INTRODUCTION TO CAPITAL MARKETS

Prepared by the University of Manitoba Finance Organization

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UNIVERSITY OF MANITOBA FINANCE ORGANIZATION

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OVERVIEW

- This guide was created to help you:
  - Present yourself as an informed, knowledgeable and prestigious student
  - Develop an understanding of the difference between buy-side and sell-side
  - Gain an understanding of the primary buy-side and sell-side roles
  - Learn basic financial terminology

STAY UP TO DATE

- Reading the daily market news can help hone your understanding of the financial markets
- It can help you understand how the economic cycle affects the capital markets
- Some free smart phone applications that will assist with this are:
  - The Wall Street Journal
  - New York Times
  - Barrons
  - Yahoo Finance
  - Bloomberg
- Try to read as many free articles as possible. You may be surprised by how much this will helps to develop an in depth understanding of the markets.

INTRODUCTION TO THE CAPITAL MARKETS

The capital markets are divided into two distinct groups known as Sell-Side and Buy-Side operations

- Sell-Side
  - Involved with the creation and sale of securities. Sell-side firms create and service financial products that will be made available to the buy-side firms.
- Buy-Side
  - Institutional investors that seek to deploy capital into a wide variety of assets, such as equities (stocks), fixed income (bonds), real estate, etc.

SELL-SIDE

- The sell-side firms work for the companies they represent (i.e. an investment banker advising a company on a merger).
- Common sell-side roles
  - Sales & trading, investment banking, equity research
- The major institutions are the big banks
  - In Canada: RBC, TD, BMO, Scotia, CIBC and National Bank
  - Internationally: Goldman Sachs, Morgan Stanley, JP Morgan, Credit Suisse, Barclays, etc.

BUY-SIDE

- Buy-side firms work for the group of investors that they represent (i.e. a pension fund works for its pension holders)
- Common buy-side roles:
  - Asset management, private equity (PE), and hedge funds
- These institutions collect money from retail and institutional investors to invest
  - Retail investors: Investors, such as yourself, that buy and sell securities for their personal account
  - Institutional investors: Individuals or firms that trade securities on a large scale, often purchasing securities in the millions

SELL-SIDE AND BUY-SIDE FIRMS

- Most major banks and larger firms have both buy-side and sell-side operations. These business lines are separated from the rest of the company by a "Chinese Wall" to eliminate conflict of interest.
  - E.g. an investment banker from TD Securities' investment banking division would be required by compliance to have a proctored phone call with an analyst in TD Securities' sales and trading department.
    - Each department would be on different floors.

Finance Industry

- **Buy-Side**
  - *Asset Management*
    - Burgundy Asset Management Ltd
    - CI Financial
    - Mackenzie Investments
    - dream
  - *Private Equity*
    - OMERS Private Equity
    - CPP Investment Board
    - Birch Hill equity partners
    - Ontario Teachers' Pension Plan
  - *Hedge Funds*
    - Bridgewater
    - Soros Fund Management
    - Citadel
    - J.P.Morgan Asset Management
- **Sell-Side**
  - *Investment Banking*
  - *Sales & Trading*
  - *Equity Research*

Goldman Sachs, Morgan Stanley, J.P.Morgan, CIBC, citi, Scotiabank, Canaccord Genuity, Credit Suisse, BMO Capital Markets, TD Securities, RBC Capital Markets, National Bank, Bank of America Merrill Lynch, Barclays

INVESTMENT BANKING (SELL-SIDE)

- Investment banks serve as financial advisors to companies who are making important business decisions that will change their operations and/or capital structure.
- They work on behalf of their clients, providing advice on and facilitating strategic transactions that are integral to business operations.
- Investment banks are paid on commission
  - Success fee: Fee charged after successful completion of a transaction. Usually calculated as a percentage of enterprise value.
  - Bought Deal: Most IPO's are fully bought by the investment bank, providing guaranteed capital to their client and upside for the bank if stock trades upwards.
- **Important:** Many students commonly misunderstand the definition of investment banking and will refer to it as various other capital markets jobs

Investment banks serve as advisors for the following transactions:

Industry Term	Explanation
Mergers and Acquisitions (M&A)	Merge with or buy another company
Debt Capital Markets (DCM)	Raise debt for companies
Equity Capital Markets (ECM)	Raise equity for companies or take private companies public through an initial public offering (IPO)
Restructuring (Rx)	Help companies revive themselves financially and prevent bankruptcy

INVESTMENT BANKING (SELL-SIDE) CONTINUED

Investment banks are large and as a result, they are divided into product and coverage groups.

- Coverage groups: Cover a certain industry
- Product groups: A business decision a company undertakes

Coverage Groups	Product Groups
Consumers & Retail	Debt Capital Markets
Diversified Industrials	Equity Capital Markets
Natural Resources	Leverage Finance
Financial Institutions Group	Mergers & Acquisitions
Healthcare	Restructuring
Gaming, Lodging & Leisure	
Technology, Media and Telecom	

Investment bank hierarchy

- As with most finance jobs, investment banking has a competitive recruitment process.
- Most undergrads will join through a summer internship, full-time recruiting or as an off-cycle hire.

Analyst

- Where you start your career. Most analysts return after a summer internship
- Works on valuing companies, creating models, pitchbooks

Associate

- Analysts often become associates after 2 to 3 years. MBA grads can also begin here
- Work focused on coordinating work of analysts and meet expectations of VP

Vice President(VP)

- Often promoted here after 2 to 3 years. Guide analysts/associates to develop models
- Where managerial work and client interaction becomes part of the job

Senior VP

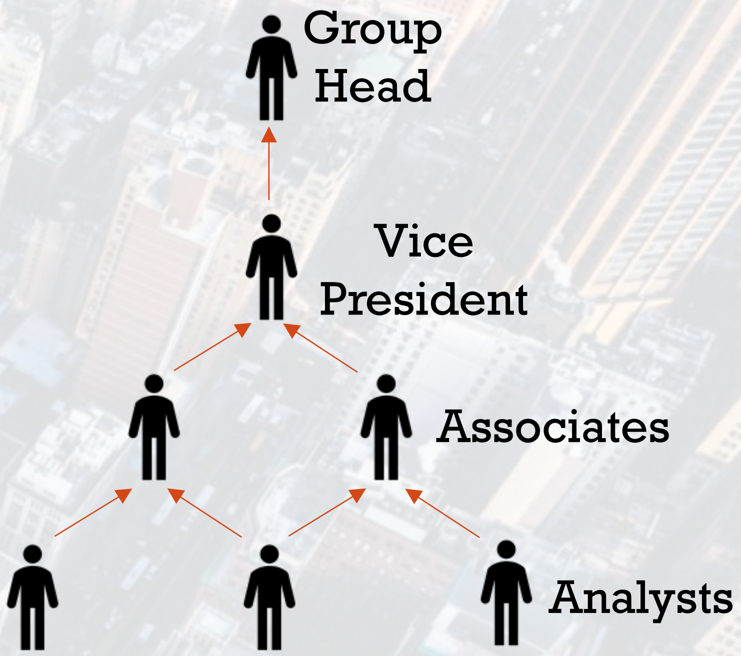
- A mix between vice president and managing director
- Focus on both executing deals and fostering client relationships

Managing Director (MD)

- The highest level you can achieve without becoming a group head or higher (CEO, etc..)
- Almost all time is spent on client relationships and sourcing new clients

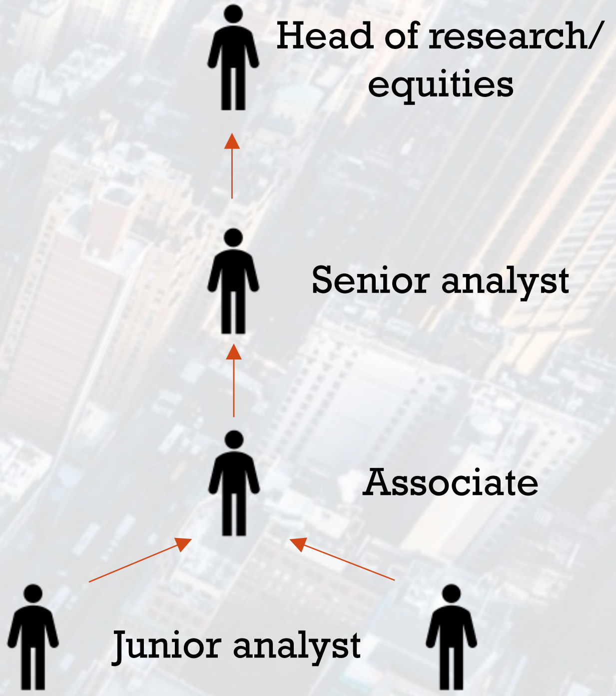
SALES & TRADING (SELL-SIDE)

- The Sales & Trading department of the major Canadian banks and international banks provide advice and assist with executing orders for their clients (usually institutional clients)
- They provide advice on entering or exiting financial positions
  - i.e. if an institutional investor is buying a $100 million position in a company, their sales & trading broker will advise and execute the trade, ensuring the share price will not be heavily affected by the size of transaction.
- Sales & trading firms provide sell-side reports and provide investment ideas/opportunities
- Two basic type of S&T traders: Agency and Prop trading
  - Agency Trading: Trading agent for their clients
  - Prop Trading: Trade the financial firm's own money



EQUITY RESEARCH (SELL-SIDE)

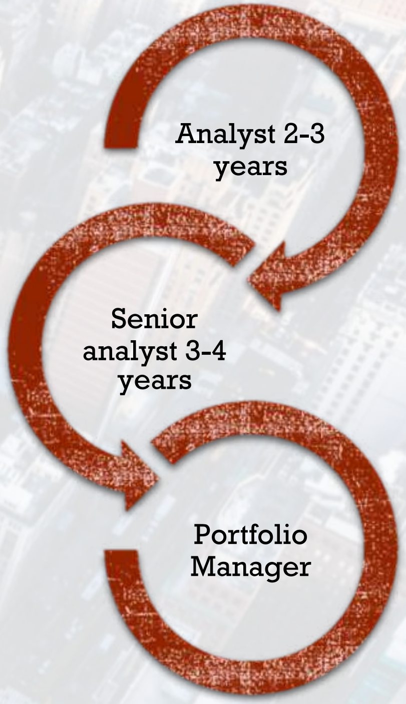
- The equity research division of a firm has a group of analysts and associates that analyze companies with ratio analysis, financial modeling, sensitivity analysis and valuation.
- Equity analysts recommend to buy or sell a stock based on their findings
- Banks often use equity research as a way of supporting their investment banking and sales & trading clients
- Both sell-side and buy-side firms may contain an equity research division



Hierarchy will vary by firm. CFA designation typically required for advancements.

ASSET MANAGEMENT (BUY-SIDE)

- Asset management companies take investor capital and deploy it in different investments such as:
  - Stocks, Bonds, Real Estate, Private Equity, etc.
- Many asset management companies restrict their services to wealthy individuals, families and institutions
  - Their services are offered at a price (management fee) that cannot reasonably be offset when servicing smaller investors
- Most asset managers are investment advisors but not all investment advisors are asset managers
  - In the same rationale that all surgeons are doctors but not all doctors are surgeons



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PRIVATE EQUITY (BUY-SIDE)

- PE firms are investment management companies that acquire private businesses by pooling capital provided from high net worth clients and institutional clients
- Their acquisition strategies include: direct investments (private companies), leverage buyouts (LBO) and sometimes partial stake purchases in public companies
- PE firms will re-sell the companies after completing the leverage buyout (converting debt to equity), restructuring or by taking the company public

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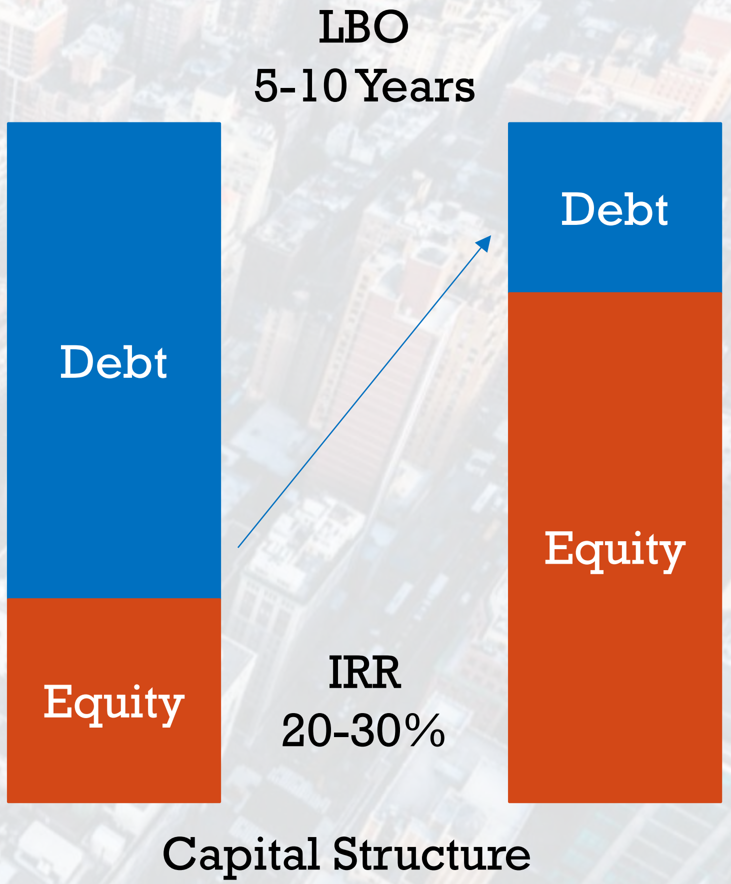
PRIVATE EQUITY (BUY-SIDE) CONTINUED

- Purchase and exit multiples
  - PE firms purchase companies that are undervalued at a lower enterprise value (EV) multiple. After completing the LBO and improving operations, the PE firm will resell the firm at a higher exit multiple.
  - Enterprise multiples: EV/EBITDA, EV/EBIT, EV/Unlevered free cash flows
- Leverage buyout (LBO) overview
  - A company worthy of an LBO will have steady cash flows, operate in a mature industry and contain hard assets (not focused on intellectual property).
  - Purchase a company using significant debt, use the cash flows from the company to pay back the debt. Effectively converting the debt into equity without needing to service the debt with the investor's money.



HEDGE FUNDS (BUY-SIDE)

- Hedge funds are special pooled investments that are limited to select wealthy investors and institutions.
- Their positions generally include arbitrage, trading in stocks, short and long positions, investment in bonds, etc.
- Their positions are very risky and they charge high fees, but they offer the potential to deliver outsized returns.

GLOSSARY OF TERMS

- Analyst: A person who studies an industry sector and makes BUY, HOLD and SELL recommendations. Also, a different term referring to an entry-level career position in many investment banks.
- Asset: An item with economic value that is owned or controlled by an individual, business or government.
- Asset Management: Fund managers investing, typically, in the financial markets, on behalf of their clients to achieve better returns than a given benchmark.
- Commodities: Goods such as oil, petrol, metal or grain.
- Basis Points: One-hundredth of a percent. A basis point is used to measure changes in interest rates.
- Bear: An investor who sells believing prices will fall.
- Bid Price: The price at which the market maker will buy.
- Blue Chip: A well-established company with a good record of earnings over a long period of time. These companies are by investors seeking safety and stability in the markets.
- Bonds: A government or company can raise capital by issuing a bond. Bondholders receive interest (a 'coupon') and the capital is repaid at maturity. The difference between bonds and loans is that bonds can be traded between investors (who are lending to the issuer).
- Boutique Bank: A non-full-service investment bank that specializes in just M&A and restructuring within banking. Some boutique banks also have asset management or other operations outside of investment banking.
- Broker: An intermediary between a buyer and a seller, receiving a commission on the trade.
- Brokerage: The payment from the client to the broker.
- Bulge Bracket Bank: A term used to describe the largest and most profitable multi-national investment banks, who also have operations in retail operations, insurance, asset management, and other divisions. Usually get on the biggest deals.
- Bull: An investor who buys believing prices will rise.

GLOSSARY OF TERMS CONTINUED

- Buy Side: Institutional investors that hold their customer's money and make buy or sell decisions on their behalf. Examples of buy-side organizations include mutual funds, pension funds, and trust companies. A buy-side firm will utilize a sell-side firm to execute the trading of securities
- Call Option: The right, but not the obligation to buy stock, shares, or futures at a specified price within a specific time period. The investor buying the option pays a premium to the seller of the option.
- Capital Markets: The market for long-term funding, e.g. bonds, and equity.
- Chartered Financial Analyst (CFA): A globally recognized US qualification by a range of professionals in the financial services industry.
- Chinese Walls: Information barriers within investment banks to manage potential compliance and conflict of interest issues.
- Clearing: The mechanism for making transactions happen: matching the buyer and seller, making sure the buyer has the cash and the seller has the securities.
- Commission: Fees paid to investment banks by clients for buying investments on their behalf.
- Credit Crunch: The term that has come into common usage to refer to a severe shortage of money or credit. The start of the global credit crunch can be dated to August 2007 when default rates on sub-prime loans in the US housing market rose to record levels.
- Credit Default Swap: an Insurance-like contract that transfers credit risk. The buyer of the swap makes payments to the seller in exchange for protection in the event of a default. Banks and other institutions have used credit default swaps to cover the risk of mortgage holders defaulting.
- Debt: Money owed to creditors/lenders or buyers of debt securities.

GLOSSARY OF TERMS CONTINUED

- Debt Capital Markets (DCM): An investment bank division responsible for issuance and pricing of debt securities (i.e. bonds).
- Derivatives: The group term for financial contracts between buyers and sellers of commodities or securities. Includes futures, options or swaps. Derivatives allow profit from the rise (or fall) of a commodity or security, without actually buying the underlying good.
- Dow Jones Index: Usually refers to the Dow Jones Industrial Index (DJII), an index of share prices for thirty very large US stocks.
- Equity: Otherwise referred to as shares. Shareholders own a percentage of the company and have a share in profits, as well as control via voting rights.
- Equity Research: The research division of an investment bank where analysts who each cover a certain sector or industry write "buy" or "sell" recommendation reports for the companies they cover.
- Equities: Securities representing ownership interest possessed by shareholders in a corporation – stock as opposed to bonds.
- Equity: The net worth of a company. It represents the ownership interest of the shareholders (common and preferred) of a company.
- Equity Capital Markets (ECM): The investment banking division responsible for structuring and pricing the issuance of equities, such as at IPO (Initial Public Offering – flotation of the company on the stock exchange).
- Exchange: A venue for companies to publicly and centrally offer their investment options to investors.
- Fixed Income (FI): Debt instruments of corporations, government or agencies characterized by a fixed interest rate and a stated maturity date. An example of a fixed income investment is a bond because a bond regularly pays a fixed amount of money (interest) to its holder until maturity.

GLOSSARY OF TERMS CONTINUED

- Foreign Exchange Market (ForEx or FX): An over-the-counter market where buyers and sellers trade the currencies of different countries.
- FTSE 100/250 index: The index of the 100/250 largest companies on the UK stock market Futures: A contract between two parties to trade a commodity or security at a fixed price and a fixed future date.
- Generally Accepted Accounting Principles (GAAP): The methodology for preparing company accounts – it varies from country to country. This accounting method is used in the US and no other countries.
- Hard market: A scarcity of a product or service for purchase, as opposed to a soft market, in which the product or service is readily available.
- Hedge: A strategy offsetting the possibility of loss by holding two contrary positions in different financial instruments.
- Hedge fund: A private investment fund that uses a range of strategies to maximize returns, including hedging.
- Initial Public Offering (IPO): This is the initial, or first offering of common stock to the public.
- Insider Trading: criminal offense made by trading on knowledge of non-public information International Financial Reporting Standards (IFRS): Universal financial reporting method that allows international businesses to understand each other and work together. Not used in the United States. Used in Canada and 110 other countries.
- Interest Rates: Lenders demand interest on loans. The rate is dependent on future inflation expectations, as well as the 'real interest rate' – the rental cost of money. Borrowers might pay extra on top in order to compensate lenders for the credit risk.

GLOSSARY OF TERMS CONTINUED

- Investment Bank: A bank providing financial services for governments, companies or very wealthy individuals, as compared to commercial banks, which provide loans and savings accounts to the general public.
- Investment Management: The buying and selling of securities (see securities) and assets (see asset) within a portfolio to achieve investment objectives.
- Investment Trust: Similar to unit trusts – collective investment but with a different structure. Investment trusts' value fluctuates with demand for shares on the stock market. The price of an investment trust does not necessarily equal the price of its underlying assets.
- Junk Bond: Bonds that have little or no collateral or liquidation value and are typically very risky. As such, they offer a higher rate of return than safer kinds of debt. Also known as high yield debt.
- Leveraged Buy Out (LBO): The takeover of a company funded by high-risk bonds or loans.
- Leveraging: Using debt to supplement investment. An institution that has borrowed heavily in addition to its funds or equity to finance growth is said to be highly leveraged.
- Leverage Finance (LevFin): Finance which takes advantage of the ratio between a company's debt and equity, often associated with relatively high risk and returns. It is also the name of the group in an investment bank which provides advisory for these opportunities.
- Libor: London Inter-Bank Offered Rate. The rate at which banks offer money to each other.
- Liquidity: The ability of an asset to be traded quickly without changing the market price.

GLOSSARY OF TERMS CONTINUED

- Market Capitalization: The value of a company's stock, which gives a picture of the company's size. It is calculated by multiplying the price of shares by the number of shares outstanding (in the public markets).
- Market maker: A bank that is obliged to offer to trade securities in which it is registered throughout the trading day.
- Mergers & Acquisitions (M&A): Negotiating the buying and selling of companies or parts of companies. This also describes the division of investment banks that consults companies on mergers and takeovers.
- Money Market: The market for short-term funding such as certificates of deposit and treasury bills. Money market securities typically have a maturity of less than one year.
- Options: Similar to futures but provide the buyer with the right rather than the obligation to complete the contract.
- Portfolio: A collection of securities held by an investor. Also known as a 'fund.'
- Principal: An investor who trades for his/her own account and risk.
- Private Equity (PE): A high risk and high return investment, holding large stakes in illiquid companies.
- Proprietary (Prop) Trading: Trading carried out using the firm's capital on its own behalf.
- Pure risk: A type of risk where the only consideration is the possibility of loss. Speculative risk, in contrast, offers the possibility of loss or gain.
- Put Option: The right to sell shares at an agreed price on a future date (see call option).
- Restructuring: The reorganization of a company's finances, often employed when the company is experiencing financial difficulty.
- Risk Management: Management of the pure risks to which a company might be subject. It involves analyzing all possible risks and determining how to handle this exposure through trading out or transferring the risk with derivatives.

GLOSSARY OF TERMS CONTINUED

- Secondary Market: The trading of securities. The 'primary market' means the launching (issuing) of bonds and equities for the first time.
- Securities: A generic term for bonds and equities.
- Securitization: Turning something into a security, for example, combining the debt from a number of mortgages to create a financial product that can be traded. Banks owning securities that include mortgage debt receive income when homeowners make mortgage payments.
- Sell Side: Used to describe brokers who sell securities to customers and the research departments of brokerage firms that make recommendations to their clientele. (See also buy side).
- Settlement: Once a deal has been made and clearing has taken place, stock and cash transfer between seller and buyer.
- Shares: A certificate issued by a company for general purchase entitling the holder to ownership rights, including dividends from any profits the company may make. Also known as stocks.
- Short Selling: When investors borrow an asset, such as shares, from another investor and then sell it in the relevant market hoping the price will fall. The aim is to buy back the asset at a lower price and return it to its owner, pocketing the difference.
- Spread: Difference between the bid and offer price – one way in which banks make profits.
- Stag: Speculator who buys shares at issue to sell them as soon as they trade on the market. Also called flippers.
- Stagflation: A combination of stagnation and inflation, when economic growth slows as prices continue to rise.

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GLOSSARY OF TERMS CONTINUED

- Sub-Prime Loans: High-risk loans to clients with poor or no credit histories.
- Superday: The final round of the interview process. Usually consists of 3-7 interviews and lasts for 2-5 hours. Final offers are typically given shortly after the Superday to successful applicants.
- Swap Rates: The borrowing rates between financial institutions.
- Trading Floor: Where all trading desks sit within an investment bank.
- Toxic Debt: Shorthand for types of assets that have caused severe problems for the financial institutions that held them since the onset of the credit crunch. US sub-prime mortgage debt was the original toxic debt.
- Underwriting: The guarantee (which is offered by a bank in return for a fee) to buy to find the buyers for an entire issue of stocks and shares.
- Unit trust: The trust issues units which represent holdings of the underlying shares. The fund is divided into units which investors trade with the fund management group.
- Universal bank: A bank offering financial services typical of both investment and commercial banking to consumers and small businesses as well as corporate clients.
- Yield: The total return on a security expressed as a proportion of its price.