FINANCIAL OCEAN

A TO Z OF CAPITAL MARKET INSIGHT

MIND AND MARKETS Inc.

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Mir Mohammad Alikhan

Chapter1

Investment in Corporate Securities

Primary Market

INVESTMENT SECURITIES OVERVIEW

Defined: A security is defined as an investment in an entity made for the sake of earning profit, with a company performing the management of the enterprise. It is compulsory for a company to list on the stock exchange otherwise its security cannot be offered to general public.

Corporate Securities: Corporate securities include such as common stock, preferred stock debt issues, rights, warrants, options, mortgage backed and collateralized mortgage obligations known as CMOs. Moreover, listed companies on the stock exchange can also offer securities to the retail public. In order to make money, it is mandatory to know all sorts of securities offered by enterprises.

LIQUIDATION ORDER

If a public company goes bankrupt and is forced to liquidate, the following Represents the order of who stands in line from first to last to get a share of any Remaining assets:

- Tax Authorities
- Secured bondholder
- Debentures (unsecured bonds)
- General creditors
- Preferred shareholders
- Common shareholders

SAFETY OF INVESTMENTS

If a public corporation has financial problems, considering the liquidation issue then investing in corporate securities has the highest level of risk attached to it. It is pretty obvious that debt instruments such as secured bonds and debentures can be safer than owning common stock. As preferred stock stands in front of common shareholders in case of liquidation of a company preferred stock can be a safer investment than common Stock

COMMON STOCK

Common stock, also known as equities, is sold by public corporations to public for the sake of raising money. The process of raising money through selling securities is known as capitalization. Some of the characteristics of common stock include the following:

- Represents ownership in the corporation for shareholders
- Limited liability for the shareholders
- Freely transferable in the secondary stock market
- May pay a dividend (not guaranteed)

- Rights attached to owning common stock include: voting, preemptive rights transferability, and the inspection of the corporate books.

STOCK CERTIFICATE

The stock certificate is a document for the shares of a corporation a shareholder owns. Most certificates are for "round lot" numbers (number of shares divisible by 100 as one round lot is equal to 100 shares that a person owns). Odd lots are for share transactions that are less than 100 shares

Negotiability

Shares of a company are negotiable in that a holder of stock can give, transfer, assign or sell shares owned with limited or no restrictions. To transfer or sell shares of stock the holder must sign the stock certificate exactly how the shares are registered (even if the name is misspelled). As an alternative, a stock power can be retained in lieu of authorization of the actual stock certificate.

ISSUANCE OF SHARES (CAPITALIZATION PROCESS)

Important Terminologies:

- **Charter:** The corporate Charter is the corporate certificate that comprises information regarding all corporate matters including how many shares of a company can be sold to the general public. The Board of Directors make the final decision as to how many of those shares will essentially be sold to the public during an IPO, Initial

Public Offering.

- **Par Value:** At the time stock is issued to the general public each stake of common stock must be given a par value. Par value is an arbitrary amount which is usually set at a low amount for accounting purposes. Usually, in Pakistan the par value of major companies is Rs10 per share . The par value of a share of a company never changes with one exception. The one exception is when a stock splits. As an example, if there is a 2:1 stock split the par alue will be cut in half. Par value is also known as the stated value
- **Capital Surplus:** The difference between the Current Market Value (value of the stock in the secondary market) and the par value is known as Capital Surplus
- **Book Value** is the prescribed estimated value of the corporation's assets and is used if a company ends doing business and intends to sell off their assets. The book value is often referred to as the abstract liquidating value or even known as corporation's net worth.
- **Stockholder's Equity** is attained by taking the company's total assets and subtracting out total liabilities. (Total assets-total liabilities Shareholder's equity) ng Price is the price recognized for each share of common stock that will be sold to the public during an IPO
- **Current Market Value** (CMV) is the actual current price that a person can buy or sell shares in the open market place, known as the secondary mark.

PRIMARY OFFERING EXAMPLE

Let's take a look at the following example which states the issuance of common stock.

The Corporate Agr are authorized to be issued. The Board of Directors decided that they will initially issue 6,000,000 of those shares. eement indicates that there are 10,000,000 shares of common that

Board of Directors

Authorized, Issued and Outstanding Shares (4,000,000 Shares)

Review of Example: .AB

1. ABC Ltd. through its Board of Directors has decided to issue 6,000,000 shares of common stock to the public.
2. These are known as authorized, issued and outstanding shares. Outstanding stock is issued stock less treasury stock.
3. The remaining 4,000,000 shares are authorized but NOT issued to the public and therefore are not outstanding. ABC may decide to issue offering sometime in the future.
4. Authorized in the corporate agreement, these Outstanding Shares denote capital invested by the firm's shareholders and owners, and may be all or only a portion of the number of shares authorized these through a secondary

Treasury Stock

From period to period a company may decide to purchase back outstanding shares of common stock. These shares are known as Treasury Stock. (ABC Ltd.) Authorized but Not Issued Shares (4,000,000 Shares) held in the corporate treasury. A Company ally purchase back its own stock when the stock, in the company's judgment, is gener undervalued or when the company needs more stock for its employee pension plan, ee bonuses or even for future company acquisitions. However, you must employ understand that treasury stock doesn't have the same rights as outstanding common stock such as (dividends and voting rights). Also, treasury stock is purch from the issued and outstanding stock, not from the non-issued shares ased back

Exam Question Example

ABC Ltd has 1,000,000 outstanding shares of common and 500,000 of unissued shares. If ABC Ltd needs 100,000 shares of common stock for its Employee pension plan (company stock plan) which of the following would be true?

A. The total number of authorized shares would now total 1,600,000.

B. The total number of outstanding shares would now total 900,000.

C. The total number of outstanding shares would now total 1,100,000.

D. The total number of outstanding shares would now total 1,400.000.

Answer: Choice B. As pointed out, stock repurchased as treasury stock would be ssued and outstanding shares. It has no effect on the total of res which would remain as 1,500,000 shares. (1,000,000 - 100,000 = 900,000)

OWNERSHIP IN THE CORPORATION

Let's suppose you purch round lot). As a se 100 common shares of ABC Ltd. (100 shares equals1 shareholder of these 100 shares you are an owner of ABC Ltd, a small onebuta owner none the less. Your stake in ownership is based upon whatever percent 100 shares represent of the total outstanding shares.

STOCK QUOTES

All stock exchanges and the NASDAQ quote equities using the decimal format. While retail customers buy at the Ask and sell at the Bid, traders do the opposite. A trader buys the stock at the Bid from a retailer customer and sells to the retail customer at the Ask.

- **Stock Quote Example**
- **ABC Ltd Stock**
- **Bid: $10.22, Ask: $10.31**

SHAREHOLDER RIGHTS AND FEATURES

- **Limited Liability** as the owner of common stocks you will have the benefit of limited liability. If something happens to PTS Inc., such as a failure of a product causing injuries to end users, you personally would not be liable. Injured parties may litigate against the corporation but they would not be able to reach your financial pockets. The most an investor can lose is his/her original investment
- **Limited Access and Review to Corporate Books**

Common shareholders have a right to a limited review of corporate books at the regular business place that corporate books are kept. .

- **Transferability**

As long as the company is still in business and registered on an exchange or trading in the over-the counter market, investors can sell their shares on any certain business day. Trading takes place in the Secondary Market which includes the various stock exchanges and the over-the-counter market place.

Dividends

- Shareholders have a right to obtain dividends assuming the Board of Directors declares one. Remember, the Board of Directors makes this decision, not the shareholders. Dividends are paid from the company's earnings and usually paid quarterly or yearly that is entirely dependent on the company's performance.Dividends are based on a per share basis such as Rs50 per share, not percentage ownership.

- Corporations are not obligatory to pay out all the earnings as dividends. In fact, the company's which have strong growth plans typically pay little or no dividends as the ings are reinvested back into the company for expansion purposes. On the contrary, companies such as Utilities tend to pay more of their earnings in dividends than other companies. This is known as a higher payout ratio
- Dividends are typically from the company's earnings but can also be paid in other acceptable forms such as stock and distributions of product. paid through check or credited in customer's bank account

Corporate Dividend Distribution Procedures

Declaration Date: The prescribed day the Board of Directors declares a dividend to be paid

Record Date: The date on which the company takes the shareholder names and addresses from the transfer agent records for mailing the dividend

Payable Date: The date the dividend checks will be dispatched by the corporation's transfer agent

Ex-Dividend Date

- Ex-Dividend Date is defined as the day in which the buyer of this stock would NOT be entitled to the dividend. Only the holder of the stock on this day would be entitled to the current dividend . The Ex-Dividend date applies only to distribution of dividends for holders of stock not mutual funds
- The Ex-Dividend date rule is a PSE rule, not a corporate rule.
- The Ex-Dividend date is established two business days prior to the record date

Procedure of Paying a Dividend

- **Record Date:** Friday October 10th.
- **Ex-Dividend Date:** Wednesday October 8th (2 business days prior to the record date
- To be an shareholder of a company and to receive a dividend, the investor must buy the stock no later than Tuesday October 7th
- If the stock is bought after this prescribed date, the trade will settle after the record date and no dividend is received by the shareholder
- If a current owner of the stock wants to sell his/her shares but still wants the currently declared dividend he/she can first sell the shares on ex-dividend day of Wednesday October 8th

Cash Way Settlement Rules

- Normally, transactions settle using Regular Way Settlement rules.
- Trades settle the same day when cash way settlement is used. .Ex-Dividend day for a cash way settlement is always one business day after the record date
- If a trade settles cash way then the stock must be purchased not later than the business day prior to the ex-dividend day which is the Record Date
- Using the calendar on the prior page and assuming a cash way settlement, what will be the last day the stock could be purchased in order to receive the currently declared dividend?

- The answer would be Friday October 10th as this is the business day before ex- dividend day Remember, in order to get the current dividend, the purchaser must own the stock by the record date

Due Bill

A Due Bill is used to claim any payment owing, especially when an investor purchases stock close to the record date. A Due Bill will be dispatched to the owner of recoro representing that the investor is entitled to the current dividend in case the dividend essentially goes to the prior owner by error

Voting Rights

Shareholders have a right to vote for posts on the Board of Director's stock splits, acceptances of buy-outs, stock dividends and issuance of additional new securities.

Shareholders do not have to show up an annual meeting to vote. Instead, a docum known as a Proxy is dispatched to all shareholders on record of owning voting common stock

Proxy

A Proxy Solicitation takes place when a company sends proxies to shareholders usually for a detailed meeting. The company must provide detailed and accurate information to the shareholders about the plans to be voted on. Before making a proxy solicitation, the company must submit this information to the SECP for assessment.

Shareholders on record get to vote one vote for each share owned. There are two types of voting that you must remember Statutory and Cumulative voting

Let's suppose that you possess 1,000 shares of ABC Ltd (common). Therefore, you are entitled to a total of 1,000' votes as states below to the two different voting types

Statutory Voting: You get to cast your 1,000 votes for each available seat on board. If there were three posts to be voted on you can cast 1,000 votes for each of the three posts. Your only constraint is the maximum of 1,000 votes per vacancy

Cumulative Voting: Cumulative voting permits the minority (small) shareholder to get representation on the board. Using the same example, cumulative voting allows the investor to syndicate the 1,000 votes for each post into one voting block for a total of 3,000 votes which can be voted in any way as long as you don't go over the 3,000 votes

Exam Question Example: ABC Ltd has four posts on its board of directors. Ahmed owns 2,000 shares of common stock. He collects a proxy and decides to vote, even though he knows that not all shareholders vote as voting is a right not an obligatory requirement. The proxy specifies that ABC Ltd entails Cumulative Voting rather than Statutory Voting. The following are the individuals running to fill the four vacancies.

Director A
DirectorB
Director C
Director D

Which of the following statements would NOT be true?

A. Ahmed must cast 2,000 votes maximum for a director

B. Ahmed can cast 8,000 shares for any one of the four directors

C. Ahmed can cast 2,000 shares for each of the four directors

D. Ahmed can cast 4,000 votes for Director A and 4,000 votes for Director B

Answer: Choice A as it is an incorrect statement. B, C and D are correct statements regarding cumulative voting rights. Remember, 8,000 shares can be voted anyway the nvestor chooses

Non-Voting Stock

Non-voting stock allows a company to obtain supplementary capital while maintaining management control and continuity without reducing current ownership of voting stock shareholders. Voting and non-voting stocks are usually distinguished by using different issues such as Class A voting stock and Class B non-voting stock.

Preemptive Rights

- These right permits present shareholders to sustain their percentage ownership in the corporation. If the company decides to obtain additional stakes then the percentage may be reduced if the present stockholders weren't permitted to purchase their proportionate share of the new stock prior to it being sold to the public. Therefore under present law or by corporate legal agreement this right is extended to all current stockholders of common stock
- Example: Hamid owns 3% of the outstanding shares of XYZ Corporation. XYZ decides to issue 1,000,000 additional shares of common stock. Hamid has the right to buy 30,000 shares of the new offering, which is 3% of the 1,000,000 new shares being issued
- It should be understood that investors do NOT have to buy any of the new shares being offered. However, if not, the investor's present ownership stake would be diluted.
- The issuance of additional shares is made through a process known as a Rights Offering. A right offering comprises the issuance of a security known as a "Right'

Right

- A "Right" is a security which includes the following features;
- Short-term in extent, usually a maximum of 30 days
- Each Right has a value (price)
- Can be sold to the company in lieu of purchasing shares of the new stock issue
- Shareholders collect one Right for each share they possess

Value of a Right Formula

(With cumulative rights, this means the value of a right prior to x-day)

M-S

N+1

M = Present Market Value of stock

S = Subscription price of new issue

N = # of Rights it takes to buy one new share of stock

Exam Question Example

CMV M = $55 S = $40 **N** = 8

M-S=55-40 = 15

N+1 = 8 +1 = 9 = **$1.66 (Value of one Right)**

Value of a Right Formula **(After x-rights day)**

- Use the same formula as above but do not add "1"' to the value of "N

Rights Agent

If an investor selects to buy any new particular stock he/she would notify the Rights Agent, not the transfer agent, at the corporation. If the investor selects not to purchase any of the shares, then the shares would be turned done to a "Standby Underwriter" to sell theTOCK SPLIT shares to the public during a secondary public offering.

STOCK SPLITS

From period to period a company may announce a stock split to make the stock price more attractive to a broader base of investors. A stock split increases the number of shares but at the same time decreases the market price and par value.

= Value of a Right

Reverse Stock Split

A reverse split behaves the opposite of a regular stock split. Subsequently a reverse split investors own fewer shares which are worth more per share

Stock Split Calculation Clues

The following represents four different scenarios

- Take the total shares owned (1,000) and multiply it by the first number of the stated split, and then divide that number by the second number of the stated split.
- No issue what so ever, after any split the investor is in the same financial situation as before, not better, not worse. In the above examples the investor started with an monetary value of $100,000. All the splits still result with $100,000 CMV.

BENEFITS OF OWNING COMMON STOCK

Short Sale Approach

Generally, investors purchase shares of stock in the expectation of price increase income or both. Those buying shares of stock are considered to have a long position or at times known as "long the stock". When selling shares of a company that investors do not own, the intent is to buy them back when the stock devalues in value at some time in the future. This contract is known as "selling short". In order to commence the sales portion of this approach, the investor must borrow shares from a brokerage firm. The proceeds of this short sale must be placed into a margin account.

An investor who sells borrowed shares is considered "short" the stock until the stock is purchased and then returned to the financier of the shares

Growth

An appreciation in the market price of shares possess by an investor is known as capital appreciation. As an example, Ali purchases 100 shares of ABC Ltd stock at $12 and six months later the shares are worth $36 each. This signifies a 200% increase in market price

Income

There are numerous companies that pay dividends on a quarterly basis. As a company's profitability rises the Board of Directors may increase the quarterly dividend.

These dividends can provide investors with a foundation of needed income.

HAZARDS (RISKS) OF OWNING STOCK

Market Risk

The risk of possessing a stock when the price has dropped and the investor needs to sell the shares at this point of time. Stock prices can differ day to day and even minute by minute on days of great volatility. Investors have no pledge that they will be able to recover any investment losses at any point in time.

Decreased or No Income

Another risk or hazard is the likelihood that a stock dividend may be decreased or eliminated by the company's Board of Directors. If a company has lower earnings or during bad times, a dividend is generally reduced or eliminated as a first step in decreasing costs

Final Right to Assets (Known as Residual Claims)

If a company defaults and goes bankrupt, holders of common stock have the final right to any assets left, supposing there are any assets left. Therefore, common shareholders have a low importance at dissolution.

CATEGORIES OF STOCKS

1. **Growth Stocks**
    a. These companies are generally aggressive and are normally involved with a large amount of research
    b. Holds maximum or all of its earnings
    c. Normally pays low or no dividends
    d. Companies grow faster than the overall economy
2. **Income Stocks**
    a. Companies that typically pay higher than normal dividends
    b. This kind of stock is attractive to those individuals who are in basic need of income such as the old and retired
    c. Utility stocks are examples of income stocks

Blue Chip Stocks

- High grade and value growth stocks of top performing companies
- Extended and continuous records of earnings and dividend payments.
- Well-established, steady and reputable companies with great financial strength.

Defensive Stocks

- Stocks that typically struggle inflation. ' In a weak economy they normally have a degree of firmness.
- Examples are businesses such as utilities, food, tobacco and pharmaceuticals.
- These are not descriptive of stocks in the Defense Production such as companies that manufacture military associated products.

Cyclical Stocks

- Companies whose earnings vary with the business cycle. environment progress, the company's profitability is increased and the share prices will rise
- When conditions worsen, business for the company decreases and its profits are reduced causing share prices to decline
- Examples include industrial sectors such as steel, machine tools and automo

Seasonal Stocks

- Earnings have a trend to fluctuate with the year's seasons.
- The best examples are merchandizing companies as their sales and profits will usually upsurge at certain times of the year such as EID and Back to School

Chapter 2

Preferred Stock

PREFERRED STOCK OVERVIEW

Preferred stock is an equity security for objectives of organization. However, has a permanent dividend rate it appears more like a debt instrument than equity because of the power of its value by interest rate moves. They are also known as senior securities as holders of preferred stock stand in line with holders of common stock to get at the financial assets of the company in situation of liquidation due to default or bankruptcy cause it

PREFERRED STOCK VS COMMON STOCK

Although preferred stock normally does not have the same growth ability as common

Stock, preferred stockholders normally have the following numerous advantages over common shareholders:

- Preferred shareholders have precedence over common shareholders when a aividend is announced by the Board of Directors. Preferred shareholders MUST constantly get their dividends prior to common stockholders receiving theirs.
- It a corporation defaults, preferred shareholders have a precedence claim over common shareholders on any remaining financial assets.
- In a rare exceptional case, preferred stock does not have voting or preemptive rights.

DIVIDEND ISSUES

Dividend Preference

Dividends, when declared by the Board of Directors, are paid first to holders of preferred stock and then remaining to those possessing common shares. If the preferred shareholders do not receive their regular dividend, then common shareholders won't receive theirs

FIXED RATE OF RETURN

As stated, preferred stock dividends are fixed as to the proportion of par value that will be paid as a dividend. The par value is typically fixed at Rs100 for preferred stock

Hence, if a preferred stock has a 5% fixed dividend it will pay 5% of Rs100 or Rs5 annually. However, just like common stock, dividends are typically paid quarterly. The

Board of Directors announces dividends which are based on company earnings which can go up or down. However, preferred share dividends remain fixed, unlike common stocks, which may differ according to the earnings picture. If a company has poorly performed in a particular quarter then the company is not liable at all to pay both preference and ordinary shareholders.

ADJUSTABLE-RATE PREFERRED

Some preferred stocks are issued with modifiable or variable dividend rates. These dividends are usualy tied to the rates of other interest rate standards such as Treasury

Bills and money market rates and can be modified as often as quarterly.

NO MATURITY DATE

Contrasting bonds, preferred stock has no maturity date and is considered to be a long-term security

TYPES OF PREFERRED STOCK

It's essential to review and recognize the differences between the numerous types of preferred stock issues. Kinds of preferred stock may vary in the dividend rate and in other ways. Preferred stock may have one or additional of the following characteristics

Straight Preferred

The following are shared to all types of preferred stock;

- Fixed dividend specified as a percent (e.g. 596)
- Dividend is paid prior to common stock dividends
- Preference over common stockholders in case of company's liquidation
- No entitlement for any missed dividends

Cumulative Preferred

Cumulative preferred performs just like the straight preferred with one key exception.

Cumulative shareholders are enabled to receive prior missed dividends before common shareholders receive their regular dividend. Hence, this doesn't mean that cumulative preferred stockholders can claim the dividends immediately

- Example: Murtaza purchased ABC Ltd. 5% cumulative preferred stock. The stock, based on 5% of par value or Rs100, pays Rs1.25 quarterly. Throughout the first quarter the Board of Directors suspend all dividends to both common and preferred stockholders because of an absence of earnings. When the second quarter turned around the Board decided to restore dividends

The right direction for receiving dividends is as follows:

All preferred stockholders will obtain the present stated dividend for the second quarter of Rs1.25. Then, only cumulative preferred stockholders will receive the dividend owed from the first quarter. Following, if funds are available, common shareholders will be paid.

Convertible Preferred

A convertible preferred works just like every other preferred but is convertible into common stock at the option of the investor, NOT the company. Consequently investors have the best of worlds, a fixed dividend security and possibly the growth potential of common stock.

Convertible Preferred Terminologies

Parity Price: Let's assume ABC Ltd. preferred stock has a current market value of

Rs50 and is convertible into 5 shares of common stock and the common shares have a current market value of Rs10 each. So, the preferred stock, valued at Rs50 is equivalent, if converted to common stock shares valued at Rs50 (5 shares times Rs10 each). In this condition the preferred is selling at Parity with the common shares

Established on the prior info it would make NO financial logic to have a customer convert from the preferred to common shares as there is no change in the current market values

Conversion Ratio

Preferred stock is issued with a par value of Rs100. You might be questioned how many shares of common stock an investor obtains when converting a share of preferred. You compute the conversion ratio by dividing par value of Rs100 by the conversion price

Conversion Examples

Example #1 (Conversion Ratio)

A conversion price of Rs10 is given let supposed in a test question. To compute the number of shares that the preferred is convertible into is the similar as the conversion ratio. Take par value of Rs100 and divide it by the conversion price of Rs10. Each share of preferred, in this case, would be convertible into 10 shares of common stock or stated in a ratio, 10:1

Example #2 (Conversion Price)

As an alternative of asking the conversion ratio or the number of common shares that a preferred is convertible into you could be questioned to compute the conversion price. If they do, they must give you the number of common shares that a preferred is convertible into. So, in the exam question

They tell you that a convertible preferred is convertible into 10 shares of common

They then probe the value of the conversion price. Take the par value of Rs100 and divide it by the number of shares, 10 giving you a conversion price of Rs10

Example #3 (Market Price for Parity)

An additional type of query includes calculating where the market price of common shares has to be to be at parity with the preferred shares. As an illustration, the test question indicates that the preferred issue is selling at Rs500 which is convertible into 25 shares of common stock. You are then tested the following question:

Where does the preferred stock have to be selling at to be at parity with the common shares?

Solution: With the preferred issue convertible into two shares of common stock precedes the current market value of the convertible preferred stock of Rs500 and divide it by 25, the number of common shares that this preferred is convertible into. (Rs500 divided by 25-Rs20). So, to be at parity with the

current market value of the convertible preferred stock, the common stock would have to have a current market value of Rs20.

Callable Preferred

Some preferred issues might be callable. The callable feature means the preferred can be called back by the Issuer Company and works for the advantage of the company not the investor. Shares would be called when interest rates fall. This same attribute is also found in callable bonds. A callable characteristic is not attractive for an investor that is dependent on interest payments as the motive for the call is the falling of interest rates. It gets poorer! If interest rates fall, the company calls in the preferred and now the investor will have to reinvest in a security with a low yield. This is also recognized as **Reinvestment Risk**

Participating Preferred

Another kind of preferred stock is participating preferred. While all other kinds of preferred stock are only authorized to the listed dividend, participating preferred shareholders are also authorized to any extra ordinary dividends that are rewarded to common shareholders. If there are no extra dividends paid to the common stockholders outside their regular quarterly dividends, participating preferred stockholders would not receive any supplementary benefits.

PROBLEMS OF INTEREST RATE AND PREFERRED STOCK

It is essential to understand the value of debt instruments that can increase and decrease liable on the direction of interest rates. Interest rates work contrariwise to the value of preferred and debt instruments. If interest rates increase the value of preferred and debt instruments fall and if interest rates fall, the value of preferred and debt instruments increase. Hence both have a vice a versa situation.

Chapter 3

Investment Returns on Assets

TOTAL RETURN

The total return is a combination of the dividend revenue (income) as well as price increase or price decline over a given period of time.

Computing Total Return on Investment

To compute the total return on a stock investment, add any dividends rewarded during the full year (four quarters) to any difference in the stock's price value and then dividing the result by the number of the price paid for the stock
Example: If the annual dividends rewarded for XYZ Ltd. is Rs1 while the stock originally cost Rs20 with the present market value at Rs25, the return for XYZ Ltd. is 30%. (Rs1 dividend plus change of Rs25 CMV and original stock price of Rs20 or Rs5 equals Rs6 Then take the Rs6 per share and divide it by the original stock price of Rs20 per share

CURRENT YIELD

The present yield signifies the return to a customer buying the security. You calculate the current yield by taking the annual dividends and dividing them by the price paid. As an example, if a stock paid a quarterly dividend of Rs0.25 and cost Rs25 the CY is 496, (Quarterly dividend of Rs0.25 times 4 quarters equals the annual dividend of Rs1 Take the Rs1 and divide it by the Rs25, the cost.)

CASH DIVIDEND

Cash dividends are paid by the company in the form of a check directly to the owner or credited directly by the company into a brokerage account if the stock is retained in Street Name". (Held in the name of the brokerage firm to facilitate trading)

STOCK DIVIDENDS

The Board of Directors might choose to use earnings for company projects so instead of announcing a cash dividend the Board may announce a stock dividend. Under these conditions the company would issue additional shares of common stock to its current shareholders.

A stock's market price and par value falls after a stock dividend, similarly like a stock split, but the company's current market value (CMV) rests the same unlike with a stock split when the current market value falls.

Chapter 4

Influential Corporate Persons

TRANSFER AGENT

- The transfer agent for a company is accountable for the following:
- Abandons old and issues firsthand stock certificates
- Certifies the issuing of securities in the right owner's name
- Preserves records of ownership . Resolves issues relating to missing, pilfered or damaged certificates
- Chooses what securities are acceptable and what good distribution is
    - Right number of shares sold
    - Certificates in good form
    - Essential to be delivered in round lots of 100 or certificates dividable into "100". (e.g 400 share deliveries can be one certificate for 400 shares Four 100 share certificates, eight 50 share certificates but not five 80 share certificates as 80 share certificates cannot be put collected to form 100 share lots
    - Delivers supplementary shares in the event of stock splits
    - Turns as the "Rights" agent during a rights offering .
    - Turns as the "Warrant" agent for any warrant exercises

REGISTRAR

- Certifies that a company does not have more shares outstanding than have been authorized
- Accountable for declaring that a bond signifies a legal debt of the issuing company
- Contrasting the transfer agent, must be sovereign of the issuing company and is usually a bank or trust company
- Ensures the Protection of securities

Chapter 5

Investment Banking

INVESTMENT BANKING

An investment banker is generally a securities broker-dealer that might perhaps also major in underwriting new issues. Utmost, if not all, of the larger brokerage firms such as AKD Securities would have an investment banking unit.

An investment bank's roles will generally contain;

- Guiding companies as to the best ways to obtain long-term capital.
- Raising finance capital for issuers by allotting new securities.
- Purchasing securities from issuers and reselling them to the public.
- Assisting issuers with their registering official papers so that the issuers conform with securities laws
- Distributing large chunks of stock to the public and to institutions

PARTICIPANTS IN A NEW ISSUE

There are a number of participants involved with a new issue.

Issuer

This is the organization selling the securities to obtain money through the process of capitalization. The Issuer would be liable for

- Filing the registration statement with the SECP which is mandatory under the rules set by Securities and Exchange Commission of
- Negotiating the price of the securities for sale and the value of the spread (split amongst members of the selling group) with the underwriter kistan (SECP)
- Investment Banker
- The investment banker supports with registering and circulation of the new security and may counsel the corporate issuer on the best way to raise capital.
- Specific guidance includes how to obtain finance how many shares they should issue, how many bonds, the market price of the new issue and more.
- Investment banks deal with new issues only.
- Any broker-dealer with an investment bank unit must create a Chinese wall. This means that there must be a parting amongst the investment banking section (new issues) and the broker-dealer section withina brokerage firm.

Underwriter

Underwriters operate to support the investment banker and even to assume some financial risk related with the new offering. The underwriters often purchase shares of the new issue and sell them to the

public by a selling group of broker-dealers. Though if the security doesn't performs well there is a possibility of considerable financial losses

Selling Syndicate

A selling syndicate is formed which is made up of the Investment -Underwriters and the Selling Group. The larger the financial risk, the larger the number of new issue shares, the more likely the selling syndicate would increase in size

A Syndicate Agreement is a legal written document in which all parties within selling syndicate must sign and agree to follow the terms the

Selling Group

The selling group is a group of companies; typically broker-dealers that support the selling syndicate sell new issues to the public. The selling group does NOT purchase securities from the issuer as underwriters do. So, they undertake no financial risk. The syndicate might negotiate with other firms (broker-dealers) to support them with the selling

Example of a Syndicate

The following is an illustration of a new issue approaching to the IPO market.

- The name of the issuer is ABC Corp
- They arbitrate with Harmony of Mind Investment Bankers of Palatine. . The decided price to the public ill be $20 per share of common stock . The issuer has agreed to take $18 of the $20 which leaves $2 to be split by the syndicate associates for each share sold. This is known as the Total Spread
- Understand, syndicates do not have the same per share return as our example.

However, they normally do have the same members

The investment banker manages the selling syndicate and is permitted to a payment for each share sold. This is identified as the management fee. Broker-dealers who sell stocks will receive a Selling Concession which is part of the underwriter's concession **Non-Member Sellers** (Go-ahead of the syndicate manager is required to bring in) .If supplementary assistance is needed to sell shares; a broker-dealer can involve in a non-member seller. His payment will be known as the Reallowance and is part of the selling concession.

PUBLIC OFFERINGS VS PRIVATE OFFERINGS

Corporate securities are sold to investors by public offerings or through general private placements.

- In a public offering, securities are sold to the general public engaged in investing through broker-dealers.
- A private placement happens when the issuing company sells securities to private individual investors as opposite to the general investing public.
- Private placement purchasers incline to be institutional investors or wealthier individuals.

- Private placements are normally exempt from the registering necessities of the Securities Act Private placements cannot be advertised or marketed in any public mass media as it is private, not a public, offering. Hence, it is restricted to only targeting private individuals

TYPES OF OFFERINGS BY INVESTMENT BANK

- **New Issues:** The new issue market is consists of companies going public through selling common stock to the public for the first time in an initial public offering (IPO)
- **Additional Issues:** The additional issues marketplace is prepared up of new securities issued by companies that are previously publicly owned
- **Primary Offering:** A primary offering is one in which the underwriting proceeds go to the issuing company. This is the process of capitalization and can be repetitive as long as the corporation does not surpass the amount of stock authorized by the corporate agreement
- **Secondary Offering:** One or additional key stockholders in the company sell all or key portion of their holdings. The underwriting proceeds are paid to the shareholders rather than to the company itself
- **Split Offering:** A split offering is a blend of a primary and secondary offering
- Shelf Offering (Rule 415): An issuer can list new securities issue without selling the present issue all at once. The issuer can sell lots of a registered shelf offering over a two-year period without having to reregister the security. Though, an additional brochure must be filed before each sale. Shelf offerings can be used for both equity and debt offerings

UNDERWRITING AGREEME

This is a contract amongst the issuer and the managing underwriter. This contract includes each underwriter's commitment and obligation for shares to be sold as well as responsibility when allotted shares are not sold

Prior to the completion of founding the selling syndicate there is an contract amongst the underwriters and issuer as to what type of underwriting offering will take place a well as the particulars that will be written into the underwriting agreement.

Types of Underwriting Agreements

The following are the main sorts of underwriting agreements that are made among the underwriters and the issuer

- **Firm Commitment**
- **Best Efforts**

Firm Commitment (Underwriter performs as a Principal)

A firm commitment underwriting is the sort of underwriting in which the syndicate (underwriters) buys the whole issue from the issuer. This upsurges the risk of loss for the underwriters in that any shares not sold would belong to the underwriters.

- **Standby Underwriting:** A During a rights offering, if any present stockholders decide not to buy any of the newly issued stock, a standby underwriter purchases the stock to offer it to the general public. tandby underwriting is a method of a firm commitment

Best Efforts (Underwriter acts as an Agent)

A best efforts offering has low risk for the underwritings as they do NOT buy the stock from the issuer. As an alternative, they do the "best job" they can in selling the shares offered

- All and None Underwriting: The whole offering might be sold or the deal is f.

Though money is being obtained and the funds are positioned into an escrow account pending ending disposition of the underwriting

- Mini-Max Underwriting: A mini-max offering identifies a lowest amount to be sold for the offering NOT to be canceled. The underwriter should place adequate interested buyers to assist the least issuance requirement.
    - Once the least number is met, the underwriter can grow the offering up to maximum amount of shares the issuer desires to sell

MARKET OUT CLAUSE

The objective of a market out clause is to permit the underwriters to pull out from the IPO offering when market situations are negative

ALLOCATION OF ORDERS

When a new issue is brought up in the Primary Market by the Investment Banker a priority of orders is developed. This priority is as follows;

- P = Pre-sale orders
- S = Syndicate orders
- D = Designation orders
- M = Member orders

You just need to know the order, not a comprehensive description of each kind of order. Try using the abbreviation, Please Send Ali Money

WESTERN VS EASTERN UNDERWRITING

A syndicate contract can be made for either a Western or Eastern kind of account. The difference among the two represents the amount of risk the underwriters are prepared to accept

Western Account

The Western Account is identified as a divided account. If a syndicate member sells its complete allotment of shares, it does NOT have to support other syndicate members in selling unsold shares.

Eastern Account

The Eastern Account is identified as the undivided account. If a syndicate associate sells its complete allotment of shares it is still accountable for a proportion of the securities left unsold by the other members. As an illustration, let's assume all the underwriting mem bers are accountable for selling 25% of the total shares available.

One of the four underwriters doesn't sell all of the allocated shares. The other members now have to sell 25% of the outstanding shares of that underwriter. This drives on and on until all of the shares are sold

ANTI-FRAUD PROVISIONS

Even though a security might be exempted from registering and prospectus necessities, no offering is exempted from the anti-fraud provisions of the _________________or any other securities act, including the Securities Exchange Act_________________

Chapter 6

Debt Instruments

OVERVIEW

This chapter will assess all debt instruments which can be issued by Organizations, the U.S. Government, U.S. Government Agencies and Municipalities. What they all have in common is that they denote an investor's loan to an issuer. So, investors become creditors of the issuer, not owners as a holder of common stock would be The borrowers make two very important promises:

1. They guarantee to pay interest as determined by the kind of debt instrument. Mostly bonds pay interest twice a year while U.S. Government Agencies usually pay on monthly basis They guarantee to redeem the bonds at face value when the bonds mature. Usually face value or par is $1,000 per bond. Bondholders also take the place of a "Senior
2. Securities" holder. This becomes significant if a corporation goes out of business and a line to get at the assets form. Bondholders position in front of both preferred and common stock holders.

ISSUERS

Corporations issue bonds to obtain working capital to pay for such things as new equipment, growth or even plant construction. Corporate bonds are normally referred to as Funded Debt. Funded debt is any long-term debt payable in five years or more time span.

- The U.S. Government issues Treasury Bills, Notes and Bonds which are funded by the full faith and credit of the U.S. Government with its limitless taxing powers.
- Municipal Securities are the debt obligations of state and local governments and their agencies. Most of these kinds of bonds are issued to obtain capital to finance public works or construction discards that benefit the general public

MATURITIES

On the maturity time, the face amount of the bond is paid back to the investor. This might be more or less than the investor initially paid.
The following signifies the three basic kinds of bond maturities

- **Term Maturity:** A term bond is organized so that the principal of the whole issue matures at once. This kind of issue can be more risky than others because of the financial demand on the company of all the bonds maturing at once. So, most companies prepare a Sinking Fund in which to accumulate additional operating income which would be used to call in bonds prior to their maturing
- **Serial Maturity:** A serial bond issue is organized so that lots of the principal mature at intervals over a period of years. In an approach, this kind of issue is safer than a term maturity issue as all bonds do not owe at the same time.

Serial Bond Issue Example

Series Issues: As an alternative of placing all of the bonds in the hands of investors at one time, any bond issuer may spread out its borrowing over several financial years as its requires dictating by issuing the bonds in separate series

Serial Bond Issue Example Maturity Interest Rate Amount to be issued

- 2010 6.00% $600,000
- 2011 6.10% $600,000
- 2012 6.20% $600,000
- 2013 6.30% $600,000
- 2014 6.40% $600,000
- 2015 6.50% $600,000

Note that every maturity has a different coupon rate. The longer the maturity is the higher the interest rate would be. Over all, if investors are anticipated to hold bonds for longer time periods then they should be rewarded more.

- Balloon Maturity: A balloon maturity includes an issuer which plans its bond's maturity using essentials of both serial and term maturities. The issuer pays back a part of the bond's principal before the final maturity date, as with a serial maturity, but pays off the key portion of the bond at maturity time. This kind of bond has a balloon, or serial and balloon, maturity.

DEBT INSTRUMENTS TERMINOLOGY

Bonds

These are long-term debt instruments. Bonds can be bought from companies, 14.5 Federal governments Government and even foreign governments. They are also recognized as funded debt

Bond Certificate

The bond certificate is evidence that terms the bond's ownership and features. Note that the U.S. Government does not issue Treasury Certificates. In its place, ownership is registered in Book Entry form which is the name and tax number registration of the holder which is then reserved in a U.S. Government registration book

Each bond certificate comprises the following information:

- Name of the issuer
- Kind of bond
- Principal amount
- Issue date of the bond
- Date of maturity of the bond
- Call features (if any)
- Coupon rate of the bond (interest rate)
- Interest payment time period
- Reference to the trust agreement

CATEGORIES OF REGISTRATIONS

Coupon (Bearer) Bonds

These are bonds with the real coupon attached. Investors would scratch off the actual interest rate coupon, take it to their local bank and receive the semiannual interest
Bearer bonds do not have any names on the registration because of security implications as well as tax problems; these bonds are no longer issued. Still, they still do exist as secondary bonds.

Fully Registered Bonds

This is the most common kind of issued bond which is registered in the investor's name. Interest is paid by the transfer agent to the bondholders automatically

Registered as to Principal Only

These are identified as partially registered bonds as they are registered in the investors name with coupons involved just like bearer bonds. Then the investor has to pin the coupons to get their interest payments. Identical to bearer bonds they are no longer issued.

Book-Entry Bonds

The investors do not receive certificates or coupons. Instead, the transfer agent preserves the security's ownership records. The trade confirmation assists as evidence of book-entry bond owners. Most U.S. Government bonds are available only as book- entry

SECURED BONDS

Secured bonds, also recognized as senior bonds, are funded by a pledge of collateral, a mortgage or other kind of lien. The positions and nature of the security is spelled out in the Indenture that is devoted to the bond. Secured bonds are different from unsecured bonds, also identified as Debentures.

Forms of Senior Bonds/Secured Bonds

Mortgage Bonds: Mortgage bonds are issued and secured by a mortgage on the issuer's property, the lien on which is conveyed to the bondholders by a deed of trust.
These bonds enjoy a preferred position relative to unsecured bonds and stand in front of unsecured bonds in the case of a corporate liquidation to get at the remaining assets.

Equipment Trust Bonds: These are typically issued by a transportation companies such as a railroad or shipping company and used to pay for new equipment. The certificate gives the bondholder the first right to the equipment in the incident that interest and principal are not paid when outstanding
Collateral Trust Bonds: This sort of corporate debt security is funded by other securities, usually held by a bank or other trustee.

OTHER BONDS

Unsecured Bonds (Known as Debentures)

Unsecured bonds are debt obligations which not funded by a pledge of specific collateral. There are more debentures due than secured obligations

Zero Coupon Bonds

Zero coupon bonds are securities that do not pay periodic interest payments coupons, but on the contrary are sold at a deep discount from its face value. The purchaser of such bonds receives the rate of return by the steady appreciation of the security which is redeemed at Face Value on a stated maturity date.

- For tax purposes, the FBR in Pakistan upholds that the holder of a zero-coupon bond owes income taxes on the interest that has accrued each year, even though the bondholder does not essentially receive the cash until maturity time
- Because zero-coupon securities contain no interest, they are the most volatile of all fixed-income securities. Subsequently zero-coupon bondholders do not receive interest payments, zeros drop more dramatically than bonds paying out interest on a present basis when interest rates increase. Though, when interest rates fall, zero- coupon securities increase more fast in value than full coupon bonds, because the bonds have locked in a specific rate of reinvestment that becomes more attractive the further rates decrease
- There are many kinds of zero-coupon bonds. Many brokerage firms strips the interest rate coupons off bonds and sell the underlying value and the coupons distinctly.

This method is used often with Treasury bonds and marketed under the following names:

- (CATS): Certificates of Accrual on Treasury Securities
- (TIGERS): Treasury Investors Growth Receipt
- (STRIPS): Separate Trading of Registered Interest and Principal of Securities

Municipal Zero-Coupon Securities

Purchasing a municipal zero delivers the purchaser of the worry about paying taxes on credited interest, since the interest is tax-exempt.

Zero Coupon Certificate of Deposit

The CD holder obtains face value at maturity but no monthly payments.

Usages of Zero-Coupon Bonds

Zero-coupon securities are often used to make strategy for a precise investment goal
For instance, parents knowing their child will join college in 10 years can purchase a zero that will mature in 10 years period, and therefore be assured of having money available for tuition. People preparing for retirement in 25 years can purchase 25-year zeros, promising them that they will get the money when they require.

Income Bonds (Adjustment Bonds)

It is a debt security that generally does not pay any income/interest. The company needs to have considerable earnings in order to pay any interest on these bonds.
Normally these bonds are is trying to reorganize. In general, income bonds trade flat (without payable interest) These bonds are highly risky! issued when the company is facing financial difficulties and

Speculative Bonds

- Rated below investment grade bonds.
- Carry a high level of risk exposure
- Bond analysts are skeptical about the issuer's ability to pay interest and repay principal
- Normally offer higher yields than those offered by investment grade issues.
- Investors demand higher returns due to the greater risk inherent in the investment.

Eurobonds

- Sold in a country other than the one in whose currency the bond is denominated
- U.S. investors must analyze their return by forecasting foreign currency movements, as interest and principal payments would have to be converted into U.S. dollars to be spendable

Eurodollar Bonds

- They pay principal and interest in U.S. dollars.
- They are often used primarily in Europe
- Mostly used by multinational companies, foreign governments and international agencies.
- Bonds are not registered in the United States and cannot be traded in the U.S financial markets; for at least three months after issuance.
- They pay interest on annual basis
- They pay either a fixed or floating variable rate.

SECONDARY TRADING OF CORPORATE BONDS

Most of the corporate bonds are listed on an exchange. Still, a great number of ate bonds issues are not listed securities. Hence, they are traded in the over-the- corpor counter markets (OTC's)

ACCRUED INTEREST OVERVIEW

When bonds are traded in financial market they trade with accrued interest. It means that the purchaser of the bonds pays the decided price for the bonds plus any payable interest. It is true because the seller is probably entitled to some of the accrued interest prior to the trade. The purchaser will obtain the entire six months of interest on the next interest payment date 4(remember, bond interest is paid on semi-annual basis)

ACCRUED INTEREST RULES

- Interest accrues up to but does not include settlement date
- Regular way settlement for corporate bonds and municipal bonds is three (3) business days hale regular way settlement for U.S. government a security is only one (1) day
- Interest initially starts to accrue from the Dated Date
- There are 30 days in every month for corporate and municipal bonds
- Actual days in every month are used for U.S. government securities.

Corporate Bond Illustration

A 7% corporate bond pays interest 4/1 and 10/1. The bond trades on June 18th.
What are the number of outstanding days and the amount of accrued interest?

- To answer this question you must first compute the number of days of outstanding interest. It is suggested that you use the following method in computing the number of accrued days of interest

Corporate Bond Illustration Solution

- Step 1: Write down the Settlement date for the security. If the bond trades on June 15th then the settlement date will be 3 days after or June 18th
- Step 2: Then deduct the date of the last interest payment date. In this illustration the last date interest was paid was April 1st.

Corporate Bond Accrued Days

Calculation
6/18
- 4/01

Deduct 4 from 6 which equal 2 months. The two months times 30 days each month equals 60 days. Now deduct 01 from 18 for a total number of 17 days. So, the total number of outstanding days will be 77 days.

Calculation of the Outstanding Interest

- It is a 7% bond which means it will pay 7% of par or $70 annually
- To compute the daily outstanding interest takes the $70 and divides it by the number days in a corporate year which is (360) 70 if divided by 360 will give a daily outstanding interest of 0.1944
- Lastly, take the daily rate of $O.1944 and multiply it by times the number of outstanding days in this instance of 77. (77 times 1944 equals $14.97)
- The buyer will have to pay the decided price of the bond in addition to the $14.97 of outstanding interest

U.S. Government Bond Illustration

U.S. Government Bonds settle the next working day, not in three days and also use the actual number of days in a month against 30 days as corporate and municipal bonds would use.

A 6% U.S Government bond pays interest 1/1 and 71. The bond trades on May 16th. What are the number of outstanding days and the amount of outstanding interest?

- To solve this question you must first compute the number of days of outstanding interest. It is suggested that you use the following method in computing the number of outstanding days of interest

Government Example Solution

- Step 1: Write down the Settlement date for this security. If the bond trades on May 16th then the settlement date would be 1 day after or May 17th.
- Step 2: Then subtract the date of the last interest payment date. In this example the last date interest was paid was January 1st

Government Bond Outstanding Days

Calculation
5 /17 (U.S. Government bond settles in 1 day, and not 3 days) - 1/01
Deduct 1 from 5 which equals 4 months. Four months' times 30 days each month equals 120 days
Now deduct 1 from 17 for a total number of 16 days
The total number of outstanding days seems to be 136 days (120 16). At this instant it is a government bond modification which would have to be made for each of the 4 months

- In the current example, the number of days needed to alter for the government bond is none. There were a total addition of 2 days and deducting 2 days. So, there are a total number of accrued days of 136.

Calculation of the Outstanding Interest

- It is a 6% bond which means it will pay 6% of par or $60 annually.
- To compute the daily outstanding interests takes the $60 and divide it by the number days in a government calendar year which is (365) 60 divided by 365 will give a daily outstanding interest of 0.1644
- Lastly, pick the daily rate of $O .1644 and multiply it by times the number of outstanding days in this instance of 136. (136 times 1644 equals $22.36)
- The buyer will pay the decided price of the bond plus the $22.36 of outstanding interest

Normal Yield Curve

- The Normal Yield Curve is also identified as an Upward Sloping or Ascending Yield Curve
- Yields normally increased as maturities lengthen.
- Yield curve will show lower yields in the smaller maturities and higher yields in the higher maturities.
- Consequently, if a customer is looking for the highest yielding debt instrument it will be essential to buy them with higher maturity dates
- Short-term instruments usually pay lower interest rates.

Yield in Percent Normal Yield Curve

Maturity 5 10 15 20 25 30 9 876

Flat Yield Curve

- This yield curve shows when short-term bonds and long-term bonds have almost the same yield
- Normally it specifies that short-term yields are increasing quicker than long-term yields .
- In an inverted yield curve short-term rates are higher than long-term rates and generally follow a flat yield

Flat Yield Curve

Maturity5 10 15 20 25 30
Yield in Percent 9 8 7 6

Inverted Yield Curve .

- This curve is also recognized as a negative, descending or downward sloping curve.
- The inverted yield curve happens when interest rates have increased just
- This is an uncommon situation.
- Short-term debt instruments are yielding more than long-term bonds.
- This yield curve generally does not last for a very long time
- With an inverted yield curve you would recommend clients to purchase short-term debt instruments than long-term

DEBT INSTRUMENTS&RELATED ITEMS REVIEW

- Bonds are long-term financial debt obligations
- Face value of a bond is recognized as the face amount, principal or par value
- Usually, the par values of most bonds are $1,000 .Bonds have a specified interest rate which is recognized as coupon rate or nominal Yield
- Repayment of the principal amount of the bond happens at the maturity
- These bonds pay the interest on semi-annual basis
- Coupon rates on bonds stay fixed for life of the bond.

Maturity 9 8 76 5 10 15 20 25 30

Inverted Yield Curve Yield in Percent

- If interest rates increase, the value (price) of an existing bond will fall as it is worth less than a new bond with a higher rate of coupon.
- If interest rates reduce, the value (price) of an existing bond will increase as it is worth more than a new bond with a lower rate of coupon.
- For a bond selling at par, the nominal yield (coupon rate), present yield and Yield-to- maturity are all equal
- For a bond selling lower than par (discount bond) the nominal yield is less than the current yield which is lower than the yield-to-maturity.

- For a bond selling higher than par (premium bond) the nominal yield is higher than the current yield which is more than the yield-to-maturity
- Normal yield curves show lower yields in the shorter maturities and higher yields in the longer maturities
- Inverted yield curves indicate higher yields in the long-term maturities and lower yields in the short term maturities.
- Discount debt financial instruments are more instruments.
- Long-term yields are more volatile than the short-term yields.
- Short-term yields change more frequently than long-term yields.
- Call features benefits the issuer and not the holder.
- If called on the amount above par value then it is recognized as the call premium.

Chapter 7

Money Markets

MONEY MARKETS OVERVIEW

There are essentially two kinds of financial market relating financing. First, the capital market, which assists as a source of intermediate-term to long-term financing which is generally in the form if equity or debt securities with maturities of more than one yearE period
The second, money markets, which offers short-term funding to companies, municipalities and the Government? Money market securities are financial debt issues with maturity periods of one year or less.

LIQUDITY AND SAFETY

- Fixed income securities have short-term maturities, normally one year or less . They are highly liquid
- They have comparatively high degree of safety because they are short-term
- They have very little chances of default

MONEY MARKET SECURITIES

Few examples of money market securities are:

- Repurchase Agreements
- Reverse Repurchase Agreements
- Bankers' Acceptances
- Commercial Paper
- Negotiable Certificates of Deposit (CDs)
- Money Market Funds

Repurchase Agreements

In a repurchase agreement (recognized as repo), a dealer obtains cash by temporarily selling some of the securities it holds with a contract to buy back the securities at a later date. So, a repo is just a contract between a buyer and a seller to conduct a transaction (purchase), then to reverse that transaction (repurchase) in the future time.

Primary Uses of repos

- Governmental and municipal securities dealers financing their inventories.
- Commercial banks obtaining short-term funding
- Central bank adjusting member bank reserves

Reverse Repurchase Agreement

In a repo, a dealer decides to sell its securities to a lender and repurchase them at a higher price in the future time. In a reverse repurchase agreement a dealer decides to buy securities from an investor to sell back later at a higher price. The difference among repos and reverse repos is that the dealer starts the sale in a repo and an investor starts the sale in a reverse repo

Bankers' Acceptances

A Bankers' Acceptance (BA) is a short-term term draft with a stated payment date drawn on a bank used to assist foreign trade. It is basically a postdated check or line of credit. The maximum payment date of a (BA) is 270 days or (nine months)

- BAs are used widely to finance international trade in as they pay for goods and services in a foreign country.
- They are aggressively traded in the money market and are eventually considered high quality as they are fortified by a guarantee from a large bank and also by the goods originally bought by the importer

Commercial Paper

Commercial paper is short-term period unsecured corporate date with a maximum maturity of 270 days (nine months). They are mainly used to obtain cash to finance accounts receivable and seasonal inventory surpluses. Commercial paper interest rates are lesser than bank loan rates

- Principal buyers of commercial paper are commercial banks, money-market funds,
- pension funds, corporations, insurance companies, and nongovernmental agencies.
- They are generally issued in book entry form.
- They are generally issued by companies with excellent credit ratings
- International Credit Agencies like Moody's and standard and Poor's issue ratings
- for commercial paper. (PACRA) and (JCR) Japan Credit Rating Agency primarily give
- ratings in Pakistan

Negotiable Certificates of Deposit (CD's)

Large commercial banks can borrow money for financing by issuing CDs in USA. These are short-term, interest bearing securities funded by the general credit of the issuing bank.

- Also known as jumbo CDs with least values of $100,000
- Usually trade in values of $1,000,000 or more

Money Market Funds

A money market is a sort of open-end investment company (known as a mutual fund) that invests in short-term financial debt securities and money market securities.

- Must be registered with the Securities and Exchange Commission of Pakistan and must be in accordance with the Company legal act of Pakistan.
- It must be sold with a prospectus
- Minimum initial investments will be specified in the prospectus.

Chapter 8

Direct Participation Programs

BUSINESS ENTITIES

Corporation

Under FBR rules of taxation, a Corporation' is a taxable entity. If the corporation incurs any net income, the corporation pays tax on that income. If the corporation distributes cash to its shareholders, dividends are paid out of after tax income. The shareholder getting the dividends must bring them on his/her tax return and tax is paid again on the same value of Rupees. It is one of the circumstances in which the same money, in this case dividends, are said to be double taxed
On the contrary, if the corporation has incurred a net loss, no tax is owed for that year but it cannot distribute any of the losses to its shareholders

Partnerships

Under IRS rules, partnerships like corporations are not taxable as a business entity. Net income or loss is not computed at the partnership level and taxed. As an alternative each partner upon receipt of his/her pro-rata share of income and/or losses must contain same on his/her tax return.

LIMITED PARTNERSHIP FORMATION

A limited partnership involves at least one general partner (GP) and at least one limited partner (LP). The general partner is the active manager of the business entity and with that assumes unlimited liability. The limited partner, on the contrary, is the passive investor (not actively involved in the business entity) whose liability is normally limited to his/her investment.
Note: there are numerous sorts of limited partnerships which involve the investors to deposit extra sums of investment after the initial investment is made

Certificate of the Limited Partnership

In order to be a legal entity a certificate of limited partnership must be filed. The principal objective of this certificate is to have a public record of all partners and their proportional interest in the partnership. Hence, creditors of the partners can always find the partners if they have legal entitlements against the partnership.
The following must be involved in the certificate;

- Name of the Partnership
- Type of business
- Mailing address
- Every partner's name, address and percentage ownership
- Every Partner's share of income and losses

- Termination Date of the partnership
- The priority of Distribution of any assets upon termination of Partnership

Partnership Certificate Changes

If any of the certificate necessities above change, such as the address of the partnership, the certificate must needs to be revised. Normally, certificates are revised annually to reflect any changes. The only exception would be an intense change such as an additional general partner brought in, as an example, in such case the partnership certificate needs to be changed immediately.

PARTNERSHIP AGREEMENT

The partnership agreement contains the rights and obligations of the general and limited partners. This contract must be signed by limited partners as well asro partnership the general partners.

Test Point: A new investor does not become a limited partner until the partnership application is signed, the partnership contract is signed and the general partner also signs the Partnership application representing the final approval of the limited partner.

Rights of the General Partner

The partnership contract must include all of the following rights of the general partner of the partnership;

- It should make all business decisions
- Should charge a management fee to manage the partnership
- It should have power to bind the partnership into contracts
- It selects whether cash distributions are made to the partners
- Chooses which limited partners are allowed in the partnership
- Any transfer of a partnership interest by a limited partner must be approved by a general partner
- Permitted to a yearly share of partnership income and loss
- Permitted to a share of partnership net assets upon dissolution of the partnership business

Obligations of the General Partner

The partnership contract should include all of the responsibilities of the general partner of the partnership which can include;

- Partners must make all choices in the best interest of the partnership
- Partners must maintain at least a 1% interest in partnership gain or loss.
- Partners cannot compete with the partnership unless specifically allowed by the partnership contract.
- If any partner dies, partnership law entails that the partnership should be dissolved, and a new agreement will be drawn up with the remaining partners.

- If a partnership is dissolved, the other general partners cannot stay to run the former partnership except specifically sanctioned in the agreement.

- If a legal judgment is brought in against the partnership, a general partner cannot consent to the judgment without endorsement of the limited partners

Rights of Limited Partners

The rights of limited partners are as follows

- Right to examine the books and records of the partnership
- Right to pro-rata yearly share in partnership's income and loss
- Right to share the partnership net assets upon dissolution
- Can prosecute the general partner for damages if the general partner does not stand by the agreement
- Has the right to vote on the admission of any new general partners
- Has the right to vote for the sale of partnership net assets

If the limited partner surpasses any of the above doings such as participating in the actual management of the partnership the limited partner will be considered to be a general partner and takes on unlimited liability

Duties of the Limited Partner

Just like the limited partner rights, obligations and duties also apply. They are as follows

- Pay an initial capital contribution
- Responsible for any recourse notes signed. A recourse note means the lender has recourse to the signer directly to pay off an obligation.
- Can be required to pay any additional assessments as determined by the general partner .
- Can compete with the partnership as he/she is merely a passive investor in the partnership

NETASSET DISTRIBUTION UPON DISSOLUTION

The following signifies the priority of any net assets upon the dissolution of the partnership;
Secured creditors

- General creditors
- Limited partners
- General partners

Chapter 9

Investment Companies

DIVERSIFIED AND NON-DIVERSIFIED COMPANY

Diversification is well-defined as the dispersal of risk by putting assets in several classifications of investments such as stocks, bonds, money ma precious metals etc.
Investing in c diversification than purchasing securities in only one industry and sector, because the likelihood o industries and sectors will all sustain losses at the same time rket instruments, ompanies of several industries and sectors involve greater f one industry sustaining losses is greater than the likelihood that several

Diversified Investment Company

A diversified investment company mutual fund or division investm extensive range of securities. investment company must meet the following test:

- Invest minimum of 75% of its assets in such a way .
- That no more than 5% of their total assets can be used to buy any one stock and
- When buying stock, not more than 10% of the owing voting stock can be bought.

Non-diversified Investment Company

- A non-diversified investment company fails to meet the above 75%-5% - 10% tests.
- Mostly mutual funds are listed as diversified management companies .

OPEN-END MUTUAL FUNDS

An open-end mutual fund sells mutual funds to the general public. This term arises from the fact that the firm frequently creates new shares on demand, though an open- end fund may close itself to new investors when its management chooses that it is too large

- Mutual fund shareholders purchase the shares at the Public Offering Price and n redeem the shares at any time at the prevailing NAV, which might be greater or lower than the price at which the investor bought them out. The shareholder's funds are invested in stocks, bonds, and money market instruments etc., based on the kind of Mutual Fund Company

Features of Open-End Closed-End

- Capitalization Unlimited,
- Continuous shares offered
- Fixed, sole offering Shares Full or fractional.
- Full only can issue Common stock only . No debt securities Common, preferred and debt securities pricing sell at the NAV.
- Purchase at the NAV in addition of sales charges if a loaded fund.
- Pricing structures included in the prospectus is price determined by supply and demand, current market value in addition of commission

- Trading Sold and redeemed only
- Continuous offering must redeem shares
- Initial Public Offering&Secondary trading happens on an exchange or OTC.

Ex-Dividend Date is established by Board of Directors of the company in accordance to SECP rules and regulations.
Mutual fund shares cannot be bought as collateral. Borrowing against funds in a margin account is permitted after 30 days.

Fund Diversification

Funds can diversify by buying many companies in different industries. Additional diversification can be attained by a fund buying different kinds of securities within a specific fund such as common stock, preferred stock, different bonds etc
Further divesification can be attained by buying securities from different kinds of issuers and from different geographic areas

Professional Management

A professional investment manager manages the entire portfolio of individual mutual funds. Occasionally the investment managing is done by an individual itself and at times by an investment board

- The job of the investment adviser is to manage the fund by buying and selling underlying securities to meet the fund's aim and to get the maximum of returns for the investors
- The Board of Directors of the fund is eventually responsible for the actions of the investment adviser.
    - The adviser is employed by the Board of Directors under an initial of two year contract.
    - Renewal of the contract must be approved annually by a majority vote of the shares or a majority of the Board of Directors.
    - Most funds need approval by both the Board of Directors and the shareholders
- The investment management agreement must be in formal writing with the reward to be paid spelled out. The annual amount of the fee will be established and noted in the fund's prospectus

INVESTMENT PURPOSES OF THE FUND

Investment purposes can be found in the fund's prospectus.
Some investment purposes may include the following:

- Safety of principal
- Preservation of capital
- Income
- Growth
- Aggressive growth
- Capital gains
- Tax-free

If a fund wanted to change their specified investment objectives, it would take a majority vote of all outstanding shares.

Securities in a Portfolio

The investment purposes of each fund will define the type of securities that will be acquired and placed into the portfolios.
For example, a municipal bond fund will include tax-free bonds, while a common stock fund will have common stock as the underlying securities

TIMING OF INVESTMENT DECISIONS

Timing in investment is crucial as an investment decision is trying to pick the best time to make a decision . For example, market timing includes the study of fundamental and technical data to select when to buy or sell stocks, bonds or mutual funds.
One of the major objectives of the investment adviser is to time their buying and selling of investments so as to make the most beneficial trades

TAX STATUS OF FUND DISTRIBUTIONS

Taxable Mutual Funds

- Dividends whether gained directly or reinvested is a taxable event. They are taxable at the investor's tax range as ordinary income, not capital gains.
- Capital gains dispersed at year's end are taxable event even if reinvested
- Capital gains made by the investor when buying and selling are a taxable event
- Capital gain rates are based on time held. Whatever held less than one year and a day is short-term and based on the investor's tax range. Anything held at least a year and a day is long-term with a maximum capital gain rate of 20% or for those in the 15% tax range is a maximum of 10%.
- Income is taxed as ordinary income at the investor's tax range

Tax-Free Mutual Funds

- Dividends from tax-free municipal funds traded are not taxable.
- Capital gains from tax-free municipal funds traded are taxable

FINANCIAL/ECONOMIC RESEARCH AND ANALYSIS

Investment consultants managing mutual funds evaluate securities and their ies prior to purchase. Several types of analysis can be done. On approach is the Fundamentalist who looks within the company and looks at such things as:

- Management team
- Earnings
- Market share of the company's product
- Financial statement assessment
- Stock price movement predictions
- Inventories

Other type of analyst is known as a Technical Analyst who looks at the following:

- Trading volume
- Price studies
- Uses charts and Figures
- Predict price trends in a market
- Not afraid with the financial condition of the company

FUND SHARES

Full and Fractional Shares

Buyers generally buy an agreed amount of a fund, unlike stock buyers who buy a number of shares, not value. So, mutual fund shares are obtainable in full and fractional shares so as to meet the demand of the purchaser. When selling shares, full and fractional shares can be redeemed.

Continual Offering and Fund Redemption

Open-end management companies constantly offer new shares. There is no boundary as to the number of shares available, unlike closed-end shares which have a restricted number of shares for sale. Shares can also be redeemed through the fund company on any business day by the investor.

VOTING RIGHTS

Mutual funds are corporations and shareholders get to vote on a number of matters such as:

- Investment purpose changes
- Investment adviser agreement renewal
- Borrowing money by the fund company
- Board of Director Job openings
- Voting is done through a proxy, just like any other corporation

BOARD OF DIRECTORS

The duty of the Board of Directors is to create investment policies for the fund and oversee the operations

- The Board of Directors is elected by the shareholders annually. Officers are selected by the Board of Directors to conduct the daily happenings of the fund .
- The company law entails that forty percent (40%) of the Board of Directors, in order to be diversified, must be made up of non-interested directors. This means they cannot be related with the fund company in any manner.
- The Board of Directors does not manage the investment portfolio like the job for the investment manager
    - But, they do describe the kind of funds to offer such as growth, income, growth and income etc. as well as defining the purposes of those funds. Moreover, they finally approve the custodian, investment adviser, transfer agent and officers of the company
- The board also creates the fund's dividend and capital gains policy and will announce them when appropriate

Adviser

Arranges selling group issues shares, holds assets investment decisions, registers fund with SECP, makes distributions paid fee by the fund paid a percent of NAV, gains selling commission, keeps list of shareholders official duties, distributes shares and capital gains
Transfers shares and funds Payables/ receivables and other distributions, redeems shares and receives income

The board of directors will

- Create investment policies .
- Choose and oversee the investment adviser
- Choose the transfer agent and custodiarn .
- Form dividend and capital gains policies
- Announce dividends and capital gains
- Appoint officers

UNDERWRITERS

- Underwriters are also recognized as sponsors or distributors
- Mutual fund companies have underwriters whose main obligation is to sell shares to the general public.
- They are selected by the Board of Directors and take a fee for selling and marketing the shares to the public.
- They actually buy the shares from the fund company then sell them to the general public directly by a selling force or to autonomous broker dealers to sell the shares to the public.
- The actual return paid to the underwriters is based on the public offering price which is computed by adding a sales charge to the net asset value Example: The NAV of the Golden Arrow Growth Mutual Fund is $20 while the Public Offering Price (POP) is $20.50. Take the difference of the POP and the NAV to calculate the sales load, which is also recognized as the underwriter's concession. The resulting difference of $0.50 is recognized as the selling concession which is part of the underwriter's concession and goes to the broker-dealer to be shared with the listed representative that sold the fund.

TRANSFER AGENT

It must be noted that the transfer agent can also assist in the capacity of the fund custodian. The fund itself pays the transfer agent for the provision of services rendered
The transfer agent is in charge for:

- Issuing, redeeming and canceling out share certificates
- Changes for the fund name .
- The customer's mailing trade confirmations
- Fund distributions
- Keeps a list of all shareholders

CUSTODIAN BANK

Under the Company law, a fund company must hire a custodian to hold the assets of the funds. Moreover holding the assets, the custodian takes care of most of the investment company's official functions. In most circumstances the custodian is a commercial bank

The custodian bank is in charge for:

- Protection of the assets of the fund company
- Can act as transfer agent
- Performing the clerical duties . Separation of investment company's assets
- Strictly following SECP rules for withdrawal of funds
- Getting interest and dividends from underlying securities
- The custodian will get a custodial fee

INVESTMENT ADVISOR (FUND MANAGER)

The investment advisor, at times also identified as the investment (fund) manager, can be an individual or even a separate company .

- Primarily, the Board of Directors agreements with the investment advisor for a period of two years. After that, the agreement is look over and renewed annually with shareholder approval.
- The investment advisory contract must be in writing and identify the compensation to be paid as a management fee. The management fee is generally a set annual proportion of the value of the fund's assets.

The investment adviser:

- Control and manages the fund's portfolio
- Obeys the fund's investment objectives and Board's policies
- Makes investment decisions
- The investment advisor gets paid a proportion of the net asset value
- Manages and controls daily trading activities
- Delivers investment advice in conformity with SECP and company law.

COST OF OPERATING A MUTUAL FUND

The following are few of the costs in operating a mutual fund:

- Custodial fees
- Transfer agent fees
- Legal fees
- Accounting fees
- Management fee (paid as a proportion of asset value)
- Sales expense (paid for underwriting concession)
- Advertising fees (paid by the fund's underwriter)

RIGHTS OF SHAREHOLDERS

- Mutual fund shareholders have the right to cast vote on certain matters. They would generally do this with a document dispatched by the fund company called a Proxy
- The proxy is also used by public companies for the objectives of shareholder voting and approval of certain issues
- Voting is concentrated on the number of shares owned by a shareholder, and not the number of shareholders in a fund

The following are some of the concerns that shareholders get to vote for:

- Changes in the fund's investment aims
- Changes in borrowing
- Issuing or underwriting other securities
- Choosing underwriters to issue future securities
- Approve investment advisory contract
- To elect directors
- For annual and semiannual reports (annual must be audited)
- Changing sales load charges

TYPES OF FUND DISTRIBUTIONS

Net Investment Income per Share

Net investment income is the income collected by an investment company from dividends and interest on their underlying securities throughout the accounting od, less management fees and admin expenses and then divided by the number of outstanding shares. When dividend and interest income is collected by the investment company, the shareholders are then paid the net investment income in the sort of dividends prorated based on each holder's share in the total portfolio
After obtaining the net investment income the following operating expenses is deducted from the gross dividends and interest received;

- Management fees (Generally the largest of the fees)
- Taxes
- Overhead expenses
- Brokerage trading fees
- Legal and audit fees

Dividends

Dividends are paid to shareholders just like any other company that pays dividends to its shareholders. Dividends are paid from the mutual fund's net investment income.

Capital Gains

Capital gain distributions are originated from realized gains and are typically made only annually and are considered to be long-term capital gains. Short term capital gains are typically distributed with dividends.

Return of Capital

A return of capital is NOT a taxable event as the distribution is not derived from income, dividends, and capital gains or from the fund's investments. A return of capital will decrease the shareholder's basis in fund shares for the aim of computing gains or losses at the time of a later sale of fund shares.

Unrealized Appreciation/Depreciation

When share prices appreciate investors do not get a profit until the fund is finally sold.
Till then it is known as unrealized increase. If fund shares depreciate known as unrealized depreciation and will not be realized until the shares are sold
Whe or decrease it is n shares are sold any gains or losses would be realized with a tax consequence

Distribution Alternatives

One of the advantages of buying mutual fund shares is the flexibility of dividend and capital gains distributions. Shareholders can take any of the following choices

- Plough both dividends and capital gains
- Take the dividends in cash for income and invest back the capital gains
- Take both the dividends and capital gains in cash

CONVENIENCE AND SERVICES PROVIDED TO INVESTORS

There are numerous benefits linked with investing in mutual funds. All of are some of the benefits and conveniences

- Investment managers make the daily routine investment decisions to maximize returns on their investments the following . The fund company is liable for the protection of mutual fund shares so that investors don't have to worry about them.
- Investors can exchange shares from one fund to another fund in the same fund family generally without a sales charge. But, this may result in a consequence of tax
- Investors can buy full and fractional shares so exact sums of money can be invested . Percentages of entire mutual fund investment may be liquidated however stll maintaining benefits of diversification.
- Mutual fund shares can be used as collateral for loans. .Easiness of diversification due to the nature of mutual funds investing in a number of industrial sectors and companies
- Easiness of account review as shareholders can call the fund's toll free number to obtain any information about their accounts - usually 24 hours a day
- Easiness of buying shares by mutual fund application or by a broker-dealer
- Automatic reinvestment of dividend and capital gain distributions without any sales charges.
    - Comfort of share redemption by
    - Telephone redemption
    - Broker-dealer redeeming shares
    - Can be redeemed on any prescribed business day

If physical share certificates are distributed to the investor than those certificates m be returned to the mutual fund company in order to redeem them.

- Logical withdrawal plans
- Redeeming shares on a consistent basis
- Logical investment plan
- Investing surplus sums on a regular basis
- Monitor writing services with some funds
- Telephonic account and customer services offered by a fund company
- Most recent fund information - Research
- Investment aims
- Telephone redemption of shares

SYSTEMATIC WITHDRAWAL PLANS

A systematic withdrawal plan is a mutual fund choice according to which the shareholder receives stated withdrawal amounts at stated intervals

Minimum Investment

Fund companies typically need a minimum investment prior to permitting a systematic withdrawal plan to be effective. The lowest usually ranges from a $5,000 to a $10,000 investment in US

Potential Exhaustion of Principal

It is the concern of registered members to inform shareholders that enrolling in a systematic withdrawal plan may contain the liquidation of shares outside any earnings being credited to the account with dividends and capital gains. Leaking out more than is being earned, over time, may cause the principal to be depleted or exhausted.

Categories of Withdrawal Plans

- Fixed dollar plan
- Fixed percentage plan
- Fixed share plan
- Fixed time plan

Fixed Dollar Plan

A fixed dollar withdrawal plan is the plan under which the investor states an amount of money to be withdrawn each period, i.e. monthly. The fund company will liquidate sufficient shares to provide the required dollars.

Fixed Percentage Plan

A fixed percentage plan is a plan under which a fixed percentage of shares will be liquidated each period. The investor is required to lay down the specific percentage such as 5% a month, as an example. With this plan the value of the amount will vary as fund share prices change

Fixed Share Plan

It is very similar to the fixed percentage plan; a particular number of shares are liquidated in every time period. The value of the amount varies as fund share values change

Fixed Time Plan

In a fixed time withdrawal plan, clients or customers liquidate their holdings over a fixed time period.

- For example, if an investor wants to take proceeds monthly for a period of five years the fund delivers an initial check for 1/60th of the current account value
- Because of the fixed time, this kind of withdrawal plan is perceived as self-exhausting and in this instance it will be liquidated in five years.

MUTUAL FUNDS BY INVESTMENT OBJECTIVE

Growth Funds

Growth funds invest money in growth stocks. The aim is to offer capital appreciation for the fund's shareholders over the long term period. Growth funds are more volatile than more conventional income or money market funds. They tend to increase faster than conventional funds in bull markets and fall more quickly in bear markets.

Aggressive Growth Fund

- This is a mutual fund that holds stocks of fast growing companies
- However these companies may be big or small, they all share projections for above average profit growth.
- Aggressive growth funds are considered exclusively for capital appreciation, since they produce little or no income from dividends
- These funds are normally more volatile than the overall stock market, which means that its shares will increase way more than the average stock during bull markets and will drop much farther than the usual stock in a bear market.

Conservative Growth Funds

Securities in these growth funds are normally more developed and well-known companies in which there is more reasonable possibility for growth in earnings than in an aggressive growth fund.

Income Funds

An income mutual fund is intended to produce current income for shareholders.
They may also contain secondary aims of preservation of capital.
Some examples of income funds are

- Government
- Mortgage-backed
- Municipal
- International bonds
- Junk bond funds (highly risk corporate bonds)

- Numerous types of equity based funds also can have income as their primary investment objective such as
    - Utility companies
    - Equity income funds which can comprise blue chip stocks as well as preferred stocks

Growth and Income Funds

These are mutual funds that look for earnings growth as well as income. These unds invest mostly in the common stock of companies with a past history of capital gains but that also have a record of constant dividend payments.

Specialized Funds (Sector)

It is a mutual fund which concentrates in only one industrial sector. By doing so; shareholders have a concentrated "play" on the riches of that industry, for better or worse. Some of the many industries with specialized mutual funds comprise.

- Banking.
- Chemicals.
- Energy
- Precious metals
- Technology
- Telecommunications

These funds have a tendency to to be more volatile than funds holding a diversified stock portfolio in many industrial sectors. Thev are also known as Sector or Specialty
Funds.

Asset Allocation Funds

Asset allocation funds invest in stocks, bonds and money market securities to maximize shareholders' returns while reducing risk.

- These sorts of funds have become very popular in recent years; relieve individual shareholders of the duty of timing their entry or exit into diverse markets, since the fund manager is deciding those decisions
- Asset allocation funds offer a built-in buffer in contrast to declining stock and bond prices because the manager can shift all the fund's assets into safe money market instruments
- On the contrary, the investment manager has flexibility to invest aggressively in international and domestic stocks and bonds if he or she realizes bull markets ahead for those securities

Tax-Exempt Funds

Mutual funds that invest completely in tax-exempt securities offer tax-free income to investors

- Whereas a fund's dividends will be totally tax-exempt on a shareholder's tax return, y would be tax free from the income tax only in proportion to the amount of interest income derived from the taxpayer's home state, supposing no interstate exchange arrangements pertain.
- The return to investors from tax-exemption of the bond is less than that from a corporate bond, because the tax exemption delivers additional compensation.

- The higher the tax bracket of the investor, the more attractive the tax-free alternative turn out to be.

MUTUAL FUNDS BY UNDERLYING INVESTMENT

Money Market Funds

A mutual fund money market's aim is to gain a decent interest yield through investing in money market instruments with high liquidity and security of principal. Yields on money market funds diligently reflect short-term interest rates which may vary relatively a bit.

Money market funds normally offer check writing privileges, have no sales charges and try to retain a $1 net asset value in US. These sorts of funds invest in the following kinds of securities

- Commercial Paper (maximum maturity of 270 days)
- Banker's Acceptances
- Repurchase Agreements
- Government Securities

Bond and Preferred Stock Funds

Bond and preferred stock funds try to offer income to investors. They do this through usage of the following kind of securities;

- Corporate bonds
- Government bonds
- Preferred stocks
- Municipal bonds (tax-free)
- International bonds

Common Stock Funds

These funds primarily invest only in common stock. These funds perform best during "bullish" markets
Municipal Bond Funds
It is a tax-free bond which invests mostly, if not all, in tax-free revenue and general obligation bonds. Highly yield municipal bonds might invest in the more risky industrial development revenue bonds. They offer higher rates but risk of loss also increases with it.

Government Securities Funds

Government securities funds invest in financial debt instruments issued by the federal government and its agencies
The following underlying securities are offered in a Government Securities Fund;

- Government Treasury Bills
- Treasury Notes
- Treasury Bonds
- Pakistan Investment Bonds

Option Funds

Option mutual funds either purchase or sell options in order to upsurge the value of fund shares. Option mutual funds may be conservative or aggressive in form.

A conservative fund purchases stocks and increase shareholder's income through the premium received by selling put and calls options on the stocks in the fund's portfolio.
This is recognized as an option income fund
An aggressive option growth fund buy puts and calls on stocks that the fund manager believes are about to decrease or increase sharply. The leverage that options offer makes it probable to multiply the return on invested funds many times over

Foreign Securities Funds

There are three sorts of funds that invest in securities outside the Pakistan. They are
International Funds that invest in the securities of foreign countries only, Global Funds that invest in the securities of both Pakistan as well foreign countries and Single Country Funds which invest in securities of only one country such as the Chinese Fund, US Fund and Britain Fund

Precious Metal Funds

Precious metal funds invest in companies that are engaged in mining or produce various precious metals (as well as the precious metals themselves) and futures contracts for precious metals
Some of the precious metals include.

- Gold
- Silver
- Platinum
- Palladium

SIGNIFICANT ASPECTS IN COMPARISON OF FUNDS

Prior to buying funds, investors should make comparisons of the numerous kinds so as to make sure they are well-matched and suitable for them. Once these comparisons are complete the investor would be ready to buy

Basis of Comparison

The following information about specific mutual funds should be look over and matched;

- Investment objectives
- Investment policies
- Quality of management.
- Risk factors

Aims of Investment

An investor needs to compare the investment aims of similar kinds of funds to insure the purposes are compatible with his/her financial goals and aims and make the ending choices.
In review, some of the aims of investment include

- Growth

- Income
- Growth and Income
- Saving taxes
- Preservation of principal

INVESTMENT POLICIES

Concerns to be compared;

- Risk taking
- Aggressive or conventional
- Investment turnover
- Performance . Taxation issues
- Costs and expenses
- Services offered
- Sales charges

Quality of Management

How an investment manager manages a fund, the form of management, and investment results can assist regulate which funds are closer to the investor's goals and purposes?
The following things should be taken into account when comparing numerous funds with the same investment aims

- Management style
- Management by individual or by committee
- Tenure of the manager
- Investment manager turnover
- Performance results

Risk Factors

Comparing the risk aspects of various funds is very important in the decision making process. It is important that investors compare their own risk tolerance to the perceived risk guidelines of funds being compared.

Performance Statistics

Prior of buying funds investors should also do appraisal of the performance statistics of potential funds that are being considered for the purchase.
The following things should be used for the objective of comparing potential funds

- The total return of a fund would contain share appreciation and dividends rewarded by the fund
- Standardized yield is a uniform method of calculating yields for a stated period of time such as one year, five years, ten years, etc .

- The present distribution rate is computed by taking the annualized current dividends paid by the mutual fund and dividing it by the present net asset value of the shares at the time of computation .
- Usually, the current distribution rate is dependent on the most current 30-day month
- If the share price and/or the dividend amount changes, the current distribution rate will also change

Expense Ratio

The fund's expense ratio lays down together the management fees and operating expenses of the fund and then calculates the ratio by dividing a fund's expenses by its total average net assets

- As an illustration, if the fund has an expense ratio of 1.59 percent it means that the fund charges $1.59 per year for every $100 invested.

- When comparing one mutual fund with other it is important to keep in mind that expense ratios of numerous funds differ depending on the kind of funds being compared.
- As an example, an aggressive growth fund's expense ratio is typically higher than an extremely rated corporate bond fund's expense ratio as more trading happens in the growth fund's portfolio
- Generally, stock funds have expense ratios between 1 percent and 1.5 percent of a fund's total average net assets. On the contrary Bond funds, have expense ratios between 0.5 percent and 1 percent

Other Factors

When comparing funds to one another different issues should be considered besides those already discusses. This includes;

- logical investment
- Withdrawal plans
- Check writing privileges
- Retirement account availability
- Fund conversion privileges
- Telephone transfers
- Minimum buying requirements
- Sales and delivery charges

SOURCES OF PERFORMANCE STATISTICS

Knowing what available sources can be used for fund comparison data purposes are very important. Some of those sources are as follows; .

- Prospectus .
- Shareholder reports (semi-annual) .
- Advertising and sales literature
- Financial periodicals
- Information services for mutual

SELLING FUND SHARES TO THE PUBLIC

Mutual fund companies can use any one specific way of distributing their fund shares to the public or a blend of methods.

Fund to Underwriter to Dealer to Investor

- This is the usual method used when shares are marketed to the public through a broker-dealer
- The mutual fund company sells shares to its underwriter - then the underwriter sells these shares to the broker-dealer then the broker-dealer sells the shares to the retail customer. It's a complete chain
- Part of the public offering price (POP) to the retail customer is the Underwriter's Concession (The difference among the POP and the NAV). The broker-dealer shares portion of the underwriter's concession, known as the Selling Concession, with the fund's underwriter

Fund to Underwriter to Investor .

- The underwriter acts as a broker-dealer and sells the shares bought from the mutual fund company directly to investors through its own sales force
- So, the fund company sells its shares to the underwriter at the NAV and the underwriter's sales force sells the shares to the general public at the POP

Fund to Investor

- The mutual fund company sells its shares directly to investors without using its underwriters or broker-dealers. This can be done without any sales charges and hence are known no-load funds

PRICE OF MUTUAL FUND SHARES

Net Asset Value (NAV)

Per share basis (Sometimes specified as the Bid Price)
The NAV of fund shares is created by mutual fund companies after the closure of the exchanges every day by taking the closing market value of all the underlying securities owned in addition to all other assets such as cash, deducting all liabilities and dividing that number by the total number of shares outstanding
The number of shares owing can differ each day based on the number of purchases and redemptions
In no-load funds, the NAV, market price and offering price are all similar figures, which the public pays to purchase shares.
Loaded funds are bought at the offer (POP) price are cited after adding the sales charge to the net asset value

Changes in the NAV

- If the portfolio securities rise in value or the fund receives investment income, the
- NAV per share will also rise
- If the portfolio securities fall in value or when portfolio income and capital gains are paid to shareholders, the NAV per share will fall.

- The NAV does not change just because fund shares are sold or redeemed or when securities are both purchased and sold because they are swapped with cash or cash is used to buy further securities. So, the total net assets would probably remain unaffected

Ex-Dividend

The ex-dividend date for mutual funds is established by the Board of Directors of the fund, not the NASD as it will be with common stock. On this prescribed date the NAV per share is reduced by the value of the distribution. In order to receive the current dividend, shares must be bought prior to ex-dividend day

SELLING DIVIDENDS RULE

It is against the rule of law to "Sell Dividends". This means that you cannot call your customers and inform them that a fund will be paying a dividend and that they should buy shares at present in order to be able to get the dividend. You would be guilty of "selling dividends. On ex-dividend day the NAV will reduce in value by the amount of the distribution. Moreover a decrease in the NAV the customer might now have an untimely tax consequence by outstanding taxes on the distribution. Therefore, the investor would now own fund shares which have fallen in value and also have to pay taxes on the dividends.

REDEMPTION FEES

These are fee payments charged by a mutual fund to its shareholders who sell fund shares in a short time period.

- The time limit and size of the fee differ between funds, but the redemption fee payments are comparatively in a small percentage such as 1%-2% of the amount withdrawn
- The purpose of the redemption fee charges is to discourage fast-moving shifts from one fund to other in an effort to time swings in the stock or bond market.
- This fee is mostly confused with the contingent deferred sales charge and made obligatory when selling Class B shares

FEES AND EXPENSES

All fund company fees and expenses can be seen in the prospectus and is recorded in a Tabular column.

SALES CHARGES

A sales charge is an amount of fee paid to a fund company by a purchaser of mutual fund shares in a loaded mutual fund

- Generally the sales charge for a mutual fund averages 4.5% to 5% of the capital invested and falls as the size of the investment rises because of reaching the fund family's breakpoints.
- Example: A $10,000 investment allocated in an equity fund may have a sales charge of 8% but an investment at the next breakpoint level of $25,000 will have a sales charge of 7.5%. Breakpoint plans differ from one fund family to other fund family and are published in the fund's prospectus.
- The maximum of sales charge allowed is 8.5% of the POP (at times indicated as the
- ASK Price) of customers' mutual fund purchases. . The certainty is that most mutual fund companies do not charge the full 8.5% but instead an amount somewhere around 5%

- The information about sales charges can be seen in the fund's prospectus. .Sales charges are generally specified as a percentage of the offering price (Ask),
- NOT a percentage of per share NAV
- The maximum sales charge of 8.5% cannot be charged and will decline to 6.25% when a mutual fund company does NOT permit dividend reinvestment at the NAV and does not allow rights of accumulation or breakpoints.

SALES CHARGES AND CLASS A SHARES

Formula #1: Computing Sales Charge Percent

As the sales charge percent is dependent on the Ask price, the formula for calculating the sales charge percent is
Sales Charge Percent = POP (Ask)-NAV (Bid) divided by the POP

Formula #2: Computing the Offering Price
The offering price or POP for the public is calculated as follows;
POP NAV divided by (1.00 . Sales Charge %).

Question: what is the sales charge % for the Acme Growth & Income Fund with a NAV of $32.87 and a POP of $34.78?
Answer: 33.78-31.87 1.91 divided by 34.78-5.49% Sales Charge

CLASS A' SHARES

- Class A shares are bought at the public offering price which means the NAV in addition of any applicable sales charges. .
- Shares are always sold at the NAV
- Shares are also recognized as having front-end loads (up-front sales charges)

CONTINGENT DEFERRED SALES CHARGE

- These are also acknowledged as Class B shares as well as a Back-End Load
- There is a sales charge imposed by a mutual fund if a client sells fund shares during a stated number of years. As an alternative of charging a Front End Load of 596, as an instance, a brokerage firm might propose the similar fund with a contingent deferred sales load
- Every year the probable redemption charge drops by one percentage point till there is no fee for selling any of the fund shares after the sixth year.
- The average Class B share company has redemption fees completed 5-6 years on a decreasing basis such as 6%-5%-4%-3%-2%-1%-0%
- After the surrender charge years' conclusion, most of the Class B shares automatically convert to Class A shares. The motive for this is that Class A shares naturally have lower marketing and advertising fees as well as other lower fees
- Class B shares have no breakpoint. Breakpoints are only seen in Class A shares
- Class B shares are bought at the NAV, similarly like a no-load fund.

LEVEL LOAD (C CLASS SHARES) .

- A level sales charge does not vary over the time. Level load shares are known as Class C shares. They can be used for short-term saving purposes
- A level load will usually be 1% to 2% of the value of the fund every year, which is generally lesser than a front-end loaded fund
- However the level load might be lesser than up front or back-end loads, an investor can close up paying higher sales charges if the fund is held for many years

REDUCED SALES CHARGES/QUANTITY DISCOUNTS

The maximum sales charge for mutual funds is 8.5% which can decline when investors known as "Persons" succeed for "volume purchases". Volume purchases are quoted in a fund's prospectus and can be known as Breakpoints. Investors succeed for these breakpoints when they are buying numerous funds as long as they are in the same Fund Family. (Ie. Aim Fund Family)
Persons or groups qualifying for breakpoints through Letters of Intent and/or Rights of accumulation can be identified as any one or more of the following; .

- Individuals.
- Individuals, their spouses and minor children
- Corporations
- Institutions
- Pension plans
- Trustees
- Employee benefit plans

However, Investment Clubs do NOT qualify for reduced sales charges

Example #1: Assume that an investor wants to buy $8,000 and the fund has the beyond breakpoint schedule.
The sales charge for this purchase will be 8.5%. Still, the purchase is close to a breakpoint, $10,000, you as a listed associate must disclose to the investor that if additional $2,000 was invested at this time period then the sales charge will be fall to 8% instead of 8.5%.

Breakpoint Schedule Example Found in a Prospectus Amount Invested Sales
Charge

- $O-$9,999 = 8.5% $
- 10,000-$19,000 = 8.0%
- $20,000-$49,999 = 7.5%
- $50,000 and higher = 7.0%

Letter of Intent (LOI)

The investor assures to invest certain sum of money to reach a breakpoint qualifying the investor for a fall in sales charge. The LOl is basically a one-sided biased contract as there is no fine if the investor fails to invest the required dollar amount in US. If the investor did not bought the amount specified by his/her LOI by the 13th month, the fund company will sell off specified amount of shares. This amount

would be the change between what the sales charges should have been on the actual amount invested against the sales charges he/she paid dependent on the larger purchase as specified in the LOI.

Fundamentals of the Letter of Intent are as follows;

- Investor assures to invest sufficient enough to reach the selected breakpoint level
- Breakpoint purchase must be completed within 13 months. If the investment is not finished then the investor will be charged the higher sales charge by selling fund shares.
- The LOI can be backdated within the first 90 days
- As an illustration, using facts in example #1, the $8,000 investment grows to $10,000 in three months. This will NOT count as meeting the LOl requirement. The investor must substantially add minimum $2,000 to achieve the requirement.

Rights of Accumulation

- Rights of Accumulation are similar like an LOI which lets mutual fund investors to qualify for reduced sales charges by reaching breakpoint levels.
- The major differences among an LOI and rights of accumulation are;
- Rights of accumulation are not open for initial transactions . They are based upon subsequent investments
- There are no time limits in Rights of Accumulation
- Accumulation levels are monitored automatically by the fund companies and sales charges are reduced as these levels are accomplished
- Investors can accomplish breakpoint levels by adding new investments to prior investments and/or in addition to the new investment to share appreciation. generally accepted method for every fund family will be specified in the fun prospectus.

Rights of Accumulation Examples

Example #1: Apply the following particulars to the breakpoint schedule shown on the prior page in ahead he invests a further $2,000. The inv hich an investor invests $8,000 but did not sign an LOI. Four months new investment in addition to the initial estment equals to $10,000 and accomplishes a breakpoint. Hence, the investor's new purchase will be based on a discounted sales charge of 8% rather than 8.5%.

DOLLAR COST AVERAGING

- Dollar Cost Averaging is an investment approach for buying shares for a longer period of time
- Investment discipline is required to invest a fixed dollar amount at consistent time intervals no matter what happens in the stock market
- With market variations an investor purchases more shares when the prices falls and less shares when the price increases
- Consequently, an investor who is involved in the dollar cost averaging will never average the highest or maximum share price nor the lowest or minimum share price, but be somewhere in between both of them.

1. Dollar Cost Average (DCA) -$1200 divided by 242 $4.96 per share
2. Maximum price per share $6.00 and the minimum price per share $4.00

3. Average Market Price $60.50 (total from price per share column)
Divided by the number of the investments by (12) $5.04

REDEMPTION OF MUTUAL FUNDS

Mutual fund shares, as an open-end management company, must be redeemed against being sold in a stock market. Shares must essentially be redeemed through the mutual fund company by a number of approaches.
Mutual fund companies must redeem an investor's shares and payment sent to the investor between seven business days. After the shares are redeemed, they are demolished.

Redemption approaches

- Shares sold right back to the fund company through a formal written request.
- Telephonic redemption happens only if the account is originally set up for this form of redemption
- Diminishing the value of the account, i.e. a money market, by writing a check when the account has check writing rights.
- Sell shares to a broker-dealer which in return redeems them with the mutual fund company (for that share must be in the investor's account)
- if the customer is in receipt of the physical fund credentials, he/she must sign the credentials and get a signature promise

PROSPECTUS

A prospectus is also recognized as the Statement of Additional Information (SAI). A fund's prospectus is responsible for all related information about the mutual fund being considered. The prospectus is mandatory to be given to all persons considering a mutual fund purchase **prior to or at the period of solicitation. The following information is usually provided in a fund's prospectus;**

- Fund's past history
- Background of the investment managers of the fund
- Fund aims and objectives . Financial statements of the fund
- Fund restrictions and policies
- Sales loads and fees
- Front-end load fee descriptions
- Exchange rights inside the family of funds
- Per-share income and capital changes
- Breakpoints, rights of accumulation and Letter of Intent information
- Contingent deferred sales charges
- Redemption fee information
- Expenses table
- Techniques of sale
- Methods of redemption
- Investment and withdrawal strategies
- Management fees
- Other expenses

SECP (No Approval Clause)

The Securities and Exchange Commission of Pakistan assess all prospectuses to ensure that there is appropriate disclosure for investors to make an informed investment decision. Still, the SECP doesn't guarantee the future success of the fund nor do they guarantee the delivered information. This clause must be printed on the Front Cover or the First Page of all prospectuses.

Chapter 10

Margin Accounts

MARGIN OVERVIEW

The aim of margin accounts is to have the ability to buy securities on credit similarly like credit card is used to make purchases in stores etc. Instead money is borrowed from a bank; however, money is borrowed from the broker dealer. The use of margin offers investors with the ability of using leveraging to maximize possible returns.
Leveraging extends the customer's rate of return or rate of loss in when undergoing adverse market conditions. In other words, margin offers the use of other people's money to finance the purchase of securities.

MARGIN AGREEMENT

- When opening a margin account, the client signs a margin and credit agreement
- Credit Agreement: This contract reveals the terms of the credit offered by the broker- dealer, including the mode of interest computation and situations under which interest rates may vary. This form MUST be signed by the customer
- Hypothecation: Clients pledge their securities to the broker-dealer in return for the loan. This is identified as Hypothecation. This form MUST be signed by the customer
- Rehypothecation: Broker-dealers take the client's pledged securities to its bank and borrow money against the securities which is then used as loans for margin customers
- Loan Consent Form: If the customer signs this form, the loan consent form gives approval to the firm to loan customer margin securities to other customers or broker- dealers, generally used for short sales. This form does NOT have to be signed by the customer
- The broker-dealer offers the customer with a loan which will pay for a portion of the buying price.
- The loan offered to the customer is recognized as the "Debit Balance"
- The brokerage firm holds the securities in the name of the broker-deale
- Central bank committee regulates credit between broker-dealers and customers.
- For instance, if an investor buys Rs.10, 000 of stock in a margin account, 50% or
- Rs.5, 000 must be provided by the investor as the initial investment. The other Rs.5 000 is provided as a loan by the broker dealer and turn out to be the debit portion of the margin account
- Broker-dealers and clearing houses can increase the amount required as margin, but can never reduce the SBP approved amount of 50%. This is known as the "House margin rule periods of volatile markets some house margin rules need additional margin totaling 65%, 75% and even 100% of the value of the security when market conditions permit the increase.
- However, 100% can be "charged" in a margin account. Though, exchanges can apply minimum maintenance margin procedures to these exempt securities.

ADVANTAGES OF MARGIN ACCOUNTS

- Customers can purchase more securities with a lower initial cash
- Customers can leverage investments by borrowing a portion of the purchase price.
- Broker-dealers can generate interest income for the firm from margin accounts.
- Broker-dealer customers typically trade larger positions because of increased trading capital, generating higher commissions for the firm.

MARGINABLE SECURITIES

Normally, include only actively traded securities are marginable. These securities would

- Securities registered on a stock exchange
- OTC issues not included in the KSE
- Note: New securities and mutual funds being sold are not marginable for a period of 30 days . Which type of securities are marginable and not is decided by the SBP Exchanges or the KSE

TYPES OF ACCOUNTS

Regulation T states the kinds of accounts in which transactions can take place as well as the ways for collecting funds for those accounts. There are three kinds of accounts that you need to become familiar with:

Cash Account

- Any security can be bought in a cash account
- Payment must be made in full Settlement date. For equities this is 3 business days.
- US Governments and options settle the next business day.
- There are essentially no penalties for settlement date violations
- However, Reg T procedures want payment for purchased equities maximum by the (5th) fifth business day. If payment is not completed by this date the following actions can be taken by a broker-dealer; - Apply for a Reg T extra time: A Reg T extension or extra time can be requested from the Exchange where the stock trades the LSE OR KSE A Reg T extension is worthy for another 5 business days
- Freeze the account for 90 days: When an account is frozen the customer cannot buy until and unless he pays with cash.
- Sell off any outstanding positions to cover broker-dealer losses.

Arbitrage Account

An arbitrage account involves transactions with simultaneous buying and selling short of the same security for the goal of achieving a profit due to an inequality in prices

Margin Account

Customers can purchase a security or sell short in a margin account as long as Reg
T initial margin is met for every transaction. If margin is not used then the trades must be paid for by the Reg T closing date of 5 busi settlement. ness days or specified another way

INITIAL MARGIN REQUIREMENTS

- Customers are mandatory to deposit a minimum amount of equity for their first purchase in a margin account
- The initial deposit for margin accounts is $2,000 under the NYSE/N
- However, for long (buy) account purchases, if the initial amount of the trade is under $2,000, 100% of the trade purchase must be paid for.
- Long Example: Billy Jones wants to purchase $1,200 of ABC stock in a new margin account. Because the purchase under $2,000, Billy will have to pay 100% of the purchase or $1,200. In other words, the use of maryin is not allowed.
- Short Margin Accounts: For short (sell) accounts, if the initial short sell is under $2,000 the value of the account must be brought up to the $2,000 level
- Short Sell Example: Billy Jones now decides to sell short stock with a total value of $1,200. Because the short sell is under $2,000, unlike a long margin account, Billy will have to bring up the value of the account to $2,000. In other words, $800 will have to be deposited into the margin account by Billy to bring the account up to the $2,000 level
- Day Trading Accounts: For day trading accounts the NYSE and NASD have set a higher margin minimum of $25,000 because of the higher risks that day trading is associated with.
- Cheap Stock Rule: An additional margin requirement is set if a customer wants to sell short (not buy) those stocks that are categorized as "penny stocks". The higher margin requirement was put in place to discourage these short sales
- Anticipate at least one question on the following;
- Cheap Stock Margin Requirement
- Stock Value Margin Requirement
- Up to $2.50 $2.50 per share or $2,000 whichever is higher $2.50-$5.00 100% of share value until the share value goes over $5.00 Above $5.00 30% of the current market value (CMV) or $5 a share, whichever is greater

Margin Accounting

LONG ACCOUNT TERMINOLOGY

- Long Market Value: This is the current market value of the stock position that was purchased by the investor
- Debit Account: This is the amount that the broker-dealer loaned the investor. Each day, interest is charged on the debit balance which increases the amount owed by the customer. Short-term interest rates apply to debit loans.
- The Debit Balance never changes unless more securities are charged on margin or the debit balance is paid down or paid off .Equity Account: This is the customers "net worth" in the margin account. It represents the portion of the securities the customer fully owns.
- The Long account equation is LMV (CMV) = Debit (DR) + Equity (EQ). Another way of stating this is LMV- Debit-Equity. When calculating answers for long margin account exam questions remember that the total of the equity and debit is equal to the market value of the account. The LMV will fluctuate as market conditions change.

- SMA (Special Memorandum Account): This is also known as "excess equity which represents the amount of equity in excess of the minimum equity required by the margin account. For exam purposes compare the SMA to the credit line of a charge card that you use and remember the following
- The amount of SMA in a margin account never decreases, just like the credit line for your charge card
- If you use all your SMA you won't be able to use anymore, just like you wouldn't be able to charge any more on your credit card if you max out your credit line

SMA can always be used except for the following;

1. Using SMA would place the margin account below the minimum maintenance threshold which would create a margin call.
2. Using SMA would cause the amount of equity to drop below $2,000
3. Using SMA to meet a minimum maintenance margin call

- Restricted Account: A margin account that falls below the required Reg T equity level is known as a Restricted Account.
- Margin Call: A margin call or minimum maintenance call or minimum margin call is created when the equity in the margin account falls below the KSE minimum maintenance level of 25% of the long market value.
- Buying Power: Using SMA to purchase additional securities in a margin account without having to add any additional cash or equity.
- Mark to the Market: Positions in margin accounts are valued at the closing market price. In Addition, as the market value changes during regular market hours, the equity in the account changes as well.

LONG MARGIN ACCOUNT MECHANICS

We would recommend using the following setup procedure when dealing with margin questions on the exam

- **Reg T**
- **CMV**
- **Debit**
- **Equity**

The following exercise with explanation will take a long margin account from the opening position to an increase in value, to a decrease in value and finally to a margin call.

Part 1: Opening a Long Margin Account

Facts: A margin account is opened with a LMV (CMV) of $50,000 with Reg T at 50%. (You are expected to remember that Reg T is 50%. Normally they will not give you the
Reg T unless they change the value)
Reg T 50%
CMV = $50,000
Debit $25,000 (broker-dealer loan to the investor)
Equity-$25,000 (50% Reg T deposit)
Part 2: CMV increases to $60,000

CMV $60,000
Debit $25,000 (Debit never changes unless charges more or pays down the loan)
Equity $35,000 (Remember, $60,000 $25,000 $35,000)

Part 3: Establishing Initial SMA

Whenever a long account increases in value there will be excess equity, which is the same as SMA
Let's take a look at the Part 2 results to determine the amount of the SMA
CMV $60,000
Debit $25,000 (Debit never changes unless charges more or pays down the loan)
Equity - $35,000 (Remember, $60,000 $25,000 $35,000)

- At this point in the margin problem you need to know how to calculate how much equity is required according to SBP rules. Once you establish this requirement, any equity in excess of the requirement represents SMA. If the actual equity level is below the requirement, the account becomes restricted .
- Use the following lyric to help you establish the required equity level!- "Reg T times theCMV, tells me where my equity needs to be.
- Applying the above lyric to the current margin account, Reg T times theCMV is (50% times $60,000) S30,000. This means that SBP rulesrequire this account to have a minimum of equity of $30,000. But the account has $35,000. Therefore, the SMA in this account is $5,000

Part 4: Uses of SMA

Use 1 -Loan: Take the SMA out of the account and use it as cash. If the investor takes this course of action, the SMA taken out of the account becomes an additional loarn and the amount is added to the debit balance
The following is how the margin account would be affected;

- **CMV $60,000 New CMV $60,000 (Not effected)**
- **Debit $25,000 New Debit $30,000 ($5,000 SMA loan)**
- **Equity $35,000 New Equity $30,000 ($5,000 reduction)**

Use 2 - Buying Power: The SMA can be taken out of the account and used as "buying power" to purchase additional securities without taking a penny out of the investor's pocket. Because the cash is being taken out of the account, just like in the prior example on the preceding page, the amount of the new purchase is also added to the debit balance .

Calculating the Buying Power: Use the acronym "S M A R T", take the SMA of 50% and divide it by Reg T. Using the current SMA of $5,000, divide it by Reg T of 50%. This would equal $10,000. If you thought, it should be $2,500 you multiplied instead of divided. (Use your calculator even for the "simplest" calculations)

The above results mean that the investor could purchase $10,000 of additional securities without taking a penny out of his/her pocket. Use 3-Leave the SMA in the account: Remember, no matter what happens to the market value of the margin account, once SMA is established it can never decrease in value.

- **Part 5: CMV Increases in Value (Good)**
- **CMV= $60.000 New CMV = $70,000**
- **Debit $25,000 New Debit= $25,000 (no change)**
- **Equity = $35,000 New Equity = $45,000 (CMV-Debit = Equity)**
- **Establish New SMA: Reg T (50%) times the CMV ($70,000) or $35,000 tells me where my equity needs to be. This account has an equity of $45,000 but only needs $35,000. Therefore, the SMA has increased to $10,000**

Part 6: CMV Decreases in Value (Not Good)

- CMV= $70,000 New CMV = $40,000
- Debit = $25,000 New Debit = $25,000 (no change)
- Equity = $45,000 New Equity = $15,000 (CMV- Debit = Equity
- Apply lyric to determine minimum Reg T equity requirement. Reg T (50%) times the
- CMV ($40,000) or $20,000, tells me where my equity needs to be.
- This account only has $15,000 in equity. Therefore, the account under SBP rules is now Restricted.

Part 7: Restricted Account Rules

- Buying Additional Stock: When buying stock in a restricted account the investor must meet the regular Reg T deposit of 50% of the current market value just like any purchase in a margin account
- SMA: SMA can even be withdrawn or be used as buying power from the account unless it places the account into a margin call situation or brings the equity below $2,000
- Retention Rule: This is the "meat" of the restricted account rules. When a sale is made froma restricted account the central bank requires that 50% (coincidental with
- Reg T 50%) of the proceeds be retained by the broker dealer to help pay down the debit balance
- Buying and Selling: If the same amount of stock is bought and sold froma restricted account the results are a "wash". Therefore, there are no additional requirements. (Example: Buy $10,000 and sell $10,000)
- Net Sell: If an investor bought and sold stock in a restricted account resulting with a "net sell" then 50% of the proceeds from the net sell must be retained by the broker dealer to help pay down the debit balance. - Purchase $10,000 and Sell $20, 000
- These results with a net sell of $10,000 (20,000-10,000). 50% of the sales proceeds $5,000 must be retained to reduce the debit balance.

SECP/KSE Minimum Maintenance Requirement

While the SBP can restrict accounts with the Restricted Account rules, the SECP and KSE established the minimum margin, also known as the minimum maintenance requirement.
In a long margin account, the minimum maintenance rule states that 25% of the current market value must be maintained as equity at all times.

If the equity falls below the maintenance requirement, the investor receives a maintenance call, also known as a margin call.

Part 8: Application of the Minimum Maintenance Rule

CMV-$30,000

Debit - $25,000

New Equity $5,000

Take 25% of the CMV of $30,000 which is 7,500. However, the equity in this account is only $5,000. Therefore, a margin call will be issued in this account for $2,500. Under
SECP rules the account is still restricted

Margin Call Rules

- The margin (maintenance) call must be paid IMMEDIATELY
- If not paid, the firm must sell out securities to pay for the call.
- Cash or marginable stock can be used to meet the margin call, but not the use of SMA
- Marginable stock can be used to meet the call. The dollar amount of marginable stock required is twice the amount of the margin call.
- Example: If a margin call is for $5,000 an investor can provide marginable stock with a current market value of double that amount of $10,000. The reason for this is that the stock has a 50% loan value according to Reg T.

SHORT ACCOUNT TERMINOLOGY

Short Market Value: This is the current market value of the stock position that was purchased by the investor

Equity Account: This is the customers "net worth" in the margin account. It represents the portion of the securities the customer fully owns.

Credit Balance: The Credit Balance represents the sum of the short market value (CMV or SMV) and the equity. The credit balance does NOT change unless additional short positions are opened or the account is closed.

The Short account equation is SMV (CMV) Equity (EQ)Credit (CR). Another way of stating this is Credit - SMV Equity. When calculating answers for short margin account exam questions remember that the total of the equity and current market value is equal to the credit. The SMV will fluctuate as market conditions change.

SMA (Special Memorandum Account): This is also known as "excess equity" which represents the amount of equity in access of the minimum equity required by the margin account
The amount of SMA in a margin account never decreases, just like the credit line for your charge card. If you use all your SMA you won't be able to use anymore, just like you wouldn't be able to charge any more on your credit card if you max out your credit line.

Restricted Account: A margin account that falls below the required Reg T equity level is known as a Restricted Account.

Margin Call: A margin call or minimum maintenance call or minimum margin call is created when the equity in the margin account falls below the SECP/ SBP minimum maintenance level of 30% of the short market value. Notice here that the short account has a higher minimum maintenance requirement than does a long account. This is because of the additional risk of a short account when compared to a long

account. . Shorting Power: Using SMA to sell short additional securities in a margin account without having to add any additional cash or equity

SHORT MARGIN ACCOUNT MECHANICS

We would recommend using the following setup procedure when dealing with margin questions on the exam
Reg T =
CMV =
Equity =
Credit =

Part 1: Opening a Short Margin Account

Facts: A margin account is opened with a short sell value (SMV) of $10,000 with Reg T at 50%. (For test purposes you are expected to remember that Reg T is 50%. Normally the test will not give you the Reg T unless it is other than 50%)

- **Reg T = 50%**
- **CMV-$10,000**
- **Equity $5,000 (50% Reg T deposit)**
- **Credit $15,000 (CMV plus the equity)**
- **Part 2: CMV decreases to $8,000 (good)**
- **CMV $8,000**
- **Equity $7,000 (Credit- CMV Equity)**
- **Credit $15,000 (Remember, credit stays the same)**

Part 3: Establishing Initial SMA

Whenever a short account decreases in value there will be excess equity, which is the same as SMA. Let's take a look at the Part 2 results to determine the amount of the SMA.

- **CMV-$8,000**
- **Equity -$7,000**
- **Credit $15,000**

At this point in the margin problem you need to know how to calculate how much equity is required according to KSE rules. Once you establish this requirement, any equity in excess of the requirement represents SMA. If the actual equity level is below the requirement, the account becomes Restricted As a reminder use the following lyric to help you establish the required equity level! "Reg T times the CMV, tells me where my equity needs to be."

Applying the above lyric to the current margin account, Reg T times the CMV is (50% times $8,000) $4,000. This means that SBP rules require this account to have a minimum equity of $4,000. But the account has $7,000. Therefore, the SMA in this account is $3,000

Part 4: CMV Increases in Value (Not Good)

- CMV- $8,000 New CMV $13,000
- Equity -$7,000 New Equity $2,000 (CR - CMV)

- Credit $15,000 New Credit $15,000 (Stays the same)
- Apply lyric to determine minimum RegT equity requirement. Reg T (50%) times the
- CMV ($10,000) or $5,000, tells me where my equity needs to be.
- This account only has $2,000 in equity. Therefore, the account under KSE rules is now Restricted
-

COMBINED MARGIN ACCOUNTS

Be prepared to answer a number of questions on the Series 7 exam asking you to calculate the "Net Equity" of a long and short margin position. You will first be shown the "textbook" method and then an alternate method which we believe is simpler However, the choice will be yours

Question: What is the net equity of this margin account?

- **Long market value $30,000**
- **Short market value $20,000**
- **Debit Balance $8,000**
- **Credit Balance $19,000**
- **Textbook Method**
- **Long Account**
- **LMV-30,000**
- **Debit 8,000**
- **Equity 22,000 (CMV - Debit)**
- **Short Account**
- **SMV 20,000**
- **Equity--1,000 (Credit - SMV)**
- **Credit = 1 9,000**
- **Net Equity Long equity of $22,000 plus Short equity of $1,000 which equals $21,000**
- **Alternative Method**
- **Long market value = $30,000**
- **Short market value = $20,000**
- **Debit Balance $8,000**
- **Credit Balance $19,000**

Using the same facts as above, you will be subtracting what you "Owe" from what u "Own" as follows; Total own of $49,000 minus Total Owe of $28,000 Net
Equity of $21,000
Alternative Method (We believe easier) Own Owe
Long market value 30,000 Short market value - 20,000
Credit balance -19,000 Debit balance - 8,000
Total Own 49,000 Total Owe 28,000

Chapter 11

Brokerage Support Services

OVERVIEW

Brokerage firms are obligatory to follow strict guidelines for retaining accurate and thorough client information.

PROCESSING AN ORDER

As it is important to study about the various broker-dealer departments that support sales orders similarly it is very important to know about how it is to process the order The following several broker-dealer departments that has to do with the routing of orders;

Order Department

- The order department is also identified as the Wire Room and Order Room.
- This department communicates orders to the proper markets for trade execution.
- Finalized trade tickets are sent to the listed representatives who initiated the trades as
- well as to the Purchase and Sales Department

Purchase and Sales Department

- Records all transactions in a customer's account
- Handles all billing
- Computes the dates on which customers must deposit money and the deposit
- amount

Margin or Credit Department

- Events involving credit for cash and margin accounts
- Works out the dates on which clients must deposit money and the deposit amount

Cashiering Department

- Receiving and delivering of securities and money
- Issues payment only if the margin department orders it to do so
- Send certificates to transfer agents to be transferred and registered
- Forwards certificates to customers

Clearing Firms

A clearing firm such as NCCPL in Pakistan helps make the process simpler by providing specialized comparison clearance and settlement services. In short, a

clearing firm acts as a Bookkeeper of various broker-dealers. Majority independent brokerage firms are recognized as correspondence firms which means the clearing firms of their choice
also holds client accounts and records.

Reorganization Department

- Controls transactions that signify a change in the securities outstanding
- Exchanging or transmitting customer securities include the following
- Tender offers (company buying back outstanding securities)
- Bond calls
- Redemptions of preferred stock/ Redemptions of bonds
- Merger/Acquisitions

Dividend Department

Credits customer accounts with dividends and interest payments for securities detained in the firm's name. When securities are held in "Street Name", firms send the dividends to the brokerage firm, not the customer. This department now must distribute the dividends again to the correct customers.

Proxy Department

- Sends proxy statements to clients whose securities are held in the firm's name.
- It also conducts out financial reports and other publications received from the issuer for its stockholders.
- Keeps the ledger that lists each stock owner and the certificate's location

Route of an Order

Procedure of an Order Route
1. Client places the order with a listed representative.
2. The listed representative delivers the order to the order department, also identified as the wire room
3. The order department transfers the order to the right market, such as the NYSE, for implementation
4. The trading market sends a wire report of execution back to the order department.
5. The order department sends back the execution report to the listed representative
6. The listed representative contacts the client to report the execution of the order.
7. The order department then delivers the report to the purchases and sales department
8. The purchases and sales department sends a confirmation note to the client and a copy of the confirmation note to the listed representative.
9. The Purchases and sales department processes the trade for settlement through the Margin Department (f credit) and Cashiering departments which finally sends the securities and exchanges payment

TRANSACTIONS

When a listed representative agrees a buy or sell order from a client, the listed representative must be sure that the customer can pay for or deliver the securities.

Order Tickets

For many years listed representatives i ave entered client orders by manually writing out order tickets and then handling the ciders tiough a manual routing of orders. Today. brokerage environment mastly trade tickets electronically on computers. The orders are then sent to the wire room hich communicates every order to the appropriate market for execution. Listed representatives used to make the trade ticket in US markets manually and a general secu.ties foremost for NASD firms or branch manager for NYSE companies used to accepi all trades by the close of the same day. But now days this system has improved to electronic means of making order tickets in all markets of the world rather than manually.

Information Required for Trade Tickets

The following information is necessary for trade order tickets

- Customer account number
- Listed representative rep number
- Detail of the security along with its symbol
- Quantity of securities traded
- Place where the security is traded (NYSE or Nasdaq etc.)
- Action (buy, sell long, sell short)
- Options (buy, write, opening, closing, covered, naked)
- Price qualifications (market, limit, day order, GTC)
- Type of account (cash or margin)
- Settlement guidelines
- Security guidelines . Payment guidelines
- Location of certificates sold

Execution Report

- Listed representatives receive reports once trades are executed
- The representative should see the execution report alongside the order ticket to make clear that everything was done as the client requested.
- If the whole thing is in order the trade is informed to the customer. . If a fault exists, the rep should report it to a supervisor or manager straightaway.

Trade Confirmations

- This is a printed paper that confirms a trade and associated required information. For every transaction, a client must be sent or given a written confirmation of the trade at or before the completion of the transaction which would be by settlement date. Trade confirmations contain the following information .
- Trade Date: The day on which the transaction is executed.
- Settlement Date: The date on which the trade settles. For corporate securities the settlement date would be the third business day after the trade date.
- RR No: Registered or listed representative's identification number.
- Trade Action: Bought (BOT) or Sold (SLD)
- Quantity: Number of shares of stock or the par value of bonds purchased or sold by a client.

- **Description:** Particular security purchased or sold by the customer
- Yield: Specifies the lower of the YTC or YTM. The Current Yield would also be incorporated
- Price: Price per share for stock or bonds before any charge or deduction
- Amount: Price paid or obtained before commissions and other charges.
- Commission: Added to purchase transactions and deducted from sell transactions completed on an agency basis. A commission will not be confirmed if a markup has been charged in a principal transaction.
- Regulation Fee (Reg.): SECP registration fee deducted from the sales made on exchanges and postage .Net Amount: Gained on purchases by adding expenses such as commissions and postage to the principal amount. Whether, the transaction is a purchase or sale, interest is added every time bonds are traded with accrued interest
- Disclosure of Capacity: The confirmation must also illustrate the capacity in which the broker-dealer acts agency or principal. Under no circumstances firms can act as an agent and a principal in the same transaction.

CUSTOMER/CLIENT ACCOUNT STATEMENTS

- Corporations must deliver every customer with an account statement at least on quarterly basis
- If transactions take place then statements are mailed or delivered monthly
- Statements must show the following
    - All activity of trade in the account since the previous statement
    - Position of Securities both (long and short)
    - Account balances of the customer, debit or credit
- If a client has cash balance the firm may hold it in the account. On the other hand, the statement must counsel the customer that these funds are available on request

FINANCIAL CONDITION DISCLOSURE

- On the written request, a member firm must provide a copy of its most recent times prepared balance sheet to
- Any client/customer with securities or cash held by the member; or
- A member firm with cash or securities on deposit or performing business with the member

CHARGES FOR SERVICES PERFORMED

- Broker-dealer charges must be reasonable
- Charges must relate to the work performed, transaction entered or advisory services provided
- Charges cannot be unfair and discriminatory among customers.
- Many broker-dealers print fee and service charges on individual customer's monthly statement .A reasonable fee is not excessive when compared with the charges that other broker dealers and investment advisers charge for similar services.

Chapter 12

Trading Securities

INTRODUCTION TO TRADING

This chapter will highlight trading activities on the exchanges and over-the counter. It is very important that you understand this area as it is expected that you have a working knowledge of the markets, trading and related strategies.

SECURITIES MARKETS

The market, in which involves buying and selling securities after the primary market and IPOs, is known as the Secondary Market. All the transactions of securities take place in one of four trading markets. These four markets are as follows;

- First Market: Exchanges
- Second Market: NASDAQ- Over-the-Counter
- Third Market: (Listed trading on the OTC)
- Fourth Market: Institution to Institution

First Market (Listed Market)

The First Market in the Secondary Market is identified as the exchange market. This market is composed of the KSE and other exchanges on which listed securities are traded. The word listed security refers to any security registered for trading on arn exchange.
Some of the Regional Stock Exchanges in Pakistan are;

- LSE
- ISE

Second Market (Unlisted Market)

The Second Market in USA is the NASDAQ or Over-the-Counter market. This market is identified as a Negotiated Market as traders and market makers negotiate trades on the NASDAO computerized trading network. Numerous securities are traded on OTC, including stocks, bonds and all municipal and U.S. government securities.

Third Market (OTC-Listed)

This is a trading market in which exchange listed securities, generally found in the First Market, are traded in the OTC market. Broker-dealers are registered as OTC market s in listed securities organize third market transactions. Trades must be reported on the Consolidated Tape between 90 seconds of completion (in US). This market is also used for trading in "after hours". In principle, market remains open 24 hours a day Still, investors need to know that after hours trading is much less liquid and order flow is very restricted. This means that attainment of execution is much tougher and can be expensive.

Fourth Market (Institutions)

This market offers trading of securities among institutions without using a broker dealer
They generally trade large chunks of stock, both listed and unlisted in privately negotiated transactions. Mostly transactions are placed through the use of Instinet Network. Instinet contains a large number of mutual funds and other institutional investors amongst its subscribers.

Chapter 13

Types of Orders

ORDER QUALIFIERS

Day Order

A trade order is a day order which expires at the closing of the trading day unless completed in that day.

Good till Canceled

A good till canceled order is an open order that is good for a time period of six months.
Though, the orders must be upgraded by the last closing day in April and/or by the last closing day in October. The brokerage firm is liable for the termination of any good till canceled orders

At-the-Open

This type of order needs the execution at the opening of the trading day once the order is placed or canceled

At-the-Close

This type of order needs the execution as close as possible to the close of trading on the day the order is placed.

Not Held Order

A not held order is a type of order which is to be filled at all time and at the price the trader thinks best. But, it must be completed that day. Market orders do not carry over to the next day.

Fill or Kill (FOK)

Either the whole order is filled on the first attempt or the order is canceled. There can be no additional tries at executing the order

Immediate or Cancel (I0C)

This kind of order must be executed quickly in full or in part. Any part of the order that is left or unfilled is canceled

All or None (AON)

Either the whole order is filled or the order is not completed. It is based on the time specified in the order; a trader is free to try a whole execution again and again until the order expires. This is sometimes called as an alternative order

Either/Or

This kind of order states two possible trades for a particular total number of shares,not more
As an example:
Buy 1200 ABC Ltd at $50 or Buy 1200 ABC Ltd with Buy Limit 55
As you can understand in the above order, the customer wants to purchase a total of 1200 shares of ABC Ltd, not 2,400 shares. If one side is filled in total, then the other side would be canceled. One side to a certain degree is filled and they will ask how the order appears in the Specialist's Book? Let's suppose that 200 shares were filled at $50 by the specialist. Both sides MUST be reduced by the fill. Therefore, the remaining order would indicate 1000 shares for both sides of the either/or order, not 1200.

MARKET ORDER

Market orders are placed to purchase or sell a security instantly at the best price available. Market orders guarantee an execution of trade but do not guarantee a particular price. The client may be filled at the current market price, at a higher price or even a lower price, but always at the best Bid and best Ask prices offered

LIMIT ORDER

Limit orders specify a price at which to buy or sell. There are Buy Limit orders and Sell
Limit orders. A limit order does not guarantee the execution of trade, like a market order but does guarantee a specific price or better, if filled

Buy Limit Order

A limit order to buy is a type of order which is placed lower the current market value
The investor wants to buy the security but not at the current
Buy 100 XYZ Ltd@ 85 GTC when the CMV of XYZ Ltd is 88 - The above order has been placed and will be executed if the stock drops to 75 or e esser - This order will be canceled, if not executed. If the order was a day order only, the order would be canceled at the close of the trading day.

Sell Limit Orders

A limit order to sell is placed higher than the current market value. The investor is willing to sell the security but not at the current price

- Sell 100 XYZ Ltd @ 85 XYZ Ltd en the CMV of XYZ Ltd is 82.
- The order is placed and will be executed if the stock increases to 75 or higher
- This order will be canceled, if not executed. If the order was a day order only, the order would be canceled at the close of the trading day

Potential Risks & Drawbacks of Limit Orders

- Clients who enter limit orders risk missing the chance to buy or sell,specifically if the market changes away from the limit price.
- The market might under no circumstances go as low as the buy limit price or as high as the sell limit price.

- At times, a limit order is not executed even if the market price of the security matches the specified limit price. This can be the outcome of other limit orders that are in front of the non-filled order. (First come first serve situation)

STOP ORDERS

Stop orders are aimed to protect a profit or avoid a loss if the stock starts to change in the wrong direction. Stop orders either turn into a market order or a limit order based on the kind of stop order placed. Stop orders are designed with two steps; 1 Trigger: The trigger transaction at which the stop price activates (awakens) the stop order becomes either a market or a limit order 2 Execution: The stop order is executed and the trade is accomplished.

Sell Stop Orders

A sell stop order states that the traders order cannot be executed until the market touches the stated price or passes lower and a trade takes place which then triggers the order (stop comes off) and turns into a market order for instant execution

Note: The risk of this kind of order is that the stock may be sold at a lower price than the investor predicted. Remember, a market order only guarantees the execution of trade and not a guaranteed price

Sell Stop Limit Orders

A sell stop limit order tells the trader that this order cannot be executed until the market touches the stated price or passes lower and a trade takes place at that price or higher (better) which then triggers the order (stop comes off) and turns into a limit order for purposes of execution
Note: The risk of this kind of order is that the stock may never be sold as the current value may decrease and stay lower than the limit price in the order. Remember, in contrast to a market order, a limit order only guarantees a particular price, not the execution of trade.

Buy Stop Orders

A buy stop order protects a profit or restricts a loss in a short position of the stock. The buy stop order is set at a price higher than the current offering price, and is triggered when the market price touches or goes through the buy stop price

- Normally, buy stop orders are common for investors who sell short position stocks and who want to "purchase insurance" in case their position goes in the wrong direction
- Remember, selling short transactions are those in which investor believes that a stock is going to decrease in value. If they're right the stock would fall in value and they close their position by purchasing the stock so as they can return the borrowed shares to their broker-dealer at a reduced or lower price.
- On the other hand, if the stock's value increases a buy stop order will automatically be executed if the stock rises to a certain price. This safeguards the investor in case the price of the stock increases dramatically

- The other reason for a buy stop order is when an investor uses technical analysis to determine that if a stock "breaks out" of its trading range it should increase in value. If the stock stays in its trading range then the stock is not desired to be own.
- Buy Stop Orders are essential to be triggered first and then become market orders
- Buy Stop Limit Orders are essential to be triggered first and then become limit orders.
- The Buy stop order conveys the trader that this order cannot be executed until the market touches the stated price or crosses higher and a triggers the order (stop comes off) and becomes a market order for instant execution.
- Note: The risk of this kind of order is that the stock may be purchased at a higher price than the investor predicted.

Buy Stop Limit Orders

A buy stop limit order tells the trader that the order cannot be executed until the market touches the stated price or crosses beyond and a trade takes place at that price or higher which then triggers the order (stop comes off) and turns into a limit order for purposes of execution
Note: The risk of this kind of order is that the stock might never be purchased as the current value might rise and remain higher than the limit price in the order. In order the trade to be executed, the price of the stock must be at the limit price or better (lower).
Remember, unlike a market order, a limit order only guarantees a particular price and not the execution of trade

More on Buy Stop Orders

Investors can also practice stop orders to profit from the market price ups and downs
Technical analysts use movements in stock prices and trading volumes to decide when to buy and sell.
They are called as "chartists" because they use the charts to analyze movements in stock prices.

Chapter 14

Exchange Trades

LONG AND SHORT SALE RULES

Long Sale

When an investor purchases shares of a company for the sake of earning profit from value appreciation it is known as a long position. When the investor sells these shares it
Is recognized as a long sale as the stock is held long in the brokerage account

Short Sale

- Selling short is a method to earn profit from the fall in a stock's price. The following are the characteristics of a short sale;
- The short seller primarily borrows stock from a broker-dealer to sell in the market.
- The investor believes that the stock price will fall enough to let him/her to purchase shares at a lower price and replace the borrowed stock at a future date.
- If the stock price falls to zero, the short seller is obligated to purchase the stock and replace the borrowed shares to end the short position contract
- Short sales are usually risky and need the use of a margin account.
- If the stock price increases instead of falling then the investor can still purchase the shares to replace the borrowed stock. As a stock's price can increase without any limit, the position has unlimited risk. This is why they Buy Stop Order can help in reducing this type of risk

Exchange Short Sale Rules

- The SECP and exchange "plus tick rules" are aimed to block a short seller from exchanging into a falling market which could hold drive the stock's price lower.
- An order to sell a registered security short can be executed on either a plus tick or a zero-plus tick. A plus tick is a price greater than the previous different price. As an example, a stock trades at 20 then trades at 20.12
- A zero-plus tick takes place when the last trade for the security was made at the similar price at the trade earlier, but that trade was greater than the previous trade The plus or minus tick brings over from the previous day's trading.

Up Tick Rule Example

Short Sale Regulations

- The Securities Exchange Commission of Pakistan restricts directors, officers and principal stockholders inside the company from selling short stock of their own companies
- Sell order tickets must be known as to whether the investor is selling from a long position or he/she is selling short.

SPECIALIST'S BOOK

The specialist's book holds track of stop and limit orders. Market orders are not retained in this book. As stop and limit orders are not executed instantly, the specialist must retain track of the outstanding orders in a book. This book is typically electronic or computerized

Other Specialist Book Rules

- The specialist will only agree with Day orders and Good till Canceled order book
- On ex-dividend date the stock price of a share decreases by the amount of the dividend. So if ABC Ltd goes x-dividend for a 0.50 dividend the market value of the stock will also fall by 0.50.
- The specialist must alter any open orders in the specialist's book for the purpose of avoiding any filled orders due to a dividend being paid.
- It's important to know that which kinds of orders are adjusted when a stock is going to pay a dividend. Always remember that Buy Limit and Sell Stop orders get adjusted by the exchange specialist
- If a customer chooses not to have his/her stock order adjusted by the specialist then the order would be market with a Do Not Reduce (DNR). on the

Trading Block

A trading block is prepared of 10,000 shares. Always remember, this means 10,000 shares not 10,000 trading units

Chapter 15

Transaction Settlement Rules

SETTLEMENT OVERVIEW

The Settlement Date is the date on which ownership transfers among buyers and sellers. This is the date on which broker-dealers need to exchange the securities and funds included in the transaction and the date on which customers are requested to pay for securities purchased and deliver securities which are sold.

REGULAR WAY SETTLEMENT

Regular way settlement for most of the securities is three business days after the trading date. If the seller delivers beforehand of the settlement date, the buyer might accept the security or reject it without prejudice.

Settlement Rules for Specific Securities

Corporate stocks and bonds settle in 3 business days
Municipal securities settle in 3 business days
Government securities settle in 1 business day
Options settle in 1 business day

CASH WAY SETTLEMENT

Cash way settlement means the settlement of all securities in the "same business day". This rule involves delivery of securities from the seller and payment from the purchaser on the same business day on which trade is executed

GOOD DELIVERY OF SECURITIES

On settlement day, the securities are delivered and paid for. Though, the securities must be delivered in "good" form to the purchaser. If the securities are not in good form they might not be acceptable and settlement will not take place

- Listed securities must be certified on the back by the registered owner in particular name. This is identified as an assignment
- As an alternative of signed certificate itself, a document known as a "Stock Power" can be used in its place.
- Signature guarantees are needed by transfer agents for the transfer to be effective.
- Signature guarantees can be completed by commercial banks and firms listed on KSE.
- Bearer bonds must be delivered including all unpaid coupons.
- Stock certificates essential to be delivered in round lots of 100 shares or multiples of 100 on the certificate. If certificates of less than 100 shares are used, they need to fer to be effective agents

add up to units of 100. If the certificates are unable to be joined into units of 100 then good delivery cannot happen.

Example: For a 500 share trade any of the following would be acceptable;

- 1 certificate for a 500 shares
- 5 certificates of 100 shares each .
- 10 certificates of 50 shares each
- 20 certificates of 25 shares each

Example of bad delivery of 500 shares

- 10 certificates let suppose of 60 shares (can't pool 60 share certificates to create units of 100)
- Securities will be rejected if mutilated unless they are accompanied with a validation letter from the transfer agent or issuer specifying that the securities would be accepted
- Municipal bonds must be delivered with a legitimate unless acknowledged at the time of the trade as "ex-legal". This means coming without the legal opinion.
- Insured municipal bonds must be delivered with evidence of insurance

WHEN, AS, AND IF ISSUED

When, as and if issued is used for fresh securities of which issuance is declared, but the certificates are not yet offered for trading.
If there is an issue and the issue is canceled, the trades are canceled automatically
A confirmation is conducted by stating the price and trade date but there is no settlement date since the securities aren't available as yet.

COMPARISONS AND 'DK' NOTICES

Comparisons must be sent to the broker on the further side of the trade, known as the "contra" broker. The contra broker (Firm B) obtains a comparison from the firm A while Firm A receives a comparison from Firm B. This comparison is then matched along with the trading record to assess that if all the terms agree so that settlement can progress. Comparisons must be sent not later then the day after the trade

Example

Your broker-dealer obtains a comparison for a trade executed at $100 per share and the comparison illustrates the trade at $90 per share. To clear the record, your firms will "DK" (Don't Know) the comparison and send it back with its record of the trade

- The two firms will then assess the trading records and clear the discrepancies so that regular way settlement can happen.
- The closing day of "DK" is the business day prior to settlement
- If a cash settlement is executed, comparisons must be delivered that same day

REJECTION AND RECLAMATION

- A rejection arises when securities are delivered to a brokerage firm on the settlement and are denied for a valid reason.

- Reclamation takes place when a brokerage firm agrees delivery of securities on settlement and future determines that the delivery was not good.

Reclamation Example

- The Brokerage firm agrees to take a large shipment of securities and is accepted by a principal of the company. Well ahead it is determined that some of the securities did not show "good delivery". Only the defective securities are reclaimed under reclamation. The complete shipment is NOT reclaimed

Chapter 16

Annuities

DEFINING AN ANNUITY

An annuity is not a life insurance but it is an invention of a life insurance company. An annuity is a contract which offers a stream of income payments that is assured for life.
The person who takes the payments is called the annuitant. There are two kinds of annuities presented by insurance companies;

- Fixed Annuities
- Variable Annuities

FIXED ANNUITY

- Investors, known to be annuitants, pay premiums to an insurance company which is then invested in the insurance company's General Account. Unluckily, creditors have right of entry to the General Account and can prove to be a issue if the insurance company is financially impaired
- The fixed annuity insurer promises the following; - Rate of return - Principal
- The most important risk with fixed annuities is recognized as purchasing power risk, also classified as inflation risk.
- License of insurance producer (agent) is needed to sell annuities

VARIABLE ANNUITIES

Over the time the variable annuity has developed as a popular retirement formation product. With tax postponed growth, a guaranteed minimum death benefit, right of entry in different professional mutual fund money managers, an extensive choice of payout options beside with favorable tax benefits the variable annuity

FEATURES OF VARIABLE ANNUITY

- Investor undertakes investment risk as they make the investment decisions.
- A variable annuity is seen as a security as well as an insurance product. So, those selling this product must have combination of both securities and insurance agent license
- Maximum mortality expenses (minimum administrative expenses are promised not to be higher.
- Premium moves into separate accounts and every separate account signifies different sorts of investments such as common stock, bonds, mutual funds etc
- Monthly payouts contain income for life but the amount of the payments will differ as determined by the separate account's performance death benefit) and maximum

Fixed vs. Variable Annuity

A fixed annuity is an agreement among the insurance company and a customer, usually called the annuitant. The contract requires the company to make a series of fixed annuity payments to the

annuitant for the period of the contract. Retirees frequently use a fixed annuity to make available a steady income for life.

A variable annuity is a tax-deferred retirement tool that lets you to select from a variety of investments, and then pays you a level of income in retirement that is based on the performance of the investments you pick. Relate that to a fixed annuity, which offers a guaranteed payout.

COMBINATION ANNUITY

Investors who purchase a combination of annuity gain the benefit of both the fixed and variable annuities. The investor contributes to both the general and separate accounts, which offers guaranteed payments as well as inflation safety

Categories of Variable Annuities

A variable annuity can be categorized according to when annuity payments are to begin. The major categorizations are immediate annuities and deferred annuities

Immediate Annuity

- Start payments to the annuitant one payment period after a lump-sum deposit has been made in the annuity agreement.
- If the agreement is for monthly payments, payments to the annuitant will start in one month once the date of purchase.
- If the agreement calls for annual payments, payments will start in one year after the date of purchase

Deferred Annuity

- A deferred annuity postpones payments to the annuitant for a time period after the date of purchase
- The initial payment may begin several years after money is deposited
- A deferred annuity may be funded witha single premium but can also be funded with periodic payments.
- Premiums can be deposited into the annuity monthly, quarterly, semiannually or annually

COMPARING VARIABLE ANNUITIES TO MUTUAL FUNDS

- The separate account of the variable annuity is comprised of purchaser's funds combined together and invested in a diversified portfolio of stocks, bonds and mutual funds.
- Investors own a proportional share of the securities

- The value of investor's shares rise and falls based on the performance of the securities in the pool.
- The separate account of a variable annuity is managed and regulated just like a mutual fund.
- If the investment manager of the insurance company passes the portfolio management respons and must register as a Unit Investment Trust under the Company Law other party, the separate account is indirectly managed

PURCHASING ANNUITIES

- Investors are offered numerous options when buying annuities. The choices are as follows
- Single Premium: Bought with a lump sum, but payment of benefits is delayed until a later date, if at all, selected by the annuitant.
- Periodic Payment Deferred: This choice tolerates investments over time. Payments of benefits are at all times deferred until a later date designated by the annuitant
- Immediate Annuity: Bought with a lump sum and the payout of benefits typically begin within 30 days

PHASES OF ANNUITY

- Growth Phase: This is recognized as the Accumulation Phase as the investor is making investments. The investments create units known as Accumulation Units
- Annuity Phase: If the investor selects to take income from the account by annuitizing the contract, the value of the accumulation units is transformed into a fixed number of
- Annuity Units. These annuity units are then liquidated to offer monthly income guarantees for the life of the annuitant. Still, the amount of every monthly payment will differ dependent on the value of the underlying securities

RECEIVING DISTRIBUTIONS

- If annuitization is selected by the investor, the whole annuity's principal value is turned over to the insurance company's control and hence insurance company holds the whole value of the annuity.
- At the time of annuitization an Assumed Interest Rate (AIR) is allocated to the variable annuity contract. AIR signifies a conservative estimate of the performance of the separate account over the projected life of the contract. It only has significance in the payout phase in which the customer chooses a payout option.

ANNUITY PAYOUT OPTIONS

If the annuitant agrees to annuitize the annuity contract in return for monthly income a selection of one of the following payout options will have to be made.

Straight Life Annuity

- This option is responsible for the annuitant with income for life. When the annuitant dies remaining sums stay with the insurance company as a beneficiary is not allowed to be selected
- This payout option is a selection for those people who want the highest monthly income

Life Annuity with a certain period

- This option also offers income for life But, the annuitant would also pick out a period certain like 4 years, 12 years or even more.
- If the annuitant dies between that certain period, monthly payments would be given to the beneficiary until the closing of that period. Once the time period ends the insurance company will not be liable for monthly payments

Joint and Last Survivor Life annuity

- Assures payments over two lives.
- Mostly used for husbands and wives
- If one spouse dies the other spouse will keep on receiving payments as long as he/she lives.

OTHER CONTRACTUAL PROVISIONS

Most annuity agreements cover provisions relating to the length, termination and expenses associated with the annuity

Mortality Guarantee

The annuity company promises that it will make payments till the annuitant's life time.
If mortality expectations change, the company is still obligated to make the payments

Expense Guarantee

- When computing the amount that the annuity company will pay to a customer over a period of time, the company is also obligatory to predict its own expenses for managing the plan.
- If the cost of administration increases, the annuity company is exclusively liable for the greater cost and may not pass this cost on to the annuitant

TAXATION OF ANNUITIES

- All assistances to annuities are made with after-tax dollars, except if the annuity is used in a qualified retirement plan.
- If the contributions are after-tax dollars then the amount considered will be based on the investor's cost basis and is not taxed when withdrawn.
- All qualified annuity circulations are treated as ordinary income based on the investor's tax bracket and not provided with beneficial capital gains treatment
- If the investor annuitizes an agreement part of the monthly payment is considered a return of his/her cost basis and relative earnings. Only the portion of earnings would be taxable
- The IRS gives non-qualifie means that any distribution first represents earnings and would be taxed first After annuities on a (LIFO), last-in-f t-out, basis. This means that any distribution first represents earnings and would be taxed first. After the earnings have been taken out then there is no further taxation because the cost basis has previously been taxed.

Chapter 17

Economics

OVERVIEW

This chapter will test on major concepts about economic performance and the monetary policy of this country. This will contain stages of the business cycle, indicators, economic theories, fiscal policy, and tools of the State Bank of Pakistan (SBP), fundamental and technical analysis, balance sheets and income statements

ECONOMICS DEFINED

Economics is a study of demand and supply. Generally, when people do not want to purchase an item that is in excess supply hence decreases the price. This same concept applies when people want an item too much but the supply is limited or less.
In this case, the price of that item would rise. The economic climate has a massive effect on the situations of individual companies and therefore, the securities markets.
Moreover, earnings and business prospects, changes in the business cycle,money supply and the SBP's actions affect securities prices and trading

BUSINESS CYCLE

Periods of economic expansion are followed by periods of economic contraction in the business cycle. Business cycle passes through four stages;
1 Expansion
2 Peak (prosperity)
3 Contraction (Recession)
4 Trough (Bottom)

- Expansion: This period of business cycle involves business activity with growing sales,manufacturing and wages. For a multiple reasons, an economy can grow for only so long. When it reaches its upper limit it has peaked
- Peak (Prosperity Reached): The top level of the business cycle is called the peak. It shows a limit of the initial expansion.
- Contraction: In this period of business cycle, the business activity in the economy starts falling. Minor short-term contractions are known as recessions. Longer and more severe contractions are known as depressions
- Trough: In this period of business cycle the business activity stops falling and levels off. It is also called bottom. As the economy makes progress a new expansion period initiates

Four Stages of the Business Cycle

Features of a Business Cycle Expansion

- High consumer demand for goods and services

- Rising stock prices of companies
- Rise in industrial production
- Increasing Gross Domestic Product (GDP) of the economy
- Rising property prices

Features of a Business Cycle Downturn

- Rising consumer debt
- High number of bankruptcies
- Falling stock prices of companies
- Decreasing Gross Domestic Product (GDP) of the economy
- Rising inventories (Excess Inventory issues)

ECONOMIC DEFINITIONS

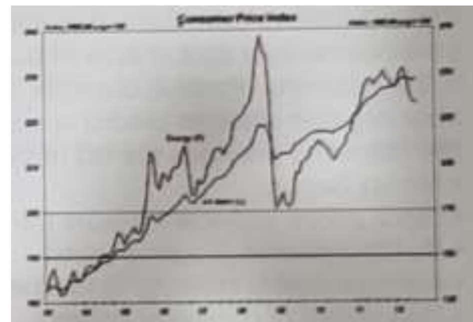
Recession (Bad)

According to the U.S. government, the economy is in a recession when a fall in real output of goods and services persists for six months (two quarters) or more.

Depression (Worse)

If a recession lasts for minimum 18 months, then the downturn has turn into a depression

Gross Domestic Product (GDP)



- It is a country's annual economic output
- All of the goods and services produced within the country in a period one year is known as GDP
- Contains personal consumption, government spending, gross private investment, foreign investment and the total value of export

Consumer Price Index (CPI)

- Most realistic measure of general price changes
- Market basket of particular goods and services in several cities across the country.
- Measures the degree of increase or decrease in a wide range of consumer prices, such as food, housing, transportation, medical care, clothing, electricity, entertainment and services.
- Computed monthly

Producer Price Index (PPI)

- The PPI is an Index of the price of numerous items such as farm products and industrial commodities
- The leading sign of inflation trends is the PPI.
- As producer costs increases, they are passed on to consumers and eventually reflected in the CPI

Inflation

Inflation is well-defined as an increase in the general price level of output in a country
Minor inflation can bring economic growth because steady increasing prices tend to encourage business investments
Increased inflation drives up interest rates because of the SBP's response to inflation.
As interest rates increases, the value of highly debt securities falls

Deflation

It is the opposite of inflation
If prices falls for the same unit of output, deflation occurs
This is most likely a rare event
Deflation generally occurs during severe recessions when unemployment is on the peak.

ECONOMIC INDICATORS

There are few aspects of economic activity that serve as measures or indicators of business cycle phases. Mainly they include leading, lagging and coincidental indicators

Leading Economic Indicators

These indicators deliver statistics that show what the economy is going to do so. They are fundamentally spot checks of business activity that consistently help predict trends in the economy. Positive changes in such indicators predict economic development while negative changes predict economic contraction.
The following provides the list of the major leading indicators;

- Money Supply
- Stock prices (indexes measure the performance of a group of stocks)
- Building permits (housing starts)
- Average weekly initial rights for state unemployment compensation
- New orders of consumer goods
- Ups and downs in inventories of durable goods (durable goods orders reflect the new orders placed with domestic manufacturers for immediate and future delivery of factory hard goods
- Unemployment

Coincident Economic Indicators

These indicators show how the economy is performing right now. While leading indicators reflect where the economy is moving, coincident indicators confirm where it is right now. They are quantifiable factors that differ directly and simultaneously with the business cycle
The following provides the list of major Coincident Indicators;

- Industrial production
- Personal Income
- Employment levels
- Nonagricultural employment
- Gross Domestic Product (GDP)

Lagging Economic Indicators

Lagging indicators reflect the leading indicators but reach their peaks and troughs at a future date. They benefit analysts in differentiating long-term trends from short-term reversals that fall in any trend. In core, they are aspects that change after the economy has initiated a new trend and serve as confirmation of the new trend.

The following provides the list of major Lagging Indicators;

- Prime rate (rate banks charge their best customers)
- Average period of unemployment
- Credit card debt
- Corporate profits
- Ratio of inventories to sales

ECONOMIC THEORIES

The following theories reflect different views that affect the economy

Keynesian Theory

- Active government participation in the economy is crucial for the health and stability of a country's economy
- Keynesians believe that demand for goods eventually controls employment and prices
- Inadequate demand for goods causes unemployment.
- Too much demand causes inflation.
- The government should intervene through spending and intervention to ensure economic growth.

Supply Side Theory

- This theory believes that government should allow market forces to determine prices of all goods
- Supply-siders believe the federal government should reduce government spending as well as taxes
- Sellers of goods will price them ata rate that permits them to meet market demand and still sell them profitably.
- Consequently, the government should remain comparatively inactive and the economy will grow by itself.

Monetarist Theory

- The money supply needs to be rightly controlled by the economy to flourish.
- The country's central money supply
- Too many Rupees chasing too few goods lead to inflation.
- Too few Rupees chasing too many goods lead to deflation
- Well-controlled, moderately rising money supply leads to price stability

FISCAL POLICY

The fiscal policy is the government's use of taxation and expenditure programs to retain a stable, growing economy

- The Fiscal Policy of the country is set by the FBR (Federal Board of Revenue) with the assistance of Ministry of Finance
- This policy normally refers to the governmental budget decisions which can consist of an increase or decrease with the following; - Money raised through taxes - Federal budget deficits or surpluses - Federal spending
- The political process determines the fiscal policy of this country. Hence, it takes time for conditions and solutions to be identified and implemented. Because of the time needed to negotiate political decisions, the fiscal policy is an inefficient means to solve short-term economic problems.

Expenditure Programs

The government spends money to create programs hoping to stimulate the economy.
When the government spends higher than what it collects from taxes, it is forced to borrow the difference. This is known as deficit spending and might affect the level of interest rates to rise

MONETARY POLICY

The monetary policy of the country is regulated by the State Bank of Pakistan while the fiscal policy is regulated by FBR with assistance from Ministry of Finance. The primary concern of the monetary policy is the control of inflation.

Money Supply

Most people think money as cash in their pockets; economists take a much wider view and would include credit loans and other liquid instruments

Categories of Money Supply in Pakistan

The money supply in Pakistan is divided into four categories. The money supply categories are as follows
M-0: Pakistan Money Supply MO is the most liquid measure of the money supply which contains coins and notes in circulation and other assets that are readily convertible into cash
M-1: This includes the sum of currency in circulation and highly liquid financial assets (like checkable deposits, travelers checks etc.) usually called M1 is a narrowly defined monetary aggregate
M-2: The M2 comprises currency in circulation, other deposits with SBP, demand deposits, time deposits and Resident Foreign Currency Deposits of the scheduled banks
M-3: M3 consist of M2 plus long-term time deposits in banks.

STATE BANK OF PAKISTAN

The State Bank of Pakistan (SBP) is the central bank of Pakistan which was formed in 1948. The SBP in the country determines monetary policy and takes actions to implement its policies which consist of

- Performing as an agent of the Pak Government
- Treasury

- Setting up reserve requirements for members
- Regulating the money supply of the country
- Managing the printing of the currency of the country
- Inspecting members to ensure compliance with federal regulations
- Clearing fund transfers during the course of the system
- Currency Management
- Foreign Exchange Operations and Settlement
- Provide Payment and Settlement Arrangements
- Provide Banking Services to the Government

SBP's Influence on the Economy

SBP has control to influence the supply of money in the economy. Every month the
SBP meets to explore trends in the economy and to select what actions, if any, are necessary to influence the current money supply

SBP Tools

Reserve Requirements

- Commercial banks are required to deposit a certain percentage of their depositor's money with the state bank.
- All money commercial banks deposit at SBP, including money higher than the reserve requirement, is known a Federal Reserve Funds
- When the SBP increases the reserve requirement, banks must deposit more funds with the SBP as a result of having less money to lend (money supply tightens).
- When the SBP decreases the reserve requirement, banks can take their funds back with a result of having more money to lend (money supply loosens).
- To expand credit throughout a recession in order to stimulate a slow economy the
- SBP would reduce the reserve requirements
- To squeeze credit to slow economic expansion in order to avoid inflation the SBP would increase reserve requirements.

Discount Rate

- The discount rate is the interest rate that the SBP offers member banks for loans using government securities or qualified paper as collateral. This offers a floor on interest rates, as banks set their loan rates a cut above the discount rates
- To pay compensation for shortfalls in its reserve requirement, a bank might borrow
- Money directly from the central bank at its discount rate or borrow the excess reserves (Federal Reserve Funds) from another member bank
- The interest rate commercial banks offer to each other for loans is known as the

Policy Rate

This rate varies daily and is most volatile of the interest rates

Prime Rate is the interest rate offered by member banks to their best customers. The prime rate normally follows the path of the discount rate.

Margin Rate

- The SBP sets initial margin rates for securities based on the constitutional act
- To tighten credit, the SBP can increase margin rates
- To loosen credit, the SBP can decrease margin rates

Repurchase Agreements

These are known as REPOS

- Agreement entered into by the SBP to buy Government securities from dealers, at a fixed price, with provisions for their resale back to the dealer at the same price in addition of a negotiated rate of interest.
- By doing the above, the SBP is lending money and as a result increases bank reserves. This may cause a decline in short-term rates for limited time period.

Reverse REPO

- It occurs when the SBP sells securities to dealers with the purpose of buying the securities back at a future date.
- This has a short-term outcome of absorbing funds from the money supply and might cause a temporary increase in the policy rate

FISCAL&MONETARY POLICY EFFECT

Securities Markets

- As the economy goes through the different stages of the business cycle, the bond and equity (stock) markets respond to these changes.
- In the bond markets, prices of bonds change inversely to interest rates. As interest rates increase, bondholders bear losses as the prices of their bonds fall. If interest rates fall, bondholders will profit from increasing prices.
- Both have an impact on the Stock Market
- Interest rate sensitive stocks respond to changes in interest rates. AS utility companies are highly leveraged, it turns out to be more expensive for these companies to raise money when interest rates increase
- Cyclical stocks are those stocks that changes with the business cycle. If the economy is in a period of success, these companies do well. However, as the economy weakens, cyclical stocks fall. Few examples of cyclical stocks would be construction companies and machine tool companies.
- Stocks of defensive companies respond less to changes in the business cycle as compared with cyclical stocks. Defensive industries consist of Utilities, tobacco, food and drugs.
- If Pleases interest rates, the money supply rises, making credit easier to obtain which will increase total liquidity
- Just like easier credit, lower tax rates are bullish for the stock market.

- Raising taxes reduces the amount of money available to businesses and consumers for spending and investment

Interest Rates

- A loan's interest rate is the cost of the money
- The supply and demand of money defines interest rates
- When the money available for loans surpasses demand, interest rates decreases.
- When the SBP tightens the money supply, interest rates increase.
- The SBP affects the money supply in several ways that can impact interest rate levels.

SBP Raises Interest Rates

- This will control a high inflation rate as inflation occurs when companies increase the price of their products because people are spending too easily.
- Helps increase the value of the Pak Rupee in relation
- If interest rates are high, the Pakistan is in a tight money situation where the Pak
- Rupee is harder to get
- The Pak Rupee is also subject to supply and demand.
- If the Pak Rupee is strong, people will be able to buy more foreign goods with the same amount of money
- High interest rates hurt the market because investors don't have the extra money to spend
- A bearish market may prevail.
- Businesses are affected as they would have to pay more interest on loans which will result with lower earnings
- The economy will slow down because the Pak Rupee would be strong in relation to foreign currency. Therefore, it would be cheaper for Paki citizens to buy their goods and cheaper for foreigners to buy their own goods foreign ie

SBP Lowers Interest Rates

- This would help Pakistan avoid or get out of a recession
- A recession is a minor 6-month economic decline.
- A bullish market might prevail.
- Low interest rates stimulate the market because people have more money to invest
- Businesses are also affected because they would not have to pay as much interest to borrow money
- PAK exports would increase because foreign currency would be strong as compared to the Pak rupee
- It would be cheaper for foreigners to buy Paki products.
- Pak Rupee would decline in relation to foreign currencies
- If Pak Rupee is weak, imports would be more expensive
- Lower interest rates would lead to higher inflation.

Disintermediation

The flow of money out of low yielding savings accounts and investing in higher yielding investments is called Disintermediation.
Disintermediation happens during periods of tight money

INTERNATIONAL MONETARY FACTORS

Balance of Payments

This is the flow of money between Pakistan and other countries.

Surplus

- The balance of payments may be a surplus, in the More Detalls at httpe//CAntedgn.in situation when there is more money flowing into the country than out

Deficit

- A deficit arises because more money is flowing out of the country than coming in. (Imports increase)
- A deficit occurs when interest rates in another country are high because money flows to where it earns the highest return.
- Exports decrease
- Foreign tourists visiting Pakistan decrease.
- Paki tourists visiting foreign countries increase
- Dividends and interest paid on Paki securities held by foreigner's increase.
- Dividends and interest paid on foreign securities held in Pakistan decrease.
- Foreign purchases of Paki securities decrease
- Pakistan purchases of foreign securities increase

Deficit Summary

- If any activity causes the Pak Rupee to be sold the value of the Pak Rupee will decrease which will add to the trade deficit
- If any activity causes the Pak Rupee to be bought then the value of the Pak Rupee increases which will add to the trade surplus.

Balance of Payments Debit (Deficit) vs. Credit (Surplus

- When debits go above credits, a deficit in the balance of payments arises
- When credits go above debits surplus in the balance of payments arises
- Deficit or Debit account means that Pak government has more cash outflows due to higher imports than exports. Credits or Surplus account means that Pak government has more cash inflows due to higher exports than imports.

Chapter 18

Portfolio Analysis

OVERVIEW

This chapter will talk about the basics of portfolio analysis. This includes

- Changing aspects that affect customer's investment objectives.
- Portfolio management policies
- Portfolio theory and its application to security selection.

FACTORS AFFECTING INVESTMENT OBJECTIVES

When involved in making recommendations for building portfolios it is vital to consider all the factors that may cause a change in the portfolio currently or in the future. When changes are needed its

important to discuss recommendations with clients and agree to what changes should be made and the timing.

Specific Examples

- Age
- Marital status
- Loss of a job
- Serious medical condition
- Disability
- Death in the family
- Divorce
- Retirement
- Education
- Income needs
- Speculative vs. Safe money
- Investment experience
- Changes in marital status
- Completion of college education
- Family responsibilities

PORTFOLIO RISKS

There are various risks that can affect a portfolio or securities which include:

Systematic Risk

This is the risk of a general market decline affecting the portfolio
It is also known as Market Risk
However, Market risk cannot be diversified away

Non-Systematic Risk

This is the risk of a single investment going bad. . This is also known as Selection Risk
By diversifying the portfolio, this risk is minimized.

Capital Risk

This is the risk that the amount invested may not be completely recovered.

Timing Risk

The risk that buying and selling take place at disadvantageous price levels because of poor market timing.

Selection Risk

The risk of picking a security that might not perform well when given a choice of many different appropriate securities

Legislative Risk

It is the risk that the possible profit from a securities investment may be adversely affected by new or revised legislation.
This can happen at the federal, provincial or local level and relates to all securities.

Liquidity Risk

The investor's ability to sell a security without a considerable loss
This kind of risk is likely to increase as the quality of an investment decreases
Purchasing Power (Inflationary) Risk
It is the risk that, due to inflation, the value of the Rupees will reduce over time causing a decline in the

purchasing power of Rupees

Generally, equities and variable annuities deliver the best protection against this kind of risk
Fixed income products such as bonds and fixed annuities have a high degree of purchasingpower risk because their income is fixed and will be eroded by inflation.

Interest Rate Risk

This risk arises with rise in interest rates as with this increase the price or value of an investor's bond holdings will decline.
Longer maturities usually have a higher interest rate risk than shorter maturities

Reinvestment Risk

It is the risk that a bondholder will not be able to reinvest interest payments at a rate equaling the current rate of return.
Zero-coupon bonds have zero reinvestment risk as there are no interest payments to reinvestment.

Call Risk

It is the risk that bondholders will have their investments redeemed (called) by the issuer prior to the specific maturity date
If a bond has a coupon rate that is greater than what is presently available in the market, the bond may be called
The bondholder would then lose the high coupon bond and have to invest in other bonds which provide the current lower yield

PORTFOLIO MANAGEMENT POLICIES

Portfolio management policies offer whether particular portfolios are aggressive defensive or even a blend between the two. Before forming a particular portfolio, the financial services person must make an agreement with the customer as to how the portfolio will be created. An investor's risk tolerance and financial aims will pay heavily to what assets are selected in the creation of a portfolio

Active Asset Management

It is dependent on the belief that fundamental analysis performed by an analyst can signify undervalued securities and produce a superior return within that asset class.

This strategy pursues to find inefficiencies in market pricing of particular securities.

Passive Asset Management

This sort of portfolio management is dependent on the belief that the market is efficient in pricing securities
An index fund can be used for every class
Hence, the desired diversification can be attained with minimum annual expenses

PORTFOLIO THEORY

There are numerous approaches to the creation of investment portfolios. They differ as to risk, management philosophy and diversification methods

Portfolio Diversification

- Portfolio diversification is dependent on the saying of "do not place all your eggs in one basket" (Reduction of risk). Some techniques to diversify are as follows; - Type of instrument (equity, debt, packaged etc.) - Industry - Companies with in an industry - Length of maturity - Investment rating -Geography
- Proper diversification must bring minimum three factors in account - Time factor: A person's selection of investments should relatively depend on his/her investment time horizon. For instance, if the individual needs the funds within six months, then the investment should be scheduled using short-term investment vehicles
- **Amount of Return required and Risk Tolerance:** These two aspects are tied together. Investors must decide how much return they want to focus at and what sort of risk acceptance they have towards the investment as it will help in assisting the kinds of
- Investments that are suitable to the investor's needs and help them avoid the most common investment errors.
- In simple words, diversification is the method of combining securities in such a way that the variability of independent factors tends to be canceled out which also helps reducing the risk.
- Few investors' belief that a portfolio can be diversified by comprising assets across all asset classes. But, investors are then required to answer the question as to how much should be invested in each asset class?
- Few investors also belief that a portfolio can be diversified on one asset class such as common stock. But, investors are then required to answer the question as to which corporations should be purchased?
- Through diversification, if any one asset sector provides lower than expected or negative returns, this will not impact the portfolio as strongly, and other sectors might perform better than expected to offset such an occurrence

Capital Asset Pricing Theory (CAPT)

Under modern portfolio theory this theory looks at portfolio performance based upon a combination of its assets' risk and return. This theory provides a framework for helping the individual understand the relationship between risk and return.

Capital Asset Pricing Model (CAPM)

- This model relates the risk as measured by beta to the required rate of return or expected level of return on a security
- The CAPM breaks down an investment's return into a risk-free rate of return (rate of a security only having systematic risk) in addition of a risk premium (unsystematic risk component)

Efficient Market Theory

This theory holds that securities prices promptly and fully show all accessible information. Because of this, random selection of a portfolio should give a return that is as good as a selection by any other analytical method.

Efficient Frontier

- The selection of securities is graphically plotted by using the securities' rate of return and risk factors
- After the securities are plotted, a line is drawn recognized as the efficient frontier line
- Portfolios that lie on or below the efficient frontier should be constructed.
- The area higher than the line signifies very high returns at low risk which are unattainable

Asset Allocation

- Asset Allocation is the procedure of determining optimal allocations for the wider categories of assets such as stocks, bonds, cash, real estate etc. that suit an investor's time horizon and risk tolerance.
- Despite the fact, this process can be performed on any portfolio with two or more assets; it is most frequently applied to asset classes. This allocation is probably the most important decision and may account for more than 80% of the return of the portfolio
- Every asset class will usually have different levels of return and risk. They also perform differently. At the time one asset is increasing in value, other one might be decreasing or not increasing as much and vice versa.
- The most important decision to be made for a client is the allocation of portfolio assets among equity investments and interest bearing investments. This decision will establish the basic risk (volatility of the return) versus rate of return characteristics of the portfolio

Equities vs. Debt

- A portfolio is required to be balanced among interest bearing and equity investments
- The basic trade-off among the two kinds of investments is
- Interest Bearing Investments: These investments have lower credit risk and no volatility of return for fixed income investments. But, the return is vulnerable to market risk and purchasing power risk.

Equity Investments: These investments have higher credit risk and much larger volatility of return. But, they have proven over the time to be able to grow at a faster rate than inflation (purchasing power).

Time Horizon Issues

Long-Term Time Horizon: Over the long time period, inflation has proven to be the greatest risk. This makes equity investments a better choice for long-term time horizons
Short-Term Time Horizon: Over the short time period, equity returns can be much more volatile and can be negative as well. This makes interest bearing securities a better choice

Liquidity Needs

Another aspect to be considered in the creation of portfolio is portfolio liquidity.
A portion of the portfolio needs to remain liquid to meet anticipated or even unanticipated cash needs.

PORTFOLIO CONSTRUCTION

Creating an investment portfolio includes the following steps:
1 Choosing which asset classes will be represented in the portfolio.
2 Determining the "target" percentage of the portfolio to allocate to every asset class.
3 Stating the allowable range for every asset class by which the allocation can be changed to take benefit of market conditions 4 Selection of the securities contained in each asset class.

Traditional Portfolio

The ordinary asset allocation, carefully chosen by the manager, is based on the client's investment purposes and risk (volatility) tolerance of the customer

- The "traditional portfolio" contains
- Government Treasury Bills
- Long-Term Corporate Bonds
- Large Company Stocks

Strategic Asset Allocation

The allocation is the percentage to be invested in different forms of securities

- The proportion of assets of every asset class is termed as the Portfolio Balance or the Normal Asset Allocation
- The target weights selected will base on the customer's investment objective, time horizon, risk tolerance, eto
- The purpose is to achieve the highest expected return versus risk (volatility) supposed by the customer.

Tactical Asset Allocation

- Maximum Minimum and bourdaries are established for every asset class's portfolio proportion
- This lets the portfolio manager to take beriefit of market conditions, within the limits set by the minimum and maximum percentages
- This is the market timing sige of portfolio creation.
- If conditions benefit one asset class over another, the manager can time the market in the allowed percentages.
- The idea behind the tactical minimum and maximum percentages is that it permits the investment manager to move portfolio emphasis based upon market conditions.

Asset Classes

- Treasury Bills
- Treasury/Agency Bonds
- International Bonds
- Large Cap Stocks
- Mid Cap Stocks
- Small Cap Stocks
- International Stocks
- REITS

ALPHA AND BETA

Portfolio managers measure the risk through the use of Alpha and Beta.

Alpha

- It is measure of stock price volatility which is primarily based on the particular characteristics of that company
- The greater the Alpha, the greater the stock specific risk
- For instance, an alpha of +1 means that the stock is not anticipated increasing at all, depending on the fundamental factors for that company and industry.
- Though, an alpha of +1.75 means that the stock is projected to increase 75% in price dependent on those fundamental factors
- Alpha is not generally followed in the real marketplace

Beta

- It is a measure of stock price volatility which is based primarily on general market movements . The greater the beta, the more volatile the stock will be relative to the market.
- Beta only measures price volatility of a stock relative to the market, while the fundamental characteristics of that stock are overlooked when computing beta.
- For instance, a beta of +1 signifies that the stock is exactly as volatile as the market.
- If the beta is +3, this signifies that the stockchanges three times as fast e market
- If the beta is-1, this signifies that when the market goes up, this stock goes down at precisely the same rate.
- A totally diversified portfolio will have a beta of "1". This will signify that its movements match that of the general market. A portfolio with a beta of "1" would only be subject to systematic risk.
- A portfolio with a beta of more than "1" signifies that nonsystematic risk is still exists in the portfolio.
- High beta stock examples consist of technology and automobile companies. These stocks are highly volatile because their earnings vary substantially
- Low beta stock examples consist of utilities companies because their earnings are more steady form year to year, their prices normally move more slowly than the market overall

Chapter 19

Charts and Patterns

OVERVIEW

Technical analysis make efforts to forecast th price levels and trading volume patterns when positioned graphically on charts. Price patterns are mostly used to make buy and sell recommendations to investors

Technical analysts are usually called "chartists" because of their use of charts plotting stock price movements in determining market changes. future trend of prices based on historical

Trend lines

- Even though a stock's price may go up or down daily, over the time its price is likely to move in one direction.
- Technical analysts find patterns in the trend lines of individual stocks from graphs as they do patterns in the overall market.
- They base their buy or sell advises on a stock's price trend line - An upward trend line is generally bullish - A downward trend line is generally bearish

Resistance& Support Lines

Over the time period, the market or stock is likely to trade in a certain range. However, in few cases, there is an increase to a specific price level where heavy selling pressure is witnessed. This is well-known as a range of resistance. Prices are too expensive causing buying to die away. This is usually referred to as an "overbought" market where as at other times there is a fall to a particular price level causing investors to buy at the attractive lower price. This buying ends the price decline. This is well-known as a range of support. Prices become so attractive that selling ends and buying begins This is usually referred to as an "oversold" market.

In Resistance level, selling pressure tends to stop the market or security from increasing. high and will consider the price level to be overbought.

In Support level, buying pressure tends to stop the additional decline of the market or security. In few cases, investors believe that preceding selling has left prices at an attractive level and will consider the price level to be oversold.

In few cases, investors believe that preceding buying has left prices too

Breakout

- A breakout situation arises when the stock's price either increases beyond resistance level or declines undera support level.
- When this sort of situation happens, a technical analyst believes the price of the stock will continue to last on its course

- A breakout beyond the resistance level is considered to be a bullish sign. To gain from this, investors would likely to execute a buy stop order marginally above the resistance level. As the stock's price increased beyond resistance, the order will be executed
- A breakout below the support level is a bearish sign. Investors would want to sell short marginally under the support level. This can be attained by executing a sell stop order under the support level.

Reversals

A reversal specifies that a rising or a falling trend line has stopped and the stock's price is shifting in the opposite direction.

Between the two trend lines, a period of consolidation falls, and the stock price levels off. This would be a sideways movement, neither up nor down.

Saucer Patterns

A saucer is a chart pattern used by technical analysts which specifies that a stock has shaped a bottom in its trading cycle and is all set to rise. The bottom of the saucer pattern is a bullish sign for the stock.

Head and Shoulders Top

It is a sign ofa bearish reversal of an uptrend

Head and Shoulders Bottom

It is a sign of a bullish reversal of a downtrend

Reverse Saucer Pattern

The reverse of the saucer pattern is also called the inverse saucer, in which the stock forms a top in its pattern and is expected to decrease. This is mostly seen as a bearish indicator by the analysts.

Chapter 20

Registration Guidelines

This chapter has been combined by taking information from CDC Pakistan's official website and Karachi Stock Exchange's official website. The chapter includes the registration of the following

- Stock Exchange
- Central Depository Company
- Clearing House
- Agents and Brokers

Stock Exchange

Eligibility for Registration

According to section 4 of the Securities and Exchange Ordinance, 1969, any Stock Exchange which satisfies such conditions or complies with such requirements as may be prescribed to ensure fair dealings, protection of investors and its sustainable economic feasibility shall be qualified for registration. These requirements, among other matters, may relate to the following

- Qualifications for membership and admission, exclusion, suspension, expulsion and re-admission of members therein to or therefrom;
- Constitution and powers of the governing body and the powers and duties of the office bearers
- Representation [from a class or classes of persons or professions] on the governing body of a Stock Exchange or any of its Committees
- The manner in which business should be transacted including restrictions on the business of the members;
- Memorandum and Articles of Association, rules, regulations and by-laws of a
- Stock Exchange; and
- The maintenance of accounts and records including those of members, and their audit

Requirement for Registration

Under section 5 of the Securities and Exchange Ordinance, 1969, any Stock Exchange which is eligible for registration under section 4 can apply to the SECP for registration on Form I, First Schedule, on payment of prescribed fee.

Grant of Certificate of Registration

The SECP, if it is satisfied, after such inquiry and after obtaining such further information as it may consider necessary that the Stock Exchange is eligible for registration and that it would be in the interest of the trade and also in the public interest to register the
Stock Exchange may granta certificate of registration to the Stock Exchange.

Central Depository Company

Eligibility for Registration

Rule 3 of Central Depository Companies (Establishment and Regulation) Rules, 1996 sets out the eligibility requirements for a company desirous of commencing business as a central depository company, which are as the following.

- That such company is incorporated as a public limited company under the Companies Ordinance, 1984 (XLVII of 1984); that such company has entered into equity participation or technical collaboration arrangement with an internationally recognized institution or agency;
- that at least one stock exchange in Pakistan is a shareholder of such a company that no promoter, director, officer or employee of such a company-
    - has'been convicted of fraud, breach of trust or an offence involving moral turpitude or removed from service for misconduct or
    - has been adjudicated as insolvent has been associated with any illegal banking business, deposit taking or financial dealings;
    - has been a sponsor, director, chief executive or a senior management officer of a defaulting co-operative finance society or finance company; and defaulter of any commercial bank or financial institution beer including non-banking financial institution or has suspended payment or has compounded with his creditors; and

That the promoters of such company are persons of means and integrity and have special knowledge of matters which the company may have to deal with as a central depository company

Requirement for Registration

Under Rule 4 of the Central Depository Companies (Establishment and Regulation)

Rules, 1996, a company, which is eligible for registration under rule 3 as a central depository company, can make an application to the SECP in Form I. The application must be accompanied by a fee of five hundred thousand rupees as registration fee.

Grant of Certificate of Registration

If the SECP is satisfied, after such inquiry and after obtaining such further information as it may consider necessary, that the applicant is eligible for registration and it would be in the interest of the capital market so to do, may grant a certificate of registration to such company on such conditions as it may deem appropriate.

Clearing House

Eligibility for Registration

Rule 3 of Clearing Houses (Registration and Regulation) Rules, 2005 sets out requirements for any person desirous of commencing business as a clearing house which are:-

- That such person is incorporated as a public limited company under the
- Ordinance of 1984;
- That at least one stock exchange in Pakistan is a shareholder of such house;
- That no promoter, director, officer or employee of such house
    - Has been convicted of fraud, breach of trust or an offence involving moral turpitude or removed from service for misconduct adjudicated as insolvent
    - Has associated with any illegal banking business, deposit taking or financial dealings
    - Has been a sponsor, director, chief executive or a senior management officer of a defaulting co-operative finance society or finance company; or
    - Has been a defaulter of any commercial bank or financial institution or non-banking financial institution or has suspended payment or has compounded with his creditors or has been
- That promoters of such house are persons of means and integrity and have special knowledge of matters which the house may have to deal with as a clearing house; and
- That such person has complied with such other conditions as may be required by the SECP in the interest of the capital market

Requirement for Registration

- Under Rule 4 of the Clearing Houses (Registration and Regulation) Rules, 2005, any person eligible for registration under rule 3 of the Clearing Houses (Registration and
- Regulation) Rules, 2005 can make an application to the SECP in such manner as the
- SECP may prescribe from time to time. The application must have accompanied by a fee as may be specified by the SECP with the approval from policy board

Grant of Certificate of Registration

- If the SECP is satisfied, after such inquiry and after obtaining such further information as it may consider necessary, that the applicant is eligible for registration and it would be in the interest of the capital market so to do, may grant a certificate of registration under its seal to such house.

Agents (Jobber) and Broker

- BROKER AND JOBBER
- BROKER: He is one acts as a intermidiary on behalf of others. A broker in a stock exchange ,is a commission agent who transacts business in securities on behalf of non members.
- JOBBER: He is not allowed to deal with the public directly .He deals with brokers who are engaged with the investors Thus, the securities is bought by the jobber from members and sells to members who are operating on the stock exchange as broker.

Application for Registration

A member desirous of acting as broker shall make an application to the SECP in Form as set out in the First Schedule of the Brokers and Agents Registration Rules 2001 for grant of a certificate of registration through the stock exchange of which he is a member. The exchange shall forward the application to the SECP within 14 days from he date of its receipt.

Eligibility for Registration

- A person is eligible for registration as a broker, if he is a member of the stock exchange; is not less than twenty-one years of age; is a citizen of Pakistan
- That promoters of such house are persons of means and integrity and have special knowledge of matters which the house may have to deal with as a clearing house; and
- That such person has complied with such other conditions as may be required by the SECP in the interest of the capital market has at least passed graduation or equivalent examination from an institution recognized by the Government;
- Provided that the SECP may relax the educational qualification in suitable cases on merit having regard to the applicant's experience is not a lunatic or a person of unsound mind; has not been convicted of an offence involving fraud or breach of trust has not been adjudicated as insolvent or has suspended payment or has compounded with his creditors; has experience of not less than five years in the business of buying selling dealing in securities has not been a partner of a brokerage firm or a director of a brokerage company which has been convicted of an offence concerning brokerage; has not defaulted in payment of dues at clearing house; or

Grant of Certificate of Registration

The SECP if it is satisfied that the applicant is eligible for registration as a broker, and that it is in the interest of the stock market to do so, may grant certificate of registration to the applicant. The certificate of registration of a broker shall be valid for one year from the date of issue.

Renewal of Registration

The certificate of registration is renewable on payment of fee as prescribed in the Second Schedule of the Rules. Requirements of initial registration are applicable to renewal of the registration

Chapter 21

Sources of Financial Information

ANNUAL REPORTS

It is a report that is shared with all the stockholders which covers all of the important financial data required by a financial analyst.
The income statement and balance sheet will be presented and analyzed by the company's management
Additional notes to financial statements are also included which will includes itemS such as the; -
Methods of depreciation - Inventory valuation used
Market price of securities
Fully diluted earnings per share
Any other data needed to make the presented data understandable and complete

NEWSPAPER LISTINGS

Stocks and bond prices are listed every day in the financial part of the newspaper
Investors are able to observe their investments, as well as the performance of companies
Information found in the newspaper is normally relevant to both fundamental and technical analysis
Daily stock section in the newspaper will provide the following information to investors;

- -Closing market price –
- Dividend –
- Yield - P/E ratio
- Trading volume

The following section reflects the financial events that have an effect on the financial statements of a company:

- Paying a cash dividend: Cash is classified as a current asset, and dividends payable as a current liability. They are both reduced by equal amounts. This will have NO effect on net working capital or stockholder's equity
- Announcing a cash dividend: Retained earnings (part of stockholder's equity) is reduced and dividends payable (part of current lia decrease net working capital as current liabilities and current assets remain unchanged lities) is increased. This will decrease net working capital as current liabilities and current assets remain unchanged.
- Stock Dividends: Only the stockholder's equity portion of the balance sheet is affected. The number of common shares increases, retained earnings is decreased, and an adjustment to capital surplus may be made.
- Stock Split: Only stockholders' eguity is affected. The number of common shares and the par value per share are changed based on the stock split but the total par value remains the same.
- Buying Equipment or Machinery for Cash: Cash which is a current asset is reduced and equipment, a fixed asset, is increased by the same amount. This will decrease net working capital because current assets are reduced and current liabilities remain the same

Chapter 22

Financial

Formulas Recap

LIQUIDITY FORMULAS

(+) add (-) subtract (/) divide (=) equals

- Net Working Capital = Total current assets-Total current liabilities
- Current Ratio = Total current assets / Total current liabilities
- Quick Asset Ratio = Total current assets-Inventory/Total current liabilities
- Cash Flow = Net Income (or loss) +Annual Depreciation

Capitalization Ratios

- Bond Ratio = Par value of bonds/Total long-term capital
- Preferred Stock Ratio = Par value of preferred stock/Total long-term capital
- Common Stock Ratio = Common stock at par +Capital surplus
- Total long-term capital
- Debt to Equity Ratio = Bonds +Preferred stock/Common st surplus +Retained earnings + Retained earnings
- Capital at par +

Coverage Ratios

Bond Interest Coverage = Earnings before interest&taxes/Annual bond interest expense
Preferred Dividend Coverage = Net income/Preferred dividends

Use of Assets

- Inventory Turnover Rate = Cost of goods sold/Inventory
- Book Value per Common Share = Total assets Intangibles -Preferred stock
- Number of outstanding shares

Profitability

- Operating income/Net sales
- Operating Profit Margin
- Net Profit Margin = Net income/Net sales

- Return on Common Equity = Net income-Preferred dividends/ Common stock at par +Capital surplus + Retained earnings

Evaluation of Earnings

- Earnings per share shares = Net income-Preferred dividends/ Number of outstanding
- Price/Earnings Ratio = Market price/Earnings per share
- Dividend Payout Ratio = Annual dividend paid on common stock/Earnings per share
- Current Yield Annual dividend per common share/Current market price

Chapter 23

Fundamental Analysis

OVERVIEW

This chapter will focus on fundamental analysis which includes balance sheets, income statements, financial events, financial ratios, analysis of a company's earnings and how to understand information found in a stock table.

FUNDAMENTAL ANALYST

The fundamental analyst takes his/her investment decisions based on fundamentals of corporations. The analyst will normally examine the following

- Outlook for the industry
- Management of the company
- Product lines of the company
- Market share of the company
- Expected introduction of new products by the company
- Companies issue quarterly and annual financial reports for their shareholder that includes a company's balance sheet and income statement.

BALANCE SHEET

The balance sheet provides a picture of a company's financial position at a specific point in time. It signifies the value of the company's assets (what it owns) and its liabilities (what it owes). The difference among the assets and the liabilities is the corporation's equity or net worth. It is called a balance sheet because the total assets will always equal the sum of the total liabilities in addition to the stockholder's equity as shown as an example on next page;

Balance Sheet, Sam's Appliance Shop

ASSETS		
Current Assets:		
Cash		$ 49,855.00
Accounts Receivable	$179,225.00	
Less Allowance for Doubtful Accounts	6,000.00	173,225.00
Inventory		455,455.00
Prepaid Expenses		8,450.00
TOTAL CURRENT ASSETS		$686,985.00
Fixed Assets		
Land		$ 59,150.00
Buildings	$74,650.00	
Less Allowance for Depreciation	7,050.00	67,600.00
Equipment	22,375.00	
Less Allowance for Depreciation	1,250.00	21,125.00
Furniture and Fixtures	10,295.00	
Less Allowance for Depreciation	1,000.00	9,295.00
TOTAL FIXED ASSETS		$157,170.00
INTANGIBLES		3,500.00
TOTAL ASSETS		$847,655.00
LIABILITIES		
Current Liabilities:		
Accounts Payable		$152,580.00
Notes Payable		83,920.00
Accrued Wages/Salaries Payable		38,150.00
Accrued Interest Payable		42,380.00
Accrued Taxes Payable		50,820.00
TOTAL CURRENT LIABILITIES		$367,850.00
Long-Term Liabilities:		
Mortgage		$127,150.00
Note		85,000.00
TOTAL LONG-TERM LIABILITIES		$212,150.00
OWNER'S EQUITY		
Sam Lloyd, Capital		$267,655.00
TOTAL LIABILITIES AND STOCKHOLDER'S EQUITY		$847,655.00

Assets

Assets are classified into current Assets which comprises cash and assets easily convertible into cash as well as other assets which include fixed assets (that could eventually be sold) and other assets (usually intangible and only of value to the corporation owning them).

Current Assets

Cash and equivalents: cash and short-term safe investments, such as money- market instruments, can be sold without difficulty as well as other marketable securities

Accounts receivables: Money owed to the company by clients who buy goods and have not yet paid. The company expects to receive these funds within one to three
Donths' time period

Inventory. The cost of raw materials, wor availabe for sale. Of the total current assets, inventories are the least liquid as they can be difficult to dispose of at full value. in process and finished goods readily

-Last in First out (LIFO): It is a method of inventory valuation. Under LIFO, the cost of the final item produced is applied to the price of the first item sold from inventory. Using
LIFO during an inflationary period would result in lower profits and lower taxes - First in First out (FIFO): It is also a method inventory valuation. Under FIFO, the cost of the first item produced is applied to the money received from the first item sold. FIFO would result in a higher profit because a lower cost basis is applied. Hence, the company would report larger profits and pay a larger amount of taxes.

Prepaid Expenses: These are items that a company has already paid for, but has not yet benefited from which include prepaid advertising, rents, and taxes and operating supplies

Fixed Assets

Fixed assets are items used by the company in its day-to-day operations to produce its products. These assets are not planned to be sold or converted into cash. They are usually property, plant and equipment. Unlike, current assets, they are not easily converted into cash. Fixed assets, with the exception of land, lose some of their value every year due to normal use. The IRS allows a company to claim this wear and tear on assets as a deduction against income. This deduction is known as depreciation.
On a balance sheet, fixed assets are presented at a value of their original cost less accumulated depreciation which is the amount of depreciation claimed on the asset to date

Depreciation Methods

Straight-Line Method: The same amount of depreciation is applied every year. It is calculated by dividing the cost of the asset by its useful life
Accelerated Method: This method lets larger depreciation deductions than straight- line in the asset's past year

Other Assets

Other assets such as intangible assets do not have any physical value but they increase substantial value to a company. Few intangible assets differentiate the company from competitors and are proprietary such as patents, trademarks franchises and copyrights
Goodwill is an example of an intangible asset. Goodwill shows the amount that was paid higher than the value of the assets to acquire the company. Factors that contribute to goodwill would be company's possible earning power due to its reputation in the marketplace, customer relations and skilled staff

Liabilities

Total liabilities on a balance sheet show all financial claims by creditors against the corporation's assets (corporate debts). The liabilities portion of the balance sheet is listed by Current Liabilities and Long-Term Liabilities

Current Liabilities

Those debt obligations that will become due in less than one year.

Examples of current liabilities include; -

- Accounts Payable: The amount a company owes for goods and services bought on credit
- Accrued Wages Payable: Include unpaid wages, salaries, commissions and interest. - Notes Payable: Include short-term loans from banks and other financial institutions.
- Dividends Payable: Cash dividends that have been announced by the Board of
- Directors but have not been paid.
- Taxes Payable: The amount of tax that is owed to the government by the company
- Interest Payable: The amount of interest the company owes on its long-term debt.

Long-Term Liabilities

- Long-term debts are financial debt obligations due for payment after twelve months
- Long-term examples include;
- Bonds (known as funded debt)
- Long-term bank loans

Stockholders' Equity

The stockholders' equity is also known as net worth or owner's equity - It signifies the stockholders' claims on a company's assets after all of its creditors have been paid. - It signifies the shareholders' ownership interest - Shareholders' equity equals to total assets less total liabilities.

Types of Stockholders' Equity

- **Preferred Stock:It** is stated on the balance sheet and is based upon the par value of the outstanding shares. The usual par value for preferred stock in USA is $100. In certain cases, the preferred stock dividend may be stated as a percentage of its par value
- **Common Stock:** Common stock is stated on the balance sheet and is based upon the par value of the company's outstanding common stock. The par value of a stock is only used for bookkeeping needs. The common stock's par value does not affect the market price of the stock. shareholders higher than par value for shares sold to the public by the company. It is also known as "paid-in capital" or "paid-in surplus"
- **Retained Earnings** (earned surplus): Retained earnings show net profits that have been invested back in the company for future. Dividends are usually paid from retained earnings
- **Capital Surplus:** The amount of premium paid by

Balance Sheet Terminology

Capitalization: This is the combined value of company's long-term debt and equity accounts.

Liquidity

- Working capital is the amount of capital or cash that a company has available.
- Hence, working capital is a measure of a firm's liquidity, its capability to quickly turn assets into cash to meet its short-term debts.
- The formula for working capital is: Current Assets-Current Liabilities = Working Capital

INCOME STATEMENT

The income statement details all sources of revenue and expenses for the year. It is also known as a profit and loss statement. The purpose of this statement is to detail the company's net income (or net loss). This is accomplished by offsetting the revenues by expenses. The following is the Income Statement example of a corporation:

INCOME STATEMENT, SAM'S APPLIANCE SHOP

SALES REVENUE		$1,870,841.00
Cost of Goods Sold:		
Beginning Inventory 1/1/8X	$ 805,745.00	
Purchases	939,827.00	
Goods Available for Sale	1,745,572.00	
Less Ending Inventory 12/31/8X	455,455.00	
COST OF GOODS SOLD	1,290,117.00	
GROSS MARGIN		$ 580,724.00
Operating Expenses:		
Advertising	$ 149,670.00	
Insurance	56,125.00	
Depreciation		
Building	18,700.00	
Equipment	9,000.00	
Salaries	224,500.00	
Travel	4,000.00	
Entertainment	2,500.00	
TOTAL OPERATING EXPENSES		$ 464,495.00
General Expenses		
Utilities	$ 5,300.00	
Telephone	2,500.00	
Postage	1,200.00	
Payroll Taxes	25,000.00	
TOTAL GENERAL EXPENSES		$ 34,000.00
Other Expenses		
Interest	$ 19,850.00	
Bad Check Expense	1,750.00	
TOTAL OTHER EXPENSES		$ 21,600.00
TOTAL EXPENSES		$ 520,095.00
NET INCOME		$ 60,629.00

Components of the Income Statement

- Sales: It is derived from the total money received from the company's primary source of business.
- Operating Expenses: It expresses the daily costs of doing business. Included in this part is the amount claimed for the depreciation of fixed assets
- Operating Income: It is a result of sales less operating expenses.
- Other Income: If there is other income it will be added to the Operating Income
- Other income will include income generated by investments (dividends and interest)
- Earnings before Interest and Taxes (EBIT): This is the addition of Operating Income plus Other Income. EBIT is deducted by bond interest and taxes to reach net income or net loss
- Bond Interest Expense: Bond interest is required to be paid irrespective of the company's profitability. If it cannot be paid, the company is in default. The amount of interest paid is created by multiplying the total par value of the bonds by the coupon rate. Also note that interest is paid before the taxes.
- Taxes: Taxes are paid to the government and deducted (rate of tax is indicated on the
- Income Statement).
- Net Income or Loss: This is the outcome of all of the above.

Statement of Changes to Retained Earnings

The Statement of Retained Earnings represents all changes to Retained Earnings during the year

- Net income increases retained earnings
- Dividend distributions decrease retained earnings

ANALYZING FINANCIAL STATEMENTS

The fundamental analyst uses the information froma company's financial statements to analyze the financial strengths and weaknesses of a company. Then analysts will match the company's performance with other companies within the same industry.
Several financial ratios and formulas will evaluate information about the company's liquidity, capitalization, ability to meet fixed costs and profitability. Formulas used to calculate financial ratios include:

Liquidity Ratios

Liquidity ratios will specify a company's ability to meet its short-term debts as well as convert current assets into cash.
Liquidity is usually analyzed by calculating the following;

Net Working Capital

Companies need working capital to finance their daily operations
Working capital will improve the company's ability to meet its current obligations expand its production and take benefit from opportunities.
Net working capital = Total Current Assets-Total Current Liabilities

Current Ratio

- This ratio specifies the company's ability to pay its current liabilities by using current assets.
- A low current ratio will show a working capital problem.
- Current Ratio = Total Current Assets divided by Total Current Liabilities
- Current Ratio is safe at 2:1

Quick Asset (Acid Test) Ratio

- The quick asset ratio is a more strict measure of liquidity than the current ratio as it deducts out the company's inventory
- Quick Assets = Total Current Assets less inventory divided by the current liabilities
- A quick asset higher than 1 to 1 is usually considered safe because it specifies that the company would be able to pay its bills for a short time period without any revenues or sales

Cash Asset Ratio

- This is the most stringent test of a company's ability to meet its current obligations
- Fundamental analysts oversee number to assess the company's ability to meet current expenses and dividends
- Cash Flow = Net Income (or loss) in addition of Depreciation Expense
- A positive cash flow shows that the company has sufficient income to pay expenses and possibly make dividend distributions.
- A negative cash flow shows that the company is losing money and may have trouble meeting its short-term obligations.

Capitalization Ratios

Capitalization ratios are used by analysts to measure the company's risk of bankruptcy
The first step is to compute the Total Long-Term Capital. This consists of the total stockholders' equity section in addition of long-term liabilities.

Bond Ratio

This ratio represents the percentage of long-term capital that is attributable to bonds
Bond Ratio = Par Value of Bonds divided by Total Long-Term Capital

Preferred Stock Ratio

Preferred Stock Ratio = Par Value of Preferred Stock divided by the Total Long-

Term Capital

Common Stock Ratio

Common Stock Ratio= Common stock at Par +Capital Surplus

Earnings divided by the Total Long-Term Capital + Retained

Additional Financial Formulas

Debt-to-Equity Ratio = Bonds +Preferred Stock divided by Common Stock at Par +Capital Surplus+Retained Earnings

Return on Common Equity

Return onCommon Equity

Common Stock at Par +Capital Surplus +Retained Earnings

Net Income Preferred Dividends divided by

Inventory Turnover

Inventory Turnover Rate = Cost of Goods Sold divided by the Inventory

Book Value per Common Share

Book Value Per Common Share = Total Assets-Intangibles-Total Liabilities-

Preferred Stock divided by the Number of Outstanding Common Shares.

Evaluation of Earnings

Earnings per Share (EPS)

- Contributes to the market price of a stock
- Calculation indicates the amount of earnings available to the common stockholder

EPS = Net Income-Preferred Dividends divided by the Number of Outstanding Shares

Earnings per Share on a Fully Diluted Basis

If a corporation has rights, warrants, convertible preferred stock or convertible bonds outstanding, the earnings per share (EPS) could be diluted (decreased) by an increase in the number of shares of common outstanding or, if the same amount of earnings available to common shareholders were allocated to more shares of stock, earnings would be less for each share. So, the EPS after dilution take lity that all convertible securities have been converted into the common.

Facts Needed to Calculate the EPS on a Fully Diluted Basis:

- For Example ABC Ltd primary EPS is 14.33
- 10,000,000 of 7% Preferred Stock (Conversion Price 20)
- 35% tax rate
- 1,000,000 common shares outstanding

Step 2: Calculate the EPS
EPS =(Net Income) less (Preferred Dividends) divided by (outstanding shares)

Step 3: If the convertible preferred stock is required to be converted then the EPS
Would be lower because of the additional outstanding common shares from the conversion. This is the EPS on a fully diluted basis.

Price Earnings Ratio (P/E)

- The P/E ratio is broadly used as it offers investors with a rough idea of the relationship between the prices of different common stocks compared to the earnings that accrue to one share of stock.
- The P/E ratio is calculated by taking the Current Market Price of the common stock and divided it by the Earnings Per Share (EPS).
- A P/E ratio of 15 means that the stock is selling at 15 times of its earnings

Chapter 24

A glance at

NASDAQ and OTC Markets

The material of this chapter has been taken from NASDAQ'S official website and series 7 exam materials for US markets.

NASDAQ

- The NASDAQ, NASD Automated Quotation service, is an electronic quotation system that shows the bid and ask prices of the more actively traded OTC stocks
- There over 10,000 stocks that trade OTC
- Larger issues such as MCI and Microsoft qualify for listing on the NASDAQ Stock
- Market which includes approximately 4,000 issues
- Smaller NASDAQ issues are the "small capitalization" issues
- Bulletin Board (OTCBB) stock is too small for the NASDAQ or the small capitalization issues. There are no listing requirements for these stocks
- The Nasdaq National Market (NNM) represents the larger and most actively traded stocks trading OTC

Over the Counter Market (OTC)

- The OTC market is the market in which broker-dealers negotiate trades directly with one another
- The following securities are traded or issued in the OTC market;
- OTC stocks
- New issues through an IPO
- Corporate bonds not listed on an exchange
- U.S. Government
- Government Agency debt
- Municipal bonds
- Money market instruments
- Bank issues
- Insurance issues
- American Depository Receipts (ADR)

- Closed end investment companies

FINANCIAL NEWS SOURCES

Pink Sheets

The smallest issues, also known as "penny stocks", are quoted in the Pink Sheets
The Pink Sheets is a weekly paper for OTC quotes to which dealers can subscribe
The quotes found in the Pink Sheets are on a wholesale basis. This means the broker- dealer's trader buying stock would have to mark the price up to build in a profit.

Yellow Sheets

The Yellow Sheets is a daily printing of wholesale quotes for OTC Corporate Bonds

Blue List

The Blue List is a daily printing of quotes for Municipal Bonds. They are primarily municipal bonds that are available in the secondary market, but can also include other types of secondary bonds.

OTC OPERATIONS

- Any OTC member is allowed to register as a market maker in an issue if minimum requirements are met.
- Retail broker-dealers are allowed to act as OTC market makers.
- NASDAQ traders, market makers, broker-dealers and even registered representatives are connected to the NASDAQ system
- There are three (3) levels to the NASDAQ system in which you need to become familiar with
- Level 1 is a summary of Level II which is known as the "Inside Market", best bid and best ask prices. This level is seen by registered representatives
- Level II shows all the market makers making a market in a particular stock. Each market maker posts its own bid and ask prices based on their interpretation of the market
- Level II also has "Firm Quotes" which means the individual market makers quarantee their quotes as shown in Level II. Firm quotes have no qualifications or restrictions.

Inside Market

Inside market quotes are found in Level I which is a summary of Level II. In other words, the best bid (price stock is sold at) and the best ask (price stock is bought at) from all the market makers are only shown on this screen.

- When an order comes in the trading desk will buy from the dealer offering the best price. In this case, the best Ask is 20.50 as it is the lowest.
- The best Bid, price stock is sold at, is the Sal Smith Barney quote of $20.25 which is the highest price available of all the market makers when selling stock

Backing Away

- The NASD prohibits "backing away" from a quote, that is, giving a firm quote and then failing to honor that quote.

Types of Quotes

- **Firm Quote:** A firm quote is the price at which a market maker or broker dealer stands ready to buy or sell at least 100 shares of stock at the quoted price with other
- NASD member firms. When an OTC firm makes a market in a security, the broker- dealer must be willing to buy or sell at least 100 shares of the security at its firm qote.
- **Subject Quote:** A subject quote means the quote is subject to confirmation and tentative. The quote is an approximate price and can be changed. Therefore, subject quotes are not firm quotes
- **Nominal Quote:** A nominal quote is not even a quote. It is a dealer's guess or assessment at the current price, but the dealer is not willing to trade at that quote.
- **Workout Quote:** A workout quote is an approximate quote with the dealer working out the exact price at which he/she will trade later on. A workout quote is not a firm quote

Front Running

The NASD prohibits "front running" a customer's order. When the firm is holding an order from a customer, the firm executes an equivalent transaction for its own account before executing the customer's order.

COMPUTERIZED ORDER ROUTING

While each exchange has developed their own electronic systems, automated order routing systems link the specialists from each exchange through the Inter market
Trading System ITS

New York Stock Exchange Super Dot

- Super Dot processes nearly 75% of all orders going through the NYSE each day.
- Broker-dealers use this computerized order routing system to choose an order's destination
- An order can be routed directly to the appropriate specialist or sent to the brokerage firm's house booth for handling by the commission broker.
- Once the specialist or commission broker receives the order, it is presented in the auction market
- Orders can be sent through the system either on a preopening or postponing basis
- The computer automatically pairs preopening orders received before the opening of trading with other orders and executes them at the opening market.
- Any order that cannot be matched before the opening is given the specialist to handle
- For a postponing order it is sent directly to the specialist post and presented to the crowd
- All NYSE listed stocks are eligible for trading on Super Dot subject to limits which you do NOT need to know for the exam.

NASD SOES System

The NASD has implemented two automated trading systems for NASDAQ issues.
1. Super SOES: This system is for automated trades of NASDAQ NNM issues
2. Small Cap SOES: This system is for automated trading of NASDAQ Small Cap issues.

SOES Advantages

- It is time efficient as a trader does not have to telephone to execute the trade as all trades are affected through "touch screens" automatically
- SOES is cost efficient as it is less expensive to effect trades through SOES than to handle the trade over the phone
- Trading errors are reduced because trading is automated and the Matching of dealer confirmations is also automated .