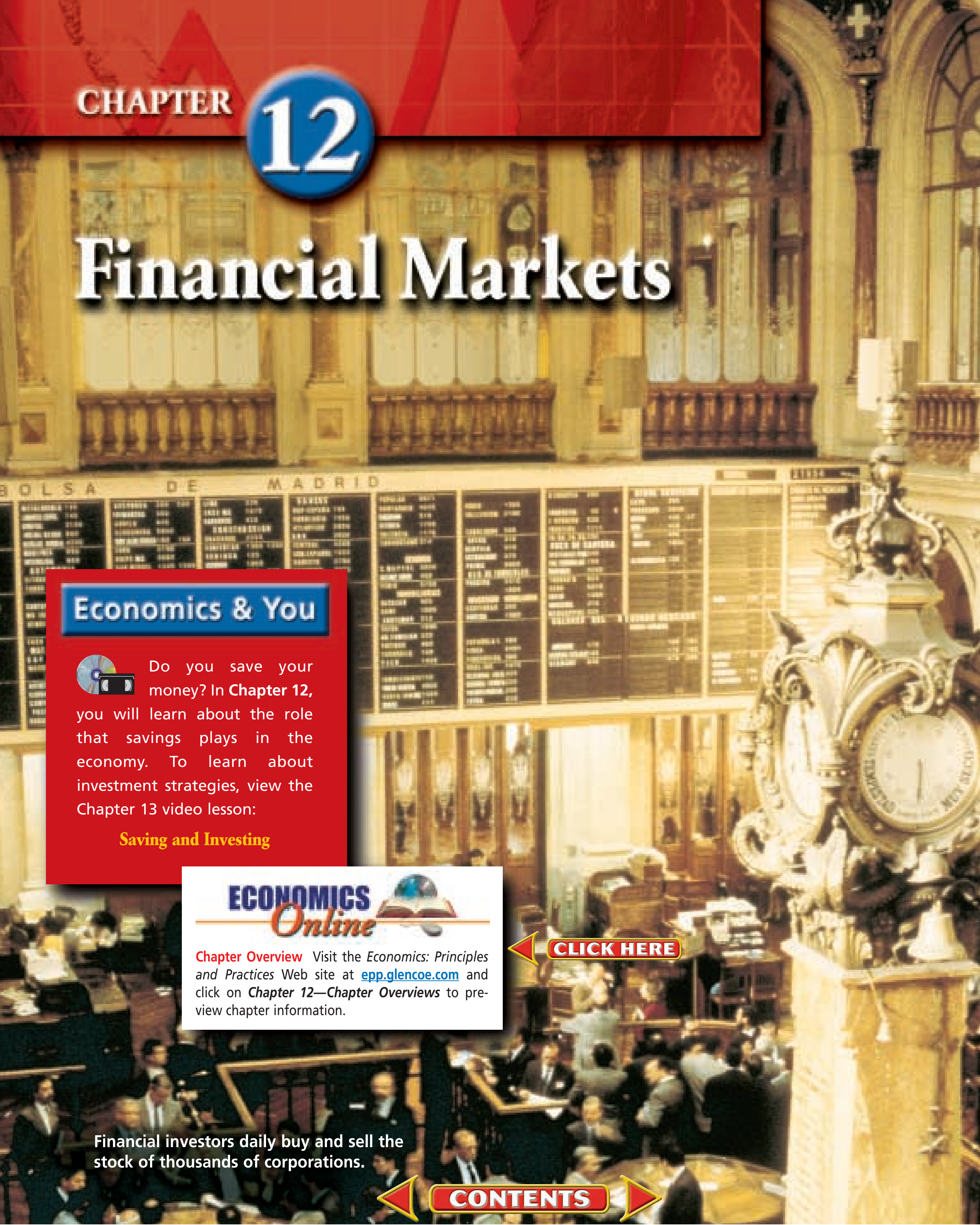


CHAPTER 12

Financial Markets

Economics & You

Do you save your money? In **Chapter 12,** you will learn about the role that savings plays in the economy. To learn about investment strategies, view the Chapter 13 video lesson:

Saving and Investing

ECONOMICS Online

Chapter Overview Visit the *Economics: Principles and Practices* Web site at epp.glencoe.com and click on ***Chapter 12—Chapter Overviews*** to preview chapter information.

CLICK HERE

Financial investors daily buy and sell the stock of thousands of corporations.

SECTION 1

Savings and the Financial System

Study Guide

Main Idea
The components of a financial system work together to transfer savings to investors.

Reading Strategy
Graphic Organizer As you read the section, complete a graphic organizer like the one below by identifying how saving and savings differ.

SAVING → Definition → Example

SAVINGS → Definition → Example

Key Terms
saving, savings, financial system, certificate of deposit, financial asset, financial intermediary, nonbank financial institution, finance company, bill consolidation loan, premium, mutual fund, net asset value (NAV), pension, pension fund, real estate investment trust (REIT)

Objectives
After studying this section, you will be able to:
1. **Explain** why saving is important for capital formation.
2. **Explain** how the financial system works to transfer funds from savers to borrowers.
3. **Understand** the role of the major nondepository financial institutions in the financial system.

Applying Economic Concepts
Financial Assets Do you have a checking account, savings account, or government savings bond? If so, you have one or more financial assets.

Cover Story

The Golden Years

The Spirit of '76

Many people think of Boston as the birthplace of democracy in our country. They may not realize that it is also the birthplace of the democratization of investing. It was there, 75 years ago, that three stock salesmen created the first mutual fund and opened up what was once an exclusive province of the affluent to just about everyone.

When the Massachusetts Investors Trust made its debut in March 1924, it had $50,000 in assets and owned 45 stocks. . . . By pooling investments, the fund made shares in American companies accessible to a broader market . . . (the) true innovation was allowing investors to redeem shares upon request, at market value of the underlying stocks.

—*U.S. News & World Report*, April 5, 1999

For an economic system to grow, it must produce capital—the equipment, tools, and machinery used in the process of production. To produce capital, people must be willing to save so that productive resources are released for use elsewhere. To the economist, **saving** means the absence of spending, while **savings** refers to the dollars that become available when people abstain from consumption. After all, there are only two things you can do with your income—spend it or save it.

Competitive markets are remarkably innovative, as the example in the cover story illustrates. The creation of the mutual fund industry is just one of many examples describing how our financial system evolves to meet the needs of savers and investors.

Saving and Capital Formation

When people save, they make funds available. When businesses borrow these savings, they can produce new goods and services, build new plants and equipment, and create more jobs. Saving makes economic growth possible.

Suppose two entrepreneurs want to set up their own businesses. Lisa wants to open a pet shop, while Juanita's lifelong dream is to run a photography studio. How do they go about it? Lisa saves her income, keeping her money in a bank account. When she saves enough money to invest, Lisa can set up her pet shop.

Eager to start her business immediately, Juanita decides to borrow the money she needs from a bank. If other people have been saving some of their income, like Lisa, the bank should have the funds to lend her. If people have been spending all of their income, however, the bank might not be able to give Juanita the loan even if it wanted to.

For investment to take place, someone in the economy must save. An individual can save as well as invest, as Lisa did. Or, a person may invest using money others have saved, as Juanita did. When people save, they provide money for others to borrow and use, making investments possible.

Financial Assets and the Financial System

For people to use the savings of others, the economy must have a **financial system**—a network of savers, investors, and financial institutions that work together to transfer savings to investors.

Financial Assets

People can save in a number of ways. They can open a savings account. They can purchase a **certificate of deposit**—a receipt showing that an investor has made an interest-bearing loan to a bank—or a government or corporate bond. In each case, the savers obtain receipts for the funds they save.

Economists call these receipts **financial assets**—claims on the property and the income of the borrower. These receipts are assets because they are property that has value. They represent claims on the borrower because they specify the amount loaned and the terms at which the loan was made.

Financial Intermediaries

You have just read about two of the main parts of the financial system. The first is the funds that the saver transfers to the borrower. The second is the financial assets or receipts that certify that the loans were made. The other parts of the financial system, illustrated in **Figure 12.1,** are the savers, borrowers, and institutions that bring the surplus funds and financial assets together.

Many surplus funds are placed with **financial intermediaries,** financial institutions that lend the funds that savers provide to borrowers. Financial intermediaries include depository institutions, life insurance companies, pension funds, and other institutions that channel savings from savers to borrowers. These institutions are especially helpful to small savers who have only limited funds to invest.

The Circular Flow of Funds

Figure 12.1 shows the circular flow that takes place when funds are transferred from savers to borrowers. Savers can provide their funds directly to the borrower or indirectly through the many financial intermediaries in the economy such as banks and credit unions. The borrowers then generate the financial assets, which return to the lender.

Any sector of the economy can supply savings, but households and businesses are the most important. As shown in **Figure 12.1,** savers provide some funds directly to borrowers, as when households or businesses purchase bonds directly from the government or businesses.

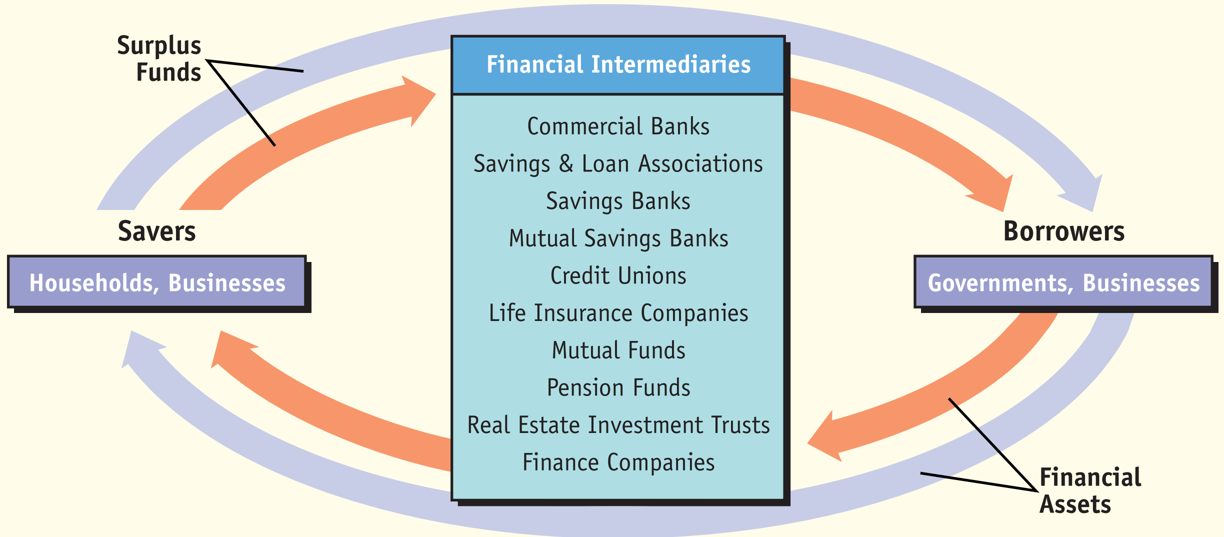
Any sector of the economy can borrow, but governments and businesses are the largest borrowers. If a corporation borrows directly from savers, or indirectly from savers through financial intermediaries, the corporation will issue a bond or other financial asset to the lender. Likewise, when the government borrows, it issues government bonds or other financial assets to the lender.

As a result, almost everyone participates in, and benefits from, the financial system. The smooth flow of funds through the system helps ensure that savers will have an outlet for their savings. Borrowers, in turn, will have a source of financial capital.

ECONOMICS AT A GLANCE

Figure 12.1

Overview of the Financial System



Using Charts Financial intermediaries help channel surplus funds from savers to borrowers, who put the money to work. **What do lenders receive in return for their funds?**

Nonbank Financial Intermediaries

Savings banks, credit unions, commercial banks, and savings associations obtain funds when their customers or members make regular deposits. Another important group of financial intermediaries includes **nonbank financial institutions**–nondepository institutions that channel savings to borrowers. Finance companies, life insurance companies, pension funds, and real estate investment trusts are examples of nonbank financial institutions.

Finance Companies

A **finance company** is a firm that specializes in making loans directly to consumers and in buying installment contracts from merchants who sell goods on credit. Many merchants, for example, cannot afford to wait years for their customers to pay off high-cost items on an installment plan. Instead, the merchant sells the customer's installment contract to a finance company for a lump sum. This allows the merchant to advertise instant credit or easy terms without actually carrying the loan full term, absorbing losses for an unpaid account, or taking customers to court if they do not pay.

Some finance companies make loans directly to consumers. These companies generally check a consumer's credit rating and will make a loan only if the individual qualifies. Because they make some risky loans, and because they pay more for the funds they borrow, finance companies charge more than commercial banks for loans. Many consumer finance companies offer **bill consolidation loans.** This is a loan consumers use to pay off other bills.

Life Insurance Companies

Another financial institution that does not get its funds through deposits is the life insurance company. Although its primary purpose is to provide financial protection for survivors of the insured, it also collects a great deal of cash.

The head of a family, for example, purchases a life insurance policy to leave money for a spouse and children in case of his or her death. The **premium** is the price the insured pays for this policy and is usually paid monthly, quarterly, or annually for the length of the protection. Because insurance companies collect cash on a regular basis, they often lend surplus funds to others.

Mutual Funds

A **mutual fund** is a company that sells stock in itself to individual investors and then invests the money it receives in stocks and bonds issued by other corporations. Mutual fund stockholders receive dividends earned from the mutual fund's investments. Stockholders can also sell their mutual fund shares for a profit, just like other stocks.

Mutual funds allow people to play the market without risking all they have in one or a few companies. The large size of the typical mutual fund makes it possible to hire a staff of experts to analyze the securities market before buying and selling securities. Their large size also allows them to buy many different stocks and bonds.

The **net asset value (NAV)**—the net value of the mutual fund divided by the number of shares issued by the mutual fund—is the market value of a mutual fund share.

Pension Funds

Another nondepository financial institution is the pension fund. A **pension** is a regular payment intended to provide income security to someone who has worked a certain number of years, reached a certain age, or suffered a certain kind of injury. A **pension fund** is a fund set up to collect income and disburse payments to those persons eligible for retirement, old-age, or disability benefits.

In the case of private pension funds, employers regularly withhold a percentage of workers' salaries to deposit in the fund. During the 30- to 40-year lag between the time the savings are deposited and the time the workers generally use them, the money is usually invested in corporate stocks and bonds. Government pension funds are similar to private ones in that the government makes regular contributions to the fund that will pay benefits later.

Real Estate Investment Trusts

Still another nonbank financial institution is the **real estate investment trust (REIT)**—a company organized primarily to make loans to construction companies that build homes. REITs help provide billions annually for home construction.

Section 1 Assessment

Checking for Understanding

1. **Main Idea** Using your notes from the graphic organizer on page 313, describe the difference between saving and savings.
2. **Key Terms** Define saving, savings, financial system, certificate of deposit, financial asset, financial intermediary, nonbank financial institution, finance company, bill consolidation loan, premium, mutual fund, net asset value (NAV), pension, pension fund, real estate investment trust (REIT).

Reviewing Objectives

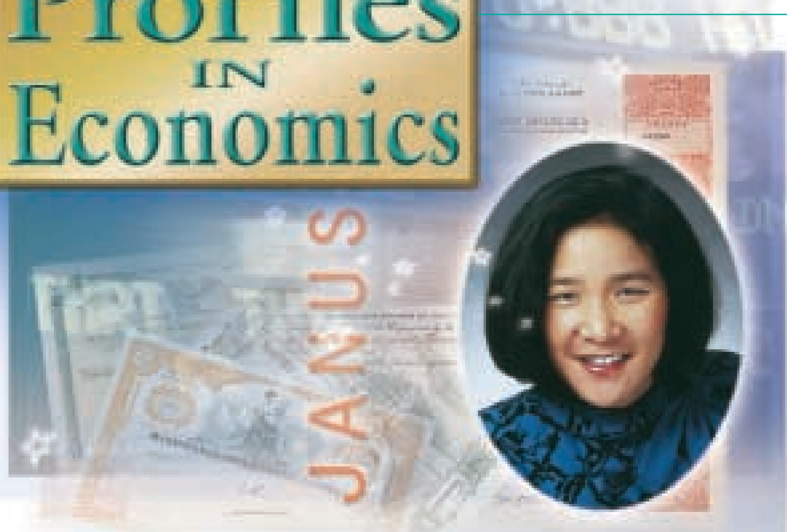
3. **Explain** why saving is required for capital formation.
4. **Describe** how the financial system works to transfer funds from savers to borrowers.
5. **Explain** the role of the major nondepository financial institutions in the financial system.
6. **Financial Assets** An I.O.U. that you draft and give to a friend in payment of a debt is an example of a financial asset. Explain why this is so.

Critical Thinking

7. **Understanding Cause and Effect** What is necessary before investment can take place?
8. **Making Generalizations** Why might an individual choose to borrow money from a finance company that charges higher interest rates than commercial banks do?

Practice and assess key social studies skills with the *Glencoe Skillbuilder Interactive Workbook, Level 2.*

Profiles in Economics



Managing Money: Helen Young Hayes

(1962–)

Helen Hayes is the type of person people trust. In fact, people have entrusted her with more than $23 *billion* of their money.

Hayes is one of the most successful mutual fund managers in the world.

Picking the right stocks, especially foreign ones, takes research. But what sets Hayes apart, and is a key to her success, is her uncanny ability to read people. When she meets with corporate executives, for example, she pays a great deal of attention to body language, which she maintains can reveal as much, or more, about a company than what the executive says.

In her spare time, Hayes trains for and competes in triathlons—grueling races that combine swimming, bicycling, and running. She claims she's not very good, and that she only competes against herself. But Hayes's gusto for athletics seems a clear reflection of the zeal she brings to bear in business.

Building a Business: Edward T. Lewis

(1940–)

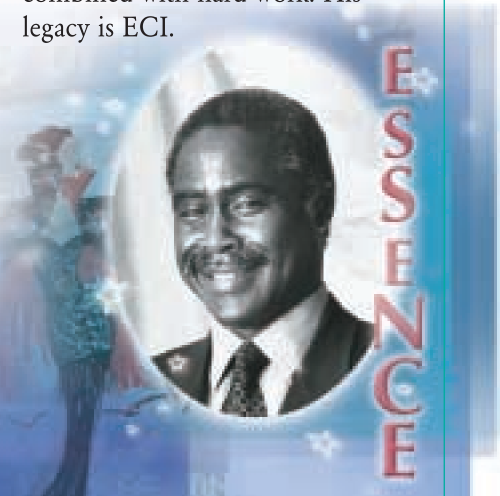
As chairman and CEO of Essence Communications, Inc. (ECI), Edward T. Lewis heads one of the largest African American businesses in the United States. His struggle to make *Essence* magazine a success shows determination and entrepreneurial skill.

In the late 1960s, Lewis, then a financial analyst for a bank, attended a conference held to encourage initiative in African American capitalism. One idea captured him: that someone could publish a magazine targeted at African American women.

Lewis launched the first issue of *Essence* in May 1970. The stylish magazine, which featured full-page color photos of African American models and cutting-edge articles, became a great success.

ECI is also a major investor in Amistad Press, a respected book publishing company that focuses on minority authors and titles. Essence Art Reproductions markets reproductions of fine art created by African American artists.

Lewis's success is the result of the age-old formula of good ideas combined with hard work. His legacy is ECI.



Examining the Profiles

1. **Making Comparisons** What similarities and differences do you see in Hayes's and Lewis's careers?
2. **For Further Research** Review several issues of *Essence* magazine. Write an analysis of the magazine's editorial policy.

Investment Strategies and Financial Assets

Study Guide

Main Idea
To invest wisely, investors must identify their goals and analyze the risk and return involved.

Reading Strategy
Graphic Organizer As you read the section, identify at least four financial assets.

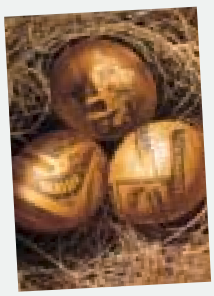
Key Terms
risk, 401(k) plan, coupon, maturity, par value, current yield, municipal bond, tax-exempt, savings bond, Treasury note, Treasury bond, Treasury bill, Individual Retirement Account (IRA), Roth IRA, capital market, money market, primary market, secondary market

Objectives
After studying this section, you will be able to:
1. **Identify** four important investment considerations.
2. **Describe** the three characteristics of bonds.
3. **Describe** the characteristics of major financial assets.
4. **Understand** four views of markets for financial assets.

Applying Economic Concepts
Risk-Return Relationship Riskier projects must offer higher returns to be attractive.

Cover Story

Popular Plan Has Attracted $1 Trillion



The 401(k) provides a nest egg for millions.

In just 15 years, 401(k) has been transformed from an obscure section of the tax code into corporate America's most popular retirement benefit.

Today, 25 million people have about $1 trillion invested in 401(k) plans, triggering a revolution in retirement planning that's made money managers out of workers from the factory floor to the corner office.

But with 401(k)s now covering as many employees as traditional pensions, an . . . analysis of the 401(k)s at the nation's largest employers finds dramatic disparities in the plans' generosity.

For individuals, the difference could easily amount to hundreds of thousands of dollars. For society, they could further widen the gap between rich and poor.

—*USA Today*, April 23, 1999

Before you invest in a financial asset, it helps to have a basic understanding of investment considerations. Possessing this information will help you make your own investment goals and decide whether a plan like the 401(k) is right for you.

Basic Investment Considerations

It is important to consider several factors when you invest in financial assets. The first concerns the relationship between risk and return. The second has to do with the investor's personal investment goals. The third deals with avoiding some types of investments, and the last deals with the consistency of investing.

The Risk-Return Relationship

One of the most important relationships in the market is the relationship between risk and return. **Risk** is a situation in which the outcome is not certain, but probabilities for each possible outcome can be estimated. Investors realize that financial assets are risky. Assets such as notes, bills, and bonds may go up or down in price, or the agency that issued the asset may even fail to redeem it, leaving the lender with a loss. As a result, investors demand a higher return to compensate for higher risk. This relationship between risk and return is illustrated in **Figure 12.2,** which shows that riskier assets offer higher returns to attract investors.

As an investor, your first consideration should be the level of risk that you can tolerate. For example, if someone offers you a risky deal that doubles your money, it may be better to focus on the chances of getting your money back rather than on the size of the return. If you are uncomfortable with high levels of risk, then consider another investment.

Investment Objectives

Another factor to consider is the reason for investing. If your goal is to save for retirement, you might want to purchase assets that simply appreciate in value rather than generate current income. If your purpose is to accumulate reserves to fund a vacation or to cover living expenses during periods of unemployment, a strategy that focuses on the accumulation of assets that are highly liquid, or easily converted into cash, might be better.

The source of income used for investment may help determine which assets are purchased. If you receive a steady salary and almost no other income, a payroll deduction plan that puts money into a special retirement fund like a 401(k) or government bonds might be best. If you receive bonuses, royalties, or other occasional payments, corporate bonds or some other large-denomination financial asset might be preferable.

In the end, each investor must consider his or her own circumstances and personal investment goals. Investors have a large number of financial assets, equities, and other investments from which to choose. The investor's knowledge of his or her own needs is important in making these decisions.

Simplicity

Most analysts advise investors to stay with what they know. Thousands of investments are available, and many are complicated. Although you do not have to understand them all to be a good investor, knowing a few fundamentals can help you make good choices.

One rule that many investors follow is this: If an investment seems too complicated, then ignore it and invest in something else. Another often-cited rule is that any investment that seems too good to be true probably is. A few investors do get lucky, but most build wealth because they invest regularly, and they avoid the investments that seem too far out of the ordinary.

Consistency

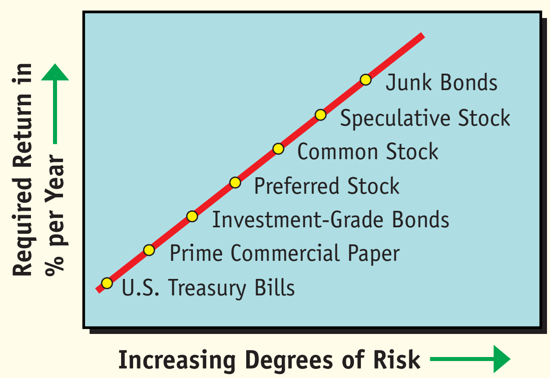
Most successful investors invest consistently over long periods of time. In many cases, the amount invested is not as important as investing on a regular basis.

Figure 12.3 shows how a small deposit of $10 per month would grow over a 5- to 30-year period at various interest rates. The balance in the account accumulates fairly quickly, even at modest interest rates. Because $10 is a small amount, imagine how

ECONOMICS AT A GLANCE

Figure 12.2

The Relationship Between Risk and Return



Using Graphs U.S. Treasury bills are regarded as the safest investment. **Why do investors require higher returns for some investments?**

the account would grow if the deposit was for $25, $50, or even $100 a month! Many investment advisers tell people to save something every month, even if it is only a small sum.

401(k) Plans

A program that has become increasingly popular among investors is the **401(k) plan**—a tax-deferred investment and savings plan that acts as a personal pension fund for employees. To contribute to the plan, employees authorize payroll deductions, which are invested in mutual funds or other investments approved by their companies. Contributing to a plan lowers your taxable income because you don't have to pay income taxes on the money you contribute until you withdraw it. An added benefit of a 401(k) plan is that more than 80 percent of employers match an employee's contributions, by typically 25 percent to 100 percent. This explains why individual plans vary widely from company to company, as noted in the cover story.

Returns on a 401(k) are especially high when the employer provides matching funds. For example, if your employer matches your contribution at 50 cents on the dollar, you have an immediate 50 percent return on the investment—even before the funds are invested. **Figure 12.4** illustrates that an annual contribution of $2,000 with a 25 percent employer match can provide a substantial retirement fund in 30 years.

The 401(k) is popular because it provides a simple, consistent, and relatively safe way for employees to save—and you can take the 401(k) with you if you change jobs. In addition, you can borrow against the money before you retire at a substantially reduced rate. You will, however, have to pay taxes on the earnings when you withdraw the money at retirement.

Bonds as Financial Assets

When the government or firms need to borrow funds for long periods, they often issue bonds. Bonds are long-term obligations that pay a stated rate of interest for a specified number of years.

ECONOMICS AT A GLANCE

Figure 12.3

The Power of Compound Interest

Annual Interest (in percent)	Value at End of Year					
	5	10	15	20	25	30
0	$600	$1,200	$1,800	$2,000	$2,500	$3,600
2	$630	$1,327	$2,097	$2,948	$3,888	$4,927
4	$663	$1,472	$2,461	$3,668	$5,141	$6,940
6	$698	$1,639	$2,908	$4,620	$6,930	$10,045
8	$735	$1,829	$3,460	$5,890	$9,510	$14,904
10	$774	$2,048	$4,145	$7,594	$13,268	$22,605
12	$817	$2,300	$4,996	$9,893	$18,788	$34,950

Using Tables This table shows the balance in an account if monthly deposits of $10 were compounded monthly. **How much interest is earned after the first 10 years at 6 percent?**

Bond Components

A bond has three main components: the **coupon,** or the stated interest on the debt; the **maturity,** or the life of the bond; and the **par value**—the principal or the total amount initially borrowed that must be repaid to the lender at maturity.

Suppose, for example, a corporation sells a 6 percent, 20-year, $1,000 par value bond that pays interest semiannually. The coupon payment to the holder is $30 semiannually (.06 times $1,000, divided by 2). When the bond reaches maturity after 20 years, the company retires the debt by paying the holder the par value of $1,000.

Bond Prices

The investor views the bond as a financial asset that will pay $30 twice a year for 20 years, plus a final par value payment of $1,000. Investors can offer $950, $1,000, $1,100, or any other amount for this future payment stream. Investors consider changes in future interest rates, the risk that the company will default, and other factors before they decide what to offer. Supply and demand will then establish the final price of the bonds.

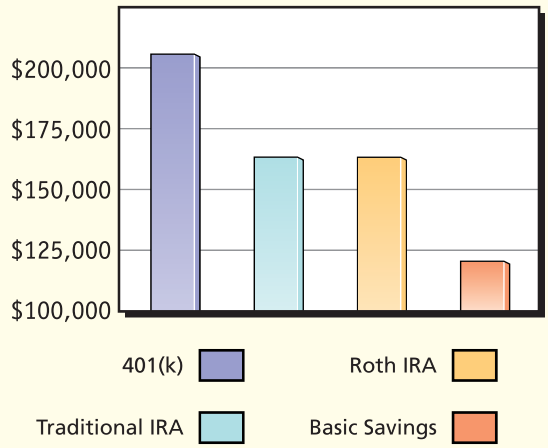
Bond Yields

In order to compare bonds, investors usually compute the bond's **current yield,** the annual interest divided by the purchase price. If an investor paid $950 for the bond described above, the current yield would be $60 divided by $950, or 6.32 percent. If the investor paid $1,100 for the bond, the current yield would be $60 divided by $1,100, or 5.45 percent. Although it may appear as if the issuer fixes the return on a bond when the bond is first issued, the interest received and the price paid determine the actual yield on the bond.

Because the credit-worthiness, or financial health, of corporations and governments differ, all 6 percent, 20-year, $1,000 bonds will not cost the same. Bonds are not insured, and there are no guarantees that the issuer will be around in 20 years to redeem the bond. Therefore, investors will pay more for bonds issued by an agency with an impeccable credit rating. Investors will pay less for a similar bond if it is issued by a corporation with a low credit rating.

ECONOMICS AT A GLANCE — **Figure 12.4**

How Much Will You Have at Retirement?



Data is based on:
- $2,000 in income invested each year for 30 years
- 8% return on investment
- Company matching 25% of employee contributions
- 28% income tax; 20% capital gains tax (paid yearly for basic savings)

Source: Quicken.com, 1999

Using Graphs Retirement investment plans provide various returns. **How much more would a traditional IRA earn over a basic savings plan?**

Bond Ratings

Fortunately, investors have a way to check the quality of bonds. Two major corporations, Standard & Poor's and Moody's, publish bond ratings. They rate bonds on a number of factors, including the basic financial health of the issuer, the ability to make the future coupon and principal payments, and the issuer's past credit history.

The bond ratings, shown in **Figure 12.5,** use letters scaled from AAA, which represents the highest investment grade, to D, which generally stands for

ECONOMICS AT A GLANCE

Figure 12.5

Bond Classifications

Standard & Poor's		Moody's	
Highest Investment Grade	AAA	Aaa	Best Quality
High Grade	AA	Aa	High Quality
Upper Medium Grade	A	A	Upper Medium Grade
Medium Grade	BBB	Baa	Medium Grade
Lower Medium Grade	BB	Ba	Possesses Speculative Elements
Speculative	B	B	Generally Not Desirable
Vulnerable to Default	CCC	Caa	Poor, Possibly in Default
Subordinated to Other Debt Rated CCC	CC	Ca	Highly Speculative, Often in Default
Subordinated to CC Debt	C	C	Income Bonds Not Paying Income
Bond in Default	D	D	Interest and Principal Payments in Default

Sources: Standard & Poor's Corporation, Moody's

Using Tables Standard & Poor's Corporation and Moody's publish bond ratings. Junk bonds, those with ratings of BB or Ba and lower, are generally the riskiest types of bonds. **How do bond ratings affect the price of bonds?**

default. If a bond is in default, the issuer has not kept up with the interest or the par value payments. These ratings are widely publicized, and investors can find the rating of any bond they plan to purchase.

Bonds with high ratings sell at higher prices than do bonds with lower ratings. A 6 percent, 20-year, $1,000 par value bond with an AAA-grade rating may sell for $1,100 and have a current yield of 5.45 percent. Another 6 percent, 20-year, $1,000 par value bond issued by a different company may have a BBB rating, and may therefore only sell for $950 because of the higher risk. The second bond, however, has a higher current yield of 6.32 percent. This points out the basic nature of the risk-return relationship—riskier investments require higher returns to offset the risk.

Financial Assets and Their Characteristics

The modern investor has a wide range of financial assets from which to choose. These include certificates of deposit, bonds, treasury notes and bills, and individual retirement accounts. They vary in cost, maturity, and risk.

Certificates of Deposit

Certificates of deposit (CDs) are one of the most common forms of investments available. Many people think of them as just another type of account with a depository institution, but they are really loans investors make to financial institutions. Because banks and others count on the use of these funds for a certain time period, they usually impose penalties when people try to cash in their CDs early.

CDs are attractive to small investors because they can cost as little as $100. Investors can also select the length of maturity, giving them an opportunity to tailor the expiration date to future expenditures such as college tuition, a vacation, or some other expense.

Finally, CDs issued by commercial banks, savings banks, and savings associations are included in the $100,000 FDIC insurance limit. The National Credit Union Association insures most CDs issued by credit unions.

Corporate Bonds

Corporate bonds are an important source of corporate funds. Some individual corporate bonds have par values as low as $1,000, but par values of

$10,000 are more common. The actual prices of the bonds are usually different from the par values because supply and demand for the bonds determine the price.

Investors usually decide on the highest level of risk they are willing to accept, and then they try to find a bond that has the best current yield. "Junk" bonds—exceptionally risky bonds with a Standard & Poor's rating of BB or lower, or a Moody's rating of Ba or lower—carry a high rate of return as compensation for the possibility of default.

Investors usually purchase corporate bonds as long-term investments, but they can also be liquidated, or quickly sold, if the investor needs cash for other purposes. The Internal Revenue Service considers the interest, or coupon, payments on corporate bonds as taxable income, a fact investors must consider when they invest in bonds.

Municipal Bonds

Municipal bonds (or "munis") are bonds issued by state and local governments. States issue bonds to finance highways, state buildings, and some public works. Cities issue bonds to finance baseball parks and football stadiums or to finance libraries, parks, and other civic improvements.

Municipal bonds are attractive investments for several reasons. First, they are generally regarded as safe because state and local governments do not go out of business. Because governments have the power to tax, it is generally presumed that they will be able to pay interest and principal in the future.

More importantly, municipal bonds are generally **tax-exempt,** meaning that the federal government does not tax the interest paid to investors. In some cases, the states issuing the bonds also exempt the interest payments from state taxes, which makes them very attractive to investors. The tax-exempt feature also allows the governmental agencies to pay a lower rate of interest on the bonds, thereby lowering their cost of borrowing.

Government Savings Bonds

The federal government generates financial assets when it sells savings bonds. **Savings bonds** are low-denomination, nontransferable bonds

THE GLOBAL ECONOMY

Investing Globally

Is it risky to invest in markets around the world? Some economists argue that investing a portion of your money in overseas markets is safe and profitable.

Many people think that there are too many uncertainties associated with investing in overseas markets. Governments can be unstable and economic information about the region may be sketchy. Countries can devalue their currencies or maintain poor accounting standards.

Economists, however, believe that investing a portion of one's money in Latin American, Asian, or European companies is a wise strategy, and many mutual funds today exist for just that purpose. Even though the United States market has been prosperous, shifting some assets overseas can serve as a safety net if the United States market plunges. Stock markets around the world generally do not experience simultaneous highs and lows, so maintaining a level of profit making can be steady. Many overseas companies are restructuring to become more efficient, creating healthy investment opportunities for American investors.

Critical Thinking

1. **Analyzing Information** What are the arguments against investing in overseas markets?
2. **Making Generalizations** Why is it important to diversify investments throughout different regions rather than in investing in a single region?

issued by the United States government, usually through payroll-savings plans.

These bonds are usually available in denominations ranging from $50 to $10,000, and they are purchased at a discount from their redemption amount. For example, a new $50 savings bond may be obtained today for $25, but it could take up to 18 years before it could be redeemed for the full $50, depending on the interest rate. The government pays interest on these bonds, but it builds the interest into the redemption price rather than sending checks to millions of investors on a regular basis.

Savings bonds are attractive because they are easy to obtain and there is virtually no risk of default. They cannot be sold to someone else if the investor needs cash, but they can be redeemed early, with some loss of interest, if the investor must raise cash for other purposes. Most investors tend to hold long-term savings bonds, treating them as a form of automatic savings.

Careers

Stockbroker

Do you enjoy scouting financial trends and doing research? Then a career as a stockbroker might be the right one for you.

The Work

The stockbroker's duties include handling individual investment accounts and advising customers on the purchase or sale of securities. They must supply the latest price quotations on stocks and keep informed about the financial activities of corporations issuing stock. The ability to act quickly is helpful in building and keeping a strong customer base.

Qualifications

Stockbrokers are college graduates with sales ability and good communication skills. Many hold degrees in business administration, with a specialization in finance.

Treasury Notes and Bonds

When the federal government borrows funds for periods longer than one year, it issues Treasury notes and bonds. **Treasury notes** are United States government obligations with maturities of two to 10 years, while **Treasury bonds** have maturities ranging from more than 10 to as many as 30 years. The only collateral that secures both is the faith and credit of the United States government.

Treasury notes and bonds come in denominations of $5,000 for maturities of two to three years, and denominations of $1,000 for maturities longer than four years. The government also keeps computerized records of its debt holders so that it can make periodic interest payments to those individuals.

Although these financial assets have no collateral or backing, they are popular because they are generally regarded as the safest of all financial assets. Due to the trade-off between risk and return, however, these assets also have the lowest returns of all financial assets.

Treasury Bills

Federal government borrowing generates other financial assets known as **Treasury bills.** A Treasury bill, also known as a T-bill, is a short-term obligation with a maturity of 13, 26, or 52 weeks and a minimum denomination of $10,000.

T-bills do not pay interest directly, but instead are sold on a discount basis, much like government savings bonds. For example, an investor may pay the auction price of $9,300 for a 52-week bill that matures at $10,000. The $700 difference between the amount paid and the amount received is the investor's return. The investor is receiving $700 on a $9,300 investment, for a return of $700 divided by $9,300, or 7.5 percent.

Individual Retirement Accounts

Individual Retirement Accounts (IRAs) are long-term, tax-sheltered time deposits that an employee can set up as part of a retirement plan. If the worker's spouse does not work outside the home, up to $2,000 per year can be deposited in a separate account for each spouse.

STANDARD &POOR'S INFOBYTE

Treasury Bonds A Treasury bond refers to a Treasury security with a maturity greater than 10 years. The only difference between a Treasury bond and a Treasury note is the longer maturity of the bond. Coupon interest on a Treasury bond is paid semiannually. Treasury bond issuance was recently increased from two auctions per year to three, settling on the 15th of February, August, and November. The 30-year bond is considered the "benchmark" bond in determining interest rate trends.

The worker deducts this deposit from his or her taxable income at the end of the year, thereby sheltering the $2,000 from income taxes. Taxes on the interest and the principal will eventually have to be paid, but it gives the worker an incentive to save today, postponing the taxes until the worker is retired and in a lower tax bracket. IRAs are not transferable, and penalties exist if they are liquidated early.

Figure 12.4 on page 321 also shows a **Roth IRA**—an IRA whose contributions are made after taxes so that no taxes are taken out at maturity. This type of IRA may work well for someone who plans to retire in a high tax bracket.

Markets for Financial Assets

Investors often refer to markets according to the characteristics of the financial assets traded in them. These markets are not really separate entities, and many overlap to a considerable degree.

Capital Markets

When investors speak of the **capital market,** they mean a market where money is loaned for more than one year. Long-term CDs and corporate and government bonds that take more than a year to mature belong in this category. Capital market assets are shown in the right-hand column of **Figure 12.6.**

Money Markets

When investors speak of the **money market,** they mean a market where money is loaned for periods of less than one year. The financial assets that belong to the money market are shown in the left-hand column of **Figure 12.6.** Note that a person who owns a CD with a maturity of one year or less is involved in the money market. If the CD has a maturity of more than one year, the person is involved in the capital market as a supplier of funds.

Money market mutual funds are issued by stockbrokers and other institutions. These firms pool the deposits by their customers to purchase stocks or bonds. Mutual funds usually pay slightly higher interest rates than banks.

ECONOMICS AT A GLANCE

Figure 12.6

Financial Assets and Their Markets

	Money Market (less than 1 year)	Capital Market (more than 1 year)
Primary Market	Money market mutual funds Small CDs	Government savings bonds IRAs Money market mutual funds Small CDs
Secondary Market	Jumbo CDs Treasury bills	Corporate bonds International bonds Jumbo CDs Municipal bonds Treasury bonds Treasury notes

Using Charts If the length of maturity is important, the market is sometimes called a money or capital market. If the ability to sell the asset to someone other than the original issuer is important, the market may be described as being a primary or secondary market. **Why do some financial assets, like CDs, appear in more than one market?**

Primary Markets

Another way to view financial markets is to focus on the liquidity of a newly created financial asset. One market for financial assets is the **primary market,** a market where only the original issuer can repurchase or redeem a financial asset. Government savings bonds and IRAs are in this market because they are both nontransferable. Small CDs are in the primary market because investors tend to cash them in early, rather than try to sell them to someone else, if they need cash.

Secondary Markets

If a financial asset can be sold to someone other than the original issuer it becomes part of the secondary market. The **secondary market** is a market in which existing financial assets can be resold to new owners.

The major significance of the secondary market is the liquidity it provides to investors. If a strong secondary market exists for a financial asset, investors know that, other than the fees paid to handle the transaction, the assets can be liquidated fairly quickly and without penalty.

Investment

Markets for Financial Assets Investing always includes some risk. ***What is the difference between a capital market and a money market?***

Section 2 Assessment

Checking for Understanding

1. **Main Idea** What rules do many investors follow in regard to investment goals?
2. **Key Terms** Define risk, 401(k) plan, coupon, maturity, par value, current yield, municipal bond, tax-exempt, savings bond, Treasury note, Treasury bond, Treasury bill, Individual Retirement Account (IRA), Roth IRA, capital market, money market, primary market, secondary market.
3. **List** four important investment considerations.
4. **Identify** the three main characteristics of bonds.
5. **Describe** the characteristics of major financial assets.
6. **Differentiate** between the four markets of financial assets.

Applying Economic Concepts

7. **Risk-Return Relationship** If you had money to invest, in which financial asset(s), if any, would you choose to invest? Explain how you arrived at your answer.

Critical Thinking

8. **Making Generalizations** Review the four basic investment considerations. Which do you think is most important? Explain your answer.

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BusinessWeek

AUGUST 10, 1998

Newsclip

What expectations might significantly alter current spending and saving? Economists develop models that explain the saving habits of people at various levels of income. A new model has been proposed that suggests why the wealthy save their money.

A Penny Earned Is a Penny Saved

It is possible to have more money than you need. As billionaire H.L. Hunt said in the '70's: "For practical purposes, someone who has $200,000 a year is as well off as I am." So why do the rich continue to pile up wealth?

High-income households save more than either of two standard economic models would predict, says Johns Hopkins University economist Christopher D. Carroll. Contrary to the "life-cycle" model, the rich save far more than they need to support themselves in old age.

And the "dynastic" model, which suggests that the rich want to leave large bequests to their children, doesn't work either. Carroll cites a study of Internal Revenue Service data showing that the childless wealthy don't spend down assets more rapidly than those who leave bequests to their children.

Carroll suggests a new explanation: a "capitalist spirit" model, in which the rich value wealth for its own sake. Even unspent wealth can bring economic services–including political power. Or, as Howard Hughes once put it, "money is the measuring rod of power."

Wealth is an accumulation of value. Spending wealth on luxuries, like expensive cars, is an option. So, too, are saving and investing.

Examining the Newsclip

1. **Analyzing Information** Describe the two economic models developed to explain why high-income households save money.
2. **Summarizing Information** How does Christopher Carroll explain the saving pattern of high-income households?
3. **Making Generalizations** Explain why you agree or disagree with the following statement: The more wealth households have accumulated, the weaker the incentive to save in order to accumulate additional wealth.

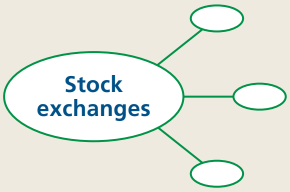
SECTION 3

Investing in Equities, Futures, and Options

Study Guide

Main Idea
Equities, or stocks, represent ownership of a corporation.

Reading Strategy
Graphic Organizer As you read the section, list three different organized stock exchanges.



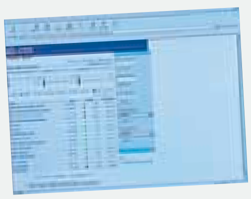
Key Terms
equities, Efficient Market Hypothesis (EMH), portfolio diversification, stockbroker, securities exchange, seat, over-the-counter market (OTC), Dow-Jones Industrial Average (DJIA), Standard & Poor's 500 (S&P 500), bull market, bear market, spot market, futures contract, futures market, option, call option, put option, options market

Objectives
After studying this section, you will be able to:
1. **Describe** the major stock exchanges.
2. **Explain** how stock market performance is measured.

Applying Economic Concepts
Futures Exchanges Have you ever negotiated to receive your allowance early, or asked to be paid right away for a service to be completed later? Read to find out how this corresponds to a futures market.

Cover Story

Rich Going Online to Research and Trade Stocks


Online market analysis

Two-thirds of the most affluent Americans use computers to research investments, while almost a third trade online, a survey reveals today.

The findings will intensify concern of the future of traditional stockbrokers in the U.S. following last week's announcement that Merrill Lynch, the largest U.S. retail broker, was launching an online trading service.

These people represent the most lucrative business for private banks and for full-service brokers such as Merrill Lynch and PaineWebber.

"We were surprised by the extent to which the affluent really have embraced technology. . . . People are changing their habits and the way they conduct commerce . . . ," [claimed an analyst].

—*The Financial Times*, June 10, 1999

In addition to financial assets, investors may buy **equities.** These are stocks that represent ownership shares in corporations. The markets for equities are reasonably competitive because there are a large number of buyers and sellers, and investors possess reasonably good information.

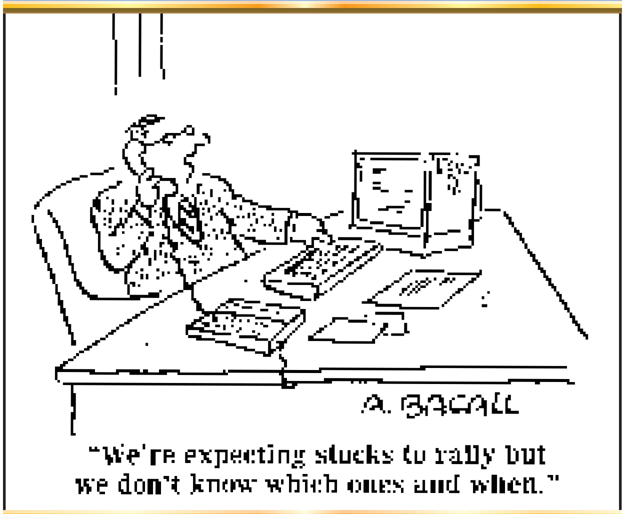
Advances in technology, as noted in the cover story, make this process even more competitive. A majority of investors now use the Internet to acquire the information they need to make their decisions.

Market Efficiency

Many things influence the price of equities. Some companies may have relatively few outstanding shares to be traded, while others have a large number. Some companies are profitable; others are not. Expectations also affect stock prices. For example, two companies may be equal in all respects, but one may have far better prospects for growth.

As a result, stock prices can vary considerably from one company to the next. The difficulty

Equities



Price Factors Equities entitle the buyer to a certain part of the future profits and assets of the corporation selling the stock. ***What factors influence the price of equities?***

facing the investor, then, is to decide which to buy—and which to avoid. Fortunately, the answer is simpler than you might imagine.

The **Efficient Market Hypothesis (EMH)**—the argument that stocks are always priced about right and that bargains are hard to find because they are followed closely by so many investors—is often used to help explain the pricing of equities. A leading expert on the topic explains how this might happen:

> *Essentially, the EMH states that there are some 100,000 or so full-time, highly trained, professional analysts and traders operating in the market and following some 3,000 major stocks. If each analyst followed only 30 stocks, there would still be 1,000 analysts following each stock. Further, these analysts work for organizations such as Merrill Lynch and Prudential Insurance, which have billions of dollars available with which to take advantage of bargains. As new information about a stock becomes available, these 1,000 analysts all receive and evaluate it at approximately the same time, so the price of the stock adjusts almost immediately to reflect new developments.*
>
> —from Eugene F. Brigham's *Fundamentals of Financial Management*

One implication for the investor is that if all stocks are priced about right, it does not matter which ones you purchase. You might be lucky and pick a stock about to go up, or you might get unlucky and pick a stock about to go down. Because of this, **portfolio diversification**—the practice of holding a large number of different stocks so that increases in some can offset unexpected declines in others—is a popular strategy.

There are different ways to purchase equities. Opening an Internet account with a discount brokerage firm is one means. The investor can then buy, sell, and monitor his or her stock portfolio from a personal computer. Or, the investor may enlist the assistance of a **stockbroker**—a person who buys or sells equities for clients. The broker arranges to have the stocks purchased at a stock exchange, or supplies the securities from an inventory, or buys them from some other broker.

Organized Stock Exchanges

A number of organized **securities exchanges** exist—places where buyers and sellers meet to trade securities. An organized exchange gets its name from the way it conducts business. Members pay a fee to join, and trades can only take place on the floor of the exchange.

The New York Stock Exchange

The oldest, largest, and most prestigious of the organized stock exchanges in the United States is the New York Stock Exchange (NYSE), located on Wall Street in New York City. This exchange, like most other organized exchanges, has certain rules for both its members and the corporations listed on the exchange.

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ECONOMICS Online

Student Web Activity Visit the *Economics: Principles and Practices* Web site at epp.glencoe.com and click on ***Chapter 12—Student Web Activities*** for an activity on the New York Stock Exchange.

ECONOMICS AT A GLANCE

Figure 12.7

The New York Stock Exchange

52 Weeks Hi	Lo	Stock	Sym	Div	Yld %	PE	Vol 100s	Hi	Lo	Close	Net Chg
12 1/8	8 9/16	EquityOne	EQY	1.04	10.4	9	283	10 3/8	10	10	– 1/4
56 1/2	37 1/4	EsteeLaudr A	EL	.20	.4	45	4612	48	46	48	+ 1
8 1/4	4 11/16	FrontrOil	FTO		...	22	80	6 7/8	6 1/2	6	– 3/16
37	16 3/8	Hasbro	HAS	.24	1.5	12	33793	16 7/16	15 13/16	16	– 1/2

Reading the Financial Page Figure 12.7 shows examples of stocks traded on the New York Stock Exchange. The price of a share of stock generally goes up and down throughout the day as the conditions of supply and demand change. At the end of the business day, each stock has a closing price. **Of the stocks shown, which made the biggest gain on this particular day?**

The NYSE has about 1,400 **seats,** or memberships, that allow access to the trading floor. Large brokerage companies, such as Merrill Lynch, may own as many as 20 seats at any given time. The members may pay several million dollars for each seat. Members have the right to elect their own directors and vote on the rules and regulations that govern the exchange.

The NYSE lists stocks from more than 3,000 companies. The firms must meet stringent requirements related to profitability and size, which virtually guarantee that the companies will be among the largest, most profitable publicly held companies. **Figure 12.7** shows how prices are listed on the NYSE.

During the last 12 months, Hasbro sold for as much as $37 and as little as $16.37 a share. Its annual dividend (Div) is $.24, which is paid in four equal installments. The yield (Yld) is the dividend divided by the closing price. The PE, or price-earnings ratio, is a stock's price divided by annual earnings of each share of common stock outstanding. Hasbro closed at $.50 lower than the day before, as indicated by $-1/2$ under Net Change (Net Chg).

The American Stock Exchange

Another prestigious national exchange is the American Stock Exchange (AMEX), which is also located in New York City. It has approximately 1,000 listed stocks.

For many years, the AMEX was the second largest organized exchange in the country behind the NYSE. Its growth then slowed, and some of the regional exchanges overtook the AMEX. Overall, the companies represented on the AMEX tend to be smaller and more speculative than those listed on the NYSE.

Regional Stock Exchanges

The regional exchanges include the Chicago, Pacific, Philadelphia, Boston, and Memphis exchanges, along with some smaller exchanges in other cities. Many of these exchanges originally listed corporations that were either too small or too new to be listed on the NYSE or the AMEX. Today, however, many stocks are listed on both the NYSE and a regional exchange. The regional stock exchanges also meet the needs of the smaller and middle-sized corporations in their regions.

Global Stock Exchanges

Stock exchanges can be found throughout the world. Exchanges operate in such cities as Sydney, Tokyo, Hong Kong, Singapore, Johannesburg, and Frankfurt. Developments in computer technology and electronic trading have linked these markets so that most major stocks can be traded around the clock, somewhere in the world.

The Over-the-Counter Market

Despite the importance of the organized exchanges, the majority of stocks in the United States are not traded on exchanges. Instead, they are traded on the **over-the-counter market (OTC)**—an electronic marketplace for securities that are not traded on an organized exchange.

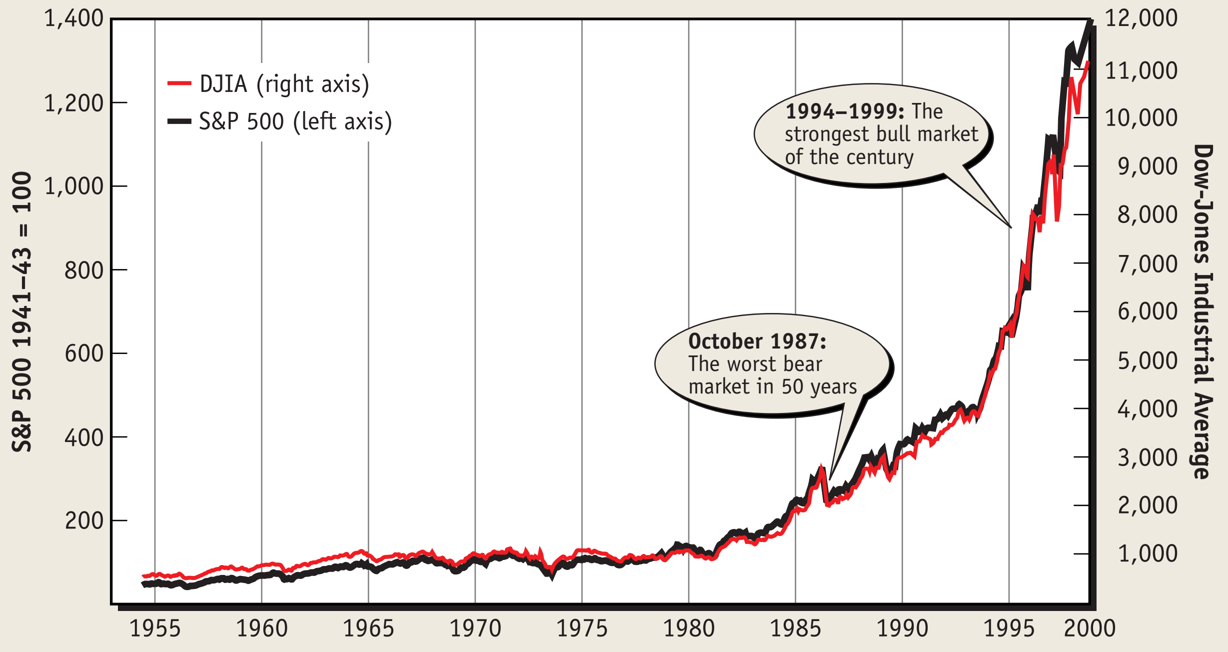
Securities traded over the counter are listed in a sophisticated computer network called the National Market System (NMS). The members of the OTC market belong to the National Association of Securities Dealers (NASD). The National Association of Securities Dealers Automated Quotation (NASDAQ), is the listing that provides information on stocks that this group trades. The main difference between a NASDAQ listing and the NYSE is that few OTC stocks pay dividends, mostly because they are issued by new firms.

The organized exchanges and the OTC market may differ, but this means little to investors. An investor who opens an Internet account with a brokerage firm may buy and sell stocks in both markets. When the investor places an order over the Internet to buy shares, the broker forwards the order to the exchange where the stock is traded and the purchase is made there—whether it be on the NYSE, AMEX, or OTC.

STANDARD &POOR'S

Figure 12.8

Tracking Stocks With the DJIA and the S&P 500



Using Graphs The Dow-Jones Industrial Average and Standard & Poor's 500 are two indices used to track stock prices. **When did the DJIA first surpass 10,000?**

ECONOMICS Online

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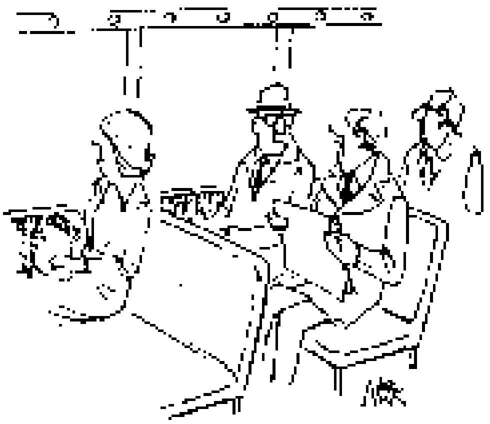
Investment



"We put all our money in precious metal—we got braces for all the kids."

Performance Some investors take chances, while others prefer a safe investment. ***What are the two most popular indicators of the market's performance?***

Measures of Stock Performance

Because most investors are concerned about the performance of their stocks, they often consult two popular indicators.

The Dow-Jones Industrial Average

The **Dow-Jones Industrial Average (DJIA),** shown in **Figure 12.8,** is the most popular and widely publicized measure of stock market performance on the NYSE. In 1884, the Dow-Jones corporation published the average closing price of 11 active stocks. In 1928, coverage was expanded to 30 stocks. Since then, some stocks have been added, and others deleted, but the sample remains constant at 30.

Because of these changes, the DJIA is no longer a mathematical average of stock prices. Also, the evolution of the DJIA has obscured the meaning of a "point" change in the index. At one time, a one "point" change in the DJIA meant that an average share of stock changed by $1. This is no longer the case. Consequently, it is better to focus on the percentage change of the index rather than the number of points.

Standard & Poor's 500

Another popular benchmark of stock performance is the **Standard & Poor's 500 (S&P 500).** It uses the price changes of 500 representative stocks as an indicator of overall market performance. Because the sum of 500 stock prices would be very large, it is reduced to an index number. Unlike the Dow-Jones, the Standard & Poor's 500 reports on stocks listed on the NYSE, AMEX, and OTC markets.

Bull vs. Bear Markets

Investors often use colorful terms to describe which way the market is moving. For example, a **bull market** is a "strong" market with the prices moving up for several months or years in a row. One of the strongest bull markets in history began in 1995 when the DJIA broke 4,000–and then reached nearly 11,000 in 1999.

A **bear market** is a "mean" market, with the prices of equities moving sharply down for several months or years in a row. In late 1987, the DJIA nearly reached the 2,700 level, and then lost nearly 700 points before it finally recovered. As you can see, these two terms take their names from the characteristics of the animals they are named after.

Trading in the Future

In **Figure 12.6** on page 325, markets are defined according to the life of the financial asset and whether or not it can be resold. Another attribute of a financial asset is time, which leads to a discussion of spot, futures, and options markets.

Spot and Futures Markets

A **spot market** is a market in which a transaction is made immediately at the prevailing price. The spot price of gold in London, for example, is the current price as it exists in that city. The term spot means "immediate" and is used to distinguish this market from two other markets that trade in the future.

Sometimes the exchange takes place later on, rather than right away. This can be arranged with a **futures contract**—an agreement to buy or sell at a specific date in the future at a predetermined price. For example, a buyer agrees to buy a specified amount of gold at $280 an ounce from a seller, who promises delivery in six months. When the settlement date arrives, the buyer takes possession of the gold and pays the seller $280—regardless of the market price.

Futures markets are the marketplaces in which futures contracts, or "futures," are bought and sold. Many of these markets are affiliated with the grain and livestock exchanges that originated in the Midwest. Futures markets include the New York Mercantile Exchange, the Chicago Board of Trade, the Chicago Mercantile Exchange, the New York Cotton Exchange, and the Kansas City Board of Trade.

Options Markets

Options are contracts that provide the right to purchase or sell commodities or financial assets at some point in the future at a price agreed upon today. Options are closely related to futures; however, options give one of the parties the opportunity to back out.

For example, you may pay $5 today for a **call option**—the right to *buy* a share of stock at a specified price some time in the future. If the call option gives you the right to purchase the stock at $70, and if the price of the stock drops to $30, you tear up the option and buy the stock at the going price. If the price rises to $100, however, you can purchase the stock for $70. Either way, the $5 option gives you the right to make the choice in the future.

If you were interested in selling instead of buying, you would have purchased a **put option**—the right to *sell* a share of stock at a specified price in the future. If you pay $3 for the right to sell at $50, and if the price of the stock drops to $40, you can require the buyer to pay the contract price for the stock. You would then net $47 from the sale, the $50 contract price minus the $3 paid for the option. If the price rose to $80 instead, you would be better off to tear up the option and sell the stock for $80. Either way, the $3 option gives you the right to make the choice in the future.

Options markets are the markets in which options are traded. Most of the exchanges that offer futures also sell options.

Section 3 Assessment

Understanding Key Terms

1. **Main Idea** If the price of a type of stock goes up, what does this suggest about the quantity of that stock being demanded and the quantity being supplied?
2. **Key Terms** Define equities, Efficient Market Hypothesis (EMH), portfolio diversification, stockbroker, securities exchange, seat, over-the-counter market (OTC), Dow-Jones Industrial Average (DJIA), Standard & Poor's 500 (S&P 500), bull market, bear market, spot market, futures contract, futures market, option, call option, put option, options market.
3. **Describe** the characteristics of the major organized stock exchanges in the United States.
4. **Discuss** two measures of stock market performance.
5. **Describe** how financial assets and equities can be traded in the future.

Applying Economic Concepts

6. **Futures exchanges** What is a futures contract? Would you ever invest in such a contract? Why or why not?

Critical Thinking

7. **Making Generalizations** Does the Efficient Market Hypothesis affect your view of playing the stock market? Explain.

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CRITICAL THINKING Skill

Distinguishing Fact From Opinion

Being able to distinguish fact from opinion can help you make reasonable judgments about what others say and write. Facts can be proved by evidence such as records, documents, or historical sources. Opinions are based on people's differing values and beliefs.

Stockbrokers at work

Learning the Skill

The following steps will help you identify facts and opinions:

- Read or listen to the information carefully. Identify the facts. Ask: Can these statements be proved? Where would I find information to verify them?
- If a statement can be proved, it is factual. Check the sources for the facts. Often statistics sound impressive, but they may come from an unreliable source.
- Identify opinions by looking for statements of feelings or beliefs. The statements may contain words like *should, would, could, best, greatest, all, every,* or *always.*

Practicing the Skill

Read the excerpt that follows, then answer the questions.

The stock market has been good to America. In recent years, it has generated enormous wealth for individuals, financing for investment, jobs for people, and tax revenue for governments. Families now depend on it for retirement, the education of their children, and, increasingly, even consumption. Millions day-trade Internet stocks, and millions more actively manage their mutual funds and 401(k)s. Soon, people may be handling Social Security investment accounts. The stock market is insinuating itself into the everyday lives of ordinary Americans as never before. . . .

A few years ago, only a small percentage of the American population—the rich—would have been affected by this. No longer. A quarter of households earning $10,000 to $25,000 now own equities, either directly or through defined-contribution pension plans such as 401(k)s. Two-thirds of all households earning $50,000 to $99,000 hold equities. And some 84% of households earning over $100,000 own stocks.

—*Business Week,* December 21, 1998

1. Identify facts. How can you verify these statements?
2. Note opinions. What phrases alert you that these are opinions?

Application Activity

Record a television interview. List three facts and three opinions that were stated. Do the facts seem reliable? How can you verify the facts? What statements, if any, seemed to contain both fact and opinion?

Practice and **assess** key social studies skills with the *Glencoe Skillbuilder Interactive Workbook, Level 2.*

CONTENTS

Chapter 12 Summary

Section 1

Savings and the Financial System

(pages 313–316)

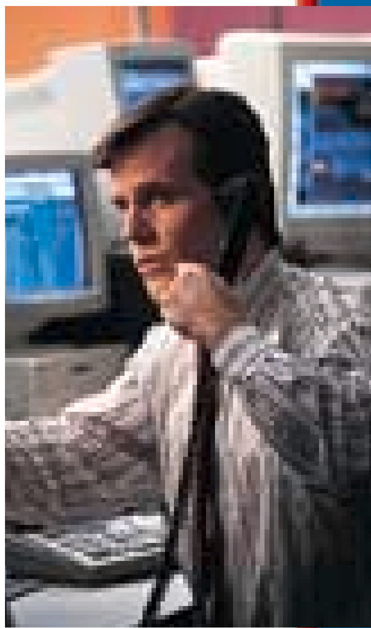
- **Saving** is a process that makes **savings** available for others to invest.
- The economy has a **financial system** that transfers savings to investors.
- **Financial assets** are the receipts savers get when they loan funds to individuals, businesses, and governments.
- **Financial intermediaries** help facilitate the transfer of funds from savers to other investors.
- Financial intermediaries include finance companies, life insurance companies, **mutual funds, pension funds,** and **real estate investment trusts,** or **REITs.** These institutions are part of the financial system, even though they do not take deposits like commercial banks, savings banks, or credit unions.

Section 2

Investment Strategies and Financial Assets

(pages 318–326)

- Investors generally require larger returns to compensate for situations with greater **risk.**
- Successful investors analyze their goals, invest consistently, and avoid complexity.
- **401(k) plans** are popular investments that offer simplicity and relatively high returns.
- Bonds are popular financial assets. The three components of bonds are the **coupon,** the **maturity,** and the **par value.**
- **Current yield** is a measure of return on bonds. Bond ratings are widely available and can be used as a measure of the bond's risk.
- Financial markets are named for the characteristics of the assets traded in them. **Capital markets** have financial assets with maturities of more than one year, while **money markets** have assets with maturities of less than one year.
- Assets traded in **primary markets** are those that have to be redeemed by the issuer.



Section 3

Investing in Equities, Futures, and Options (pages 328–333)

- **Equities,** or stocks, are different from financial assets because equities represent ownership of a corporation rather than a loan to it.
- Because equity markets are reasonably efficient, most investors diversify their portfolio to protect against risk.
- Many stocks are traded on organized exchanges such as the NYSE, the AMEX, and a number of regional stock exchanges.
- The majority of stocks are traded in a computerized marketplace of organized dealers called the **over-the-counter market.** These stocks represent newer and sometimes smaller companies that could not get listed on the NYSE.

Chapter 12 Assessment and Activities

ECONOMICS Online

Self-Check Quiz Visit the *Economics: Principles and Practices* Web site at epp.glencoe.com and click on ***Chapter 12—Self-Check Quizzes*** to prepare for the chapter test.

CLICK HERE

Reviewing Key Terms

For each of the investments below, write a brief paragraph that describes at least three of the term's principal characteristics.

1. **Treasury bond**
2. **Treasury bill**
3. **equities**
4. **Treasury note**
5. **futures**
6. **Individual Retirement Account**
7. **401(k)**
8. **Roth IRA**
9. **option**
10. **municipal bond**

Reviewing the Facts

Section 1 (pages 313–316)

1. **Explain** the relationship between savings and capital formation.
2. **Describe** how financial assets are created in the free enterprise system.
3. **Describe** five nonbank financial intermediaries in the American economy.

Section 2 (pages 318–326)

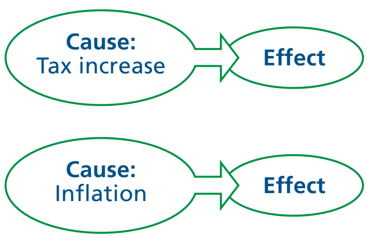
4. **Name** four considerations important to investors.
5. **Explain** how a 401(k) plan works.
6. **Explain** how current yields are computed.
7. **Compare** four types of bonds that are commonly traded in the United States.

Section 3 (pages 328–333)

8. **Explain** what the Efficient Market Hypothesis means to investors.
9. **Compare** the NYSE to the other organized stock exchanges.
10. **Describe** the nature of the over-the-counter market.
11. **Compare** the similarities and differences between the Dow-Jones Industrial Average and the Standard & Poor's 500.
12. **Explain** how options contracts are different from futures contracts.

Thinking Critically

1. **Drawing Conclusions** If you contacted several local banks to get their rates paid on various CDs, you would find that rates vary only slightly from one institution to another. Do you think the similarities are caused by efficient markets or by other causes? Explain.
2. **Understanding Cause and Effect** Explain how each of the following will affect saving. Use a graphic organizer similar to the one below to answer the question.
   a. An increase in the federal personal income tax is instituted.
   b. The United States undergoes a prolonged period of inflation.



Chapter 12 Assessment and Activities

Applying Economic Concepts

1. **Risk-Return Relationship** List five possible investments a person could make if funds were available. Rank the investments in order of how much risk each entails (from highest to lowest). Then rank the investments according to expected returns (from highest to lowest). What is the significance of the rankings to the risk-return relationship?
2. **Financial Assets** Visit a local bank or a nonbank financial institution. Ask for its free brochure that outlines the institution's investment opportunities such as savings accounts, certificates of deposit, money market accounts, and stock brokerage accounts. Write a brief report describing the financial assets the institution generates or trades.
3. **Market Efficiency** What does the Efficient Market Hypothesis mean to you as an investor, especially with respect to the composition of your stock portfolio?

Math Practice

Complete the following table by filling in the correct data in the blank spaces.

Total Income	Consumption	Saving
a. $2,000	$1,800	
b.	$2,500	$1,000
c. $7,000		–$500
d. $10,000	$10,000	
e. $12,500		$400

Thinking Like an Economist

How do you think the Internet will affect future competition among stockbrokers for individual investors' business?

Technology Skill

Using the Internet Scan the stock market listings in the business section of your local newspaper. Assume that you have $50,000 to invest in a stock portfolio, and select one or more stocks in which to invest. Study the information on reading the financial page in the Economics Handbook in the front of this book. Then, in your journal, track the progress of your stock(s) for one week or more. To help you keep track, use the following Internet sites:

The Dow Jones Industrial Averages®
http://averages.dowjones.com

The New York Stock Exchange
http://www.nyse.com

American Stock Exchange
http://www.amex.com

Chicago Board of Trade
http://www.cbot.com

After you have completed the activity, write a one-page paper in which you explain what types of information people should have before they invest in stocks. Share your results with the rest of the class.

Building Skills

Distinguishing Fact from Opinion Read the following statements. Identify each as a statement of fact or a statement of opinion. Then, explain the reasoning behind your answer.

1. A share of stock is a unit of ownership in a corporation.
2. Market analysts' predictions are of little value.
3. Junk bonds are excellent investments because they have high yields.
4. The United States is not the only government to sell bonds.
5. Financial intermediaries take part in every financial transaction.

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