CAPITAL MARKETS

A capital market refers to place where the buying and selling of long term financial products or instruments takes place.

OR

A capital market may be described as a place or market where **long term financial products or securities** (bonds, shares) are traded in.

A money market is a place where short term financial products such as treasury bills, commercial papers (promissory notes, bill of exchange, IOU'S etc) are traded in.

N.B.

A security is a document that guarantees the holder access to the sum of money equivalent or more than its face value.

The major purpose of establishing capital markets is to provide a link between capital owners and capital seekers so as to enable the capital seekers to get access to the necessary funds for long term investment.

The key players on capital market.

Different individuals play different roles on a capital market. Nevertheless the important actors on a capital market include the following.

1. The brokers/ dealers

   These are licensed financial professionals authorized to sell and buy shares on behalf of their clients / companies.

   Brokers help to link the share owners and the share buyers (public)

   Brokers are divided into three categories.

   i. **Bulls**. These are dealers who buy shares when the price is low and sell them to interested individuals when the price rises.
   ii. **Bear**. These are dealers who sell shares to the public when the price is high anticipating a decline in price of such shares in the future.
   iii. **Stags**. These are brokers who deal in newly issued shares or shares of newly incorporated companies.

2. The registrar.

   This is a person in charge of keeping records of stocks and shares floated by different individuals or companies on a capital market.

3. Investment advises
   These are individuals licensed to help the different clients (investors / public) about the different shares and stocks floated and their profitability to the members interfered.

4. The share holders
   These are individuals investing in different shares floated by different companies and they earn dividends on their investment depending on the nature of shares held.
   Note: a dividend is a share of the profits given by the company to its shareholders.

5. Capital market authority
   This is an autonomous body which was established by the government to oversee / monitor/ regulate the development and operation of capital markets in Uganda.
   N. B.
   Capital market authority was established in 1997 as an autonomous body responsible for promoting, developing and regulating the capital market industry in Uganda.

6. The fund managers
   These are individuals or companies who undertake the contract of management of the different funds raised on a capital market on behalf of different companies or individuals.

7. The custodians
   These are individuals who perform the actual role of holding or safe keeping the securities on behalf of the owners.
   Note:
   Custodians may either be employees of the brokers or employees of the funds manager.

KEY TERMS USED IN CAPITAL MARKETS.

1. Par value / nominal value. This refers to the face value of the security being floated.
2. Market value. This refers to the value at which securities (shares, bonds etc) are being sold on a capital market. Hence the market value is determined by the forces of demand and supply.
3. Securities. There are investments or stock being floated by different companies or individuals on a capital market.
4. Portfolio. Refer to funds managed on behalf of the clients at the discretion of a fund manager.
5. Stock split. This is the division of a company's existing stock into more shares.

6. Blue chip. These are shares of a well established, financially sound and stable company that has demonstrated its ability to pay dividends in both good and bad times.

Products / instruments in Uganda's capital markets.

Different instruments are made available to facilitate easy flow of capital from the public to the investors interested in such capital. These include the following.

1. Bond. This is a long term debt instrument used by either the government or corporate bodies to obtain funds / borrow money from the public for a fixed period of time. Bonds are classified into;
   i) Corporate bond. This is prepared and issued by a public limited company purposely to obtain funds from the public to boost their investment.
   ii) Government bond. This is prepared and issued by the government purposely to obtain funds from the public to finance the different state projects.
   iii) Callable bond. These are debt instruments which permits the borrower to pay back the borrowed money before maturity date.

Advantages of investing in bonds.

1. Bonds are predictable. One knows how much interest he / she can expect to receive, how often he / she will receive it when ones' principal will be repaid etc.
2. Bonds are steadier than stock which can fluctuate wildly in short period of time.
3. People earn a fixed income in form of interest. Most bonds pay interest to bond holders on a regular basis with the exception of zero coupon bonds.
4. The interest rates paid by bonds typically exceed those paid by banks on savings accounts, especially short term bonds.

Disadvantages of investing in bonds.

i) Companies and municipalities can go bankrupt and in such a case, ones bonds lose value and possibly become worthless.
ii) Long term bonds will have ones money tied up in low yielding bonds should interest rates go down.
iii) Unlike stock, bonds don't offer the possibility of high long term returns.
iv) Although bonds are less volatile than stocks, they are not immune from price fluctuation. Bonds from riskier companies can be very volatile.

2. **Treasury bill.** This is a short term debt instrument used by the government to raise money to finance state activities or enterprises.

3. **Stocks**. These are short term debt instruments used by local authorities (town councils, municipalities etc) to raise funds to finance their activities.
4. **Share**. A share is a unit of capital of a limited liability company and it offer a chance to the holder to become a full member / owner in the issuing company.

Note. A holder of a share is called a shareholder and he / she is a legitimate member in the respective company and therefore entitled to the share of dividends.

A dividend is a share of the profits made by the company in a given trading period.

TYPES OF SHARES / FORMS OF SHARE CAPITAL.

There are two broad categories of shares i.e.

a) Ordinary shares. These are shares that carry a fixed rate of return on capital invested and the dividends earned by the share holder tend to vary depending on the performance of business or company in a given period i.e. the better the performance the higher the dividends and the worse the performance the lower the dividends.

b) Preference shares. These are shares to which share holder is entitled to dividend payment regardless of the performance of the business or company.

Note: preferences shares are subdivided into the following;

1) Cumulative preference shares. These are shares to which the holder is entitled to a fixed rate of payment (dividend) annually and incase the company fails to make profits, his or her share of the profits (dividends) is carried forward to the next financial year.
2) Non – cumulative preference shares. These are shares to which the holder is entitled to a fixed rate of dividend but incase the company fails to make profits, his or her share of dividends is not carried forward to the following financial year.
3) Redeemable preference shares. These are shares that can be bought back by the company from the share holder after a given period of time.
4) Irredeemable preference shares. These are shares that cannot be bought back by the company from the share holder i.e. the share holder earns dividends on such shares until the company is liquidated.

Advantages of investing in shares.

1. It is a source of income to the share holder inform of dividends.
2. It helps to increase the value of capital of a joint stock company hence accelerating its expansion / growth.

3. It helps individuals with limited capital which cannot be used to open up meaningful investment to have a chance of investing it in shares to accumulate more funds for investment in the future.
4. A share certificate can act as collateral to access a loan from financial institutions or private money lenders.
5. Shares are transferable i.e. In case a share holder wants to live the company, he/she can sell the shares to other interested individuals. Hence there are no possibilities of a company running short of capital for its operations.

Disadvantages of investing in shares.

1. Sometimes, a share holder may not be consulted at the time of making major decisions thus any poor decision made affects him or her.
2. At the time of liquidating the company, some share holders (ordinary share holders) may not be paid especially where the liquidation exercise or process yields little income.
3. It results into depreciation of the value of one's investment i.e. share prices sometimes reduce or fall due to changes in demand and supply conditions on a capital market. This reduces the amount of share capital raised by the company.

Qn.

Explain the process followed when buying shares.

- ✓ Visiting a broker, the issuer or a selling agent.
- ✓ Getting a copy of the prospectus and reading it well or seeking advice.
- ✓ Filling the **securities central depository account opening form** with the help of a broker.
- ✓ Filling in a share application form, paying for the shares and receiving of a receipt.
- ✓ Depositing of the allocated shares on the buyers SCD account after allocation period.
- ✓ Depositing of money on the buyer's account in case of a refund.

Process of investing in shares (Secondary market – Uganda securities exchange)

- ✓ Visiting a broker, requesting for his advice about companies to invest in and their prices.
- ✓ Filling in an SCD account opening form with the broker's help.
- ✓ Filling in a purchase / sell order form.
- ✓ Depositing money on an account given by the broker and giving a copy of payment slip to a broker.
- ✓ Going to the market and transacting by the broker on behalf of the buyer, relative to demand and supply.
- ✓ Depositing of shares on the buyers SCD account in case of purchase or money is deposited on the buyer's bank account in case of sale.

Placing an order through a broker / dealer.

- ✍ Filling in the clients information form after reading through the company prospectus.
- ✍ Signing a purchase transfer.
- ✍ Paying for the number of shares one is willing and able to buy.
- ✍ Receiving a receipt from the broker / dealer.
- ✍ Sending/issuing purchase contact note by the broker to buyer which entitles or acts as a proof of ownership until the certificate is received.
- ✍ Forwarding the signed purchase transfer to the registrar through exchange by the broker.
- ✍ Issuing a certificate by the registrar up on receiving transfers.

4. **Debenture**. This is a unit of capital given by the public to a joint stock company. A debenture holder is entitled to a fixed interest annually.

   TYPES OF DEBENTURES.

   i) **Naked / debenture.** There are debentures which are not secured or debentures to which no property is pledged as security upon their acquisition.

   ii) **Mortgaged debentures / secured debenture.** These are debentures to which meaningful security (property) is attached. Failure to clear the amount given, the debenture holder has a right to possess and sell the property attached to the loan given.

   iii) **Redeemable debenture**. These are debentures which can be bought back or repossessed by the debenture holder after a given period of time.

   iv) **Irredeemable debentures.** These are debentures that cannot be repossessed but the debenture holder keeps earning interest until the company is liquidated.

5. **Commercial papers**. There are short term unsecured promissory notes issued by a company with short term maturity date after which the holder is paid the amount due with interest as agreed upon.

The role of capital markets in Uganda.

(Use present continuous tense or action verb)

1. Provision of a plat form for the government and corporate bodies to raise the necessary funds needed for different investments through selling shares debentures and bonds.
2. Improving on peoples standard of living i.e. individuals who buy the different instruments offered on a capital market earn interest or dividends.

3. Capital markets offer employment opportunities to different individuals such as brokers, funds managers etc helping to reduce the unemployment problem in the country.
4. Provision of investment opportunities to different individuals especially these with little capital which cannot start meaningful investment.
5. Providing a basis for foreign capital inflow i.e. capital markets enable foreign investors to invest indifferent investments / products offered.
6. Provision of revenue to the government. A capital market provides an avenue for the government to raise revenue directly through selling treasury bills and bonds or indirectly by taxing the different players on a capital market.
7. Promoting investment. Capital markets provide valid technical information to investors about different investment opportunities and encourage individuals to invest in high yielding opportunities available.
8. Promoting the savings culture. Capital markets promote the development of the savings culture among individuals through providing different investment opportunities.

Qn.
Explain the objectives of promoting capital markets in Uganda.
(Use to, in order to, so as to)

- ✍ To provide a platform for the government and corporate bodies to raise necessary funds.
- ✍ To provide investment opportunities to different individuals.
- ✍ To improve on peoples standard of living.
- ✍ To provide a basis for foreign capital inflow in order to enable foreign investors to invest in different products offered.
- ✍ To provide revenue to the government through selling treasury bills and bonds.
- ✍ To promote investment
- ✍ To promote the savings culture.

Explain the advantages of capital markets in Uganda.
(Use the present simple tense)

- They provide a platform for government to raise necessary funds needed for different investments.
- They promote the saving culture.
- They promote investment.
- They provide revenue to the government.
- They provide a basis for foreign capital inflow.
- They improve people's standards of living.

Capital market authority (CMA)

A capital market authority is an autonomous body established to promote, develop and regulate the operations of capital markets in the country.

It was formed in 1996 and became operational in July 1997.

FUNCTIONS OF THE CAPITAL MARKET AUTHORITY.

It helps to formulate and maintain guidelines for the smooth operation of the securities exchange markets in Uganda i.e. it gives policies that are followed by the security exchange markets in buying or selling the different securities.

It helps to license the different individuals / the key players on a capital market such as the bulls, bears, stags.

It helps to develop aspects of capital markets with emphasis on creating various avenues for long term investment in productive enterprises.

They help to license collective investment schemes and monitor their operation so as to safe guard the interest of the member.

It helps to approve the activities of the stock exchange market (Uganda securities exchange) in the country.

It helps to operate the corporation fund on the capital markets.

N.B.

A corporation fund is an arrangement where money is collected with the aim of granting compensation to investors who suffer financial loss in the capital market business.

PROBLEMS FACED BY CAPITAL MARKET AUTHORITY IN UGANDA.

1. Ignorance. Most Ugandans are not aware of the operation of capital markets and capital authority. Even then, those who are aware of the presence of capital markets and capital market authority are reluctant to take up investment opportunities available.
2. High level of inflation in the country. This makes the prices of shares change frequently depending on the value of the shilling hence scaring the would- be potential investors in the different securities.
3. Influence from the government/political interference. Sometimes the government dictates the terms and conditions upon which the capital market authority operates and this adversely affects its activities.

N.B.
Most individuals / officials working in the capital market authority are politically appointed with limited resistance to government orders.

4. Poverty. Most individuals are poor and therefore cannot save a substantial amount to invest in the different opportunities available. Even then, most Ugandans have a poor savings and investment culture i.e. they have a high MPC and a low MPS.
5. Limited knowledge and skills, to run the capital market business especially where most officials are politically appointed with limited entrepreneurial skills.
6. Insecurity / political instability.

COLLECTIVE INVESTMENT SCHEMES.

A collective investment scheme is an arrangement where individuals pool resources from different small savers to make reasonable amount of capital to be invested in long term financial products or securities.

Collective investment can be made in products such as bonds, shares treasury bills etc with the aim of making profits inform of interest.

Some common terms used in collective investment scheme.

1. Investment advisor. This is an individual who provides relevant information to the investors regarding the different securities available where investment can be done.
2. The funds manager. This is a technical person or company licensed by the capital market authority to undertake any transaction on behalf of the collective investment scheme owners.
3. The trustee. This is a person or company licensed by the CMA to hold or take care of the assets of a C.I.S on behalf of the investors e.g. East African Alliance (U) ltd.
4. Trustee deed. This refers to the agreement written between the fund manager and the trustee contracted to manage the assets of the scheme.

Advantages of collective investment schemes.

1. They provide a basis or an opportunity for low income earners to make meaningful investment that can yield high return overtime.
2. They help to lower the transaction cost for any security invested in i.e. with collective investment schemes there is a better bargain for the portfolio/ security due to a strong financial position.
3. They lead to diversification of risks i.e. through the money collected; investment can be made in different securities so as to be able to reduce the risks that may come along by investing in a single security.

4. Liquidity is made easy in a collective investment scheme i.e. it becomes easy to liquidate the members investment in the scheme by selling back the units owned to the fund's manager of the scheme.
5. They help to protect the funds of the investor due to the different regulatory policies put in place upon which the scheme is operated.
6. They provide full time professional management i.e. C.I.S.'s are able to hire technical individuals to manage the pool of funds / resources and guide the owners on the different investment opportunities.
7. They are flexible on the side of investors that is, the investor is free to change the security or the portfolio to his or her personal demand at little or no cost.
8. The investor can easily access high market prices for their securities since C.I.S. carry out comprehensive research about the most highly paying securities in the market / on the capital market.

Disadvantages of collective investment scheme.

1. There is loss of control since investors are not directly in control of their funds i.e. they are not involved in making major investment decisions since this is a responsibility of the fund's manager.
2. It increases the operational costs of the collective investment scheme since the technical individual hired are paid a lot of money to manage the scheme on behalf of the investors.
3. It is hard to speculate whether the collective investment scheme will perform better than bodies / entities operating on a capital market e.g. the joint stock companies.
4. Sometimes individuals selected to run a C.I.S are not trust worthy.

CONDITIONS NECESSARY FOR THE EFFECTIVE OPERATION OF A COLLECTIVE INVESTMENT SCHEME.

1. Stable macroeconomic environment. This helps to ensure protection of people's investment due to the stability of the prices of securities especially where small savers invest their mega income.
2. Reliable banking system i.e. money invested in a collective investment scheme need to be kept in the bank under the name of the scheme. This enables the scheme to operate smoothly with limited or no funds emblements / misappropriation.
3. Strong savings culture. For collective investment schemes to operate smoothly, individuals must have the desire to save and invest hence a strong saving culture promotes the persistent existence of a collective investment scheme.

4. The existence of a free market environment. This allows the fund manager to fully invest the money collected at the most attractive interest rate as it may be determined by the forces of demand and supply.
5. Conducive legal environment. successful operation of a C.I.S. requires a friendly legal environment that facilitates effective management of the scheme by both the fund's manager and trustee.

Qn.

1a) Explain the circumstances under which the C.I.S may operate smoothly.

b) Explain the challenges of operating a C.I.S.

Types of collective investment schemes.

There are mainly two major types.

1) The unit trustee scheme.
2) The investment company with viable capital (ICVC)

UNIT TRUSTEE SCHEME

This is a form of collective investment scheme where the investments are classified or divided into units which are sold to different investors(savers). The more units one holds; the stronger he or she is in the scheme.

The unit trustee scheme is regulated / governed by a trustee deed / agreement which spells out terms and conditions under which the scheme is to be operated and clearly spells out the roles of the fund manager and the trustee.

Investment Company with variable capital

This is a type of collective investment scheme where investments are categorized into shares which are sold to the members of the scheme. Hence the more shares held the stronger the individual / investor.

Note:

Investment company which variable capital operates like an ordinary company, the difference being that shares is an investment company with variable capital **can be bought back by the scheme at the wish of the investor** yet in an ordinary company it may be **difficult for the company to buy back the shares**. Instead, the shareholder sells his or her shares to another interested member of the public.

Qn.

a) Distinguish between a unit trustee scheme and I.C.V.C scheme.
b) Explain the advantage of investing in a unit trustee scheme.

The process / procedure of buying shares / units in a C.I.S.

1. Visiting the unit trustee manager. This involves approaching the authorized person or company and finding out the activities of a particular collective investment scheme where one plans to invest his or her savings e.g. In Uganda the interested investor in the scheme can approach the East African Alliance located at the workers house.
2. Filling the account open form. Having obtained all the necessary information the intending investor/saver is required to fill a form giving his / her personal details and the details of the kind of investment to be undertaken.
3. Selecting the type of unit trustee account i.e. the investor is required to determine/ indicate whether to invest in short term or long term securities.
4. Depositing the money on the selected account of the scheme through a specified bank and remitting the deposit slips to the fund manager.
5. Becoming a unit trustee account holder and an investor in the scheme.

The process of redeeming share or units in a collective investment scheme.

The process of redeeming ones investment in the collective investment scheme is done as indicated below.

1. Sending form to the fund manager. The collective investment scheme member is required to deliver a fully filled form to the fund manager expressing his / her intention to redeem part of the shares or all the shares held in the scheme.
2. Transfer the money. This is done by transferring the money to the sellers account within four days from the date of submitting the form.
3. Determining the number of the shares to be sold to the new member. The fund manager determines whether to sell all the redeemed shares or part of the redeemed shares to the new member.
4. Finalizing the selling process by transferring the rights of ownership to the new buyer / new share holder.

Equity financing Vs debt financing.

Equity financing refers to a situation where the entrepreneur raises business capital through selling shares to the public. This is common with most listed companies.

N.B.

A listed company is a business entity that has been allowed to float its shares on the capital market for the public to buy.

Examples of listed companies include Uganda Clays Kajjansi, New Vision Group of companies, Development Finance Corporation Uganda (DFCU), FUFA (U) Ltd - Federation of Uganda's Football Association.

Advantages of equity financing.

1. It safe guards business assets i.e. business assets may not be sold in an effort to raise capital to finance business activities.
2. It saves the business from the burden of making numerous payments inform of debt clearance and the interest there of.
3. Leads to better management of the company especially where committed supervisor / Board of Governors are elected to supervise the activities of the company.
4. Alot of capital is raised through selling shares.

Disadvantages

1. There is no direct control over the company by the owners (share holders)
2. There is a possibility of making losses and failing to earn dividends on ones investment.
3. Sharing of profits reduces the company's operating capital and the dividend paid to share holders.
4. The process of selling shares is costly and tedious, that is it involves a lot of advertising and different activities before shares are finally given to the share holder.
5. Companies that raise capital through equity financing are by low required to publish their financial records in the news papers annually. This reduces privacy/ secrecy in the activities of the company.
6. Equity financing may be limited to a few entities/ companies i.e. public limited companies hence denying others a chance to access capital for their business.

Debt financing

This is a situation where a business raises capital for its activities through borrowing loans from the bank or the public (debenture)

Advantages of debt financing.

1. Large amount of capital is readily available i.e. the entrepreneur can easily and quickly raise capital through debt financing provided he or she has the security.
2. Payment of the loans is spread over a long period of time hence making it a convenient way of raising business capital.
3. Creditors are less subjected to a loss in case winding up the company or the business.

Disadvantages of debt financing.

1. It requires collateral which may not readily be available.
2. Repayment of the principle and interest increases the cash out flow hence reducing the working capital of the business.
3. Sometimes interest charged is high thereby reducing the profits of the company.

Qn.

a) Distinguish between;
   i) A company limited by shares and a company limited by guarantee.
   ii) A public limited company and a private limited company.
b) Explain the differences and similarities between private limited companies and public limited companies.