INVESTMENT FUNDS IN CANADA COURSE

Buying and Selling Securities: The Financial System and Its Participants

- The financial system within our country consists of four major segments:
  - **"Segment One", the financial markets**, (e.g., long-term capital market, money market, derivatives market, foreign exchange market, real estate market).
  - **"Segment Two", the financial intermediaries** such as banks and trust companies that act as "the gate keepers" to these markets.
  - **"Segment Three", the suppliers and users of investment capital**, (i.e., supplying to or using from these markets).
  - **"Segment Four", the regulators** who regulate the activities of all participants within the financial system.

Markets

- There are five distinct markets within the financial system; each represents a grouping of securities that have similar financial claims and risk return characteristics.

The Long-Term Capital Market

- This is the market for longer term securities, (i.e. either stocks or bonds with a remaining time to maturity of longer than one year).
- There are two types of stocks: preferred and common. Since stocks do not have a stated maturity date they are considered to be a longer term security.
- Stocks are purchased with the hope of receiving dividends and with the expectation of being able to sell them for a capital gain.
- Dividends are paid on common stocks, depending on the profitability of the company and if the directors vote to pay dividends to the shareholders.
- Holders of common stock have the right to elect directors at the company's annual meeting.

- The directors also vote whether or not to pay dividends on preferred shares; however, preferred dividends are at a rate that is fixed when the shares are originally issued and must be paid before dividends on common shares may be paid.

- Because preferred shareholders have a "preferred" claim on dividends (and assets) before common shareholders, an investment in preferred shares is considered to be less risky than an investment in common shares.

- Preferred shareholders do not have the right to vote at annual meetings (common shareholders do); however, preferred shares may become voting if dividend payments are not made. Dividends not paid are "in arrears" and must be paid before any dividends may be paid to common shareholders.

- There are two types of bonds: government bonds and corporate bonds. All bonds have maturity dates (i.e. usually between 5 and 20 years).

- Trading in the capital markets takes place either on a securities exchange or over the counter.

- There are two organized exchanges that do most of the equity trading:

    - The Toronto Stock Exchange (TSX), for the buying and selling of equities of the senior or larger companies.

    - The TSX Venture Exchange (formerly CDNX), for junior companies (amalgamation of the former VSE, ASE and Winnipeg).

- Commodity trading takes place on the Winnipeg Exchange. The Montreal Exchange trades smaller Quebec-based companies and derivatives.

- The Over The Counter Exchange (OTC) does not have a physical location; trading on the OTC takes place by computer where the bid (the highest price the buyer will pay) and the ask price (the lowest price the seller is willing to take) are posted electronically.

- In Canada, the OTC market is known as the Canadian Dealing Network (CDN). In the U.S., it is called the NASDAQ.

- All bonds are traded OTC; because of this, the OTC market is much larger than all (combined) trading on all exchanges.

The Money Market

- This is the market for short-term securities (i.e. less than one year to maturity). However, Government of Canada bonds with less than three years remaining to maturity are also traded in this market.

- Securities traded in this market are very liquid; this means that they may be bought or sold very quickly and easily (e.g. without discounting the price).

- Securities traded in this market have very low "default risk"; only issuers with very high credit ratings may issue securities in this market.

- T-bills issued by the federal government are the most frequently traded security in this market. They are offered at auction every Tuesday with maturities of 91, 182 or 364 days.

- Other securities traded in this market include Banker's Acceptances, Commercial Paper and provincial T-bills.

- Transactions in this market are also completed by computer (the same as the OTC market).

The Derivatives Market

- A derivative is a type of security; two types of derivatives are options and futures.

    - An Option is a formal contract that applies to a certain quantity of a specific security, at a stipulated price and for a stated period of time.

- There are purchasers of Options and sellers of Options.

- To "Hold" is to own the Option.

- To "Write" is to sell the Option.

- There are two types of Options: a CALL and a PUT.

- The premium is the price the holder pays to purchase the Option (i.e., the price of the Call or the Put). The holder pays the premium; the writer receives it.

- The Underlying Interest is the stock, commodity, index or future contract to which the Option applies.

- The Exercise or Strike Price is the price at which the Underlying Interest may be purchased (for a call) or sold (for a put) if the holder exercises his or her right.

- The Expiration (Expiry) Date is the date the contract/Option expires.
- Options are traded on Options Exchanges.
- The value of a future is dependent on the value of the underlying asset to which it relates (e.g. the value of a futures contract on coffee depends on the intrinsic value of coffee).
- In a futures contract, the investor agrees to either accept delivery or to deliver a specified amount of the commodity, at a pre-arranged price and time.
- Payment for a futures contract only occurs when the delivery is made (i.e. the settlement date).

The Foreign Exchange Market

- This is the market for the buying or selling of foreign currencies, either on the "spot market" for immediate delivery, or the "forward market" for delivery at some future date.
- Buying or selling on the forward market provides a hedge against an unfavourable decline or increase in the value of the Canadian dollar. Mutual Fund Managers use the foreign exchange market to protect the Canadian dollar value of securities that are denominated in foreign currencies and held in a Mutual Fund's portfolio.
- Transactions in this market are completed by computer.

The Real Estate Market

- This is the market for either residential or commercial property, rather than the market where Real Estate Mutual Funds are traded.
- Real Estate Mutual Funds consist of a portfolio of real estate properties and trade as any other Mutual Fund (e.g. bond funds, equity funds, etc.).

Financial Intermediaries

- Suppliers and users of investment capital access the various markets for capital through financial intermediaries.
- There are four major financial intermediaries (the four pillars of the financial system):
  - Banks.

- Trust companies.
- Insurance companies.
- Investment dealers.

- Although there is currently cross-ownership among the four pillars, the intermediaries may be categorized as:

  - Deposit taking (banks and trust companies).

  - Non-deposit taking (insurance companies and investment dealers).

- A life insurance company pools the premiums that it receives from its thousands of policy holders and invests these premiums in the capital markets.

- As a financial intermediary, investment dealers have two roles: the underwriting of new securities and providing brokerage services.

The Underwriting Services Of An Investment Dealer

- An Investment Dealer (can be an individual or an investment firm) acts as a principal in a transaction; this means that they own and hold an inventory of the security that they bought from an investor or an issuer.

- Dealers are often referred to as "underwriters"; this is because they "underwrite" new issues of securities.

- To "underwrite" an issue simply means that the Investment Dealer purchases the issue from the issuing company, on a given date and at a given price and, therefore, takes the responsibility (and risk) for selling the securities.

- When the dealer purchases 100% of the issue, it is called a "bought deal" ("the Investment Dealer bought the deal"). The dealer pays the issuing company the agreed upon price, regardless of the success of the sale of the stock to the public. The dealer then either sells the stock privately to another investor or to the public, either through an exchange or OTC.

- The dealer also maintains ***"an after market"****;* this means that they keep enough of the issue in their inventory so that buy and sell orders in the stock can be readily executed.

- The "spread" or profit that the dealer makes is the price at which he sells the stock to the public minus the price that he paid to the company that was issuing the stock.

- If the risk of not being able to sell a new issue of stock is high, the dealer may sell the issue on a ***"best efforts"*** basis. This means that the dealer does not guarantee that the securities will be sold at the issuing price nor that the total number of shares that are being issued will be sold. Rather, the dealer commits to sell as many shares as possible at the best selling price that they can get (hence, "best efforts").

- When issues are sold ***"best efforts"*** the dealer typically receives a commission for his role.

- A primary distribution is the original sale of any issue of a company's securities (i.e. the first time the security has been made available to investors). This may also be known as an "initial public offering" or a "primary market" offering.

- The re-distribution of a large block of a security issue, at some time after it has been originally sold, is called a secondary distribution. Often an Investment Dealer or group of dealers may agree to purchase a secondary distribution and then re-sell the securities to the public. If the securities are re-sold above the purchase price, they make a profit on the sale; if re-sold below the purchase price, they incur a loss.

- If the company is already trading shares in the capital markets, then the price of the new issue of shares is based on the price of the shares that are already trading; otherwise, the Investment Dealer recommends the price at which the shares of the new issue should be sold.

- An underwriting syndicate is made up of a group of many Investment Dealers. These dealers pool their financial resources and their sales forces in order to underwrite and distribute a large issue of securities.

- Each member of the syndicate assumes a liability for their allotted portion of the issue and each is responsible for selling their allotment.

- Stock brokers act as agents for the buyers and sellers (i.e. the same as a real estate agent); this means that they buy or sell on behalf of the buyer or seller.

- A broker does not own the security that he is buying or selling and he charges a commission for buying or selling the security. Most stock brokers also provide their clients with investment advice and recommendations.

- An investment firm may therefore, be both a dealer and a broker, depending on whether the firm is buying to or selling from its inventory of securities or buying or selling on behalf of a client and charging a commission.