Investment Management
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Lecture - 02
Role of Financial Markets and Institutions

Hi there. Welcome back to the course Investment Management. Previously, we were discussing about the investment process in which we understood the investment management begins with the objective of the client that is the investor. And if we are working on behalf of the investor then we have to keep our objective at the top of the mind.

So, that whatever actions we take should be based and directed towards the investor's interest. Now, before we start discussing about tools and techniques in today's session we will discuss about financial markets and institutions particularly in the context of investment management.

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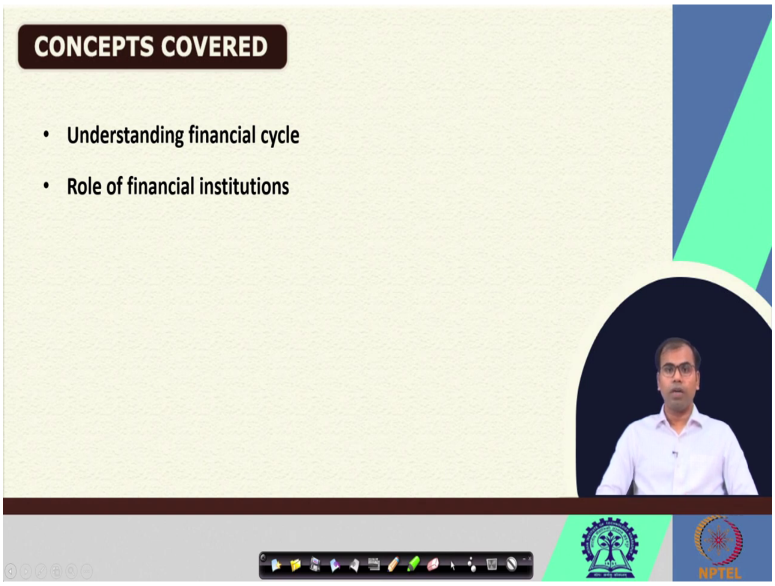

So, essentially, we are going to talk about the role of financial markets and institutions and how they connect with the financing financial cycle. So, basically when we talk about financial cycle, essentially, we mean to indicate the relationship between those who have firms that can be used as finance for those who are in need of funds.

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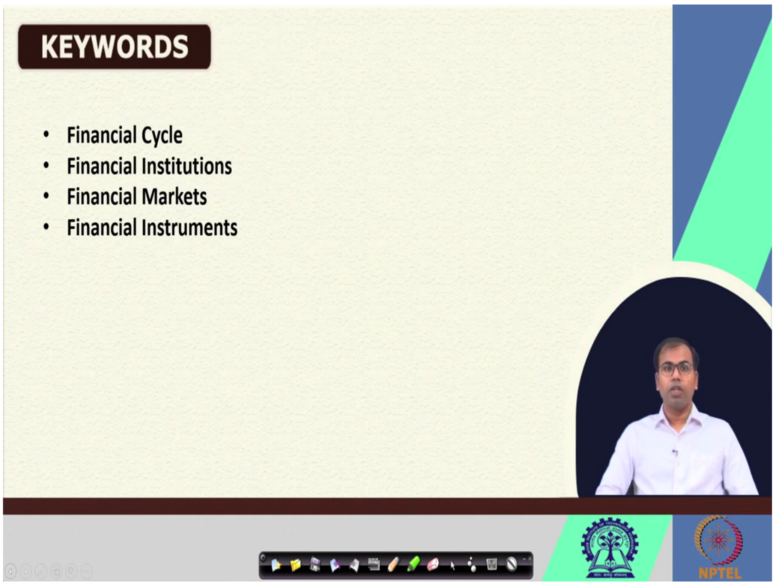

Essentially, we are going to talk about the financial cycle and then connect the financial cycle with the role of financial institutions and markets.

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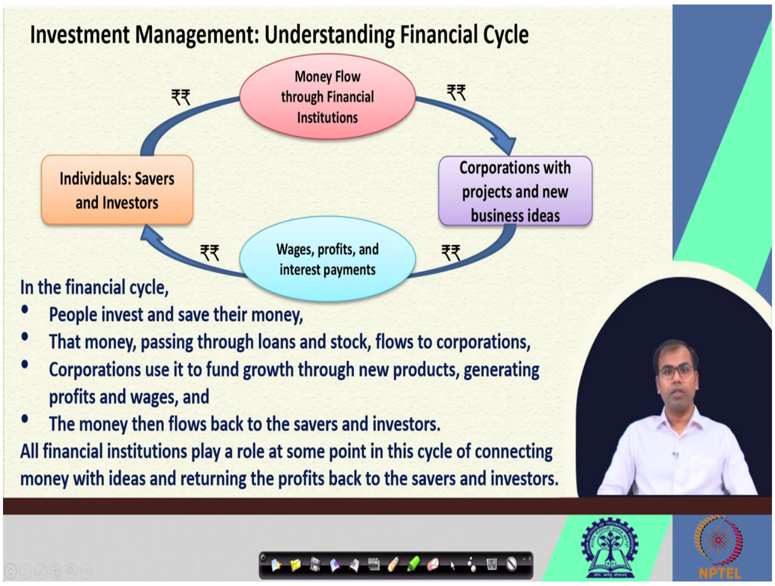

So, essentially financial cycle begins and ends with those individuals or those entities which have funds as their savings or funds available for investment and those entities or individuals who are in need of funds. To simplify this, we assume that it is the individuals who are the net savers and they are willing to invest their savings in corporations that have projects and new business ideas.

When we say corporations have new business ideas, what we mean is companies or firms or business entities have new projects where they can invest some money and in future they expect to generate more cash flows that can be given back to those investors who had invested their money in the first place.

So, what happens in this financial cycle is, the individuals, the savers and investors generalize their funds through financial institutions or financial intermediaries towards the corporations which have projects and new business ideas and that are in need of funds.

Once corporations invest those money sourced from investors and savers, the money can be utilized to generate further profit and cash flows which can be subsequently returned back to the investors or savers who had given their money in the beginning. Essentially, this money the cash flow that the companies have generated can be given back in various forms including wages, profits, sometimes interest payment depending on the type of investment that individuals and savers have met, the cash flow can be given back to the investors in different format.

For example, if I have some savings and I have invested in a company in the form of buying a share of that company, then in case the company makes any profit at the end of the year and company decides to give back that profit to the investors who have invested in their shares, then company will declare a dividend and I will receive part of the dividend as entitled to the share holding of mine.

In case I wish to invest my money in the form of a bond or a debt instrument which is entitled to coupon or interest from the land borrower, then I will be receiving at the end of the period interest payment coming from the company which has borrowed money from me through issuing debt or bonds.

If I am working for the company then I will be entitled to wages payment and similarly if there are people there entities that have been supplying raw material on credit, those entities might be entitled to receive the payment for their raw material. So, essentially this is the financial cycle that keeps the flow of money from savers to corporations and subsequently back to the savers.

Now, imagine an individual who have some savings and that savings have been invested in corporations in the form of investment in shares or bonds, Later on, the corporation or the company declares dividend or decide to make payment for interest on the bonds, then that money comes back to the investor and then investor after consuming some part of the money decides to invest that money again.

So, this flow can continue for forever. Now, in a typical financial cycle this is how people or entities invest and save their money. That money is channelized through different entities or different financial intermediaries, particularly financial institutions such as banks or investment companies to the corporations which have you which have requirements for funds.

And then once they flow that money in the projects or business ideas that money can be used for generating more profit, more cash flows and that money can then flow back to the savers and investors. You might notice that in the entire cycle in this entire process financial institutions play a significant role because in the absence of financial institutions or financial intermediaries investors or saver will have no direct way to invest in the corporations or their projects.

For example, I might not know whether a company located in a different part of the world would be willing to take my money and invest that money in some new project which will generate future cash flows. So, I might not find that opportunity at all. So, financial institutions such as banks and investment companies generate those cash flows from the lender to the borrower and subsequently the profit is given back to the savers and investor essentially the lenders.

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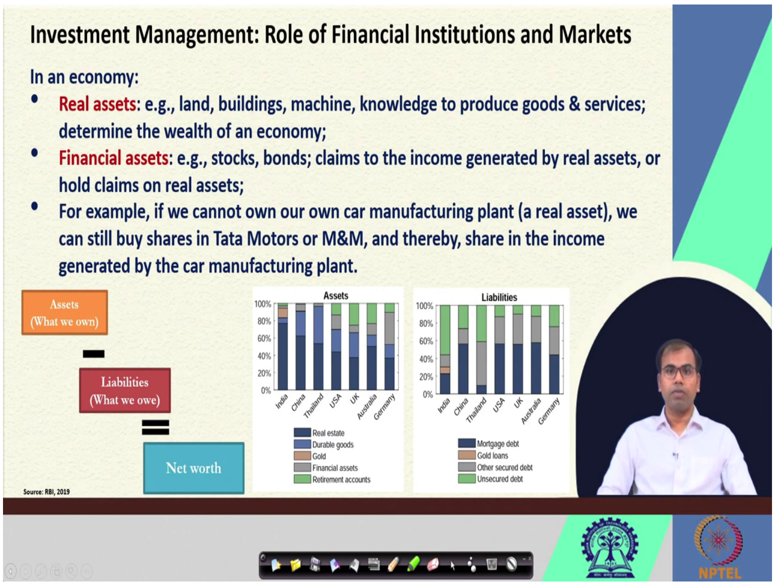

Now, here the importance of financial institution and market become very critical because once in a typical economy we observe that there are real assets such as land, buildings, machine, knowledge that can be used for producing goods and services and these real assets are the inputs that determine the wealth of an economy.

On the other side, there are financial assets which are such assets such as stocks, bonds and any other similar financial assets. These assets can be considered as the claims to the income generated by the real assets. In some cases, it could be considered as a holding or the holder of that financial asset can have a claims on real asset. For example, let us say there is there is a an individual who cannot own a car manufacturing plant essentially a real asset.

Suppose, I have some money, but I cannot use or I cannot have sufficient money to own a car manufacturing plant or automobile manufacturing plant. So, in that case I can use that money to buy shares in any other car manufacturing plant for example, Tata Motors or Mahindra and Mahindra or Suzuki Motors and thereby I can share in the income generated by the car manufacturing plant.

Similarly, investors who are positive who are optimistic about certain types of businesses, certain types of investment they can indirectly hold investment or hold share in the companies or in the businesses which they are positive about and thereby they can hold the claim on real asset owned by that company.

So, when we talk about holding or assets, we know that there are items or there are things that we own and these are considered as assets when we deduct all the liabilities that we owe from the assets that we own we get net worth. In this context it is interesting to know that in different countries people hold different types of assets and different type of liabilities and that is what determine the net worth of the country or people residing in it.

So, for example, if I quote a particular data where we see that there are countries where real assets form the major holding of assets for the individual for the people living in it. If you look at this graph you will observe that in India most of the people hold their asset in the form of real assets, very few durable goods and substantial amount or substantial amount of assets held in gold and very little financial assets and retirement account.

And this situation is completely different for developed countries like Germany or UK where very few proportion of the population hold real assets most of them hold financial assets or retirement account. Very few countries have as much holding in gold as India has and this is about assets.

When we talk about liabilities, we see a very similar trend where in India most of the people have liabilities in the form of unsecured debt and very few people have liability towards secure or mortgage debt. Whereas in developed countries like USA or UK or Germany we see that most majority of people, majority of individuals living in those countries hold liabilities in the form of mortgage debt and to certain extent unsecured debt, but not many have gold loans as their liabilities.

Now, this kind of data gives an understanding about the nature of assets and liabilities that individuals or the people living in those countries hold and this it essentially tells us about their preferences for investment. Suppose and as an Indian I hold majority of my money, majority of my savings in the form of real asset then I will not be able to participate in financial assets in in markets which offer financial assets.

And my I might not be able to generate sufficient profit or sufficient income from the asset holding that I have in the form of real assets. So, it is very critical to understand different types of assets and liabilities of course, that people or individuals hold and how they are using those assets to channelize to generate more funds, more income, more profit in future.

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Speaking of financial institutions and markets, we cannot ignore the role of financial markets that play a very critical role in an economy.

To start with if you want to highlight the importance of financial markets particularly in a country like India, we know that financial markets play one of the major roles in the form of providing information for capital allocation. The financial markets provide information to investors. In fact, the information is available to both borrowers and lenders.

So, lenders who are the investors who have some spare funds to invest in projects and there are lenders who would like to borrow who would like to invest their funds in companies or in projects that are going to require some funds and that will be in the form of new business ideas or new projects by the companies. So, here the role of financial market becomes very important because investors including lenders and borrowers get sufficient information about capital allocation.

So, it is the investors that are going to determine whether a company will survive or it will vanish. If a company shows some positive, some good prospects of future profitability, if they observe that certain companies have future business prospects which means if we invest money in those companies, those companies will generate future profit.

In such case investors will build up the stock price of that companies and subsequently making it easier for the company to raise further funds. So, if a company is showing good prospects for future profitability, it might not find a find difficulty in raising funds because investors will be willing to lend money to such company or such projects.

On the other side, if a company does not show good prospects or companies prospects seem to be poor about future profitability, then investors would typically bed down its stock prices and in this case such a company might find it very difficult to raise funds and maybe it has true down size or subsequently it may disappear. So, this kind of information is typically disseminated to the investors via financial markets.

We look at the prices, we look at the financial statements that companies have to display, have to share through financial markets and then we decide whether we want to invest in a particular company or we want to sell those shares or buy or do not buy and so, on.

One criticism say suggests that this kind of mechanism or this kind of informational role of financial markets can be misleading because sometimes we observe that some stocks or some companies or certain projects of some companies might seem hot for short term which means it might look very attractive, but very short time and in this way, it will attract huge amount of funds but in future it might not be as attractive or as well performing.

So, in that case, investors who have been lured by or who have been attracted by the short term attractiveness of generating more returns, they cannot sustain or they cannot earn sustainable profit in future from such an investment and that is where informational efficiency of financial markets become questionable.

Other role of financial market is about consumption timing. Since investors or lenders and borrowers both play in financial markets or financial markets basically is a medium to channelize the funds from savers to borrowers. Then typically it gives investors or individuals a choice to decide whether they want to store their wealth in financial assets, whether they want to shift their purchasing power from high earning period to low earning period and that can be possible only through the financial markets.

Suppose, I am doing a job and I am in my high earning period which means I am getting salary, I am earning money and I cannot consume the entire money that I am earning right now. So, I can use part of this money as investment in the through the financial markets and I can hope to get this money, this this investment back when I do not have that much earning in my life.

So, for example, if I am on job right now, I can use the savings from the income of from my job to invest in through financial market with the hope that when I retire and I do not have that much earning, I can use that investment in that period. So, it financial market gives investors a choice to store their wealth in financial assets in the form of stocks or bonds or any other financial securities and shift their purchasing power from high earning period to low earning period.

And finally, another important role of financial market is allocation of risk. We all know and have heard about this anecdote that says high risk should get high return and vice versa which means if we are investing in high risky opportunities, we should expect higher return and if we are investing in low risk opportunities, we should not expect that much return. Through financial market, it is possible to observe that several financial instruments which bear varying types of risk can generate varying returns.

So, it is possible for people who have risk seeking characteristics or who are willing to accept or willing to take on risk to invest in risky assets such as stocks and there are people who might not like to take on so, much risk, those people are risk-averse. So, they may want to buy less risky or risk-free assets such as bonds and treasury bills. So, financial market gives this opportunity to investors of different risky nature whether they are risk-seeker or they are risk-averse to invest in the assets of their choice.

So, if I am an investor who would be willing to take on more risk, I can go for risky investment and if you are not such a risk-seeker, you would rather like to be risk-averse then you do not have to necessarily buy stocks or risky other risky assets, you can go to a safer investment such as bonds and treasury bills. So, this is how allocation of risk is also maintained in the financial markets through financial institutions.

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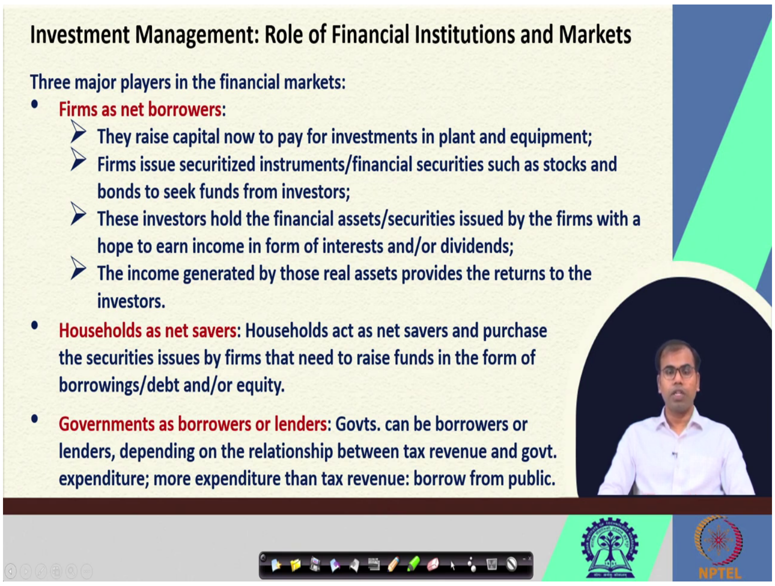

When we talk about financial markets and institutions and their roles, we know that there could be three major players, we have already seen the financial cycle. So, we know that in financial markets there are three major players. The first major player is a firm, essentially firms that act as net borrowers.

So, if you look at the overall savings and borrowing tendencies, we observe that firms act as net borrowers because they raise capital in the present time to pay for investment that are required to be made in plant and in equipment and other activities as part of the business.

To raise such capital, firms typically issue securitized instruments or financial securities such as stocks and bonds to seek funds from those who have investable funds like investors. And then these investors essentially hold the financial assets or financial securities issued by the firms with a hope to earn future income in the form of interest or dividends.

As highlighted earlier, if I invest in stock of a company, I can expect to earn dividend in future. If I invest in the bond of a company or bond issued by any other entity, I can expect to earn interest payment and that choice depends on the riskiness of the individual or the investors.

Here I would like to highlight the securitized nature of such instruments because once such assets are securitized or such instruments are securitized, then it becomes easy for such instrument to be traded across several people, several holders. And once these holders or investors invest their money in such securitized instruments and these instruments act as a medium to raise funds for the corporations.

For the companies that invest that the money raised in different projects and subsequently earn profit. So, the income, the profit that is generated by those companies through real assets provide the return to the investors. And that is how the entire cycle works for firms as net borrowers.

Another critical player in the financial market is households. A households as net savers, they basically act as net savers and they purchase the securities issued by firms and firms need funds. So, they raise funds by issuing those financial securities in the form of borrowing or debt which could be considered as a bond and or in some cases equity as well.

So, that is how households act as net savers and firms act as net borrowers. Now, third important player in the market is government. The government can act as borrowers as well as lenders. If we look at the balance sheet or the assets and liabilities of the of a government or any entity for that matter, the nature or the act of being a borrower or a lender depends on the relationship between revenue and expenditure.

And it its very much relatable or it is very much valid for households as well as firms. If a firm has more revenue than the expenditure, then it would like it would probably become an investor because it have some spare funds that can be invested somewhere.

If you look at the corporations or businesses in India or abroad, there you might find one or the other company or business entity that will be having net positive cash flow business and that cash flow can be that spare cash flow can be invested in new projects or new venture or other investment.

Similarly, households can also have more revenue than expenditure in some particular month or particular period and in that case, they can invest that spare funds in the assets of their choice. But in some other month maybe the household can become net borrower. So, that depends on the relationship between revenue and expenditure.

And similarly in case of government they can be borrowers or lenders depending on the relationship between tax revenue and government expenditure. If government expects more expenditure than tax revenue, then it will like to borrow from public and if it has more revenue than expenditure, then it will be lender in to the public in the form of more cash flow flowing in the market or spending more money on activities that would be in the interest of the public.

So, that is how typically the financial cycle works and as we discussed earlier financial markets play a very important role.

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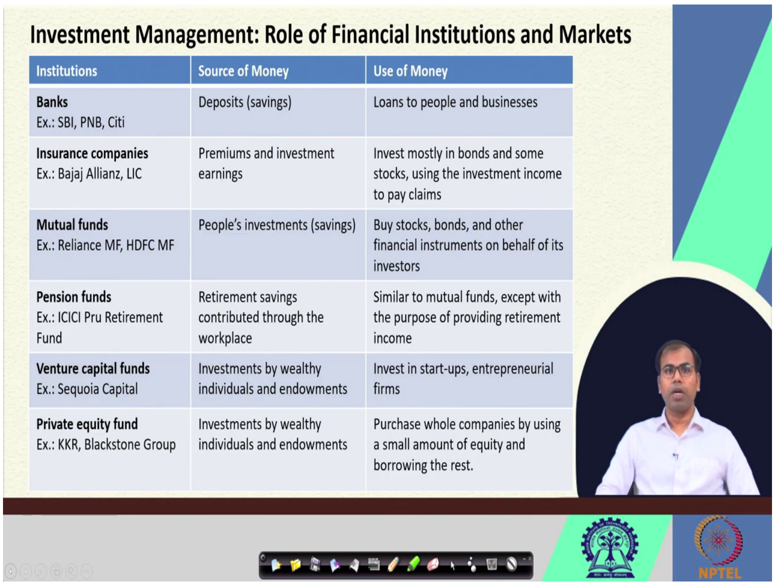

And in financial markets there could be several financial institutions. So, if we quickly touch upon the types of institutions that are active in financial markets, we know that there are banks, there are insurance companies, there are mutual funds or investment companies, pension funds, similarly investment companies, venture capital funds and private equity funds.

You can see the examples, we see examples of banks around us, we know the State Bank of India or Punjab National Bank, Citibank, ICICI Bank, HDFC Bank, these are the financial institutions that typically take deposits from the savers and use that deposit to give loan to public or institutions. So, this is how they make money. So, they seek deposits from those who have savings and use that money to give loans to common public or business entities and in the process they earn money.

Insurance companies like Bajaj Allianz, Life Insurance Corporation of India, General Insurance Corporation of India and so, on, they are typically going to raise funds or they raise funds through a premier that is paid by the people who are holding the insurance policies and those money can be invested in different avenues from where they earn.

And they use that money raised through premier to invest in bonds and stocks and other assets depending on the type of policy, type of expectation, expected return that they are hoping. There are indirect fund management businesses like mutual funds, pension fund, private equity fund, venture capital funds.

So, mutual funds are very common, you can see the examples like Reliance Mutual Fund, HDFC Mutual Funds. Again, these mutual funds are companies or business entities or financial institutions which raise funds by pulling money from different people, those who have savings and use that money to invest in different assets depending on their preferences for return.

Pension funds typically take money from people who are in job and promise them to give them give them back when they retire. So, they take money from people in the form of retirement savings and use that money to invest in different assets like stocks and bonds so, that when the people who are retiring ask for their money.

The pension funds can take some money out of it and give it back to the people who have retired in the form of regular income or one lump sum income and so on. Venture capital funds like Sequoia Capital, those are entities which raise funds by way of investment by wealthy individuals and endowments, family businesses and invest in high risk businesses like startups, entrepreneurial firms.

Similarly, private equity funds like KKR, Blackstone Group, they raise funds by again wealthy individuals like high net worth individuals, endowment family firms and use that funds to purchase whole companies by using a small amount of equity and borrowing the rest and that is how they generate huge amount of return on the investment.

These are some tentative list of financial institutions that are at play in the market and what they do.

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We know that these institutions typically act as financial intermediaries which bring lenders and borrowers together. These include bank financial institutions, investment companies, insurance companies, nowadays, fintech firms, credit unions. They can issue their own securities also at times to raise funds and then purchase security of other corporation.

For example, a bank can issue a fixed deposit certificate or certificate of deposit to the people who are giving their money as deposits and then that fund can be used for lending the two different borrowers and in the process, they make some money. Similarly, these institutions can play in primary and secondary market depending on their exposure or their nature of business. Several of these financial firms, financial intermediaries play in primary and or secondary markets.

We will discuss more about primary and secondary markets later on, but just to give heads up primary markets are places where new issue of financial securities are offered to common public or those who are willing to invest. For example, if I want to buy shares through an IPO then IPOs are issued in a primary market, but if a company has already issued some shares, it goes to secondary market where investors can trade previously issued financial securities among themselves.

So, stock exchanges are typically a where secondary transactions take place. So, once a company issue the IPO, then other people can trade among themselves that is called secondary market trading.

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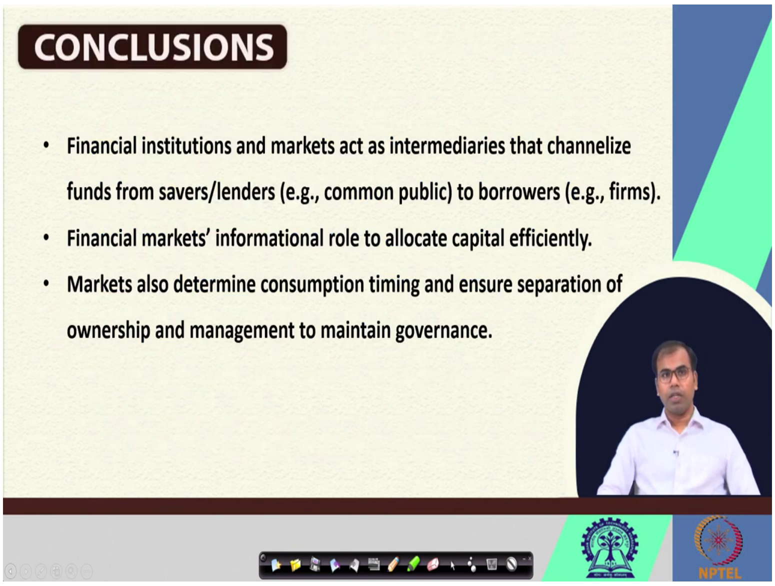

So, just to conclude we have discussed that financial institutions and markets act as intermediaries that basically channelize funds from savers or lenders to borrowers and in the process, they make some money, it is beneficial for both savers and the lenders.

They also play as a source of information for allocation of capital in a more efficient way and at the same time they also determine consumption timing for in investors because they can differ their consumption have some savings for now. So, that they can have more income in future institutions and markets also ensure separation of ownership and management to maintain stronger corporate governance. More will be more on these issues will be discussed in detail later for now that is all.

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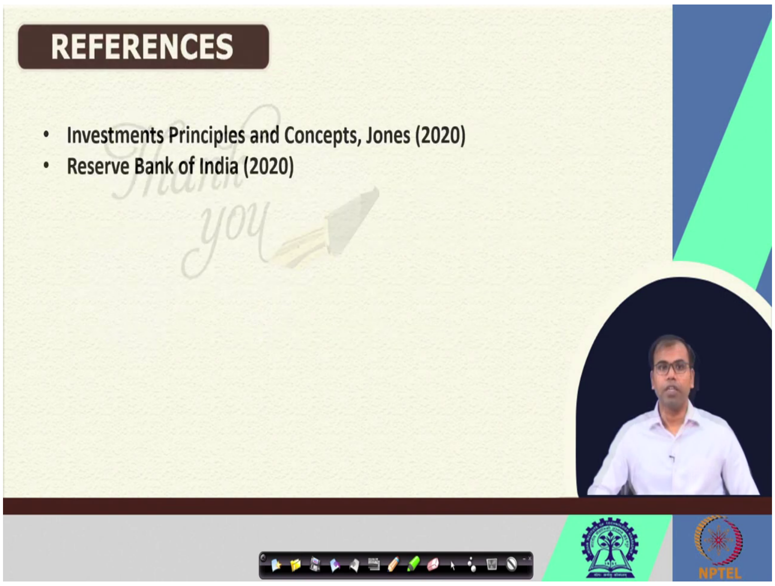

Thank you very much.