COURSE: INVESTMENTS |CHAPTER 3

SECURITIES MARKETS

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Chapter Purpose

How securities markets connect the economy

Investors
Supply capital

Corporations
Raise funds

Governments
Finance spending

Intermediaries
Connect the two sides

Topics covered in this chapter

- Primary and secondary markets
- Security issuance
- IPOs and seasoned offerings
- Investment banking
- Exchanges and dealer markets
- Trading orders
- Bid–ask spreads
- Margin trading
- Short selling
- Trading costs
- Market regulation

Learning Objectives

By the end of this chapter, students should be able to:

1. Explain the economic role of securities markets.
2. Distinguish primary and secondary markets.
3. Explain how firms issue securities.
4. Describe IPOs and seasoned offerings.
5. Explain private placements.
6. Describe the role of investment banks.
7. Explain underwriting.
8. Compare exchange and dealer markets.
9. Explain electronic trading.
10. Interpret bid and ask prices.
11. Distinguish market, limit and stop orders.
12. Explain margin trading.
13. Explain short selling.
14. Identify major trading costs.
15. Explain the role of securities-market regulation.

What Is a Securities Market?

A mechanism for issuing, trading and pricing financial claims

Securities are:

- Priced

Examples of securities:

Shares

Bonds

Treasury securities

Derivatives

Buyers ▶ Securities market ▶ Issuers and sellers — the market is the meeting point.

Why Securities Markets Matter

Core economic functions

Capital formation

Investment

Liquidity

Price discovery

Risk transfer

Portfolio adjustment

Key idea: securities markets connect those who have funds with those who need funds — supporting economic growth.

Flow of Funds

From savings to economic activity

SAVERS / INVESTORS
Provide capital

▼

SECURITIES MARKETS
Allocate funds

▼

BUSINESSES & GOVERNMENTS
Use capital

▼

PRODUCTIVE INVESTMENT

▼

ECONOMIC ACTIVITY

Major Market Participants

Who takes part in securities markets

Individual investors

Institutional investors

Corporations

Governments

Brokers

Dealers

Investment banks

Exchanges

Regulators

Individual Investors

Motivations and routes to the market

Why they participate

How they invest

Directly

Through mutual funds

- Achieve financial goals

Through pension funds

Through other investment companies

Institutional Investors

Large pools of professionally managed capital

Pension funds

Insurance companies

Mutual funds

Banks

Hedge funds

Investment companies

Sovereign wealth funds

Institutions often account for a large share of total market activity and trading volume.

What Is the Primary Market?

Where new securities are sold for the first time

Investors
Provide funds

▶

Issuer
Receives capital

▶

Investors
Receive new securities

In the primary market the issuing company or government receives the proceeds of the sale.

Why Firms Raise Capital

Typical uses of newly raised funds

Start operations

Expand production

Purchase equipment

Enter new markets

Develop products

Acquire businesses

Firms may also issue securities to refinance existing debt on better terms.

Equity Financing

Issuing shares — selling ownership claims

Company
Issues ownership claims

▶

Investors
Provide capital

▶

Investors
Become shareholders

Shareholders obtain a residual ownership claim — they share in profits and in risk.

Debt Financing

Issuing bonds — creating creditor claims

Company
Issues debt securities

▶

Investors
Provide funds

▶

Company
Promises interest and principal

Bondholders become creditors, not owners — they hold a contractual claim on cash flows.

What Is an IPO?

Initial Public Offering — a private firm's first public share sale

Before IPO
Private company

IPO
Public share offering

After IPO
Publicly traded company

An IPO converts privately held ownership into shares that trade in a public market.

Why Companies Conduct IPOs

Potential motivations for going public

Raise equity capital

Finance expansion

Liquidity for existing owners

Increase visibility

Establish market valuation

Ease future capital raising

Potential Costs of Going Public

What a public listing demands in return

Underwriting costs

Legal costs

Reporting requirements

Regulatory compliance

Public scrutiny

Ownership dilution

Public companies must also meet significantly greater ongoing disclosure obligations.

IPO Process

A typical simplified sequence

Decision to Go Public → Appoint Advisers → Due Diligence → Prepare Offering Documents → Regulatory Review

Marketing / Bookbuilding → Pricing → Issue Shares → **Begin Trading**

IPO Pricing

What price should be charged for the new shares?

Company fundamentals

Market conditions

Investor demand

Comparable firms

Expected growth

Risk

Pricing too high risks a failed offering; pricing too low leaves capital on the table.

IPO Underpricing

When shares begin trading above the offer price

IPO price	First trading price	Initial increase
ETB 100	**ETB 120**	**+20%**

(120 − 100) ÷ 100 × 100 = 20% — this initial price jump is commonly called IPO underpricing.

Underpricing may reflect uncertainty about value, the need to attract demand, and compensation to investors for taking on issue risk.

Seasoned Equity Offering

An already public company issues additional shares

IPO

First public issue of shares by a private company

SEO

Additional equity issued by an already listed company

A seasoned offering adds new shares to a market where a price already exists — market price guides the terms.

Why Conduct an SEO?

Uses of additional equity capital

Expansion

Acquisition

Debt reduction

Major capital projects

Balance-sheet strengthening

Private Placement

Securities sold directly to a limited group of investors

Company
Issues securities directly

Selected investors
Limited, mostly institutional

Possible investors

- **Pension funds**
- **Banks**
- **Insurance companies**
- **Private funds**
- **Institutional investors**

Public Offering vs Private Placement

Two routes to raising capital

Public Offering	Private Placement
Broad investor base	Limited investor group
Greater disclosure	Often more negotiated
More formal issuance process	Potentially faster
Higher issuance costs	Potentially lower issuance cost
Liquid public market possible	May be less liquid

Role of Investment Banks

Advising and executing security issuance

Design securities

Value offerings

Prepare issuance

Market securities

Underwrite offerings

Distribute securities

Investment banks sit between issuers and investors, and advise on the overall financing strategy.

What Is Underwriting?

An intermediary helps an issuer sell new securities

Issuer → **Underwriter** (Prices, markets, distributes) → **Investors**

Depending on the agreement, the intermediary may assume:

- **Distribution risk**
- **Pricing risk**
- **Marketing responsibility**

Firm-Commitment Underwriting

The bank buys the issue, then resells it

Step 1 — Purchase
Investment bank buys securities from the issuer

Step 2 — Resale
Investment bank resells securities to investors

The underwriter bears substantial risk that the securities may sell for less than expected.

Best-Efforts Offering

The intermediary agrees to try, not to guarantee

Best efforts
The intermediary agrees to try to sell the securities; unsold securities remain the issuer's problem.

Firm commitment
The intermediary buys the issue outright and carries the resale risk.

Under best efforts, the issuer generally bears more of the risk that not all securities will be sold.

Underwriting Spread

Compensation for taking on issuance risk

Underwriter buys at	Sells to investors at	Spread
ETB 95	**ETB 100**	**ETB 5**

The spread helps compensate for:

- **Risk**
- **Marketing**
- **Distribution**
- **Advisory services**

What Is the Secondary Market?

Where existing securities trade among investors

Investor A
Sells security

▶

Market

▶

Investor B
Buys security

The issuer usually receives no new funds from a secondary-market trade.

Why Secondary Markets Matter

Functions that support the primary market

Liquidity

Price discovery

Market valuation

Portfolio rebalancing

Entry and exit

Market information

Primary vs Secondary Market

Two distinct market functions

Primary Market	Secondary Market
New securities	Existing securities
Issuer receives funds	Selling investor receives funds
Capital raising	Trading
IPO / SEO / bond issue	Exchange transactions
Issuer focused	Investor focused

Major Trading Structures

How secondary trading is organised

Organized exchanges
Centralised, listed securities

Dealer markets
Dealers quote and trade own inventory

Brokered markets
Brokers search for counterparties

Electronic systems
Automated order matching

Modern markets often combine several of these features in a single trading venue.

Organized Exchanges

An organized venue for trading listed securities

Listing

Trading

Price dissemination

Market surveillance

Rule enforcement

Exchange rules and surveillance support orderly, transparent and fair trading.

Stock Exchange Examples

Selected exchanges around the world

New York Stock Exchange
United States

Nasdaq
United States

London Stock Exchange
United Kingdom

Tokyo Stock Exchange
Japan

Johannesburg Stock Exchange
South Africa

Ethiopian Securities Exchange
Ethiopia

Listing Requirements

Typical conditions for an exchange listing

Financial statements

Governance

Capital

Disclosure

Share distribution

Ongoing reporting

Dealer Markets

Dealers trade using their own capital

Bid price

The price at which the dealer is willing to buy from you.

Ask price

The price at which the dealer is willing to sell to you.

The dealer stands between buyer and seller, supplying immediacy and earning the spread.

Brokers vs Dealers

Agent versus principal

Broker — Agent
Acts on behalf of clients and connects buyers and sellers; earns commission.

Dealer — Principal
Trades using own inventory and capital; earns the bid–ask spread.

A broker takes no position in the security; a dealer does.

Bid Price

The price at which a participant is willing to buy

Bid

ETB 98

The bid price is the price at which a dealer or market participant is willing to buy the security.

In this example the dealer stands ready to buy at approximately ETB 98 — this is the price an investor receives when selling.

Investor sells ▶ dealer buys at the bid.

Ask Price

The price at which the dealer is willing to sell

Ask

ETB 100

The ask price is the price at which the dealer is willing to sell the security.

An investor purchasing from the dealer would pay approximately ETB 100.

Investor buys ▶ dealer sells at the ask.

Bid–Ask Spread

Spread = Ask − Bid

Bid	Ask	Spread
ETB 98	**ETB 100**	**ETB 2**

100 – 98 = ETB 2

The spread is an important component of trading cost and an indicator of market liquidity.

What Influences the Spread?

Drivers of quoted bid–ask spreads

Trading volume

Liquidity

Volatility

Information risk

Dealer inventory risk

Competition

Generally: higher liquidity ▶ narrower spread ▶ lower trading cost.

Electronic Markets

Modern markets rely on electronic systems

Receive orders

Route orders

Match buyers and sellers

Execute trades

Display prices

Record transactions

Advantages of Electronic Trading

Potential benefits of automation

- **Speed**
- **Accessibility**
- **Lower processing cost**
- **Greater transparency**
- **High transaction capacity**
- **Automated execution**

What Is a Trading Order?

Instructions given to a broker or trading system

- What security to trade
- Price conditions

Common order types

Market
Execute now

Limit
Price condition

Stop
Trigger price

Market Order

Buy or sell immediately at the best available price

Advantage
High probability of execution — the order fills quickly.

Risk
The final execution price is uncertain, especially in volatile or thin markets.

A market order prioritises execution over price.

Limit Order

An order that sets a price boundary

Buy limit

Buy at the specified price or lower.

Sell limit

Sell at the specified price or higher.

A limit order prioritises price over certainty of execution — it may never fill.

Limit Order Example

Buying below the current market price

Current market price
ETB 105

Order submitted
Buy 1,000 @ 100

Executes at
ETB 100 or less

> The order executes only if the shares can be purchased for ETB 100 or less — subject to market conditions and order priority.

If the price never falls to the limit, the order simply remains unexecuted.

Stop Order

Activated when the market reaches a trigger price

Limit losses

Protect gains

Enter after a price trigger

Important: once triggered, the execution price may differ from the stop price.

A stop order is dormant until the trigger is reached; it then becomes an active order in the market and executes at prevailing prices.

Market vs Limit vs Stop

Matching the order type to the objective

Order	Main Priority
Market	Execution
Limit	Price
Stop	Triggered action

The appropriate order depends on:

- **Investor objective**
- **Market liquidity**
- **Volatility**
- **Price sensitivity**

What Is Margin Trading?

Buying securities with own funds plus borrowed funds

Investor's own money
Equity contribution

Borrowed funds
Loan from broker

Larger position
Financial leverage

Leverage increases the size of the position an investor can control for a given amount of equity.

Margin Example

A 60% initial margin requirement

Value of shares
ETB 100,000

Investor contributes (60%)
ETB 60,000

Borrowing (40%)
ETB 40,000

Equity 60%	**Loan 40%**

100,000 × 60% = 60,000 own funds | 100,000 − 60,000 = 40,000 borrowed

Leverage Magnifies Returns

Position rises from ETB 100,000 to ETB 120,000

Gain on position	Investor equity	Return on equity
ETB 20,000	**ETB 60,000**	**33.3%**

20,000 ÷ 60,000 = 33.3% return on the investor's own funds — while the asset itself returned only 20%.

Figures ignore interest on the loan and transaction fees, which reduce the leveraged return.

Leverage Also Magnifies Losses

Position falls from ETB 100,000 to ETB 80,000

Loss on position	Investor equity	Return on equity
ETB 20,000	**ETB 60,000**	**−33.3%**

−20,000 ÷ 60,000 = −33.3% — the same 20% move against the investor cuts equity by a third.

Key lesson: leverage magnifies both gains and losses.

Maintenance Margin and Margin Call

Minimum equity must be maintained

MARGIN CALL

If account equity falls below the required maintenance level, the investor may need to:

- **Deposit cash**
- **Add securities**
- **Reduce the position**

Failure to meet the call may lead the broker to close positions.

What Is Short Selling?

Seeking profit from a decline in a security's price

Borrow shares → **Sell shares** → **Price falls** → **Buy back shares** → **Return shares**

The short seller profits from the difference between the sale price and the lower repurchase price.

Short-Selling Example

Shorting 100 shares at ETB 50

Sale proceeds (100 × 50)
ETB 5,000

Repurchase cost (100 × 40)
ETB 4,000

Gross gain
ETB 1,000

5,000 – 4,000 = ETB 1,000 gross gain as the price falls from ETB 50 to ETB 40.

Gross figures exclude borrowing fees, commissions and any dividends payable to the lender of the shares.

Short-Selling Risk

What happens if the price rises instead

Sale proceeds	Repurchase at ETB 70	Loss
ETB 5,000	**ETB 7,000**	**–ETB 2,000**

5,000 – 7,000 = –ETB 2,000. Because share prices can theoretically rise without limit, potential losses on an uncovered short position are theoretically unlimited.

Trading Costs

Explicit and implicit costs of trading

Explicit costs

- Brokerage commissions
- Exchange fees
- Taxes where applicable

Implicit costs

- Bid–ask spread
- Market impact
- Slippage

Gross return ▶ **Trading costs** ▶ **Net return**

Trading costs reduce realized investment return.

Why Markets Need Regulation

Objectives of securities-market regulation

- **Investor protection**
- **Market integrity**
- **Fair dealing**
- **Transparency**
- **Disclosure**
- **Orderly trading**

Together these objectives sustain confidence — without confidence, markets lose liquidity and capital.

Market Misconduct

Conduct that is prohibited or closely regulated

- **Insider trading**
- **Market manipulation**
- **Fraud**
- **False disclosure**
- **Misleading information**
- **Unauthorized securities activities**

Practical Exercise — From IPO to Trading

Scenario: ABC Manufacturing needs ETB 500 million for expansion

ABC Manufacturing requires ETB 500 million and management plans to issue shares.

Student tasks

1. Is the issue a primary-market transaction?
2. What role may an investment bank play?
3. Explain underwriting.
4. What happens when shares later trade among investors?
5. Why is secondary-market liquidity important?
6. When might an investor use a limit order?
7. What additional risk arises from margin trading?
8. How would short selling work?
9. Why is market regulation important?

Key Takeaways

Chapter 3 in fifteen points

- Securities markets connect savers and users of capital.
- The primary market handles newly issued securities.
- The secondary market handles trading of existing securities.
- IPOs allow private companies to offer shares publicly.
- Seasoned offerings raise additional equity for listed firms.
- Private placements sell securities to selected investors.
- Investment banks support issuance, pricing and distribution.
- Secondary markets provide liquidity and price discovery.
- Exchanges and dealer markets use different mechanisms.
- Brokers act as agents; dealers act as principals.
- Bid–ask spreads represent an important trading cost.
- Market orders prioritize execution; limit orders price.
- Margin trading magnifies both gains and losses.
- Short selling can profit from falling prices but risks large losses.
- Regulation supports investor protection and confidence.

Next Chapter

Chapter 4 — Mutual Funds and Other Investment Companies

- Investment companies
- Pooled investment
- Net Asset Value
- Open-end mutual funds
- Closed-end funds
- Exchange-Traded Funds
- Money-market funds
- Bond funds
- Equity funds
- Balanced funds
- Index funds
- Active vs passive management
- Fund expenses and fees
- Fund returns
- Performance evaluation
- Benefits and limits of collective investment

THANK YOU

Questions and Discussion

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