Course: B.Com Part III

Paper: VII

Topic: Kinds of Securities

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Kinds of Securities

Before the electronic era, if you made an investment, you were issued a paper certificate or note of some kind, which served as documentation of your investment and outlined the terms of the investment. These paper certificates were called securities, and they were proof of your investment. Paper securities could be bought and sold, just as we buy and sell stocks or bonds or shares of mutual funds today.

Today, the term security refers to just about any negotiable financial instrument, such as a stock, bond, options contract, or shares of a mutual fund. Securities fall into three broad categories: debt, equity, or derivative.

Debt Securities

When a business borrows money to grow, first, it will borrow using traditional means: banks. Banks don’t want to take too much risk, so they will only lend so much to a business. Once that option has been exhausted, a business must go to the capital markets and issue a debt security called a bond. When you buy a bond, you are lending your money to a company (or municipal), and they must pay it back with interest. These interest payments are called coupons payments and typically issued semi-annually.

Equity Securities

When a business takes on additional owners to grow, it can either find private investors or go to the capital markets and issue securities in the form of publicly-traded stock. Equity represents ownership; when you buy a stock, you are purchasing ownership in a company, and as the company makes a profit, you will participate in that profit in one of two ways. Either the company will pay a dividend—which you will receive quarterly—or they will use their profits to grow the business further. If the business continues to grow, you should subsequently see your stock rise in value.

Derivative Securities

With derivative securities, instead of owning something outright, like shares of a stock, you own the right to trade other financial securities at pre-agreed upon terms. Options contracts are a type of derivative security. They give you the right to buy or sell shares of an existing security at a

specific price by a specified date in the future. You pay for this right, and the price you pay is called the premium.

Think of it as an insurance premium. For example, let's say WIDGET stock is trading at $50 a share. You buy an option contract that gives you the right to buy it at $50 a share because you feel sure it is going to $60, but just in case it doesn't, you don't want to be out the full cost of $50 a share. Your option costs $1 per share. WIDGET does go to $60, and so you immediately exercise your option and flip the stock, making an instant $9 a share ($10 profit minus the $1 premium cost.)

The Securities Market

The securities market is not all that different than the real estate market. Just as the housing market is composed of millions of families who all have a dream of homeownership, the securities market is composed of thousands of business owners who all have a vision of building and growing a successful, thriving business. Most of these large businesses would never be able to achieve their level of success without borrowing or raising money in some way, just as most of us would not be able to own a home without first taking out a mortgage. Every business idea must get capital from somewhere, as it is used to build the infrastructure necessary to grow the business.

In rare cases, the business owners have enough money to fund the business themselves. In these cases, the company remains privately owned, and the owners get to keep all the profits. If the business owners don't have the money they need to expand, they can either borrow it or take on additional owners who do have capital—which is where you, the investor, become involved.

When businesses issue securities in the form of stocks and bonds, investors buy them and provide the company with the capital it needs. Once these securities have been issued, they can then be traded between investors on the secondary market. In the U.S., the securities market is regulated by the Securities and Exchange Commission.

How Securities Get Issued Through the Capital Markets

When a business has to go on the capital market, it hires an investment banking firm that looks at the financials of the business and the total amount of money the business needs to raise. The investment bank then advises the business on the best way to raise that money—by either issuing stock or bonds—and then helps put together and sell a public offering of the securities. The newly issued stocks and bonds (securities) are offered to public investors through a network of brokerage firms.