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Introduction - Types Of Financial Markets And Their Roles

A financial market is a broad term describing any marketplace where buyers and sellers participate in the trade of assets such as equities, bonds, currencies and derivatives. Financial markets are typically defined by having transparent pricing, basic regulations on trading, costs and fees, and market forces determining the prices of securities that trade.

Financial markets can be found in nearly every nation in the world. Some are very small, with only a few participants, while others - like the New York Stock Exchange (NYSE) and the forex markets - trade trillions of dollars daily.

Investors have access to a large number of financial markets and exchanges representing a vast array of financial products. Some of these markets have always been open to private investors; others remained the exclusive domain of major international banks and financial professionals until the very end of the twentieth century.

Capital Markets
A capital market is one in which individuals and institutions trade financial securities. Organizations and institutions in the public and private sectors also often sell securities on the capital markets in order to raise funds. Thus, this type of market is composed of both the primary and secondary markets.

Any government or corporation requires capital (funds) to finance its operations and to engage in its own long-term investments. To do this, a company raises money through the sale of securities - stocks and bonds in the company's name. These are bought and sold in the capital markets.

Stock Markets
Stock markets allow investors to buy and sell shares in publicly traded companies. They are one of the most vital areas of a market economy as they provide companies with access to capital and investors with a slice of ownership in the company and the potential of gains based on the company's future performance.

This market can be split into two main sections: the primary market and the secondary market. The primary market is where new issues are first offered, with any subsequent trading going on in the secondary market.

Bond Markets
A **bond** is a debt investment in which an investor loans money to an entity (corporate or governmental), which borrows the funds for a defined period of time at a fixed interest rate. Bonds are used by companies, municipalities, states and U.S. and foreign governments to finance a variety of projects and activities. Bonds can be bought and sold by investors on

credit markets around the world. This market is alternatively referred to as the debt, credit or fixed-income market. It is much larger in nominal terms that the world's stock markets. The main categories of bonds are corporate bonds, municipal bonds, and U.S. Treasury bonds, notes and bills, which are collectively referred to as simply "Treasuries." (For more, see the *Bond Basics Tutorial*.)

Money Market

The money market is a segment of the financial market in which financial instruments with high liquidity and very short maturities are traded. The money market is used by participants as a means for borrowing and lending in the short term, from several days to just under a year. Money market securities consist of negotiable **certificates of deposit**(CDs), banker's acceptances, U.S. Treasury bills, commercial paper, municipal notes, eurodollars, federal funds and repurchase agreements (repos). Money market investments are also called cash investments because of their short maturities.

The money market is used by a wide array of participants, from a company raising money by selling commercial paper into the market to an investor purchasing CDs as a safe place to park money in the short term. The money market is typically seen as a safe place to put money due the highly liquid nature of the securities and short maturities.Because they are extremely conservative, money market securities offer significantly lower returns than most other securities. However, there are risks in the money market that any investor needs to be aware of, including the risk of default on securities such as commercial paper. (To learn more, read our ***Money Market Tutorial***.)

Cash or Spot Market

Investing in the cash or "**spot**" market is highly sophisticated, with opportunities for both big losses and big gains. In the cash market, goods are sold for cash and are delivered immediately. By the same token, contracts bought and sold on the spot market are immediately effective. Prices are settled in cash "on the spot" at current market prices. This is notably different from other markets, in which trades are determined at forward prices.

The cash market is complex and delicate, and generally not suitable for inexperienced traders. The cash markets tend to be dominated by so-called institutional market players such as hedge funds, limited partnerships and corporate investors. The very nature of the products traded requires access to far-reaching, detailed information and a high level of macroeconomic analysis and trading skills.

Derivatives Markets

The derivative is named so for a reason: its value is derived from its underlying asset or assets. A derivative is a contract, but in this case the contract price is determined by the market price of the core asset. If that sounds complicated, it's because it is. The derivatives market adds yet another layer of complexity and is therefore not ideal for inexperienced traders looking to speculate. However, it can be used quite effectively as part of a risk management program. (To get to know derivatives, read *The Barnyard Basics Of Derivatives*.)

Examples of common derivatives are forwards, futures, options, swaps and contracts-for-difference (CFDs). Not only are these instruments complex but so too are the strategies

deployed by this market's participants. There are also many derivatives, structured products and collateralized obligations available, mainly in the over-the-counter (non-exchange) market, that professional investors, institutions and hedge fund managers use to varying degrees but that play an insignificant role in private investing.

Forex and the Interbank Market

The interbank market is the financial system and trading of currencies among banks and financial institutions, excluding retail investors and smaller trading parties. While some interbank trading is performed by banks on behalf of large customers, most interbank trading takes place from the banks' own accounts.

The forex market is where currencies are traded. The forex market is the largest, most liquid market in the world with an average traded value that exceeds $1.9 trillion per day and includes all of the currencies in the world. The forex is the largest market in the world in terms of the total cash value traded, and any person, firm or country may participate in this market.

There is no central marketplace for currency exchange; trade is conducted over the counter. The forex market is open 24 hours a day, five days a week and currencies are traded worldwide among the major financial centers of London, New York, Tokyo, Zürich, Frankfurt, Hong Kong, Singapore, Paris and Sydney.

Until recently, forex trading in the currency market had largely been the domain of large financial institutions, corporations, central banks, hedge funds and extremely wealthy individuals. The emergence of the internet has changed all of this, and now it is possible for average investors to buy and sell currencies easily with the click of a mouse through online brokerage accounts. (For further reading, see *The Foreign Exchange Interbank Market*.)

Primary Markets vs. Secondary Markets

A primary market issues new securities on an exchange. Companies, governments and other groups obtain financing through debt or equity based securities. Primary markets, also known as "new issue markets," are facilitated by underwriting groups, which consist of investment banks that will set a beginning price range for a given security and then oversee its sale directly to investors.

The primary markets are where investors have their first chance to participate in a new security issuance. The issuing company or group receives cash proceeds from the sale, which is then used to fund operations or expand the business. (For more on the primary market, see our *IPO Basics Tutorial*.)

The secondary market is where investors purchase securities or assets from other investors, rather than from issuing companies themselves. The Securities and Exchange Commission (SEC) registers securities prior to their primary issuance, then they start trading in the secondary market on the New York Stock Exchange, Nasdaq or other venue where the securities have been accepted for listing and trading. (To learn more about the primary and secondary market, read *Markets Demystified*.)

The secondary market is where the bulk of exchange trading occurs each day. Primary

markets can see increased volatility over secondary markets because it is difficult to accurately gauge investor demand for a new security until several days of trading have occurred. In the primary market, prices are often set beforehand, whereas in the secondary market only basic forces like supply and demand determine the price of the security.

Secondary markets exist for other securities as well, such as when funds, investment banks or entities such as Fannie Mae purchase mortgages from issuing lenders. In any secondary market trade, the cash proceeds go to an investor rather than to the underlying company/entity directly. (To learn more about primary and secondary markets, read *A Look at Primary and Secondary Markets*.)

The OTC Market

The over-the-counter (OTC) market is a type of secondary market also referred to as a dealer market. The term "over-the-counter" refers to stocks that are not trading on a stock exchange such as the Nasdaq, NYSE or American Stock Exchange (AMEX). This generally means that the stock trades either on the over-the-counter bulletin board (OTCBB) or the pink sheets. Neither of these networks is an exchange; in fact, they describe themselves as providers of pricing information for securities. OTCBB and pink sheet companies have far fewer regulations to comply with than those that trade shares on a stock exchange. Most securities that trade this way are penny stocks or are from very small companies.

Third and Fourth Markets

You might also hear the terms "third" and "fourth markets." These don't concern individual investors because they involve significant volumes of shares to be transacted per trade. These markets deal with transactions between broker-dealers and large institutions through over-the-counter electronic networks. The third market comprises OTC transactions between broker-dealers and large institutions. The fourth market is made up of transactions that take place between large institutions. The main reason these third and fourth market transactions occur is to avoid placing these orders through the main exchange, which could greatly affect the price of the security. Because access to the third and fourth markets is limited, their activities have little effect on the average investor.

Financial institutions and financial markets help firms raise money. They can do this by taking out a loan from a bank and repaying it with interest, issuing bonds to borrow money from investors that will be repaid at a fixed interest rate, or offering investors partial ownership in the company and a claim on its residual cash flows in the form of stock.

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