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Level : M1_ Economics of Money and Banking ***Academic year :2024-2025***

What Is a Security?

The term "security" refers to a fungible, negotiable financial instrument that holds some type of monetary value. A security can represent ownership in a corporation in the form of stock, a creditor relationship with a governmental body or a corporation represented by owning that entity's bond; or rights to ownership as represented by an option.

Understanding Securities

The Securities Act of 1933 is the first federal legislation to regulate the U.S. stock market, an authority that was previously regulated at the state level. Under the law, anyone who wishes to sell investment contracts to the public must publish certain information regarding the proposed offering, the company making the offering, and the principal figures of that company.

These requirements are intended to protect the investing public from deceptive or misleading marketing practices. The company and its leading figures are strictly liable for any inaccuracy in its financial statements, whether intentional or not. Later legislation created the Securities and Exchange Commission (SEC), which is responsible for regulations and enforcement.

Although the term "securities" is commonly associated with stocks, bonds, and similar instruments, the U.S. Supreme Court gives the term a much broader interpretation. There is an investment of money.

1. The investment is made into a "common enterprise."
2. The investors expect to make a profit from their investment.
3. Any expected profits or returns are due to the actions of a third party or promoter.

Under this rule, it does not matter if a securities offering is formalized with a legal contract or stock certificates; any type of investment offering can be a security. On several occasions, courts have enforced securities provisions on unconventional assets such as whiskey, beavers, and chinchillas.123 In recent years, the SEC has also sought enforcement against issuers of crypto currencies.

Types of Securities

Securities can be broadly categorized into two distinct types: equities and debts. However, some hybrid securities combine elements of both equities and debts.

Equity Securities

An equity security represents ownership interest held by shareholders in an entity (a company, partnership, or trust), realized in the form of shares of capital stock, which includes shares of both common and preferred stock.

Holders of equity securities are typically not entitled to regular payments—although equity securities often do pay out dividends—but they are able to profit from capital gains when they sell the securities (assuming they've increased in value).

Equity securities do entitle the holder to some control of the company on a **pro rata basis**, via voting rights. In the case of **bankruptcy**, they share only in residual interest after all obligations have been paid out to creditors. They are sometimes offered as **payment-in-kind**.

Debt Securities

A debt security represents borrowed money that must be repaid, with terms that stipulate the size of the loan, interest rate, and maturity or renewal date.

Debt securities, which include government and corporate bonds, **certificates of deposit** (CDs), and **collateralized securities**, generally entitle their holder to the regular payment of interest and repayment of principal (regardless of the issuer's performance), along with any **other stipulated contractual rights** (which do not include voting rights). They are typically issued for a fixed term, at the end of which they can be redeemed by the issuer. Debt securities can be secured (backed by collateral) or unsecured, and, if secured, may be contractually prioritized over other unsecured, subordinated debt in the case of a bankruptcy.

Hybrid Securities

Hybrid securities, as the name suggests, combine some of the characteristics of both debt and equity securities. Examples of hybrid securities include **equity warrants** (options issued by the company itself that give shareholders the right to purchase stock within a certain timeframe and at a specific price), **convertible bonds** (bonds that can be converted into shares of common stock in the issuing company), and **preference shares** (company stocks whose payments of interest, dividends, or other returns of capital can be prioritized over those of other stockholders).

Risk and Return

Definition

The concept of **risk and return** makes reference to the possible economic loss or gain from investing in securities. A gain made by an investor is referred to as a return on their investment. Conversely, the risk signifies the chance or odds that the investor is going to lose money. In the case that an investor chooses to invest in an asset with minimal risk, the possible return then is often modest. In contrast, an investment with a high-risk component has a higher probability of generating larger profits.

A **risk** is the chance or odds that an investor is going to lose money.

A **gain** made by an investor is referred to as a **return** on their investment.

Types of Risk and Return

There are several types of both risk and return.

Risks

Whenever you invest or save, there are different types of risks that can be involved. But there are typically two categories that the risks are placed into: **systematic risks** and **unsystematic risks.**

- **Systematic**

  Risks that can influence a complete economic market or at minimum a significant portion of it are known as **systematic risks**. They are the dangers of losing assets as a result of various macroeconomic or political risks which impact the general market performance. There are many types of systematic risks; a few of those are:

  - **Political risk -** Political risk arises largely as a result of political insecurity in a nation or area. For example, if a country goes to war, the firms that operate there are deemed unsafe, and therefore risky.

- **Market risk** - Market risk is the by-product of investors' overall inclination to follow the market. So it is essentially the inclination of security values to shift together.
- **Exchange rate risk** - This type of risk arises from the unpredictability of currency value fluctuations. As a result, it impacts enterprises that conduct foreign exchange operations, such as export and import firms, or firms that do business in a foreign country.
- **Interest rate risk** - A shift in the market's rate of interest causes this type of risk. It mostly affects fixed-income assets since bond costs are connected to interest rates, but it also affects the valuation of stocks.

Risks that can influence a complete economic market or at minimum a significant portion of it are known as **systematic risks.**

- **Unsystematic Risk**

Unsystematic risk is a type of risk that impacts only one sector or one business. It is the danger of losing money on an investment because of a business or sector-specific hazard. A shift in leadership, a legislative reform that might reduce firm sales, or a new rival in the market are all examples of unsystematic risk.

Unsystematic risk is the danger of losing money on an investment because of a business or sector-specific hazard.

Systematic vs Unsystematic

In order to help you better understand; let's review a few of the main differences between systematic and unsystematic risks:

- Systematic risks can't be controlled but unsystematic risks can be controlled.

- Systematic risks are caused by external factors while unsystematic risks are caused by internal factors.

- Systematic risks can cause chaos within an entire economy while unsystematic risks can only cause issues to a specific organization or sector.

Return

There are two types of return that are most focused on: realized return and expected return.

- **Realized**

  Realized return refers to the actual return on an investment over a specific time frame. It is critical to recognize that nothing can alter a realized return. It's really a post-fact number that no action can alter. It merely provides information to investors to help them make wiser financial choices in the future.

- **Expected**
  An expected return is the estimate of profits or losses that an investor may expect from an investment. The expected return is a metric used to estimate if an investment will have a positive or negative net outcome on average. The expected return is often founded on previous data and so cannot be guaranteed in the foreseeable future; yet, it frequently establishes acceptable expectations.

<u>Text based Activities</u>

- Give a suitable title to the text?

1. **What is the definition of a security?**

2. **What is the role of the Securities and Exchange Commission (SEC)?**

3. **Differentiate between systematic and unsystematic risks.**

4. **What is the difference between realized and expected returns?**

Exercise 02 :Multiple Choice Questions

1. Which of the following is NOT an example of a security?

a) Stock

b) Bond

c) Real estate property

d) Convertible bond

2. What type of risk arises from fluctuations in currency values?

a) Market risk

b) Exchange rate risk

c) Interest rate risk

d) Political risk

3. Which of the following statements about equity securities is true?

a) They guarantee regular payments.

b) They give shareholders voting rights.

c) They are prioritized over debts in bankruptcy.

d) They do not allow for capital gains.

Exercise 03 : Fill-in-the-Blanks

1. The concept of _______ refers to the potential gain or loss from an investment.
2. Securities can be classified broadly into _______ and _______ categories. _______ securities include government and corporate bonds and are typically issued for a fixed term.
3. _______ risks are caused by external factors such as macroeconomic or political changes, while _______ risks arise from internal factors like leadership changes.
4. _______ refers to actual investment returns over a given time, while _______ refers to estimated future returns.
5. A _______ is a financial instrument that combines features of both equity and debt securities._______ securities represent borrowed money, while _______ securities represent ownership in a corporation.
6. _______ risk is uncontrollable and affects the entire market, whereas _______ risk is specific to a single business or sector.

Exersise 04 : True or False

1. Equity securities provide holders with voting rights in the company.
2. Debt securities are secured by voting rights and ownership interests in a company.
3. Hybrid securities are exclusively classified as debt instruments.
4. Political risk is a type of systematic risk.
5. Unsystematic risks can typically be managed by investors.
6. Securities are always represented by legal contracts or stock certificates.

7. Convertible bonds allow holders to convert their bonds into common stock of the issuing company.
8. A high-risk investment always guarantees high returns.
9. Hybrid securities combine features of both debt and equity.
10. Systematic risks are caused by internal factors within a company.

Exercise 05: Match the Term to the Definition

1. **Security**
2. **Equity Security**
3. **Debt Security**
4. **Systematic Risk**
5. **Unsystematic Risk**
6. **Realized Return**
7. **Expected Return**
8. **Hybrid Security**

Definitions:

a) Ownership interest in a corporation.

b) Borrowed money that must be repaid with interest.

c) A risk that impacts the entire market or economy.

d) A financial instrument that combines features of equity and debt.

e) Actual returns from an investment over a specific period.

f) The potential gains or losses projected from an investment.

g) A negotiable financial instrument with monetary value.

h) A risk specific to a particular sector or business.