The relation between intermediaries and efficiency in the capital market

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Abstract:
Different theories along with a large number of reviews and research papers have dealt and still up to the current times, dealing with market efficiency and how capital market players can generate abnormal returns making profit out of the inefficient situations in the capital markets. The paper reviews some of the literature on the inefficiency that sometimes can be caused by the financial intermediaries during the process of their functions.
Key words: *Capital markets, financial intermediaries, markets efficiency.*

ملخص:
تعاملت النظريات المختلفة جنبا إلى جنب مع عدد كبير من الآراء والأبحاث والتي لا تزال حتى العصر الحالي، والتي تناولت طرق تعامل صانعي السوق مع الكفاءة المالية وكيفية تحقيق عوائد غير عادية للربح على غرار حالات عدم الكفاءة في أسواق رأس المال. وتستعرض الورقة بعض ما كتب حول عدم الكفاءة التي يمكن أن يكون سبب في بعض الأحيان من قبل الوسطاء الماليين خلال عملية وظائفهم.

Introduction:

The advanced economy that we know nowadays is an economy that depends principally on the financial system. As the "Financial Regulators" are considered to be one component of the financial system; "Financial Markets" (with "Capital Markets" as a part of them) are one component of this system where funds are exchanged among allocators and investors. The other component is "The Intermediaries" who are the players of a key role in facilitating the financial exchange.

In this paper, we focus particularly on the aspects of the capital market, and we examine in a general way the respective types and roles of the different financial intermediaries. This work also documents a number of studies and literature exploring how the functionality and the behavior of these intermediaries affect the efficiency of the capital markets since they are not just counterparts who monitor and screen all kinds of related information.in this context we will try to find out the concept of financial efficiency and the capital market, because of that we divided this paper into the following points:

1. capital markets;
2. roles of intermediaries in the capital market;
3. markets efficiency.

1. Capital markets:

Definition:

It is that part of the financial market where the long-term financial instruments issued by the government or corporations are traded. The basic characteristic of these markets is that money is channeled

from those with more funds than they need (savers) to those who have an immediate productive use for it (borrowers)[1] Both savers and borrowers can be people, companies and/or governments. The maturity of the financial instruments of the capital markets is greater than one year (besides to those with no maturity). Hence, it is the market to raise long- term capital.

Instruments of the capital market:

A large variety of financial instruments is available to investors in capital markets. These securities are in general debt and equity instruments with maturities greater than one year, and are also considered to be fairly risky investments than those of the money market. The most common types of securities traded in the capital markets are:

1. Shares:

Shares are the portion of the financial capital of a limited company, they are divided into:

- ✓ Equity shares: the type of shares that gives its holder an entitlement to a variable dividend decided by the board of directors. They are also known as ordinary or common shares.
- ✓ Preference shares: the type of shares that gives its holder an entitlement to a fixed return.

2. Bonds:

A special form of loan instruments issued by companies, financial institutions, municipalities or government companies, which commits the issuer to make a definite sequence of payments until a specified terminal date; in short, it is a contract or an agreement between the borrower and the lender. This type of securities is mostly a low-risk asset as it assures future cash flows, and usually pays a fixed rate of interest[2]

There are many types and examples of bonds such as: convertible bonds, municipal bonds, tax-saving bonds, foreign bonds, junk bonds, zero-coupon bonds, regular income bonds …etc. There is also what is known as debentures, another type of loan instruments issued on the assets of the issuing company (Fully convertible debentures -FCDs, Non-Convertible debentures -NCDs, Partly Convertible Debentures- NCDs)[3]

3. Derivatives:

Sophisticated financial products that consist of any security that derives its value from the price of another instrument or asset, and this is the reason why they are called "derivatives"[4].The capital invested in derivatives is less than the price of the underlying asset. Derivatives contracts are generally used for speculation and risk management, and can be traded in a different market from that in which the underlying product itself is traded. They are offered in relation to exchange rates, short-term and long-term interest rates and stock exchange indices.

The types of derivatives include: Options, Forwards, Futures, Swaps and various forms of bonds.

Futures: a future is an agreement or an obligation to buy or to sell a particular product (an asset, currency or commodity) but with specified date and price. All futures are traded on organized exchanges and have the following specified terms: specific product, quality (or grade), contract size, pricing convention and delivery date[5]

Forwards: are agreements or contracts to exchange a specified amount of designated product for both specified price and date or dates. Forward contracts are not traded on organized exchanges, and their terms are not standardized.

Options: the right but not the obligation to purchase (call option) or to sell (put option) a particular product: Financial instrument, currency or commodity, on or before the exercise date, at a specified price.

Swaps: an agreement between two counterparties to exchange cash flows over an agreed period according to a prearranged formula. There are two common swaps:

a) Interest Rate Swaps: an agreement to exchange a fixed interest rate for a variable one.
b) Currency Swaps: an agreement to exchange a loan in one currency for a loan in another currency.

Capital markets division:

Capital markets are generally divided into:

1. Primary market:

It is the market where corporations first issue their financial instruments in order to raise capital. The securities sold in this market can be issued in domestic markets and/or international markets. The issuer may be a new company or an existing one, and it is the responsibility of the issuing houses, investment bankers and brokers to sell the new securities to the public.

2. Secondary market:

It is the market where already existing or second hand financial instruments are traded among investors; here no new capital is raised by the issuer[6]. This market usually takes the form of stock exchange, its growth reflects the health of the economy, but secondary markets can also include bond markets, futures and options markets among others. It is fair to say that this division of markets is where most of the trading of different kinds of securities is done. Secondary markets are classified in terms of:

I. **Organized Stock Exchanges**: is a market that exists both physically and electronically, in which different securities that must satisfy given conditions are traded at a regular basis. It is also a market where only specialized members can operate and where demand and supply do not directly meet[7]

II. **Over-the-Counter Markets (OTC):** a market where licensed brokers trade in unlisted financial instruments. The counterparties can meet directly in this market and less restrictive rules can be met[8]

The roles and functions of Capital Markets:

Capital Markets form a necessary part of the financial system in the economies that depend mostly on the individual activity and the economic freedom, moreover in what is known as the open market. It has principle functions or roles, which can be summarized in the following:

- ✓ Capital markets provide a large set of investment opportunities; hence they form channels for investments and income for individuals and companies, whatever goals or potentials or sizes they have.
- ✓ Capital markets have a large ability to draw funds from savers (those with funds more than they need) so that those parts who actually need it (investors) will have the necessary funds to their projects.
- ✓ The funding of the financial opportunities that really have economic benefits, which in its turn leads to the raise of production and labor levels.
- ✓ Through the channeling of the funds from those who have a surplus of it, to those who have a shortfall of it, there will be a savings orientation from consumerism towards investment and to more productive sectors[9]which means the absorption of the monetary liquidity, which, in its turn, means the limitation of the inflation rates.
- ✓ Providing information for traders to follow up and observe the changes of prices and the rates of exchange[10]

Secondary market on its own has two very important roles that can be identified[11]

I. Liquidity: secondary markets make assets more liquid and increase their values, as they are frequently traded among investors who would only invest in those securities in the condition of their possibility to sell it at a later date.

II. Value: secondary markets allows the transmission of the assets' information to make proper decisions as the provided information give valuation to the asset, which will eventually lead to economic efficiency.

Orders in the Capital Market: Market intermediaries respond to different sets of orders to sell or to buy a security immediately at the best price that can be obtained. These orders are defined with relation to many factors as: time, volume and price, and can be influenced by the stop and continuity mechanisms.

- ✓ A Market Order: is a request for the broker to either buy or sell and it is usually certain that the broker will complete the transaction[12]
- ✓ A Limit Order: the broker is given a specified limit price; a maximum buying price or a minimum selling price[13]
- ✓ A Stop Order: this kind of orders aims at protecting market participants' profits or limiting their losses[14]

Participants in the Capital Market: In addition to the authorities inside the capital market that are responsible for the regulation of the market, participants in this market can be divided into two broad groups:

First- Financial Instruments' issuers: this type of issuers can be either from the public sector (like governments that issue bonds to cover their financial needs in order to meet a budget's deficiency or to provide finances for its production and investment expenditures). Or from the private sector (like the case of manufacturing or commercial or holding companies, that issue financial instruments of different types) to meet their financial needs.

Second- Intermediaries: are economic agents who mobilize the savings of many individuals and lend them to project owners. Their roles and types are stated in details in the following.

2. **Roles of Intermediaries in the Capital Markets:** intermediaries are the basic link between those who issue the securities and those who invest in them by making the issued liabilities become more liquid instruments[15]. They also can reduce information costs, and diversify portfolios which allow them to promote efficient investments[16]. Among other roles of the intermediaries are:

- ✓ Their contribution to the economic growth by facilitating exchange process and the majority of firms' performance[17].
- ✓ Improvement of resource allocation in the credit market as a result of their capabilities in a better acquisition of different and all new information.
- ✓ Sharing the risks among investors leading to the achievement of diversification as they are selectors of investment projects[18].

Types of Intermediaries: Intermediaries in capital markets can exist in many types, the most important ones are:

- ✓ Banks: those which participate in capital markets include Central Banks, Commercial banks, Savings Banks and Investment Banks.
- ✓ Brokers: are individuals who make transactions on behalf of the investors who give them orders to execute. As a return for their services they take commission fees, this latter shouldn't be included in the price of the transaction. Whenever there are excessive recommendations for trading, commissions are generated[19], Therefore, brokers trade for other parts, not for their own account[20].
- ✓ Dealers: agents who work for their own account (as they gain profits when they buy at the bid price, and sell at the ask price, which creates an equilibrium between demand and supply.

There are other types of intermediaries in the capital market including Insurance Companies, Pension Funds, Mutual Funds, Savings and Loans Associations, Investment Companies, Mortgage Companies… etc.

A further distinction of intermediaries can be useful in analysis, which is between primary and secondary financial intermediaries[21]. The first group draws its funds from households, enterprises or governments; while the second group mostly relies for funding on the primary intermediaries among them are brokers and other stock exchange members.

- ✓ **Market Makers**: are designated dealers or stock brokers who have to ensure that the trading mechanism functions efficiently. Besides to working for their own account, they both take orders from investors to buy or to sell electronically and paid for providing liquidity. Their best advantage is their capability of seeing the limit order book[22].
- ✓ **Specialists**: are market makers but for securities listed on an organized stock exchange, they reduce variability of the securities prices.
- ✓ **Registered traders**: they own seats on a stock exchange and trade on their own account large volumes of trade.
- ✓ **Odd- Lot Brokers**: a group of brokers executing transactions of fewer than 100 shares. They take fees for breaking round lots (a multiple of 100 shares) into odd- lots and vice versa.
- ✓ **Issuing Intermediaries:** usually investment banks who act as agents to issue new securities on behalf of a borrower.
- ✓ **Arbitrageur:** makes profit from buying and redeeming financial assets that are priced differently in two markets at the same time which makes him earn free money[23]
- ✓ **Hedgers:** trade in a security in order to avoid risk of devaluation of currency, change of interest rates or prices of the securities in the market.

3. **Market efficiency:** In his review paper, Fama(1970) gave an original definition of market efficiency stating that:

"A market in which prices always 'fully reflect' available information is called 'efficient' "[24]

Market efficiency has three different forms: the Weak Form (includes the available past prices), the Semi-Strong Form (includes the available public information (news, prices…) and the Strong Form (all information including inside information)[25].

Some economists and financial specialists gave it the description of being: "One of the most hotly contested propositions in all the social sciences"[26] Fama(1976) also writes that:

"An efficient capital market is an important component of a capitalist system"

That is why thousands of studies involved around this subject along several decades of research, but yet it has not been concluded whether capital markets are indeed efficient or not, furthermore, the possibility of market inefficiency must be admitted (Dimson and Mussavian, 2000).

However, in a perfectly efficient market, the prices will reflect the real values of the securities. The reason why capital markets were believed to be extremely efficient is because whenever new information about the security is available it spreads very quickly and without any delay which will necessarily cause its price to change up or down. Prices reflected on an efficient market depend principally upon perfectly informed financial intermediaries, investors and market participants in general[27]. One would wonder how the uninformed investors and intermediaries would obtain the new information; well simply because the prices are shown on the same tableau of prices in the market. It is clear here that the use of electronic trading system and technology in general, plays a major role in enhancing capital markets efficiency.

In reality, however, prices only reflect an estimated worth of the security, as it constantly gets adjusted as a response to the coming news related to the security, either negative or positive. So for the investors (buyers or sellers) to estimate the true value of the security, they must be up-to–date with the market information; otherwise, they will be buying the security at a higher price, or selling it at a lower price. The up- to–date information here comes from analyzing securities through two main approaches [28] that are both supposed to give the intermediaries and investors the ability to achieve returns greater than that can be obtained by holding a randomly selected portfolio:

a) Fundamental analysis: through the study of the company's data, its earnings, management, competition, market conditions, and several other factors and related information to the company.

b) Technical analysis: provides the means to indicate the right levels to invest in a security. Technical analysts, another category of intermediaries, follow a series of statistical charts on the past price movements to have an accurate prediction of future prices in order to arrive at a buy- sell recommendation[29]

Efficiency is a factor of competition among brokers and different types of intermediaries. Whenever they hold new information about the assets, they will either immediately invest on behalf of their investors, or they would take a return for their advisory services. Consequently, financial intermediaries would spend a lot of time analyzing information and data in order to detect "mispriced" securities (J. Clarke et Al, 2001). Theoretically, the investors' rational decisions are going to be based on the knowledge acquired from their intermediaries. This process will make the securities market, hence, the capital market more efficient. But one should point that this does not exclude the anomalies in the capital markets in general, whether caused by asset pricing theories or contributed to chance, which is the perspective of Fama and French (1998). Or the second explanation given in the behavioral approach by Kahneman and Tversky (1979); which explains that the anomalies are caused by cognitive limitations that investors suffer when they have to make their decisions[30]. Here, Investors preferences, sentiments and their ways of thinking are studied in "Cognitive psychology". This latter is one of the two blocks that make "Behavioral Finance", which is a relatively new field of study in economics that is concerned with the examination of markets irrationality[31]. The second block is "limited arbitrage" that is an attempt to have a proper prediction about the effectiveness of arbitrage circumstances. R.Jarrow and M.Larsson(2011) show in their paper that[32]

".. to test for an efficient market, one only needs to show that there are no arbitrage opportunities nor dominated securities…"

They even go further more and say that:

"...market efficiency is in fact equivalent only to the notion of no arbitrage".

Therefore, the behavior of financial intermediaries needs to be disciplined through the conduction of business regulation in order to ensure the reliability of information provided by professionals. So, the market will be stimulated to become self- corrected[33] and hence more efficient.

The importance of the functions played by the financial intermediaries in a proper and a productive way, leading to a more efficient market is still a question of study seeing that there is a wide agreement that the improvement of capital allocation is a result of efficient intermediation. Additionally, the fact that profitable investment opportunities are still referred to as "anomalies" as it is argued in so many research papers and reviews starting from Fama(1997) going to so many others such as (Elroy Dimson et al., 2000; G.W. Schwert, 2003; Kadir Can Yalçin, 2010; Madiha Latif et al., 2011; …) indicates that market efficiency is an important issue[34]

Conclusion:

The purpose of this paper has been to present a brief introduction to the principle ways in which financial intermediaries may affect capital markets efficiency. The general framework developed in this study departs from existing literature related to the subject that is still vague up to the current time, and no attempt was made to fully reflect all available information. As subjects around capital markets efficiency are always a key issue of research and exploration.

Alongside with the principal roles that financial intermediaries play in the market, it is not argued that they also affect its efficiency and represent a source of vulnerability to it, at least to some extent; whether by properly interpreting new information, consequently over reacting or under reacting to it, or by the unequal competition among intermediaries, or even by facing a moral hazard while presenting their services to their customers. What is for sure is that further approaches are still required in order to really achieve efficient markets with efficient financial intermediation.

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