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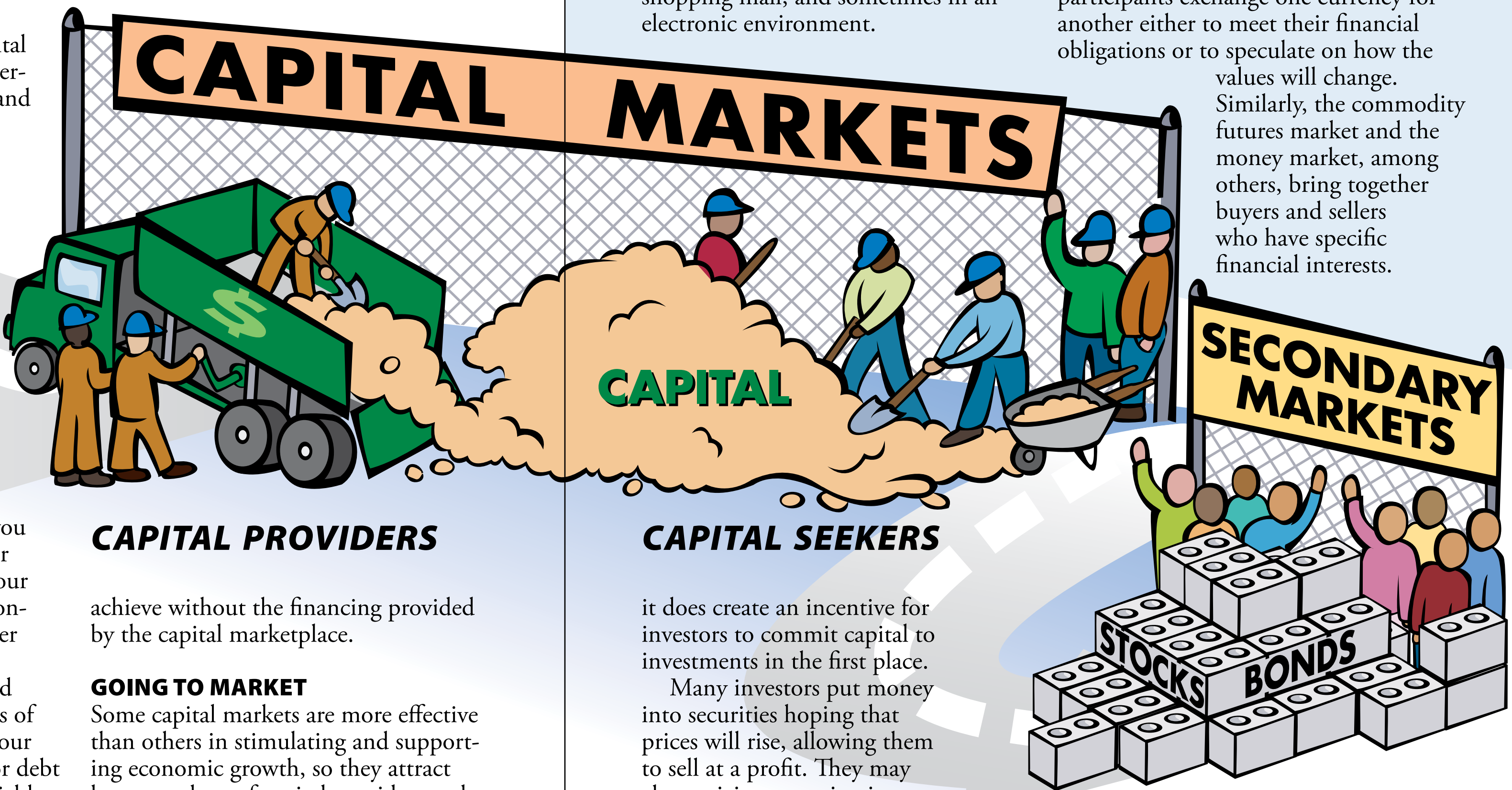
Understanding Capital Markets

Buyers and sellers interacting in a common space use wealth to create more wealth.

Essentially, capital means financial assets, usually in liquid form. Capital markets exist when two groups interact: those who are seeking capital and those who have capital to provide. Capital, in this context, means money or financial assets that can be converted to money.

The capital seekers are the businesses and governments that want to finance their projects and enterprises by borrowing or selling equity stakes. The capital providers are the people and institutions who are willing to lend or buy, expecting to realize a profit.



A CAPITAL IDEA

Investment capital is money that you put to work. You might invest your capital in business enterprises of your own to realize a profit or fund a nonprofit enterprise. But there's another way to achieve a similar goal.

By participating in the stock and bond markets, which are the pillars of the capital markets, you commit your capital by investing in the equity or debt of issuers that you believe have a viable plan for using that capital. Because so many investors participate in the capital markets, they make it possible for entities to raise substantial sums—enough to carry out much larger projects than might otherwise be possible.

The amounts they raise allow businesses to innovate and expand, create new products, reach new customers, improve processes, and explore new ideas. They allow governments to carry out projects that serve the public—building roads and bridges, funding education, and financing scientific research, for example.

All of these things would be more difficult—perhaps even impossible—to achieve without the financing provided by the capital marketplace.

A DIFFERENT PERSPECTIVE

There are times when individual investors play a different role in the capital markets and become seekers, rather than suppliers, of capital. The best example is a mortgage.

HOUSE FOR SALE

GOING TO MARKET

Some capital markets are more effective than others in stimulating and supporting economic growth, so they attract large numbers of capital providers and capital seekers eager to compete for the best deals. Among the factors contributing to a market's appeal are its efficiency, its liquidity, and investor confidence that trades will be cleared and settled quickly and accurately. In this context, efficiency means that market participants have ready and inexpensive access to all the information affecting market prices. Liquidity means that trading is active and capital flows are steady.

PRIMARY AND SECONDARY

There are actually two levels of the capital markets in which investors participate: the **primary markets** and the **secondary markets**.

Businesses and governments raise capital in primary markets, selling stocks and bonds to investors and collecting the cash. In secondary markets, investors buy and sell the stocks and bonds among themselves—or more precisely, through intermediaries. While the money raised in secondary sales doesn't go to the stock or bond issuers, it does create an incentive for investors to commit capital to investments in the first place.

Many investors put money into securities hoping that prices will rise, allowing them to sell at a profit. They may also anticipate earning interest or dividends. In addition, in an active secondary market, they can liquidate publicly traded securities easily, though not always at a profit.

Some capital seekers may offer less liquid, or sometimes **illiquid**, nontraded or private placement investments. Qualified investors may be willing to accept the greater risks these alternatives pose for access to their potentially higher returns.

OTHER PRODUCTS, OTHER MARKETS

The capital markets aren't the only markets around. To have a market, all you need are buyers and sellers—sometimes interacting in a physical space, such as a farmer's market or a shopping mall, and sometimes in an electronic environment.

There are a variety of financial markets in the economy, trading a range of financial instruments. For example, currency markets set the values of world currencies relative to each other. In this case, market participants exchange one currency for another either to meet their financial obligations or to speculate on how the values will change. Similarly, the commodity futures market and the money market, among others, bring together buyers and sellers who have specific financial interests.

THE PRICE IS RIGHT

One of the most notable features of both the primary and secondary financial markets is that prices are set according to the forces of supply and demand through the trading decisions of buyers and sellers. When buyers dominate the markets, prices rise. When sellers dominate, prices drop.

You've undoubtedly experienced the dynamics of market pricing if you've ever haggled with a vendor. If the two of you settle on a price at which you're willing to buy and the vendor is willing to sell, you've set a market price for the item. But if someone comes along who is willing to pay more than you are, then the vendor may sell at the higher price.

If there are a limited number of items and many buyers are interested, the price goes up as the buyers outbid each other. But if more sellers arrive, offering the same item and increasing the supply, the price goes down. So the monetary value of a market item is what someone is willing to pay for it at a given time.

In fact, price often serves as an economic thermometer, measuring supply and demand. One of the problems in **command economies**, in which prices are set by a central government authority instead of the marketplace, is that, without changing prices to clue them in, producers don't know when to adjust supplies to meet demands, resulting in chronic overstocks and shortages.

Market Regulation

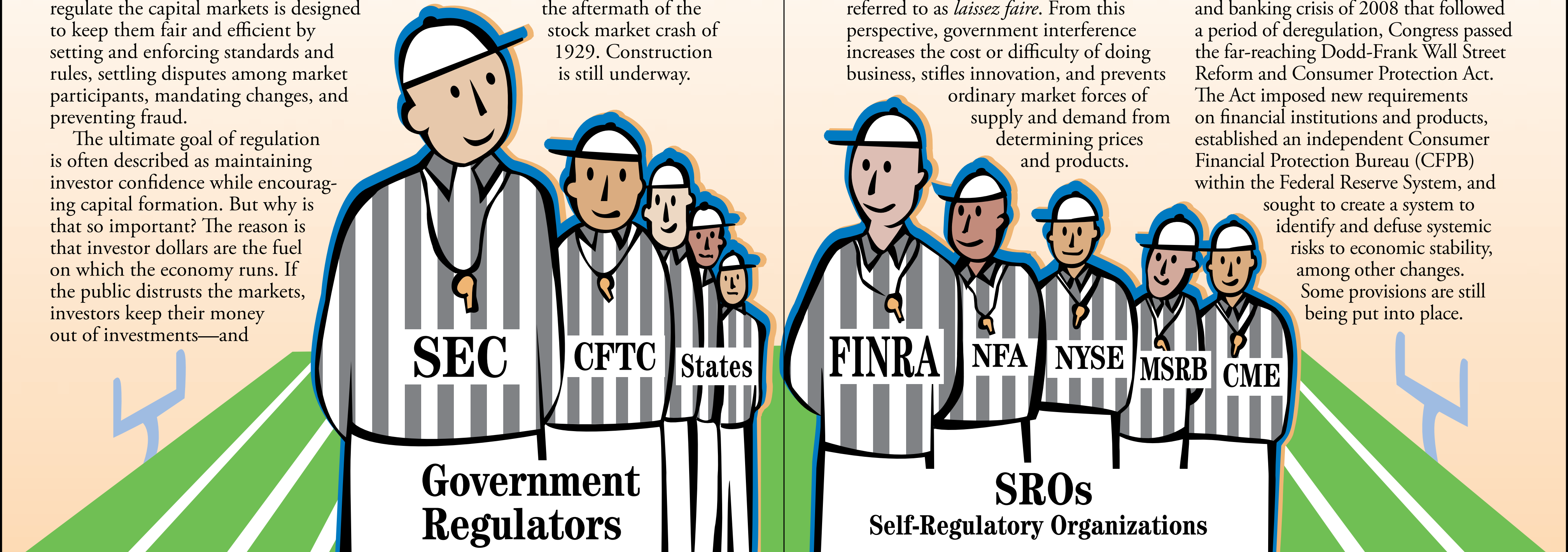
Rules and referees help keep the investment markets fair.

In a perfect world, every player in the capital markets would always deal honestly and fairly with every other player. The field would be perfectly level, giving everyone the same access to information and opportunities.

But in the absence of perfection, there is regulation. The system that has developed in the United States to regulate the capital markets is designed to keep them fair and efficient by setting and enforcing standards and rules, settling disputes among market participants, mandating changes, and preventing fraud.

The ultimate goal of regulation is often described as maintaining investor confidence while encouraging capital formation. But why is that so important? The reason is that investor dollars are the fuel on which the economy runs. If the public distrusts the markets, investors keep their money out of investments—and out of US businesses. But when people trust the markets, they're willing to put money into investments like stocks and bonds, giving companies money to innovate and expand.

Although individual states began regulating securities trading in the early 20th century, the foundations of federal regulation were laid in the aftermath of the stock market crash of 1929. Construction is still underway.



MEET THE REFEREES

In the current structure, no single regulator oversees all the interlocking elements of the capital markets. Instead, there are a number of regulators with different but sometimes overlapping jurisdictions. And some segments of the markets are only lightly regulated.

There are two types of market regulators: **government regulators**, at the federal and state levels, and **self-regulatory organizations (SROs)**, through which industry players govern themselves.

At the federal level, the Securities and Exchange Commission (SEC) oversees the nation's securities industry, enforcing laws passed by Congress as well as its own rules. The SEC also supervises the SROs and has the right to demand changes in their rules.

The Commodities Futures Trading Commission (CFTC) regulates futures markets, as well as certain derivatives and derivative clearing organizations. Its mission is to foster an open, competitive, and financially sound trading environment, and protect investors against abusive practices.

Each state also has its own securities regulator to supervise business within its borders and regulate activities that fall outside the SEC's or CFTC's scope. These regulators belong to the North American Securities Administrators Association (NASAA).

FINRA, the Financial Industry Regulatory Authority, the largest industry SRO, oversees brokers, brokerage firms, and investment companies.

The National Futures Association (NFA) is the self-regulator for the derivatives industry, including exchange-traded futures contracts as well as retail trading in foreign currencies and swaps trading.

TOO MUCH OR NOT ENOUGH?

Regulation is a dynamic, evolving system of guidelines and controls, adapting to changes in the market environment and to events—such as scandals and failures—that reveal vulnerabilities.

When things go wrong, however, not everyone believes that more regulation is necessarily the best solution. Although few people argue for zero government oversight, what's often debated is exactly how much oversight is the right amount.

Opponents of regulation argue that the markets work best when government lets them alone—what is sometimes referred to as *laissez faire*. From this perspective, government interference increases the cost or difficulty of doing business, stifles innovation, and prevents ordinary market forces of supply and demand from determining prices and products.

But proponents of government regulation point to the industry's failure to prevent past problems as the reason to appoint and strengthen third-party watchdogs, especially since the securities markets are so central to the health of the US economy. They argue that outside policing is necessary to protect investors, whose interests may conflict with industry interests. They also maintain that government intervention is needed to calm public concerns, especially in cases where the public doesn't believe the industry can or will resolve its own problems.

For example, in response to the credit and banking crisis of 2008 that followed a period of deregulation, Congress passed the far-reaching Dodd-Frank Wall Street Reform and Consumer Protection Act. The Act imposed new requirements on financial institutions and products, established an independent Consumer Financial Protection Bureau (CFPB) within the Federal Reserve System, and sought to create a system to identify and defuse systemic risks to economic stability, among other changes. Some provisions are still being put into place.

SHARED RESPONSIBILITY

In 1996, the National Securities Markets Improvements Act gave federal regulators sole authority to review and register what the act described as *covered securities*. This category includes all securities listed on a national securities exchange, mutual funds and other securities issued by a registered investment company, securities sold to accredited purchasers, and securities exempt from registration under Rule 506 of Regulation D of the Securities Act of 1933. Accredited purchasers are those whose net worth or annual income meets the minimum levels the government sets.

States, on the other hand, can require the registration of securities that are not defined as covered, all broker-dealers doing business in the state, and registered investment advisers (RIAs) who manage less than $100 million. States also regulate the insurance companies that operate within their borders and the products those companies issue, with the exception of products that are defined as securities, such as variable annuities.

Both federal and state regulators can investigate and prosecute fraud, deceit, and any illegal actions by any issuer, broker-dealer, or adviser, though in the case of a state the action must have occurred within its borders.

ACTING ON REGULATION

The landmark federal legislation that governs financial markets—the Securities Act of 1933, the Securities Exchange Act of 1934, the Commodities Exchange Act of 1936, the Investment Company Act of 1940, and the Investment Advisers Act of 1940—are amended and expanded regularly, often in response to financial market innovations or in reaction to market abuses.

International Investing

In the new economy, investors looking for ways to diversify their portfolios have a world of opportunity.

To diversify a portfolio that's concentrated in US securities, you may want to add the equity and debt of companies that are registered in other countries. Global investing can be an effective way to help offset investment risk, in large part because while world markets are interconnected, they're not always positively correlated.

In fact, the cyclical ups and downs in a country's or region's securities markets tend to be more sensitive to the local environment, including interest rates and employment levels, than to what's happening globally—though there are exceptions.

THERE ARE RISKS

Investing globally means taking on many of the same risks you face when you invest at home. Prices may fall rather than rise. Dividends may be cut. Interest earnings may decline. But it may also mean taking on some risks that you hadn't anticipated.

- Some markets may be less liquid than others, so it may be hard to buy or sell at the price you want.
- Some less regulated markets may provide fewer investor protections.
- It may be harder to find reliable information about the potential risks an investment poses.
- Political and economic instability in a country or region can affect investment values.
- Changes is currency values can have major consequences.

...AND ALSO REWARDS

Investment return in an overseas market, as in a domestic one, depends on growth in the value of the investments you make, your dividend or interest income, or a combination of growth and income. But there's another factor in play when you invest away from home: **floating currency values**. A significant gain or loss in the value of the dollar in relation to the value of the currency in which an investment is priced can have a major impact on your profit or loss if you sell.

Unlike a volatile stock, whose price can change quickly, shifts in currency rates tend to occur gradually. While you can't predict when your financial interests will align with what's happening in the stock market, in most cases you should have time to buy or sell while currency values are still working to your advantage.

THE CURRENCY RISK—AND ITS REWARD

Whether you invest directly or indirectly in securities priced in currencies other than the US dollar, it helps to understand how changing currency values affect the cost of investments you make. Generally speaking, buying securities when the dollar is strong means investing costs you less. The same is true when you pay for any other product, such as a sweater or a train ticket, denominated in a currency that is weaker than the dollar.

Conversely, selling a stock when the dollar is strong reduces your return. That's because the weaker currency in which you invest translates into fewer dollars.

	Cost of stock in euros	Exchange rate €/$	Cost of stock in dollars	
BUY Euro and dollar at par	€50	1:1	$50	
BUY Euro gains against dollar	€50	1.1	$55	Euro is 1.10 to dollar
BUY Euro gains more against dollar	€50	1.2	$60	Euro is 1.20 to dollar
BUY Euro weaker than dollar	€50	0.9	$45	Euro is .90 to dollar
BUY Euro loses value against dollar	€50	0.8	$40	Euro is .80 to dollar

WAYS TO INVEST

There are many ways to add international exposure to your investment portfolio.

Perhaps the easiest is to buy the securities of multinational companies that operate in more than one country, realize a large percentage of their profits outside the United States, but are listed on a US exchange.

The stocks of many large non-US companies are listed on US exchanges though their primary operations are elsewhere.

You can buy mutual funds and exchange traded funds (ETFs) that invest in different asset classes and subclasses on a worldwide, regional, or individual country basis.

Large US brokerage firms registered with the SEC operate internationally and can buy and sell investments anywhere they have a presence.

To convert the price per share from one currency to another, you calculate the exchange rate by dividing one currency by the other. If you are using US dollars to buy stocks priced in euros, you divide euros by dollars.

In the example shown in the chart, if the euro is 1:10 to the dollar, the exchange rate is 1.1 (€1.10 ÷ $1 = 1.1). If the euro is 0.90 to the dollar, the exchange rate is 0.9 (€0.90 ÷ $1 = 0.9).

To find the price (C) in the currency you're using, you multiply the security's price (A) times the exchange rate (B).

A x B = C
€50 x 1.1 = $55

GAIN OR LOSS

If you buy a stock priced in euros when the euro and the dollar are at par, the amount you pay is the same. In the example here, it's $50 or €50 a share.

If the value of the euro is stronger than the value of the dollar, it costs you more per share to buy than it would cost an investor using euros. When the euro is 1.10 to the dollar, a €50 stock would cost a US investor $55. If the euro gains value, the per-share cost in dollars increases.

But if the dollar is stronger than the euro, the cost per share for an investor using dollars is less than the price in euros. When the euro is 0.90 to the dollar, a €50 stock would cost a US investor $45. If the dollar gains more, the cost per share drops still further.

If the underlying stock increases or decreases in value, the gain or loss for an investor using dollars will reflect, but not necessarily be identical to, the gain or loss for an investor using euros. The greatest gain in dollars occurs if the share price increases and the dollar loses value.

* These hypothetical examples, which don't include the impact of commissions or taxes, do not reflect the performance of any specific investments.