



Asset Classes and Financial Instruments

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I. The money market

II. The bond market

III. The equity market



I. The money market

The money market is a subsector of the fixed-income market. It consists of very shortterm debt securities that usually are highly marketable. Many of these securities trade in large denominations, and so are out of the reach of individual investors. Money market funds, however, are easily accessible to small investors. These mutual funds pool the resources of many investors and purchase a wide variety of money market securities on their behalf.



1. Treasury Bills U.S.

Treasury bills (T-bills, or just bills, for short) are the most marketable of all money market instruments. T-bills represent the simplest form of borrowing: The government raises money by selling bills to the public. Investors buy the bills at a discount from the stated maturity value. At the bill's maturity, the holder receives from the government a payment equal to the face value of the bill. The difference between the purchase price and ultimate maturity value constitutes the investor's earnings.



2. Certificates of Deposit

A certificate of deposit, or CD, is a time deposit with a bank. Time deposits may not be withdrawn on demand. The bank pays interest and principal to the depositor only at the end of the fixed term of the CD.

3. Commercial Paper

Large, well-known companies often issue their own short-term unsecured debt notes rather than borrow directly from banks. These notes are called commercial paper. Commercial paper maturities range up to 270 days. The yield on the CP depends on the time to maturity and the credit rating.



4. Bankers' Acceptances

A banker's acceptance starts as an order to a bank by a bank's customer to pay a sum of money at a future date, typically within 6 months. Acceptances sell at a discount from the face value of the payment order, just as T-bills sell at a discount from par value.

5. Eurodollars

Eurodollars are dollar-denominated deposits at foreign banks or foreign branches of American banks. Most Eurodollar deposits are for large sums, and most are time deposits of less than 6 months' maturity.



6. Repos and Reverses

Dealers in government securities use repurchase agreements, also called “repos” or “RPs,” as a form of short-term, usually overnight, borrowing. The dealer sells government securities to an investor on an overnight basis, with an agreement to buy back those securities the next day at a slightly higher price. The increase in the price is the overnight interest. The dealer thus takes out a 1-day loan from the investor, and the securities serve as collateral.



7. Federal Funds

Just as most of us maintain deposits at banks, banks maintain deposits of their own at a Federal Reserve bank. Each member bank of the Federal Reserve System, or “the Fed,” is required to maintain a minimum balance in a reserve account with the Fed. The required balance depends on the total deposits of the bank’s customers. Funds in the bank’s reserve account are called federal funds, or fed funds. At any time, some banks have more funds than required at the Fed. Other banks, primarily big banks in New York and other financial centers, tend to have a shortage of federal funds. In the federal funds market, banks with excess funds lend to those with a shortage. These loans, which are usually overnight transactions, are arranged at a rate of interest called the federal funds rate.

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Treasury bills—short-term obligations issued by the U.S. government.

Federal funds—short-term funds transferred between financial institutions usually for no more than one day.

Repurchase agreements—agreements involving the sale of securities by one party to another with a promise to repurchase the securities at a specified date and price.

Commercial paper—short-term unsecured promissory notes issued by a company to raise short-term cash.

Negotiable certificates of deposit—bank-issued time deposit that specifies an interest rate and maturity date and is negotiable (saleable on a secondary market).

Banker's acceptances—time drafts payable to a seller of goods, with payment guaranteed by a bank.



II. The Bond Market

The bond market is composed of longer term borrowing or debt instruments than those that trade in the money market. This market includes Treasury notes and bonds, corporate bonds, municipal bonds, mortgage securities, and federal agency debt. These instruments are sometimes said to comprise the fixed-income capital market, because most of them promise either a fixed stream of income or a stream of income that is determined according to a specific formula.



1. Treasury Notes and Bonds

The U.S. government borrows funds in large part by selling Treasury notes and Treasury bonds . T-notes are issued with maturities ranging up to 10 years, while bonds are issued with maturities ranging from 10 to 30 years. Both notes and bonds make semiannual interest payments called coupon payments. At maturity, the investor get an amount equal to the face value of note or bond.

2. International Bonds

Many firms borrow abroad and many investors buy bonds from foreign issuers. A Eurobond is a bond denominated in a currency other than that of the country in which it is issued. For example, a dollar-denominated bond sold in Britain would be called a Eurodollar bond. Similarly, investors might speak of Euroyen bonds, yen-denominated bonds sold outside Japan. In contrast to bonds that are issued in foreign currencies, many firms issue bonds in foreign countries but in the currency of the investor.



3. Municipal Bonds

Municipal bonds are issued by state and local governments. They are similar to Treasury and corporate bonds except that their interest income is exempt from federal income taxation.

4. Corporate Bonds:

Corporate bonds are the means by which private firms borrow money directly from the public. These bonds are similar in structure to Treasury issues—they typically pay semiannual coupons over their lives and return the face value to the bondholder at maturity. They differ most importantly from Treasury bonds in degree of risk.

5. Mortgages and Mortgage-Backed Securities

Because of the explosion in mortgage-backed securities, almost anyone can invest in a portfolio of mortgage loans, and these securities have become a major component of the fixed-income market. A mortgage-backed security is either an ownership claim in a pool of mortgages or an obligation that is secured by such a pool.



III. The Equity Market

- **Common stocks (shares)**
- **Preferred stocks (shares)**



1. Common Stock as Ownership Shares

Common stocks, also known as equity securities or equities, represent ownership shares in a corporation. Each share of common stock entitles its owner to one vote on any matters of corporate governance that are put to a vote at the corporation's annual meeting and to a share in the financial benefits of ownership. The corporation is controlled by a board of directors elected by the shareholders. The board, which meets only a few times each year, selects managers who actually run the corporation on a day-to-day basis. Managers have the authority to make most business decisions without the board's specific approval. The board's mandate is to oversee the management to ensure that it acts in the best interests of shareholders.



Characteristics of Common Stock

The two most important characteristics of common stock as an investment are its residual claim and limited liability features. Residual claim means that stockholders are the last in line of all those who have a claim on the assets and income of the corporation. In a liquidation of the firm's assets the shareholders have a claim to what is left after all other claimants such as the tax authorities, employees, suppliers, bondholders, and other creditors have been paid. For a firm not in liquidation, shareholders have claim to the part of operating income left over after interest and taxes have been paid. Management can either pay this residual as cash dividends to shareholders or reinvest it in the business to increase the value of the shares. Limited liability means that the most shareholders can lose in the event of failure of the corporation is their original investment. Unlike owners of unincorporated businesses, whose creditors can lay claim to the personal assets of the owner (house, car, furniture), corporate shareholders may at worst have worthless stock. They are not personally liable for the firm's obligations.



2. Preferred Stock

- Preferred stock has features similar to both equity and debt. Like a bond, it promises to pay to its holder a fixed amount of income each year. In this sense preferred stock is similar to an infinite-maturity bond, that is, a perpetuity. It also resembles a bond in that it does not convey voting power regarding the management of the firm.
- Preferred stock is an equity investment, however. The firm retains discretion to make the dividend payments to the preferred stockholders; it has no contractual obligation to pay those dividends. Instead, preferred dividends are usually cumulative; that is, unpaid dividends cumulate and must be paid in full before any dividends may be paid to holders of common stock. In contrast, the firm does have a contractual obligation to make the interest payments on the debt. Failure to make these payments sets off corporate bankruptcy proceedings.
- Preferred stock also differs from bonds in terms of its tax treatment for the firm. Because preferred stock payments are treated as dividends rather than interest, they are not tax-deductible expenses for the firm.



3. Depository Receipts

American Depositary Receipts, or ADRs, are certificates traded in U.S. markets that represent ownership in shares of a foreign company. Each ADR may correspond to ownership of a fraction of a foreign share, one share, or several shares of the foreign corporation. ADRs were created to make it easier for foreign firms to satisfy U.S. security registration requirements. They are the most common way for U.S. investors to invest in and trade the shares of foreign corporations.

References:

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2. Saunders, A & Cornett, M. M. (2012). Financial Markets and Institutions: 5 edition, McGraw-Hill Irwin.