Research
Based
Curricula

You've Got to Speculate to Accumulate: Financial Markets and Portfolio Investments

Key Stage 5 Business Resource

2019

Resource Two Overview

Topic Financial Securities

A-Level Modules Competitive and concentrated markets

Objectives After completing this resource you should be able to understand:

- ✓ The main financial securities.
- ✓ The difference between types of securities.
- ✓ The advantages and disadvantages of each.

Instructions

1. Read the data source
2. Complete the activities
3. Explore the further reading

Context Financial securities, also referred to as financial instruments or financial assets, is a generic term used to describe stocks, bonds, money market securities (e.g., treasury bills), and other instruments representing the right to receive future benefits under a set of stated conditions.

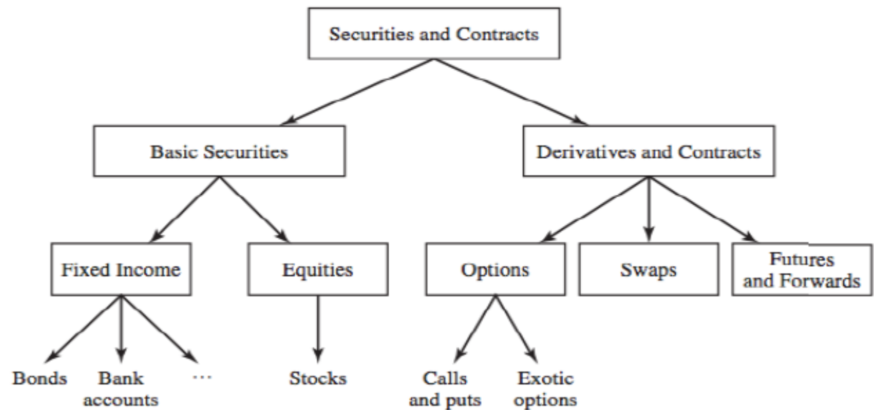
Financial assets are claims on the income generated by real assets (or claims on income from the government). Real assets are the land, buildings, equipment and knowledge used to produce goods and services.

Resource Two
Data Source

A security is a document that confers upon its owner a financial claim. In contrast, a general financial contract links two parties nominally and not through the ownership of a document.

Figure 1

A classification of financial instruments: financial securities and contracts



Section A

Bonds

Definition of a Bond: A bond is a saleable right to receive a finite sequence of guaranteed payments.

In a very broad sense, a bond is a security (a document) that gives its owner the right to a fixed, predetermined payment, at a future, predetermined date, called maturity. The amount of money that a bond will pay in the future is called nominal value, face value, par value, or principal.

A bond is characterised by its interest and its maturity. In principle, bonds represent the paradigm of risk-free securities, in the sense that there is a guaranteed payoff at maturity, known in advance. The lack of risk is the result of the certainty about that amount.

Types of bonds:

- Short-term bonds
- Long-term bonds
- Pure discount bonds also called zero-coupon bonds: involve only an initial payment (the initial price) and a final payment (the nominal value)
- Coupon bonds
- A coupon bond is equivalent to a collection, or a basket, of pure discount bonds with nominal values equal to the coupons

Resource Two
Data Source

Section B

Stocks

Definition of a Common Stock: A share of common stock is a saleable right to receive an indefinitely long sequence of future payments, with the size of each payment contingent on both the firms future earnings and on the firms future opportunities to finance new investment projects

So, a stock is a security that gives its owner the right to a proportion of any profits that might be distributed (rather than reinvested) by the firm that issues the stock and to the corresponding part of the firm in case it decides to close down and liquidate. The owner of the stock is called the stockholder. The profits that the company distributes to the stockholders are called dividends.

Section C

Difference between stocks and bonds

- Randomness of dividend payments and absence of a guaranteed nominal value represent the main differences with respect to the coupon bonds: the bond's coupons and nominal value are predetermined.
- The stock, in principle, will not expire. We say “in principle," because the company might go out of business, in which case it would be liquidated and the stockholders will receive a certain part of the proceedings of the liquidation.
- When there is no risk of default, we can predict exactly how much a bond will pay if held until maturity. With stocks there is no such possibility: future dividends are uncertain, and so is the price of the stock at any future date. Therefore, a stock is always a risky security.
- With respect to the inflation uncertainty, stocks can behave better than bonds.
- General price increases mean that corporations are charging more for their sales and might be able to increase their revenues, and profits will go up. This reasoning does not apply to bonds.

Resource Two
Data Source

From an economic point of view, an important difference results from the type of legal claim they represent:

1. Bonds are financial instruments that allow people to allocate their purchasing decisions over time
    - With a bond, we have two people or entities, a debtor and a creditor. No physical assets or business activities involved
2. Stocks represent claims to the wealth in the economy
    - There has to be a corporation conducting some type of business behind the stock
    - Stock is issued when there is some business opportunity that looks profitable
    - When stock is issued, wealth is added to the economy
3. A stock will go up in price when the business prospects of the company improve. That increase will mean that the economy is wealthier
4. An increase in the price of a bond does not have that implication

Resource Two Activities

Activities

1. Why are stocks usually more risky than bonds?

In questions 2-5 complete sentences with explanation or a specific term:

2. To have or own a share in a company is to have a ...
3. A certificate of a loan to the government or a corporation that is repaid with interest or a sum at a future time is a...
4. Profits of a firm that are distributed or given out to its investors are called...
5. A type of stock in which the stockholder gets a certain percentage of dividends each year based on the profits of the company is...

Resource Two
Further Reading

Explore

Book: "Options, Futures and Other Derivatives" by John Hull

Investopedia article:
https://www.investopedia.com/video/play/stocks-versus-bonds/

www.researchbasedcurricula.com

www.access-ed.ngo

@_AccessEd

hello@access-ed.ngo

100 Black Prince Road
London, SE1 7SJ

AccessEd is a non-profit company registered in England (#10383890)