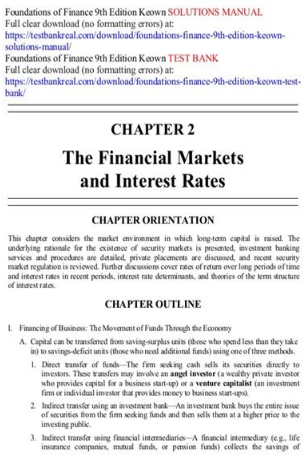

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CHAPTER 2

The Financial Markets and Interest Rates

CHAPTER ORIENTATION

This chapter considers the market environment in which long-term capital is raised. The underlying rationale for the existence of security markets is presented, investment banking services and procedures are detailed, private placements are discussed, and recent security market regulation is reviewed. Further discussions cover rates of return over long periods of time and interest rates in recent periods, interest rate determinants, and theories of the term structure of interest rates.

CHAPTER OUTLINE

I. Financing of Business: The Movement of Funds Through the Economy
   A. Capital can be transferred from saving-surplus units (those who spend less than they take in) to savings-deficit units (those who need additional funds) using one of three methods.
      1. Direct transfer of funds—The firm seeking cash sells its securities directly to investors. These transfers may involve an **angel investor** (a wealthy private investor who provides capital for a business start-up) or a **venture capitalist** (an investment firm or individual investor that provides money to business start-ups).
      2. Indirect transfer using an investment bank—An investment bank buys the entire issue of securities from the firm seeking funds and then sells them at a higher price to the investing public.
      3. Indirect transfer using financial intermediaries—A financial intermediary (e.g., life insurance companies, mutual funds, or pension funds) collects the savings of