



# A CLEAR UNDERSTANDING OF THE INDUSTRY

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Investment Foundations is a certificate program designed to give you a clear understanding of the investment management industry. Whether you're just starting a career in financial services or want to learn essential industry concepts, Investment Foundations offers an accessible solution for breaking through the complexities of the global investment industry and raising your professional profile.

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Investment Foundations is a comprehensive global education certificate program that provides a clear understanding of investment industry essentials. The certificate program is designed for all professional disciplines outside of investment roles, including IT, operations, accounting, administration, and marketing. There is no education or experience requirement and the exam can be taken at your convenience at available test centers around the world.

## WHAT YOU LEARN

The certificate program covers the essentials of the investment management industry:



**Module 1:**  
Industry Overview



**Module 2:**  
Ethics and Regulation



**Module 3:**  
Inputs and Tools



**Module 4:**  
Investment Instruments



**Module 5:**  
Industry Structure



**Module 6:**  
Serving Client Needs



**Module 7:**  
Industry Controls

## HOW WILL YOU BENEFIT



### Clarity

Benefit from having a common understanding of industry structure and terminology, regardless of your job function or geographic location.



### Collaboration

Work more effectively with global colleagues by understanding industry functions, building stronger relationships and raising your professional competence.



### Confidence

Gain the knowledge to identify issues and the confidence to speak up. Get a better sense of your role and how you connect with the complex global industry at large.

*"[CFA Institute Investment Foundations] is very relevant to the current market and I can study on the move. The program cleared up a lot of concepts for me and now I am much more comfortable speaking with clients about what is happening in the market."*

**MITALI BHANDARE**  
MORNINGSTAR,  
INVESTMENT FOUNDATIONS  
CERTIFICATE HOLDER

*"The main benefit of [CFA Institute Investment Foundations] was an ability to see a bigger picture of the finance industry and the role of our business within it."*

**ALEXANDER TARASOV**  
CITCO FUND SERVICES,  
INVESTMENT FOUNDATIONS  
CERTIFICATE HOLDER

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# CHAPTER 1

## THE INVESTMENT INDUSTRY: A TOP-DOWN VIEW

by Ian Rossa O'Reilly, CFA



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## LEARNING OUTCOMES

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After completing this chapter, you should be able to do the following:

- a** Describe the financial services industry;
- b** Identify types of financial institutions, including banks and insurance companies;
- c** Define the investment industry;
- d** Explain how economies benefit from the existence of the investment industry;
- e** Explain how investors benefit from the existence of the investment industry;
- f** Describe types and functions of participants of the investment industry;
- g** Describe forces that affect the evolution of the investment industry.

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## INTRODUCTION

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# 1

Like it or not, the vast majority of us have to work. We work to sustain ourselves and our dependents. Often, we earn money for our labour and use that money to purchase goods and services. But money can be used for more than everyday needs. If we spend less than we earn, we have savings. If we seek to earn a return on our savings, we are investing.

To explain how savers become investors, consider the example of a Canadian entrepreneur who needs money to set up a new business. She needs to find savers who are willing to invest in her business, so she spends weeks asking her friends and neighbours until she eventually finds a friend who is willing to invest. This friend believes he will get back more money than he lends, so he is prepared to invest some of his savings.

The entrepreneur is happy because she can now start her business. But the search for money has taken a long time; it could have been so much quicker and easier for her to find the money if there was a system that connected those who need money with those who have savings and are willing to invest these savings. Well, there is such a system! It is called the financial system.

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## THE FINANCIAL SERVICES INDUSTRY

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# 2

The financial system helps link savers who have money to invest and spenders who need money. Within the financial system, the **financial services industry** offers a range of products and services to savers and spenders and helps channel funds between them. *Note that in this chapter and in the rest of the curriculum, the terms money, cash, funds, and **financial capital** (or capital) are used interchangeably.*<sup>1</sup>

Savers include individuals (households), companies, and governments that have money to invest. Spenders also include individuals, companies, and governments. For example, individuals borrow to pay for houses, education, and other expenses. Companies borrow to invest in land, buildings, and machinery. Governments borrow when their current tax receipts are insufficient to meet their current spending plans.

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<sup>1</sup> Bolded terms are glossary terms. Many important terms are introduced in this chapter, but only the terms that are critical to your understanding of what is discussed in this chapter are bolded. The terms that are discussed more thoroughly in subsequent chapters are bolded in those chapters.

**TERMINOLOGY**

Typically, the term saver characterises those who have accumulated savings. As illustrated in the example earlier, these savings are often invested. When savers have made investments, they are typically called investors and become providers of capital. If the investment is a loan—that is, money that is expected to be repaid with interest—investors are often referred to as lenders. Similarly, the term spender characterises those who need money. When spenders have received the money they need and start using it, they become users of capital. If they are recipients of a loan, they are typically called borrowers. *Note that there are times when the terms savers/investors/lenders/providers of capital or spenders/borrowers/users of capital are used interchangeably.*

Savings can be invested in a wide range of assets. **Assets** are items that have value and include real assets and financial assets. **Real assets** are physical assets, such as land, buildings, machinery, cattle, and gold. They often represent a company's means (or factors) of production and are sometimes referred to as **physical capital**. In contrast, **financial assets** are claims on real, or possibly other financial, assets. For example, a share of stock represents ownership in a company. This share gives its owner, who is called a shareholder, a claim to some of the company's assets and earnings. An investor's total holdings of financial assets is usually called a **portfolio** or investment portfolio.

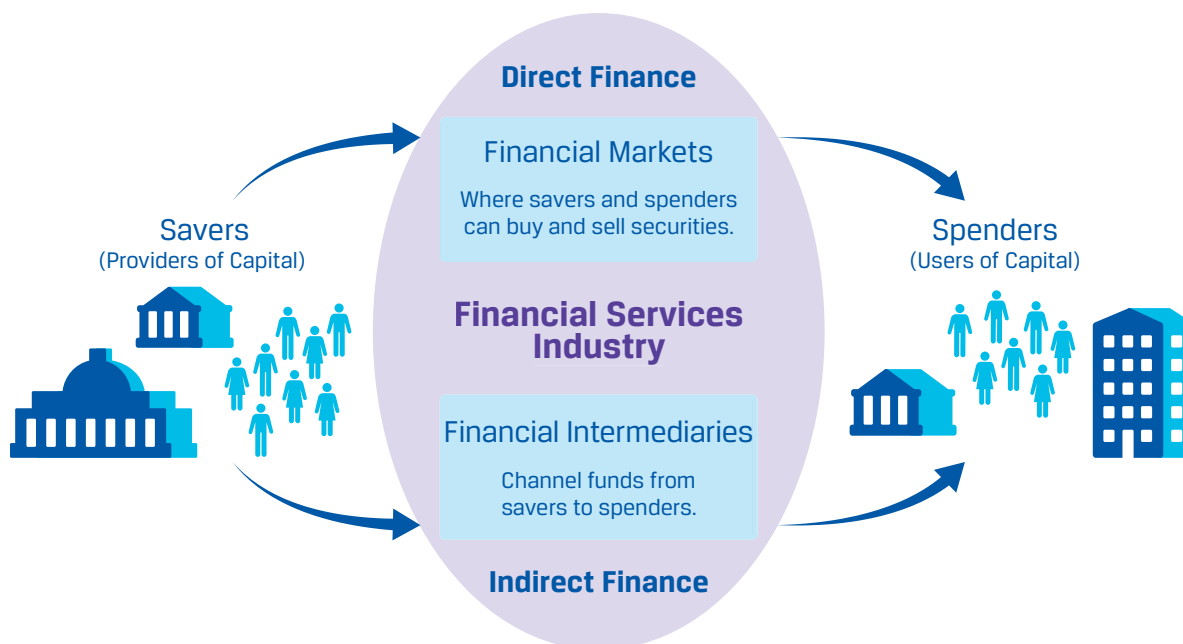
Financial assets that can be traded are called **securities**. The two largest categories of securities are debt and equity securities.

- Debt securities are loans that lenders make to borrowers. Lenders expect the borrowers to repay these loans and to make interest payments until the loans are repaid. Because interest payments on many loans are fixed, debt securities are also called fixed-income securities. They are also known as bonds, and investors in bonds are referred to as bondholders. More information about debt securities is provided in the Debt Securities chapter.
- Equity securities are also called stocks, shares of stock, or shares. As mentioned earlier, shareholders (also known as stockholders) have ownership in a company. The company has no obligation to either repay the money the shareholders paid for their shares or to make regular payments, called dividends. However, investors who buy shares expect to earn a return by being able to sell their shares at a higher price than they bought them and, possibly, by receiving dividends. Equity securities are discussed further in the Equity Securities chapter.

Markets are places where buyers meet sellers to trade. Places where buyers and sellers trade securities are known as securities markets, or **financial markets**. How securities are issued, bought, and sold is explained in The Functioning of Financial Markets chapter.

Exhibit 1 shows how the financial services industry helps channel funds between those that have money to invest (the savers that become providers of capital) and those that need money (the spenders that become users of capital). Key industry participants and processes are described in more detail later in this chapter.

### Exhibit 1 Overview of the Financial Services Industry



Providers and users of capital may interact through financial markets or through financial intermediaries. The movement of funds through financial markets is called direct finance because the providers of capital have a direct claim on the users of capital. For example, if you own shares of Nestlé, you have a claim on the assets and earnings of Nestlé.

Providers and users of capital often rely on financial intermediaries to find each other and to channel funds between each other. This process is indirect finance because **financial intermediaries** act as middlemen between savers and spenders; the former do not have direct claims on the latter. Financial intermediaries may also create new products and securities that depend on other assets.

Financial intermediaries play an important role in the financial services industry. Many savers do not have the time or the expertise to identify and select individuals, companies, and governments to lend to or invest in. Once savers have lent money, they have to monitor the borrower's behaviour and financial health to ensure that they will get their money back—a task that is time consuming and costly. Matching savers and borrowers and monitoring borrowers' behaviour and financial health are functions that financial intermediaries can perform better and more cheaply than most investors can do on their own.

# 3

## FINANCIAL INSTITUTIONS

**Financial institutions** are types of financial intermediaries. Their role is to collect money from savers and to invest it in financial assets. The two major types of financial institutions are banks and insurance companies.

### 3.1 Banks

**Banks** collect deposits from savers and transform them into loans to borrowers. In doing so, they indirectly connect savers with borrowers. The saver does not have a direct claim on the borrower but rather has a claim on the bank through its deposit, and the bank has a claim on the borrower through the loan. Banks are also called **deposit-taking institutions** (or depository institutions) because they take deposits. In exchange for using the depositors' money, banks offer transaction services, such as check writing and check cashing, and may pay interest on the deposit. Banks may also raise money to make loans by issuing and selling bonds or stocks on financial markets.

Banks vary in whom they serve and how they are organised. They may have different names in different countries. Building societies (also called savings and loan associations in some countries) specialise in financing long-term residential mortgages. Retail banks provide banking products and services to individuals and small businesses. These products and services include checking and savings accounts, debit and credit cards, and mortgage and personal loans. An increasing number of retail banking transactions are now performed either electronically via automated teller machines (ATMs) or over the internet. Commercial banks provide a wide range of products and services to companies and other financial institutions.

Co-operative and mutual banks are financial institutions that their members own and sometimes run. They may specialise in providing mortgages and loans to their members. Some co-operative and mutual banks may offer a wider range of products and services, similar to those offered by commercial banks. Depositors benefit because they earn a return (in interest, transaction services, dividends, or capital appreciation) on their capital without having to locate the borrowers, check their credit, contract with them, and manage their loans.

If borrowers default, banks still must pay their depositors and other lenders. If the banks cannot collect sufficient money from their borrowers, the banks will have to use their owners' capital to pay their debts.<sup>2</sup> The risk of losing capital should focus the banks' attention so that they do not offer credit foolishly. However, notable lapses occasionally occur, such as in the run-up to the financial crisis of 2008. Investors too often were not aware of, ignored, or could not control the risks that banks were taking.

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<sup>2</sup> In many countries, depositors benefit from government-guaranteed deposit insurance. This insurance gives depositors comfort that their savings are not at risk, although the amount that is guaranteed is usually capped.

### 3.2 Insurance Companies

**Insurance companies** help individuals and companies offset the risks they face. To protect themselves against a potential loss, individuals and companies buy insurance contracts (also known as policies) that provide payments in the event that losses occur. They typically pay insurance companies upfront, non-refundable premiums when they purchase insurance contracts. If the insured risks materialise, the insured individual or company makes a claim to the insurance company and collects the insurance settlement.

There are two main types of insurance companies: property and casualty insurers that cover assets such as homes, cars, and businesses, and legal liability and life insurers that pay out a sum of money upon death or serious injury of the person insured.

Insurers are financial intermediaries because they connect buyers of their insurance contracts with providers of capital that are willing to bear the insured risks. The buyers of insurance contracts benefit because they can transfer risk without searching for somebody who would be willing to assume those risks. The providers of capital benefit because the insurance company allows them to earn a return for taking on these risks without having to manage the insurance contracts. The insurance company manages the relationships with the insured individual and companies—primarily, the collection of the premiums and the settlement of claims. In addition, the insurance company hopefully controls various issues in insurance markets—for example, fraud, moral hazard, and adverse selection. **Fraud** occurs when people deliberately cause or falsely report losses to collect insurance settlements. **Moral hazard** occurs when people are less careful about avoiding losses once they have purchased insurance. Moral hazard potentially leads to losses occurring more often with insurance than without. **Adverse selection** occurs when only those who are most at risk buy insurance, causing insured losses to be greater than average losses.

Insurers are not only financial intermediaries but also among the largest investors. They usually invest a significant portion of the premiums they receive from the buyers of insurance contracts in financial markets in order to meet the cost of future claims.

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## HOW ECONOMIES BENEFIT FROM THE EXISTENCE OF THE INVESTMENT INDUSTRY

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# 4

The **investment industry** is a subset of the financial services industry. It comprises all the participants that are instrumental in helping savers invest their money and helping spenders raise capital in financial markets. Major investment industry participants, such as types of investors and service providers, are presented in Section 6 of this chapter. The activities performed by service providers are discussed further in the Structure of the Investment Industry chapter.



## 4.1 Economic Systems

The investment industry and its participants do not exist in isolation; they operate within economic systems that vary from country to country. Economic systems can take many forms, from pure capitalism with free markets to planned economies with centralised authorities. A goal of most economic systems is the efficient allocation of scarce resources to their most productive uses.

Resources, such as labour, real assets, and financial capital, are necessary to produce goods and services. Desire for goods and services is unlimited, but resources are limited. To illustrate this concept of scarcity, assume that an individual has a limited budget; in other words, his financial capital is scarce. Should he spend his money buying food, paying his mortgage, purchasing a new car, or going on holiday? Similarly, should a company focus its resources on an existing product or on a new one that might produce a higher profit? And should governments spend money on health care, education, defence, or infrastructure?

Because resources are scarce, decisions must be made regarding the allocation of these resources. Participants in economic systems must address three questions: (1) Which goods and services should be produced? (2) How should the goods and services be produced? (3) Who should receive the goods and services that are produced? The allocation of scarce resources is efficient if the scarce resources are used to produce goods and services that best satisfy the needs of consumers.

**Capitalism** is an economic system that promotes private ownership as the means of production and markets as the means of allocating scarce resources. In a pure, free market, capitalistic economy, there is no central authority, such as a government, directing economic activity. Instead, individuals and companies make their own decisions about what goods and services to manufacture and provide, and they get to keep the profits from their activities. When scarce resources are used in an efficient manner through the markets, economies can grow and society benefits.

However, pure, free market capitalism exists only in theory. In the real world, governments play a role in all economic systems. In some capitalistic economies, such as in Western economies, the government's role in business may be relatively minimal. In economies largely dependent on the extraction of natural resources, such as some former Soviet Republics and some Middle Eastern, African, and South American countries, the government may maintain significant control over key national industries. In transition economies, which are moving from planned economies to market economies, the government may play a significant role in business. China's economy is often described as state capitalism because the Chinese central and local governments have significant ownership of many businesses. People can also create and invest in businesses in China, and market competition is increasing.

## 4.2 How the Investment Industry Fosters Economic Growth

So, what role does the investment industry play in supporting the creation of goods and services and, ultimately, enhancing the lives of consumers? As mentioned previously, the investment industry is instrumental in channelling funds between savers who have money to invest and those who need money to finance businesses and projects.

The investment industry contributes to the efficient allocation of resources in the economy. Without the investment industry, savers would have to spend significant resources finding individuals, companies, and governments offering suitable investment opportunities. Resources would also be spent on the search for capital rather than on considering how to best use it, which would result in less efficiency.

The investment industry plays an important role in providing and processing information about investment opportunities. It helps investors collect and analyse data about economies and information about individuals, companies, and governments. It also assists investors in determining the value of real and financial assets. The types of inputs and tools used by investment industry participants are described in the chapters in the Inputs and Tools module.

Investment industry participants package investment opportunities so that they satisfy the needs of investors. In particular, the investment industry offers a wide range of services and products that makes it easier for savers to invest. These investment services and products are discussed in the chapters in the Industry Structure module.

The investment industry also provides liquidity. Liquidity refers to the ease of buying or selling an asset without affecting its price. Some assets, such as real estate (land and buildings), are inherently illiquid. For example, if you want to sell your house, it will likely take some time to sell, even if it is priced fairly compared with other houses in your neighbourhood. If you want to sell your house quickly, you may have to sell it at a lower price than you think is fair. Other assets are more liquid, such as shares that trade actively. But an investor may hold a large number of shares and selling all the shares quickly could have a negative effect on the share price. For example, if an investor owns 100 shares in a company with actively traded shares, she will likely be able to sell her shares quickly and not affect the share price. But if she owns 100,000 shares, she may not be able to sell her shares quickly without affecting the share price. As a result, she may have to accept a lower price for some or all of the shares she wants to sell. Liquidity is a very important aspect of well-functioning financial markets. Highly liquid markets allow investors to complete a transaction quickly (and to reverse it quickly if they change their minds) and to have confidence that they are getting a fair price at that particular moment.

All of these benefits increase the willingness of savers to supply funds to those who need them. Capital that is put to more productive use fosters economic growth, which ultimately benefits society.

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## **HOW INVESTORS BENEFIT FROM THE EXISTENCE OF THE INVESTMENT INDUSTRY**

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# **5**

In a well-functioning investment industry, investors are treated fairly and honestly. As a result, they have confidence to commit their savings to investments. Ideally, investment industry participants compete fairly for investors' business, and they are competent and trustworthy in advising on investment matters and managing investment products and portfolios.

## 5.1 How the Investment Industry Serves Investors

Below are some of the most important features that define a well-functioning investment industry and, in turn, benefit investors.

An important feature that characterises a well-functioning investment industry is the availability of a broad range of investment opportunities that meets investors' needs. Investors can invest in debt and equity securities and they can also invest in derivatives and alternative investments. These investments are described in more detail in the Investment Instruments module. Investors may also choose to save through investment vehicles that exist solely to hold investments on behalf of their shareholders, partners, or unitholders (units refer to shares and bonds for equity and debt securities, respectively). The ownership interests of these companies are called pooled investment vehicles because investors in these vehicles pool their money for common management. Types and characteristics of investment vehicles are discussed in the Investment Vehicles chapter.

Investment industry participants may also buy and sell various real and financial assets and then package them to create new assets that suit the needs of investors better than the original assets. Mortgage-backed securities are an example; they represent a claim on the money generated by a large number of mortgages that have been grouped together in a process called securitisation, which is further discussed in the Debt Securities chapter.

In addition to being able to choose from many investment opportunities, investors benefit from having access to a broad range of investment services that help them make better decisions and implement those decisions. The investment industry offers services of value to investors including planning, management, information, and trading services. These services are discussed in the Structure of the Investment Industry chapter. How investment industry participants assess and serve the needs of investors is discussed further in the chapters in the Serving Client Needs module.

Investors benefit when financial markets are competitive. Competitive markets lead to fair prices, which ensure that buyers pay and sellers receive a reasonable and satisfactory price. Markets in general and financial markets in particular are competitive if a large number of participants compete with one another without any one of them having an undue influence on supply or demand. Supply refers to the quantity of a good or service sellers are willing and able to sell, whereas demand refers to the quantity of a good or service buyers desire to buy. More information about supply and demand and how the interaction of supply and demand affects prices of goods and services is presented in the Microeconomics chapter. Competitive markets promote higher production efficiency and help keep the prices of goods and services, including investment products and services, down.

Investors also benefit when financial markets are liquid and transaction costs are low. As mentioned earlier, liquidity ensures that investors can quickly buy or sell an asset without affecting its price. Transaction costs are the costs associated with trading. Because transaction costs reduce the return savers make on their investments, the lower the transaction costs, the better.

To make reasonable judgments about what to invest in, savers need relevant and reliable information about the companies and governments to which they provide or may provide capital. By helping collect and process financial information, investment industry participants provide benefits to investors. The timeliness of this information

is also critical because securities prices may change quickly in response to new, relevant information. For example, the share price of an oil company that announces it has discovered a large new oil field will likely increase as investors anticipate that the company will make higher profit.

Another important feature of a well-functioning investment industry is the ability to deal with risk. Risk refers to the effect of uncertain future events on an organisation or on the outcomes the organisation achieves and is discussed in greater detail in the Risk Management chapter. Risk is an inherent element of investing, and investors should always consider both return and risk when they make investment decisions. For example, the man who lent his savings to help start his friend's business faces the risk that the friend's business fails and he never gets his money back. Although the friend's business could turn out to be the next Apple, Google, or Microsoft, the investor may decide not to lend money to his friend if losing his entire investment would have a devastating effect on his lifestyle. The investment industry can help him assess how risky the investment is.

The investment industry also provides ways of reducing risk. For example, contracts and products that represent some form of insurance may be available for purchase. Or industry professionals may provide advice on how best to mitigate the risk of investments. Those who are willing and able to take on risk may sell insurance or offer investments that allow others to reduce their risks.

## 5.2 Need for Trust, Laws, and Regulations

The many benefits that the investment industry provides to the economy and investors are not sustainable without trust, laws, and regulations.

Trust is essential to the proper functioning of the financial system in general and the investment industry in particular. Savers should be confident that they will be treated fairly by those they lend to or invest in as well as by those who advise them, sell them investment products or services, and manage their investments. If trust is lacking, savers will be reluctant to invest, and the economy and society will suffer.

Laws and regulations are necessary to ensure that investors are treated fairly and honestly. Usually, laws are passed by a legislative body, such as Congress in the United States, Parliament in the United Kingdom, and the Diet in Japan. Regulations are created by agencies, such as the Canadian Securities Administrators in Canada, the Autorité des Marchés Financiers in France, and the Securities & Futures Commission in Hong Kong. Laws and regulations must be enforceable to be effective.

The form and extent of laws and regulations vary between countries and change over time, but a number of general principles are widely applied. Laws and regulations are designed to

- prevent fraud,
- protect investment industry participants, in particular investors, and
- promote and maintain the integrity, transparency, and fairness of financial markets.

For example, trading based on non-public information that could affect a security's price—known as insider trading—is forbidden in most jurisdictions. For example, an analyst who learns during a private meeting with a company's management that the company is about to acquire a competitor is not allowed to buy or sell shares in the company or its competitor until the company has officially announced the acquisition. If the analyst trades before this information is available to all market participants, he could gain from this inside information and the integrity and fairness of the financial market would be compromised. In many jurisdictions, the analyst could also face punitive legal or regulatory measures.

Although the investment industry is subject to laws and regulations, these laws and regulations cannot cover every situation and cannot prevent fraud or market abuse from happening. This risk is why it is important that

- individuals who work in the investment industry behave ethically, in accordance with a set of moral principles, and act professionally, and
- organisations promote cultures of integrity.

Ethical behaviour on the part of investment industry participants is paramount to protect the reputation of and maintain trust in the industry. Without trust, savers are less likely to make investments, which would be detrimental to the economy and society.

We return to the discussion of ethics and regulation in the chapters in the Ethics and Regulation module. The Risk Management chapter addresses the issue of compliance with laws and regulations.

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## 6

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### INVESTMENT INDUSTRY PARTICIPANTS

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There are many investment industry participants who help spenders raise capital and savers invest their money. Anybody working in the investment industry or purchasing products and services provided by the investment industry is likely to come in contact with a number of these participants. Key participants are introduced in Sections 6.1 and 6.2. The rest of the curriculum provides more information about how investment industry participants operate and how they interact with investors and with one another.

As a way of introducing some of the main investment industry participants, let us take a look at the Canadian entrepreneur's company five years later. Over that time, the company has been successful, and it now needs new capital to continue growing. The money the company generated from its operations is not enough to support its growth plans, and the company has to turn to investors to provide additional capital. The financial services industry can help the Canadian company raise the money it needs and allow investors to participate in the company's growth. We first introduce those participants that can help the company to raise capital. Then, we discuss investors and focus on the main investment industry participants that can help them to invest their money.

## 6.1 How Companies and Governments Raise Capital

The Canadian company wants to issue shares to raise capital. Until now, it has been a private company; it has not raised money by issuing shares publicly. It wants to take the opportunity to become a public company and have its shares listed on the Toronto Stock Exchange. Stock exchanges are organised and regulated financial markets that allow buyers and sellers to trade securities with each other.

The company contacts an investment bank to help it. **Investment banks**, also known as merchant banks, are financial intermediaries that have expertise in assisting companies and governments raise capital. Investment banks help companies organise equity and debt issuances—that is, the sale of shares and bonds to the public. In the case of the Canadian company, the equity issuance is called an initial public offering (IPO) because it is the first time the company sells shares to the public. The Equity Securities and The Functioning of Financial Markets chapters provide more details about IPOs and other equity issuances.

Investment banks are specialists in matching investors with companies and governments seeking capital. The investment banks pay close attention to the types of investments that investors most want so that they can help companies and governments design securities that will suit the needs of the company or government and appeal to investors. By offering securities that investors want to purchase, companies and governments are able to obtain capital at a lower cost.

The investment bank will help the Canadian company determine the price at which the new shares will be issued. To do so, the investment bank has to gauge investor interest in purchasing the company's shares. The investment bank's analysts—often called sell-side analysts because they work for the organisation selling the securities—will collect and analyse information about the company and its competitors and prepare a detailed report that can be shared with potential investors.

When the Canadian company becomes a public company, it will have to comply with the rules of the Toronto Stock Exchange and with relevant Canadian laws and regulations. It will, for instance, have to file quarterly financial statements and audited annual financial statements. Auditors will evaluate the company's internal controls and financial reporting and ensure that investors receive relevant and reliable financial information, a key feature of well-functioning financial markets. More information about financial statements and the role of auditors is provided in the Financial Statements chapter.

## 6.2 How the Investment Industry Helps Savers Invest Their Money

The Canadian company may sell its shares to many investors whose needs vary. A basic distinction is often made between individual and institutional investors. The designation “individual investor” is self-explanatory; an individual investor is simply a person who has investments. In contrast, institutional investors are typically organisations that invest either for themselves to advance their missions or on behalf of others.

Within each of these two categories of investors—individual and institutional—there is further variation. For example, investment industry practitioners typically distinguish between individual investors according to their total amount of investable assets. There is no universal standard to classify individual investors; the distinction between

categories of individual investors varies across countries, currencies, and investment firms. But as a general rule, retail investors have the lowest amount of investable assets, whereas high-net-worth investors have higher amounts of investable assets.

The services that the investment industry provides to individual investors differ depending on the investor's wealth and level of investment knowledge and expertise, as well as on the regulatory environment. Retail investors tend to receive standardised services, whereas wealthier investors often receive services specially tailored to their needs.

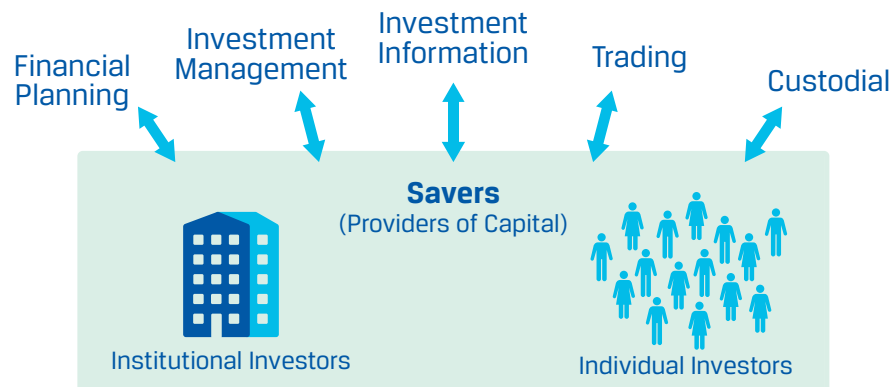
Institutional investors that invest to advance their missions include the following:

- Pension plans, which hold and manage investment assets for the benefit of future and already retired people, called beneficiaries.
- Endowment funds, which are long-term funds of not-for-profit institutions, such as universities, colleges, schools, museums, theatres, opera companies, hospitals, and clinics.
- Foundations, which are grant-making institutions funded by financial gifts and by the investment income that they produce.
- Sovereign wealth funds, which typically invest a government's surpluses. Governments may accumulate surpluses by collecting taxes in excess of current spending needs, by selling natural resources, or by financing the trade of goods and services. These surpluses are usually invested. Some governments with significant surpluses have created sovereign wealth funds to invest their surpluses for the benefit of current and future generations of their citizens.

Institutional investors that invest on behalf of others include investment firms and financial institutions, such as banks and insurance companies. Different categories of investors and their needs are discussed further in the Investors and Their Needs chapter.

Despite the differences between investors and their needs, many of the services they require are common to all of them. Some of these services are shown in Exhibit 2.

### Exhibit 2 Investor Services





When investors want to buy or sell shares, they need to find another investor who is willing to sell or buy shares. Brokers and dealers are trading service providers that facilitate this trading. Brokers act as agents—that is, they do not trade directly with investors but help buyers and sellers find and trade with each other. In contrast, dealers act as principals—that is, they use their own accounts and their own capital to trade with buyers and sellers in what is known as proprietary trading. They “make markets” in securities by acting as buyers when investors want to sell and as sellers when investors want to buy. They often have thousands of clients so if one client wants to sell shares at a certain price, the dealer can usually identify another client who is willing to buy the shares at a similar price. Brokers and dealers both provide liquidity and help reduce transaction costs; as mentioned earlier, liquidity and low transaction costs are beneficial to investors.

Other participants that provide trading services include clearing houses and settlement agents, which confirm and settle trades after they have been agreed on. Custodians and depositories hold money and securities on behalf of their clients.

Institutional investors may employ analysts to review potential investments. These analysts are called buy-side analysts because they work for the organisation buying the securities. To gather data about a company and the markets in which it operates, analysts often rely on investment information providers, such as data vendors that provide information resources and investment research providers that produce information reports.

Individual investors often do not have the time, the inclination, or the expertise to manage the entire investment process on their own, so many of them seek the help of investment professionals. Financial planning service providers, such as financial planners, help their clients understand their future financial needs and define their investment goals. Investment management service providers, such as asset managers, make and help their clients make investment decisions in order to achieve the clients’ investment goals.

Many investors, particularly retail investors, are willing to invest but lack sufficient financial resources to contract with an investment manager to look after their investments. These investors often buy investment products created and managed by investment firms, banks, and insurance companies. For example, an individual who wants to plan for her retirement may need a convenient and inexpensive way to invest money regularly. She may buy shares in a mutual fund, a professionally managed vehicle that invests in a range of securities.



## MEET SOME OF THE INVESTMENT INDUSTRY PARTICIPANTS



Zhang Li is a retail investor. She earns 5,000 Singapore dollars a month and wants to save for a deposit on an apartment in the suburbs of Singapore. She also wants to save to pay for her son's university education. She goes to her bank for investment advice.



Mike Smith is a high-net-worth investor who lives in California. He has recently sold his technology company and has \$10 million to invest. He hires a financial planner to help him define his investment objectives in terms of return and risk.



Anna Huber is an institutional investor for Euro Pension Fund, which is located in Frankfurt, Germany. The fund receives money to finance the retirement of the Euro Pension Plan members, invests the money received, and pays out money to the retired members. It has an asset management team that devises its strategy and implements it, managing a €50 billion portfolio invested in a wide range of assets. Huber is a member of that team.



Peter Robinson is an asset manager for Aus Ltd., which is based in Sydney. Aus Ltd. invests money on behalf of its clients in shares, bonds, and alternative investments. It hires a data vendor and two investment research providers to keep it updated with the latest market developments. Aus Ltd. has a broker that carries out trades on its behalf and a custodian that safeguards clients' money and assets.



Amina Al-Subari is a broker at Middle East Corp., which is based in Dubai. Investors, such as Aus Ltd. and Euro Pension Fund, ask her to find and trade assets in the market. Middle East Corp. can find and trade these assets on an exchange and also deal directly with other investors who want to sell their assets.



James Armistead is with Big Bank Financial Services, a custodian with offices all over the world. When an investor, such as Euro Pension Fund or Aus Ltd., buys securities, the trade is confirmed by a clearing house and settlement agent. The custodian then holds the security on behalf of the investor and makes sure a proper record is kept of the security and its price.

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## KEY FORCES DRIVING THE INVESTMENT INDUSTRY

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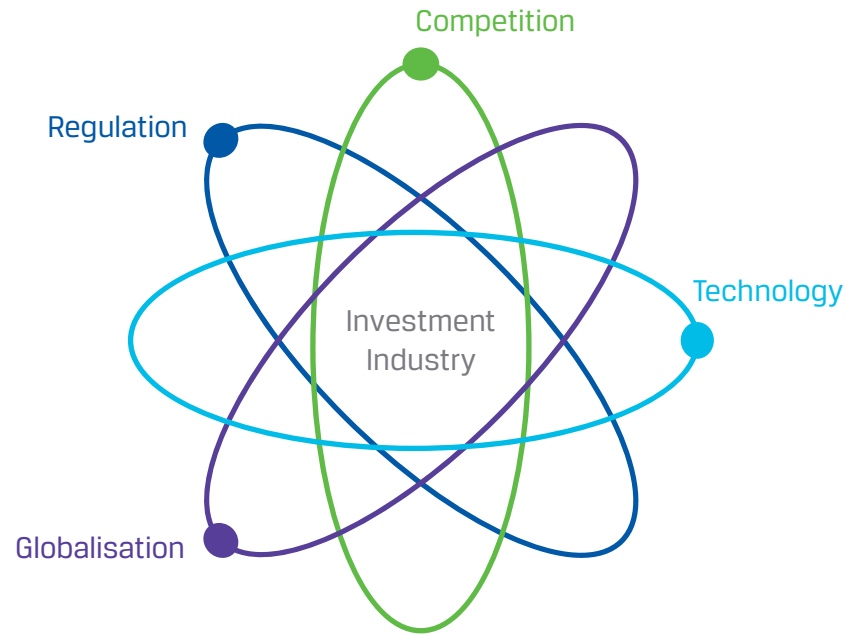
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Like most industries, the investment industry is not static. It is constantly changing to meet new needs and to react to events and evolution in financial markets. Some of these changes are driven internally—that is, by industry participants. These internal forces are

- **Competition.** Competition in the investment industry is fierce and manifests itself through innovative investment product and service offerings, pricing, and performance.
- **Technology.** Technology, and computerisation in particular, has dramatically decreased trade processing costs and increased trade processing capacity. It has also spurred the development and analysis of innovative types of investment products and vehicles.

Other changes are driven by external forces. These external forces are

- **Globalisation.** Investors look outside their domestic markets to diversify their investments and generate higher returns. These foreign investments contribute to economic development and to the overall profits of the investment industry.
- **Regulation.** Globally, there is a trend toward greater regulation of the financial services industry, including the investment industry. International co-operation among financial regulators has played and should continue to play an important role in raising global standards of securities regulation.



## SUMMARY

Without the financial services industry, money would have difficulty finding its way from savers to individuals, companies, and governments that have businesses and projects to finance but insufficient capital to do so themselves. At its best, the industry efficiently matches those who need money with those who have savings to invest, minimising the costs to each and allowing money to support the most productive businesses and projects. The investment industry acts on behalf of savers, helping them to navigate the financial markets. When the investment industry is efficient and trustworthy, economies and individuals benefit.

The points below summarise what you have learned in this chapter about the financial services and investment industries.

- The financial services industry exists to provide a link between savers/lenders/providers of capital who have money to invest and spenders/borrowers/users of capital who need money.
- Financial intermediaries act as middlemen between savers and spenders.
- The main financial institutions are banks and insurance companies. Banks collect deposits from savers and transform them into loans to borrowers. Insurance companies are not only financial intermediaries that connect buyers of insurance contracts with providers of capital who are willing to bear the insured risks, but also among the largest investors.

- The investment industry, a subset of the financial services industry, includes all participants that help savers invest their money and spenders raise capital in financial markets.
- A goal of economic systems is the efficient allocation of scarce resources to their most productive uses. Financial markets and the investment industry help allocate capital, a scarce resource, to the most productive uses, which fosters economic growth and benefits society.
- The investment industry provides numerous benefits to the economy, including the efficient allocation of scarce resources, better information about investment opportunities, products and services that are appropriate for providers and users of capital, and liquidity.
- The benefits for investors of a well-functioning investment industry include a broad range of investment products and services that meet their needs, competitive markets that provide liquidity and keep transaction costs low, timely and efficient disclosure of information, and the ability to modify their risk exposures.
- Trust is essential to the functioning of the investment industry as well as to the broader financial services industry. Laws and regulations are necessary to protect investors and ensure the integrity, transparency, and fairness of financial markets.
- Companies and governments use investment (merchant) banks to help them raise capital.
- Key investment industry participants on the investing side include the following:

Categories	Participants	Key Characteristics
Investors	Retail investors	Individual investors with the least amount of investable assets
	High-net-worth investors	Individual investors with a higher amount of investable assets
	Institutional investors	Organisations that invest to advance their mission or on behalf of their clients
Financial advisory service providers	Financial planners	Professionals who help their clients understand their future financial needs and define their investment goals
Investment management service providers	Asset managers	Professionals who help their clients carry out investments to achieve their investment goals
Investment information service providers	Buy-side analysts	Professionals who review potential investments
	Data vendors	Organisations that provide information resources
	Investment research providers	Organisations that produce information reports

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Categories	Participants	Key Characteristics
Trading service providers	Exchanges	Organised and regulated financial markets that allow investors to trade
	Brokers	Professionals and their firms that facilitate trading between investors, acting as agents (they do not trade with their clients)
	Dealers	Professionals and their firms that facilitate trading between investors, acting as principals (they trade with their clients)
	Clearing houses and settlement agents	Organisations that confirm and settle trades
Custodial service providers	Custodians and depositories	Organisations that hold money and securities on behalf of their clients

- Four key forces that drive the investment industry are competition, technology, globalisation, and regulation.