Chapter 13

The nature of the financial markets

Introduction

The money and capital markets are at the economic centre of the industrial and commercial world. Both firms and individuals rely upon the efficient operation of these markets for obtaining capital for investment purposes or money to meet their short-term financial needs. Over the last fifty years the operation of the money and capital markets has been progressively 'globalised' both to finance international trade but also to support multinational business and governments finance their activities. This globalisation has been facilitated by a number of political, economic and technological developments. In this chapter, we explore the financial markets with an outline of their history and their development in modern globalised economies. We devote some time to the concept of a security as a negotiable claim and the phenomenon of securitisation. We outline the structure of the financial markets and, in particular, how the money and capital markets interact. We then turn to the equity market as the primary risk market and discuss the role of information in the pricing of securities and the concept of information efficiency. Although we take a bias towards market efficiency, some anomalous evidence will also be described. Risk and return are then defined and an intuitive appreciation given of the concept of diversification and risk partitioning. The risk–return trade-off is then discussed, leading to an informal discussion of the capital asset pricing model. Finally, topics in the fixed interest market are then discussed before closing with a section on the sources of long- and short-term finance.

Learning objectives

Securities and the financial markets

- To understand the characteristics of a financial market security.
- To understand the nature of the financial markets and the different motives of traders.
- To understand the money markets and the determinants of exchange rates.

The capital markets

- To be able to distinguish between the roles of the primary and secondary capital markets.
- To understand the distinguishing features of equity and debt capital.
- To have an understanding of the concept of market efficiency.
- To understand the nature of risk and return and the concept of portfolio risk.

The cost of capital

- To be able to use the capital asset pricing model to measure the expected return on equity.
- To be able to estimate the rate of return required by debt investors.
- To be able to calculate the weighted average cost of capital and understand its significance.

Securities and the financial markets

A financial security is a negotiable claim upon the value of some underlying asset. 'Negotiability' is the legal term applied when a claim is 'tradeable' in an open market. The claim will be evidenced by some form of certificate or **bond**, or in the modern era of computerised record systems as a record of entitlement maintained within a database attached to the relevant security trading system. The asset can be either real or intangible, it can be a company or indeed it can be another security. Securities backed by other securities are known as **derivatives**.

The key features of a security are:

- the asset that backs it which will have value
- its 'negotiability' in that it can be traded in a securities market
- the 'entitlement' which it gives to the holder.

The security derives its 'fundamental value' from the asset that backs it. It may well be that the value of the underlying asset is uncertain. This uncertainty imparts 'risk' to the financial return that the holder can expect to get through holding the security concerned.

The financial markets

There is evidence that early financial markets developed to support trade in the ancient world as merchants bought and sold goods and needed investors to provide the money to provision their ships and to purchase commodities to buy and sell. The first financial market of the modern era appears to have arisen at the fairs in the medieval cities of Lagny, Troyes, Provins and Bar-sur-Aube in the Champagne region of France. These fairs were well-regulated events where travelling merchants from across Europe would buy and sell their goods, settle claims with debtors and creditors, and make use of the first banks. One of the innovations of these banks was the creation of letters of credit that were negotiable throughout Christendom. A letter of credit is simply a statement that a certain amount of money is owed to the original