

# [Functions of investment banks](https://assignbuster.com/functions-of-investment-banks/)

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A Critical Discussion of the Major Functions Performed by Investment Banks.

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Abstract

Investment banks evolved as a result of lucrative merchant centers located in the north of Italy, Belgium as well as Holland from the 17th through 19th centuries. During that period Europe’s most influential merchant families moved to the United Kingdom as it was becoming the merchant and banking center of the region. Said list included the Barings, Rothchilds, and Warburg families and their interests (Kuhn, Robert. 1990) [1] . Developments in the United States resulted in that country becoming the center of financial activity in the late 20th century and saw the rise of JP Morgan, Goldman Sachs Merrill Lynch and Morgan Staley joining the ranks of the older investment powers (Carosso, 1970) [2] .

Investment banking represents a broad spectrum of financial services that are dispensed by various specialists in conjunction with global investment banks. The services performed by these institutions includes (Lott, 2001) [3] :

1. Underwriting,
2. Distribution,
3. The maintenance of markets in bonds, shares and securities issued by public entities and businesses, as well as
4. Other services

In contrast to the services provided by commercial banks, where the principle functions are to accept deposits and make loans to consumers and business on a short-term basis, investment banks engage in four important functions (Lott, 2001) [4] :

1. Assist in the arrangement for the provision of funds to corporations and governments through underwriting as well as distributing new securities issues,
2. Maintenance of markets for securities through the trading and execution of orders for secondary market transactions,
3. Administer advice with respect to the purchase, sale and issuance of securities as well as other financial areas,
4. The creation and management of varied investment vehicles.

In addition to the foregoing, investment banks also perform a number of other important transactions and functions that are the subject of discussion in this paper.

Chapter 1 –The Major Functions of Investment Banks

1. 1 Summary

Investment banking consists of a broad array of financial transactions. Some of the more familiar are (Lott, 2001) [5] :

1. Underwriting,
2. Syndication,
3. Corporate Demand Capital
4. Tenders and,
5. Investment banking functions

It is this last area that shall for the basis for examination.

1. Bills of Exchange (Williamson, 1988) [6]

These are independent instruments of debt that carry the signature of the customer (debtor). In summary, it is an order that directs a specific sum is to be paid to a specific individual. This instrument safeguards that a bill is accepted so that control is not lost of the item(s) involved. A ‘ bill of exchange’ contains a stated date of payment that must be concluded on that date irrespective of any disputes concerning the item named. There are legal measures to prevent payment, termed ‘ non-honoring’, which are subject to differing rules depending upon the country involved.

1. Corporate Finance (Williamson, 1988) [7]

This aspect of investment banking represents a specific finance area that deals with corporate financial decisions as well as the tools and analysis formulas and processes utilized to arrive at these decisions. It is divided into ‘ short-term’ and ‘ long-term’ techniques and decisions whereby the objective is to enhance corporate value through ensuring the ‘ return on capital’ is more than the ‘ cost of capital’. The equation rests on a conservative application of risks.

Corporate finance is related to managerial finance, although the latter is larger in scope as it entails financial techniques that are possible in all business forms, whether they are corporate or non-corporate.

1. IPO’s (efmoody, 2005) [8]

Termed ‘ Initial Public Offerings’, IPO’s represent the beginning of a publicly listed company and as such those investors whom are in position at this stage are poised to reap almost immediate gains if the stock rises on opening day. Similarly, these same investors stand to lose money if the opening price drops substantially. During the last few years the offering prices have tended to average out as being overpriced. This is borne out by the fact that the closing price, on average, the day of opening generated an annual return of just 2%.

In terms of profitability, IPO’s generate large fees for the participating firms and represent the most profitable underwriting area. Fees generally average seven percent (7%). After the various splits between managing underwriters, brokerage firms, law firms and staff the profit hovers in the 34% through 40% range. This service is a cornerstone in aiding firms to float securities needed to expand or underwrite operations and as such represents one of the more important functions performed by investment banks.

1. Rights Issues (Constantinides et al, 2002) [9]

These are equity issues whereby shareholders of record have the right to purchase new shares that have a fixed exercise price.

1. Mergers & Acquisitions (Allen et al, 2000) [10]

Investment banks act in the capacity as advisors in merger and acquisition deals. In working with both the target(s) of acquisition as well as the acquirer(s), investment banks provide their information expertise to help arrive at the ‘ reservation price’. They also calculate the potential for gains and the risks in the transaction. And while investment banks have a vested interest in these deals, their pragmatism is an effective counter weight in maintaining a balance between undervaluing and overvaluing. Operating under banking regulations, investment banks represent a sort of intermediary that engenders public trust in the legitimacy of the transaction and is a part of a system that represent checks and balances over these types of transactions.

Commercial banks might have potential conflicts of interest in these types of deals, so even while they have recently taken on this role, the majority of these transactions are still funneled through investment banks.

1. Investment Management (Williamson, 1988) [11]

As the term implies, investment management is also known as portfolio management as well as money management. It is a segment of investment analysis that examines the management of money relating to securities purchases as well as their sale.

1. High Net Worth Individuals (Williamson, 1988) [12]

Investment banking services for individuals of high net worth has been a long standing feature for an elite group whose banking investment needs exceed the capabilities of commercial banks and traditional specialists. The complex variable regarding the client’s return targets and relative degrees of risk along with long as well as short-term requirements represent specialized analysis. The resources of an investment bank are suited to meet the demanding requirements of these types of individuals as well as confidentiality. The extremely sophisticated variables comprising recommendations and placement in various instruments are crafted to fit an approved plan of action. Because high net worth individuals have access to their own channels of information, the demands of these types of clients in terms of sophistication requires the resources of a specialized institution.

1. Corporations (Williamson, 1988) [13]

The investment management of corporations entails handling a number of asset management areas. As is the case with high net worth individuals, it entails an extensive analysis of the goals and objectives desired as well as the cash availability requirements for specific periods of time. The preceding represents a valuable service as a result of the high level contacts and access to specialized information, opportunities and rates of return with moderate risk that investment banks can avail themselves of.

1. Pension Funds (Williamson, 1988) [14]

These funds represent extremely large sums that require placement in investment avenues that contain high degrees of safety as well as meeting return rates in established parameters. The important nature of these retirement funds requires an institution to pay close attention to risk avoidance as well as any potential changes and shifts in the market that could potentially affect the money in the Fund.

1. Mutual Funds (Williamson, 1988) [15]

In terms of mutual funds, there are literally hundreds of fund types to select from as a result of the classifications within this group. One particular type of fund which investment banks have an advantage over commercial banks is in hedge funds. These types of funds are unregulated and usually governed by unconventional strategies. Hedge funds trade in equities, money markets and bonds and offer yields as well as risks that exceed traditional long stock and bond methodologies. The secretive nature of these funds and the fact that they cater to institutions, corporations and high net worth individuals only is within the purview of investment banks.

The mutual fund classifications contains a number of differing types, these are as follows:

1. Objective Oriented
   1. Growth

This type is structured so that it appreciates in value over time by investing principally in the common stock of companies that have shown or are showing a high growth potential.

1. Income

These are structured to generate dividends on a regular basis as the priority, with growth in value as the secondary selection criteria.

1. Balanced

These funds are a balance between growth and income funds thereby providing investors with dividend payouts while the fund appreciates in value as a result of the growth in the corporations selected.

1. Market Oriented
   1. Specialized

Through limiting holdings in one industry sector these ‘ sector growth’ funds place their emphasis on one industry classification. The preceding entails risks if that classification or segments of that classification perform poorly. The reverse is also true if the sector experiences growth.

1. Bond Funds

These tend to be conservative investments, principally in debt securities, with the objective of providing income while preserving capital. The focus is similar to Income Funds, which is the payment of dividends.

1. Municipal

These types of bonds can be either short or long term and represent state and or local government issuances.

1. Corporate

These funds are composed of bond issuances by corporations and are guaranteed by companies to pay out both interest as well as principle.

1. Zero-coupon

These are bonds that are sold to investors at a discount and payout only on the maturity of the face value. Because the investor purchased these at a discount, the face value represents the gain.

1. International

These are composed of the debt securities of corporations and governments located in other nations. As some countries pay higher rates, the gains can be interesting depending upon currency fluctuations and conversion rates.

1. Convertible Securities

These funds invest in securities (debt) that permit conversion of their bonds into stock. The objective is the preservation of capital yielding growth and income.

1. Money Market

Money market funds invest in the short-term obligations, debt, of both governments and corporations and are structured by and large to permit smaller investors to participate for amounts starting at approximately $500, depending upon the fund. Without the fund, direct participation requires increments of $10, 000. The pooled sums are then invested and managed.

1. Multifunds

This type of fund invests in the performance of other types of mutual funds.

1. All Weather

These are designed to weather all types of business and economic phases.

1. Emerging Growth

These types of mutual funds invest in companies with high growth potential.

1. Precious Metals

As the name indicates, these are funds that take positions in various types of valuable metals.

1. Green

A newer category within this classification, Green Funds select growth companies that have a record of being responsive on environmental issues and adhere to policies within that arena.

Chapter 2 – Conclusions

Investment banks serve a valuable purpose in financial and business markets through their handling of public offerings (IPO’s) and private placements. These functions help corporations with their liquidity requirements and the issuance of securities. As investment banks can sell stock in an IPO as well as secondary offering and private placements they represent a centralized location that is able to fill the needs of corporations, governmental entities and high net worth individuals. The decades, and in some cases centuries of participation in high level finance has resulted in connections within finance arenas whereby investment banks maintain ties and associations at participation levels that are beyond commercial banks. In addition, this sector represents the top of the talent pool in finance, thus the intelligence factor exceeds the personnel employed in commercial banking.

Because investment banks are primarily paid on a success basis, their commitment to the deals is higher and so are the monetary rewards. Typically, the compensation in the industry ranges 50 through 60% of profits paid out to partners and employees. Investment banking executives, analysts, junior bankers and junior partners generally earn twice their commercial bank counterparts as their jobs entail making money for the firm as well as performance reviews for themselves. The high pressure and performance nature of these positions means only the brightest in their fields work in this sector, thus the reason for investment banks receiving the biggest and the best of deals in all of the service function areas mentioned above.

The preceding emphasis on profits, earnings, fees and performance might seem like a focus on greed, however it is geared to bring out the best, through competition among firms, which benefits investors, the general public and the economies of the countries in which these firms operate.

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### Footnotes

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