# 1 Context & Essence

## 1.1 Learning outcomes

After studying this text the learner should / should be able to:

1. Understand the slot the equity market occupies in the financial system.
2. Be acquainted with the general terminology of the equity market.
3. Dissect the equity market definition into its elements.
4. Appreciate the statutory backdrop to equities and the equity market.
5. Know of the existence of equity derivative instruments.

## 1.2 Introduction

The purpose of this text is to provide an overview of the equity market and its role in the financial system. We start with a brief introduction to the financial system, and then contrast the equity market with the money and debt markets. A definition of the equity market is presented and dissected into its elements. The statutory backdrop to equities and the equity market is presented in brief and the equity derivatives are merely mentioned for the sake of completeness.

The following are the sections:

- The financial system in brief.
- The money and bond markets in a nutshell.
- Essence of the equity market.
- Statutory backdrop to shares and share market.
- Equity derivatives.
- Summary.

## 1.3 The financial system in brief

As seen in Figure 1, the financial system is essentially concerned with borrowing and lending. Lending occurs either directly to borrowers (e.g. equities held by an individual) or indirectly via financial intermediaries (e.g. an individual holds units and the unit trust holds as assets the liabilities of the ultimate borrowers). Although this is the main function, there are many related others as reflected in the following definition of the financial system:

*The financial system is a set of arrangements / conventions embracing the lending and borrowing of funds by non-financial economic units and the intermediation of this function by financial intermediaries in order to facilitate the transfer of funds, to create additional money when required, and to create markets in debt and equity instruments (and their derivatives) so that the price and allocation of funds are determined efficiently.*

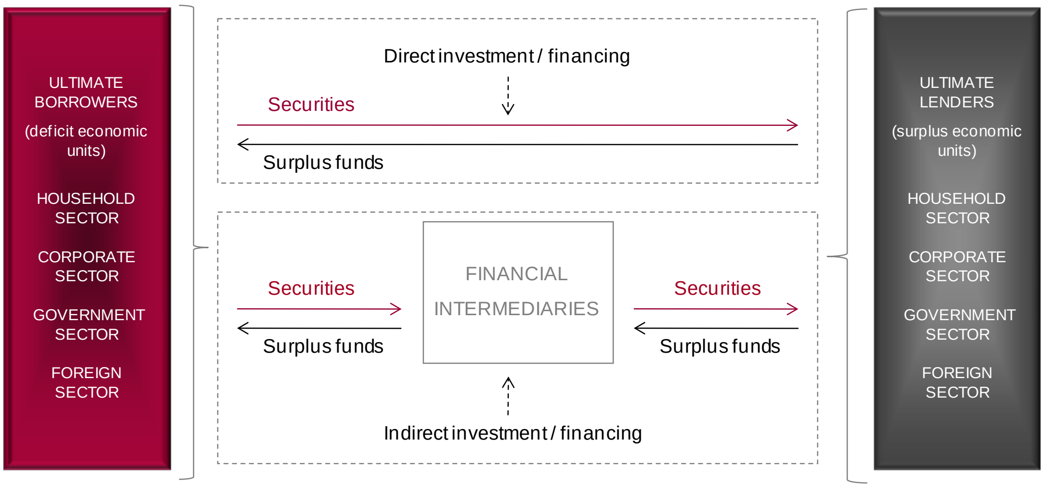



**Figure 1:** simplified financial system

Dissecting this definition reveals six essential elements:

- First: *lenders* (surplus economic units or supplies budget units) and *borrowers* (deficit economic units or deficit budget units), i.e. the non-financial economic units that undertake the lending and borrowing process. There are four groups of lenders and borrowers: household sector, corporate sector, government sector and foreign sector, and many members of these groups are lenders and borrowers at the same time.
- Second: *financial intermediaries* which intermediate the lending and borrowing process. They interpose themselves between the lenders and borrowers.
- Third: *financial instruments*, which are created to satisfy the financial requirements of the various participants; these instruments may be marketable (e.g. treasury bills) or non-marketable (e.g. participation interest in a retirement annuity).
- Fourth: the *creation of money* when demanded. Banks have the unique ability to create money by simply lending because the general public accepts bank deposits (= money) as a medium of exchange.
- Fifth: *financial markets*, i.e. the institutional arrangements and conventions that exist for the issue and trading (dealing) of the financial instruments.
- Sixth: *price discovery*, i.e. the price of equity and the price of money / debt (the *rate of interest*) are "discovered" (made and determined) in the financial markets. Prices have an allocation of funds function.

In this text on the equity market we will not cover *money creation* and the *genesis of short-term interest rates* (this takes place in the money market). We do cover the other elements briefly here as they form the context of the equity market. We begin with the financial intermediaries.

The financial intermediaries that exist in most countries are shown in Box 1 in categories. The individual intermediaries or categories are then presented in Figure 2 in terms of their relationship to one another.

**BOX 1: FINANCIAL INTERMEDIARIES**

MAINSTREAM FINANCIAL INTERMEDIARIES

DEPOSIT INTERMEDIARIES

Central bank (CB)
Private sector banks

NON-DEPOSIT INTERMEDIARIES

**Contractual intermediaries (CIs)**

Insurers
Retirement funds

**Collective investment schemes (CISs)**

Securities unit trusts (SUTs)
Property unit trusts (PUTs)
Exchange traded funds (ETFs)

**Alternative investments (AIs)**

Hedge funds (HFs)
Private equity funds (PEFs)

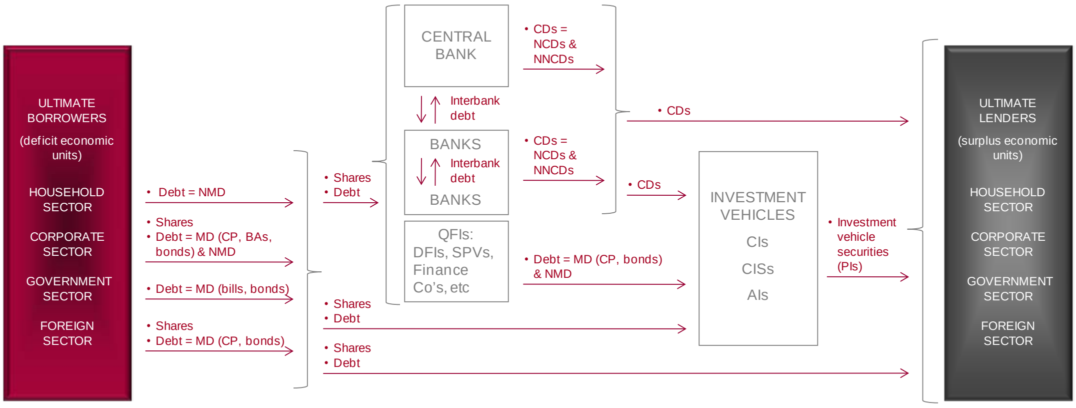
**QUASI-FINANCIAL INTERMEDIARIES (QFIs)**

Development finance institutions (DFIs)
Special purpose vehicles (SPVs)
Finance companies
Investment trusts / companies
Micro lenders
Buying associations

The *financial instruments* issued by the ultimate borrowers and the financial intermediaries are also shown in Figure 2. They can be categorised into:

- debt instruments
- deposit instruments (which are a variation of debt instruments)
- equity instruments.

Our focus is on the latter.




MD = marketable debt; NMD = non-marketable debt; CP = commercial paper; BAs= bankers' acceptances; CDs = certificates of deposit (= deposits); NCDs = negotiable certificates of deposit; NNCDs = non-negotiable certificates of deposit; foreign sector issues foreign shares and foreign MD (foreign CP & foreign bonds); PI = participation interest (units)

**Figure 2:** financial intermediaries & instruments / securities

If we combine deposit instruments with debt instruments there are two *financial markets*: the debt and equity markets. They are depicted in Figure 3 together with the foreign exchange market. Note that:

- The money market and the bond market which together make up the debt market are also known as the interest-bearing market and the fixed-interest market. The terms *interest-bearing* and *fixed-interest* oppose the debt market from the equity market because the returns on shares are dividends and dividends are not fixed – they depend on the performance of companies.
- The debt and equity markets make up the *capital* market; called as such because companies access long-term or permanent capital in these markets.
- The foreign exchange (forex) market is not a financial market, but a conduit for foreign investors into local financial markets and for local investors into foreign financial markets.

To the debt and equity (and forex) markets we may add the derivative markets. Although lending and borrowing also do not take place in the derivative markets, they play an important role in the financial system in terms of enabling participants in the real economy to hedge (thereby creating stability in production).

Financial markets can be categorised into primary and secondary markets. The former is the market for the issue of new securities and the latter the market for the trading of securities that are already in issue. It will be apparent that non-marketable debt (NMD) instruments only have primary markets (e.g. a participation interest in a retirement fund) and that marketable debt (MD) instruments are issued in the primary markets and traded in the secondary markets (e.g. treasury bills).

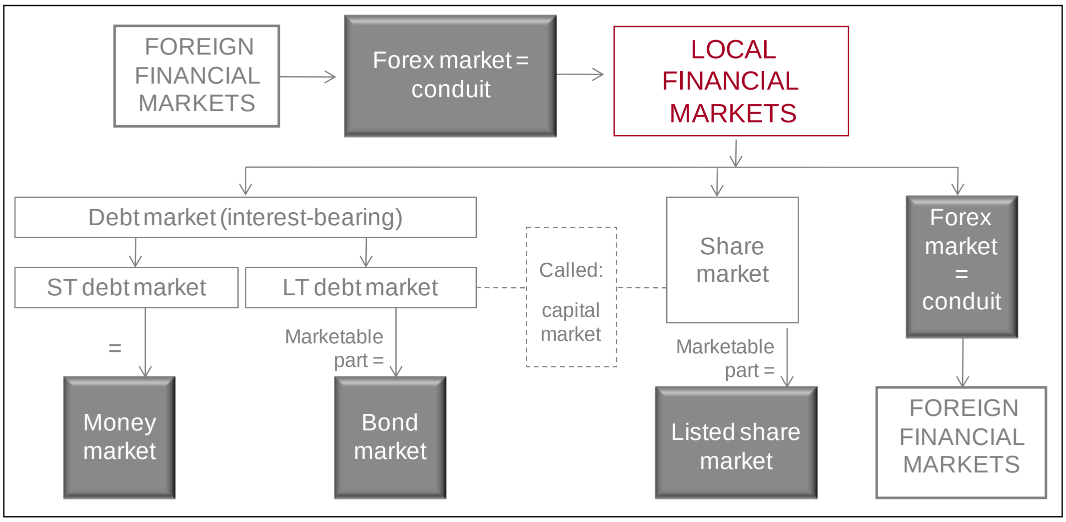



**Figure 3:** financial markets

Financial markets are either OTC (over the counter), such as the money market, or exchange driven, such as the equity market. Next we define the debt market which leads to a detailed description of the equity market.

## 1.4 The money and bond markets in a nutshell

The money market is usually defined as the market for short-term debt instruments and the bond market as the market for long-term debt instruments. However, the money market is more than this. It is comprised of the following markets:

- The primary markets that bring together the supply of retail and wholesale short-term funds and the demand for wholesale and retail short-term funds.
- The secondary market in which existing marketable short-term instruments are traded.
- The creation of new money (deposits) and the financial assets that lead to this (loans in the form of NMD and MD securities).
- The central bank-to-bank interbank market (cb2b IBM) and the bank-to-central bank interbank market (b2cb IBM) where monetary policy is played out and interest rates have their genesis (i.e. where repo is implemented).
- The b2b IBM where the repo rate has its secondary impact, i.e. on the interbank rate.
- The money market derivative markets (= an addendum).

Thus the money market plays a crucial role in the economy including, as we shall see, in the equity market. As far as financial instruments are concerned it is essentially the short-term debt market (NMD and MD). The debt market's long-term arm is the long-term debt market and this is where the bond market fits. Unlike the money market where NMD and MD are included, in the bond market only long-term MD is included, which is the definition of bonds. Bonds are only issued by prime borrowers: government, parastatals, SPVs and large companies that have ratings acceptable to lenders / investors.

## 1.5 Essence of the equity market

### 1.5.1 Introduction

The equity market is part of the capital market (= bond and equity markets). The capital market is the market in which prime borrowers are able to access long-term and/or permanent funding. Two notes are required here:

- We also use the term "borrowers" for the issuers of equity because equity includes preference shares which in many markets are redeemable. (Strictly speaking an ordinary share represents part-ownership and not a debt of a company.)
- Equity is actually a wider concept that includes retained profits (reserves), but we use it to denote the marketable shares of listed companies.

We define the equity market as follows:

*The equity market is the mechanisms / conventions that exist for the issue of, investing in, and the trading of marketable equity instruments that represent the permanent or semi-permanent capital of the issuers (companies).*

If this definition is dissected, we arrive at the following key words:

- Equities.
- Market mechanism.
- Issue (primary market).
- Investing.
- Trading (secondary market).
- Permanent or semi-permanent capital of the issuers.

Each of these key words will be explained briefly.

### 1.5.2 Equities

Equities (also called shares in this text) are issued by companies in terms of the statute that regulates them (usually called the Companies Act) and there are two types:

- *Ordinary shares* (also called common shares or common stock) that represent the permanent capital of companies; they have no maturity date (as such they are much like perpetual bonds).
- *Preference shares* (also called preferred shares or preferred stock). These shares may be redeemable (i.e. have a fixed maturity date), redeemable at the option of the issuer or non-redeemable (have no maturity date). The latter are sometimes called perpetual preference shares.

Shares pay dividends, as opposed to bonds and money market instruments that pay interest. Dividends on preference shares are usually fixed-rate dividends and they have preference over dividends on ordinary shares (explained in more detail later).

### 1.5.3 Market mechanism

The *market mechanism* is the structure, systems and conventions that exist to facilitate the issue and trading of shares. There are two types of market, i.e. the over the counter (OTC) market and the exchange-driven (and regulated) market. Most share markets around the world are exchange-driven markets.[1]

### 1.5.4 Issue (primary market)

Shares are issued by companies, which may be local or foreign (see Figure 4). In most countries shares issued by foreign companies are rare, and they are usually called inward-listed shares or foreign shares. The original shares of companies are unlisted shares and are issued to the founders of the companies (this is the primary market).

The directors of companies only list the shares (and issue new shares) when they have established a good profit record and are able to comply with the listing requirements of the exchange. The main motivation for listing the shares on an exchange is to have the mechanism to acquire further capital easily and at a good price.

### 1.5.5 Investing

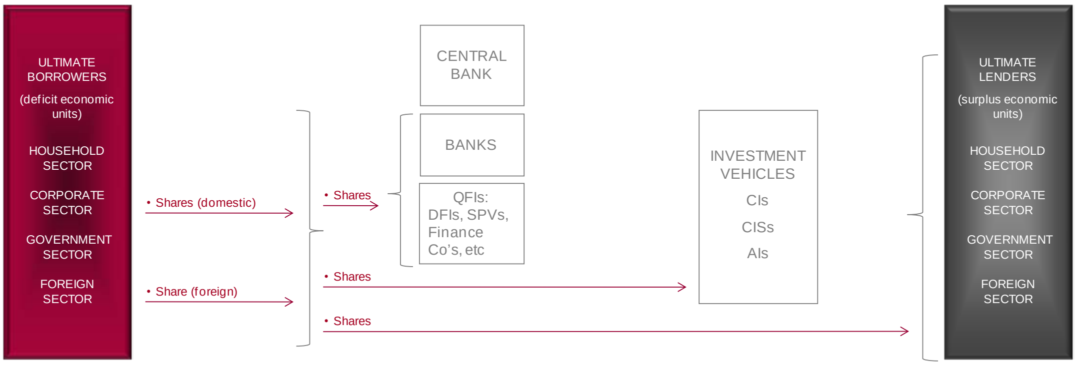



**Figure 4:** equity issuers & investors

The *investors* in (or holders of) equities are also depicted in Figure 4. In most countries all the ultimate lenders are holders of equity. The government holds equity in public enterprises. The foreign sector's involvement in the equity markets of countries differs widely. In some it is a large investor, while in others it is an insignificant investor. Generally speaking, the household sector is a small direct investor in equities; however, it is a large holder of equities via the investment vehicles.

All the mainstream financial intermediaries are investors in equities, with the exception of the central bank (and most of the QFIs). In most countries the largest holders of equities are the retirement funds (CIs), the long-term insurers (CIs), the securities unit trusts (CISs) and the exchange traded funds (CISs).

### 1.5.6 Trading (secondary market)

*Trading* in shares (i.e. secondary market broking and dealing) is a sizeable business in most financial markets. As noted earlier, the majority of secondary share markets are exchange-driven. The secondary equity market participants are:

- *Members of share exchanges*. The members (also called users in some markets) of share exchanges are usually separately-capitalised subsidiaries of the *banks*, smaller companies owned by participants and individuals (who then have unlimited liability). The generic name we use here for all the members is *broker-dealers.*
- *Issuers of equity*. Companies not only supply equity to the market, but they are, in many countries, permitted to purchase their own shares and hold them as "treasury stock" or cancel them.
- *Investors.* As we have seen, the investors include all the ultimate lenders and certain financial intermediaries. Of the latter the major participants are the retirement funds, the insurers, the exchange traded funds and the securities unit trusts. In some countries the foreign sector plays a major role.
- *Speculators / arbitrageurs*. These may be members of exchanges (the members that only deal for themselves) or non-members. Most of them trade intra-day in order to avoid settlement outlays. Their usefulness lies in increasing the turnover in the equity market, thereby contributing to efficient price discovery.

### 1.5.7 Permanent or semi-permanent capital of the issuers

Common shares and perpetual shares represent the permanent capital of a company. Preference shares (redeemable) and other forms of borrowing (for example bank overdraft facilities utilised in the case of smaller companies and the issue of bonds and commercial paper in the case of the larger companies) represent the semi-permanent capital of a company.

Permanent capital is the capital required to maintain the ongoing business of the company, to invest in plant and equipment and to hold the permanent core of inventories. The holders of common shares are rewarded by sharing in the profits of the company.

Redeemable preference shares are issued when temporary but medium-term funding is required. This medium-term funding is required in preference to bank loans. There are two main financial considerations (and inconveniences) in this regard:

- The uncertainty of obtaining funds at each rollover at maturity.
- The uncertainty of the rate of interest to be paid at each rollover date.

The ability to issue preference shares removes these uncertainties. The issuer has a fixed (i.e. a known) rate that is paid at known intervals and the funds are available for the full period required. Payments in some cases can be delayed (cumulative preference shares).

## 1.6 Statutory backdrop to shares and share market

Shares are issued by companies and companies are regulated under a statute (in most countries called the Companies Act). This statute defines a company and there are usually two types: private and public. Only the latter may be listed.

Most countries' statutes relating to companies also define / cover the following issues in respect of shares and the share market:

- Equity share capital (issued share capital and shares).
- Definition of share (a share in the share capital…).
- Register of shareholders.
- Transfer of shares.
- Dividends and reserves.
- Increase, decrease, conversion, consolidation, subdivision cancellation of shares.
- Payments to shareholders.
- Uncertificated securities.
- Preference shares.

- Letter of allocation and rights offer.
- No offer for subscription to public without prospectus.
- No offer for sale to the public without prospectus.
- Matters to be stated in prospectus.
- Underwritten issues of shares.
- Voting rights of shareholders.
- Power of directors to issue share capital.

A share (usually called stock) exchange is licensed under a statute and this statute usually lays out the conditions for self-regulation which includes the skeleton of the Rules and Directives under which the members of the exchange operate.

## 1.7 Equity derivatives

In the many equity markets of the world there exist vibrant markets for the derivative instruments that have been created for the purpose of transferring interest rate risk / transforming assets and liabilities. The derivative instrument types are depicted in broad terms in Figure 5.

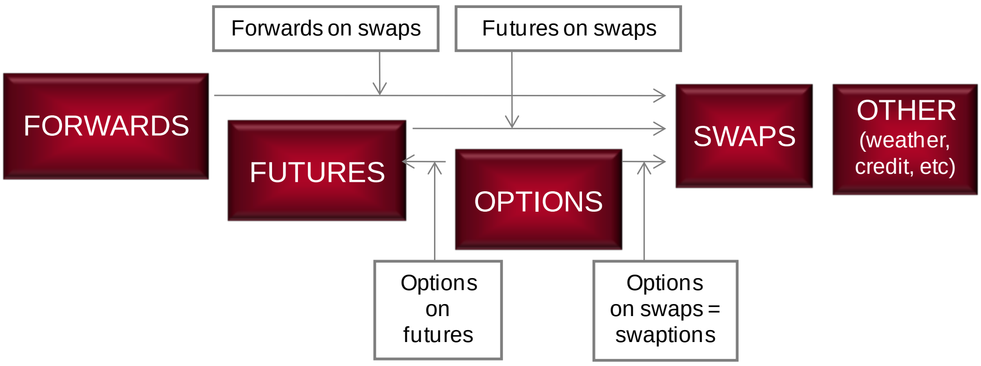



**Figure 5:** derivative instruments / markets

In the equity derivative markets we find:

- Forwards.
- Futures.
- Options:
  - options on "physicals"
  - equity warrants[2].
- Swaps:
  - equity-bond swaps.
- Hybrids:
  - options on futures
  - swaptions.

## 1.8 Summary

There are two types of equity: common shares and preference shares. Equity represents the permanent or semi-permanent capital of the issuers (companies).

The equity market can be described as the mechanism / conventions that exist for the issue (primary market) of, investing in, and the trading (secondary market) of, equity instruments.

The statutory backdrop of equities and the equity market are the statutes that regulate companies and the share exchange. Most regulators embrace the concept of exchange self-regulation.

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