

ACTIVITY OF INVESTMENT BANK IN CONTEMPORARY MARKET ECONOMY

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Abstract—In contemporary market economy, banking is increasingly related to financial market on which securities are issued by companies and the state. Issued securities, which have found their buyers in primary market, can still be in circulation in secondary market. Development of primary market of securities is largely based on development of secondary market, which provides permanent liquidity of long term securities. In this paper, the following is analyzed: 1) functions of investment banks; 2) goals of investment policies of banks and 3) strategies of complex portfolio.

Keywords—investment banks, investment portfolio, shares, bonds, risk.

I. INTRODUCTION

DEVELOPMENT level of secondary market is measured by: (1) height of market capitalization; (2) scope of circulation in secondary market and (3) number of registered companies in capital market. By market capitalization we imply the product of total number of shares and market price of one share. Relative size of market capitalization is obtained when it is put in relation with nominal social product of the country or within the same country we observe the movement of market capitalization rate in time series. Annual scope of circulation in secondary market, put in relation towards market capitalization or nominal social product, shows to what extent market capitalization as financial potential is effectively used in market transactions. [1].

There are two types of investment banks. One type of investment banks provides complete set of services that are included in investment banking. Those are not only the jobs of primary issuance of securities, but also broker jobs with citizens. Precisely for that reason investment banks have jagged subsidiary network. The most famous banks of this type are American investment banks Merrill Lynch and Morgan Stanley. Investment banks of the second type do not have jagged subsidiary network, because they are focused on doing business with companies. These investment banks are particularly engaged in primary emissions of shares and bonds, as well as jobs of fusions and acquisitions. The most famous American investment banks of the second type are Goldman Sachs and Salomon Smith Barney.

In processes of emissions of company's shares, four

types of transactors take place: company-issuer, investors (individual and institutional), investment bank and state commission for securities. Ultimate participants in these transactions are companies-issuers and investors. Investment banks do not have a mediatory role.

II. FUNCTIONS OF INVESTMENT BANKS IN EMISSIONS OF SECURITIES

Investment banks have three functions in the process of emitting securities of companies: 1) advisory; 2) taking risk and 3) selling issued securities in primary market.

Each of the mentioned three functions of investment banks has its price that issuer company pays by reducing the total selling price in the form of provision from total selling price of issued amount of securities in primary market. If selling price of one share is 20 USD, with the assumption that margin that belongs to investment bank is 5 %, company issuer obtains 19 dollars per share, while the one dollar is for covering advisory and selling costs, as well as coverage of guarantee risk.

1) *advisory function of investment banks is rather significant in preparatory phases for emission of company's securities. In that aspect, investment bank helps companies-issuers to make a preliminary prospect. This document contains basic information that show the level of company's solvency, as well as effects of new emission of securities. Preliminary prospect is sent to state commission for securities that makes a decision on registration of new series of shares and bonds of companies. Meaning of decisions on registration is for the state commission to prevent registering of securities of those companies that do not meet the conditions of solvency. However, registration of shares/bonds of a company does not imply that state commission guarantees that the company will be successful and that the value of its shares will keep growing. Registration at state commission implies only that company-issuer (with professional help of investment bank) has offered all relevant information that lead to the conclusion that company disposes with solvency for emission of securities. Main responsibility for future market performances of issued shares/bonds is on the company-issuer, as well as investment bank as advisor and guarantee for particular emission. After*

- the registration of planned emission of securities performed at state commission, the final version of prospect is formulated. This document is not only the information for potential buyers of securities, but also legal obligation for the company that has issued the prospect. In prospect, it is necessary to mention all relevant conditions under which the sale of shares/bonds is performed in primary market. Here, we primarily have in mind the price of shares and interest rate on bonds. Prospect must contain general information that refer to particular company and new series of securities such as: management goals in relation to emission, amount of shares/bonds that will be exposed to sale in primary market, income and loss of the company, purpose of using the funds gained through the sale of securities, etc. In developed countries, it is usual for the prospect in short version to be published in financial press as wide circle of potential investors would be familiar with upcoming emission of securities [2].*
- 2) *function of taking risk is extremely important for emission companies. Therefore, there are two options that refer to guarantee of emission risk. Main option is that group of investment banks guarantees company-issuer that the predicted amount of shares or bonds will be sold in primary market by prices and conditions offered. In that case, it is about solid obligation of selling the shares by emission price. Solid obligation of investment banks is realized in such a manner that they buy entire series of shares and later sell it to investors in secondary market. In case of the second option, investment banks undertake only the obligation that they will make "the best effort" to realize the sale of newly-created securities by emission price.*

In the function of undertaking guarantee risk and organizing selling campaign, investment banks perform in consortium. However, only one investment bank has the role of coordinator in a specific consortium. Formation of consortium is significant primarily due to risk diversification for specific emission of securities. Therefore, each bank in consortium participates with previously determined quote in business risk. The height of that quote is affected by height of capital of the bank, as well as level in which bank wants to be engaged in specific emission business.

Share of investment banks in covering the risk in emission of shares/bonds of companies affects more realistic evaluation of possibilities for placement of securities, as well as conditions under which that placement can be performed. In order to be highly profitable, investment banks shouldn't finance stocks of securities for longer time. For those reasons, investment banks, for their own interest, carefully evaluate the amount and prices so that securities could be sold in primary market in short period. In order to be able to make such an evaluation, investment bank must answer the following questions:

- a) *How strong is the company that performs the emission of securities?*
- b) *What is the evaluated demand for securities of particular company like?*
- c) *How strong or weak is the primary capital market in that moment?*

The first question could be answered by company-issuer, although it is always good to perform a cross verification of the grades of experts of both the specific company and investment bank. The second and third question can be answered by the experts of investment banks [3].

Main forms of emissions of securities are:

- i) *Public offer,*
- ii) *Direct placement of newly-created shares and bonds to institutional investors and*
- iii) *offer of shares to existing shareholders on the basis of priority purchase.*

Public offer of shares and bonds of companies is in total mechanism of emission of securities for the reason that this form of emission is aimed at broad audience and it is carried out in open capital market. Precisely for the reason that public offer of shares and bonds is also aimed at individual investors, it goes through a special procedure that is supposed to protect the interests of small investors [4].

By regulations of state regulatory commission or regulations of appropriate financial stock markets, minimal rate of the participation of new shares that must be offered to broad audience is determined. In many countries, mentioned minimal rate of shares for individual investors is 25 % of the total amount of newly emitted shares [5].

Direct placement of newly created shares and bonds occurs on the basis of previous agreement between company-issuer and institutional investors that appear as buyers of a particular quantum of securities. Among institutional investors, there are primarily insurance bureaus, pension funds and investment funds. Therefore, we must keep in mind that in the latest period there came to the rapid growth of financial potentials of institutional investors. Growing potentials of institutional investors seek to be placed in appropriate securities. Thus, specific and sophisticated capital market was created [6].

Offer of shares for existing shareholders is on the basis of priority purchase. This channel refers exclusively to emission of shares, having in mind that privileged right is given to existing shareholders to purchase particular contingent of newly created shares in proportion with previous holdings of shares for each shareholder individually. For example, the company can decide that each shareholder can (but doesn't have to) buy one newly emitted share on each three shares. Existing shareholders are privileged in the aspect that they buy shares with discount of 15-20 % in relation to the price of shares of that company in secondary market. This right can be used by existing shareholders in relatively short period (2-3 months) [7].

3) *in case of shares and bonds emission in primary capital market, there appears the problem of determining the price by which mentioned securities will be offered in capital market, especially in public offer. That issue is less expressed in forming the prices of bonds, because their price is basically formed inversely in relation to the height of appropriate interest rate. When interest rates in market grow, market price of bonds in appropriate measures drops and new series of bonds must, in the aspect of price, be in compliance with rates of yield obtained on bonds that are already in secondary market. In addition, it is relatively simple to determine initial price of new series of shares that are, by its characteristics, identical to earlier series of shares that already have market prices in secondary circulation.*

The most serious problem is how to form initial prices of shares for companies that did not have shares emissions until then. In preparing shares emission, it comes to an agreement among relevant company and investment bank. Basically, there are two methods for forming contractual relations between company-issuer and investment bank.

The first method is based on the principle of the deepest tendency and it contains in agreement on shares offer price between the company and investment bank. In case of this modality, investment bank put "the best efforts" to sell the total amount of shares at contracted price, holding from charged mass the funds that represents its provision.

The second method that is dominant in primary shares emissions in contemporary capital market, known as solid obligation of offer. In that case, investment bank guarantees the company that it will get the contracted amount on the basis of emission of shares in public bid. Investment bank is ready to purchase entire amount of shares that remains unsold by contracted price, after the margin is deducted. Investment bank, even with lowered selling price of shares, must pay company-issuer the total amount on the basis of initial price of emitted shares after the margin is deducted. In that case, for investment bank it is especially important to determine the price of shares in initial bid.

The initial price of shares is affected by the following factors:

- 1) Overall situation in capital market,
- 2) Specificities of company-issuer and
- 3) Policy of investment banks.

III. GOALS OF INVESTMENT POLICIES OF BANKS

Investments in securities are, in financial literature and practice, called investments in the sense of financial investments. Banks place available credit potentials in the form of loans and purchase of securities. On that basis, banks carry out portfolio management of loans and securities (investments). Proportion among placements in

loans and investments generally depends on strategy of business policy of particular bank. The change in proportions among loans and investments occurs also due to changes in overall economic situation, as well as directly due to movements of market interest rates.

There are three important differences between placements of banks in loans and investments.

Loans are granted to enterprises having in mind long-term client relations, as well as personal relations with managers, while investments are non-personal. In case of loans, the rule is for seekers to start the initiative for getting the loan, while in case of securities purchase in secondary market, the buyers have the initiative. In case of buying securities of a bank, investors choose the option that suits them best.

The banks keep loans, as a rule, up to maturity date, so it is considered that loans are non-liquid assets of banks. However, the bank can sell securities that it keeps in its assets on financial market at any moment, which particularly refers to state securities for which there is a deep secondary market.

Securities that banks dispose within their assets can be divided into two categories.

The first category of this securities consists of secondary reserves of liquidity, which provides the bank liquidity preservation in case of sudden outflow of funds. Since primary reserves of liquidity, found in transaction deposits of banks at Central Bank, represent non-interest assets, banks tend to keep the greatest part of overall liquidity reserves in the form of interest bearing secondary reserve assets.

The second category of securities in banks are placements in so-called investment account. Banks keep these securities primarily for the purpose of acquiring the income and impact of height of interest risk.

Basically, banks use high-quality bonds that are easily marketable in monetary market as secondary reserve. Medium-term and long-term securities, with maturity dates of more than one year, principally are included in investment accounts of banks.

General goals of investment policy of banks in market economies consist of providing liquidity, income and control of interest risk. Secondary reserves provide primarily the function of banks liquidity, although they simultaneously create interest income and can be used to regulate interest risk. On the other hand, securities in investment account of banks have primarily the goal to create interest income, as well as regulation of interest rate.

In case of portfolio management of securities, there are following types of risk:

- 1) *credit risk;*
- 2) *interest risk;*
- 3) *inflation risk;*
- 4) *liquidity risk.*

The most important part of portfolio risk contains of interest risk that is reflected in change of market price of bonds, which results in capital gains or losses. But, the

other forms of portfolio risk, such as credit risk, inflation risk and illiquidity risk are also important. For those reasons, banks are carriers of investment portfolio must be able to manage portfolio risk. It is about the selection of instruments with acceptable credit risks, portfolio diversification, type of securities, etc. Based on this, we obtain acceptable structure of portfolio with minimization of portfolio risk with adequate yield rates. Changes in portfolio structure are performed through purchase and sale of particular securities, paying attention to selection of appropriate moment for these operations [8].

IV. STRATEGIES OF COMPLEX PORTFOLIO

By complex portfolio of securities, we imply such a portfolio that contains both the shares of companies and bonds of the state and companies. These presentations are not valid only for the banks, but also other financial institutions, such as insurance bureaus, pension funds and investment funds. Actually, in case of non-banking financial institutions, managing complex portfolio is more significant than in banks because securities are a smaller part of banks' assets.

When it comes to complex portfolios, number of options is increased along with greater number of different types of securities in portfolio structure. Therefore, bank (financial institution) must precisely define specific goals of its investment policy, particularly interrelations of yield, risk and liquidity. In case of complex portfolio, bank (financial institution) must choose between active and passive strategy of complex portfolio.

- 1) *passive strategy of complex portfolio is simpler variant contains of the policy of retaining primarily formed portfolio structure. That is the essence of the concept buy and hold which means that shares and bonds in bank's assets (financial institution) are kept up to maturity date.*

From the above-mentioned reasons, in case of passive portfolio strategy, initial construction of complex portfolio is important. The essence of passive strategy is that portfolio managers do not strive to achieve gain from current transactions in financial market, but they are interested to obtain fair yield for acceptable risk level. Important characteristic of passive portfolio strategy contains of high level of risk diversification. Therefore, the principle that is valid is that if higher level of risk diversification is performed, the non-market risk that refers to risk of a particular security is reduced. If we maximally reduce non-market risk, the market risk related to overall oscillations in financial market is left and no diversification can reduce it. Height of portfolio risk is measured by beta coefficient that shows the relations of particular portfolio risk and overall market risk. If beta coefficient is higher than one, the specific portfolio of shares contains risk that is higher than the risk of overall shares market. If, based on maximal and optimal diversification, portfolio risk of shares of particular financial institution is reduced to portfolio risk

of shares in overall financial market, then beta equals one. Since in passive strategy, it is taken into consideration the permanent keeping of shares and bonds up to their maturity, this strategy implies low circulation and low transaction costs of financial institutions. In addition, financial institution can hold minimal amount of liquid assets (transaction money) because it has small needs for short-term interventions in financial market. Revision of portfolio structure is performed only on exceptional occasions, when conditions in financial market are significantly changed [9].

Contemporary version of passive strategy of complex portfolio are index funds. The essence of index funds is that portfolio managers, in order to maximally reduce non-market risks, performs as greater as possible diversification of portfolio structure. Therefore, it is not particularly significant to perform maximal diversification of shares, having in mind that risks with shares are basically significantly higher than with bonds. Shares index Standard & Poor 500 (S&P 500 index) represents good approximation of overall market movement of shares prices in American financial market. Therefore, if some portfolio management has in its assets these 500 shares, non-market risks that come from deviations of the price of some shares in relation to market average are practically neutralized. However, in financial circles it is evaluated that portfolio managers do not have to keep these 500 types of shares in their assets but it is sufficient to keep 20 to 50 types of shares in order to obtain almost optimally diversified portfolio structure. Keeping greater number of diverse securities would not significantly contribute to further reduction of non-market prices.

If financial institution chooses passive strategy of complex portfolio, it has lower expenses, because there is no need for analysts of securities. It is especially the case if complex portfolio consists of securities in exact proportions. The essence of this strategy is that it does not pretend to achieve better performances of particular portfolio in relation to performances of overall financial market. In that sense, we say that passive strategy, especially in index funds, does not aim at affecting financial market in the aspect of achieving better performances. Strategy of index funds simply illustrates financial market and tends to achieve those performances that are achieved in this market. Strategy of index funds is used by many institutional investors, as well as banks. Some corporations also use the strategy of index funds for pension funds of employees.

- 2) *active strategy of investment portfolio seeks almost permanent sales/purchases of securities in order to gain profit from unbalances prices of shares and bonds in financial market. Therefore, active portfolio policy starts from the assumption that there are always shares and bonds with unbalanced prices and that it is important to discover such securities. In that sense, active strategy must count with engagement of investment analysts who permanently study movements in financial market in order to discover shares and bonds with*

unbalanced prices. For that reason, active portfolio strategy counts with high circulation in financial market, which draws high transaction costs. In addition, we need to mention that active strategy draws frequent revisions of desired portfolio structure.

Standard variant of active strategy of complex portfolio consists of using fundamental and technical analysis of securities, especially shares. Fundamental analysis has the goal to discover overrated or underrated shares and bonds. Therefore, fundamental analysis keeps in mind the performances of company that has emitted those shares and from that analysis it draws conclusions about its yield rates and other significant characteristics of business. Technical analysis relies on graphical observation of typical patterns of movements of the prices of securities, especially shares, and draws conclusions about the optimal moment to perform purchase or sale of particular paper with unbalanced price. While fundamental analysis represents starting point for short-term interventions of active investment policy, technical analysis points to timing of these operations.

V.CONCLUSION

Banks place available credit potentials in the form of loans and purchase of securities. Based on it, banks implement portfolio management of loans and securities (investments). Proportion between placements in loans and investments generally depends on strategy of business policy of particular bank [10, 11].

General goals of investment policy of banks in market economies imply providing liquidity, income and control of interest risk. Secondary reserves primarily provide liquidity of banks, although simultaneously they create interest income and can be used in regulation of interest risk.

On the other hand, securities in investment account of banks primarily have the goal to create interest income, as well as regulate income risk.

The most important form of portfolio risk consists of interest risk that is reflected in change of market price of bonds, which results in capital gains or losses. There are other important forms of portfolio risk such as credit risk, inflation risk and illiquidity risk of securities. For those reasons, banks as carriers of investment portfolio must be able to manage portfolio risks.

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