INVESTMENT *facts*

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The Capital Markets

About INVESTMENT *facts*

Investment Facts is published by the Investor Learning Centre of Canada, an independent not-for-profit organization. Our aim is to help people like you become better informed about your investment choices.

The ILC works closely with the Canadian Securities Institute – the official educator of the securities industry – and other highly regarded organizations. This helps ensure our publications and programs are accurate and non-promotional.

This issue of Investment Facts is part of an ongoing series. It complements our many other national investment learning programs, including books, seminars and a walk-in-phone-in resource centre.

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Investor Learning Centre OF CANADA
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Is financial capital just another name for money?

Not quite – you can't carry capital in your pocket! Financial capital is any extra cash you put aside after you've paid all your bills and bought all the things you need or want. When you've built up some savings, this capital can be used to make more money.

There are lots of ways to do that. People often put their savings in the bank and collect interest on it. You can also buy something which you hope to sell later for a higher price. A painting or a house will often grow in value (while most cars do not). The difference between what you paid and what you sell it for is a *capital gain*.

Putting your money to work so that you make more capital is called investing. Putting your money to work so that users of your capital also benefit and provide benefits to others is *productive* investment.

This newsletter will introduce you to the ins and outs of productive investing. Productive investing takes place when savings are funneled through Canada's capital markets, the marketplaces for stocks and bonds. This special kind of investing drives our economy and creates jobs.

What exactly is a capital market?

Let's start with what a market is first. A market is really just a place where people gather to sell and buy goods. A Saturday morning farmers' market is a good example. Markets tend to occur at a set time and place so lots of people come. Buyers have a broad choice readily available and can comparison shop to ensure the best price. Sellers have the benefit of reaching many buyers very easily which saves money and time.

A capital market works the same way. People who have extra money to invest are brought together with people who are looking for money to fund an enterprise and are prepared to pay for the privilege of using it.

Naturally, people don't actually go to a marketplace and exchange funds with someone else for a fee. What they do is buy a stock or bond or some other security which represents this exchange of cash. By doing that, they funnel money to those who are looking for capital.

By investing your savings in the capital market, you are helping to drive our economy and create jobs.

A capital market is the sum of all providers and users of capital, all the financial products like stocks and bonds which make the transfer of capital possible, and all the people and organizations which support the process.

Who provides capital: people like me?

You are taking part in the capital market if you so much as put some savings away in the bank. That's because banks take your money and lend it out again to people and companies who want to borrow. They pay you for using your funds, but they make a profit on the difference between what they pay you and what they charge their borrowers. You'll never get rich or even stay much ahead of inflation by leaving your money in a bank savings account! Of course, savings accounts are

easy to access and low risk. When you invest in the capital markets, you take on additional risks to get better returns on your money. One of these risks is called market risk, the chance that the value of your investment will fluctuate, or that it might not be easy to turn into cash when you want it. Another risk is called issuer risk, which is the possibility that the company or government whose securities you invest in will go bankrupt. In general, though, to get higher returns, you have to take on more risk.

Many Canadians invest in the capital markets despite myths that you have to be rich and that securities are risky.

Many people prefer to invest directly in the capital markets to try improve their returns. Although myths abound that keep newcomers out of the markets, such as the belief that all securities are too risky or that you have to be rich to invest, individuals in Canada actively invest in stocks and bonds. Roughly two-thirds of Canadians invest in stocks and bonds. Every person who invests is important to the capital markets. A market where lots of people participate is much more efficient than one with only a few buyers and sellers. Prices are more competitive and people can make deals much faster.

However, the largest investors are often not individuals. Dollars saved by many people are pooled or grouped together and managed under one umbrella by a professional money or fund manager. These large funds are called *institutions.* An example of an institutional investor is a mutual fund. Individuals invest directly in these funds. However, you could be investing without knowing you are doing it. Pension funds, for example, invest the money you are contributing through your company pension or RRSP. Institutions like these are very active in today's capital markets.

Markets also provide opportunities for foreign investors. Large investors from around the world may find better returns in Canada than in their home country, especially when economic conditions are better here.

Who uses the capital I invest?

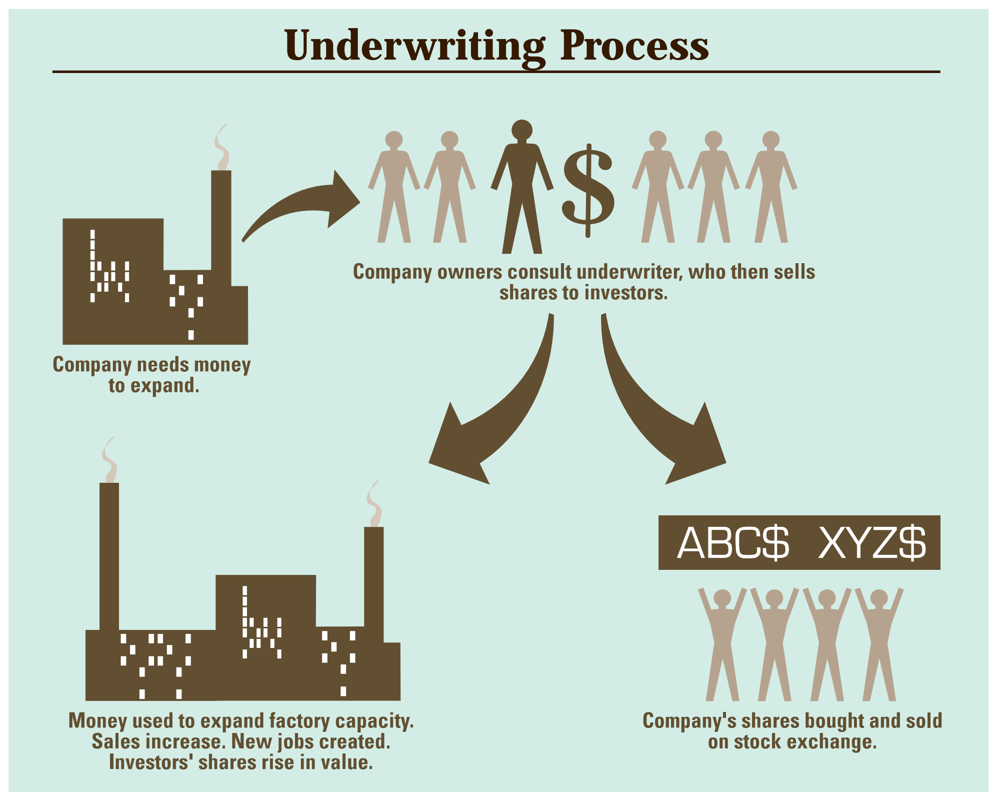
The biggest users of capital are governments and businesses. Both of these are very expensive to run. They need a ready source of money.

Why do governments need money?

The three levels of government – federal, provincial and municipal – need money to pay for public services for all Canadians. Services provided by schools and universities, by hospitals, for welfare and unemployment insurance, for road building and maintenance, for garbage pickup and the like are all paid for out of the public purse. Government expenditures are divided between *capital projects,* large building projects which are intended to serve Canadians for many years, and *social services* such as government pensions and welfare systems which help individual Canadians. In addition, governments have to pay a lot of interest on money they have already borrowed.

Governments raise money to pay for capital and social programs in lots of ways. The taxes we pay are a big source of funds. Unfortunately, governments are not always good at balancing their budgets so their expenses are sometimes larger than their incomes. When that happens to you or me, we must make up the difference somehow. We can borrow the money or we can sell something. Governments do the same thing.

When governments and companies issue bonds, they are borrowing money from you.



How do governments borrow?

Governments can't just go to the bank as the average person would do. No bank has enough money in its treasury for that! But governments go into debt just the same. Instead of borrowing from a bank, they borrow from the public at large.

The way they borrow is by issuing bonds. A bond is what people in the securities industry call a *debt instrument.* A home mortgage is also a debt instrument. Debt instruments are simply IOUs which describe the terms of a contract between a borrower and a lender. Such terms usually include a promise of repayment in full by a certain time and an outline of what the cost of borrowing will be.

Governments don't have to offer any security for their loans but the average person, or even large corporate bond issuers, are expected to pledge some assets, such as a house, to ensure the lender is protected if the borrower walks away. Governments get special treatment because they have the ability to raise taxes to cover their debt payments. That's pretty effective collateral!

Can governments borrow too much money?

Certainly. When you or I have too much debt, the cost of paying interest can really cut into our standard of living. We try to get out of debt and are careful how we spend. If we choose to use our charge card for a holiday, we know we'll pay for it over and over again.

Today's governments also have a tremendous amount of debt and a huge burden of interest to pay. For many years Canadian governments spent more than they took in, creating budget deficits.

The interest burden caused by running large deficits over many years results in governments spending less on productive programs and goods and services that benefit all Canadians. Furthermore, a lot of the interest goes to foreign investors since many bonds are sold outside of Canada. Foreign investors won't likely spend their income in Canada and that hurts the economy even more.

Clearly, governments have a responsibility to ensure they spend carefully and borrow productively. Our economic health relies on it.

When they're strapped for cash, wouldn't it be better for governments to sell something instead of borrowing?

Unfortunately, governments have limited assets that they can sell. Federal and provincial governments own land, but much of it is used for roads, airports or parks, or is not marketable. They are able to sell forest, mineral and other rights, but factors like environmental impact prevent governments from developing Canada's natural resources willy-nilly.

Some assets can be sold. Governments own businesses called *crown corporations* which are unlike public companies and do not have to be profitable to survive. These crown corporations often have responsibilities that serve the public interest, adding extra cost to the business. Over time, the government may decide that the public interest could continue to be served without the crown corporation. When this happens, the government might sell the company and raise money this way. This is called *privatization,* and has been done with companies like Air Canada and PetroCanada.

Governments borrow to fund capital projects and social programs that they can't cover out of our taxes.

Despite this, governments rely most heavily on borrowing in the bond market to fund public programs.

Why does business need capital?

Business is the other big user of capital. A business needs an inflow of cash at several times in its life cycle. First, it needs money to get started. There are things to buy for even the simplest at-home business...a desk and file cabinet, perhaps a computer and software. Budding manufacturing businesses need even more up-front cash to pay for everything from raw materials to machinery. As well, there is often a long dry spell before a business makes money and it's important to have enough resources to last through this start-up period.

Whenever a business is ready to grow or develop, another large cash infusion is called for. Perhaps the company must expand its factory and manufacturing capacity in order to fill increasing orders. Perhaps its current equipment is out-of-date. These expenses are usually over and above what the company can pay for out of its profits. But spending this money is usually a good investment because it will help the business make more profit.

A business must also have the funds to pay back any loans it has taken out and to cover any interest payments.

What happens if business can't get the money it needs?

Businesses that can't get hold of financing either never get going or stay very small. Most people don't have the resources to cover the up-front cost of starting and running a business themselves, at least not for very long.

It is important to our economy that promising businesses are not nipped in the bud because they lack funds. Business provides the goods and services that make our lives comfortable and productive. Business also means jobs. In fact, small business in Canada has traditionally been the biggest creator of new jobs.

If the flow of capital to business is hampered, growth and development stops, jobs disappear and the economy stagnates. By investing your savings in the capital market, you are fuelling growth and development and making a productive investment in economic health.

How does a company raise money?

When someone starts a company, the most obvious way to get money is to borrow either from friends and family or from a bank. As a company grows, banks continue to be useful as a source of funds.

The company can pay for growth out of its profits, if it has any. When these profits are plowed back into a company, they are called *retained earnings.* Retained earnings are an important source of capital for companies of all sizes.

It is also possible to sell a part of a company, or *share,* to raise money. Selling shares means that all the buyers become part-owners. They have *equity* in the company. Equities are just another name for company stocks or shares.

Large companies also have the option of borrowing through debt instruments like bonds.

So investing in the capital market means that I either lend my money to governments or to business or I buy a share in a company?

That's it, really. You can choose between a stock and a bond. Which one you choose will depend on a number of factors.

What are the main differences between bonds and stocks?

When you buy a bond or another debt instrument, you are lending your money. That means you are a creditor, which is someone who is owed money. You must be paid back in full together with interest. If the company goes out of business, you have a good claim on any assets that may be left over.

As a shareowner, you own part of the company. You have the right to share in the profits and the growth of the company. However, if the company goes under, your claim to what's left over falls behind any claims of creditors. This makes your investment a little riskier, although that will depend on the particular stock you are thinking of buying.

Bonds and other debt instruments offer interest or some form of *fixed income,* a term which means that you know how much you can expect as a fee for lending your money and you know when you will be paid that income.

When you buy a bond or another debt instrument, you are lending your money.

Stocks, on the other hand, don't have to pay any interest because you are not lending money to the company. You may be paid a dividend, which, though a payment like interest, is actually a share of profits. Some kinds of shares always pay a dividend while others do not. Whether dividends are paid often depends on how well a company is doing. With some stocks what you are counting on is that the company will grow in value and that your share, as part-owner, will grow in value with it. When you sell it, you will then make a profit or a *capital gain.*

So how do I know which to buy?

Whether you buy a debt instrument or a share will depend on your needs as an investor. Do you want regular income? How much risk do you want to take on? How much money can you afford to invest?

By reading other Investment Facts newsletters, you will get a better idea of what products are available and how they might suit you. The next step, though, is to learn more about the securities industry and what it does.
You will find this information in the Investment Facts newsletter on the Market System.

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