

Pricing in the Financial Markets

Plan

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Introduction

Keynes acknowledged; stock markets offer one singular advantage: they are the best way to bring people with money to invest together with people who can put that investment to productive use.

I. What Is Bid and Ask?

Bid and ask (also known as "bid and offer") is a two-way price quotation representing the highest price a buyer will pay for a security and the lowest price a seller will take for it. The difference between bid and ask prices, or the spread, is a key indicator of the liquidity of the asset. In general, the smaller the spread, the better the liquidity.

The bid price—the price a buyer is willing to pay—is the first price in the pair.

The ask price—or the price a seller is willing to accept—is the second.

BID

Price at which the
buyer is willing to pay

← **SPREAD** →

Difference between the
Bid and **Ask** price

ASK

Price at which the
seller is willing to sell

II. The Different Kinds of Value in Finance

Value Type	Stocks	Bonds
Book Value	The value of a company's assets minus its liabilities. It represents the theoretical value of a share if the company were liquidated.	Not applicable to bonds.
Face Value/Par Value/Nominal Value	The given value of a share, typically with little relevance in modern markets. Historically, it represented the initial price of the stock.	The amount the bond issuer promises to repay the bondholder at maturity.

Intrinsic Value

An estimate of a stock's true value based on its underlying fundamentals, such as earnings, assets, and growth potential.

The present value of future cash flows (coupon payments and principal) from the bond, discounted at a rate reflecting the bond's risk and interest rates.

Market Value

The present price at which a share is traded on the stock exchange.

The price at which a bond is being traded. This can fluctuate based on interest rates, credit risk, and market conditions.

Net Asset Value (NAV)

The value of a company's total assets minus its liabilities, often used for mutual funds and exchange-traded funds (ETFs). Represents the per-share value of the fund's holdings.

Not applicable to individual bonds, but can be relevant for bond funds.

Premium/Discount Value

Not directly applicable to stocks, but refers to a stock trading above (premium) or below (discount) its intrinsic value.

Refers to a bond trading above (premium) or below (discount) its face value.

Present Value

The value of a future stream of cash flows (dividends for stocks) discounted at a rate reflecting the risk and time value of money.

The present value of future cash flows (coupon payments and principal) from the bond, discounted at a rate reflecting the bond's risk and prevailing market interest rates.

Principal Value

Not applicable to stocks.

The amount of money originally invested in the bond or the amount outstanding at a particular time.

III. Trading shares:

A share trade begins when an investor contacts a stockbrokerage firm to place an order to buy or sell stock. There are many different types of orders, which give the broker varying amounts of discretion.

1. A market order or an at best instruction, which instructs the broker to buy or sell the desired number of shares at the best price presently available in the market. is type of order guarantees that the order will be executed, but does not guarantee the execution price. A market order generally will execute at or near the current bid (for a sell order) or ask (for a buy order) price. However, it is important for investors to remember that the last-traded price is not necessarily the price at which a market order will be executed.

2. A limit order requires the broker to complete the transaction only at the specified price or better, with the risk that the order will never be executed because the specified price is not reached. A buy limit order can only be executed at the limit price or lower, and a sell limit order can only be executed at the limit price or higher. Example: An investor wants to purchase shares of ABC stock for no more than \$10. The investor could submit a limit order for this amount and this order will only execute if the price of ABC stock is \$10 or lower.



3. A stop order, also referred to as a stop-loss order instructs the broker to buy or sell the shares once a specified price is reached, although the actual transaction price can be above or below the specified level.

4. A buy stop order is entered at a stop price above the current market price. Investors generally use a buy stop order to limit a loss or protect a profit on a stock that they have sold short. A sell stop order is entered at a stop price below the current market price. Investors generally use a sell stop order to limit a loss or protect a profit on a stock they own.

Investors may also qualify their orders in various ways. **A day order** is good on only one particular day and is cancelled if it is not executed. **A good-till-cancelled order**, also known as an open order, remains active until it is either filled or cancelled. **A fill-or-kill order** requires the brokerage firm to buy or sell all the shares immediately or else to cancel the entire order, and **an immediate or cancel order**, known as an execute or eliminate order in the UK, tells the broker to buy or sell as many shares as possible immediately and to cancel the remainder of the order.

After verifying the investor's order, the brokerage firm passes it to its brokers at the appropriate stock exchange. In some cases, a given equity may trade on several exchanges. A broker working in its client's best interest will undertake the trade wherever it can obtain the best price.

IV. How stock exchanges work

There are vast differences in the ways that stock exchanges function.

The traditional model for a stock exchange is known as **an auction market**, in which shares for purchase or sale are offered to brokers on a trading floor. An auction market uses specialised brokers, known as specialists or marketmakers, who are required to ensure orderly trading in the particular shares for which they are responsible. A brokerage firm sends each buy or sell order to its floor broker, who communicates it to the specialist.

Each specialist maintains a book listing the bid price for each pending offer to buy the share and the asked price or offer price for each offer to sell. Floor brokers of other firms may accept the highest bid price or the lowest offer price to complete the trade. If there is a lack of bids or an imbalance between buy and sell orders that keeps a particular share from trading, the specialists must buy or sell shares in order to keep the market functioning smoothly.

This sort of auction market used to be the norm. But in the past few years computerisation has permitted the development of electronic auction markets as well. All major stock exchanges now operate primarily through electronic auctions, with the sole exception of the New York Stock Exchange.



Electronic auction markets function in one of three different ways. Some offer a continuous or order-driven auction, in which the highest prices being bid and lowest prices being offered are continuously updated by computers, which automatically match buy and sell orders. Call auction markets execute trades at predetermined times rather than continuously, to assure adequate liquidity in particular shares. Dealer markets, such as America's nasdaq, have substantial human involvement. On nasdaq, marketmakers post the prices at which they are prepared to buy and sell shares on brokers' screens, and brokers choose among the competing marketmakers to handle the desired trade. Other exchanges use hybrid systems, with the way in which a transaction is handled depending upon the size and liquidity of the particular stock.

V. Institutional trading

Individual investors' stock markets trades almost always involve a small number of shares of a single security. Institutional investors, however, have different requirements, and their trades may be handled differently.

1. Block trades involve offers to buy or sell large amounts of stock, usually 10,000 shares or more. On a floor-based exchange, block trades are often handled off the floor by brokers who must assemble enough buyers or sellers to complete the transaction, but who must act quickly and discretely to prevent word of the impending deal from moving prices in the market. Block trades are more difficult to complete on screen-based exchanges, because posting an investor's intentions on members' screens would immediately change the price. In such a case, the trade is typically broken into smaller transactions conducted over a period of time, and the broker seeks to disguise the magnitude of the intended purchase or sale.

2. Basket trades: allow investors to trade shares in several different companies as part of a single transaction. This type of trading, which is confined to a few big exchanges, is popular among investors that are attempting to mimic a particular index, and who therefore want to buy or sell some shares of each stock in the index at the same time.

3. Program trades are initiated by computers which have been programmed to identify share prices that are out of line with 162 GUIDE TO FINANCIAL MARKETS the prices of futures or options on those same shares. The program trader may then buy shares and sell options, or vice versa, in some combination in order to profit from what may be a tiny anomaly in prices. Program trades accounted for more than half of all trading on the New York Stock Exchange in 2005.

4. Short sales are transactions in which an investor (a short seller) borrows shares for a specified period and then sells them at the current market price, in the expectation that the price will be lower when it must buy shares to repay the lender. The short seller loses money if the share price does not fall as expected. In some countries, information about short positions must be reported and published. This can be important information for investors, because the existence of large short positions in a particular share means that short sellers will be needing to buy those shares in the market so they can repay the brokers from whom they have borrowed.





Thank you

Dr. Lamia OUDAI FIA

Study.finance21@gmail.com