Chapter 2

The Financial Environment

Topics Covered

- The Flow of Savings to Corporations
- Functions of Financial Markets
- Functions of Financial Intermediaries

Flow of Savings to Corporations

[Diagram showing the flow of savings to corporations through financial markets and intermediaries]

[Continued on next page]
Flow of Savings to Corporations

- Financial markets, intermediaries, & institutions help funnel savings to corporations and other investors.

Different Financial Markets

- Stock Markets
  - New York Stock Exchange (NYSE)
  - Over-the-counter dealer market (NASDAQ)
  - Regional and International Exchanges
- Debt (Fixed Income) Markets
  - Corporate & Government Bonds, mostly traded over-the-counter through dealers and banks

Classification of Financial Markets

- Primary Market
  - Newly issued securities
- Secondary Market
  - Exchanging securities among investors
- Capital Market
  - Long-term (more than year): Common and Preferred Stocks, Bonds, etc...
- Money Market
  - Short-term (less than year): Treasury bills, Commercial Paper, short-term bank CDs
Financial Intermediaries

- Mutual Funds (diversification and management)
  - Load or No load
  - Open-ended or Closed-end

- Pension Funds
  - Defined Contribution Plan
  - Defined Benefit Plan

Mutual Funds and Flow of Savings

<table>
<thead>
<tr>
<th>Bank of America</th>
<th>$</th>
<th>Windsor Fund</th>
<th>$</th>
<th>Investors</th>
</tr>
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<tbody>
<tr>
<td>Sells shares</td>
<td></td>
<td>Issues shares</td>
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Financial Institutions

- Banks
  - Take deposits and make loans to corporations and individuals
  - In U.S., other than loans can only invest in government bonds.

- Insurance Companies
  - Sell insurance policies and promise to pay policyholders in certain situations.
  - Can make corporate loans, invest in corporate & government bonds, and stock.
Banks and the Flow of Savings

- **Company**
  - **Loan** $2.5 mil
- **Intermediary**
- **Banks**
- **Depositors**
- **Investor**
  - **Cash**

Insurance Companies and Flow of Savings

- **Company**
  - **Loan** $250 mil
- **Intermediary**
- **Insurance Company**
- **Policyholders**
  - **Cash**
  - **Sell policies**
  - **Issue Stock**
- **Investor**

Other Functions of Financial Markets, Intermediaries & Institutions

- Transporting cash across time.
- Liquidity
- Payment Mechanism
- Reducing Risk
- Provide Information
  - Commodity prices
  - Interest rates
  - Company values
Financial Markets and The Opportunity Cost of Capital

- Financial markets can help corporations estimate their cost of capital for capital investments.
- This cost of capital is the minimum acceptable return for a capital budgeting project.
- This rate depends upon the rates of return that the company’s investors can earn on other financial market investment opportunities.

Opportunity Cost of Capital and the Investment Decision

- **Cash**
  - Firm
  - Shareholders
  - Investment opportunities (real asset)
  - Shareholders invest for themselves
  - Alternative: pay out cash to shareholders
  - Investment opportunities (financial Markets)

- **Invest**