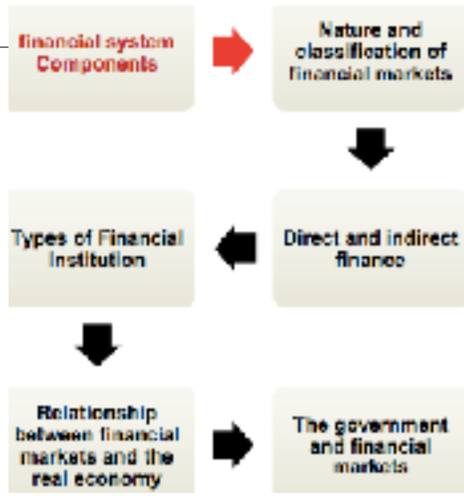
Financial Markets BAFI1002

Overview

- in class tests - 20%
- dealing report (market view presentation & final report) - 40%
- Final exam - 40%
- need a financial calc

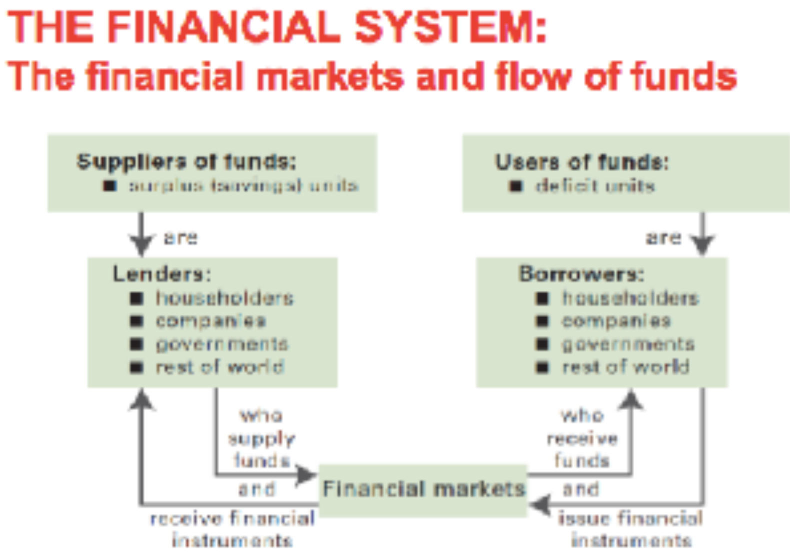
Week	Lecture Topic	Activities and Assessments
1	Course Guide Topic 1: Introduction to Financial Markets	Tutorial - Preparation to form groups
2	Topic 2: Interest Rates	Tutorial: T1
3	Topic 3: Money Markets	Tutorial: T2
4	Topic 4 A: Foreign Exchange	Tutorial: T3
5	Topic 4 B: Foreign Exchange	Mid-Semester Test (T1 to T3)
6	Foreign Exchange Dealing Session	3 hours Dealing Session
7	Topic 5: Debt Markets	Tutorial: T4 A **Submission of Market View**
8	Foreign Exchange Dealing Session	3 hours Dealing Session
9	Topic 6: Equity Markets	Tutorial: T5 A & B
10	Topic 7: Derivative Markets	Tutorial: T6 **Submission of FX Final Report**
11	Topic 8: Australian Financial System	Tutorial: T7
12	Revision Q&A	Tutorial: T8

Introduction to Financial Markets



Financial System Components

- Financial system compromises a range of financial institutions, instruments, markets that facilitate transactions for goods and services and financial transactions
- key elements of the Australian financial system
  - financial instruments
  - financial markets
  - financial institutions
- functions of the financial system
  - to facilitate the transfer of funds from surplus economic units to deficit economic units, by the creation of new financial assets
  - to facilitate the trade of existing financial assets
- components of the financial system
  - surplus economic units
    - individuals, households and companies with more funds than needed for the immediate future
    - savers
    - potential lenders
  - deficit economic units
    - individuals, households and companies who need additional funds to meet expenditure plans
    - potential borrowers
  - financial institutions
    - organisations whose core business involves borrowing & lending (financial intermediation) and
    - provision of financial services
  - financial assets/ financial instruments
    - issued by a deficit economic unit
    - acknowledge a financial commitment and entitle the holder to specified future cash flows
  - financial markets



Nature & Classification of Financial Markets

- Types of Financial Assets
  - Debt: represent an obligation on the art of the borrower to repay principal and interest
    - deposits & loans
    - contractual savings
    - discount securities
    - fixed interest securities
  - Equity: represent an ownership claim over the profits and assets of a business
    - ordinary shares
  - Hybrid: financial assets which have features of both debt and equity
    - preference shares
    - convertible notes (bonds)
  - Derivatives: financial assets whose value is derived from another financial asset, rate or index
    - forward contracts
    - furures
    - options
    - swaps

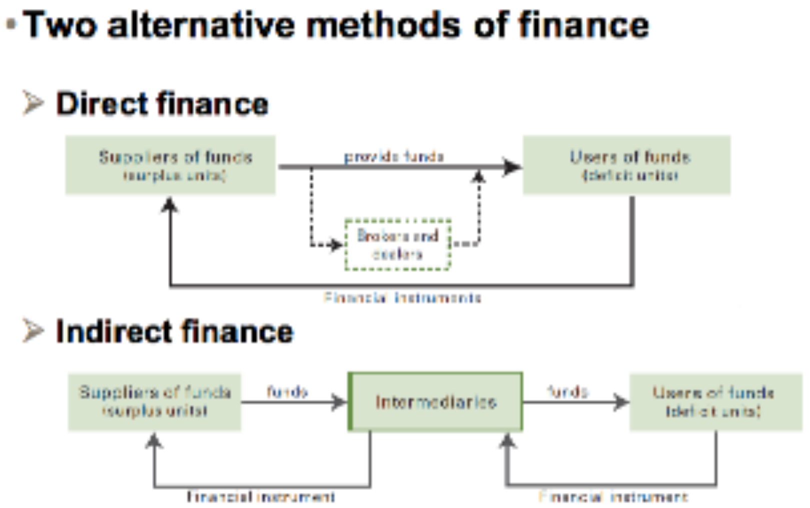
- Attributes of financial assets (important when considering investment)
  - Return V Risk
    - Return: the gain or loss of an investment over a specific period, expressed as a percentage increase over the initial investment cost
    - gains/ losses on investments: periodic income received from the security + realised capital gains/ losses
    - Risk: the chance that an investment's actual return will be different than expected
    - always a TRADE OFF between risk and return
  - Liquidity: the degree to which an asset or security can be bought or sold in the market without affecting the asset's price
    - ability to convert an asset to cash quickly (aka Marketability)
    - particularly critical with a high level of trading activity
    - is safer to invest in liquid assets than illiquid ones because it is easier to get your money out of the investment
  - Time pattern of the cash flows: when the specified or expected cash flows related to a financial asset are to be received by an investor
    - when, how much, how often
  - Portfolio structuring: a combination of assets and liabilities to maximise the returns from a set of investment for a given level of risk
    - a good portfolio is not simply a collection of individually good investments

- Classification of financial Markets
  - by the nature of the assets
    - Primary Markets:
      - financial assets first created
      - funds flow from surplus economic units to deficit economic units
    - Secondary Markets
      - existing financial assets are traded - financial securities
      - economic units do not directly participate in secondary market transactions

- By the term of the assets
  - Money markets: funds are lent for periods of less than 12 months
  - capital markets: funds are lent for periods of 12 months or more

---

Direct and indirect finance



- Direct finance: funds are transferred directly from surplus economic units to deficit economic units
  - primary financial assets are issued directly from deficit units to surplus units
  - financial institutions play a role in direct finance by providing financial services (e.g. financial advice, underwriting) in return for fees and commissions
- Indirect Finance (intermediated finance): financial institutions act as intermediates, borrowing from surplus units and lending to deficit units
  - primary financial assets are issued by deficit units to intermediates, and secondary financial assets are issued by intermediaries to surplus units
  - financial institutions earn income by way of net interest margin
  - advantages: asset value transformation, maturity transformation, credit risk reduction & diversification, increased quantity of national savings, very useful for households
  - disadvantages: increased costs of funds for borrowers, reduced return for savers (net interest margin), less likely to secondary financial assets to be securitised

---

Types of Financial Institutions

- Deposit Taking Financial Institutions: attract the savings of depositors through on-demand deposit and term deposit accounts (e.g. commercial banks, building societies and credit cooperatives
- Non-deposit taking financial institutions: may manage funds under contractual arrangements and provide a wide range of financial services (e.g. investment banks, general insurance companies and superannuation funds)

- Main types of financial institutions
  - commercial banks
    - largest group of financial institutions within a financial system
    - core business of banks is often described as the gathering of savings (deposits) in order to provide loans for investment
    - provide off-balance-sheet transactions (e.g. underwriting, issue of derivatives or execute FX transactions
  - building societies and credit cooperatives
    - authorised deposit-taking institutions that primarily give loans for housing finance
    - majority of funds are deposits from customers. residential housing the main form of landing. credit union funds are sourced primarily from deposits of members
    - common for credit unions to have a common bond of association of its members, based on employment, industry or community
  - investment banks and merchant banks (MM corp)
    - off-balance-sheet (OBS) advisory services to support corporate & government clients
      - e.g. advice on mergers, acquisitions, portfolio restructuring, finance and risk management
    - may also provide some loans to clients but are more likely to advise on raising funds directly in capital markets
    - execute FX transactions
  - managed funds
    - attract the savings from individual investors and invest in both money and capital market
    - funds normally managed by professional investment managers with extensive investment knowledge and skill
    - provide access to wholesale markets
    - investors can obtain right to assets of the fund or the income derived from those assets