

# International financial markets 18441



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Chapter 1

Introduction

## Purpose of the Reuters Guide to the International Financial Markets

Why The Reuters Guide to the International Financial Markets? Whenever I talk to students, especially those not studying economics, about the world of the financial markets they express huge interest but tell me they want to know more. In general this desire for information is related to being able to understand what goes on so that job hunting can be carried out from a position of knowledge rather than ignorance! This Guide, seeks to fill this gap and help, you the student, understand something of the mechanics of the International Financial Markets, the players and the sheer opportunity for satisfying and rewarding jobs within them. The Guide supplements a series of seminars which will be given in October 1997 at a number of UK universities, see the Graduate web-site, address below, for dates and locations. Of course, the markets comprise the obvious companies, such as the investments banks, but they are only part of the story. The International Financial Markets function because they receive a continuous supply of information - prices, facts, figures, news of politics, economics, natural disasters to name but a few. And it is these companies, such as Reuters, whose job it is to search out this information and to deliver it quickly, accurately and without bias. Understanding the information within the financial markets is a crucial part of understanding the market themselves - not least because the information providers are also major employers! This Guide is provided for private educational purposes only and within this usage you are free to copy it. Beyond this usage it is protected by copyright and written permission from Reuters is required prior to reproduction. To ensure the fastest possible download time from the Internet, the document is text

only and it is only a guide, giving a flavour without being exhaustive. I hope you find it useful. Should you have any comments about how we might improve I would welcome them and in the meantime good reading.

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What does Reuters Guide to the International Financial Markets provide?

Reuters Guide to the International Financial Markets provides a general overview of the International Financial Markets markets, for which Reuters is the major supplier of information, and roles within those markets. The document then profiles five customer groups, and provides an analysis of their roles. These groups are: + Foreign Exchange traders + Fixed Income traders + Salespeople + Analysts + Fund Managers

What is contained in the detailed analysis? Each of the profiled roles in this document contains the following information:

+ characteristics such as demographics, career path, computer literacy + working relationships both within and external to the institution where they work + common tasks.

Sources of information Information for Reuters Guide to the International Financial Markets was gathered from:

See Bibliography on + introductory finance books + internal Reuters documents + interviews with financial markets practitioners + interviews with Reuters customer trainers and marketing staff.

## Chapter 2

### Who's Who in the International Financial Markets

#### The Roles in the International Financial Markets

The participants in the International Financial Markets work in a wide variety of roles. Figure 0. 1 illustrates these roles.

#### Figure 1 Roles in the International Financial Markets

##### Traders

Traders buy and sell in the financial markets. Trading may take place at physical exchanges, for example, for commodities or futures, or over the counter, for example, in foreign exchange. A trader specialises in a particular type of financial instrument. Different types of trader have different roles and requirements. Common types of trader are described below.

##### Money

Money traders buy and sell currencies and short term debt to fund the business of their employer, such as lending or trade, or for profit. The instruments that they trade are usually of maturity between one month and one year. The instruments may be cash, for example, deposits, treasury bills, Certificates of Deposits or derivatives, such as Interest Rate Futures, FRAs, swaps.

Money traders work in banks and corporate treasury departments. Trading in the cash market does not take place at an exchange but is performed over

the counter using telephones and dealing terminals Money traders require foreign exchange rates, bank deposit rates and news information.

### Foreign Exchange

See Foreign Exchange Traders on page 33 Foreign exchange traders generally trade currencies on a shorter term basis than money traders: up to one month maturity. The trading environment is over the counter using telephones and dealing terminals. Foreign exchange traders require foreign exchange rates, bank deposit rates and news.

### Bonds

See Fixed Income Traders on page 55 Bond traders buy and sell government, quasi-government and corporate bonds for customers and for their own account. They work in investment banks and securities houses. Most bond trading is over the counter. Traders' requirements include bond data such as issuers, prices and yields; interest rates, foreign exchange rates, graphical analysis and news.

### Equities

Equities traders buy and sell equities (stocks and shares) for customers and for their own account. They work for investment and securities houses and are members of an exchange, such as the London Stock Exchange for UK equities. Some traders specialise as market makers; they are obliged to quote buy and sell prices for a selection of chosen instruments at all times during market hours Most equity trading is exchange based, although large over-the-counter equity markets exist, for example NASDAQ in the US.

Equities traders require equity prices, information about related instruments such as convertibles and warrants, interest rates, graphical analysis and news.

### Commodities

Commodities traders buy and sell commodities such as metals, softs, grains for customers and for their own account. They are normally members of a commodity exchange, such as the Chicago Board of Trade, where trading takes place. Commodities traders work in independent companies and as part of larger financial institutions. They require market future and spot prices, graphical analysis and news.

### Energy

Energy traders buy and sell energy contracts oil and gas for customers and for their own account. They are members of an exchange where the trading takes place, such as the International Petroleum Exchange in London. Energy traders work in independent companies and a small number of financial institutions. They require market future and spot prices, foreign exchange rates, graphical analysis and news.

### Derivatives

Derivatives trading is a relatively new activity. Traders buy and sell derivatives instruments such as swaps, futures and options for customers and for their own account, and operate across money, bond, equity and commodity markets. Derivatives traders require a wide variety of information, including data which relates to the underlying instruments of

the derivatives they trade. They need access to exchange and OTC prices, both real time and historical, plus of course, relevant news. news.

## Brokers

Brokers intermediate between traders and customers. They earn commission on the deals that they arrange. Brokers do not normally manage a position, that is, own equities, currency or other instruments, in the market in which they trade. Brokers exist in the foreign exchange, bond and equity markets. They work for independent brokerage companies. Brokers require the same type of information as traders: a money broker would require foreign exchange rates, bank deposit rates, bond data, graphical analysis and news. However, brokers need to obtain this data from a large number of players in the market, so that their prices reflect the market as closely as possible.

Brokers also need to create interest in instruments to persuade their customers to do business. They need to publicise their prices and be able to respond quickly to calls asking their opinion on particular markets and instruments.

## Sales

See Salespeople in the Financial Markets on page 65 Sales staff transact buy and sell orders for customers, often institutional investors, and also act as an intermediary between customers and traders. They work for investment banks, integrated securities houses and stock, commodity and energy brokerage houses, and include those working on the corporate desk. The sales function exists in all markets. In equity, commodity and energy



markets, sales staff may also be known as brokers. However, sales staff differ from traditional brokerage in that they may hold positions in the market.

Sales staff may use the same information as brokers, depending on the instruments they specialise in. This includes foreign exchange rates, bond and equity data, other market prices, graphical analysis and news. They use any information they can to build relationships with customers, including leisure topics such as sport.

### Investment Institutions

See Fund Managers on page 89 The primary interest of some institutions is to invest in, that is, buy and hold, instruments. These institutions are said to work on the buy side. Fund managers, portfolio managers and staff in corporate treasury invest the funds they manage in all financial markets to generate a return for the investors in those funds. Fund and portfolio managers work for pension fund and insurance companies and fund management divisions of major investment institutions. Most large companies have a corporate treasury department to manage their capital requirements, whether surplus or deficit.

Those working on the buy side use interest rate, foreign exchange, bond and equity data, typically across a broader range of markets than a trader. Corporate treasurers also require forward and deposit rates. Fund and portfolio managers require portfolio management facilities, with data-feed inputs, to value their portfolios on an intra-day or inter-day basis.

## Decision Support

What does decision support mean? The term decision support describes the function that provides the research information, analysis and interpretation of that information. They include: + economists + analysts + researchers. These groups of people forecast economic performance and market movements to provide guidance to traders and sales staff. They may also publish their forecasts, for a fee, to a wider market audience. Analysts play a key role in the services provided by the sell side to the buy side. Decision management exists in all markets and in all financial institutions. Those in decision management require price information, access to large quantities of historical data, spreadsheet and graphical analysis and notification of impending financial events and announcements.

## General Management

The term general management describes the following groups of people: + those from dealing room manager upwards who may be active in the day-to-day trading operation + those in corporate finance and mergers and acquisitions in financial institutions + managers in a variety of roles in non-financial companies who are users of limited financial information and news. Managers may require historic and current information about companies in their sector or areas of interest. They also require basic foreign exchange information for the countries in which they operate.

## Trader Support

Trader support can be split into two distinct roles: + position keeping, assisting traders in the dealing room + order entry, a book-keeping role in the Back Office of a financial institution. Those who work in trader support roles require a general view of the financial marketplace, for example foreign exchange rates, interest rates and inter-bank offered rates for currencies of interest.

### Back Office

The Back Office exists in all financial institutions. It is here that the administrative tasks connected with dealing are performed. Those working in the Back Office carry out transaction administration (clearing and settlement), credit control (limit setting) and statutory and management accounting. The information they require is mostly internal, with company financial data needed for credit control.

### Retail Sector

This term covers those working in retail banking. Retail banks provide exchange transactions and derivatives trading

## Chapter 3

### Introduction to Financial Markets

#### Overview of Financial Markets

What is a Financial Market? A financial market is an environment where various types of financial entities are bought and sold, such as equities, currencies, money, bonds, commodities and energy according to a set of

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rules. Various derivatives of these base entities are also traded, for example, futures, options and swaps. A market for a particular entity exists when there are enough buyers and sellers to influence its liquidity. The more buyers and sellers, the more liquid the market is likely to be. Historically, markets have been physical places, a trading floor for example. Increasingly they are becoming electronic 'places' where traders use computer terminals with which to communicate their buy/sell requirements to each others and to conclude the trades.

What is a Financial Security? Financial securities of all types including foreign exchange and money are traded in the financial markets. A financial security is a contract between the buyer and seller of the security. This contract specifies future cash flows of the security, in terms of the amount (fixed or variable), timing, how long the contract lasts (maturity) and the price the buyer pays the seller. In many cases, it is obvious who the buyer and who the seller is. However, for certain types of financial securities, for example, swaps, the market determines the buyer and seller roles by convention - for example, the buyer in a fixed-for-floating interest rate swap is the fixed rate payer.

Over-the-Counter (OTC) and Exchange Traded (ET) Markets There are two main types of financial market: + Exchanges: where standard products are traded and where the exchange is responsible for administration, clearing, settlement, some regulation and price dissemination. + Over-the-counter: where products traded tend be non-standard and are designed to satisfy a particular financial need of one of the counterparties, for example, a client who requests a broken date FRA.

Who are the participants in the Financial Markets? In general, participants in the financial markets are the buyers and sellers which can be sub-divided into various roles. There are also indirect participants (who facilitate but do not buy or sell) such as regulators, clearers information providers and intermediaries. The main group of intermediaries are called brokers - whose main business is to bring buyers and sellers together for commission.

### Types of Instruments

Instruments can be classified as: + equity, debt, or commodity + over the counter or exchange traded + cash or derivative + domestic or global electronic or physical

### Equity

An Equity Security can be defined as " A security that represents ownership in a company and the right to receive a share in the profits of that company."

### Debt

A debt involves the lending of money for a given " price" which is the interest rate. The party that puts forward the money is the lender and he receives interest plus principal from the borrower for the risk he is taking. There is a wide variety of debt instruments, for example money market deposits, company bonds, government bonds and Mortgages.

### Commodity

The commodities market is where products such as metals, grains and softs are traded. Although some commodities are traded spot, the main market for commodities is the futures market, the largest of which is the Chicago Board of Trade (CBOT).

### Over The Counter or Exchange Traded

General Attributes of Instruments Instruments which are traded directly between counterparties are said to be over the counter (OTC) traded and instruments which trade on an exchange are said to be exchange traded. Exchange trading matches buyers and sellers, either electronically or physically. An OTC instrument is tailored to the buyer or seller. They can be traded in various denominations, amounts and maturities. This in contrast to Exchange traded instruments which tend to be standardized, although there is a move by exchanges to trade OTC-like products in order to compete with OTC markets.

### Cash or Derivative

Derivatives can be defined as “ instruments derived from existing instruments in the cash market.” The source of the derivative is called the underlying cash instrument. Derivative and cash markets tend to be quite distinct, with different players - although the current trend within security houses is towards integration of cash and derivative operations. A derivative can have more than one underlying instrument, for example, an equity convertible bond. Theoretically, it is possible to have a derivative of a derivative, for example, a compound option, although these instruments are not directly traded. The value of a derivative depends on the price and other

market characteristics, such as volatility or correlation, of the underlying instruments.

### Domestic or Global

With the expansion of global financial markets, a number of instruments are traded internationally. This makes geographical boundaries between markets more or less irrelevant as trading books are often passed from one time zone to another as the markets close in one and open in the other. The largest example of a truly global market is the foreign exchange cash market which effectively runs 24 hours a day. There are also instruments which are issued in one currency and traded in another, for example, Japanese warrants issued in Yen but traded in Swiss Francs or US dollars.

### Electronic or Physical

Financial markets have historically been associated with physical trading – buyers and sellers meet face to face or over the telephone. Increasingly though, technology is creating electronic ‘places’ where instruments can be traded over computer networks. The first major market was in Foreign Exchange with Reuters Dealing 2000-1. It’s OTC-nature lent itself to screen-based trading. Electronic trading, of one form or another, is now possible in equities, bonds and commodities as well as Foreign Exchange. Even exchanges, which had long been associated with physical trading are now launching electronic systems.

### Types of Markets

Markets use instruments to exchange assets. A brief introduction to each of the following main markets in the financial sector is given below: + Foreign Exchange + Fixed Income + Equities and Equity Linked + Commodities  
Instruments traded by these markets are defined in Types of Instrument.

### The Foreign Exchange (FX) Market

What is traded on the FX Market? The FX market is an international market which currencies are exchanged for spot or forward delivery. The “ prices” of the various currencies are in most cases quotes against the US dollar. When this is not the case, the price is called a cross rate. Further details of the FX market are in Chapter [4].

### Fixed Income Market

What is traded on the FI Market? Bonds of different types are traded in the fixed income (FI) market. A bond is a contract of the indebtedness of one organisation to the holder of the bond. The different types of bonds purchased within the fixed income market include: corporate, euro, government and asset-backed bonds which include mortgage bonds. The most important type of bond in the market is usually government bonds because the government is normally the largest organisation that issues bonds, in a given country. Also, government bonds in developed countries are considered risk-free.

Maturity of FI Instruments Maturities in the fixed income market tend to be longer which is a factor that distinguishes the fixed income market from the money market. In general terms, any debt instrument that matures in over 1



year is regarded as a fixed income instrument, or bond. However, the one year boundary is not strictly adhered to, for example, a 12X18 FRA is clearly over 1 year in maturity but is considered a money market instrument.

## Equities Market

What is traded on the Equities Market? When a business is an incorporated company, a number of shares are issued which represent part ownership of the company. If a company wishes to raise capital from the public by issuing shares, it often seeks to list its shares on an exchange. In order to list its shares on an exchange, a company must comply with the regulations of that exchange. These regulations usually involve reporting the profits and losses and assets of the company. The exchange provides a means for institutions and the public to buy newly issued shares and to buy and sell previously issued shares. These shares are bought and sold in the equities market and traders in this market must be members of a stock exchange, such as the London Stock Exchange. Membership binds them to the rule of the exchange.

Maturity of Equity Instruments Shares issued by companies last for the lifetime of the company.

## Commodities Market

What is traded in the Commodities Market? Physical commodities such as metals, grains and precious metals are traded within the commodities market. The companies which trade in this market are normally members of a commodity exchange such as the LME, where trading takes place.

Physical vs. Cash Delivery Much of the activity in the commodities markets takes place in the form of futures trading, that is, agreements to deliver commodities at a future date for a price agreed today.. However, most of the commodity trading is cash settled, in other words, there is no actual physical delivery involved.

### Relationships between Instruments and Markets

Although some markets are characterised by the instruments in which they deal, some instruments may be traded across more than one market. The following table illustrates these inter-relationships.

#### Markets

Instruments FX Money Fixed Income Equities Commodities

Bill

Bond

CD

Convertibles

CP

Deposits

Equity

EuroCurrency

Forward

FRA

FRN

Futures

MTNs

Options

Preference Share

Repos

Rights

SPOT

SWAPs

Treasury Bills

Warrants

Types of Institutions

The term financial institution describes an organisation involved in some capacity in the financial markets. Care is needed in the use of this term since “institution” is sometimes reserved for the “buy-side” of the market with the term “securities house” generally implying the “sell side”. It is useful to

discuss institutions since their business goals and the instruments they trade determine to a large extent the roles of employees of that institution.

**International and Domestic Institutions** The financial market consists of international and domestic institutions. International institutions deal with international loans, import/export finance, and foreign exchange dealing. Domestic institutions deal with banking and monetary issues in their respective countries (although some domestic institutions are becoming increasingly global). A financial institution such as a bank, uses investors, depositors or its own funds to invest in financial assets such as equities or bonds to make profit. Examples of institutions are: + banks + building societies + broking firms + corporations + local authorities + fund management and insurance companies.

## Banks

Most countries have regulations governing the operation of banks. If a company is to operate as a bank, it must have a licence granted by the government and conform to the regulations which apply to banks in that country. For an institution to operate as a bank in the United Kingdom, it must be authorised by The Bank of England. The institution must satisfy the Bank of England that : + it has adequate capital + it has adequate liquidity (that is sufficient funds to meet its obligations when due) + it has a realistic business plan + it has adequate systems and controls + it has made provision for bad or doubtful debts + it's business is carried out in a prudent manner + its directors, managers and controllers are " fit and proper" Banks are often given an exclusive right to undertake activities that other

institutions may not be able to, for example, take deposits or clear cheques. The government usually acts as a guarantor for bank deposits. Because of the advantages given to banks by the government, they often have the largest financial asset base in a country, making them pivotal in the financial market. Most of a bank's assets are held in loans or other instruments which give a return, this gives the bank a cash flow. The bank also has deposits which are its liabilities and tries to maximise the difference between the money it pays to its depositors and the money it receives from its creditors, or the financial assets it holds.

Although banks can be grouped together as a broad type of financial institution, there are different types of bank. These are: + Commercial + Investment + Universal + Central.

**Commercial Banks** Banks whose principal activities are taking deposits and lending money to individuals and small and medium sized businesses, are often called retail, clearing or commercial banks. These banks have large cash flows and they aim to maximise their profits by getting the largest possible spread between the rate at which they acquire money via deposits or through loans from other institutions, and the rate at which they lend money. A commercial bank participates in the financial markets to manage the flow of cash in and out of the bank and to get the best return on the financial assets of the bank.

**Investment Bank** An investment bank, or merchant bank as it is sometimes known in the United Kingdom, is a bank which helps large businesses to raise capital, usually by underwriting the issue of shares or bonds. Fees charged

for this service provide income for the investment bank. Investment banks also take trading positions using the assets of the company - this is known as proprietary trading. The activities of underwriting and proprietary trading involve some risk which must be managed by the investment bank.

Universal bank A universal bank is one which takes deposits, underwrites securities and offers fund management services. Regulations in different countries may or may not allow universal banks to operate. For example, in the United States, a bank which underwrites securities is forbidden by the Glass-Steagall Act 1933 to take deposits. This act was designed to protect depositors' funds from the risky activity of underwriting securities. European banks, in particular Swiss and German banks, are not under the same restrictions and can take deposits and underwrite securities. These banks are known as Universal Banks because they encompass all banking activities. Increasing deregulation in the United States and the United Kingdom has resulted in a trend towards banks in these countries either broadening their areas of operation or merging with banks operating in different areas.

Central Banks Governments are involved in financial markets to implement their monetary policy and to raise funds to finance the government's activities. Most governments participate in the financial markets via a central bank. These banks fulfil a number of functions such as: + issuing bank notes + supervision of banks + management of exchange reserves + issuing Government debt. The central bank in different countries has various names, for example, The United State Federal Reserve System, Deutsche Bundesbank, The Bank of England. The specific responsibilities of the Bank of England as stated in the 1995 Report and Accounts : " ...maintaining the

stability of the financial system, both domestic and international; and seeking to ensure the effectiveness of the UK's financial services sector.”

When central banks get involved in financial markets, it is usually to intervene either in the currency market or to implement monetary policy by setting long or short term interest rates. Arguably, the central banks of the major economic powers have the most important influences on world interest rates.

### Building Societies

Building Societies (known as Savings and Loans in the United States) are organisations which are set up to pool depositors funds so that they may be lent to other members to purchase real estate. In general they have a far smaller asset base than commercial banks, but they operate in a similar way, that is, they take deposits and make loans. Traditionally they have restricted their lending to mortgages against real-estate. Recently there has been a trend for building societies to merge and/or gain licences to become banks.

### Broking Firms

Broking firms provide an intermediary service between buyers and sellers in the financial market. For this service, they charge the buyer and the seller a commission on any deal they broke, and the more deals they broke the greater the profit they make. Brokers are agents working within a broking firm who do not hold a position in the market. They are not principals as they simply provide a matching service between buyers and sellers.

## Corporations

Corporate Treasury A company may have large and variable cash flows because of the nature of its business, and they may need to buy or sell goods and services overseas or raise capital for large projects. The management of the cash flow, assets and liabilities of a company is usually performed by the corporate treasury department.

## Local Authorities

Local Authorities form part of the government structure, although they often participate in the financial markets independently of central banks. Local authorities have large cash flows and often require short term funding or have a temporary surplus of funds.

## Fund Management

Fund Management encompasses pension funds, insurance funds and collective investments such as mutual funds and unit trusts. Fund managers select what instruments to hold positions in for maximum return and minimum risks and manage these investments on a medium to long term basis. In addition to return objectives, fund managers have to operate within trustee requirements. Insurance and pension fund managers also need to structure their portfolios to meet the various claims on the fund, such as insurance or pension claims, a process called “ portfolio dedication”.

Fund Manager Skills There are several analytical techniques that a fund manager can use to protect the return on his investments. The first is called switching. When the fund is not performing, the fund manager uses available



market information and his skills to restructure his portfolio by selling some positions and replacing them (switching) with assets which have better prospects. In most cases, the amount of turnover in a fund is either restricted by regulation or by the tax implications of the fund. The second technique is called immunisation - and is typically used in fixed income portfolios, where for example, the fund manager sets the duration of a portfolio to equal the longest period over which he can predict events.

### Attributes of Institutions

It is important to recognise the differences between institutions because the objectives of the institution will be a large factor in determining the goals and how they go about achieving them. Institutions can differ greatly, although the majority of financial institutions, such as Building Societies and Banks, have common attributes.

Revenues Institutions earn revenues and therefore can generate profits in a number of different ways: + Market makers make a profit through the "turn" - that is, the difference between their bid and ask prices on any instrument. + Traders make a profit through their skill in determining when and at what price to buy and sell. + Brokers earn their revenues by charging commission on trades they complete for their clients - the "fills". + Fund managers earn fees, which in most cases are based on return or risk performance. + Investment banks earn fees for underwriting new issues.

**Business Objectives** All organisations or institutions develop and try to meet business objectives that steer the activities of the organisation towards the achievement of certain goals. Some common objectives are to: + satisfy

customers and develop a good business relationship with them + increase earnings per share + increase market share + reduce costs + expand into new developments.

In order to meet these objectives, institutions must perform these activities: + trading + sales activities + cash flow management + asset management + risk management.

**Trading** Trading involves taking a position. A position is held when there is an imbalance between the sales and the purchases of an instrument. When there are more purchases than sales of an instrument the position is said to be long. When there are more sales than purchases the position is said to be short.

**Sales Activities** The sales role is the customer-facing one in most security houses. The role of sales is to drum up business with clients, private clients, corporate clients or fund management companies. In security houses that also perform proprietary trading or market-making, the security house must be careful not to off-load unattractive positions onto unsuspecting clients. The new tighter regulatory structure is intended to minimise this practice. Many institutions offer to buy or sell financial instruments on behalf of other institutions, for commission. An example is a bank which buys foreign currency such as Deutschmarks on behalf of a corporate treasurer. This activity will leave both institutions with a position in the market since the bank will be short on Deutschmarks and the corporate treasury will be long on Deutschmarks. The institution usually hedges this position.

**Cash Flow Management** Large organisations often have temporary cash surpluses or deficits in their domestic currency or foreign currency. These need to be managed by making deposits or loans. An example of where cash flow management may be required is pension or insurance claims in an investment management institution. If a company does not have sufficient funds to cover the cash requirement, it may arrange a loan to cover the shortfall.

**Asset Management** Asset allocation accounts for a significant number of the tasks of many players in the financial markets, especially portfolio and fund managers. The aim of asset allocation is to select the assets in which to invest, for a stipulated risk and return, subject to a variety of constraints, for example, “ no more than x% of the fund must be invested in emerging markets” or “ at least 20% of the fund must be cash” etc. Asset allocation is important, as the user will want to browse through and search for the available instruments that fall within the constraints and meet the objectives of the business.

**Risk Management** Most financial institutions hold positions in the financial markets, and are therefore exposed to a number of different types of risk. Risk is the probability that a loss may occur due to an unforeseen development in the market. Risk management is a term used to cover all the tools and strategies managers use to minimise risk and avoid a possible financial loss on a position. It is important to note that there are various types of risk, for example, market risk, counterparty, or settlement, risk. Hedging is a strategy used to manage market risk by using one position to offset another. Different types of instruments can be used to hedge, such as

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forwards, options and futures. These instruments allow the investor to limit market risk.

**Limits** Limits are net amounts which define the range within which an institution or trader can trade. These are set by the institutions management in order to manage risk. A trader who reaches his limit must get authorisation from his manager if he intends to exceed that limit. A trader's limit increases as his experience and responsibilities increase.

The following table illustrates how the strategy used depends upon the type of risk to be managed:

#### Risk Type Management Strategies

**Credit Risk/CounterParty Risk** The exposure to counterparties defaulting on a payments due, such as a bank becoming insolvent. Set counter party limits.

**Country Risk/Sovereign Risk** The total exposure of investments in a particular country. Possible problems could include economic collapse, changes to local regulations or government seizing or freezing assets. Set country limits.

**Currency Risk** The potential losses due to adverse movements in exchange rates. Setting limits on traders and desks exposed to a particular currency, and hedging large positions with derivatives.

**Inflation Risk** Associated with the return on an investment being eroded by the loss of purchasing power. Investing in inflation-linked investments such as Gold or index-linked bonds.

**Market Risk** The risk associated with losses due to the reduced value of investments, reduced income or increased costs due to interest rate movements. Hedge, plus limits, plus capital adequacy constraints

**Liquidity Risk** The risk of not being able to purchase or sell an instrument at the times desired. Only participate in liquid markets.

**Settlement Risk** The risk of a counterparty not settling on time. If the counterparty settles late, this means you either have a long or short position until the deal is settled. Dealing with reputable market participants, and using efficient settlement procedures. Bilateral limits. Netting.

## Roles within Markets

This section defines the roles in the markets and details the activities they are involved in and the type of information they require.

### Traders

What do Traders do? Traders buy and sell in all areas of the financial market. They aim to buy low and sell high. Trading may take place at physical exchanges, for example, for commodities or futures, or over the counter (OTC), for example, in foreign exchange. A trader may specialise in a particular type of financial instrument and different types of traders have different roles and requirements depending on the instruments they trade in. A trader who has gained responsibility in his career for managing a group of traders may be classed as a chief trader. The chief trader sets the credit limit for each trader and ensures that at the end of the day, all his traders are not long or short, that is, their buy and sell deals balance.

What is Order Driven Trading? If a trader is buying or selling instruments to fulfil an order for a customer, it is said to be order-driven trading. To avoid potential confusion with another meaning of this term, it is best to refer to this type of trading as “customer-driven trading” to distinguish it from “proprietary trading. It is important to note that order-driven and quote-driven trading in the markets are also used to describe different types of trading markets. For example, the old Seaq Level II and also NASDAQ are quote-driven markets, in which market-makers quote firm two-way prices and sizes. The new UK equity market Sequent 6 and Reuters Dealing 2000-2 matching are both examples of order-driven markets.

What is a Proprietary Trader? If a trader takes positions on behalf of his institution, he is known as a proprietary trader. Proprietary traders tend to take decisions based on detailed technical and fundamental research, analytic calculations and time series forecasting. In most cases, the tools available to the proprietary traders are developed in-house and are jealously guarded.

What is Arbitrage Trading? Arbitrage trading involves the buying and selling of the same or similar instruments in different markets in order to take advantage of any misalignment in the relationships between these instruments. The arbitrageur makes a profit when the relationships are restored. For example, a currency options trader who believes that the put-call parity relationship between a call, a put, and the DEM underlying on the IMM may execute an arbitrage strategy whereby he will buy the call and sell the put, or vice-versa, depending on his view of the misalignment.

What information do they need? Traders require real time prices for the market in which they trade, plus any supporting technical analyses and related news. However, because of the relationships between various instruments, they may also look at information from markets that they do not directly trade. For example, an equities trader may look at foreign exchange rates, deposit rates, bond prices and yields.

### Fund Managers

What do Fund Managers do? Fund managers may invest funds for themselves or on behalf of their customers. Fund managers deal within the FX and money, fixed income and equities markets. An individual fund manager may specialise in a given market, or country, or region, or currency. They generally manage medium to long term investments such as pension funds, insurance funds, investment trusts or unit trusts.

What information do they need? Fund Managers require information on markets in which they directly invest. However, they also look closely at interest rates, foreign exchange, bond and equity data for any trends that may affect their investment strategy.

### Corporate Treasurers

What do Corporate Treasurers do? Corporate Treasurers work within the FX and money markets, as part of a treasury department within an institution. Their main functions are to manage the institution's day to day cash, invest cash surpluses, and borrow funds at minimum costs to the institution.

What information do they need? Corporate Treasurers require information on interest rates, foreign exchange, bond and equity data as well as forward and deposit rates. They also require the cash flow status of the institution they work for.

## Brokers

What do Brokers do? Brokers mediate between buyers and sellers which means, in practice, customers and traders. Brokers also mediate between dealers or market makers - in which case they are referred to as inter-dealer brokers. They operate in the foreign exchange, bond and equity markets and usually work for independent brokerage companies. The main means of communication between brokers and clients is the phone. Most brokers have a constant live telephone connection with a number of dealers to increase the chance of obtaining best deal for their clients in terms of price and speed. Brokers earn commission on the deals they arrange. Brokers are agents. They are not principals and as such they do not normally manage a position, namely own equities, currency or other instruments, in the market in which they trade. Brokers have to be in touch with the market and be aware of developments so they can talk knowledgeably to customers when they ring.

Agency Broker Agency brokers buy or sell instruments on behalf of their customers on the buy side of the market. As brokers, they earn their living by charging a commission or brokerage fee for this service.



Inter-Dealer Broker Inter-Dealer Brokers match buys and sellers on the sell side of the market. They ensure that traders can trade with each other anonymously.

Brokers also need to create interest in the relevant instruments to persuade their customers to do business with them and to attract new business. By virtue of the fact that brokers are in constant touch with the market, they have access to the latest dealable prices. A number of the bigger brokers assemble these prices into a price service for their clients. For example, money brokers such as Tradition, Tullett and Tokyo, Harlow Butler all have price services distributed by various vendors on their behalf.

What information do they need? Brokers require the same type of information as traders. a money broker requires foreign exchange rates, bank deposit rates, bond data, graphical analysis and news information, as does a money trader.

## Sales

What do Sales staff do? Sales staff take orders from customers to buy and sell instruments and act as an intermediary between customers and traders. Sales staff function in all markets. In equity and commodity markets, sales staff may also be known as brokers. Their customers are often institutional investors and they work for investment banks and agency brokerage houses. However, sales staff differ from traditional brokerage in that their institutions can hold a position in the market.

What information do they need? The sales function exists in all markets. In equity and commodity markets, sales staff may also be known as brokers. Sales staff may use the same information as brokers, depending on the instruments they specialise in. This includes foreign exchange rates, bond and equity data, other market prices, graphical analysis and news information. They use any information they can to build relationships with customers.

### Decision Management

What is Decision Management? The term decision management describes the function performed by: + economists + analysts + researchers.

These groups of people forecast economic performance and market movements to provide guidance to traders and sales staff. They may also publish their forecasts, for a fee, to a wider market audience.

What information do they need? Decision management exists in all markets and financial institutions. Those engaged in decision management require price information, access to large quantities of historical data, spreadsheet and graphical analysis and notification of impending financial events and announcements.

### General Management

What is General Management? The term general management describes the function performed by the following groups of people: + those from dealing room manager upwards, who may be active in the day-to-day trading operation + those in corporate finance, mergers and acquisitions +

managers in a variety of roles in non-financial companies who are users of limited financial information and news information.

What information do they need? Managers may require historic and current information about companies in their sector or areas of interest. They also require basic foreign exchange information for the countries in which they operate.

### Trader Support

What is Trader Support? Trader support can be split into two distinct roles: + position keeping, assisting traders in the dealing room + order entry, a book-keeping role in the back office of financial institutions.

What information do they need? Those who work in trader support roles require well developed operation skills and the patience to deal with traders in a hurry. They also need to have a general view of the financial marketplace.

### Back Office Support

What is the Back Office? The back office is where the administrative tasks connected with dealing are performed. The back office staff are responsible for clearing, settlement, consolidation, integration with accounting, and so on. They also perform credit control and statutory and management accounting.

What information do they need? In addition to deal ticket flow, the information they require is mostly internal – credit limits, ledgers, etc.

## International Considerations

Although the financial markets are becoming increasingly global, each country has its own currency and laws, taxation and other nuances such as number of currency days per year, bond yield calculation conventions, and so on. Considerations for internationalisation of software products, in addition to language issues, should be given during the design and development of products.

Since the FX market is an international market, all the standards, rules and regulations are in place to ensure smooth running of the market. All businesses, regardless of size, must register within the appropriate bodies before they can trade in the market. By registering, the business must agree to adhere to any guidelines laid down by the regulatory authorities.

## Chapter 4

### Foreign Exchange Traders

#### What Does a Foreign Exchange Trader Do?

#### The Foreign Exchange Trader's Role

A foreign exchange (FX) trader, or dealer, buys and sells currencies in the foreign exchange markets. He may specialise in one of the major currency pairs, for example dollar/mark or dollar/yen, or trade several of the less active ones.

**Size of the FX Market** The Foreign exchange market is one of the largest markets in terms of turnover. It is essentially a 24-hour global market which

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never really closes. Typically, \$1 trillion a day is traded in this market. In this market, \$5m dollars is a small deal since deals can be as large as \$100m or more. Traders in major currencies may perform up to 1000 deals per day. Individual traders have been known to make their banks 10 million in one day.

What motivates traders? Traders are motivated purely by profit which they earn from their bid/ask spread. They buy (that is, take long positions in) currencies that they think will rise in value and sell (that is, take short positions in) currencies they think will fall in value. Foreign exchange traders look for mispriced currencies in the market so that they can benefit from long positions in undervalued currencies and short positions in overvalued ones. They assess a currency's prospects using a number of sources. These include currency rate trends from inter-day and intra-day charts, interest rate policy, news of major political developments, economic announcements and the outlook of its domicile country. They also keep a look out for relevant developments in related markets such as the debt markets, equities and commodities, as these might also affect exchange rates.

How much can a trader risk? Unless appropriate controls are put in place, an FX trader can expose the bank to quite large currency or counterparty risks. The dealing room manager sets a daylight limit on the size of the position, or quantity of currency, that a trader can hold. Traders cannot ordinarily trade beyond their limits and must notify the dealing room manager if they make a loss in excess of the loss reporting limit that has been set.

Specialisms Within the Foreign Exchange Market

Different types of foreign exchange transaction exist; traders tend to specialise in one particular type of transaction. Traders may however trade a number of currency pairs.

**Spot trader** A spot trader conducts spot deals. A spot deal is an agreement to exchange one currency for another, settled over a standard period of trade (spot), usually two business days. By convention, one of the currencies in a spot deal is the US dollar. When this is not the case the deal is a cross rate deal, although settlement is still spot. A spot deal always involves a single outright exchange of principal and in the majority of cases leads to transfers through the payments system of the countries in which the currencies are issued.

As all the spot trader's deals are settled spot, delivery dates do not have to be matched and as a result turnover and liquidity are high and the markets can be volatile. In April 1992, about 47% of the foreign exchange market was in spot activity.

**Forward trader** A forward trader conducts two types of forward deals: outright and swap. In April 1992, forward deals amounted to 46% of foreign exchange turnover. A forward outright deal is similar to a spot deal, but is settled on a date other than spot. Outright deals represent somewhat less than 15% of the total forwards market and about 7% of total foreign exchange turnover. An outright rate is quoted in the same way as spot. A forward swap consists of two separate parts. Two counterparties agree to exchange two currencies at a particular rate on one date called the near date, and to reverse the transaction, generally at a different rate, at a future

date called the far date. For most swaps, the near date is normally spot but a number of forward/forward transactions exist, where the near date is not spot. Forward swaps make up somewhat more than 85% of the forwards market, which represents about 39% of the foreign exchange turnover, and are heavily concentrated on the US dollar. A forward swap is quoted as a margin. This is the difference between the exchange rates for the near date and far date and there are conventions governing how the subtraction is done using the two bid/ask exchange rates. Nearly two thirds of all forward transactions have a maturity of seven days or less. Only around 1% of forward deals have maturities greater than 1 year.

Derivatives trading Derivatives trading is relatively new, with 6% of turnover in April 1992, yet is the fastest growing sector of foreign exchange. FX derivatives include futures and options. Strictly speaking, a currency forward or swap is also a derivative, as its value depends on time to maturity, spot and deposit rates. Currency Futures are contracts which specify delivery of a particular currency at a given rate on a date more than two days hence. They differ from forwards in that they are standardised contracts tradable through an exchange clearing house.

Currency Options give the purchaser the right, but not the obligation, to buy or sell a certain amount of currency in the future at a predetermined rate. They are traded on an exchange or over the counter (OTC). Around 80% of currency activity is OTC where a whole range of customised products (exotic options) have evolve

Currencies Traded

The US dollar is the predominant counter-currency in foreign exchange trading and it appears in over 80% of all transactions. Other major currencies, for which there is an active cross-market, are the German mark representing 38%, and the Japanese yen representing 24% of all transactions.

Europe In Europe in general, and London in particular, the most heavily traded currency is the dollar against the mark (\$/DM). Other heavily traded currencies include: + sterling against the dollar ( /\$) and mark ( /DM) + dollar against Swiss franc (\$/CHF) and yen (\$/ ) + mark against yen (DM/ ) + all European Monetary System (EMS) currencies.

Asia In Asia, and Tokyo in particular, the most heavily traded currency is the dollar against the yen (\$/ ). Other important currencies are: + Australian dollar (A\$) + New Zealand dollar (NZ\$) + Hong Kong dollar (HK\$) + Singapore dollar (SG\$) + Thai Baht (THB).

Americas In the Americas the vast majority of foreign exchange trading is performed in the USA and Canada, and the majority of that in New York.

The emphasis is on the major currencies: + mark (DM) + sterling( ) + Swiss franc (CHF) + yen ( ) + Canadian dollar (CA\$). Periods when the New York markets trade are especially important. This is because the release of US economic indicators is carefully tracked and the US Federal Reserve (the “ Fed”) is the most influential central bank. What the Chairman of the Fed says about the state of the financial market has the power to move all markets

Typical Employers

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Most foreign exchange traders are employed by international banks such as Barclays or Citibank.

Locations London has the largest share of foreign exchange dealing, about 27% of trading activity. All the world's large banks have branches or subsidiaries there. Dealing is carried out in any convertible currency.

Other major dealing centres are the United States (mainly New York) with 17% of turnover, and Japan (Tokyo) with 11%. Singapore, Switzerland and Hong Kong are also important centres, and dealing takes place in many other cities worldwide. Modern technology even allows dealing to be performed from home. A trader in London may phone his or her New York or Tokyo branch in the late evening to take, or get out of, a currency position.

## Characteristics of Foreign Exchange Traders

### Demographics

As of 1995, there were approximately 15,000 foreign exchange traders worldwide. London is the largest centre, employing about 3,800 traders. However this number has declined slightly in recent years partly as a result of new trading methods and company mergers and acquisitions.

In London, the majority of traders are in their mid 20s to mid 30s. Very few are over the age of 50. There are few female traders working in London.

Educational background Although some banks currently recruit graduates only, approximately half the FX traders in London dealing rooms are estimated to have a degree. Often the degree is not in a financial subject.

**Typical skills** Traders have to be quick-thinking and able to prioritise information. They need to be able to assimilate new market information and relate this to their current or potential position. Information arrives from all sides in many different forms. Experienced traders can pick up what is most relevant to them and what represents potential trading opportunities.

**Work experience** Some traders work their way up from the bottom. A school leaver could begin in the Back Office checking deal details, then move to the trading floor to assist traders as a position keeper or dealer's assistant. The aspiring trader might then be allowed to deal small amounts in quiet currencies and gradually take on more responsibility and risk. A graduate might begin working in the dealing room as a dealer's assistant and progress from there.

**Work performance targets** Many traders are required to achieve appropriate profit targets. This is the main mechanism for determining salary. Traders need to sustain consistently high performance to retain their jobs and to progress within their company.

**High staff turnover** Employers tend to be unsympathetic to traders who do not achieve required levels of performance.