



The True Nature of Capital Markets

"If you can't explain it to a six year old, you don't understand it yourself."

- Attributed to Albert Einstein

One of our partners was recently asked to give a career day presentation to his son's elementary school class. He enthusiastically accepted, but soon began to have some concern with the challenge of explaining to a group of children just exactly how stock and bond investing works and why these investments are important to everyday people in every developed economy on Earth. Concern quickly turned to terror as he imagined having to present the story of his career in wealth management after the class had already heard from a judge, a doctor, a veterinarian, and most formidable, a fireman in uniform.

Although this career day story has a happy ending, it underscores the fact that explaining the true nature of capital markets can be difficult. And, it is difficult not simply because the topic is complex, but because capital markets are such a fixture of contemporary American life that they are often taken for granted by amateur and professional investors alike, and their core purpose is often misunderstood or overlooked entirely.

Take the stock market as an example. It might be easy to explain what a stock is, but it is a bit more involved to understand *why* the stock market exists in the first place. Think about it: Most companies begin their

lives as "private" corporations. They are owned entirely by the founders and original investors of the company and all of the company profits are retained by those few individuals. Eventually some corporations, usually the most successful ones, reach a point where they have opportunities for growth that are too large to be financed by the original owners; those companies will "go public" by selling a portion of the founders' ownership to strangers in exchange for cash to fund the company's growth ambitions. Those strangers (now known as shareholders) then have the option to retain their ownership interest in the company or sell it to another investor at a mutually agreed price. These secondary buy and sell transactions make up the stock market. Although this is the essential reason for the existence of the stock market, it is unlikely that this explanation would make it into an elementary school career day presentation.

What about the bond market? You probably know that when you buy a bond you receive a series of interest payments and, at a predetermined future maturity date, your original investment principal is returned to you. But have you ever stopped to consider that when you buy a bond what you are actually doing is making a loan? Whether you give

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your cash to a corporation, a municipality, or the US Treasury, you are essentially acting as a bank, lending money for an interest payment with a promise of future return of your principal. And, the billions of dollars in bonds that change hands on the global bond markets each day are merely loans that are being bought and sold by various lenders with different income needs and risk appetites.

These mundane explanations of stock and bond markets provide a very different impression from the flashing lights, ringing bells, and screaming traders that are depicted by the financial media. And although the lights and bells of the trading floor would make for a more engaging presentation on career day, the mundane version represents the true nature of the markets.

We have this market infrastructure for a reason, and the reason is not to provide a casino for hedge funds and computerized trading programs to gamble with each other (although that has been a side effect). This market infrastructure exists because it serves as the grease in the wheels of capitalism. It identifies corporations that need capital for growth and governments that need to finance spending, and it matches them with investors who can supply that capital. Those suppliers of capital demand a financial return for their investment, and this return is a source of wealth enhancement for millions of large and small investors around the world.

Any individual who owns a bond, a share of stock, or

a mutual fund benefits from the capital market system. Any retiree who is receiving payments from a company pension plan also benefits. Employees who are covered by a 401(k) plan at work and aspiring college students who have 529 college savings plans benefit from capital markets as well. Although this diverse group of beneficiaries may not always realize it, their savings are providing capital to finance today's production and tomorrow's technological innovations.

Stock and bond markets are an essential element of contemporary life as we know it, and although our industry is full of impressive jargon, perhaps we can take a lesson from elementary school and recognize that a simpler, more fundamental understanding of capital markets would be more useful to most people. That said, no matter how fundamental we make it, we will never be able to compete with the fireman on career day.

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