

3. Securities Markets

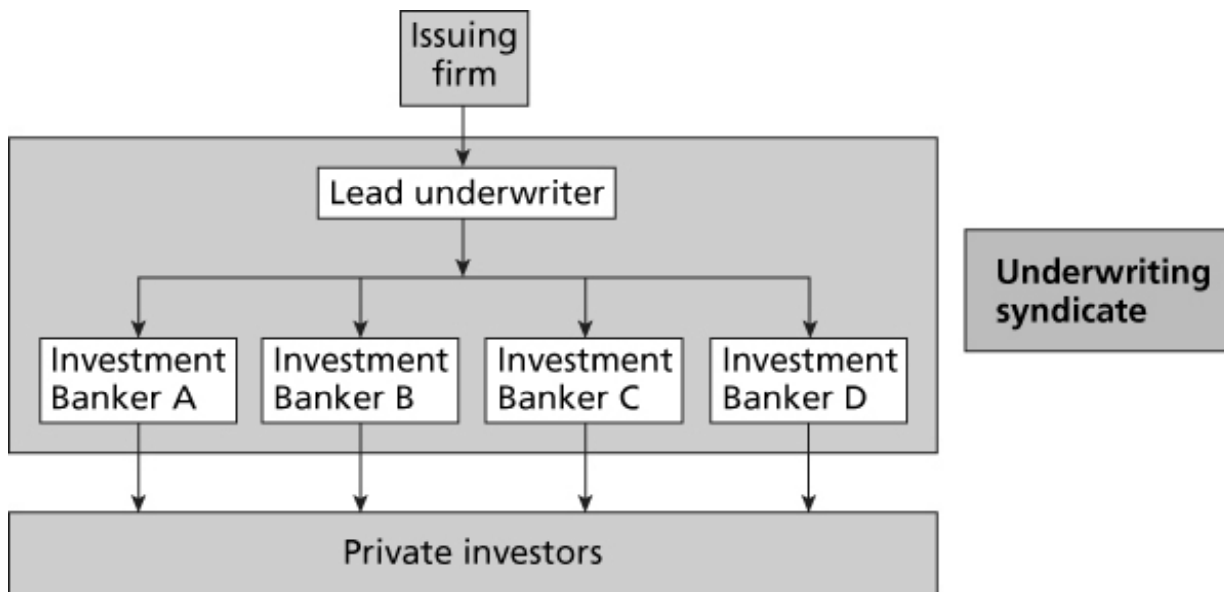
- Primary Markets
- Secondary Markets
- Trading Strategies
 - Margin
 - Short Sales – uptick rule repealed (2008).

- Note: How *you* can trade stocks:
 - Contact full service broker
 - Contact an on-line broker –
 - Send \$\$\$ and start trading!

- Notes:
 - Commissions \$8-\$100/trade. $\frac{1}{4}$ - $\frac{1}{2}$ kept by broker.
 - Online trading firms earn $\frac{1}{2}$ profits from margin and pymt for order flow!
 - Pymt for order flow – trading firm returns part of spread
 - Wrap accounts – 1%-3%, with $\frac{1}{4}$ to broker; $\frac{1}{4}$ to mgr; $\frac{1}{2}$ to firm.

Primary vs. Secondary Sales

- Primary (IPO) –
 - Some web IPO’s via Dutch Auction – See OpenIPO at openipo.com
 - Investment banks – advise firms on going public.
 - Goldman Sachs, Merrill Lynch, Morgan Stanley, Lehman Brothers
Citigroup, Credit Suisse.
- Secondary – Sale of “used” securities.



Primary: Steps to an IPO

- Select underwriter and Set Terms
 - “best efforts” less common even for IPOs; most (esp SEOs) “firm commitment”
 - Direct costs about
 - Issuer meets with underwriters, accountant, attorneys.
 - Due diligence –

- Offering
 - Registration statement filed with SEC
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 - Underwriter prepares syndicate and builds book – Road show
 - Underwriter prices offering; distributes proceeds to issuing firm.
 - Some Web offerings;

- Underpricing? Leaving money on the table?
 - 1980’s (7%); 1990-98 (15%) 1999-00 (65%)
 - Tech bubble extremes - Theglobe.com in Nov 98
 - IPO at \$9 (\$28M mkt cap); Traded at \$97 (\$300M+);
 - Longer-run performance of new issues – under-perform in years 1-5.

Secondary Markets: Overview

- Exchange trading – auction markets with centralized order flow.
 - NYSE-Euronext, AMEX, Regionals (Boston, Pacific, Phil, Chi, National).
 - Specialists on floor (2) conduct auctions.

- Over the Counter (OTC) trading – dealer market without centralized order flow.
 - Dealers observe quotes then negotiate, but now can trade electronically.
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- Electronic Control Networks (ECN) – more dealer markets for electronic trading.
 - Growing rapidly and merging with older markets.
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- General issues – SEC requires orders be filled at market displaying “best” price.
 - Bid – price at which dealer is willing buy.
 - Ask (offer) – price at which dealer is willing to sell.
 - Spread –
 - Most markets are now public companies (NYX, NDAQ)

NYSE and Order Execution

- Example of order execution on NYSE – you place mkt order to buy 100 sh XOM.
 - Your broker (Merrill Lynch) may sell from own inventory (internalization)
 - Your broker (Merrill Lynch) may send order to NYSE specialist post through
 - Superdot computer system
 - Floor brokers on at NYSE.
 - Electronic platform
 - Specialist will act as either
 - Dealer –
 - Broker –
 - Bystander – brokers on floor trade with each other

Market Listing Requirements	NYSE	Nasdaq Global	Nasdaq Capital	OTC Bulletin	Pink Sheets
Pre-Tax Income	\$2m	\$1m	\$0.75m	Listing firms must file and register with SEC.	No real listing requirements. Highly Speculative.
Revenue	\$75m	\$6m	\$4m		
Market Value	\$100m	\$8m	\$5m		
Public Shares	1.1m	1.1m	2.5m		
# shareholders of 100+	2200	400	300		
Governance Standards	Yes	Yes	Yes		

Trading: Protect Yourself with Limit Orders !

- Market Order - execute at best market price.
 - Many got burned with fast moving IPOs !
- Limit Order - execute order at specified price or better.
 - Some shares might not transact
 - Limit-buy - buy if price stays below limit
 - Limit-sell - sell if price stays above limit
- Stop Order – execute order when trigger price is reached.
 - Some shares may transact at worse price, esp in “fast” mkt.
 - Buy Stop - used to limit loss or protect profit on short sales.
 - Sell Stop - used to limit losses or protect profit if stock price continues to drop.
- Stop-limit orders - “Stop” triggers and “limit” ensures price. All combos.
 - E.g., Current price is 70. Sell with stop of 65 and limit 62.
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Margin: Leveraging your Investment!

- Margin
 - Paying fraction of initial cost and borrowing rest. Securities held as collateral
 - Similar to buying a house or car with a loan!
 - Margin will magnify returns/losses

- Margin Rules
 - Max initial margin is 50% (set by Fed Reserve)
 - Maintenance margin usually 30-50%.
 - Arrangement may differ for various stocks, futures and by brokerage firm.

- Technical notes
 - Regulatory min maintenance is 25% for longs and 30% for shorts.
 - Stocks – margin calls must be to *maintenance*, but in practice to *initial*.
 - Futures – margin calls must be to *initial margin*.
 - If margin call not honored, brokerage can liquidate 4 times call amount.
 - Day-traders post \$25k (buys/sells same day 4x in 5 days unless <6% of trades)

Buying Houses on Margin

Buy a house for \$100,000 with 20% down payment

$$\text{Margin} = \text{Equity}/\text{Value} = 20\%$$

Assets	Liabilities and OE
House	Loan at 0% Equity

What happens if price falls 20% to \$80,000?

House	Loan at 0% Equity
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Margin is now $E/V =$
Return on Initial Equity is

Buying Stocks on Margin

Buy 1000 Shares YHOO @ \$100 with 50% initial margin

Assets	Liabilities and OE
YHOO Stock	Loan at 0% Equity

What happens if price falls to \$80? And maintenance margin is 40%

YHOO Stock	Loan at 0% Equity
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Margin is now $E/V =$

- How far can price fall before margin call?

Suppose maintenance is $E/V=40\%$.

$$(A - L) / \text{Value} = 40\%$$

Tech bubble - Record margin; abuses. Restrictions for some stocks/traders (01)

Shorts: Getting Rich When Prices Fall!

- Short Sales - allows profit from a decline in prices
 - Borrow stock through a dealer
 - Sell stock and deposit proceeds and margin in an account
 - Must reimburse for dividends
 - Close position: buy stock and return to the lender

- Short Sale Rules
 - Initial margin is usually 50%
 - Maintenance margin is usually 30-50%.

- Comments
 - Some mutual funds and many hedge funds short.
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Short Sale

Short 1000 shares IBM @ \$100 with 50% initial margin

Assets	Liabilities and OE
Cash Proceeds (from short) Securities	Short Equity

What happens if price increases to \$110?

Cash Proceeds (from short) Securities	Short Equity
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New Margin $E/V =$

- How much can stock price *rise* before a margin call?
 - Suppose maintenance $E / V = 30\%$

$$(A - L) / \text{Value} = 30\%$$

Trading Tips for the Savy Investor

- If you are offered IPO allocation, beware! Also beware IPO/analyst hype.
- Stock screeners are powerful – see <http://finance.yahoo.com>
- Costs of trading
 - Commission - fee paid to broker.
 - Low for on-line brokers, but must pick your own stocks
 - Spread - cost of trading with dealer
 - Poor order execution – cost of dealing with non-reputable broker
- Use Limit/Stop orders in fast mkts, to limit losses, and with margin
- Margin magnifies gains/losses, so must be closely monitored
- Shorts can be risky
 - Market trends upward;
 - Nobody held a short all through the tech bubble!

End – NYSE Picture - Back

