Chapter 11: Financial Markets
Section 1

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ECONOMICS

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Objectives

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1. **Describe** how investing contributes to the free enterprise system.
2. **Explain** how the financial system brings together savers and borrowers.
3. **Explain** the role of financial intermediaries in the financial system.
4. **Identify** the trade-offs among liquidity, return, and risk.

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Key Terms

- **investment:** the act of redirecting resources from being consumed today so that they may create benefits in the future
- **financial system:** the network of structures and mechanisms that allows the transfer of money between savers and borrowers
- **financial asset:** a claim on the property or income of a borrower

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Key Terms, cont.

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- **financial intermediary:** an institution that helps channel funds from savers to borrowers
- **mutual fund:** an organization that pools the savings of many individuals and invests this money in a variety of stocks, bonds, and other financial assets
- **hedge fund:** a private investment organization that employs risky strategies to try to make huge profits for investors

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Key Terms, cont.

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- **diversification:** the strategy of spreading out investments to reduce risk
- **portfolio:** a collection of financial assets
- **prospectus:** an investment report that provides information to potential investors
- **return:** the money an investor receives above and beyond the sum of money initially invested

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Introduction

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- What are the benefits and risks of saving and investing?
  - Savings you deposit in a bank will grow with hardly any risk at all.
  - Investing, while more risky, may yield a larger return for your initial investment. It may also prove to be financially devastating if it is ill-timed or mismanaged.

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Investing and Free Enterprise

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- Investing is essential to the free enterprise system.
  - It promotes economic growth and contributes to a nation's wealth.
  - People deposit money into a savings account and the bank lends this money to businesses.
  - Businesses can then increase production, which leads to expansion and growth.

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The Financial System

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- Financial systems are established in an economy so investments can take place.
- When people save money they are really loaning it to other people.
  - Savers receive a document, such as a passbook or a bond certificate, that confirms their purchase or deposit.
  - These documents represent the claims, or financial assets, of the borrower.

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Savers and Investors

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- Financial systems bring together savers and investors, or borrowers, which fuels investment and economic growth.
  - Savers include:
    - Households
    - Individuals
    - Businesses
  - Investors include:
    - Businesses
    - Government

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Financial Intermediaries

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- Financial intermediaries, including banks and other financial institutions, accept funds from savers to make loans to investors.

Savers make deposits to . . .

Financial Institutions that make loans to . . .

Investors

Commercial banks
Savings & loan associations
Savings banks
Mutual savings banks
Credit unions

Life insurance companies
Mutual funds
Pension funds
Finance companies

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Sharing Risk

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- Dealing with financial intermediaries offers three advantages:
  - Sharing risk
  - Providing information
  - Providing liquidity
- Sharing risk
  - Diversification allows you to spread out your investments so that you don't put all of your money into one single investment.
  - Sharing risk helps ward against losing everything on a bad investment.

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Types of Risk

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- Investors must weigh the risks of investment against the potential rate of return on their investment.
  - How does diversification lesson the risks described in the chart?

Name	Description	Example
Credit risk	Borrowers may not pay back the money they have borrowed, or they may be late in making payments.	You lend $20 to your cousin, who promises to pay you back in two weeks. When your cousin fails to pay you on time, you don't have money for the basketball tickets you had planned to buy.
Liquidity risk	You may not be able to convert the investment back into cash quickly enough for your needs.	Your MP3 player is worth $100. You need cash to buy concert tickets, so you decide to sell your MP3 player. To convert your MP3 player into cash on short notice, you have to discount the price to $75.
Inflation rate risk	Inflation rates erode the value of your assets.	Ricardo lends Jeff $1,000 for one year at 10 percent interest. If the inflation rate is 12 percent, Ricardo loses money.
Time risk	You may have to pass up better opportunities for investment.	Lili invests $100 in May's cleaning business, to be repaid at 5 percent interest one year later. Six months later, Lili is unable to invest in Sonia's pet-sitting business, which pays 10 percent interest, because she has already invested her savings.

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Providing Information and Liquidity

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- By providing vital data, either in a portfolio or a prospectus, financial intermediaries reduce the costs in time and money that lenders and borrowers would pay if they had to get the information on their own.
- Financial intermediaries also help people get access to their money when they need it, depending on how liquid the investment is.
  - Checkpoint: Why do savers and investors generally work through financial intermediaries?

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Return and Risk

- Some investments, like CDs, are very safe because they are insured by the government.
- Investing in a new business is far more riskier, but if the business is a success, the return could be very big.

"Forgive the mess. Warren just put everything into cash."

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Return and Risk, cont.

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- In general, the higher the potential return, the riskier the investment.

- Whenever people evaluate their potential investments, they must balance the risks involved with the rewards they expect to gain.

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Review

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- Now that you have learned about the benefits and risks of saving and investing, go back and answer the Chapter Essential Question.
  - How do your saving and investment choices affect your future?

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