Firms and the financial market term paper

Business, Company

FIRMS AND THE FINANCIAL MARKET

Financial markets play an important function of channeling funds from agents who have saved money and are willing to lend it out to agents who need funds and are also willing to borrow. Financial market is defined by Brigham E. F & Ehrhadt, M. C. (2011) as what brings together people and organizations needing money with those having surplus funds. There are many financial markets in a developed economy or a geographic location. In contrast to physical (real or tangible) asset markets where products like machine parts, automobiles, real estate, computers and machinery are sold, the financial asset market on the other hand is where stocks, bonds, notes, mortgages, derivatives and other financial instruments are traded. This in fact goes a long in raising funds for a firm or corporation, depending what the firm’s needs are at that given moment in time.

In corporate financing, real and financial functions of the firm are strongly linked and the prices of financial instruments are also closely related to the profits as much as the prices of the goods and services produced and or offered by the firm in the real sector. The access to finance in some cases alters the objective function of the firm and the market interaction of shareholders’ influences the firm’s behavior in the real sector (Brigham E. F & Ehrhadt, M. C., 2011). This is particular as financial sector integrates the preferences of all shareholders into the decisions for production and ownership structure.

Some examples of financial markets according to Brigham & Ehrhadt are;

(a) Spot markets and futures markets which are markets in which assets are bought and sold " on the spot" delivery mostly in few days or for delivery at some future in the near future for example six months or a year into the future.

(b) Money Markets which are short term and highly liquid debt securities.

(c) Capital markets. These markets are mainly for stocks and debt maturing more than a year in the future e. g. NYSE. For the capital markets, the short – term is for one year, intermediate is one to five years where as long – term period is more than five years.

(d). Mortgage Markets. These markets deal with loans on residential, agricultural, commercial and industrial real estate property. In this category, consumer credit markets involve loans for automobiles, home appliances, children education, vocations and consumables of the like.

(e) Private Markets. In this type of market, transactions are worked directly between two parties for example bank loans. Private market securities are tailor- made but though less liquid whereas public market securities are more liquid but are always subject to greater scrutiny and greater standardizations.

These financial markets are structured in terms of;

Debt and equity markets for example government and corporate bonds

Primary and secondary markets where primary market is where newly issued securities are sold to initial buyers by the firm or government borrowing funds. Here basically it is about raising new capital. Examples of these are

initial public offerings (IPOs), a case in point is when Microsoft had its IPO in 1986. The insiders normally sell some of their shares and the firm sells the newly created shares to the public to raise some additional capital for operations, most of time for expansion into bigger markets. Another case is an instance when US Treasury can issue new US government bonds and sell them to a private firm.

Whereas secondary market is where previously issued securities are traded for example a private firm selling existing government bonds to another private firm and in this situation brokers and dealers play a great role to complete these transactions. Secondary markets also exist for securities like bonds, mortgages and other financial assets. The firm in this case is not involved in a secondary market transaction and therefore does not receive any of the finances generated from the secondary market.

Exchanges and over the counter markets where buyers and sellers meet in a central location for example the New York Stock Exchange (NYSE) and over the counter (OTC) market where dealers are transacting businesses at different locations and are trading using computers and telephone networks for example the National Association Of Securities Dealers' Automated Quotation System (NASDAQ). Money and capital markets which are short term debt traded instruments (Money market) and intermediate and or long term debt and equity traded (for capital markets)

The principal money market instruments are treasury bills, negotiable bank certificates of deposit, commercial paper, bank's acceptances, repurchase agreements, federal or government debt. These are short term instruments maturing in one year or less. The financial institutions involved in the

financial markets are commercial banks, savings and credit associations, mutual savings banks, credit unions, mutual funds, money markets, hedge funds and other private equity funds. We explain some of the instruments according to Callahan, T. & Nandakumar, I. (2010)

Stocks and Shares: These are types of securities that ideally and practically signify firm ownership and represent a claim on the firm's assets and earnings. Practically a stock or share holder carries a certificate which is a notarized piece of paper that corresponds to a stake in the firm in which shares have been bought. There are basically two types of stock namely common and preferred stocks. Common stock gain value and can also be sold for a profit on the market or can be retained and the person holding to them receives periodical payments which are called dividends. The dividends depend on the firm's ability to make profits and increase earnings in the given period. On the other hand, preferred stocks guarantee dividends but may not provide much profits as common stock may. The holders of proffered stocks are the ones allowed to vote on the firm's decisions and are normally paid prior to common shareholders.

Derivatives: derivatives are the most of the variety of contracts which are based on things that do not actually have to change hands at the time of the transactions. The contract made between parties involved is the derivative. Some of these derivatives are futures, futures and forwards, options, swaps, etc.

Bonds: these are essentially loans that are given to companies and or governments by investors that promise with promise that they repay the balance of the loan which is the face value after a certain amount of time

which is the maturity date. Bonds are also called debt securities because the bond owner purchases a debt and becomes a creditor. The advantages of bonds over equity based securities because they have lower risk associated with them since they are fixed income securities. They are also preferred for the reason that in event that the issuing entity goes into administration, the bond owners can be paid by the share holders.

Mutual funds: these are basically a collective investment in stocks, bonds, and or other securities. The main aim of mutual funds is to minimize risk and the potential for the large growth over extended periods of time. In organizing for mutual funds, a group of investors give their money to a fund manager who is an expert in financial analysis and able to make informed decisions as to what kind of securities may be best to be invested in at a given moment in time.

The role of financial intermediaries: There are varied business reasons firms enter financial markets. A company may choose to enter a market in a foreign country or may remain listed only on the local exchange market. Whatever the reasons, the firm's future is very paramount. The extent of getting financed externally from the capital market or raising funds internally can be a motivating factor. However the company size also plays a role. Financial constraints affect different sized companies differently. According to Love (2003) shows that smaller firms may face greater transaction costs relative to their size and size may expose the firm to greater information asymmetry. Other studies like show that smaller firms face tighter financial constraints than the large ones (Akiko & Hiro, 2011)

There are several benefits firms derive from listing on the financial markets

and stock exchanges. It is noted that listings can reduce market-segmentation problems as stated in (Foerster & Karolyi, 1999). It is also documented that listing on exchange markets improves and enhances the firm's visibility and also lessens information asymmetries (Baker, Nofsinger & Weaver, 2002). Other authors indicate that listing of the firm on the exchange market also lowers the cost of capital and in the same way improves liquidity of the firm (Domowitz, Glen & Madhavan, 2001). The advantages of stock or financial market also include strengthening investor protection. This is indicated in (Coffee, 1999). We shall not however fail to note the importance of international trade, cultural similarities and geographical proximities when any firm chooses to list especially across the border.

It should also be known that it is through the financial markets that intermediaries are realized. These play a role to reduce transaction cost of business and help the firm enjoy the economies scale. As any business may be there is time and money spent in carrying out financial transaction. The firm entry into financial market helps ease this burden on the business or firm. There is risk sharing and diversification with the entry of more shareholders into the firm.

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