
Chapter 2: CONCEPT AND FUNCTIONS OF A FINANCIAL MARKET.

Concept

Financial markets are defined by having transparent pricing, basic regulations on trading, cost and fees, and **market forces determining the prices of securities that trade.**

They are not something which comes naturally, they need to be regulated. But in the end is any marketplace where buyers and sellers participate in the trade of assets such as equities, bonds currencies and derivatives.

Functions:

1. Mobilization of Savings:

Financial market provide utility and rentability to the savings of people. They do so by putting together **investors** (those who have the savings) and **instruments** (places where money can be invested)

2. Facilitates Price Discovery:

Markets, if they are efficient, we can trust the prices, as these prices will be representing the **real value of the instruments or assets you invest in**. It will represent the relationship between demand and supply.

When more people invest, is easier to find a common price for an specific asset or instrument.

3. Provides Liquidity to Financial Assets

This is the **clue of becoming more than a simple market**. It also allows the companies to resell the assets to gain on liquidity.

Basically, it provides tools to **convert their investment into money whenever they so desire**.

4. Reduces the Cost of Transactions

All the intermediaries are in one place, so no extra cost on them needs to be done. As well as the information given which is the same for everyone.

Classification of the Financial Markets.

A. Primary Market:

Is the moment when the investor and the seller get together, the first person who owns that bond or asset that is used to finance the business. Here appears the initial public offering (IPO) so when it **sells stocks to the public for the first time**.

B. Secondary market

When the original company gets out of the equation and the trading is done between traders, the different investors.

Stock Exchange.

Main features

- **Stock exchanges are perfect markets as it meets the basic requirements:**
 - ✓ Nobody can influence prices
 - ✓ Any participant has equal access to relevant information
 - ✓ Every investor knows the best price you can buy or sell.
- **It is transparent market:**
 - ✓ The new information is reflected in the price changes.

Main Functions

1. Investors

- Channeling savings
- Provide liquidity to securities trading
- Share the management of the company by voting

2. Company

- Financing
- Valuation of the company

Spanish stock exchange structure

We need an institution, in Spain is the “*Comisión Nacional del Mercado de Valores*”.

Their functions are:

- **Transparency:** Ensure it in the market.
- **Enforcing the rules:** For all the participants.
- **Conditions:** Secure the law and have the conditions.
- **Control, monitoring, suspension and exclusion:** So nothing strange happens.
- **Diffuse market information:** So is efficient for all.

Institutions regulating the market

For each market of exchange in Spain (Barcelona, Madrid, Bilbao and Valencia) there is a “*Sociedad Rectora*” which regulates and do similar functions as the commission explained before, **they do not regulate, but they do proposals to the commission which will decide.**

Their functions:

- **Manage:** The operations of its own market.
- **Propose:** Suspensions of trading
- **Information:** It provides information
- **Advise locally:** They know each activity in their market.

Joke

- ✓ Why don't scientists trust atoms?
- ✓ Because they make up everything

"Sociedad de Bolsas"

These are institutions whose shareholders are the four governing bodies of the stock exchanges equally. Their functions are:

- **Recommend who enters the exchange:** But the commission on top decides.
- **Owner of the IBEX-35:** All the information provided will be done by this institution. They do the calculation, management, diffusion and review the information.
- **Management of the electronic trading system:** You know what it is.

The Securities Clearing and Settlement Service (SCLV)

They compensate, settle and records values of stock. Their functions are:

- Manage the accounting records of the stock.
- Design transformation of all securities in book-entry form.
- Clear and settle transactions executed through stock exchanges daily.

Market Intermediaries

Markets members are the only ones authorized for securities trading. There are types:

1. Members of the market:

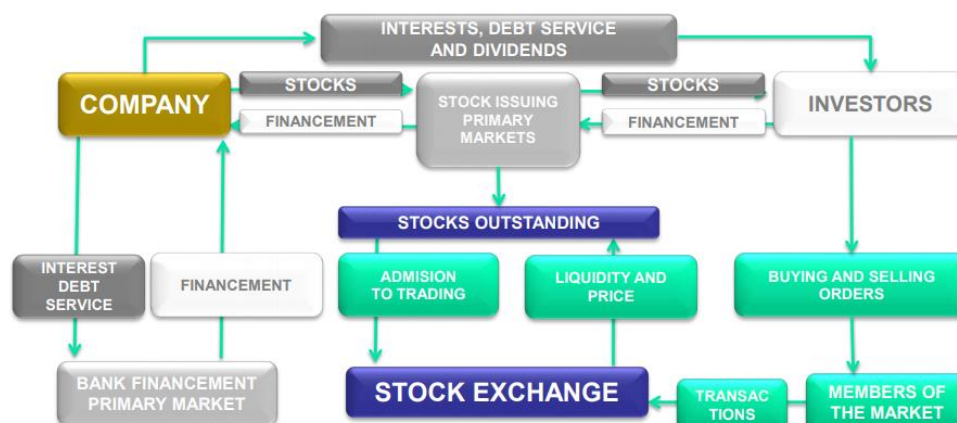
- 1.1. Security dealers
- 1.2. Brokers
- 1.3. Financial entities

2. Common functions:

- 2.1. Reception, transmission and execution of orders on behalf of a third parties
- 2.2. Management of investment portfolios
- 2.3. Being depository and manage securities by book entries
- 2.4. Investment advice
- 2.5. Act as registered traders for foreign exchange transactions related to transactions in foreign markets

3. Additionally, Securities dealers and Financial entities may:

- 3.1. Trade securities on their own
- 3.2. Ensure underwriting of stock emissions
- 3.3. Grant loans to operate in securities

Summary

Market Indexes

Definition

A Market Index is an indicator of the **movement in the price of major stocks** listed on the market and is **representative of the evolution of the market or a segment of it.**

Main Functions

- **Indicator:** Development of the market.
- **Reference or benchmark:** To manage personal or business assets. Compare basically.
- **Underlying for certain derivative financial instruments:** Like Futures or Options.

Types

1) According to the time:

- Fixed based Index:** The value in any specific time period is based on the value in the initial time period and this base remains unchanged throughout the index.
- Chain based Index:** A value in any specific time period is based on the value of the same entity in the preceding period. It can be compared between sequential time periods.

2) In accordance with the stocks they incorporate:

- General indices:** Represent a mean of the variation of all companies listed on the securities market.
- Sectoral or partial indices:** Those that incorporate the stocks of a particular industry.

3) Considering the time taken for its construction:

- Short indices:** These indexes whose duration is less than a year.
- Long indices:** Constructed continuously in time.
 - Standard indexes reflect the effects of the capital increase.
 - Total indexes reflect the effects of the payment of dividends and capital increases. The dividends are reinvested.

Interesting video

<https://youtu.be/kZZj831VbEM> - Sorry, but let's laugh a little



← TERM 1

TERM 3 →