Financial Markets

Chapter Two

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Introduction to stocks and equities

- **Stocks** are a very important asset class for most individual investors as they are relatively cheap, don't require large initial investments, and are freely accessible.
- **Stocks** are a relatively riskier type of investment meaning that they offer a much higher rate of return than most other investment classes open to retail investors.

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Understanding the Stock Market

The stock market allows buyers and sellers of securities to meet, interact, and transact. The markets allow for price discovery for shares of corporations and serve as a barometer for the overall economy. Buyers and sellers are assured of a fair price, high liquidity, and transparency as market participants compete in the open market.

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Stock Trading

Stock trading broadly refers to any buying and selling of stock, but is colloquially used to refer to more shorter-term investments made by very active investors. Stock trading is a difficult and risky enterprise, but with education, you can work to lower risks and increase your likelihood of success.

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What Is the Stock Market?

- The term stock market refers to several exchanges in which shares of publicly held companies are bought and sold. Such financial activities are conducted through formal exchanges and via over-the-counter (OTC) marketplaces that operate under a defined set of regulations.

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What Is Over-the-Counter (OTC)?

- **Over-the-counter (OTC)** is the process of trading securities via a broker-dealer network as opposed to on a centralized exchange like the New York Stock Exchange.
- Over-the-counter trading can involve stocks, bonds, and derivatives, which are financial contracts that derive their value from an underlying asset such as a commodity.

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How Does the Stock Market Work?

- The stock market or share market is a virtual marketplace where companies sell their equity to investors to collect funds while investors purchase shares to grow their wealth.
- Trades on this market are carried out by stock exchanges, which serve as an interface between the different investors.
- Some of the assets traded in the stock market include shares, bonds, derivatives, ETFs, forex, etc. Investors including both individuals and institutions trade among themselves under an open pricing mechanism that is derived from demand and supply in the market.

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Stock exchanges and trading mechanisms

There are a number of different stock markets. The two leaders are the New York Stock Exchange (NYSE) and the Nasdaq stock market. Stocks are traded using a variety of market procedures, but there are just two basic types: **(1) physical location exchanges, which include the NYSE, the American Stock Exchange (AMEX), and several regional stock exchanges**, and **(2) electronic dealer-based markets, which include the Nasdaq, the less formal over-the-counter market, and the recently developed electronic communications networks (ECNs).**

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How to Invest in the Stock Market?

Investing in the stock market is easier with digital options; however, you must prepare yourself to understand market behaviour to get good returns.

Step 1: The first step to invest in the stock market is to open a **DEMAT** account and register with a depository. Dematerialised Account (DEMAT) is a virtual account that stores all your financial assets with the depositories in a dematerialised form. It is compulsory to have a Demat account to invest in stocks.

Step 2: Research is very important for investing in market assets. You should do your research about companies, and stock market practices and create an investment goal before you start investing in shares.

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Steps of investing in stock market

- **Step 3:** You need to create a budget for your investment plan and keep aside a percentage of your savings to invest in stocks.
- **Step 4:** You need to select stocks that you want to invest in and watch their performance before you invest.
- **Step 5:** Invest in your desired stocks when the price point is right for you.
- **Step 6:** Monitor the graphs and performance of all stocks you invest in.

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Stock valuation methods

Stock valuation is an important tool that can help you make informed decisions about trading using a share market app. It is a technique that determines the value of a company's stock by using standard formulas. It values the fair market value of a financial instrument at a particular time. The reason for stock valuation is to predict the future price or potential market prices for the investors to time their sales or purchase of investments.

The stock valuation fundamentals aim to value the Intrinsic value of the stock that shows the profitability of the business and its future market value.

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Bond Markets and Fixed Income Securities

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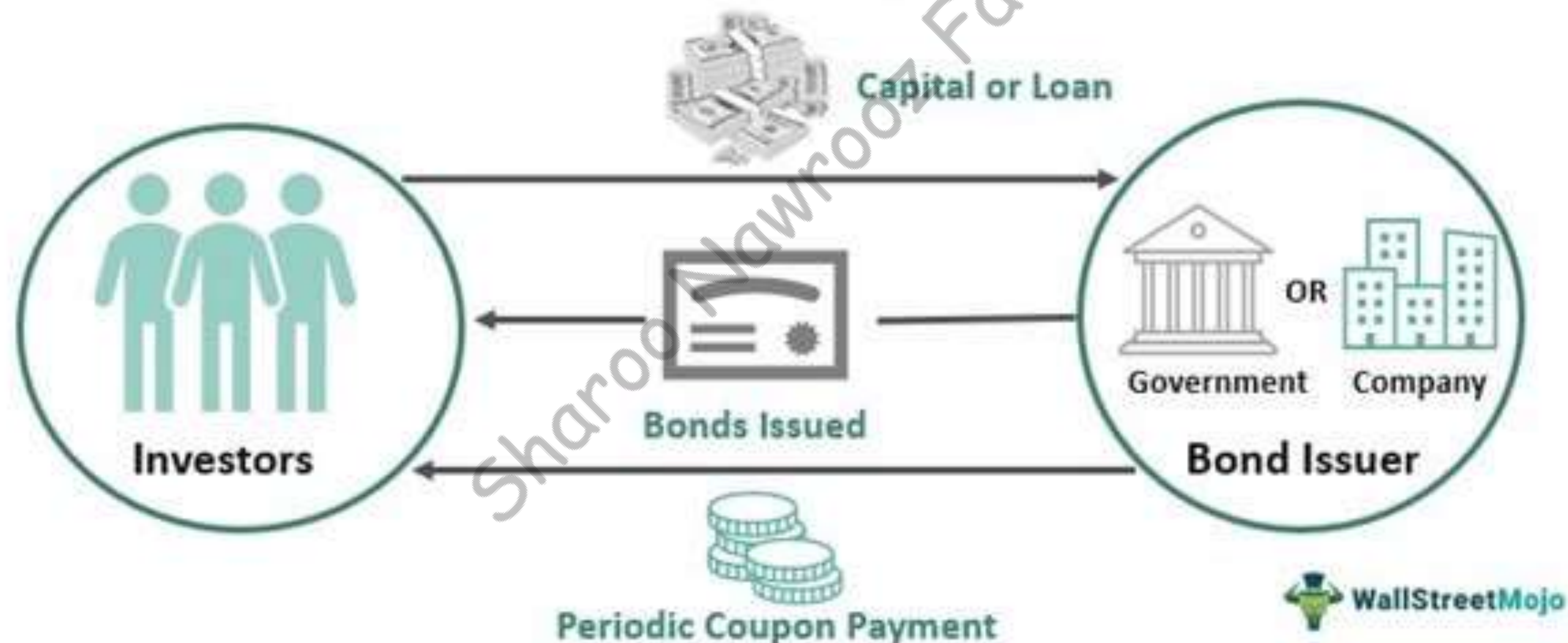
Bonds

Bonds are the debt instruments issued by government or a company to borrow funds from the individual or corporate investors for a specific duration. In return, the issuer offers periodic interest (coupon) to the holders.



Types of bonds

There are three main types of bonds which are:

1. Government
2. Corporate
3. Municipal

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Government Bond

Government Bond

- Governments take loans from the public by issuing bonds;
- In return, the investors earn interest income;
- Upon maturity, investors also earn back the principal.

Public

Government

Money

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WallStreetMojo

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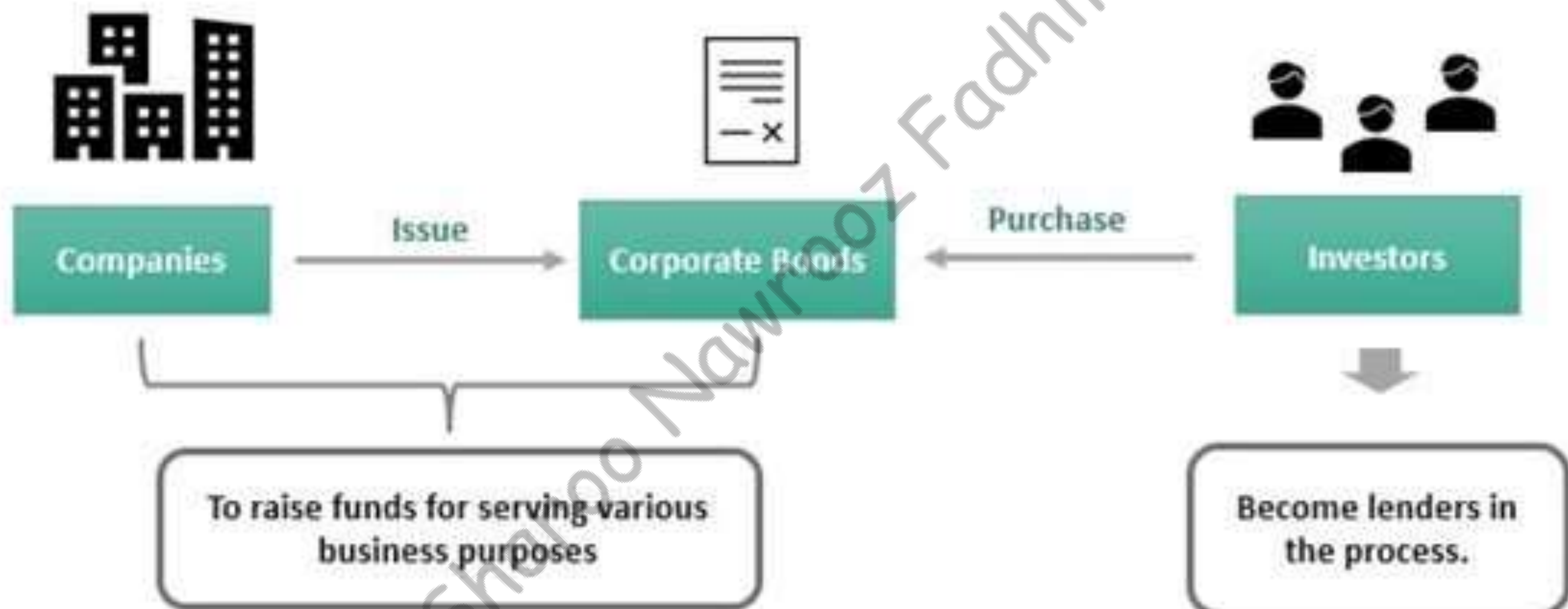
What Are Corporate Bonds?



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MUNICIPAL BONDS

LOANS TO GOVERNMENT ENTITIES TO FUND PUBLIC PROJECTS

WHO ISSUES

MAIN BENEFIT

NO FEDERAL TAXES ON INTEREST YOU EARN

FUN FACT

GOLDEN GATE BRIDGE
BUILT WITH MUNI BONDS!

Napkin Finance

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Bond pricing, yields, and risk assessment

1. **Bond Pricing**:
   - **Face Value (Par Value)**: This is the nominal value of the bond, which is typically $1,000 per bond.
   - **Coupon Rate**: The coupon rate is the fixed annual interest rate paid by the issuer on the bond's face value.
   - **Coupon Payment**: This is the annual interest payment the bondholder receives, calculated as (Face Value) x (Coupon Rate).
   - **Maturity Date**: The date on which the bond will be repaid at its face value.
   - **Market Price**: The current price at which the bond is trading in the secondary market.

Bond prices can vary from their face value due to changes in interest rates and credit risk. When interest rates rise, bond prices tend to fall, and vice versa.

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Bond pricing, yields, and risk assessment

2. Yields:

- **Yield to Maturity (YTM)**: YTM is the total return an investor can expect to receive if the bond is held until maturity. It takes into account the bond's current market price, par value, coupon interest payments, and the time left until maturity.
- **Current Yield**: This is the bond's annual coupon payment divided by its current market price.
- **Yield to Call (YTC)**: If a bond is callable (can be redeemed by the issuer before maturity), YTC calculates the yield an investor can expect if the issuer calls the bond on the next call date.
- **Yield to Worst (YTW)**: YTW considers the lowest potential yield an investor might receive from a bond, considering all possible scenarios like call options or sinking funds.

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Bond pricing, yields, and risk assessment

3. **Risk Assessment**:

- **Credit Risk**: This is the risk that the issuer of the bond may default on its interest or principal payments. Credit rating agencies like Standard & Poor's (S&P), Moody's, and Fitch assess and assign ratings to bonds based on their creditworthiness.
- **Interest Rate Risk**: This risk arises from changes in market interest rates. If interest rates rise, the value of existing bonds with lower coupon rates decreases.
- **Reinvestment Risk**: Reinvestment risk occurs when an investor receives coupon payments and has to reinvest them at lower interest rates than the original bond's coupon rate.
- **Liquidity Risk**: Some bonds may be less liquid, meaning they are harder to buy or sell in the secondary market without affecting the price.

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Thank you

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