A stock market is a market for the trading of company stock, and derivatives of same; both those securities listed on a stock exchange as well as those only traded privately.

Contents

1 Definition
2 Trading
3 Market participants
4 History
5 International markets
6 Importance of stock markets for the global economy
7 Stock market index
8 Derivative instruments
9 Leveraged Strategies
9.1 Short selling
9.2 Margin buying
10 New issuance
11 Investment strategies
12 See also
12.1 Lists
13 External links
[edit]

Definition

Securities

Securities
Bond
Commercial paper
Hybrid security
Stock
Warrant

Markets
Bond market
Stock market
Stock exchange

Stocks
Share
Stock
Warrant

Bonds by coupon
Fixed rate bond
Floating rate note
Zero coupon bond
Inflation-indexed bond

Bonds by collateral
Asset-backed security
Collateralized debt obligation

Collateralized mortgage obligation
Credit linked note
Mortgage-backed security
Unsecured bond

Bonds by issuer
Corporate bond
Government bond
Municipal bond
Sovereign bond

Although common, the term 'the stock market' is a somewhat abstract concept for the mechanism that enables the trading of company stocks. It is also used to describe the totality of all stocks, especially within one country, for example in the phrase "the stock market was up today", or in the term "stock market bubble".

It is distinct from a stock exchange, which is an entity (a corporation or mutual organization) in the business of bringing buyers and sellers of stocks together. For example, 'the stock market' in the United States includes the trading of stocks listed on the NYSE, NASDAQ, and Amex, and also on the OTCBB and Pink Sheets.

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Trading

Participants in the stock market range from small individual stock investors to large hedge fund traders, who can be based anywhere. Their orders end up with a professional at the stock exchange, who executes the order.

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Market participants

Many years ago, worldwide, buyers and sellers were individual investors, such as wealthy businessmen, with long family histories (and emotional ties) to particular corporations (think Ford). Over time, markets have become more "institutionalized"; buyers and sellers are largely institutions (e.g., pension funds, insurance companies, mutual funds, hedge funds, investor groups, and banks). The rise of the institutional investor has brought with it some improvements in market operations (but not necessarily in the interest of the small investor or even of the naïve institutions, of which there are many). Thus, the government was responsible for "fixed" (and exhorbitant) fees being markedly reduced for the 'small' investor, but only after the large instiutions had managed to break the brokers' solid front on fees (they then went to 'negotiated' fees, but only for large institutions).

Unfortunately, corporate governance (at least in the West) has greatly suffered from the rise of institutional 'owners.'

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History

In 12th century France the courratier de change were concerned with managing and regulating the debts of agricultural communities on behalf of the banks. Because these men also traded with debts, they could be called the first brokers.

In late 13th century Bruges commodity traders gathered inside the house of a man called Van der Bourse, and in 1309 they institutionalized this until then informal meeting and became the "Bruges Bourse". The idea quickly spread around Flanders and neighbouring counties and "Bourses" soon opened in Ghent and Amsterdam.

In the middle of the 13th century Venetian bankers began to trade in government securities. In 1351 the Venetian government outlawed spreading rumors intended to lower the price of government funds. Bankers in Pisa, Verona, Genoa and Florence also began trading in government securities during the 14th century. This was only possible because these were independent city states not ruled by a duke but a council of influential citizens.

The Dutch later started joint stock companies, which let shareholders invest in business ventures and get a share of their profits - or losses. In 1602, the Dutch East India Company issued the first shares on the Amsterdam Stock Exchange. It was the first company to issue stocks and bonds.

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International markets

The Bombay Stock Exchange in India.
Enlarge The Bombay Stock Exchange in India.
The first stock exchange to trade continuously was Amsterdam's Beurs, in the early 17th century. The Dutch "pioneered short selling, option trading, debt-equity swaps, merchant banking, unit trusts and other speculative instruments, much as we know them" (Murray Sayle, "Jpan Goes Dutch", London Review of Books XXIII.7, April 5, 2001).

There are now stock markets in virtually every developed and most developing economies [1], with the world's biggest markets being in the United States,UK, Germany, France, and Japan.

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Importance of stock markets for the global economy

Just as it is important that networks for transport, electricity and telecommunications function properly, so is it essential that, for example, payments can be transacted, capital can be saved and channelled to the most profitable investment projects and that both households and firms get help in handling financial uncertainty and risk as well as possibilities of spreading consumption over time. Financial markets constitute an important part of the total infrastructure for every economy that has passed the stage of domestic production.

The financial system performs three main tasks: firstly, it handles payments; secondly, it channels savings to investments with a good return for future consumption; and thirdly, it spreads and reduces (local enterprise) economic risks in relation to the players' targeted returns (but note that systemic risk is not thereby reduced— it merely becomes less concentrated and uneven). Moreover, unforseen risks may not be capable of being spread, or insured against.

A smooth functioning of all these activities facilitates economic growth in that lower costs and enterprise risks promote the production of goods and services as well as employment. In this way the financial system contributes to increased prosperity.

The stock market is one of the most important sources for companies to raise money. Experience has taught us that the price of shares and other assets is an important part of the dynamics of economic growth. Rising share prices, for instance, tend to be associated with increased business investment and vice versa. Share prices also affect the wealth of households and their consumption. Therefore, central banks tend to keep an Argus eye on the development of the stock market and reflect on how the financial system functions. Another reason is the oversight of financial stability.

The financial system in most western countries has undergone a remarkable transformation. One feature of this development is disintermediation. A portion of the funds involved in saving and financing flows directly to the financial markets instead of being routed via banks' traditional lending and deposit operations. The general public's heightened interest in investing in the stock market, either directly or through mutual funds, has been an important component of this process. Statistics show that in recent decades shares have made up an increasingly large proportion of households' financial assets in many countries. In the 1970s, in Sweden, bank deposits and other very liquid assets with little risk made up almost 60 per cent of households' financial wealth, as against less than 20 per cent in the 2000s. The major part of this adjustment in financial portfolios has gone to shares but a good deal now takes the form of insurance saving. The trend towards forms of saving with a higher risk has been accentuated by new rules for insurance companies, permitting a high proportion of shares, although this is arranged more indirectly. Similar tendencies are to be found in other industrialised countries. In all developed economic systems, such as the European Union, the United States, Japan and other first world countries, the trend has been the same: saving has moved away from traditional (government insured) bank deposits to more risky securities of one sort or another.

This is clearly a positive social trend. However, such riskier long-term saving requires that an individual possess the ability to manage the associated increased risks. Stock prices fluctuate widely, in marked contrast to the stability of (government insured) bank deposits or bonds. This is something that could affect not only the individual investor or household, but also the economy on a large scale. The following deals with some of the risks of the financial sector in general and the stock market in particular. This is certainly more important now that so many newcomers have entered the stock market, or have acquired other 'risky' investments (such as 'investment' property, i.e., real estate and collectables).

With each passing year, the noise level in the stock market rises. Television commentators, financial writers, analysts, and market strategists are all overtalking each other to get investors' attention. At the same time, individual investors, immersed in chat rooms and message boards, are exchanging questionable and often misleading tips. Yet, despite all this available information, investors find it increasingly difficult to profit. Stock prices skyrocket with little reason, then plummet just as quickly, and people who have turned to investing for their children's education and their own retirement become frightened. Sometimes there appears to be no rhyme or reason to the market, only folly.

This is a quote from the preface to a published biography about the well-known and long term value oriented stock investor Warren Buffet. (1) Buffet began his career with only 100 U.S. dollars and has over the years built himself a multibillion-dollar fortune. The quote can illustrate a view held by some of what was going on in the stock market during the end of the 20th century and the beginning of the 21st.

From experience we know that investors may temporarily pull financial prices away from their trend level. Over-reactions can occur so that excessive euphoria drives prices unduly high, just as undue pessimism can push them down too far. New theoretical and empirical arguments have been put forward against the notion that financial markets are efficient.

According to the efficient market hypothesis, it is only changes in fundamental factors, such as profits or dividends, that ought to affect share prices. Something that no doubt helped to question the explanatory power of the efficient-market hypothesis was the stock market crash in 1987, when the Dow Jones index plummeted 22.6 per cent - the largest-ever one-day fall in the United States. This dramatic event demonstrated that share prices can fall even though nothing more fundamental appears to have happened; a thorough search failed to detect any specific or unexpected development that might account for the crash. It also seems to be the case more generally that many price movements are not occasioned by new information; a study of the fifty largest one-day share price movements in the United States in the post-war period confirms this. (2) Moreover, a number of studies have shown that price movements have occurred solely because the company in question has been included in or excluded from Standard & Poor's 500 index, without any new information about fundamentals.

Various explanations for such overreactions have been found. For instance, research has shown that risk management systems and the use of strategies such as stop-loss limits and VaR limits, theoretically could cause financial markets to over-react.

Other research has shown that different forms of psychological factors can also cause those developments. Experimental psychology has found that people often perceive a wider pattern in the light of just a few observations that are actually entirely random. In the present context this means that a succession of good news items about a company's profits may lead investors to project the trend well into the future and accordingly generate an over-reaction; if the share price then rises, this is seen as confirming the analysis. A period of good returns also boosts the investor's self-confidence, making her/him bolder and more prone to take risks. Bit by bit the over-reaction takes shape and, if the worst comes to the worst, leads to a bubble. (3)

A phenomenon - also studied in experimental psychology - that works against taking an independent stance is group thinking. It is not easy to stick to an opinion that differs from what a majority of the group seems to hold; "surely all the others cannot be wrong" is a common thought. An example with which you may be familiar is the reluctance to enter a restaurant that is empty; people generally prefer one that has many guests - they simply rely on the judgement of others.

Even if you hold a different opinion from others, it could be profitable to act as you think the majority will. An investor who considers a stock to be valued above its fundamental level could still decide to buy or hold on to the stock if he or she believes that others might still be interested in buying the stock at an even higher price, for instance due to the factors mentioned earlier. In a paper the authors draw an analogy with a game of poker. (4) In normal times the market behaves like a game of roulette; the probabilities are known and independent of the investment decisions of the different players. In times of market stress, though, the game becomes poker. The players have to take into consideration the position of others and their likely behaviour.

We are also liable to succumb to wishful thinking. An example is when supporters of a national football team, for instance, are frequently over-confident about the chances of winning.

The so-called IT boom, combined with markedly lower transaction costs as a result of new technology and deregulation of trading commissions, induced many inexperienced people to invest in shares. Moreover, access to the Internet leads to an increased number of share transactions, often with poorer results. Investors have also become younger. The same tendency applies to stockbrokers and analysts, many of whom began their careers in the 1990s. Inexperienced investors did not get the assistance and support they needed. In the period running up to the Nasdaq crash, less than 1 per cent of the analyst's recommendations had been to sell. The media accentuated the exuberant mood, with reports of rapidly rising share prices, and the notion that quick money could be earned in the so-called new economy became the conventional wisdom.

From the past years' experience we can identify some important and interesting issues.

What can be done to make the stock market function better? What can be done to provide more support in the future for long-term saving by households? How could more education and knowledge be provided so that the inexperienced investor becomes experienced and well-educated instead.

Shareholders associations all over the world have an important role to play in this respect. Further, it goes without saying that prompt, up-to-date, cor-rect and relevant information is crucial. However, we must remember that more information is not the same as better information. Quality is not the same as quantity. The inexperienced investor must be helped to interpret the information and pick out what matters most. An important role could be played by independent analysts, not to mention media. There have to be agents in society that can see through and criticise corporate managements that are unduly optimistic or provide information selectively.

The argument for this is that international studies indicate that in the second half of the 1990s firms, banks and analysts had incentives to talk inexperienced people into investing in new enterprises on grounds that were not entirely sound. Many new technology companies were not generating a profit and had to rely instead on paying for wages and equipment by issuing shares. For this to be feasible, stock market valuation needs to be high. In this sense there were incentives for managements to trim reports and statements about their firm's future profits. At the same time, analysts and investment banks, with potential earnings from launching share issues, lacked incentives to take a critical look at these reports, so inexperienced investors did not get the assistance and support they needed.

In order to reduce the risk of financial market imbalances, it is important that we have a well thought-out legislative, regulatory and supervisory infrastructure that functions properly and follows changes in the rest of the world. This is a never-ending task that requires the participation of all concerned.

Today, households face what are sometimes very difficult risk management decisions that were not called for or even possible before. Many people still lack the relevant knowledge for this and it may be asked whether people in general can be expected to have such knowledge in the future. Everyone cannot be a specialist in risk management and financial theory.

Therefore, banks and other financial institutions should become more consumer-oriented, instead of today's greater focus on products. The increased exposure of households to the stock market calls for tailor-made plans for the life cycle that take all important risks into account. Central matters here are, of course, investment horizons, how buying and selling is arranged and the degree of diversification across companies and geographical regions. Another parameter is, as indicated, the life cycle; the possibility of saving for the long run is restricted by how much capital is likely to be needed in the nearer future.

Admittedly, this process has to some extent begun already. However, the decisive steps lie ahead.

Note: 1) Hagstrom, R.G. (2001), The Essential Buffet, John Wiley & Sons, Inc. New York.

2) Cutler, D. Poterba, J. & Summers, L. (1991), Speculative dynamics, Review of Economic Studies 58, pp. 520-546.

3) See e.g. Tversky, A. & Kahneman, D. (1974), Judgement under uncertainty: heuristics and biases, Science 185, pp. 1124-1131.

4) Stephen Morris and Hyun Song Shin, Oxford Review of Economic Policy, vol. 15, no 3, 1999.

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Stock market index

Main article: Stock market index
The movements of the prices in a market or section of a market are captured in price indices called stock market indices, of which there are many, e.g., the S&P, the FTSE and the Euronext indices. Such indices are usually market capitalization (the total market value of floating capital of the company) weighted, with the weights reflecting the contribution of the stock to the index. The constituents of the index are reviewed frequently to include/exclude stocks in order to reflect the changing business environment.

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Derivative instruments

Main article: Derivative (finance)
Financial innovation has brought many new financial instruments of which the pay-offs or values depend on the prices of stocks. Examples are exchange traded funds (ETFs), stock index and stock options, equity swaps, single-stock futures, stock index futures, etc. These latter may be traded on futures exchanges such as Euronext.liffe (which are distinct from stock exchanges—their history traces back to commodities futures exchanges), or traded over-the-counter. As all of these products are only derived from stocks, they are sometimes considered to be traded in a (hypothetical) derivatives market, rather than the (hypothetical) stock market.

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Leveraged Strategies

Stock that a trader does not actually own may be traded using short selling; margin buying may be used to purchase stock with borrowed funds; or, derivatives may be used to control large blocks of stocks for a much smaller amount of money than would be required by outright purchase or sale.

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Short selling

Main article: Short selling
In short selling, the trader borrows stock (usually from his brokerage which holds its clients' shares or its own shares on account to lend to short sellers) then sells it on the market, hoping for the price to fall. The trader eventually buys back the stock, making money if the price fell in the meantime or losing money if it rose. Exiting a short position by buying back the stock is called "covering a short position." This strategy is also used by unscrupulous traders to lower the price of a stock. Hence most markets either prevent a short sell or place restrictions on when and how a short sell can occur. These restrictions are usually referred to as tick rule.

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Margin buying

Main article: margin buying
In margin buying, the trader borrows money (at interest) to buy a stock and hopes for it to rise. Most industrialized countries have regulations that require that if the borrowing is based on collateral from other stocks the trader owns outright, it can be a maximum of a certain percentage of those other stocks' value. In the United States, the margin requirements have been 50% for many years (that is, if you want to make a $1000 investment, you need to put up $500, and there is often a maintenance margin below the $500). A margin call is made if the total value of the investor's account cannot support the loss of the trade. Regulation of margin requirements (by the Federal Reserve) was implemented after the Crash of 1929. Before that, speculators typically only needed to put up as little as ten percent (or even less) of the total investment represented by the stocks purchased. Other rules may include the prohibition of free-riding: putting in an order to buy stocks without paying initially (there is normally a three-day grace period for delivery of the stock), but then selling them (before the three-days are up) and using part of the proceeds to make the original payment (assuming that the value of the stocks has not declined in the interim).

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New issuance

Main article: Thomson Financial league tables
Global issuance of equity and equity-related instruments totaled $505 billion in 2004, a 29.8% increase over the $389 billion raised in 2003. Initial public offerings (IPOs) by US issuers increased 221% with 233 offerings that raised $45 billion, and IPOs in Europe, Middle East and Africa (EMEA) increased by 333%, from $ 9 billion to $39 billion.

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Investment strategies

Main article: Stock valuation
One of the many things people always want to know about the stock market is, "How do I make money investing?" There are many different approaches; two basic methods are classified as either fundamental analysis or technical analysis. Fundamental analysis refers to analyzing companies by their financial statements. One example of a fundamental strategy is the CANSLIM method, which aims at finding companies with superior earnings growth and heavy buying demand from market participants, although there are some people who would classify its philosophy a combination of fundamental and technical analysis. Technical analysis studies price actions in markets through the use of charts and quantitative techniques to attempt to forecast price trends regardless of the company's financial prospects.

Additionally, many choose to invest via the index method. In this method, one holds a weighted or unweighted portfolio consisting of the entire stock market or some segment of the stock market (such as the S&P 500 or Wilshire 5000). The principal aim of this strategy is to maximize diversification, minimize taxes from too frequent trading, and ride the general trend of the stock market (which, in the U.S., has averaged nearly 10%/year, compounded annually, since World War II).

Finally, one may trade based on inside information, which is known as insider trading. However, this is illegal in most jurisdictions (i.e., in most developed world stock markets, more or less).

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See also

Balance sheet
Shareholders' equity
Stock investor
Stock market bubble
Stock market crash
Stock market boom
Stock Market Regulation in the United States
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Lists

List of accounting topics
List of economics topics
List of economists
List of finance topics
List of management topics
List of marketing topics
List of stock exchanges
List of stock market indices
List of stock market slang terms
[edit]

External links

Yahoo! Finance - Stock Screener - Market Cap
ECB: Statistics pocket book
Industry Exchanges / Regulator resources
the compelling Real DJIA, 1924-now
the 3 Fed Chair warnings, Real DJIA

Financial markets
Economic subtypes: Capital markets (Stock markets, Bond markets | Primary markets, Secondary markets) | Derivatives markets (Futures Markets)
Money markets | Insurance markets | Foreign exchange markets

Organisations: Stock exchange | Futures exchange

Related Topics: List of stock exchanges | List of futures exchanges | Lloyd's of London | List of stock market indices