FinanceTalking
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Introduction to Companies & the Capital Markets

September 2013

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Our assignments range from graduate training programs through to helping large in-house media relations, investor relations and internal communications departments and IR training for new board directors.

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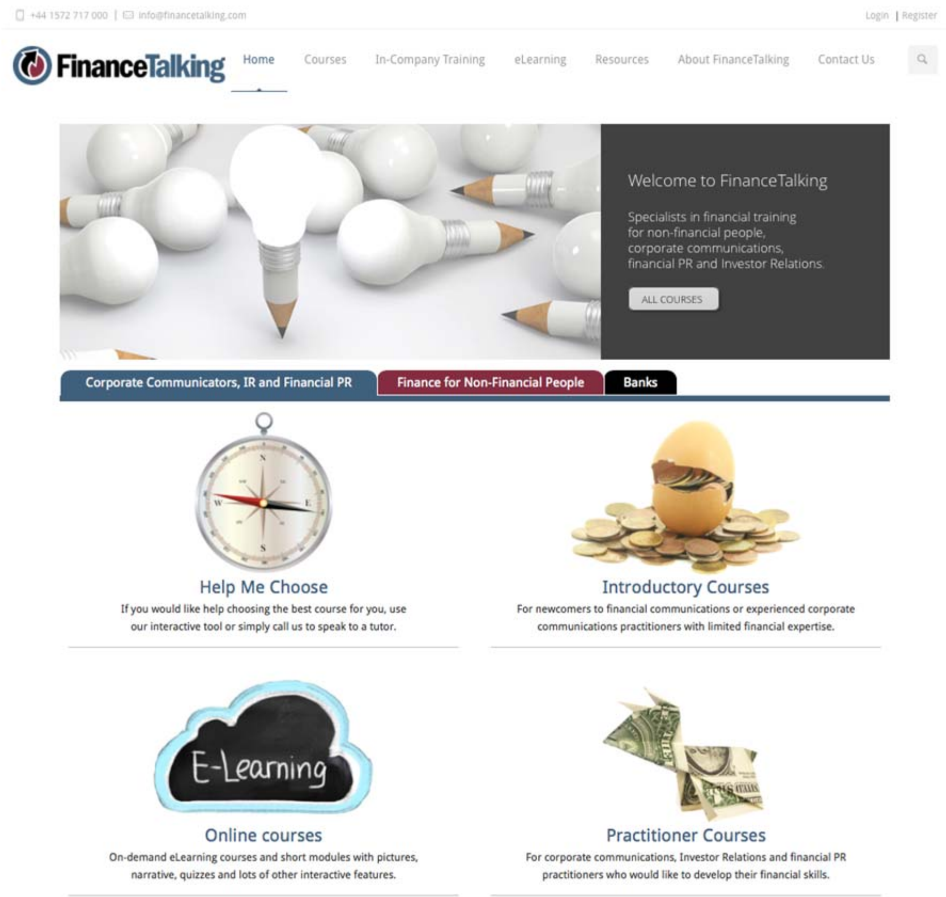


Contents

1. What Do We Mean By Financial Markets?

All markets exist to bring together buyers and sellers and enable them to trade (like the traditional markets in town centres). However, markets do not have to have a physical location. For example, when we talk about the housing market, we are referring to buyers and sellers of houses and the websites and real estate agents who bring them together and advertise the houses for sale (i.e. who act as “brokers”), rather than a particular place.

Financial markets consist of large numbers of people and organisations with money to invest and equally large numbers of people and organisations who want to borrow that money. The intermediaries who bring the buyers (borrowers) and sellers (lenders) together are retail and commercial banks, investment banks and brokers.

Financial markets are a useful way of creating “liquidity” – i.e. enabling people to buy and sell easily, when they want, at a fair price. Many financial markets provide electronic access to continuous price information so that people can make day-to-day decisions on a well-informed basis. For example anyone can access up-to-date share prices and foreign exchange rates online.

Financial markets facilitate all sorts of activities associated with money:

- Borrowing and lending short-term, typically less than one year (money markets)
- Borrowing and lending long-term, typically more than one year (capital markets)
- Investing and trading investments such as bonds and shares (stock markets/capital markets)
- Exchanging currencies (foreign exchange market)
- Trading commodities such as metals, wheat, coffee etc (commodities markets)
- Arranging insurance (insurance market)

The focus of this briefing paper is capital markets – the markets for long-term funding/investment.

2. What Are Financial Instruments?

A financial instrument or financial asset (or security) is something that gives the owner a legal claim to some future benefit. Unlike a tangible asset (an asset you can touch), the value is not related to the physical form of the asset. Instead, the value is related to the future cash that the asset (or investment) is expected to generate.

The organisation that has agreed to pay the cash in future is called the issuer of the financial instrument. The owner or holder of the financial instrument is called the investor.

Two examples of financial instruments are:

A government bond: The issuer is the government, who agrees to pay the investor interest every 6 months and to repay the amount borrowed at the maturity date. A company bond is similar, but the issuer is a company rather than a government.

A share issued by a company: The issuer is the company, who agrees to pay the investor dividends (if the directors decide to pay profits out of the company). The investor also has a claim to a pro rata share of the net asset value of the company in the case of liquidation. Otherwise, to get their money back, an investor must sell his or her shares to another investor.

2.1 Debt Versus Equity

A financial instrument may offer a claim over a fixed amount or a varying or residual amount.

In the case of a bond, the claim is for a fixed amount and this is a debt instrument or “fixed income” instrument.

In the case of a share, the instrument offers a claim to payments out of profit (dividends) only after all other claims, such as interest, have been paid. Similarly, if a company is wound up, the shareholders have a claim over what is left after all other amounts owed have been paid. This type of instrument is referred to as equity.

Some securities have characteristics of both debt and equity. For example, preference shares (preferred stock) entitle investors to a fixed amount of income, but this payment is contingent on other claims being met first.

Similarly, a convertible bond allows the investor to convert debt into equity under certain circumstances.

2.2 Comparison of Debt and Equity

Debt	Equity
• A loan	• A share
• Investor is entitled to interest as part of the contract	• Investor is entitled to dividends (but payment of dividends is at the directors’ discretion)
• Investor gets his/her capital back at the maturity date	• Investor only gets his/her capital back if he/she sells the shares to another investor or the company is wound up
• Lower risk for the investor	• Higher risk for the investor

2.3 Introduction to the Pricing of Financial Instruments

The value (and therefore price) of any financial instrument is today’s value of all the future cash flows that the investor expects to receive.

For example, if a US government bond promises to pay $30 every 6 months for the next 30 years, then $1,000 at the end of 30 years, then these are the cash flows that the investor expects. These cash flows are virtually certain, so the price should fluctuate relatively little.

Of course some debt instruments have more certain cash flows than others. For example, although the US government is unlikely to default, a company just might – i.e. there might be credit risk. The price of a corporate bond might fluctuate a little more than a government bond.

And equity instruments tend to be even less certain. We don't know exactly when a company might pay a dividend or indeed whether it will pay one at all. So it is not surprising that share prices move considerably in response to changing expectations.

There are other issues too. If we invest in government bonds, we are fairly certain about the cash flows, but we do not know what the purchasing power of that cash will be in future – i.e. the value might be eroded by inflation. Also if we buy bonds issued by for example the Japanese government, we would also face foreign exchange risk.

Finally, there are always alternative investments and these can have a significant impact on price as they will influence supply and demand. For example, if investors come to believe they can earn a higher risk-adjusted return in US government bonds than developing market bonds, they re-allocate their capital accordingly, pushing US government bond prices up and developing market bond prices down.

3. Financial Markets

There are lots of ways of categorising financial markets:

3.1 Money Markets versus Capital Markets

Money markets are the financial markets for short-term debt instruments. The capital markets are the markets for longer-term financial assets (debt and equity).

3.2 Equity versus Debt

The equity markets are markets for shares. Debt markets are markets for bonds and other loans (also called the "fixed income market").

3.3 Primary versus Secondary

Primary market participants deal with the issuance of financial instruments such as shares and bonds. Secondary market participants deal with the trading of financial instruments between investors.

3.4 Cash versus Derivatives

When financial instruments are traded for immediate delivery, this is called the cash market (or spot market). Financial instruments can also be traded for delivery on a future date. In this case, the contract between the buyer and seller derives its value from the value of the underlying financial asset. So these contracts are called "derivatives".

Derivative contracts provide issuers and investors with an inexpensive way of reducing some major risks. For example, a pension fund owns a portfolio of shares. The fund manager knows that he must sell a significant number of shares in 2 months' time to pay beneficiaries of the plan. The risk is that share prices might fall between now and then. The fund manager can protect himself by taking out a contract that gives him the option to sell the shares at a price that is fixed now, in two months' time.

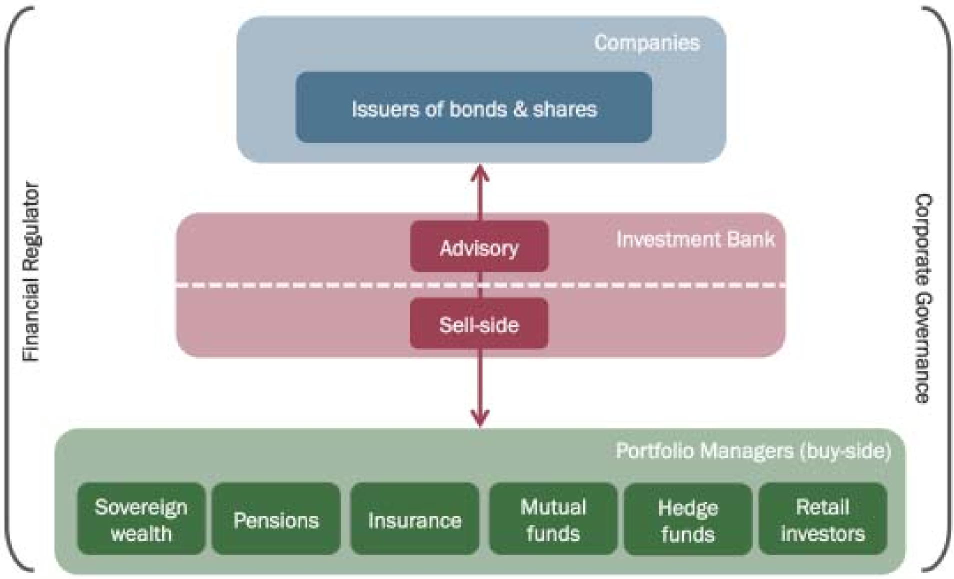
4. Capital Markets

4.1 Introduction to Capital Markets

The capital markets are the markets for bonds (debt capital markets) and shares (equity capital markets). These markets channel the wealth of long-term savers to those who can put it to productive long-term use, such as large companies or governments.

In order to access the capital markets successfully, companies need to be large enough that their securities will be sufficiently liquid. For smaller companies, funding tends to come from bank debt or from specialist private equity investors.

The Capital Markets Big Picture



4.2 Companies

Companies often need capital to expand their businesses. They can raise this capital in the form of shares (equity) or bonds (debt) and it is up to the directors to decide on the best mix of the two.

Typically, large companies use investment banks to advise on the best option and to help arrange their financing.

The capital comes mainly from institutional investors - large investment funds managed by professional portfolio managers, but also from banks and individuals.

The role of company directors is to manage the business in the best interests of all the owners (i.e. the shareholders) and in the case of listed companies; the directors are often pressured to do so by portfolio managers.

4.3 Investment Banks

Investment banks act as intermediaries; helping companies raise capital from investors on the one hand and helping investors decide how to allocate their investors' capital on the other.

The corporate finance team, on the advisor side of the bank, takes fees from companies for advising on fund raising and strategy. The equity and debt capital markets teams help arrange the issuance of shares and bonds (again in exchange for fees from the company).

On the other side of the "Chinese wall", the sell-side advises portfolio managers on which investments to make and facilitates trading, in exchange for commissions.

4.4 Sell-Side Analysts

Analysts working within the investment banks research companies and sectors and advise portfolio managers on which investments to make - i.e. which shares or bonds to buy.

We refer to these analysts as "sell-side" analysts because they sell their investment ideas to their clients on the buy-side. Although banks have credit analysts, who research bonds, as well as equity analysts, when we refer to "sell-side analysts" we are referring to equity analysts.

Sell-side analysts analyse corporate strategy in the context of the sector. They examine financial results and forecast future profits and cash flows in order to value shares (remember that the value of an investment is today's value of the future cash flows the investment is expected to generate). They then compare their valuation to the share price in the market and, if they can see an opportunity to make money, they recommend that their clients on the buy-side should buy or sell.

Sell-side analysts' research reports and general comments often reach the media, which means that sell-side analysts can be very influential in the big picture.

4.5 Investors and their Portfolio Managers

In most mature markets, the bulk of capital for investment comes from institutional investors. These are pools of savings money, often originating from peoples' long-term investments such as pensions, life insurance, or mutual funds. Mutual funds are collective investment schemes, whereby each investor owns a small piece of a collection of investments managed by a professional portfolio manager.

Pensions, insurance and mutual funds are by far the largest institutional investors, accounting for roughly a third each of funds under management globally.

In developing markets, retail shareholders tend to dominate until the savings and investments market matures.

Capital also comes from sovereign wealth funds – countries with surplus funds to invest (often derived from natural resources), for example Abu Dhabi Investment Authority and China Investment Corporation.

The role of professional fund managers is to allocate the investment capital wisely and generate returns for their clients, which compensate them for the risk they are taking – the more risk they take, the more return investors expect.

4.6 Buy-Side Analysts

Asset management firms (portfolio managers who manage funds on behalf of investors) often employ in-house analysts to help them decide how to allocate their investors' capital. These analysts are referred to as "buy-side" analysts and these asset management firms are generally referred to as "buy-side" institutions or simply "institutional investors".

Buy-side analysts, like their counterparts on the sell-side, are heavily involved in valuing companies' shares and evaluating companies' strategic decisions.

4.7 Retail Investors

Retail investors – private individuals who invest directly into shares and bonds - are a feature of some markets. For example in the US, the pension system allows individuals to have their own share dealing account. Private shareholders are also a feature of many developing markets. In the UK, on the other hand, although retail investors are numerous, they typically control less than 10% of a company's shares.

4.8 Corporate Governance

In private companies, the directors are often also the shareholders. However for listed companies, there is a separation between ownership and control. The company will be run by a board of directors, but is owned by public shareholders.

Of course, the directors must run the company in the best interest of all shareholders (large or small). Corporate governance rules, such as the Sarbanes-Oxley Act in the US and the UK Corporate Governance Code, are designed to protect the shareholders in this respect.

Apart from the relationship between directors and shareholders, the term "corporate governance" also covers issues such as:

- The appointment of external auditors and their relationship with the board
- The structure of the board (the role of the chairman and CEO, the number of independent non-executive directors etc)
- Board remuneration policy and disclosure.

4.9 Regulators

Each market has a financial regulator, which is tasked with protecting investors on the one hand and the integrity of the market, ensuring that people are happy to participate, on the other. These regulators set or approve the rules for companies whose shares are traded publicly.

The US financial regulator is the Securities and Exchange Commission (SEC). The UK regulator is the Financial Conduct Authority (FCA), which also acts as the UK Listing Authority (UKLA).

4.10 Financial Media

Listed companies are required to announce publicly all price-sensitive information (information that is important to investors in their decision-making) and this of course includes strategic and financial information, including earnings releases (results announcements) and news on deals such as mergers and acquisitions (M&A). These announcements are likely to be picked up by the financial media.

The financial media sees individual companies in the context of the big picture - the overall economy and results for others in the sector - and so their stories will be set in this context.

4.11 Financial PR and Investor Relations

Financial PR and IR practitioners advise their clients on strategic communications. This includes counsel on how communications can best achieve fair value for the companies' shares.

They help companies to write their news releases and prepare them for conference calls with investors, analysts and the media - and for the questions that are likely to follow.

They also advise on how to respond to rumor and speculation and how to deal with M&A situations, investor activism and crises.

5. Raising Capital

In this section we are going to look capital raising in more detail, including how bonds and shares work.

An imaginary company, Megacorp, requires capital to expand the business. What are the options?

Equity

Megacorp could issue shares to raise equity capital. The company would simply create new shares and sell them to investors. Note that this would dilute the existing shareholders' stake in the business - they would end up with a smaller slice of a larger cake.

The shareholders are risking their money in Megacorp. The only way they can get their capital back is to sell their shares to another investor. Shareholders are not entitled to interest, but may receive dividends if the company makes profits and the directors decide to pay those profits out, rather than reinvesting them back into the business. Dividends are usually declared to shareholders 6-monthly or quarterly, with the announcement of financial results and paid shortly afterwards.

Shareholders generally expect to make a return that will compensate them for the risk they are taking – i.e. significantly more than they could get for putting their money in the bank. This return comes partly as dividends and partly as capital gains (being able to sell the shares on at a higher price). Typically, investors expect more capital gains than dividends as shares are more usually held for growth than for income.

Debt

Megacorp could borrow money from a bank or another lender.

The lender must be satisfied that Megacorp can afford the interest on the loan and that it will be able to meet the required repayment schedule since interest and capital repayment are contractual entitlements for the lender.

Again, lenders expect a return that compensates them for the risk they are taking, but since they are taking less risk than shareholders, the required return will be lower. Unlike equity, debt is an income investment.

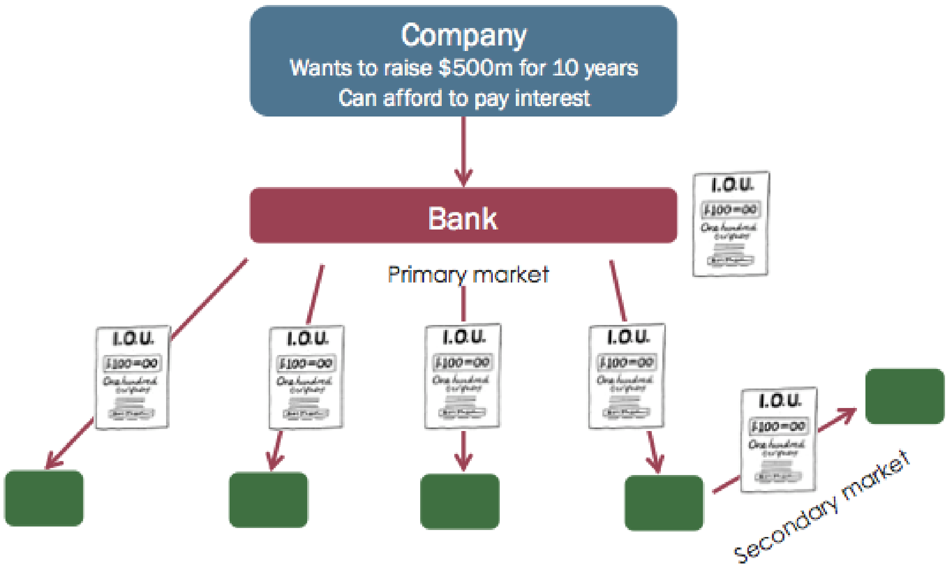
5.1 Bonds

Imagine Megacorp goes to the bank wanting to raise $500m for 10 years. The bank will have two problems with this. Firstly, $500m is probably too much for one bank to lend to a company – it's too risky. Secondly, 10 years is a long time. How does the bank know that Megacorp will be around in 10 years' time to repay the loan?

The bank could get round the first problem by sharing the loan with other banks. This is called syndication – and the loan is a "syndicated loan**"**. This gets round the problem of the amount being too large.

To get round the 10 years problem, the bank could securitise – turn the loan into securities – bits of paper which represent little chunks of loan, which can then be traded by the banks whenever they like. This is a bond issue and it gets round the problem of the 10-year term – lenders can get their money back whenever they want by selling their bond on to another investor in the secondary market.

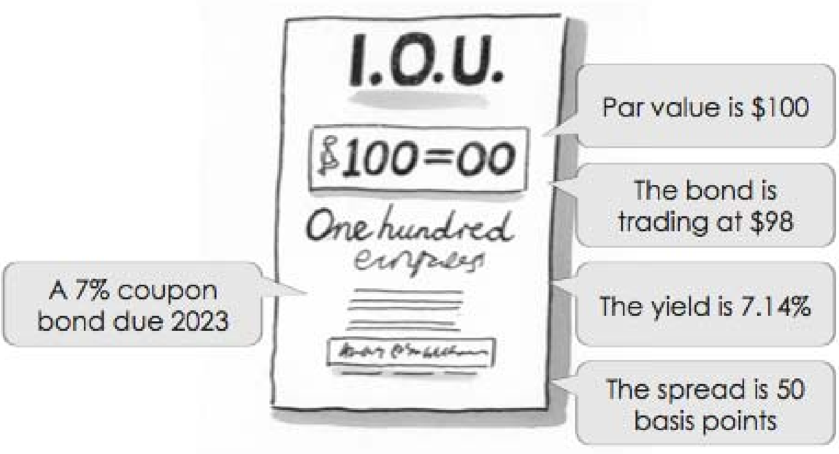
5.1.1 Bond Issues



The issue of bonds is referred to as a “primary market” transaction. The subsequent trading of the bonds is a “secondary market” transaction. In order to have a healthy primary market, investors need to be able to sell their bonds on to other investors easily and at a fair price – i.e. they need a liquid secondary market.

You can see that the financial markets enable the amount and maturity of the loan to be transformed so that the transaction works for everyone. The company is happy because it gets its $500m for 10 years at a reasonable interest rate. The bond investors are happy because they have only lent a small amount each and can, in theory, get their money back whenever they want by trading their bonds on the secondary market. Finally, the intermediary bank is also happy because it has earned fees for arranging the transaction.

5.1.2 Bond Jargon



Par value: The par value is the face value of the bond - i.e. how much the company has borrowed (and therefore how much will be repaid at the end of the bond's life). Par value is usually $100 or $1,000. Of course a bond can be denominated in any currency.

Coupon: The coupon is the interest rate on the bond. It's called the coupon for historic reasons. When bonds were issued in paper form, they used to have a series of coupons on the bottom. Every 6 months, the bond holder would cut off a coupon, fill in their name and address and mail the coupon to the company. The company would then know who to send the interest to.

Date: The date is simply the date on which the bond will be repaid.

Pricing: The interest rate on the bond (in this case, 7%) does not change over the life of the bond. Initially the coupon is set in relation to prevailing rates in the market - the benchmark is usually an equivalent government bond, to which a "spread" is added, to compensate the lender for the additional risk inherent in a corporate bond.

Subsequently, market interest rates may change. This will be reflected in the price of the bond in the secondary market. For example, if the benchmark bond is now giving a return of 8%, this bond doesn't look very attractive and the price will fall below $100. Similarly, if interest rates fall, the bond price may rise above $100.

Yield: The yield on a bond is the coupon (7% in our example) as a percentage of the bond price ($98 in our example). This gives a yield of 7/98 x 100 = 7.14%.

Spread: The bond carries a coupon of 7%. To reflect the additional risk inherent in a corporate bond, a "spread" is added. In this case the spread is 50 basis points (half of one per cent). This means that the benchmark yield at the time of pricing must have been 6.5%.

Basis points: Bond spreads are often referred to in terms of basis points rather than fractions of a per cent. 100 basis points (bps) = 1%. 50bps = 0.5%. 10bps = one tenth of a per cent etc.

5.1.3 Rating Agencies

When a company issues bonds, it will generally pay one or more of the large rating agencies like Standard & Poor’s or Moody’s to rate the bond.

The rating helps investors assess the risk. It is a measure of the probability of default in the opinion of the ratings analyst. The higher the rating, the lower the probability that the company will be unable to meet its interest payments or repay the capital as it falls due.

Countries too are rated – the rating of the country is known as the sovereign ceiling – the idea being that individual companies would be highly unlikely to have a rating higher than this ceiling.

You can see that the highest rating is AAA (which means that the lender is highly unlikely to default) and the lowest is D (which means in default). The debt markets draw a big distinction between investment grade bonds and those that fall below investment grade (speculative and high default risk). All bonds rated BB and below are referred to as junk bonds. Generally if a company’s bond rating falls to junk status, this triggers a higher interest payment on the bonds. Many mainstream investors avoid investing in junk bonds because of the significant risks, so issuing debt into this market can be difficult.

Ratings Scales for Major Agencies

Less risk
Lower interest rate

S&P	Moody's	Fitch
Investment Grade		
AAA	Aaa	AAA
AA	Aa	AA
A	A	A
BBB	Baa	BBB
Speculative Grade		
BB	Ba	BB
B	B	B
High Default Risk		
CCC	Caaa	CCC
CC	Ca	CC
C	C	C
In Default		
D	None	DDD/DD/D
S&P and Fitch use + or – ratings to adjust ratings further. Moody's adds digits – eg Ba1 beats Ba2		

More risk
Higher interest rate

High yield debt
Junk bonds

Communication with ratings analysts is usually handled by the CFO or the treasury team within a company. The ratings agencies have a privileged position under the market regulations and can be given access to confidential information. For this reason, equity analysts watch changes in debt ratings very carefully.

The major banks also employ credit analysts – who increasingly share research ideas with their equity counterparts.

Key concerns for lenders are:

- Ability to service and repay debt
- Quality of profits/cash flows during the loan period

Of course, both of these will be priced into the interest rate.

5.2 Shares

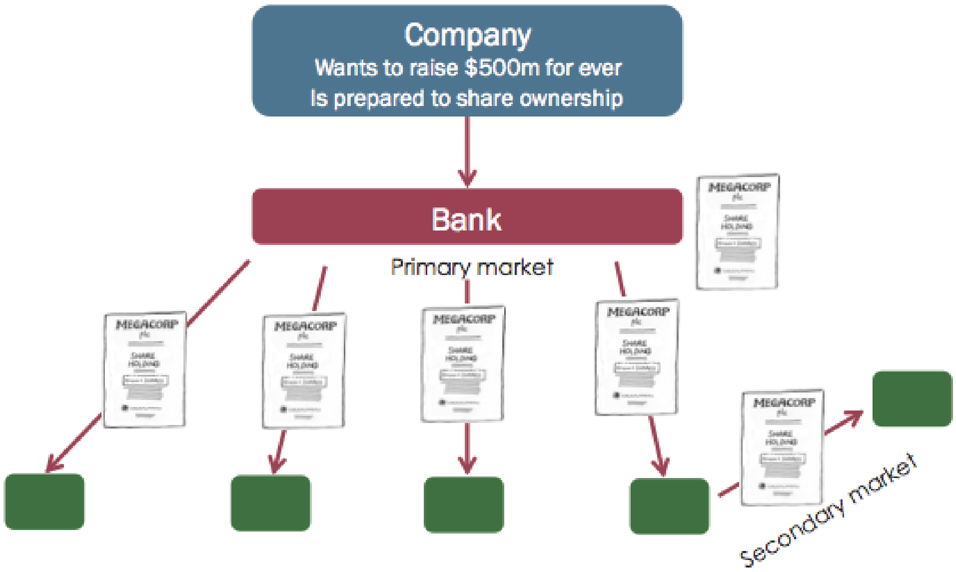
5.2.1 Share Issues

A share issue (issue of stock) follows very much the same process as a bond issue. The company goes to an investment bank which, for a fee, will help the company to raise money from investors by issuing shares. This is a primary market transaction.

The shares are traded subsequently on the secondary market (usually via a stock exchange). In order to have healthy markets, investors need to be able to sell their shares on to other investors easily and at a fair price – i.e. they need a liquid secondary market.

The liquidity of a particular share depends on the size of the company, its popularity as an investment, the number of shares available to the public (as opposed to owned by management or major shareholders) – i.e. its free float - and the general liquidity of the market on which the shares are traded – i.e. how many buyers and sellers there are.

A Share Issue

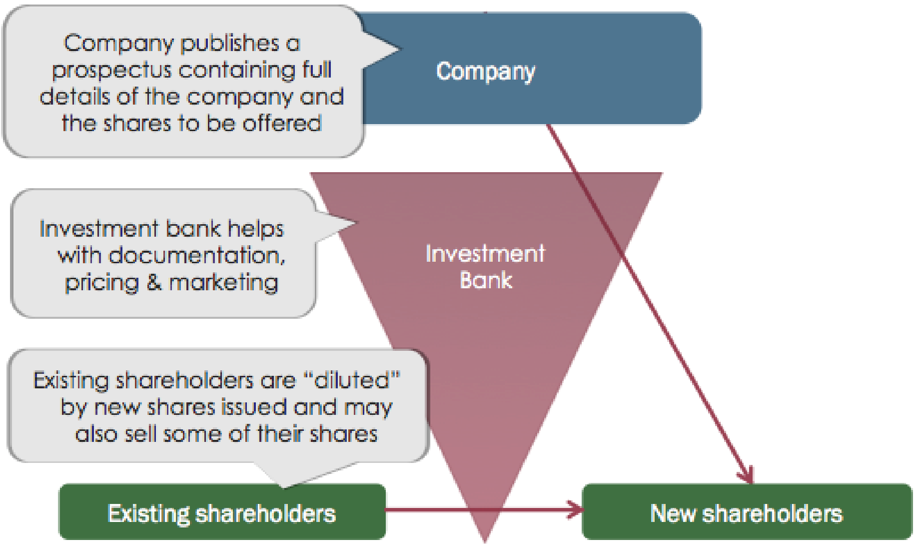


5.2.2 Initial Public Offers

An initial public offer (IPO) is the first time a company issues shares to the public via a stock exchange with the help of an investment bank. It is also referred to as a "flotation" – ie the company floats its shares on the exchange. The company is likely to issue new shares and existing shareholders often sell some of their shares as part of the transaction.

In many markets, the process works in 2 stages. First the company must apply to the local regulator (eg the FCA in the UK or the SEC in the US) for approval/registration, then it must apply to the local exchange for the shares to be traded (eg London Stock Exchange or New York Stock Exchange). The marketing document that a company publishes during an IPO is called a prospectus.

IPO Process



The key adviser in an IPO is of course the investment bank, who helps with the documentation, marketing and pricing of the issue. PR and IR are also important in stimulating demand. However, these activities must be carried out within the regulations, which vary significantly from country to country. You should check with the investment bank or your lawyers to be sure that this is clear.

5.2.3 Secondary Share Issues

Once a company has floated, it may need further capital. This capital can either be raised from existing shareholders or new investors.

As with an IPO, the key adviser in a share issue is the investment bank, who helps with the documentation, marketing and pricing of the issue. Of course, PR and IR are also important in stimulating demand. Again, however, these activities must be carried out within the regulations, so check with the investment bank or your lawyers to be sure you know what you can and can't do.

In most countries the law protects existing shareholders from having their control diluted by granting them “pre-emption rights”. Pre-emption rights effectively give existing shareholders first refusal over any new shares that are issued, protecting them from seeing their stake diluted when new shares are created and issued to new investors.

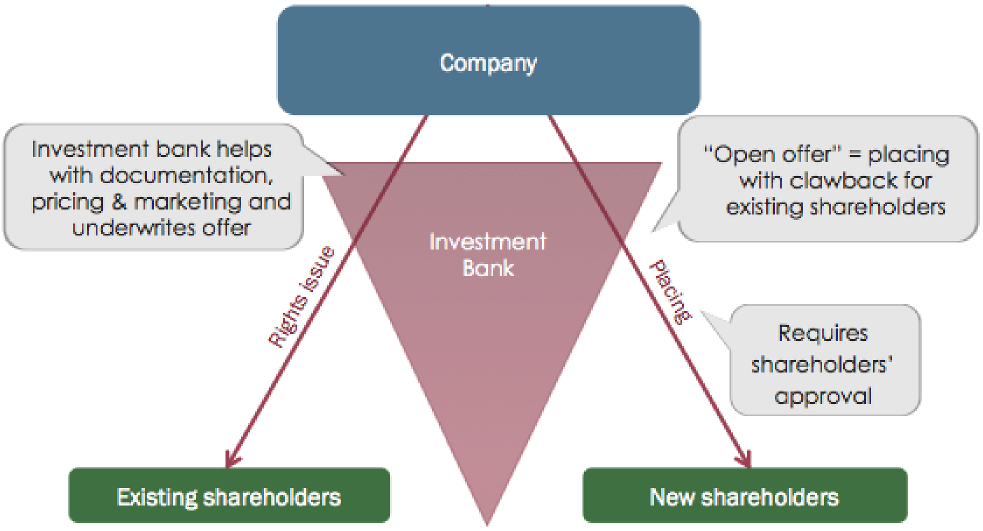
This means that when a company needs to raise large amounts of new capital, it is likely to do this by way of a “rights issue” – an issue of shares to existing investors (in proportion to their existing holdings). Rights issues will be underwritten by investment banks or fund managers, who will agree, for a fee, to take any shares that existing shareholders don’t want, so that the company can be sure of raising the capital.

In secondary share issues, the shares will usually be offered at a discount to the current market price, so that investors have an incentive to invest. The discount is likely to be greater in a rights issue because the company needs to persuade existing investors to put in more money, often a significant amount.

If the company wishes to place shares with new investors, it will usually have to ask existing shareholders to agree to waive their pre-emption rights. Placings are normally for much smaller amounts of capital. The discount offered will be lower than in a rights issue and no underwriting is required. Note that sometimes shares will be placed with selected existing shareholders as well as new investors.

Another alternative is an “open offer” - a combination of a rights issue and a placing. Shares are placed with new investors but existing shareholders have a right to buy their proportion of the new shares if they wish, via a "claw back" arrangement.

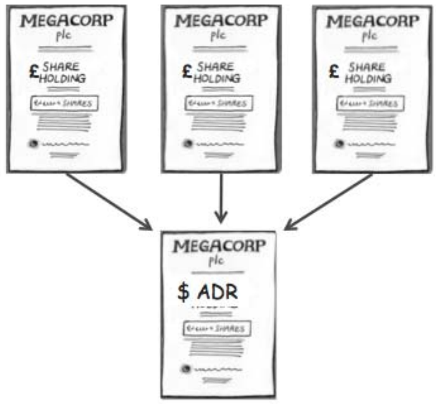
Secondary Share Issues



5.2.4 GDRs & ADRs

Companies usually issue ordinary shares in their domestic market, in their own currency.

If a company wishes to issue shares on an international market, it may issue depository receipts (GDRs - global depository receipts or ADRs - American depository receipts).



These are certificates which represent title to one or more shares. They are bought and sold in currencies other than a company's domestic currency (e.g. American depository receipts are issued in US dollars for a UK issuer. For this reason, they are easier to trade for international investors than foreign shares.

6. How Your Investments Fit In

6.1 Savings

Most of us put money into the bank. If we want to save long-term, we might also invest in a pension fund, a life insurance policy or a mutual fund. Many employers operate pension schemes for their employees, so pensions and similar funds tend to be a large source of long-term capital globally.

Some of us invest a small amount of money on a monthly basis into a fund. Effectively, we are pooling our money with other investors and letting a portfolio manager decide which shares or other investments to buy. These pooled investments are called mutual funds (or in the UK/Europe, unit trusts or open-ended investment companies - OEICS).

Some of us decide to become retail shareholders and buy shares directly in selected companies. In many countries retail ownership is a result of governments selling off state-owned enterprises. Also, early stage stock markets tend to be retail led because these are the only investors in the absence of developed packaged products and hence institutional investors.

In the US, private shareholders are significant. They comprise direct investors, investors who invest via retail brokers, pension accounts and investment clubs.

In the UK, retail investment is lower than in the US, with most of the investment arising as a result of company share-save schemes, privatisations and demutualisations of building societies.

6.2 Pensions

Many companies offer occupational pensions to their employees. The type of scheme varies from company to company and from country to country. Generally there is a move away from defined benefit (final salary) schemes, where the company takes the investment risk, towards defined contribution (money purchase) schemes, where the individual takes the investment risk.

A defined benefit (DB) scheme is where the company agrees to fund a pension which is defined as a percentage or a multiple of the employee’s final or average salary. The investment risk here is with the company. The company needs to ensure that there is enough in the fund to pay the promised pensions.

DB schemes have been relatively common in the US, the UK, the Netherlands, Scandinavia and Switzerland but much less common in most other parts of the world.

Most companies, even in these countries, no longer wish to take the investment risk associated with DB schemes and so have closed them to new members, offering only defined contribution (DC) schemes to new employees.

A DC pension is where the company (and/or the individual) agrees to contribute a percentage of the employee's salary to a fund. The investment risk in this case is with the saver. Most new companies only offer this type of scheme and many old companies now only offer DC schemes to new employees.

6.3 Life Insurance

Life insurance companies offer a mixture of protection policies (which pay out to your dependents if you die before a specified date) and investment policies (which pay out at the end of a defined period, or on death, if that is the sooner). Life insurance companies also offer pension products such as annuities (these policies offer annual income for life in exchange for a single premium).

Investment policies vary in terms of who is taking the investment risk (the insurance company or the policyholder). Where the insurance company is taking the risk, the underlying investments tend to be bonds as these expose the company to less risk. Where the policyholder is taking the risk, the investments may include equities.

6.4 Where the Money Goes

Every month, for many of us, money comes out of our pay packets and goes into pensions and life insurance. This money is passed to a portfolio manager who will decide what investments to make.

We have seen that shares and bonds form an important part of a portfolio. The other conventional investments are property and cash. “Alternative” investments (i.e. not conventional) might include things like art and wine.

7. The Role of Investment Banks

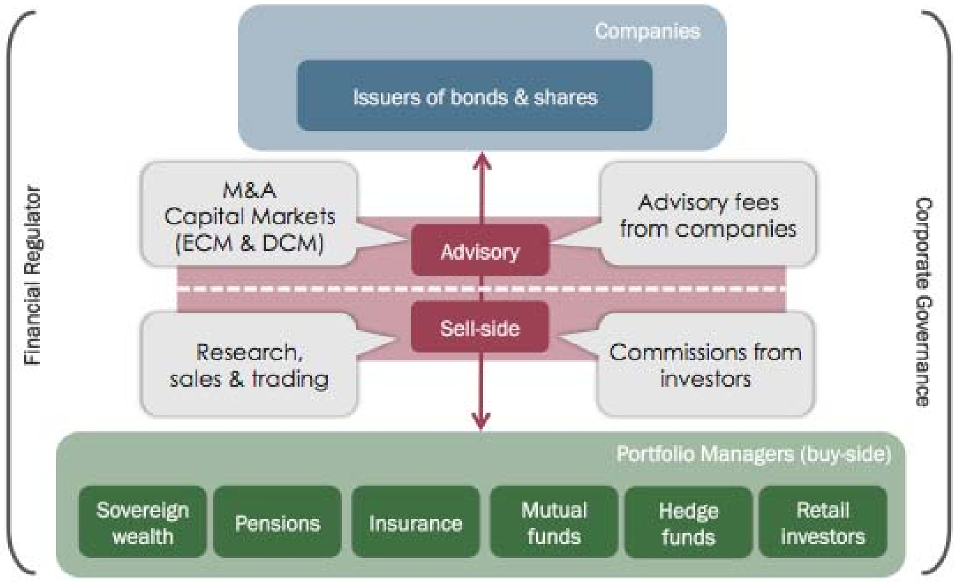
Investment banks act as intermediaries in the capital markets, helping companies raise money from investors and helping investors find a home for their funds.

7.1 Investment Bank Activities

The term investment bank covers a multitude of activities. A typical investment bank is involved in banking, corporate finance (investment banking) and stockbroking (sell-side). Many investment banks also own fund management businesses and are therefore also buy-side institutions.

The investment management part of the bank will operate completely independently to avoid conflicts of interest. Meanwhile, the Chinese walls (shown by a dotted line in the diagram below) should ensure that conflicts are managed in other parts of the business.

Investment Bank Activities



Above the Chinese wall, the investment bank earns fees from companies for giving advice on and raising funds for corporate finance activities such mergers and acquisitions.

Below the Chinese wall, the investment bank earns commissions from investors for facilitating the buying and selling of investments and for giving investment advice.

The Chinese wall separates corporate advisory (advisers to the company) from broking (providing services to the buy-side).

Members of the corporate advisory teams are insiders - advisers who are privy to confidential information about their clients. On the other side of the Chinese wall are the "market participants" involved in the trading of shares.

You should always avoid making selective disclosure of inside information to market participants (unless they have been formally made insiders). Corporate financiers are advisers to the company and are therefore insiders. However, equity salesmen and sell-side analysts are market participants.

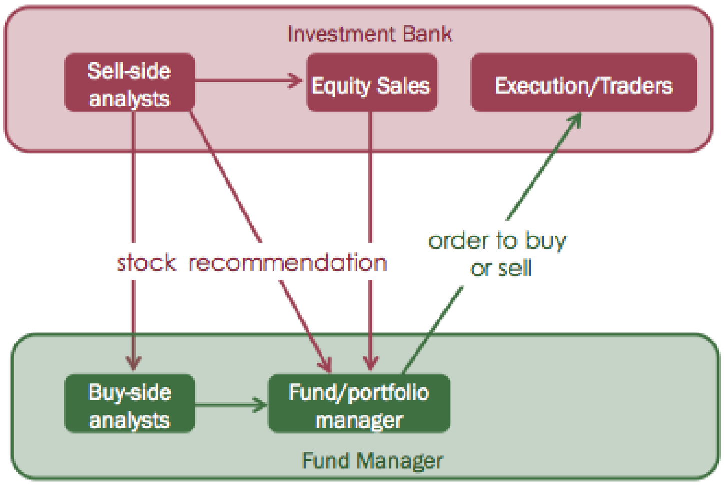
Many investment banks have corporate access teams, sitting alongside the sell-side. The corporate access team operates as part of broking - giving investors access to companies by helping to arrange one-to-one meetings between investors and management and arranging investor roadshows for companies which are raising funds or doing large deals (deal-related roadshows). Some corporate access teams also arrange non-deal roadshows (generally when deal volume is low). Corporate access departments are sometimes called Investor Relations or IR. A roadshow is a series of individual meetings with investors in their offices.

In the UK only, listed companies are required to retain the services of a corporate broker (house broker). The corporate broker (sitting on the advisory side) is required to assist with regulatory compliance and will usually also offer IR services. The corporate broker is of course regarded as an insider. However, it is worth remembering that the corporate broker's analyst is a market participant like any other sell-side analyst.

7.2 Sell-Side & Buy-Side

This picture illustrates how the sell-side and buy-side interact. The sell-side analyst comes up with an investment idea, either driven by a company announcement or event or by his/her own research. He or she shares the investment idea with the sales team and between them, the sell-side sell the idea to the buy-side with a view to generating orders (and therefore dealing commissions).

How Sell-Side and Buy-Side Work Together



Buy-side analysts assist with or drive the investment decision-making process for the asset management firm. These analysts research for the firm's own benefit and so their research will not be available to outsiders. In some fund management firms buy-side analysts are career analysts and therefore very senior. In others, they may be trainee portfolio managers.

7.2.1 Fundamental Analysis

Analysts who look at fundamentals examine the prospects for a sector and a company and use this information to forecast future cash flows for the company and determine the value of the shares.

7.2.2 Quantitative Analysis

Quants focus on creating computer models and trading programmes based on financial theories and complex statistical models, which aim to predict likely price movements and therefore trading opportunities.

8. Stock Markets and Trading Platforms

The term “stock market” is used as a generic term to describe markets for trading shares (like the housing market for domestic property). Companies who wish to have their shares publicly traded will apply to have them listed on one or more stock exchange.

The largest stock exchange in the world is the New York Stock Exchange (NYSE), which is now combined with Euronext, a pan-European exchange. Then comes NASDAQ – the largest electronic screen-based share trading market in the US. Third by value of share trades is the London Stock Exchange (LSE). Fourth is Tokyo.

Almost everywhere in the world, shares are now traded via electronic screens. NYSE still has a trading floor, where traders meet, but this is now very rare. Different markets use different systems to match buyers and sellers. There are two common ways of achieving this. Buy orders can either be posted on electronic order books to be matched with sell orders, or orders can be placed with marketmakers, specialists who agree to quote continuous prices in particular stocks during market hours.

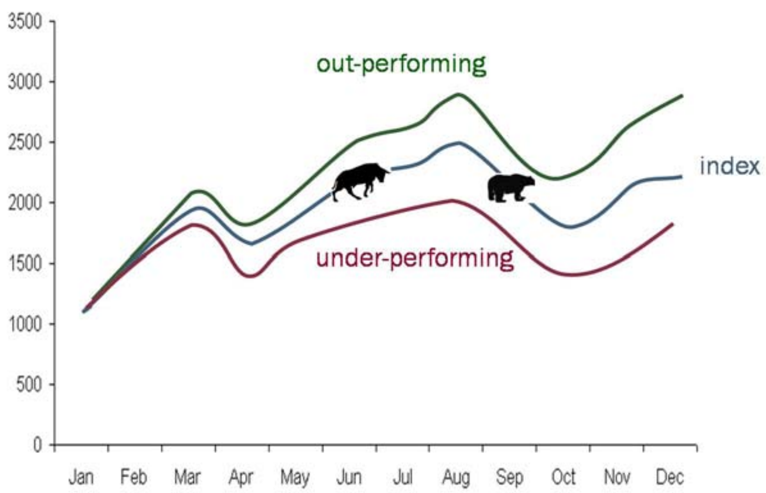
9. Indices

The performance of a stock market can be measured using an index. An index is simply a number that measures the relative performance of a group of stocks. As the value of the stocks in the group changes, the index changes. So if the index goes up by 1%, this means that the total value of the shares that make up the index has gone up by 1%.

Each market has its own index series, often provided by third parties (such as FTSE, Dow Jones and S&P). Each market will have one or more leading indices, which are sometimes referred to as a “benchmark” indices.

The performance of portfolio managers (fund managers) is often measured against a benchmark index. Funds which do better than the index are said to outperform. Those that perform less well than the index are said to underperform.

Measuring Portfolio Performance Against a Benchmark Index



When the market is going up, people tend to feel confident and invest. We call this a bull market. When the market is in decline, people tend to feel pessimistic and may switch out of shares into cash. We call this a bear market.

9.1 Inclusion in Indices

- Inclusion is usually based on size[1] and sometimes also on liquidity (ie the number of shares traded). For indices, size is measured using market capitalisation – the number of shares multiplied by the current share price. Most indices only count the free float to determine a company’s size for index inclusion – the number of shares available to be bought by the public.

[1] You could also measure a company’s size by revenue (the value of goods sold during a year) or the number of employees.

- Companies in an index are weighted so that the largest companies have the biggest impact. A weighting is the proportion of an index accounted for by one company or one sector.
- If a company's market capitalisation increases significantly, this can make it eligible for inclusion in a benchmark index, such as the FTSE 100 or the S&P 500. The result of this is that fund managers whose performance is judged against that index will be more likely to buy the shares and this increase in demand may result in a higher share price. Similarly a company that falls in value may be ejected from the index and its share price is likely to suffer.

9.2 Share Price Influences

Shares in the stock market trade like any other commodity, on the basis of supply and demand. Very simply, if lots of people want to buy something it pushes the price up and if they want to sell, it pushes the price down. Supply and demand are influenced by fundamentals (the market's estimate of the present value of future cash flows) and sentiment.

10. Portfolio Managers

As we have seen, portfolio managers are responsible for investing their clients' funds in a portfolio of shares, bonds and/or other investments. They are also referred to as fund managers, asset managers or investment managers.

10.1 Active or Passive

"Active" fund managers actively try to beat a particular benchmark index. They aim to outperform the index. This is difficult over the long term, as the index is of course an average.

"Passive" fund managers aim to replicate a benchmark index. They may attempt to out-perform, but they will not stray too far from index weightings - i.e. they tend to select shares roughly in proportion to the index.

The ultimate passive fund is an "index tracker", where the portfolio is selected to exactly or almost exactly replicate the index and where performance is measured by reference to the tracking error (the extent of deviation from the index).

10.2 Top Down or Bottom Up Approaches to Stock Selection

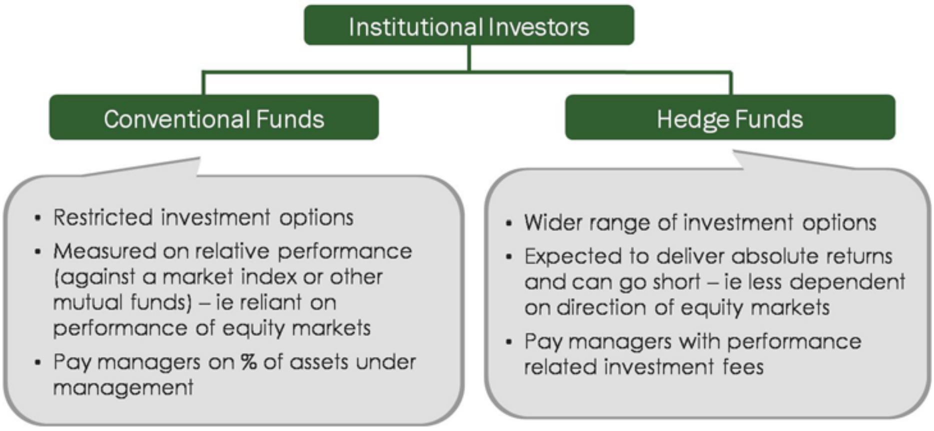
A "top down" approach to investing means deciding first which region to invest in, then which sectors and then selecting the companies.

A "bottom up" approach to investing would involve choosing undervalued companies without much regard to which sector or which currency is involved.

10.3 Growth, Income or Value

These terms describe the objective of the fund – ie to concentrate mainly on capital growth, or income or stocks that are inherently undervalued in relation to their prospects.

10.4 Conventional or Hedge Funds



Conventional funds are those where the manager's performance is measured against a benchmark index.

Hedge funds are collective investment schemes which are not conventional funds - i.e. they do not measure their performance relative to a benchmark index. Instead, they aim for absolute performance (a certain percentage each year).

Hedge funds are often limited partnerships and may be based off shore. This means that they avoid some of the regulations governing conventional funds and many are therefore only available to institutional investors. One of the strategies used by hedge funds is to “short” stocks. This means selling shares you don’t own with a view to buying them later when the price has fallen, thereby making a profit.

11. Sell Side Analysts

Sell-side analysts work within the broking (investor facing) part of an investment bank. They sell ideas to fund managers (the buy-side).

Sell-Side Characteristics

11.1 The Role of the Sell-Side

The role of the sell-side is serve their client base both internally (eg sales teams within the investment bank) and externally (portfolio managers). To do this, they need to constantly monitor news flow and market movements and be ready to react to events as they happen.

A typical day might involve:

- Examining and analysing company results
- Morning meeting with the sales team
- Client calls (portfolio managers)
- Company results meetings and conference calls
- Company background meetings
- Updating forecasts & spread-sheets and writing research
- Presenting or talking to fund managers on sectors & stocks

The sell-side needs to generate ideas that will encourage their clients to deal.

With an increasing proportion of volumes and commission being provided by hedge funds (up to 40% of revenues for some securities houses), the style of their hedge fund clients is increasingly affecting sell-side research and the nature of recommendations.

Each year various organizations such as Thomson Reuters (StarMine) and Institutional Investor publish rankings of sell-side analysts by sector and by region and awards prizes. These are useful for prioritising management time spent talking to the sell-side. The same rankings also have a bearing on how individual analysts are paid by the firms they work for.

12. Managing Expectations

Investment decision-making is driven by the need to determine whether a company's shares are under or over-valued by the market (and thus whether or not they constitute a good buy at the current price). In order to value a company, analysts and investors must forecast future profits and cash flows. Sell-side analysts publish their forecasts within their research notes and the average of these forecasts is known as the "consensus" or "market expectations" (note that consensus is in fact an average, not a forecast with which the market agrees).

Companies should monitor market expectations to ensure that they are not out of line with internal expectations (management's latest forecast). If the market is operating under a misapprehension, the company should correct this by way of a public statement (press release). In many markets (e.g. Europe) this is a regulatory obligation.

The consequences for a company which misses market expectations – i.e. does not achieve the consensus forecast - are invariably a substantial share price drop. Not only has business performed less well than expected, but the market may begin to doubt management's ability to understand its own business or market. Such disappointments also have implications for management's relationship with the sector analysts who may feel that they have been misled.

The process of monitoring and managing market expectations is therefore a crucial part of IR. This often starts with the issuing of earnings guidance – guidance on future numbers included by management in investor communications such as results press releases.

12.1 **Example Sell Side Research Report**

US Retail

Super Stores Inc

ABC BANK
March 2013

Hi alpha

Analyst: Caroline Muir
Specialist Sales: Fred Red

Long term growth

Market Cap: $700m

REASON FOR REPORT	RECOMMENDATION	CURRENT PRICE	TARGET PRICE
Full year results	BUY	$6.25	$8.50

Summary Forecasts

$m	2012A	2013E	2014E	2015E
Sales	2,550	2,933	3,372	3,878
EBITDA	106.5	122.5	141.6	162.9
EBIT	76.5	88.0	101.2	116.3
EPS	42c	48c	56c	64c
DPS	21c	24c	28c	32c
P/E	15	13	11	10
Yield	3.4%	3.8%	4.5%	5.1%

Summary

Super Stores results came in at the top of expectations as usual and although there was no upgrade for 2013, management's body language was relaxed and confident.

International growth is accelerating and European comps were still very strong. We continue to see lots of potential for this new format both here and in overseas markets.

It is early days in the new Asian markets, but Super Stores' low risk approach of partnering local businesses has worked in Taiwan and the early signs from China are promising.

Super Stores' discount model should prove defensive in current market conditions – the US MD confirmed that they are already seeing shoppers switch from conventional supermarkets – and we think the margin is sustainable given their very low cost operating model.

Super Stores currently trades at a slight premium (based on 2013 P/E) to its peer group but emerging markets exposure will help the company to grow at a more rapid rate than its peers. We believe that this would justify a 10% premium to its peers. To reflect this, our 12-month price target is $8.50.

IMPORTANT DISCLOSURES ARE INCLUDED IN THE APPENDIX AT THE END OF THIS REPORT

This is a mock-up of a sell-side research note. These reports are designed to supply investment ideas to the buy-side (thereby generating commissions for the sell-side).

Reason: Most analyst notes are event-driven. Typically notes will be written on the back of results announcements, M&A and other major corporate events that have been announced by way of a news release.

Recommendation: The analyst will recommend the shares as a "buy", "sell" or "hold". Alternative jargon might be "overweight", "underweight" or "neutral". These terms relate to the proportion of an investor's portfolio that the analyst advises to invest in shares. A third alternative is to use the terms "out-perform", "under-perform" and "market perform". These terms signal that the analyst expects the shares to do better or worse than the average in the forthcoming months.

Target Price: This is the price that the analyst thinks the shares should move to over the next 12 months.

Forecasts: The process of valuing the company, to determine the target price requires the analyst to forecast revenues, costs and profits. In the picture above, you can see actual reported figures for 2012 and forecasts for 2013, 2014 and 2015.

Market Cap: Market capitalisation is the stock market's value of the company's equity (shares). It is calculated by multiplying the current share price by the number of shares in issue. It is a good indicator of the size of a company and is important in determining whether a share will be part of a benchmark index (entry criteria usually include market cap).

EBITDA: Earnings before interest, tax, depreciation and amortisation is the company's profit from its operations before non-cash expenses, relating to the using up in value of assets. It is often used as an indicator of profitability across a sector as it strips out the different accounting policies that companies can choose for depreciation and amortisation.

EBIT: Earnings before interest and tax is the company's operating profit (the profit from what it does).

EPS: Earnings per share is simply the net profit (after interest and tax) attributable to ordinary shareholders, divided by the average number of shares in issue.

DPS: DPS is dividend per share - the amount of profits paid out to shareholders in cash.

P/E: The P/E ratio measures price to earnings per share and is expressed as a number of times (hence it is often called a "multiple").

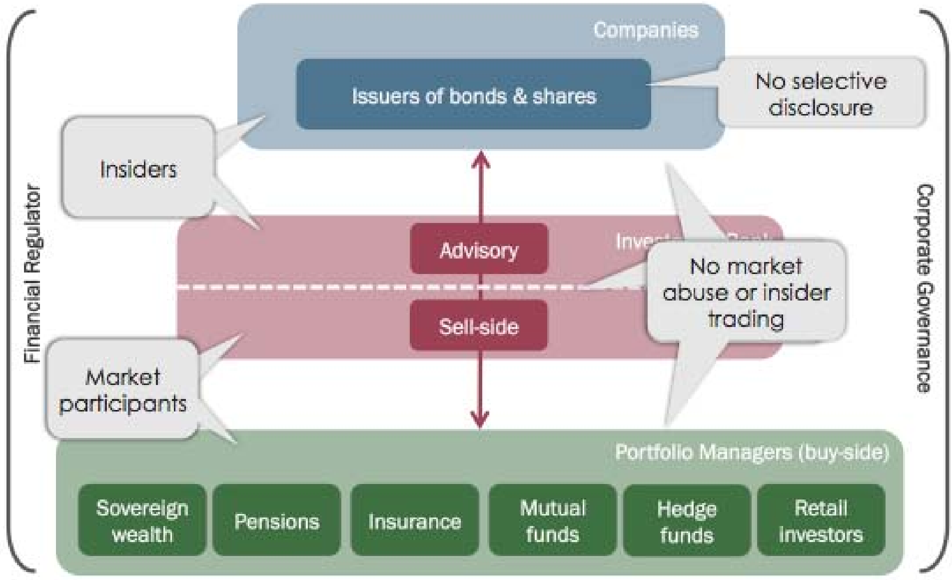
Yield: Yield (or dividend yield) measures the dividend as a percentage of share price.

Summary: Note that the analyst in our example is writing for an audience she knows well, so the language is often chatty and full of abbreviations, which she knows fund managers will understand. For example LFL stands for "like for like" - meaning here, growth from stores that were in the portfolio last year (as opposed to from new stores). The first sentence is interesting because it refers to management's body language. Research shows that up to 70% of communication is non-verbal. This highlights the need to ensure that management are aware of this.

Disclosures: The disclosures at the end of a research report state that the research is the analyst's own view and list any potential conflicts of interest. Typically the report will state that the investment bank/broker is either doing business with the company being researched or is seeking to do business with that company. Of course this relationship could compromise the independence of the research, which is why these disclosures are made.

13. Regulations for Listed Companies

Regulations Overview



13.1 The Most Important Rules

Regulators are generally focused on two key objectives – to promote efficient, orderly and fair markets and to protect the interests of retail consumers – ensuring that they get a fair deal. You should note that while not all domestic regulators enforce the same regulations, these are the standards that would be expected by international investors and therefore they apply in most international stock markets.

The most important rules globally are:

- No selective disclosure of price-sensitive information as this would make the markets unfair. You may have heard of Regulations Fair Disclosure in the US (Reg FD). This is exactly what that regulation is trying to achieve.
- No insider dealing or market abuse
- Prompt release of important high quality information to the market through the required channels including financial results.

13.2 Fair Disclosure

There should be no selective disclosure of unpublished, price-sensitive information.

Price-sensitive information is:

- Specific news
- Likely to have a significant effect on share price
- News that investors would want to know before making an investment decision

In Europe, unpublished price-sensitive information is referred to as "inside information". As a general rule, all price-sensitive information should be announced publicly through the required channels without delay.

13.3 Market Abuse

Market abuse is an offence in most markets. It includes:

- **Insider dealing** - dealing in shares whilst in possession of unpublished, price-sensitive information or encouraging others to deal. This unfair practice is a criminal offence in many markets.
- Disclosing inside information other than in the proper course of business (including strategic leaks)
- Issuing inaccurate or misleading information about a company
- Issuing inaccurate or misleading information about stock trades or share ownership and
- **Share price manipulation** (e.g. starting a rumour to raise or lower a share price).

Of course market abuse rules apply to anyone who handles price-sensitive information and to those who trade shares in the market.

13.4 Disclosure Rules

The rules in most markets require price-sensitive information to be carefully controlled.

- It must not be leaked or dripped out into the market
- Price-sensitive information should never be disclosed selectively
- All press releases should be thoroughly checked for accuracy and signed off by the Board before being issued to the public through the required channels - usually to the local exchange and/or via a number of news wire services.

13.5 Process for Disclosure of Information

Each country has its own system for making price-sensitive information public. Here are some representative examples:

In **Australia,** inside information must be notified to the Australian Stock Exchange without delay.

In **Germany**, companies must notify all price-sensitive information to the Frankfurt Stock Exchange and the regulator, BaFin before publishing the information on the company's website and elsewhere.

In the **UK**, information must be made public via one of the FCA authorized Primary Information Providers or PIPs. Information can of course be distributed more widely, but not before Regulated Information Services release. The Information must also be published on the company's website.

In the **US**, price-sensitive information must be released via news wire services. Certain announcements, such as earnings releases, must also be filed electronically on special forms with the SEC. For example, US companies must file their annual report on form 10-K and quarterly reports on form 10-Q.

13.6 Financial Calendar

Regulations impose a financial calendar of events on listed companies. Much of the IR and financial PR effort is directed to turn these obligations to communicate publicly into opportunities.

The precise requirements for the financial calendar vary from market to market. For example, in the US, companies are required to announce earnings (results) quarterly. The UK financial calendar follows the European Transparency Directive and so applies in principle across the European Union for listed companies. However, individual stock markets vary according to whether they require quarterly results or six-monthly results with interim management statements in between.

14. Summary and Conclusion

All markets are a meeting place, physical or virtual, where people with something to sell meet with people who want to buy. Buyers and sellers are often assisted by intermediaries who can advise on what to buy or sell and what the price should be and by others who facilitate the process by acting as middlemen.

The capital markets are no different and around the world they all operate in the same way, whether in the developed markets of London and New York or the emerging markets of South-East Asia and Latin America.

As the globalisation process progresses, so the role of the capital markets is becoming more and more important, channeling funds to where the returns are commensurate with the risks undertaken.

At one end of the spectrum, they provide debt capital to the US Government, at the other they will provide equity funding to an IPO in a frontier (very immature) market.

The beautiful efficiency of the capital markets is that the capital is allocated to where it can best be used, and the governments and companies who use the markets must deliver the returns and adopt the markets' disciplines or else face the threat of paying more for their funding or even losing access to capital altogether.

The growing importance of the capital markets has also resulted in some dramatic changes to the banking system, with the role of investment banks assuming greater importance and increasing numbers of companies turning to the capital markets to service their debt requirements and away from the traditional lending banks.

If you would like FinanceTalking to help you with financial training and/or communication ideas in this area please contact us on:

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