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ECO 2200: Module 2

Dorina Tila

CUNY Kingsborough Community College

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Financial Markets & Institutions



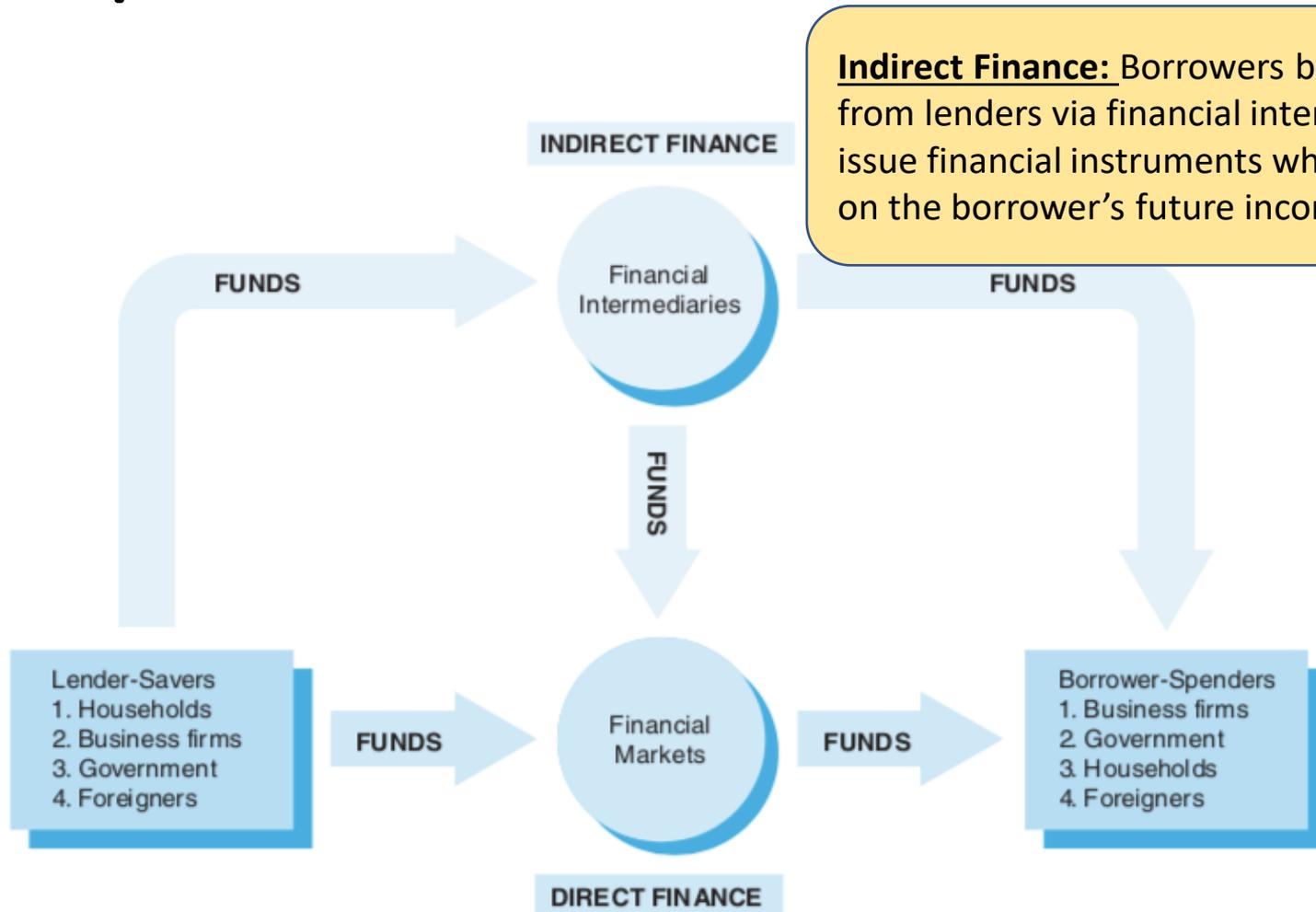
Module 2: Outline

- I. Capital Allocation Process
- II. Financial Markets
- III. Type of Financial Markets & Importance
- IV. Market Efficiency Theory

I. Capital Allocation Process

- Recall Supply & Demand
 - Goods and Services flow from those who produce them to the ones who demand them
- Capital Market
 - Capital flows from those who supply capital to those who demand it.
 - Suppliers of Capital
 - Agents (individual or institutions) with “excess funds.”
 - Lenders of money
 - Savers of money
 - Demanders of Capital
 - individuals and institutions who need to raise funds to finance their investment opportunities. These groups are willing to pay a rate of return on the capital they borrow.

I. Capital Allocation Process



Indirect Finance: Borrowers borrow indirectly from lenders via financial intermediaries that issue financial instruments which are claims on the borrower's future income or assets.

Direct Finance: Borrowers borrow directly from lenders in financial markets by selling financial instruments (securities) which are claims on the borrower's future income or assets.

I. Time to Think

- Why do we trade?
 - Opportunity cost
 - Mimi is better to singing
 - Gimi is better at math
 - Mimi teaches him singing and Gimi teaches her math
 - Example of other trades between people, countries, etc.

• Why do we “trade” money? How do we save?

- Save
 - Wallet
 - Deposit
 - _____
- Invest
 - Start a new business
 - Buy an investment house, collection, art, etc.

Allow others to invest your money and receive a higher interest than bank deposit.

Buying securities (bonds or stocks) – what

- savings/ investing
- lending/ borrowing

Saving

Lending

II. Markets

- Markets

- Venue where goods and services are exchanged.
- Voluntary exchange of goods between buyers and sellers
- Supply & Demand

- Financial Markets

- A market where instead of trading goods and services, you trade “**money.**”



Financial Instruments – Securities (Bonds / Stocks)

Pieces of paper that give the owner a claim on the issuer’s assets or future payment.

- Simple contracts
- Negotiable (can be resold, traded)

II. Markets

- Markets

- Venue where goods and services are exchanged.
- Voluntary exchange of goods between buyers and sellers
- Supply & Demand

- Financial Markets

- A market where instead of trading goods and services, you trade “**financial instruments.**”
- It is a place where individuals and organizations wanting to borrow funds are brought together with those having a surplus of funds.

II. Importance of Financial Markets

- Importance of markets for goods & services
 - Allows efficient allocation of resources
 - The buyer who values it the most receives the good
 - The seller who has the lowest cost supplies the good
 - Voluntary exchange:
 - makes buyers and sellers better off
- Importance of capital market
 - Capital flows from savers to investors.
 - Savers lend money (postpone their consumption/use of money) and receive a return (usually known as interest rate)
 - Examples: You (household), lending institutions
 - Users (demanders) of capital are able to receive and use funds to finance their investment projects. They are willing to pay a rate of return (e.g., interest) to borrow and use someone else's capital.
 - Examples: Firms, Government...

II. Time to Think

Who performs better

Economies with efficient capital markets

OR

Economies with poorly-functioning markets

Efficient markets promote economic growth

III. Type of Financial Markets

Type of Financial Markets

**Physical Assets
v.
Financial Assets**

**Spots
v.
Futures**

**Money
v.
Capital**

**Primary
v.
Secondary**

**Public
v.
Private**

**Dealer
v.
Auction**

III. Dealer v. Auction markets

Participants trade through a dealer rather than directly with each other.

	NASDAQ	NYSE
Founded	1971	1792
Market Type	Dealer's market	Auction market
Market Capitalization*	\$11 trillion	\$21.3 trillion
Location of Transactions	New York City, NY and Mawah, NJ	New York City, NY
Volatility	Stocks often more volatile	Stocks often less volatile
Traffic Control	Market maker	Specialist
Interesting fact	Recognized as the first electronic stock market	

Participants transact between each other on an auction basis

Public v. Private

Primary v. Secondary Markets

- A publicly owned corporation is a company whose shares are held by the investing public, which may include other corporations as well as institutional investors.
- Secondary Market
 - You purchase 10 Starbucks (SBUX) stocks from your uncle.
 - You purchase 2 Tesla (TSLA) through dealer in NASDAQ
- Primary Market
 - New stock issuance: Example, Twitter issues 1,000 shares of new stock and sells them to the public through an investment banker.
 - Initial Public Offering

Examples of a stock market transaction

- Apple decides to issue additional stock with the assistance of its investment banker.
- An investor purchases some of the newly issued shares.
- Is this a primary market transaction or a secondary market transaction?
 - **Since new shares of stock are being issued, this is a primary market transaction.**
- What if instead an investor buys existing shares of Apple stock in the open market. Is this a primary or secondary market transaction?
 - **Since no new shares are created, this is a secondary market transaction.**

I. IPO

- An **initial public offering** (IPO) occurs when a company issues stock in the public market for the first time.
- Advantages
 - “Going public” enables a company’s owners to raise capital from a wide variety of outside investors.
- Disadvantages
 - Public companies are subject to additional regulations and reporting requirements.
- Other
 - Once issued, the stock trades in the secondary market

Investment Banks

- JPMorgan Chase
- Goldman Sachs
- Morgan Stanley
- Citigroup
- Bank of America
- Credit Suisse
- Deutsche Bank

Financial Intermediaries

- Exchange traded funds (ETFs)
 - Like a stock, it is traded in exchange markets, but it is a basket of securities rather than a single security.
- Pension funds
- Mutual funds
- Index funds
- Hedge funds
- Private equity funds
- https://www.ici.org/files/faqs_hedge

Efficient Market Theory

You hear in the news that Pfizer vaccine for Covid-19 received FDA approval. If the market is highly efficient, can you expect to take advantage of this information by purchasing the stock?

No. If the market is efficient, this information is already included into the company's stock price.

Conclusion: Securities Efficient Markets mean that equilibrium is reached and securities are priced "fairly" (close to their intrinsic value).

We CANNOT "beat the market"

Suggested Reading

- A Random Walk Down Wall Street: The Time-Tested Strategy for Successful Investing, by Burton Gordon Malkiel. See the book review for details.
- <https://www.publishersweekly.com/978-0-393-05782-9>

“A blindfolded monkey throwing darts at a newspaper's financial pages could select a portfolio that would do just as well as one carefully selected by experts.”

- Efficient market theory: all publicly available information about a stock's value is already reflected in its share price. Hence, you can't predict them at all.

Time to think

***What about publicly unknown information – inside information?
Can you see why insider trading is not allowed?***

The 15 Largest Exchange Traded Funds (February 12, 2021)

<https://etfdb.com/compare/market-cap/>

Symbol	Name	AUM	Avg Volume
SPY	SPDR S&P 500 ETF	\$324,689,000.00	63,911,684
IVV	iShares Core S&P 500 ETF	\$240,572,000.00	4,061,117
VTI	Vanguard Total Stock Market ETF	\$211,167,000.00	4,130,083
VOO	Vanguard S&P 500 ETF	\$191,977,000.00	2,983,105
QQQ	Invesco QQQ	\$155,661,000.00	28,530,643
VEA	Vanguard FTSE Developed Markets ETF	\$90,158,800.00	8,674,635
AGG	iShares Core U.S. Aggregate Bond ETF	\$86,178,100.00	5,703,219
IEFA	iShares Core MSCI EAFE ETF	\$85,061,400.00	8,461,604
VWO	Vanguard FTSE Emerging Markets ETF	\$77,408,000.00	10,360,213
IEMG	iShares Core MSCI Emerging Markets ETF	\$77,291,100.00	11,979,848
BND	Vanguard Total Bond Market ETF	\$70,419,800.00	5,125,495
VUG	Vanguard Growth ETF	\$69,497,900.00	800,787
GLD	SPDR Gold Trust	\$68,417,400.00	9,253,833
IWF	iShares Russell 1000 Growth ETF	\$64,646,200.00	1,436,078
VTV	Vanguard Value ETF	\$63,757,000.00	2,423,178

Example: SPY Holding

SPY Stock Profile & Price

Dividend & Valuation

Expenses Ratio & Fees

Holdings

Fund Flows

Charts

ESG

Performance

Technicals

Realtime Rating

Fact Sheet

Read Next

More at ETFTrends.com

Disclosures

Top 15 Holdings

Symbol	Holding	% Assets ▼
AAPL	Apple Inc.	6.55%
MSFT	Microsoft Corporation	5.56%
AMZN	Amazon.com, Inc.	4.25%
FB	Facebook, Inc. Class A	1.98%
GOOGL	Alphabet Inc. Class A	1.90%
TSLA	Tesla Inc	1.85%
GOOG	Alphabet Inc. Class C	1.84%
BRK.B	Berkshire Hathaway Inc. Class B	1.41%
JNJ	Johnson & Johnson	1.33%
JPM	JPMorgan Chase & Co.	1.29%
NVDA	NVIDIA Corporation	1.11%
V	Visa Inc. Class A	1.06%
DIS	Walt Disney Company	1.04%
PYPL	PayPal Holdings Inc	1.00%
UNH	UnitedHealth Group Incorporated	0.96%

Stock Quote for Twitter

Twitter, Inc. (TWTR)

NYSE - Nasdaq Real Time Price. Currency in USD

[★ Add to watchlist](#)

[👤 Visitors trend](#) 2W ↓ 10W ↑ 9M ↑

73.67 -3.96 (-5.10%) **73.51** -0.15 (-0.21%)

At close: 4:02PM EST

After hours: 5:52PM EST

[Summary](#) [Company Outlook](#) [Chart](#) [Conversations](#) [Statistics](#) [Historical Data](#) [Profile](#) [Financials](#) [Analysis](#) [Options](#)

Previous Close	77.63	Market Cap	58.8B
Open	76.61	Beta (5Y Monthly)	0.75
Bid	73.51 x 1200	PE Ratio (TTM)	N/A
Ask	73.92 x 1400	EPS (TTM)	-1.44
Day's Range	73.56 - 77.09	Earnings Date	Apr 29, 2021
52 Week Range	20.00 - 80.75	Forward Dividend & Yield	N/A (N/A)
Volume	18,817,110	Ex-Dividend Date	N/A
Avg. Volume	19,858,831	1y Target Est	68.41

Fair Value ⓘ [🔒](#)

XX.XX

Overvalued



[View details](#)

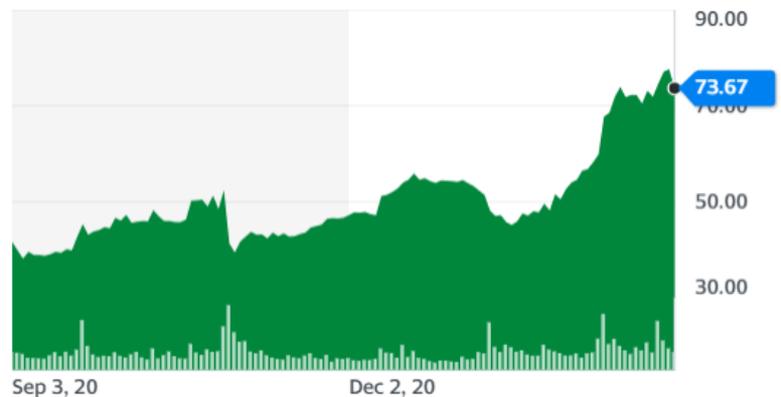
Related Research ⓘ [🔒](#)

[📄](#) Technical Assessment: Bullish in ...

[📄](#) Analyst Report: Twitter, Inc.

[View more](#)

1D 5D 1M 6M YTD 1Y 5Y Max [📊](#) [↗️ Full screen](#)



Trade prices are not sourced from all markets

Chart Events ⓘ [🔒](#)

Bullish pattern detected

Intermediate-term KST

[View all chart patterns](#)

Performance Outlook

Short Term 2W - 6W	Mid Term 6W - 9M	Long Term 9M+
➡️	⬆️	⬆️

Stock Quote for Bitcoin

Bitcoin USD (BTC-USD)

CCC - CoinMarketCap. Currency in USD

☆ Add to watchlist

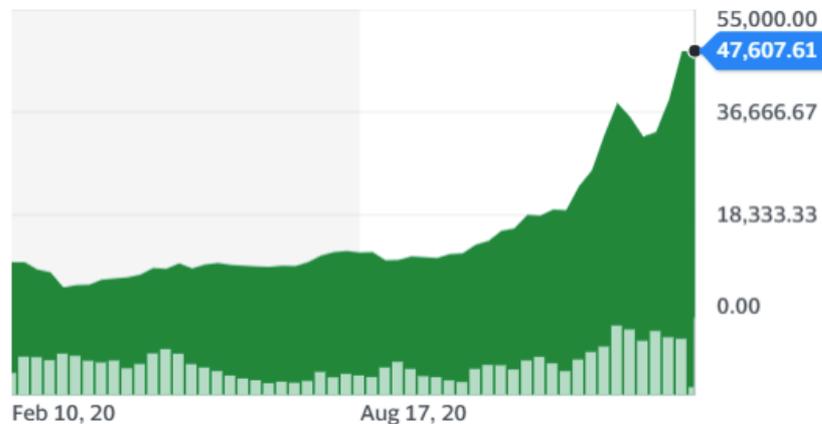
47,607.613 +298.3945 (+0.6307%)

As of 6:37AM GMT. Market open.

[Summary](#) [Chart](#) [Conversations](#) [Historical Data](#) [Profile](#)

Previous Close	47,907.13	Market Cap	886.515B
Open	47,907.13	Circulating Supply	N/A
Day's Range	47,344.062 - 47,980.184	Max Supply	N/A
52 Week Range	4,106.98 - 47,980.184	Volume	72,723,636,224
Start Date	2013-04-28	Volume (24hr)	72.69B
Algorithm	N/A	Volume (24hr) All Currencies	72.69B

1D 5D 1M 6M YTD 1Y 5Y Max  [Full screen](#)



Data provided by  CoinMarketCap

<https://finance.yahoo.com/quote/BTC-USD?p=BTC-USD>

Bitcoin

Summary **Chart** Conversations Historical Data Profile



<https://finance.yahoo.com/quote/BTC-USD?p=BTC-USD>

Other

Implications of Market Efficiency

- It is costly and/or risky for traders to take advantage of mispriced assets.
- Cognitive biases cause investors to make systematic mistakes that lead to inefficiencies. This is an area of research known as “behavioral finance.”
Behavioral finance borrows insights from psychology to better understand how irrational behavior can be sustained over time. Some examples include:
 - Evaluating risks differently in up and down markets.
 - Investors become "anchored" to certain viewpoints, and fail to optimally respond to new information that conflicts with their existing views.

Index Funds

- An index fund is a mutual fund or exchange-traded fund designed to follow certain preset rules so that the fund can track a specified basket of underlying investments.
- A hedge fund is a pooled investment fund that trades in relatively liquid assets and is able to make extensive use of more complex trading, portfolio-construction and risk management techniques in an attempt to improve performance, such as short selling, leverage, and derivatives.
- Lower Fees Motivate Investors to Move Toward Index Funds
- Hedge Funds vs. Mutual Funds
 - https://www.ici.org/files/faqs_hedge

I. IPO

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III. Capital Formation

