Different types of instruments in capital market pdf

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Listen to this: Capital market, also known as the securities market is a market where the funds from the investors are made available to the companies and government for the development of the projects. Similarly, if a company wants money to expand its business, then it can issue shares in the stock market and investors who want to invest in that company can buy these shares. The Capital Market includes the bond market as well as the securities market. It serves as a pathway for entities that have a surplus fund that is being transferred to the ones who need capital for their business purpose. These funds are being utilized by the companies in multiple ways into productive areas. In this blog, we will discuss what are the functions and 5 types of instruments that are traded in the capital market. What are the Functions of the Capital Market? It is the best medium of finance for companies and offers different modes of investment avenues to all investors which encourage building capital. The main functions of the capital market are: The capital market acts as the link between the investors and savers.It helps in facilitating the movement of capital to more productive areas to boost the national income.It boosts economic growth.It helps in the mobilization of savings for financing long term investment.It facilitates the trading of securities.It reduces transaction and information cost.It helps in quick valuations of financial instruments.Through derivative trading, it offers hedging against market risks.It helps in facilitating transaction settlement.It improves the effectiveness of capital allocation.It provides continuous availability of funds to the companies and government. What are the types of Capital Market? Capital Market can be divided into Primary Market and the Secondary Market: 1. Primary Market: The primary market is a new issue market that mainly deals with the issues of new securities. It is a place where the trading of financial instruments is done for the first time also known as Initial Public Offer (IPO). Now, let us discuss the main functions of the primary market: Origination: Origination refers to the examination, evaluation, and process of new project proposals in the primary market. It begins before an issue is presented in the market with the help of commercial bankers.Underwriting: Underwriting firms ensure the success of new issues that guarantee minimum subscription. When the issue remains unsold then it is bought by the underwriters.Distribution: For the success of the issue generally the brokers and dealers who are in direct contact with investors are given the job of distribution. 2. Secondary Market: The secondary market is another type of capital market where trading takes place for existing securities. It is known as the stock market where the securities are bought and sold by the investors. Let us discuss the main functions of the secondary market: It regularly informs about the value of security.It offers liquidity to the investors for their assets.It involves continuous and active trading.It provides a marketplace where the securities are traded. What are the instruments traded in the Capital Market? Below are the 5 types of instruments that are traded in the capital market: Equity securities refer to the part of ownership that is held by shareholders in a company. In simple words, it refers to an investment in the company's equity stock for becoming a shareholder of the organization. The main difference between equity holders and debt holders is that the former does not get regular payment, but they can profit from capital gains by selling the stocks. Also, the equity holders get ownership rights and they become one of the owners of the company. When the company faces bankruptcy, then the equity holders can only share the residual interest that remains after debt holders have been paid. Companies also regularly give dividends to their shareholders as a part of earned profits coming from their core business operations. 2. Debt Securities: Debt Securities can be classified into bonds and debentures: 1. Bonds: Bonds are fixed-income instruments that are primarily issued by the centre and state governments, municipalities, and even companies for financing infrastructural development or other types of projects. It can be referred to as a loaning capital market instrument, where the issuer of the bond is known as the borrower. Bonds generally carry a fixed lock-in period. Thus, the bond issuers have to repay the principal amount on the maturity date to the bondholders. 2. Debentures: Debentures are unsecured investment options unlike bonds and they are not backed by any collateral. The lending is based on mutual trust and, herein, investors act as potential creditors of an issuing institution or company. 3. Derivatives: Derivative instruments are capital market financial instruments whose values are determined from the underlying assets, such as currency, bonds, stocks, and stock indexes. The four most common types of derivative instruments are forwards, futures, options and interest rate swaps: Forward: A forward is a contract between two parties in which the exchange occurs at the end of the contract at a particular price.Future: A future is a derivative transaction that involves the exchange of derivatives on a determined future date at a predetermined price.Options: An option is an agreement between two parties in which the buyer has the right to purchase or sell a particular number of derivatives at a particular price for a particular period of time.Interest Rate Swap: An interest rate swap is an agreement between two parties which involves the swapping of interest rates where both parties agree to pay each other interest rates on their loans in different currencies, options, and swaps. 4. Exchange-Traded Funds: Exchange-traded funds are a pool of the financial resources of many investors which are used to buy different capital market instruments such as shares, debt securities such as bonds and derivatives. Most ETFs are registered with the Securities and Exchange Board of India (SEBI) which makes it an appealing option for investors with a limited expert having limited knowledge of the stock market. ETFs having features of both shares as well as mutual funds are generally traded in the stock market in the form of shares produced through blocks. ETF funds are listed on stock exchanges and can be bought and sold as per requirement during the equity trading time. 5. Foreign Exchange Instruments: Foreign exchange instruments are financial instruments represented on the foreign market. It mainly consists of currency agreements and derivatives. Based on currency agreements, they can be broken into three categories i.e spot, outright forwards and currency swap. How to Invest in these Instruments? The first step that investors need to take in order to invest or trade in these capital market financial instruments is by opening a trading account through a registered broker. Then you will be able to place a buy or sell order from your trading platform for trading or investing in these financial instruments. After opening the account you can research the stocks in which you want to invest with the help of StockEdge. Watch our video below on how to start investing in the stock market: Bottomline: All these five types of instruments are part of the capital market. As each of them is unique and has distinguishing features, they are traded in different ways. Thus, it is important to understand these different types of capital market instruments so that you can invest in them according to your financial goals. Frequently Asked Questions: Money markets are mainly used for short-term borrowing of the assets which are held for less than a year or one year whereas, Capital Markets are used for long-term securities which have a direct or indirect impact on the capital. Capital markets include both the equity market and the debt market. There are mainly two types of capital markets, primary and secondary markets. The primary market is where a private company goes public by making its shares available for trading to the public while the secondary market is where those shares are traded by investors. Bonds are backed by the collateral or asset of the issuer. On the other hand, debentures are not backed by any of the physical assets or collateral. Happy Investing! Tags: basiccapital marketstock markettrading instruments The capital market, as it is known, is that segment of the financial market that deals with the effective channeling of medium to long-term funds from the surplus to the deficit unit. The process of transfer of funds is done through instruments, which are documents (or certificates), showing evidence of investments. The instruments traded (media of exchange) in the capital market are: 1. Debt Instruments A debt instrument is used by either companies or governments to generate funds for capital-intensive projects. It can obtained either through the primary or secondary market. The relationship in this form of instrument ownership is that of a borrower – creditor and thus, does not necessarily imply ownership in the business of the borrower. The contract is for a specific duration and interest is paid at specified periods as stated in the trust deed* (contract agreement). The principal sum invested, is therefore repaid at the expiration of the contract period with interest either paid quarterly, semi-annually or annually. The interest stated in the trust deed may be either fixed or flexible. The tenure of this category ranges from 3 to 25 years. Investment in this instrument is, most times, risk-free and therefore yields lower returns when compared to other instruments traded in the capital market. Investors in this category get top priority in the event of liquidation of a company. When the instrument is issued by: The Federal Government, it is called a Sovereign Bond; A state government it is called a State Bond; A local government, it is called a Municipal Bond; and A corporate body (Company), it is called a Debenture, Industrial Loan or Corporate Bond 2. Equities (also called Common Stock) This instrument is issued by companies only and can also be obtained either in the primary market or the secondary market. Investment in this form of business translates to ownership of the business as the contract stands in perpetuity unless sold to another investor in the secondary market. The investor therefore possesses certain rights and privileges (such as to vote and hold position) in the company. Whereas the investor in debts may be entitled to interest which must be paid, the equity holder receives dividends which may or may not be declared. The risk factor in this instrument is high and thus yields a higher return (when successful). Holders of this instrument however rank bottom on the scale of preference in the event of liquidation of a company as they are considered owners of the company. 3. Preference Shares This instrument is issued by corporate bodies and the investors rank second (after bond holders) on the scale of preference when a company goes under. The instrument possesses the characteristics of equity in the sense that when the authorised share capital and paid up capital are being calculated, they are added to equity capital to arrive at the total. Preference shares can also be treated as a debt instrument as they do not confer voting rights on its holders and have a dividend payment that is structured like interest (coupon) paid for bonds issues. Preference shares may be: Irredeemable, convertible: in this case, upon maturity of the instrument, the principal sum being returned to the investor is converted to equities even though dividends (interest) had earlier been paid. Irredeemable, non-convertible: here, the holder can only sell his holding in the secondary market as the contract will always be rolled over upon maturity. The instrument will also not be converted to equities. Redeemable: here the principal sum is repaid at the end of a specified period. In this case it is treated strictly as a debt instrument. Note: interest may be cumulative, flexible or fixed depending on the agreement in the Trust Deed. 4. Derivatives These are instruments that derive from other securities, which are referred to as underlying assets (as the derivative is derived from them). The price, riskiness and function of the derivative depend on the underlying assets since whatever affects the underlying asset must affect the derivative. The derivative might be an asset, index or even situation. Derivatives are mostly common in developed economies. Some examples of derivatives are: Mortgage-Backed Securities (MBS) Asset-Backed Securities (ABS) Futures Options Swaps Rights Exchange Traded Funds or commodities Of all the above stated derivatives, the common one in Nigeria is Rights where by the holder of an existing security gets the opportunity to acquire additional quantity to his holding in an allocated ratio. *Note: a Trust Deed is a document that states the terms of a contract. It is held in trust by the Trustee.

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