Common Stocks |
|---|---|---|---|
| Growth in capital | * | ** | *** |
| Stability of principal | *** | ** | * |
| Liquidity | *** | ** | * |
| Current income | * | *** | ** |
| Growth in income | ** | * | *** |

Note: *** = best or highest.

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A key to successful investing is finding a strategy that has an appropriate level of risk. Banks and investment firms such as Wells Fargo often provide investment advice.

investment will fall below the price the investor originally paid are virtually zero. Furthermore, when an investor buys a Treasury bill or other money market instrument, the investor can be pretty sure the original investment will be returned. For example, a 90-day Treasury bill has a face value of $10,000. If you buy the T-bill today, you're virtually ensured that you'll receive $10,000 in three months. With stocks, there is no such guarantee.

***Liquidity*** Because the prices of stocks, and to a lesser extent bonds, can vary widely, investors cannot count on making profits whenever they decide or need to sell. Liquidity is a measure of the speed at which assets can be converted into cash. Because money market instruments such as a CD issued by Wells Fargo have short maturities and stable prices, they offer investors the highest amount of liquidity.

***Current Income*** Historically, bonds have provided the highest current income of any security. Interest rates on bonds are usually higher than money market interest rates or the dividends paid on common stocks. For instance, Lowe's has an outstanding bond that pays about 5 percent interest per year. By contrast, the company's common stock has a current dividend yield (annual dividend divided by the stock price) of less than 1 percent. Also, money market interest rates vary, but the interest rate on a bond remains constant. Investors looking for high current income should invest a large portion of their funds in bonds.

***Income Growth*** When you buy a bond, the interest you receive is fixed for the life of the bond. Interest rates on money market instruments can increase over time, but they can decrease as well. On the other hand, common stock dividends have historically risen at a rate that exceeds the rate of inflation. Over the past 20 years, for instance, Johnson & Johnson's common stock dividend has risen at an average annual rate exceeding 10 percent. There is, however, no guarantee that a company's common stock dividend will *always* increase and can, in fact, decrease. For instance, over the past four years Kodak has cut its common stock dividend by more than 75 percent.[12]

**assessment check**

1. Who purchases securities?
2. What are the five motivations for investing? On which of the five motivations for investment do common stocks rank highest?
3. Discuss the tax implications of investing. Are all sources of investment returns taxed equally?

## Taxes and Investing

Interest received from government and corporate bonds is considered ordinary income and is taxed at the investor's marginal tax rate. (Interest received from municipal bonds is usually exempt from federal income taxes, although not always from state income taxes.) Dividends received from common and most preferred stocks is taxed at a lower rate than ordinary income. Furthermore, investors who sell securities at a profit owe so-called capital gains taxes on the difference between the selling price and the purchase price.

Taxes can influence investment decisions in a number of ways. Investors in high marginal tax brackets, for instance, are more likely to hold municipal bonds than investors in lower tax brackets. Because capital losses (selling a security for less than the purchase price) offset capital gains, an investor might decide to take a capital loss at the end of the year rather than waiting until the following year.

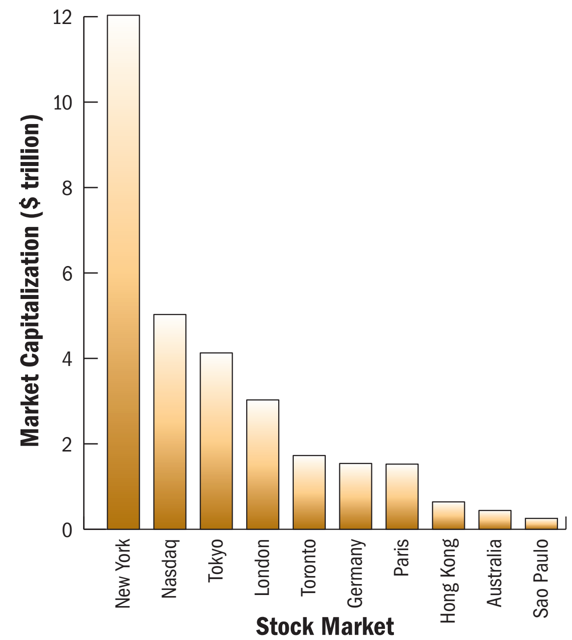
# SECURITIES EXCHANGES

Securities exchanges are centralized marketplaces where stocks and bonds are traded. Most of the largest and best-known securities exchanges are commonly called **stock exchanges,** or *stock markets,* because most securities traded are common-stock issues. Stock exchanges are secondary markets. The securities have already been issued by firms, which received proceeds from the issue when it was sold in the primary market. Sales in a securities exchange occur between individual and institutional investors.

Stock exchanges exist throughout the world and most countries today have at least one stock market. The five largest stock exchanges, based on the market value of the stocks traded, are shown in Figure 18.1. As the figure shows, the two largest stock exchanges are located in the United States.

Figure 18.1

The World's Ten Largest Stock Markets




**Source:** *NYSE Fact Book* (interactive edition), New York Stock Exchange, accessed August 22, 2005, http://www.nyse.com.

**stock exchange** financial market where stocks are traded.

## The New York Stock Exchange

The New York Stock Exchange—sometimes referred to as the Big Board—is arguably the most famous and one of the oldest stock markets in the world, having been founded in 1792. Today, more than 3,000 common- and preferred-stock issues are listed on the NYSE. These stocks represent most of the largest, best-known companies in the United States and have a total market value exceeding $13 trillion.[13] In terms of the total value of stock traded, the NYSE is the world's largest stock market.

For a company's stock to be traded on the NYSE, the firm must apply to the exchange for listing and meet certain listing requirements. In addition, the firm must continue to meet requirements each year to remain listed on the NYSE. Corporate bonds are also traded on the NYSE, but bond trading makes up less than 1 percent of the total value of securities traded there during a typical year.

Trading on the NYSE takes place face-to-face on a trading floor. Buy and sell orders are transmitted to a specific post on the floor of the exchange. Buyers and sellers then bid against one another in an open auction. Only investment firms that are members of the NYSE are allowed to trade, meaning that the firm owns at least one of 1,366 "seats." Seats are occasionally bought and sold. Recently a seat on the NYSE sold for $2.8 million.[14]

Each NYSE stock is assigned to a specialist firm. Specialists are unique investment firms that maintain an orderly and liquid market in the stocks assigned to them. Specialists must be willing to buy when there are no other buyers and sell when there are no other sellers. Specialists also act as auctioneers and catalysts, bringing buyers and sellers together.

Some observers portray the NYSE and its trading practices as somewhat old-fashioned, especially in this technological age. Most


MONIKA GRAFF/UPI/LANDOV

The New York Stock Exchange is one of the oldest stock exchanges in the world.

markets, they note, have abandoned their trading floors in favor of electronic trading. However, even though the NYSE still retains a trading floor, the exchange has become highly automated in recent years. Its computer systems automatically match and route most orders, which are typically filled within a few seconds.

**"They Said It"**

*"Wall Street people learn nothing and forget everything."*
*—Benjamin Graham (1894–1976) Investor, author, and educator*

## The Nasdaq Stock Market

The world's second-largest stock market is the Nasdaq Stock Market. It is very different from the NYSE. Nasdaq—which stands for National Association of Securities Dealers Automated Quotations—is actually a computerized communications network that links member investment firms. It is the world's largest intranet.[15] All trading on Nasdaq takes place through its intranet, rather than on a trading floor. Buy and sell orders are entered into the network and executed electronically. All Nasdaq-listed stocks have two or more market makers—investment firms that perform essentially the same functions as NYSE specialists.

Around 5,000 companies have their stocks listed on Nasdaq. Compared with firms listed on the NYSE, Nasdaq-listed corporations tend to be smaller, less well-known firms. Some are relatively new businesses and cannot meet NYSE listing requirements. It is not uncommon for firms eventually to transfer the trading of their stocks from Nasdaq to the NYSE—sixteen did so in a recent year.[16] However, dozens of major companies currently trade on Nasdaq—such as Amgen, Cisco Systems, Dell, Intel, and Microsoft—that would easily meet NYSE listing requirements. For a variety of reasons, these firms have decided to remain listed on Nasdaq.


ADAM ROUNTREE/BLOOMBERG NEWS/LANDOV

The Nasdaq Stock Exchange, the second-largest exchange in the world, conducts trading through a computerized network.

## Other U.S. Stock Markets

In addition to the NYSE and Nasdaq Stock Market, several other stock markets operate in the United States. The American Stock Exchange, or AMEX, is also located in New York. It focuses on the stocks of smaller firms, as well as other financial instruments such as options. In comparison with the NYSE and Nasdaq, the AMEX is tiny. Daily trading volume is only around 60 million shares compared with the one-billion-plus shares on each of the larger two exchanges.[17]

Several regional stock exchanges also operate throughout the United States. They include the Chicago, Pacific (San Francisco), Boston, Cincinnati, and Philadelphia Stock Exchanges. Originally established to trade the shares of small, regional companies, the regional exchanges now list securities of many large corporations as well. In fact, more than half of the companies listed on the NYSE are also listed on one or more regional exchanges.

## Foreign Stock Markets

As noted earlier, stock markets exist throughout the world. Virtually all developed countries and many developing countries have stock exchanges. Examples include Bombay, Helsinki, Hong Kong, Mexico City, Paris, and Toronto. One of the largest stock exchanges outside the United States is the London Stock Exchange. Founded in the early 17th century, the London Stock Exchange lists approximately 2,900 stock and bond issues, more than 500 of which are shares of companies located outside the U.K. and Ireland. Trading on the London Stock Exchange takes place using a Nasdaq-type computerized communications network.

The London Stock Exchange is very much an international market. Around two-thirds of all cross-border trading in the world—for example, the trading of stocks of American companies outside the United States—takes place in London. It is not uncommon for institutional investors in the United States to trade NYSE- or Nasdaq-listed stocks in London. These investors claim they often get better prices and faster order execution in London than they do in the United States.

## ECNs and the Future of Stock Markets

For years a so-called *fourth market* has existed. The fourth market is the direct trading of exchange-listed stocks off the floor of the exchange, in the case of NYSE-listed stocks, or outside the network, in the case of Nasdaq-listed stocks. For the most part, trading in the fourth market was limited to institutional investors buying or selling large blocks of stock.

Now the fourth market has begun to open up to smaller, individual investors through markets called **electronic communications networks (ECNs).** Buyers and sellers meet in a virtual stock market in which they trade directly with one another. No specialist or market maker is involved. ECNs have become a significant force in the stock market in recent years. Around half of all trades involving Nasdaq-listed stocks take place on INET or Archipelago—the two largest ECNs—rather than directly through the Nasdaq system.[18] Some have suggested that ECNs represent the future for stock markets. In fact, INET and Archipelago were recently acquired by Nasdaq and the NYSE, respectively. Industry watchers now speculate that NYSE's acquisition of Archipelago could eventually lead to the exchange's abandoning its centuries-old trading floor and becoming an electronic market.

**assessment check**

1. Compare and contrast the NYSE and Nasdaq stock markets.
2. Explain the role of specialists and market makers.
3. What is an ECN?

# BUYING AND SELLING SECURITIES

Unless an investor is a member of one of the stock exchanges, the investor must use the services of a brokerage firm that is a member of one or more stock exchanges. A **brokerage firm** is a financial intermediary that buys and sells securities for individual and institutional investors. Examples include A. G. Edwards, Raymond James, Morgan Stanley, and Wachovia Securities. Brokerage firms are usually members of most major stock markets. Choosing a brokerage firm, and a specific stockbroker in some cases, is one of the most important decisions investors make. The "Business Etiquette" feature discusses one aspect of developing good business relations—networking.

**brokerage firm** financial intermediary that buys and sells securities for individual and institutional investors.

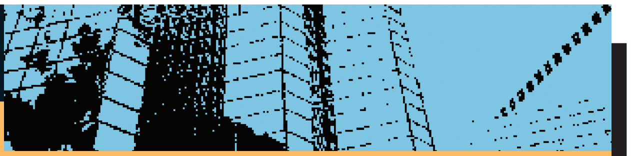
## Placing an Order

An investor who wants to purchase shares of a stock typically initiates the transaction by contacting his or her brokerage firm. The firm transmits the order to the appropriate market, completes the transaction, and confirms the transaction with the investor, all within a few minutes.

An investor's request to buy or sell stock at the current market price is called a market order. A **market order** instructs the brokerage firm, such as Edward Jones, to obtain the highest price possible, if the investor is selling, or the lowest price possible, if the investor is buying. By contrast, a **limit order** instructs the brokerage firm not to pay more than a specified price for a stock, if the investor is buying, or not to accept less than a specified price, if the investor is selling. If Edward Jones is unable to fill a limit order immediately, it is left with either an NYSE specialist or Nasdaq market maker. If the price reaches the specified price, the order is carried out. Limit orders are often recommended during periods of extreme price volatility.

**"They Said It"**

*"There's always a bull market somewhere."*
*—Jim Cramer (b. 1955) Host of Mad Money on CNBC*




## Networking for Successful Business Contacts

Networking is a fact of business life. But there is no need to feel intimidated by it—networking is really a matter of connecting with people and communicating effectively, which is something you do in your life as a student, friend, and family member. Networking helps you reach the right people at the right time to obtain a job, learn more about customers, or close a deal. It involves moving beyond your immediate circle of colleagues and friends. Here are a few suggestions for how to network smoothly and successfully.

1. Be clear about the purpose of your networking. Are you looking for a job in the financial industry? Do you want to develop customers in a certain region? Understanding your purpose will direct your search for the right person or people.
2. When you contact someone, introduce yourself and state your reasons for the contact. Ask for a few minutes of the person's time—a brief phone conversation or e-mail. If you set up a meeting or phone conference, be prompt and respect the person's time.
3. Ask clear questions, and listen carefully to the answers. Give the person an opportunity to give advice or voice an opinion.
4. Build on common ground—you might have attended the same college, grown up in the same region, or cheered for the same sports teams. However, don't stray far off the path of the visit.
5. Thank the person for his or her time and effort, even if the contact was not as helpful as you hoped. The contact may still be helpful at a later date. Offer to reciprocate, if appropriate.
6. When the meeting is over, be sure to respect any confidentiality implied or agreed on. Networking relationships are built on trust.

**Sources:** Lawrence K. Jones, "Practice Networking Etiquette," Career Key, accessed July 28, 2006, http://www.careerkey.org; Randall S. Hansen, "Online Discussion Group Networking Etiquette Do's and Don'ts," Quintessential Careers, accessed July 28, 2006, http://www.quintcareers.com; "Networking Etiquette," Massachusetts Institute of Technology, accessed July 28, 2006, http://web.mit.edu.

## Costs of Trading

When investors buy or sell securities through a brokerage firm, they pay a fee for the related services. Today, these costs vary widely among brokerage firms. A trade that costs less than $20 using E*Trade might cost more than $50 using Smith Barney. Often, the cost depends on what type of brokerage firm the investor uses. A full-service firm—such as NatCity—provides extensive client services and offers considerable investment advice, but charges higher fees. Brokers at full-service firms make recommendations and provide general advice to investors.

By contrast, a discount firm—such as Charles Schwab and Fidelity—charges lower fees but offers less advice and fewer services. However, most discount firms provide a variety of research tools to customers to help them make better decisions, and some offer investment-planning advice for an additional fee. All investors need to weigh the appropriate trade-off between cost, advice, and services when choosing a brokerage firm.

Online brokerage firms—such as Ameritrade—charge among the lowest fees of all brokerage firms. Investors enter buy and sell orders on their PCs or wireless devices. Most online firms also give customers access to a wide range of investment information, although they do not directly provide advice to investors. As online trading increased in popularity, most discount and full-service brokerage firms started offering online trading services. Merrill Lynch, for instance, now offers a wide range of online trading services. In addition, the company's 15,000 brokers—called financial advisors—now offer clients more comprehensive personal financial planning advice.[19]

## Reading the Financial News

At least four or five pages of most daily newspapers are devoted to reporting current financial news. This information is also available on countless Web sites. Much of the financial news coverage focuses on the day's securities transactions. Stocks and bonds traded on the various securities markets are listed alphabetically in the newspaper, with separate sections for each of the major markets. Information is provided on the volume of sales and the price of each security.

Today all major stock markets throughout the world quote prices in decimals. In the United States, stock prices are quoted in U.S. dollars and cents per share. In London, stock prices are quoted in pence, and in Japan they are quoted in yen.

**Stock Quotations** To understand how to read the stock tables found in newspapers, you need to understand how to interpret the symbols in the various columns. As Figure 18.2 explains, the symbol in column 1 is the 52-week indicator. An arrow pointing up means that a stock hit its 52-week high during the day, and an arrow pointing down means that a stock hit its 52-week low. Column 2 gives the stock's highest and lowest trading prices during the past 52 weeks. Column 3 contains the abbreviation for the company's name, footnotes that provide information about the stock (*pf,* for instance, refers to preferred stock), and the stock's ticker symbol. Column 4 lists the dividend, usually an annual payment based on the last quarterly declaration. Column 5 presents the yield, the annual dividend divided by the stock's closing price.

Column 6 lists the stock's **price-earnings (P/E) ratio,** the current market price divided by the annual earnings per share. The stock's trading volume in 100-share lots is in column 7, and its highest and lowest prices for the day appear in column 8. Column 9 gives the closing price for the day, and column 10 summarizes the stock's net change in price from the close of the previous trading day.

PHOTODISC/GETTY IMAGES

Using online brokerage firms can lower the cost of trading.

Figure 18.2

How to Read Stock Quote Tables

| 1 | 2 | | 3 | | 4 | 5 | 6 | 7 | 8 | | 9 | 10 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 52-Weeks High | 52-Weeks Low | Stock | Sym | Div | Yld % | PE | Vol (100s) | High | Low | Close | Net Chg |
| ↑ | $50^{70}$ | $29^{45}$ | AAAComp | AAC | 1.00 | 2.00 | 20 | 15800 | $50^{70}$ | $49^{50}$ | $50^{00}$ | + 50 |
| | $30^{00}$ | $14^{00}$ | AAElec | AAE | | ... | 26 | 510 | $22^{00}$ | $19^{45}$ | $21^{06}$ | $-1^{34}$ |
| | $78^{23}$ | $65^{00}$ | AaronInc. | AAI | .25 | .38 | 17 | 890 | $66^{56}$ | $65^{00}$ | $65^{00}$ | $-1^{78}$ |
| ↓ | $51^{55}$ | $48^{00}$ | AaronInc. pf. | | 3.50 | 7.00 | ... | 54 | $50^{10}$ | $49^{75}$ | $50^{00}$ | + 05 |

1. **52-Week Indicators:** ↑ = Hit 52-week high during the day. ↓ = Hit 52-week low.
2. **52-Week High/Low:** Highest and lowest per-share trading prices in the past 52 weeks, adjusted for splits (dollars and cents–$78.^{23}$ means $78.23 per share).
3. **Stock, Sym, and Footnotes:** The company's name abbreviated. A capital letter usually means a new word. AAA-Comp, for example, is AAA Computer. The stock ticker symbol is expressed in capital letters. For AAA Computer, it is AAC. Stock footnotes include the following: **n**–new issue, **pf**–preferred stock, **rt**–rights, **s**–stock split within the past 52 weeks, **wi**–when issued, **wt**–warrant, **x**–ex-dividend.
4. **Div:** Dividends are usually annual payments based on the most recent quarterly declaration. AAA Computer, for instance, declared a dividend of $0.25 per share in the most recent quarter.
5. **Yld %:** Percentage return from a dividend based on the stock's closing price.
6. **PE:** Price/earnings ratio, calculated by taking the last closing price of the stock and dividing it by the earnings per share for the past fiscal year.
7. **Vol:** Trading volume in 100-share lots. A listing of 510 means that 51,000 traded during the day. A number preceded by **z** is the actual number of shares traded.
8. **High/Low:** The high and low for the day (dollars and cents).
9. **Close:** Closing price (dollars and cents).
10. **Net Chg:** Change in price from the close of the previous trading day.

**Figure 18.3** How to Read Bond Quote Tables

1. **Bond:** Abbreviation of company name.
2. **Annual Interest Rate:** Annual percentage rate of interest specified on the bond certificate.
3. **Maturity Date:** Year in which the bond matures and the issuer repays the face value of each bond.
4. **Cur Yld:** Annual interest payment divided by current price; **cv** means a convertible bond.
5. **Vol:** Number of bonds traded during the day.

| 1 2 3 Bond | 4 Cur Yld | 5 Vol | 6 Close | 7 Net Chg |
|---|---|---|---|---|
| AAA 9s20 | 7.8 | 15 | 104 3/4 | – 1 1/8 |
| ABGasElec 6.5s10 | 6.6 | 10 | 98 1/2 | + 3/4 |
| AlbertoPharm 5s15 | cv | 20 | 109 1/2 | + 1/2 |

6. **Close:** Closing price.
7. **Net Chg:** Change in the price from the close of the previous trading day.

***Bond Quotations*** To learn how to read corporate bond quotations, pick a bond listed in Figure 18.3 and examine the adjacent columns of information. Most corporate bonds are issued in denominations of $1,000, so bond prices must be read a little differently from stock prices. The closing price of the first AAA bond reads 104 3/4, but this does not mean $104.75. Because bond prices are quoted as a percentage of the $1,000 price stated on the face of the bond, the 104 3/4 means $1,047.50.

The notation following the bond name—such as 6.5s10 in the case of AB Gas and Electric—indicates the annual interest rate stated on the bond certificate, 6.5 percent, and the maturity date of 2010. The *s* means that the bonds pays half of its annual interest every six months, so the investor would receive $32.50 every six months. The current yield for the AB Gas and Electric bond is 6.6 percent, slightly more than the 6.5 percent interest rate because the bond is selling for slightly less than $1,000. The price of a bond rises and falls to keep the current yield in line with market interest rates. The *cv* notation means that the bond is convertible.

The next column indicates the total trading volume for the day. The volume of 15 listed for the AAA bond means that $15,000 worth of bonds were traded. The closing bond price is listed next, followed by the change in price since the previous day's closing price.

## Stock Indexes

A feature of most financial news reports is the report of current stock indexes or averages. The most familiar is the *Dow Jones Average* (or *Dow*). Two other widely reported indexes on U.S. stocks are the Standard & Poor's 500 and Nasdaq Composite indexes. In addition, there are numerous indexes on foreign stocks, including the DAX (Germany); the FT-100, or "Footsie" (London); and the Nikkei (Tokyo). All of these indexes have been developed to reflect the general activity of specific stock markets.

While several Dow Jones indexes exist, the most widely followed is the so-called *Dow Jones Industrial Average,* consisting of 30 stocks of large, well-known companies. The S&P 500 is made up of 500 stocks, including industrial, financial, utility, and transportation stocks, and is considered a broader measure of overall stock market activity than the Dow. The Nasdaq Composite index consists of all the approximately 5,000 stocks that trade on the Nasdaq Stock Market. Because technology companies—such as Oracle and Intel—make up a substantial portion of the Nasdaq Stock Market, the Nasdaq Composite is considered a bellwether of the "tech" sector of the economy.

The Dow Jones Industrial Average has served as a general measure of changes in overall stock prices and a reflection of the U.S. economy since it was developed by Charles Dow, the original editor of the *Wall Street Journal,* in 1884. The term *industrial* is somewhat of a misnomer today, because the index now combines industrial corporations such as Alcoa, Boeing, General Motors, and United Technologies with such nonindustrial firms as American Express, Citigroup, Home Depot, and Walt Disney.

Periodic changes in the Dow reflect changes in the U.S. economy and composition of the stock market. In fact, General Electric is the only original member of the Dow industrials that remains in the index today. In the most recent changes, American International Group, Pfizer, and Verizon Communications were added and AT&T, Eastman Kodak, and International Paper were dropped from the Dow.

**assessment check**

1. Explain the difference between a market order and a limit order.
2. Distinguish between full-service and discount brokerage firms.
3. List some of the information contained in stock price quotations.
4. What are the two most closely followed stock market indexes?

# MUTUAL FUNDS AND EXCHANGE-TRADED FUNDS

Many investors choose to invest through mutual funds or exchange-traded funds (ETFs). **Mutual funds** are financial institutions that pool money from purchasers of their shares and use it to acquire diversified portfolios of securities consistent with their stated investment objectives. While mutual funds and exchange-traded funds have similarities, important differences distinguish the two. Let's examine each.

**mutual fund** financial institution that pools money from purchases of its shares and uses the money to acquire diversified portfolios of securities consistent with the fund's investment objectives.

## Mutual Funds

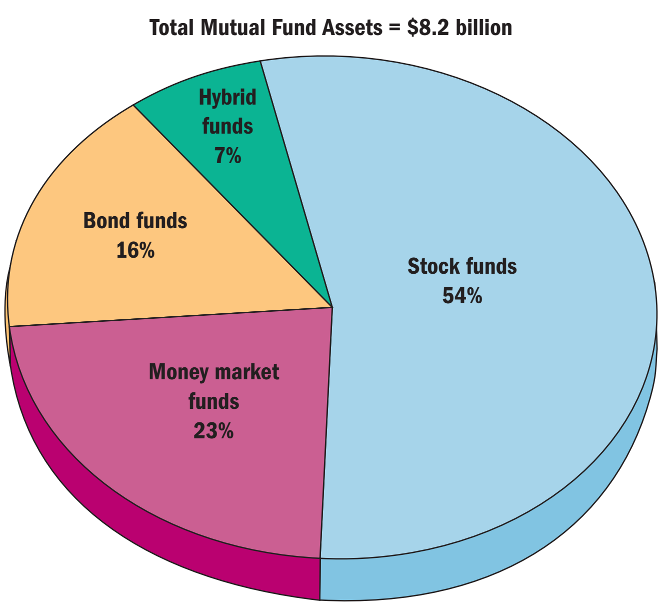
Investors who buy shares of a mutual fund become part owners of a large number of securities, thereby lessening their individual risk. Mutual funds also allow investors to purchase part of a diversified portfolio of securities for a relatively small investment, $250 to $3,000 in most cases. Mutual funds are managed by experienced investment professionals whose careers are based on success in analyzing the securities markets and choosing the right mix of securities for their funds. Mutual fund ads often stress performance or highlight the fund's investment philosophy. Most mutual funds are part of mutual families, a number of different funds sponsored by the same organization. The largest mutual fund families in the United States include Dreyfus, Fidelity, Janus, T. Rowe Price, and Vanguard.

Mutual funds have become extremely popular in recent years. Today mutual fund assets exceed $8 trillion. The number of American households owning mutual fund shares has increased from less than 5 million in 1980 to close to 55 million. Mutual funds are not limited to the United States either. Mutual funds in Europe have more than $5 trillion in assets.[20]

Today's mutual fund investors choose among around 8,000 funds in the United States. Some mutual funds invest only in stocks, some invest only in bonds, and others invest in money market instruments. The approximate breakdown of mutual fund assets by stock, bond, and money market funds is shown in Figure 18.4. Most funds pursue more specific goals within these broad categories. Some stock funds concentrate on small companies; others concentrate more on the shares of larger firms. Some bond funds limit their investments to municipal bonds; other bond funds invest in only investment-grade corporate bonds.

Unlike stocks, mutual funds don't trade on stock exchanges. Investors purchase shares directly from the fund. Moreover, an investor who wishes to sell shares of a mutual fund simply sells the shares back to the fund (the technical

Figure 18.4 Distribution of U.S. Mutual Fund Assets by Type of Fund




Note: Hybrid funds invest in both stocks and bonds.
**Source:** "Trends in Mutual Fund Investing," Investment Company Institute, accessed July 3, 2006, http://www.ici.org.

**Figure 18.5** How to Read Mutual Fund Tables

| Issuer (1) | NAV (2) | Net Chg (3) | YTD % ret (4) |
|---|---|---|---|
| Zardoz Funds: | | | |
| AggreGro | 34.45 | −0.37 | +3.5 |
| Gro | 55.09 | −0.45 | +1.8 |
| GroInc | 20.17 | +0.05 | +6.9 |

1. **Issuer:** Financial organization issuing and managing the mutual fund. Under the Zardoz family of funds are the different funds developed for investors with different objectives.
2. **NAV:** Net asset value. Market value of fund's assets divided by the number of outstanding shares. Also the purchase price for no-load funds. (Load funds assess a sales charge on top of the NAV.)
3. **Net Chg:** The change in NAV from the previous day's close.
4. **YTD % ret:** The fund's total return for the year to date, from December 31 of the previous year. The percentage return assumes that all cash distributions were reinvested.

term is *redemption of shares*). Consequently, the size of a mutual fund, and the number of shares outstanding, can change daily. Another important feature of mutual funds is how investment returns are taxed. Mutual funds themselves don't pay taxes on investment profits (dividends, interest payments, or realized capital gains). Instead, the fund passes the profits to shareholders in the form of cash distributions. Shareholders then pay any taxes due.

A number of mutual funds have been developed for investors who want their religious or personal philosophies reflected in the management of the fund. For instance, there are funds designed for Catholics, conservative Christians, Lutherans, Mennonites, and Muslims. All attempt to follow investment philosophies that don't conflict with their religious teachings. Certain Muslim funds, for instance, don't invest in bank stocks because banks charge interest, which some believe is contrary to Islamic teachings. So-called *socially responsible mutual funds* limit their investments to companies meeting certain standards in areas such as environmental protection, ethical behavior, and labor relations. The Calvert Fund and the Domini Fund are both examples of socially responsible mutual funds.

Reading mutual fund tables is a relatively simple task. The first two columns in Figure 18.5 list the organization issuing and managing the fund, the different types of funds offered for investors, and footnotes. The NAV column lists the fund's net asset value (the market value of fund assets divided by the number of outstanding shares), the price at which investors can buy shares if the fund is a no-load fund. Purchasers of shares of load funds pay a fee called a *load charge* on top of the NAV. The net change column shows gains or losses in the NAV from the previous day's close. The figures in the last column, the year-to-date percentage return, indicate each funds' total return from the beginning of the year.




Spiders are examples of exchange-traded funds that track the S&P 500 index.

## Exchange-Traded Funds

A relatively new investment option is the **exchange-traded fund** (or **ETF**). As described in the "Hit and Miss" feature, an ETF is similar to a mutual fund in that it raises funds by selling shares to investors and then uses those funds to purchase a portfolio of securities. Unlike mutual funds, however, an ETF sells a fixed number of shares to investors in what is effectively an initial public offering. Then ETF shares trade on stock exchanges much like shares of individual companies. Most ETFs are sponsored by investment companies and other financial institutions. ETFs have grown rapidly since the first one was introduced in 1993, and today there are close to 200 ETFs with total assets of around $250 billion.[21]

# HIT & MISS

## Investors Get Their Hands on Spiders and Diamonds

If "spiders and diamonds" sounds to you like the title of a new CD, check the financial pages of your newspaper. There's a new type of investment on the market called *exchange-traded funds (ETF),* and investors have been scooping them up at a rapid pace. ETFs are funds that are listed and traded like equity investments. Like index mutual funds, they track the indexes of stocks, bonds, or other assets, but they are priced several times a day rather than just once, at the close of the market. In addition, their annual operating fees are usually lower than those of traditional mutual funds, and their tax liability is less. Where do the spiders and diamonds come in? Spiders are ETFs that track the Standard & Poor's 500 index, while diamonds are those that track the Dow 30.

ETFs have become so popular in the United States that they now account for about 25 percent of U.S. trading volume in stocks. In Europe, they represent just 1 percent. Still, U.S. investors are using ETFs to get into a global market because they work as a kind of shortcut. "Investors are increasingly using ETFs to gain exposure to international benchmarks," explains a global ETF strategist for Morgan Stanley. As the jobs of portfolio managers increase in complexity, they may not have the time or resources to enter each market in each country, so they turn to ETFs.

As with any investment, ETFs have both benefits and drawbacks. Because they are a newer type of investment, long-term results won't be known for a while. Because of their complexity, ETFs may be more difficult for the average individual investor to understand. And firms that are interested in getting into the market may have trouble because the number of indexes is limited—they must be linked to Dow Jones, S&P, Morgan Stanley Composite, or the like. With each purchase or sale, the investor must pay a broker's commission, which is why ETFs work best for investors who want to buy and hold them for a period of time. Finally, investors must remember that ETFs aren't fail-safe; they are vulnerable to the ups and downs of the stock market. They may sparkle like a diamond or bite like a spider.

### Questions for Critical Thinking

1. For what type of investor would an ETF work best? Why?
2. What might be the benefits and drawbacks of using an ETF to enter an international market?

**Sources:** Matt Ackermann, "ETF Sales Grow Rapidly as Sellers Dwindle," *Financial-Planning.com,* accessed August 16, 2006, http://www.financial-planning.com; Carla Fried, "Exchange-Traded Funds, in a Rainbow of Choices," *New York Times,* accessed July 28, 2006, http://www.nytimes.com; Susan Morris, "Exchange-Traded Funds Still Going Strong," *Pittsburgh Tribune-Review,* accessed July 28, 2006, http://www.pittsburghlive.com; M. Stanely, "Global ETF Trading Volume Surges in H1" Yahoo! News, accessed July 18, 2005, http://news.yahoo.com.

Another characteristic of ETFs is the fact that most are not actively managed, unlike the typical mutual fund. Rather, the ETF is designed to track a well-known stock or bond index, such as the Dow or the S&P 500. As the index rises or falls, so does the price of the ETF's shares. Dividends or interest payments are passed through to ETF shareholders on a prorated basis.

Exchange-traded funds appeal to many investors for two reasons. First, shareholders of ETFs are charged little, if anything, for annual operating expenses. By contrast, the typical stock mutual fund charges shareholders around 1.5 percent of the net asset value each year to pay for annual operating expenses. Operating expenses are paid before investment income is distributed to shareholders. Second, for some investors ETFs are more tax efficient. Because the typical ETF doesn't trade (buy or sell securities) very often, they don't generate a lot of taxable capital gains. Mutual funds, by contrast, usually trade frequently and generate more capital gains that are passed on to shareholders in the form of taxable distributions.

### assessment check

1. What is a mutual fund? Why are mutual funds popular investments?
2. Explain how an exchange-traded fund differs from a mutual fund.

# LEGAL AND ETHICAL ISSUES IN SECURITIES TRADING

As the number of Americans owning securities has increased, so have concerns about illegal and unethical trading practices. Practices such as churning (excessive trading), giving misleading investment advice to clients, conflicts of interest, insider trading, disclosing false information, and outright fraud are just some of the practices that concern investors, the securities industry, and government regulators. Government laws and regulations, as well as industry self-regulation, are designed to protect investors.

## Government Regulation of the Securities Markets

Regulation of U.S. securities markets is primarily a function of the federal government, although states also regulate the securities markets. Federal regulation grew out of various trading abuses during the 1920s. During the Great Depression, in an attempt to restore confidence and stability in the financial markets after the 1929 stock market crash, Congress passed a series of landmark legislative acts that have formed the basis of federal securities regulation ever since.

As noted in Chapter 16, the U.S. Securities and Exchange Commission (SEC), created in 1934, is the principal federal regulatory overseer of the securities markets. The SEC's mission is to administer securities laws and protect investors in public securities transactions. The SEC has broad enforcement power. It can pursue civil action against individuals and corporations, but actions requiring criminal proceedings are referred to the U.S. Justice Department. For instance, the SEC recently settled civil fraud charges against a former columnist for the popular investment Web site CBS MarketWatch.com. According to the SEC, the columnist made more than $400,000 by buying shares of companies and then writing highly favorable stories about the companies. After the prices of the shares rose—in part based on his recommendations—the individual quickly sold his shares.[22] The SEC argued that by not disclosing that he held a position in the stocks he was recommending, the columnist was committing securities fraud.

The SEC requires that virtually all new public issues of corporate securities be registered. Before offering securities for sale, an issuer must file a registration statement with the SEC. As part of the registration process for a new security issue, the issuer must prepare a *prospectus.* The typical prospectus gives a fairly detailed description of the company issuing the securities, including financial data, products, research and development projects, and pending litigation. It also describes the stock or bond issue and underwriting agreement in detail. The registration process seeks to guarantee **full and fair disclosure.** The SEC does not rule on the investment merits of a registered security. It is concerned only that an issuer gives investors enough information to make their own informed decisions.

**full and fair disclosure** requirement that investors should be told all relevant information by stock or bond issuers so they can make informed decisions.

Besides primary market registration requirements, SEC regulation extends to the secondary markets as well, keeping tabs on trading activity to make sure it is fair to all participants. Every securities exchange, including Nasdaq, must by law follow a set of trading rules that have been approved by the SEC. In addition, the *Market Reform Act* of 1990 gave the SEC emergency authority to halt trading and restrict practices such as program trading (when computer systems are programmed to buy or sell securities if certain conditions arise) during periods of extreme volatility.

One area to which the SEC pays particular attention is so-called insider trading. **Insider trading** is defined as the use of material nonpublic information about a company to make investment profits. Examples of material nonpublic information include a pending merger or a major oil discovery. The SEC's definition of insider trading goes beyond corporate insiders—people such as the company's officers and directors. It includes lawyers, accountants, invest-

**insider trading** use of material, nonpublic information to make investor profits.

ment bankers, and even reporters—anyone who uses nonpublic information to profit in the stock market at the expense of ordinary investors. In a recent case, the SEC filed complaints against several individuals who, it claims, had advance knowledge of the acquisition of Reebok by German footwear company Adidas. The SEC alleges that these individuals purchased Reebok stock before the acquisition announcement was made public.[23] While some actions or communications are clearly insider trading, others are more ambiguous. Consequently, all employees of public companies have to be mindful of what is and isn't permitted.

**Regulation FD** requires firms to share information with all investors at the same time. It prohibits selective disclosure of information by companies to favored investment firms. Clients of these firms often received the information sooner than other investors. The SEC recently settled charges against Flowserve Corporation—an oil services firm—and two of its executives. The complaint alleged that a private meeting Flowserve held with security analysts in which future company earnings were discussed violated Regulation FD.[24]

Securities laws also require every public corporation to file several reports each year with the SEC; the contents of these reports become public information. The best known, of course, is the annual report. Public corporations prepare annual reports for their shareholders, and they file another report containing essentially the same information, Form 10-K, with the SEC. The SEC requires additional reports each time certain company officers and directors buy or sell a company's stock for their own accounts (Form 4) or anytime an investor accumulates more than 5 percent of a company's outstanding stock (Form 13-d). All of these reports are available for viewing and download at the Free Edgar Web site (http://www.freeedgar.com). As we discussed in Chapter 16, the Sarbanes-Oxley Act increased the reporting requirements of public companies. Not surprisingly, complaints over the escalating cost of SEC-required reports has increased in recent years. The "Solving an Ethical Controversy" feature debates whether it is time to rethink the reporting requirements of public companies.

## Industry Self-Regulation

The securities markets are also heavily self-regulated by professional associations and the major financial markets. The securities industry recognizes that rules and regulations designed to ensure fair and orderly markets promote investor confidence to the benefit of all participants. Two examples of self-regulation are the rules of conduct established by the various professional organizations and the market surveillance techniques used by the major securities markets.

***Professional Rules of Conduct*** Prodded initially by federal legislation, the National Association of Securities Dealers (NASD) established and periodically updates rules of conduct for members (both individuals and firms). These rules try to ensure that brokers perform their basic functions honestly and fairly, under constant supervision. Failure to adhere to rules of conduct can result in disciplinary actions. The NASD also established a formal arbitration procedure through which investors can attempt to resolve disputes with brokers without litigation.

***Market Surveillance*** All securities markets use a variety of techniques to spot possible violations of trading rules or securities laws. For example, the NYSE continuously monitors trading activity throughout the trading day. A key technical tool used by the NYSE is called Stock Watch, an electronic monitoring system that flags unusual price and volume activity. The NYSE then seeks explanations for unusual activity from the member firms and companies involved. In addition, all market participants must keep detailed records of every aspect of every trade (called an *audit trail*). The NYSE's enforcement division may impose a variety of penalties on members for rule violations. In addition, the exchange turns over evidence to the

## SARBANES-OXLEY: TOO FAR OR JUST ABOUT RIGHT?

***Many consider the Sarbanes-Oxley Act the largest change in corporate regulations since the 1930s. Passed in response to accounting scandals of the early 21st century, the law known in the business world as SOX was designed to protect the stakeholders in a corporation from inadequate and unethical documentation of finances by management.***

No one would argue with the good intentions of SOX, but it seems that the hardest hit are the smallest companies, who may spend more than $1 million to implement the new accounting law.

Do the benefits of implementing changes mandated by the Sarbanes-Oxley Act outweigh the hardships for some companies?

### PRO

1. "Sarbanes-Oxley has recognized fairness toward shareholders—that a company is not run just for the benefit of management," says Ron Weinberg, chairman and CEO of a medium-sized firm.
2. Sarbanes-Oxley has raised the standards for all company directors. "Finding qualified directors has become a new growth industry in the recruiting world," remarks one legal expert.

### CON

1. "Criminals find ways to take advantage of whatever system exists," argues Ted Frank, president of Axentis LLC, which makes software that helps companies comply with the new law.
2. The initial costs of compliance with SOX can be hard to bear. It "took us from making money to losing money," says Richard Leone of RTI International Metals Inc.

### Summary

Sarbanes-Oxley has forced public companies to examine their boards of directors for any conflicts of interest and to rethink many of their financial practices. In doing so, many believe that the law has helped rebuild investor confidence in the stock market. But others say it is too early to claim results. "The jury is still out as to whether the internal control review processes are a cost-effective way to improve investor confidence," notes one CFO.

**Sources:** Barbara Hagenbaugh and Matt Krantz, "New Accounting Rules Raise Price of Audits," *USA Today,* accessed July 28, 2006, http://www.usatoday.com; Steven Martin, "Gaining Strength from Sarbox," *Information Week,* accessed July 28, 2006, http://www.informationweek.com; Alison Grant and Mary Vanac, "The Hefty Costs of Compliance," *Cleveland Plain Dealer,* accessed July 28, 2006, http://www.cleveland.com/plaindealer.

solving an ETHICAL controversy

**assessment check**

1. Is securities regulation primarily a state or federal responsibility? When was the SEC created?
2. Define insider trading.

SEC for further action if it believes that violations of federal securities laws may have occurred. In one recent case, the NYSE fined Merrill Lynch $10 million for various violations of exchange rules regarding the timely delivery of documents to clients, improper record keeping, and other actions inconsistent with proper business practices.[25]

## WHAT'S AHEAD

*Contemporary Business* concludes with three appendixes. Appendix A examines risk management and insurance. It discusses the concept of risk, alternative ways of dealing with risk, and various kinds of insurance available for businesses and individuals. Appendix B discusses some of the important components of personal financial planning such as budgeting, credit, and retirement planning. Finally, Appendix C describes how to write a business plan.

## Summary of Learning Goals

### 1 Distinguish between the primary market for securities and the secondary market.

The primary market for securities serves businesses and governments that want to sell new security issues to raise funds. Securities are sold in the primary market either through an open auction or via a process called underwriting. The secondary market handles transactions of previously issued securities between investors. The business or government that issued the security is not directly involved in secondary market transactions. In terms of the dollar value of trading volume, the secondary market is about four times as large as the primary market.

#### Assessment Check Answers

**1.1 Distinguish between the primary and secondary markets for securities. Is the primary market or secondary market larger?**
In the primary market, securities are sold to investors for the first time, and the issuing corporation or government receives the proceeds from the sale. The secondary market involves trades between investors of previously issued securities. The secondary market is far larger than the primary market.

**1.2 Explain the two ways in which securities are sold in the primary market.**
The two ways in which securities are sold in the primary market are in open auctions and through a process called underwriting. The U.S. Treasury sells securities through open auctions. It announces before the auction what types of securities it wants to sell and solicits bids from investors. The higher the bid, the lower the interest rate. Corporate and municipal securities are sold via underwriting. The securities are sold to a specialized investment firm called an investment banker, which then sells the securities to investors. Investment bankers charge for their services by paying the issuer less than they charge investors. Investment bankers are specialists in the securities markets, and issuers find it more efficient and easier to use the services of investment bankers.

### 2 Compare money market instruments, bonds, and common stock, and explain why particular investors might prefer each type of security.

Money market instruments and bonds are debt instruments. Money market instruments are short-term debt securities and tend to be low-risk securities. Bonds are longer-term debt securities and pay a fixed amount of interest each year. Bonds are sold by the U.S. Treasury (government bonds), state and local governments (municipal bonds), and corporations. Financial institutions such as Fannie Mae and Freddie Mac sell mortgage pass-through securities—bonds backed by a self-liquidating pool of mortgage loans. Most municipal and corporate bonds have risk-based ratings. Common stock represents ownership in corporations. Common stockholders have voting rights and a residual claim on the firm's assets.

#### Assessment Check Answers

**2.1 Explain the difference between a money market instrument and a bond.**
All money market instruments mature within one year from the date of issue. Bonds mature anywhere from 2 to 30 years from the day of issue.

**2.2 What are the two types of bonds issued by state and local governments? Describe the difference between a secured and unsecured bond.**
The two types of bonds issued by state and local governments are general obligation bonds and revenue bonds. General obligation bonds can be issued only by governmental units that have taxing authority (such as cities or states) and are backed by the full faith and credit of the state in which they are issued. Revenue bonds are issued to pay for public projects that generate revenue, such as toll roads. Only revenue from the project is used to pay interest and to repay principal. A secured bond is backed by specific collateral. An unsecured bond is backed only by the financial reputation of the issuer.

**2.3 Discuss the major investment characteristics of common stock.**
Common stock represents ownership claims in firms. Common stockholders are often paid cash dividends, but the amount of dividends varies widely from stock to stock. However, the major motivation for buying common stock is expected price appreciation. As a firm's profits grow, so too should the value of its stock.

### 3 Identify the five basic objectives of investors and the types of securities most likely to help them reach each objective.

The five basic objectives are growth in capital, stability of principal, liquidity, current income, and growth in income. Common stocks are the most likely to meet the objectives of growth in capital and growth in income. Historically, common-stock investments have had far higher returns on average than either bonds or money market instruments. Common-stock dividends have also generally risen over time. Money market instruments are the most stable in price and rarely lose value. Money market instruments are also the most liquid security. Bonds tend to provide the highest current income of any security. Investment income from government bonds, corporate bonds, common stocks, and realized capital gains are usually taxed at the federal level but often at different rates. Interest income from municipal bonds is exempt from federal income taxes but may be subject to state income taxes.

## Assessment Check Answers

**3.1 Who purchases securities?**
Securities are purchased by institutions—such as pension funds and life insurance companies—and individuals. Many individuals purchase securities indirectly through institutions.

**3.2 What are the five motivations for investing? On which of the five motivations for investment do common stocks rank highest?**
The five motivations are growth in capital, stability of principal, liquidity, current income, and growth in income. Common stocks have historically ranked highest in growth in capital and growth in income.

**3.3 Discuss the tax implications of investing. Are all sources of investment returns taxed equally?**
Income received from government and corporate bonds is taxed as ordinary income. Common-stock dividends, for most individuals, are taxed at a lower rate, as are realized capital gains, which result when a security is sold for more than its purchase price.

### 4 Describe the characteristics of the major stock exchanges.

Exchanges exist throughout the world. The two largest—the New York Stock Exchange and Nasdaq—are located in the United States. The NYSE is larger, measured in terms of the total value of stock traded. Larger and better-known companies dominate the NYSE. Buy and sell orders are transmitted to the trading floor for execution. The Nasdaq Stock Market is an electronic market in which buy and sell orders are entered into a computerized communication system for execution. Most of the world's major stock markets today use similar electronic trading systems. Electronic communication networks are electronic markets in which buyers and sellers trade directly without the use of a specialist or market maker.

## Assessment Check Answers

**4.1 Compare and contrast the NYSE and Nasdaq stock markets.**
The NYSE still maintains a trading floor, and all trading takes place on the floor, even though the trading process has become much more automated in recent years. Larger, better-known companies tend to be listed on the NYSE. The Nasdaq Stock Market is an electronic market—it is considered the world's largest intranet—and all trading takes place electronically. Nasdaq-listed stocks tend to be smaller, newer companies. Technology companies especially tend to be listed on Nasdaq. Each NYSE-listed stock has one specialist assigned to it. By contrast, each Nasdaq listed stock has at least two market makers.

**4.2 Explain the role of specialists and market makers.**
Specialists and market makers maintain an inventory of their stocks and act as buyers when no other buyers are present and sellers when no other sellers are present. This function adds liquidity to stock markets. Specialists and market makers also track unfilled limit orders.

**4.3 What is an ECN?**
*ECN* stands for *electronic communications network.* An ECN is a virtual stock market in which buyers and sellers trade with each other without the presence of a market maker or specialist.

### 5 Explain the process of buying or selling a security listed on an organized securities exchange and the information included in stock and bond quotations and stock indexes.

Investors use the services of a brokerage firm that is a member of one of the stock exchanges. After a broker receives a customer's order, it is sent electronically to the appropriate stock exchange for execution. A market order instructs the broker to obtain the best possible price, but a limit order limits the transaction price. Full-service brokers provide the most advice but charge the highest fees. Customers at discount firms and online trading firms have to make their own decisions but are charged lower fees. Information in a stock quote includes the highest and lowest trading prices during the previous 52 weeks, the dividend, the dividend yield, the price/earnings ratio, the trading volume, the stock's highest and lowest prices for the day, and the closing price for that day. A bond quotation includes the maturity date and interest rate, the current yield, the trading volume, and a comparison of the day's closing price with that of the previous day. Stock indexes measure the overall direction of a particular market or particular types of stocks.

### Assessment Check Answers

**5.1 Explain the difference between a market order and a limit order.**
A market order instructs the broker to get the "best" price (lowest if buying or highest if selling). By contrast, a limit order specifies the highest price the investor will pay (if buying) or the lowest price he or she will accept (if selling).

**5.2 Distinguish between full-service and discount brokerage firms.**
Full-service firms provide order execution, record keeping, and extensive investment advice. By comparison, discount firms provide order execution and record keeping but don't necessarily provide investment advice. Most, however, give their clients access to a wide range of independent investment research so that clients can make their own investment decisions. Discount brokerage firms charge lower commissions than full-service firms.

**5.3 List some of the information contained in stock price quotations.**
Information contained in stock price quotations includes the 52-week high and low prices, the dividend, the price-to-earnings ratio, and the closing price.

**5.4 What are the two most closely followed stock market indexes?**
The two most closely followed stock market indexes are the Dow Jones Industrial Average (known as the Dow 30) and the Standard & Poor's 500 (S&P 500).

## 6 Discuss the role of mutual funds and exchange-traded funds in the securities markets.

Mutual funds are professionally managed investment companies that own securities consistent with their overall investment objectives. Investors purchase shares of a mutual fund, which make them part owners of a diversified investment portfolio. Investors can purchase shares of mutual funds for relatively small amounts. Mutual funds have become extremely popular in recent years. More than half of all American households own mutual fund shares. Exchange-traded funds (ETFs) are sponsored by investment companies that sell a fixed number of shares and use the proceeds to buy a portfolio of securities. Shares of ETFs trade on the major stock markets and are generally unmanaged.

### Assessment Check Answers

**6.1 What is a mutual fund? Why are mutual funds popular investments?**
A mutual fund is an investment company that sells shares to investors and uses these funds to purchase securities consistent with the fund's investment objectives. Mutual funds are popular because they allow small investors to purchase a piece of a diversified portfolio of securities, thereby reducing the risk associated with holding an individual security. Most mutual funds are professionally managed.

**6.2 Explain how an exchange-traded fund differs from a mutual fund.**
An exchange-traded fund is similar to a mutual fund in that an ETF sells shares to investors and uses these funds to purchase securities. However, most ETFs sell only a fixed number of shares in an initial public offering. Afterward, shares of ETFs trade on the major stock markets like individual common stocks. In addition, most ETFs are unmanaged, and many are designed to track one of the major indexes such as the S&P 500 or Dow.

## 7 Evaluate the major features of regulations and laws designed to protect investors.

In the United States, financial markets are regulated at both the federal and state levels. Markets are also heavily self-regulated by the financial markets and professional organizations. The chief regulatory body is the Securities and Exchange Commission. It sets forth a number of requirements for both primary and secondary market activity, prohibiting a number of practices, including insider trading. The SEC also requires public companies to disclose financial information regularly. Professional organizations and the securities markets also have rules and procedures that all members must follow.

### Assessment Check Answers

**7.1 Is securities regulation primarily a state or federal responsibility? When was the SEC created?**
In the U.S., securities regulation is primarily a federal responsibility, although the states do have some regulatory authority. The SEC (Securities & Exchange Commission) was created in the 1930s.

**7.2 Define *insider trading.***
Insider trading is the use of material, nonpublic information to make investment profits.

## Business Terms You Need to Know



## Other Important Business Terms



## Review Questions

1. Explain the differences between a primary market and a secondary market. In what two ways are securities sold in the primary market?
2. Outline the underwriting process. Why do corporations and state and local governments use the services of investment bankers?
3. What are the major characteristics of money market instruments? How do money market instruments differ from bonds?
4. What is the difference between a government bond and a municipal bond? What is the difference between a secured bond and an unsecured bond?
5. Explain the purpose of bond ratings. What is a junk bond?
6. What is common stock, and how does it differ from preferred stock? Over the long run, what does a company's stock price tend to follow?
7. What are the primary investment motivations or objectives? Which security best meets each objective?
8. Explain the difference between a market order and a limit order. What are the differences between full-service, discount, and online brokerage firms?

9. How does the New York Stock Exchange operate? Compare the operations of the NYSE with those of the Nasdaq stock market.
10. What is an ECN? Why did the NYSE and Nasdaq purchase the two largest ECNs?
11. Explain how a mutual fund operates. What are the benefits of investing in mutual funds?
12. What is an exchange-traded fund? How does an ETF differ from a mutual fund?
13. Define *insider trading* and cite an example. List some ways in which the securities industry is self-regulated.

## Projects and Teamwork Applications

1. Assume you just inherited $50,000 from your uncle and his will stipulates that you must invest all the money until you complete your education. Prepare an investment plan. What are your primary investment objectives? How much would you invest in money market instruments, bonds, and common stocks? Compare your results with those of a classmate.
2. Would you feel comfortable investing the $50,000 you inherited in Question 1 using a discount (or online) broker, or would you use a full-service firm? Discuss the reasons behind your choice.
3. Working with a partner, review the trading activity on the NYSE and the Nasdaq Stock Market for the past five trading days. Which market was more active? By how much did major indexes rise or fall? Which stocks were the most active? Prepare a brief report discussing your findings.
4. Assume you are considering buying shares of Lowe's or Home Depot. Describe how you would go about analyzing the stocks and deciding which, if either, you would buy.
5. Visit the Standard & Poor's Web site (http://www.standardandpoors.com) and click "Indexes" and then "S&P 500." Answer the following questions:
   a. What stocks have recently been added to the S&P 500? Which stocks did they replace?
   b. Which five stocks have the highest market values?
   c. Identify and briefly describe three other S&P indexes.
6. You've probably heard of U.S. savings bonds—you may even have received some bonds as a gift. What you may not know is that there are two different types of savings bonds. Do some research and compare and contrast the two types of savings bonds. What are their features? Their pros and cons? Assuming you were interested in buying savings bonds, which of the two do you find more attractive?
7. Go to the MSN Money Web Site (http://moneycentral.msn.com). Click "fund screener." Assume you're investing money for retirement. Specify several investment criteria you believe are most important. Identify at least three mutual funds that best meet your criteria. Choose one of the funds and research it. Answer the following questions:
   a. What was the fund's average annual return for the past five years?
   b. How well did the fund perform relative to its peer group and relative to an index such as the S&P 500?
   c. What are the fund's ten largest holdings?
   d. Did your research change your opinion of the fund as an appropriate investment for your retirement savings? Why or why not?
8. Visit the SEC's Web site (http://www.sec.gov) and review five recent enforcement actions. How many dealt with cases of suspected insider trading? What actions did the SEC propose taking?

## Case 18.1

### The Future of the New York Stock Exchange

An investment community has existed in New York even before it was New York. When Dutch settlers arrived on the island of Manhattan in the mid-1600s, their purpose was commerce. They named their settlement New Amsterdam and set about building an economic empire. Four hundred years later, New York is a commercial powerhouse of global proportions, and many would claim that the center of this powerhouse is the New York Stock Exchange. With company listings worth $20 trillion, the NYSE has historically banked on its name and the ability of its trading floor specialists to guarantee their investors liquidity. But in the wake of tighter regulations from the Securities and Exchange Commission (SEC) and rapidly evolving technology that threatens to leave the NYSE in the dust, the exchange is poised for change.

When the SEC decided to tighten up the "trade-through" rule that links America's markets, it meant that all investors must have equal access to the best prices available on a given day. The only way to achieve this parity is electronically—something that other stock exchanges had already begun to implement. This put the NYSE—and its customers—at a disadvantage. Nasdaq and the Chicago Mercantile Exchange were already using some form of electronic trading, as were large institutional investors, who often rely on electronic communication networks (ECNs) for rapid trading. NYSE's customers began to complain.

In a radical move, the NYSE acquired Archipelago Holdings, owner of ArcaEx, a large ECN that already handled 25 percent of the trading in Nasdaq-listed shares and had recently acquired the Pacific Stock Exchange, which specializes in high-risk investments called *derivatives*. The merger means some big changes at the NYSE. First, it became a public company—it can raise a huge amount of capital, but it must also answer to shareholders. Second, it now has a way to compete for Nasdaq shares and accept listings from smaller companies that previously did not qualify for listing on the NYSE. Third, the NYSE can now participate more fully in the growing derivatives and ETF markets.

The merger seems to plant the NYSE squarely in the 21st century. But it does have its detractors. Some experts warn that the NYSE and Archipelago are like two different species and that their organizational cultures will not integrate very well. Others worry that the NYSE does not yet know how to use the trading technology used by ArcaEx. Still others point out that Nasdaq has actually acquired a better-fitting company—the electronic trading division of Instinet, which is owned by Reuters. But NYSE's entrance into the electronic trading market should step up competition, which in the long term should decrease costs for investors, speed up transactions, and even encourage more innovation—which is what commerce is all about.

#### Questions for Critical Thinking

1. Describe at least two regulations that apply to NYSE's acquisition of Archipelago and its future methods of trading.
2. Do you think that the NYSE and Nasdaq will become more similar in the next few years? How might they differentiate themselves?

**Sources:** "The Cyberbuttonwood Arrives," Economist.com, accessed April 16, 2003, http://www.economist.com; Donna Block, "What NASDAQ Sees in Instinet," *Daily Deal,* accessed August, 2006, http://www.thedeal.com; Jenny Anderson, "Big Changes at the Exchanges Bring Their Self-Regulation into Question," *New York Times,* accessed July 28, 2006, http://www.nytimes.com.

## VIDEO Case 18.2

### A.G. Edwards: Helping Businesses Grow

This video case appears on page 628. A recently filmed video, designed to expand and highlight the written case, is available for class use by instructors.

The Second City



# The Second City Theater Continuing Case
## Managing Financial Resources: Keeping Creativity in the Money

When Second City Communications negotiates a deal with Motorola, or the Chicago Cubs, or Chicago's Steppenwolf Theatre, keeping an eye on the finances is chief financial officer Lou Carbone. Joining the company at its Toronto location in 1998, Carbone became CFO for the entire organization in 2005. He currently operates out of Second City's Chicago office as a strategist, a liaison, a treasurer, and, in his own words, "the father figure who may have to say 'no, you can't play with that toy.'" Behind a desk stacked full of project proposals, Lou Carbone manages Second City's unyielding creation of business ventures. He watches the risk-return trade-offs and designs accurate financial plans to turn concepts into reality. The reality for Lou Carbone is that a company as creative and well recognized as Second City needs a CFO with a practical disposition and an appreciation for the art of acting and the entrepreneurial spirit.

Second City has excelled as a company based on creative mission. As CFO, Lou Carbone approaches the company's lofty ambitions from a pragmatic angle. "My primary function" says Carbone, "is to ensure that there is accurate and timely financial reporting." He does this by developing financial statements with his team and distributing them regularly to top management. Carbone's staff consists of four professionals: a senior accountant, a payroll administrator, a junior accountant, and the building manager. Though a small financial team, they operate as a close-knit crew, well suited for a for-profit business, functioning with a not-for-profit attitude. They have a variety of challenges. For instance, the company is stretched across North America with disparately functioning theaters. Revenue also fluctuates unpredictably throughout the year, and new projects encounter unforeseen costs. Meeting one-on-one with department heads, Lou Carbone has streamlined financial reporting within the organization to improve on past practices in which each department did its own budget. This is just one way in which Lou Carbone has helped Second City evolve financially.

Lou Carbone keeps the Second City stages lit, its actors paid, and its new ideas funded through his relationships with outside agencies. As a liaison for the comedy theater, Carbone meets with Second City's bank, lawyers, and insurance firms to ensure compliance and confirm that there are adequate reserves. Keeping a strong relationship with Second City's bank has been vital for the organization. Amid changes in revenue and struggling project starts over the last 28 years, Second City has come across times in which bank loans have allowed it to develop as planned. Impressively, Lou Carbone and SC's financial team have maintained a strong alliance with the same bank that it has used since its start.

For all its growth and corresponding challenges, Second City remains a small business choosing to stay private for the foreseeable future. It is owned by three shareholders, two of whom are still closely involved with business operations and maintain a recognizable character throughout the organization.

Second City is clearly an unconventional business. In fact, its five theaters are structured with financial and organizational differences. Second City's Detroit stage is a franchise; Denver has been designed as a limited run to test the market; Las Vegas is a partnership. Chicago and Toronto are the only stages fully owned by the three sole investors, though Toronto operates as a separate legal entity.

Second City's financial management team must oversee all operations while paying close attention to these organizational differences. Overall, Second City's different U.S. bank accounts fuse into a whole that can be used flexibly throughout the organization. This enables Second City to fund start-up operations such as new Theatricals produced in performing arts centers with revenue garnered from mainstage ticket sales. This effort keeps the Second City mission intact across the board.

As the numbers fly around Second City and fall on the desk of Lou Carbone, putting them together to forecast and develop strategic plans is what he finds most interesting. Carbone balances available funds, needed funds, the costs of expansion, and pricing specifics to help inform the top management team about which ventures seem most reasonable. Through this analysis Second City has, for example, determined that new theater expansion should be put on hold. There won't be new Second City Theaters opening any time soon, but finding Second City's style of comedy in the business world is increasingly likely. It has seen its most significant growth in the corporate division over the past five years. Tom Yorton, president of Second City Inc., and Lou Carbone collaborate regularly in negotiations with corporate clients for SC Communications, the division of Second City that provides entertainment, training, and creative and multimedia services to businesses. Companies are looking to foster a more creative atmosphere within the workplace, and SC Communications finds itself increasingly relevant to contemporary business.

Carbone brings financial savvy to a company that is otherwise focused on creating an ideal environment for excellent acting. Yorton says, "Thank God for Lou. The fact is that none of us really have a finance background. He can help educate us to make the place run better. We're an improv theater, so we make it up as we go along. Finance is one area where you really can't make it up as you go along."

The hardest part of Lou Carbone's job isn't finding ways for Second City to increase revenue but to watch where all of it is going. With Detroit operating as a franchise, its status as a locally owned business means less exposure for Second City, and separate accounting practices present less concern for the company's home base. Second City's center, in Chicago, is busy monitoring the other operations around the country. Both Las Vegas and Denver are far enough away that accurate monitoring is a consistent dilemma. Toronto has its own two accountants, and they've been challenged by a struggling economy in their region throughout the last decade. Second City Chicago pulled from reserves and credit lines to back the operation. With so many divisions, Carbone must pay strict attention to monthly reports and annual audits.

At Second City, 40 to 50 percent of all revenue goes toward covering labor costs. Second City's profit fluctuates throughout the fiscal year as demands change, so funds must be carefully managed to meet payroll and cover fixed expenses. For example, the touring companies experience a decrease in sales over the summer, when most schools and colleges are not in full operation. Economic climate and real estate costs present consistent challenges. The company aptly chooses to rent its property, which makes a change of locations easier should its real estate needs change.

Through a small door adjacent to Second City's box office, up a staircase adorned with caricatures of SC alumni and tucked into an office overlooking the famous corner of North and Wells, Lou Carbone can be seen smiling as he wrestles with new project proposals. "I have to be the one to pull in the reins," he says. Carbone sifts through an assortment of inspired business ventures and evaluates the financial and social needs of the project. Inspired and innovative ideas are met with practical evaluation, considering all the costs involved. Perhaps the most innovative use of SC's widely used improv technique "Yes, and," comes from Lou Carbone. In a top management meeting a new idea may come up, to which Carbone must find a way to say "Yes, and . . . then we'd be out of business." Luckily, Second City has listened to its CFO, and the organization can continue to be as creative as possible.

## QUESTIONS

1. What are some of the challenges faced by Second City's CFO?
2. If Second City were to create more theaters, would you suggest franchising, partnerships, or another organizational format?
3. Would it be a sound financial decision for Second City to become a public company?
4. What is Lou Carbone's most important function at Second City? Why?

# Part 6: Launching Your Finance Career

Part 6, "Managing Financial Resources," describes the finance function in organizations. Finance deals with planning, obtaining, and managing an organization's funds to accomplish its objectives in the most effective way possible. In Chapter 17, we discussed financial plans, sources of funds, and financial institutions, such as commercial banks. In Chapter 18, we examined the structure of the financial, or securities, markets. Throughout both chapters we described the finance functions of a variety of businesses, governments, and not-for-profit organizations. As Part 6 illustrates, finance is a very diverse profession and encompasses many different occupations. According to the U.S. Department of Labor, over the next decade most finance-related occupations are expected to experience employment growth that is at least as fast as the average for all occupations. However, employment in several finance occupations is expected to grow faster than average.[1] Computers and related technology have affected the finance function significantly in recent years.

In most business schools, finance is either the most popular or second most popular major among undergraduates. Combining finance with accounting is a common double major. Those with degrees in finance also enjoy relatively high starting salaries. A recent survey found that the average starting salary for a person with an undergraduate degree in finance was more than $42,000 per year.[2]

All organizations need to obtain and manage funds, so they employ finance professionals. Financial institutions and other financial services firms employ a large percentage of finance graduates. These businesses provide important finance-related services to businesses, governments, and not-for-profit organizations. Some graduates with finance degrees take jobs with financial services firms such as Bank of America and Merrill Lynch, while others begin their careers working in the finance departments of businesses in other industries such as 3M and Boeing, governments, or not-for-profit organizations. You may begin your career evaluating commercial loan applications for a bank, analyzing capital investments for a business, or helping a not-for-profit organization decide how to invest its endowment. Often finance professionals work as members of a team, advising top management. Some individuals spend their entire careers working in finance-related occupations; others use their finance experience to move into other areas of the firm. Today, the chief financial officer—the senior finance executive—holds one of the most critical jobs in any organization. In addition, the number of CEOs who began their careers in finance is growing.

Finance is a diverse, exciting profession. Here are a few of the specific occupations you might find after earning a degree in finance.

*Financial managers* prepare financial reports, direct investment activities, raise funds, and implement cash management strategies. Computer technology has significantly reduced the time needed to produce financial reports. Many financial managers spend less time preparing reports and more time analyzing financial data. All organizations employ financial managers, although roughly 30 percent of all financial managers work for financial services firms such as commercial banks and insurance companies.[3] Specific responsibilities vary with titles. For instance, credit managers oversee the firm's issuance of credit, establish standards, and monitor the collection of accounts. Cash managers control the flow of cash receipts and disbursements to meet the needs of the organization.

Most *loan officers* work for commercial banks and other financial institutions. They find potential clients and help them apply for loans. Loan officers typically specialize in commercial, consumer, or mortgage loans. In many cases, loan officers act in a sales capacity, contacting individuals and organizations about their need for funds and trying to persuade them to borrow the funds from the loan officer's institution. So loan officers often need marketing as well as finance skills.

*Security analysts* generally work for financial services firms such as Fidelity or Wachovia. Security analysts review economic data, financial statements, and other information to determine the outlook for securities such as common stocks and bonds. They make investment recommendations to individual and institutional investors. Many senior security analysts hold a CFA (Chartered Financial Analyst) designation. Obtaining a CFA requires a specific educational background, several years of related experience, and a passing grade on a comprehensive, three-stage examination.

*Portfolio managers* manage money for an individual or institutional client. Many portfolio managers work for pension funds or mutual funds for which they make investment decisions to benefit the funds' beneficiaries. Portfolio managers generally have extensive experience as financial managers or security analysts, and many are CFAs.

*Personal financial planners* help individuals make decisions in areas such as insurance, investments, and retirement planning. Personal financial planners meet with their clients, assess their needs and goals, and make recommendations. Approximately 40 percent of personal financial planners are self-employed, and many hold CFP (Certified Financial Planner) designations. Like the CFA, obtaining a CFP requires a specific educational background, related experience, and passing a comprehensive examination.

## Career Assessment Exercises in Finance

1. Assume you're interested in pursuing a career as a security analyst. You've heard that the CFA is an important designation and can help enhance your career. Visit the CFA's Web site (http://www.cfainstitute.org) to learn more about the CFA. Specifically, what are the requirements to obtain a CFA and what are the professional benefits of having a CFA?
2. Arrange for an interview with a commercial loan officer at a local bank. Ask the loan officer about his or her educational background, what a typical day is like, and what the loan officer likes and doesn't like about his or her job.
3. Ameriprise Financial offers financial planning services to individuals and organizations. Visit the firm's Web site (http://www.ameriprise.com) and click the "Careers" link. Review the material and write a brief summary of what you learned about being a personal financial planner. Does such a career interest you? Why or why not?