Chapter 5  The Stock Market

Primary
  New Securities
  Money flows to the person whose name is on the security

Secondary
  "Used" Securities
  Money flows among Investors

IPO
  Initial Public Offering

Primary
  Follow On Offering

The biggest primary market is for Bonds

Some Terms

Dealer - A trader who buys and sells securities from inventory. Commissions via a Bid-Ask spread.

Broker - An intermediary who arranges a securities transaction (i.e. matches buyers and sellers). Are compensated via a commission.
Bid Price - The price a dealer will pay you for a security (i.e. the price at which the dealer buys).

Ask Price - The price at which a dealer is willing to sell. Also called the offer price.

Spread or Bid-Ask Spread
= Ask - Bid
= (sell high) - (buy low)

The college bookstore analogy:
- When a new textbook is produced, it's like an IPO. When additional printings or editions are offered, that's like a follow on offering.
- When you buy the book new, the money goes to the textbook publisher [primary].
- When you buy a used book, the money goes to the seller [secondary next].
- When you sell your book back to the bookstore, it buys it at the "Bid" price.
- When you buy a used book from the bookstore, you pay the "Ask" price.
The bookstore makes money on "the spread."

Why don't you always deal with the bookstore? People will try to trade inside the spread.

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### Secondary Securities Markets

<table>
<thead>
<tr>
<th>Exchange</th>
<th>Over the Counter</th>
</tr>
</thead>
<tbody>
<tr>
<td>eg. NYSE, Amex</td>
<td>Nasdaq</td>
</tr>
<tr>
<td>Physical location</td>
<td>Cyber space</td>
</tr>
<tr>
<td>has specialist</td>
<td>Network of dealers</td>
</tr>
<tr>
<td>○ Broker or</td>
<td>Multiple dealers</td>
</tr>
<tr>
<td>○ Dealer</td>
<td>in each stock</td>
</tr>
<tr>
<td>Specialists have a monopoly in their stocks</td>
<td>&quot;unlisted&quot; securities</td>
</tr>
<tr>
<td>must maintain an orderly market in their stock</td>
<td>&quot;listed&quot; securities</td>
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</tbody>
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How does trading take place?

1. Indirectly through a broker (most individual trade this way).
2. Trade directly with a dealer (more common for institutions).
3. Directly with other investors.
The NYSE (New York Stock Exchange)
- Largest in the US in terms of $ trading
- 1366 members (or seats)
- Non profit corporation
- Those with seats trade for free

1. Commission Brokers (more than 500)
   - Execute trades for their firms
     (e.g. Merrill Lynch)

2. Specialists (almost 500)
   - are market makers that facilitate trading (i.e. Post a Bid and Ask at all times)
   - Maintain the "Limit Order Book" for their stocks
   - are located at their trading post

3. Floor Brokers - do the over load work of the commission brokers

4. Floor Traders - trade on their own account (i.e. Buy low - Sell high)
   - The original "day traders"
Types of Orders

1. Market Order - A customer order to buy or sell marked for immediate execution, at the current market price.
   - Execution will take place, but the price is unknown.

2. Limit Order - Order to transact (either buy or sell) at a specific price.

3. Stop Order - If the stop price is reached, the order is converted to a market order.

NYSE Uptick Rule - Can only short sell a stock (on the NYSE) after an uptick in the stock price (i.e. after a price increase)

Nasdaq - used to be NASDAQ National Association of Securities Dealers Automatic Quotation - A computerized network of dealers
OTC = Over the Counter
    - is now basically Nasdaq

ECN's - Electronic Communication Network
    - an online service that allows investors to trade with each other

Third Market - Trading listed stocks away from the exchange

Fourth Market - Direct trading among investors (often via ECN)

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Measuring Stock Market Performance

Dow Jones Industrial Average
    - has 30 "Blue Chip" stocks

\[ \text{Stock Price} = \frac{\sum_{n=1}^{30} \text{Stock Price}}{\text{Divisor}} \]

- It's called a "Price Weighted" average, where the highest priced stocks tend to have the greatest influence.
**Dow Jones Divisor**

**Book Example:**
- Stock A: $10
- Stock B: $50

\[ \text{Average} = \frac{10 + 50}{2} = 30 \]

Now after closing, Stock B splits 2 for 1. Because a stock split, by itself, does not cause the company to change value, its opening price the next day will be $25, though the market has not changed. How do you handle this with stock market average? Solution: Change the divisor.

\[ \frac{10 + 25}{\text{divisor}} = 30 \]

\[ \frac{35}{\text{divisor}} = 1.1666 \]

When stocks split, the divisor falls. The divisor also changes when the stocks in the Dow are changed.

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S&P is often favored over Dow Jones Index

1. It's a value-weighted index
2. It has more firms (S&P 500)
Using a value weighted index means that GE has a greater effect on the index than STARBUCKS.

On Test 10 question 1 Error on key
Answer is d. Won't have Q.3 on quiz or exams.

<table>
<thead>
<tr>
<th>Company</th>
<th># Shares</th>
<th>BEG</th>
<th>END</th>
</tr>
</thead>
<tbody>
<tr>
<td>K</td>
<td>35</td>
<td>95</td>
<td>102</td>
</tr>
<tr>
<td>P</td>
<td>65</td>
<td>54</td>
<td>63</td>
</tr>
</tbody>
</table>

\[ P_{\text{BEG}} = \frac{95 + 54}{2} = 74.5 \]

\[ P_{\text{END}} = \frac{102 + 63}{2} = 82.5 \]

\[ \text{hpr} = \frac{EV - BV}{BV} = \frac{82.5 - 74.5}{74.5} = 10.74\% \]

**#5**

Value BEG = \((35 \times 95) + (65 \times 54)\) = 6835

Value END = \((35 \times 102) + (65 \times 63)\) = 7665

\[ \text{hpr} = \frac{7665 - 6835}{6835} = 12.14\% \]

**#6**

\[ \text{Index} = \frac{\text{Cur Mkt Value}}{\text{Beg Mkt Value}} \times 100 \]

Beg = \(\frac{6835 \times 100}{6835}\) = 100

End of Yr = \(\frac{7665}{6835} \times 100\) = 112.14