Stock Markets

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WHAT'S COVERED

In this lesson, you will learn how financial forecasting influences a company's strategic planning. Specifically, this lesson will cover:

1. Market Actors

The individual actors in the financial markets can be broken down into three main categories:

- *Investors:* Investors can take on many forms. Essentially, an investor is someone that provides capital with the assumption of a financial return on that capital. There are many different types of investments that can be made. In the sections to come, we will discuss various roles that are necessitated by the practice of investing.
- *Issuers:* An issuer is a legal entity that registers and creates securities so that they can be sold. The issuer can also sell these instruments as well. Common examples of an issuer include investment trusts, foreign governments, and corporations.
- *Intermediaries:* Financial institutions (intermediaries) perform the vital role of bringing together those economic agents with surplus funds who want to lend, with those with a shortage of funds who want to borrow. The classic example of a financial intermediary is a bank that consolidates bank deposits and uses the funds to transform them into bank loans. Other classes of intermediaries include credit unions, financial advisers or brokers, collective investment schemes, and pension funds.

Specifically, market actors include individual retail investors, institutional investors such as mutual funds, banks, insurance companies and hedge funds, and also publicly traded corporations trading in their own shares.

Funds	Description
Pension funds	A pension fund, as the name implies, is any financial plan whose purpose is to provide some type of retirement income. In this type of investment, large institutional investors make up the majority of the market. It is commonly one of the largest categories of investments.
	A mutual fund is a collection of diversified investments that are professionally managed. Typically these investments seek to pool funds from a variety of investors with the purpose to purchase additional securities. While there is no legal definition of mutual fund, the term is most commonly applied only to those collective investment vehicles that are regulated, available to

Mutual funds	the general public, and open-ended in nature. Hedge funds are not considered a type of mutual fund. There are three types of US mutual funds: open-end, unit investment trust, and closed-end. The most common type, the open-end mutual fund, must be willing to buy back its shares from its investors at the end of every business day.
Index fund	An index fund or index tracker is a collective investment scheme (usually a mutual fund or exchange-traded fund) that aims to replicate the movements of an index of a specific financial market, or a set of rules of ownership that are held constant, regardless of market conditions. As of 2007, index funds made up over 11% of equity mutual fund assets in the United States.
Exchange-traded fund (ETF)	An exchange-traded fund, commonly referred to as an ETF, is composed of a mixture of stocks, bonds, and other commodities. The majority of ETFs track an existing stock index such as the S&P 500. These are desirable for many investors, as they offer a low cost, tax-efficient option that is easy to acquire.
Hedge fund	A hedge fund is a fund that can undertake a wider range of investment and trading activities than other funds. It is generally only open to certain types of investors specified by regulators. These investors are typically institutions, such as pension funds, university endowments and foundations, or high-net-worth individuals, who are considered to have the knowledge or resources to understand the nature of the funds. As a class, hedge funds invest in a diverse range of assets, but they most commonly trade liquid securities on public markets. They also employ a wide variety of investment strategies and make use of techniques such as short selling and leverage.

HINT

Exchange-traded funds are open-end funds or unit investment trusts that trade on an exchange. Open-end funds are most common, but exchange-traded funds have been gaining in popularity.

BIG IDEA

The value of a stock is derived from buying and selling decisions of these actors. Some studies have suggested that institutional investors and corporations trading in their own shares generally receive higher risk-adjusted returns than retail investors.

2. NYSE

The New York Stock Exchange, commonly referred to as the NYSE, is a stock exchange, or a secondary market. With primary issuances of securities or financial instruments, or the primary market, investors purchase these securities directly from issuers such as corporations issuing shares in an IPO or private placement, or directly from the federal government in the case of treasuries.

After the initial issuance, investors can purchase from other investors in secondary markets like the NYSE. If an investor wished to buy a stock from Apple, for example, the actual company is not directly involved. Secondary markets can be further subdivided into auction or dealer markets, typified by the mode of transactions. The NYSE is an auction market. Buyers and sellers meet at a physical location (in this case, Wall Street) and announce their bid or ask prices.

At the NYSE, traders gather around a specialist broker, who acts as an auctioneer in an open outcry auction market environment to bring buyers and sellers together and to manage the actual auction. The auction market format aims to bring together the parties with mutually agreeing prices in an efficient manner. The auction process moved toward automation in 1995 through the use of wireless handheld computers (HHC). The system enabled traders to receive and execute orders electronically via wireless transmission.

The NYSE represents the largest stock exchange in the world in terms of companies listed and**market capitalization**. Most of the largest US companies are listed on the NYSE. The NYSE's biggest competitor is NASDAQ; both are major secondary markets vying for large and profitable companies to list on their exchange.

Secondary markets like the NYSE serve a vital function as a setting where companies can raise capital for expansion through selling shares to the investing public. They also gain advertising and a boost in prestige, which likely increases their stock value. To be able to trade a security on the NYSE, it must be listed. To be listed on the New York Stock Exchange, a company must have issued at least a million shares of stock worth $100 million and must have earned more than $10 million over the last three years. They must also disclose certain information to the exchange, providing a measure of transparency that prevents insider manipulation of the stock prices.

TERM TO KNOW

Market Capitalization
The total market value of the equity in a publicly-traded entity.

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3. NASDAQ

The NASDAQ stock market, also known simply as the NASDAQ, is an American stock exchange. "NASDAQ" originally stood for "National Association of Securities Dealers Automated Quotations." It is one of the largest stock exchanges in the world, along with the New York Stock Exchange. The NASDAQ is a dealer-based market in which stock dealers sell directly to investors or firms electronically via phone or Internet. The New York Stock Exchange conducts its trading in person.

NASDAQ was founded in 1971 by the National Association of Securities Dealers (NASD), who divested themselves of it in a series of sales in 2000 and 2001. It is owned and operated by the NASDAQ OMX Group and regulated by the Financial Industry Regulatory Authority (FINRA), the successor to the NASD.

When the NASDAQ stock exchange began trading on February 8, 1971, it was the world's first electronic stock market. At first, it was merely a computer bulletin board system and did not actually connect buyers and sellers. The NASDAQ helped lower the spread (the difference between the bid price and the ask price of the stock), but paradoxically was unpopular among brokerages because they made much of their money on the spread.

Firms including Microsoft began doing business through NASDAQ early in their history, and remained with this exchange as the technology industry boomed. NASDAQ became known for its concentration of tech and high-growth firms, making it the primary tech market and an indicator for industry trends.

A stock index or stock market index is a method of measuring the value of a section of the stock market. It is computed from the prices of selected stocks, which vary depending on the index. Investors and financial managers can use it as a "snapshot" to describe the market conditions, and also as a tool to compare the return on specific investments.

NASDAQ's major indices include:

- NASDAQ-100
- NASDAQ Bank
- NASDAQ Biotechnology Index
- NASDAQ Transportation Index
- NASDAQ Composite

HINT

The NASDAQ Composite is often referred to as the NASDAQ. It is calculated from weighting common stocks and similar securities listed on the NASDAQ stock market. Thus "NASDAQ" can mean two things: either the stock exchange itself, or the index.

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4. Market Reporting

A stock index provides the ability to measure a particular value of a stock or set of stocks. It is assembled by combining prices of existing stocks and determining a weighted average. It offers investors and fund managers the ability to evaluate the market and make comparisons on the current return on certain investments.

An index is a mathematical construct, so it may not be invested indirectly. Many mutual funds and exchange-traded funds attempt to "track" an index. The funds that do may not be judged against those that do not.

Stock market indices may be classed in many ways. A 'world' or 'global' stock market index includes (typically large) companies without regard for where they are domiciled or traded. Two examples are MSCI World and S&P Global 100.

By contrast, a national stock index provides details regarding the stock market performance of an entire nation. This is often used to assess investors' perception of the current state of that nation's economy.

> EXAMPLE The most commonly referenced national indices include the U.S. S&P 500, Japan's Nikkei 225, Britain's FTSE 100, and India's SENSEX.

Stock market indices provide invaluable information for investors and accountants. For instance, the current market price per share, market capitalization, and trading volume are all readily available. With this information, along with a company's consolidated financial statements, the following ratios and calculations can be performed:

- Dividend yield on common stock ratio = Dividend per share of common stock
- Payout ratio on common stock = Dividend per share of common stock
- Earnings per share (EPS)

By comparing the above ratios with those of other companies, investors, accountants, and forecasters can determine the position and health of their respective company's stock.

SUMMARY

In this lesson, you learned about the different individual and institutional **market actors** who engage in the stock market. You also learned about the two major stock exchanges in the United States, the **NYSE** (New York Stock Exchange) and the **NASDAQ**. Finally, you learned that **market reporting** is often done through market indices, which provide investors with information about stock valuation and individual sectors of the stock market.

Best of luck in your learning!

TERMS TO KNOW

Market Capitalization

The total market value of the equity in a publicly-traded entity.