CHAPTER TWO: ASSET CLASSES AND FINANCIAL INSTRUMENTS

CHAPTER OVERVIEW

This chapter describes the financial instruments traded in the primary and secondary markets. The broad market place is divided into Money Markets and Capital Markets. The chapter begins with Money Market characteristics and examples of Money Markets instruments. It then moves to longer-term Capital Markets. The four subdivisions of Capital Markets are discussed: Longer-term bonds, equity, futures and options.

LEARNING OBJECTIVES

Upon completion of this chapter the student should have a thorough understanding of the various financial instruments available to the potential investor. The student should have an insight as to the interpretation, composition, and calculation process involved in the various market indexes presented on the evening news. The student should have some understanding of the basics of options and futures.

PRESENTATION OF MATERIAL

2.1 The Money Market

The major money market instruments are presented here. In describing the individual instruments, it is helpful for the students' understanding of the market to integrate discussion of institutional characteristics of the instruments. For example, commercial banks are the major participants for many of the instruments. If students have adequate backgrounds from prerequisite classes, discussion of characteristics of marketability, liquidity, and default risk may be appropriate. Discussion of the concepts should be delayed to later chapters if students' backgrounds are not adequate.

2.2 The Bond Market

Debt instruments are issued by both public and private entities. The Treasury and Agency issues have the direct or implied guaranty of the federal government. Since state and local entities issue municipal bonds, performance on these bonds does not have the same degree of safety. Since the interest income on municipal bonds is not subject to federal taxes, the taxable equivalent yield is used for comparison.

Key characteristics of the Treasury Notes and Bonds are described here. Debt of federal agencies has become a very significant component of the debt market. Major issuers of agency debt are described. Municipal bonds issued by state and local governments can be general obligation bonds or revenue bonds. General obligation bonds are considered less risky since they are backed by the full taxing power of the government entity. Revenue from specific projects is dedicated to revenue bonds. Interest income on most municipal bonds is not subject to taxes. To compare the yield on municipals with other taxable securities the taxable equivalent yield is used.

Bonds issued by private corporations are subject to greater default risk than bonds issued by government entities. Corporate bonds often contain imbedded options such as the call feature which allows an existing corporation to repurchase the bond from issuers when rates have fallen. Bonds backed by mortgages have grown to compose a major element of the bond market. Such bonds can represent proportional shares of a pool of mortgages or specific portion of a pool of mortgages. The mortgage backed market has grown rapidly in recent years.

2.3. Equity Securities

Two key points are relevant in the discussion of equity instruments. First, it should be emphasized that with the issue of common stock owners having a residual claim to the earnings of the firm. The priorities of debt holders and preferred stockholders are contrasted with common shareholders. Second, the differences in preferred stock and common stock dividends should be emphasized. Preferred shareholders have a priority claim to income in the form of dividends. Preferred stockholders are limited to the fixed dividend while common shareholders do not have limits. The partial tax exemption on dividends of one corporation being received by another corporation is important in discussing preferred stock. A brief discussion on depository receipts can introduce international investing to the students.

2.4 Stock and Bond Market Indexes

The uses of stock indexes provide a good starting point for the discussion of the structure and construction of stock indexes. Motivational factors include tracking average returns, making comparisons of managers' performance to average performance and, increasingly, indexes are used as a base for derivative instruments. Discussion of the factors in constructing or using an index focuses the students' attention on key differences in the indexes. For example, the DJIA captures the returns from the bluest of blue chips. Tables 2.3 and 2.4 are useful ways to introduce the construction of an index.

The major factor to contrast in the discussion is whether the index is price weighted or market value weighted. The third possibility is equal weighting. While this method is not too commonly observed in published indexes, it is commonly used in research. Example 2.2 provides an example of price weighting which is used in the DJIA. An example of a broad-based index is the Standard & Poor Index. It provides an example of a market-value-weighted index as compared to the price-weighted average computed in Example 2.2. The examples of market-value indexes used in the text shows their diversity. The Wilshire, being the broadest of the indexes, captures the overall domestic market.

The international indexes represent the most popular indexes used by investors. They include only a small example of what it available but they are representative of the major types of indexes and major countries. The text has several examples of greater detail in several exhibits.

2.5 Derivative Markets

Basic positions and terms for options and futures are described here. The basic positions and terms are used to contrast the differences in futures and options. The essential difference is that while an option confers the right but not the requirement to exercise, a futures contract represents a firm commitment to buy or sell for future delivery. The text provides discussion of options for individual stocks and on agricultural futures contracts. The extension to discussion of other assets enhances understanding of the uses and differences of options and futures.