As per New CBCS Syllabus for B.Com. (Honors), 3rd Year, 6th Semester
for All the Universities in Telangana State w.e.f. 2018-19

INVESTMENT MANAGEMENT

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PREFACE

Stock market operations are often compared to operations in gambling dens, and winning strategies are all supposed to be backed by Lady Luck. Investors are most often guided by the sentiments of immense faith and untold phobia. There are plenty of soothsayers/financial wizards offering advice and strategies to investors. They need organised information, logical reasoning backed by scientific method and techniques. Several academicians and practitioners have contributed new knowledge, enhancing our understanding of stock market behaviour. The present book is a humble attempt at presenting this accumulated knowledge.

This book explains some theories through which different securities can be combined to get a high return. It explains different theories of Portfolio Management and guides an investor to take correct decisions in combining their securities. Investors should take their own decisions and through fundamental analysis. They should not follow a herd or group.

The 20th century of the book has been completely revised to provide the latest information and gives an insight to the investor of the investment climate in India. It is useful for students of management, commerce, accounting and finance in their respective fields. Many topics had been discussed widely and to the need of the syllabi widely, and given number of Illustrations for students to go through.

We would like to show our sincere gratitude to our Publishers M/s. Himalaya Publishing House Pvt. Ltd., Shri Niraj Pandey (Managing Director) and Vijay Pandey (General Manager – Marketing), and to Mr. G. Anil Kumar (Sales Manager, Hyderabad) who had guided and given his valuable support while preparing this manuscript.

Though we had taken every care in presenting this book in simple and lucid style, some unknown mistakes may occur here and there while overlooking. We request to our beloved teachers and students, while going through the books, if they found any matter that is most reliable to the need of the subject, those suggestions and criticisms will accepted wholeheartedly and we assure you that we shall see to incorporate them in our consequent revised editions. For feedback and suggestion, please mail to ***Dr.madanamohan@gmail.com*** and ***Brind333@gmail.com***

January 2019

Hyderabad **Authors**

SYLLABUS

Objective: To familiarise with concepts of risk and return relating to Investment.

Unit - I:

Introduction: Investment Management: Meaning and Definition – Objectives – Scope – Investment vs. Speculation – Investment vs. Gambling – Factors Affecting Investment Decisions – Investment Alternatives – Types of Investors (Theory).

Unit - II:

Risk and Return: Meaning of Risk – Risk vs. Uncertainty – Causes of Risk – Types of Risks – Risk and Return of a Single Asset – Ex-ante and Ex-post – Risk-Return Relationship – Risk-Return Trade-off (Simple Problems).

Unit - III:

Market Indices: Concept of Index – Methods of Computing Stock Indices – Leading Stock Price Indices in India – Sensex and Nifty – Uses of Market Index (Simple Problems).

Unit - IV:

Time Value of Money: Concept – Techniques – Compounding Techniques – Doubling Period – Multiple Compounding Period – Present Value Techniques (Simple Problems).

Unit - V:

Portfolio Analysis: Traditional vs. Modern – Rationale of Diversification – Markowitz Portfolio Theory – Effect of Combining the Securities – Measurement of Expected Return and Risk of Portfolio (Simple Problems).

CONTENTS

Unit 1 INTRODUCTION

Nature and Scope of Investment

Investment involves making of a sacrifice in the present with the hope of deriving future benefits. Two most important features of an investment are current sacrifice and future benefit. Investment is the sacrifice of certain present values for the uncertain future reward. It involves numerous decision such as type, mix, amount, timing, grade, etc. of investment the decision-making has to be continuous as well as investment may be defined as an activity that commits funds in any financial/physical form in the present with an expectation of receiving additional return in the future. The expectation brings with it a probability that the quantum of return may vary from a minimum to a maximum. This possibility of variation in the actual return is known as investment risk. Thus every investment involves a return and risk.

Investment is the process of, "sacrificing something now for the prospect of gaining something later". So, the definition implies that we have four dimensions to an investment- time, today be sacrifice and prospective gain. The word investment has many interpretations as it means different things to different persons. For a person who has lent money to another, it may be an investment for a return. Similarly, if a person purchases share of a company, bullion or real estate's for the purpose of price appreciation, it is also an investment for him and an insurance plan or a pension plan is an investment to its purchaser. It is clear that investment is a commitment of funds for earning an additional income. In other words, investment is considered the sacrifice of certain value of money in anticipation of a reward.

Meaning of Investment

The term "investing" could be associated with the different activities, but the common target in these activities is to "employ" the money (funds) during the time period seeking to enhance the investor's wealth.

Funds to be invested come from assets already owned, borrowed money and savings. By foregoing consumption today and investing their savings, investors expect to enhance their future consumption possibilities by increasing their wealth. Some information presented in some chapters of this material developed for the investments course could be familiar for those who have studied other courses in finance, particularly corporate finance. Corporate finance typically covers such issues as capital structure, short-term and long-term financing, project analysis and current asset management. Capital structure addresses the question of what type of long-term financing is the best for the company under current and forecasted market conditions. Project analysis is concerned with the determining whether a project should be undertaken. Current assets and current liabilities management addresses how to manage the day-by-day cash flows of the firm. Corporate finance is also concerned with how to allocate the profit of the firm among shareholders (through the dividend payments), the government (through tax payments) and the firm itself (through retained earnings). But one of the most important questions for the company is financing. Modern firms raise money by issuing stocks and bonds. These securities are traded in the financial markets and the investors have possibility to buy or to sell securities issued by the companies. Thus, the investors and companies, searching for financing, realize their interest in the same place in financial markets.

Corporate finance area of studies and practice involves the interaction between firms and financial markets and Investment area of studies and practice involves the interaction between investors and financial markets. Investment field also differ from the corporate finance in using the relevant methods for research and decision making. Investment problems in many cases allow for a quantitative analysis and modeling approach and the qualitative methods together with quantitative methods are more often used analysing corporate finance problems. The other very important difference is, that investment analysis for decision making can be based on the large data sets available from the financial markets, such as stock returns Thus, the mathematical statistics methods can be used.

Investment Definitions

1. "An investment is a commitment of funds made in the expectation of some positive rate of returns. If the investment is properly undertaken, the returns will commensurate with the risk the investor assumes".
2. "The purchase by an individual or institutional investor of a financial or real asset that produces a return in proportion to the risk assumed over some future investment period".
3. "Investment means conversion of cash or money into monetary asset or a claim on future money for a return. Purchase of assets like shares and securities can be either for investment or speculation or both. Investments are long term in nature".

In the financial sense, investment is the commitment of a person's funds to derive future income in the form of interest, dividend, premiums, pension's benefits or appreciation in the value of their capital. Purchasing of shares, debentures, post offices savings certificates and insurance policies are all investments in the financial sense. Such investments generate financial assets.

Investing in various types of assets is an interesting activity that attracts people from all walks of life irrespective of their occupation, economic status, education and family background. When a person has more money than he requires for current consumption, he would be coined as a potential investor. The investor who is having extra cash could invest it in securities or in any other assets like or gold or real estate or could simply deposit it in his bank account. The companies that have extra income may like to invest their money in the extension of the existing firm or undertake new venture. All of these activities in a broader sense mean investment. Investment has many meaning and facets. However, investment can be interpreted broadly from three angles –

1. Economic: Investment includes the commitment of the fund for net addition to the capital stock of the economy. The net additions to the capital stock means an increase in building

equipment or inventories over the amount of equivalent goods that existed, say, one year ago at the same time.

2. Layman: uses of the term investment as any commitment of funds for a future benefit not necessarily in terms of return. For example a commitment of money to buy a new car is certainly an investment from an individual point of view. In the Economic sense, investment means the net addition to the economy's capital stock which consists of goods and services that are used in the production of other goods and services. Investment, in this sense, includes the information of new productive capital in the form of new construction, plant and machinery; inventories etc., such investment generate real assets.
3. Financial: investment is the commitment of funds for a future return, thus investment may be understood as an activity that commits funds in any financial or physical form in the presence of an expectation of receiving additional return in future. In the present context of portfolio management, the investment is considered to be financial investment, which imply employment of funds with the objective of realising additional income or growth in value of investment at a future date. Investing encompasses very conservative position as well as speculation. The field of investment involves the study of investment process.

Investment is concerned with the management of an investors' wealth which is the sum of current income and the present value of all future incomes. In this text investment refers to financial assets. Financial investments are commitments of funds to derive income in form of interest, dividend premium, pension benefits or appreciation in the value of initial investment. Hence the purchase of shares, debentures post office savings certificates and insurance policies all are financial investments. Such investment generates financial assets. These activities are undertaken by anyone who desires a return, and is willing to accept the risk from the financial instruments

A genuine investor is interested in a good rate of return, earned on a rather consistent basis for a relatively long period of time. The speculator, on the other hand, seeks opportunities promising very large returns, earned rather quickly. In this process, he assumes a risk that is disproportionate to the anticipated return. Thus, from the discussion we cannot infer that there exists a demarcation between stocks and speculative stocks. The same stock can be purchased as a speculation or as investment, depending on the motive of the purchaser. For example, the decision of the professor to invest in the stock of Reliance Industries is considered as a genuine investment because he seems to be interested in a regular dividend income and prospects of long-term capital appreciation. However, if another person buys the same stock with the anticipation that the share price is likely to rise, his decision will be characterised as speculation.

But at the same time, both Corporate Finance and Investments are built upon a common set of financial principles such as the present value, the future value, the cost of capital. And very often investment and financing analysis for decision making use the same tools, but the interpretation of the results from this analysis for the investor and for the financier would be different. For example, when issuing the securities and selling them in the market the company perform valuation looking for the higher price and for the lower cost of capital, but the investor uses valuation search for attractive securities with the lower price and the higher possible required rate of return on his/her investments.

Together with the investment the term speculation is frequently used. Speculation can be described as investment tool, but it is related with the short)term investment horizons and usually involves purchasing the salable securities with the hope that its price will increase rapidly, providing a quick profit. Speculators try to buy low and to sell high, their primary concern is with anticipating and profiting from market fluctuations. But as the fluctuations in the financial markets are and become more and more unpredictable, speculations are treated as the investments of highest risk. In contrast, an investment is based upon the analysis and its main goal is to promise safety of principle sum invested and to earn the satisfactory risk. There are two types of investors:

1. **Individual Investors:** These are individuals who are investing on their own. Sometimes individual investors are called retail investors.
2. **Institutional Investors:** These are entities such as investment companies, commercial banks, insurance companies, pension funds and other financial institutions.

In recent years the process of institutionalisation of investors can be observed. As the main reasons for this can be mentioned the fact, that institutional investors can achieve economies of scale, demographic pressure on social security and the changing role of banks. One of important preconditions for successful investing both for individual and institutional investors is the favorable investment environment.

Direct Investing vs. Indirect Investing

Investors can use direct or indirect type of investing. Direct investing is realized using Financial markets and Indirect investing involves financial intermediaries. The primary difference between these two types of investing is that by applying direct investing investors buy and sell financial assets and manage individual investment portfolio themselves. Consequently, investing directly through financial markets investors take all the risk and their successful investing depends on their understanding of financial markets, its fluctuations and on their abilities to analyse and to evaluate the investments and to manage their investment portfolio.

Contrary, using indirect type of investing investors are buying or selling financial instruments of financial intermediaries (financial institutions) which invest large pools of funds in the financial markets and hold portfolios. Indirect investing relieves investors from making decisions about their portfolio. As shareholders with the ownership interest in the portfolios managed by financial institutions (investment companies, pension funds, insurance companies, commercial banks) the investors are entitled to their share of dividends, interest and capital gains generated and pay their share of the institution's expenses and portfolio management fee. The risk for investor using indirect investing is related more with the credibility of chosen institution and the professionalism of portfolio managers. In general, indirect investing is more related with the financial institutions which are primarily in the business of investing in and managing a portfolio of securities (various types of investment funds or investment companies, private pension funds, etc.). By pooling the funds of thousands of investors, those companies can offer them a variety of services, in addition to diversification, including professional management of their financial assets and liquidity.

Investors can "employ" their funds by performing direct transactions, bypassing both financial institutions and financial markets (for example, direct lending). But such transactions are very risky, if a large amount of money is transferred only to one's hands, following the well-known American proverb "don't put all your eggs in one basket" that turns to the necessity to diversify your investments. From the other side, direct transactions in the businesses are strictly limited by laws avoiding possibility of money laundering.

Types of Investing and Alternatives for Financing

Types of Investing in the Economy	Alternatives for Financing in the Economy
Direct investing (through financial markets)	Raising equity capital or borrowing in financial markets
Indirect investing (through financial institutions)	Borrowing from financial institutions
Direct transactions	Direct borrowing, partnership contracts

Companies can obtain necessary funds directly from the general public (those who have excess money to invest) by the use of the financial market, issuing and selling their securities. Alternatively, they can obtain funds indirectly from the general public by using financial intermediaries. And the intermediaries acquire funds by allowing the general public to maintain such investments as savings accounts, certificates of deposit accounts and other similar vehicles.

Investment Environment can be defined as the existing investment vehicles in the market available for investor and the places for transactions with these investment vehicles. Thus, further in this sub-chapter, the main types of investment vehicles and the types of financial markets will be presented and described.

Investment Vehicles: The financial investments that mean the object will be financial assets and the marketable securities in particular. But even if further in this course only the investments in financial assets are discussed, for deeper understanding the specifics of financial assets comparison of some important characteristics of investment in this type of assets with the investment in physical assets is presented.

Investment in financial assets differ from investment in physical assets in the following important aspects:

- **Financial Assets** are divisible, whereas most physical assets are not. An asset is divisible if investor can buy or sell small portion of it. In case of financial assets, it means that investor, for example, can buy or sell a small fraction of the whole company as investment object buying or selling a number of common stocks.
- **Marketability (or Liquidity)** is a characteristic of financial assets that is not shared by physical assets, which usually have low liquidity. Marketability (or liquidity) reflects the feasibility of converting of the asset into cash quickly and without affecting its price significantly. Most of financial assets are easy to buy or to sell in the financial markets.
- The planned Holding Period of financial assets can be much shorter than the holding period of most physical assets. The holding period for investments is defined as the time between signing a purchasing order for asset and selling the asset. Investors acquiring physical asset usually plan to hold it for a long period, but investing in financial assets, such as securities, even for some months or a year can be reasonable. Holding period for investing in financial assets vary in very wide interval and depends on the investor's goals and investment strategy.
- **Information** about financial assets is often more abundant and less costly to obtain, than information about physical assets. Information availability shows the real possibility of the investors to receive the necessary information which could influence their investment decisions and investment results. Since a big portion of information important for investors in such financial assets as stocks, bonds is publicly available, the impact of many disclosed factors having influence on value of these securities can be included in the analysis and the decisions made by investors. Even if we analyse only financial investment, there is a big

variety of financial investment vehicles. The ongoing processes of globalisation and integration open wider possibilities for the investors to invest into new investment vehicles which were unavailable for them some time ago because of the weak domestic financial systems and limited technologies for investment in global investment environment.

The most important characteristics of investment vehicles on which bases the overall variety of investment vehicles can be assorted are the return on investment and the risk which is defined as the uncertainty about the actual return that will be earned on an investment. Each type of investment vehicles could be characterised by certain level of profitability and risk because of the specifics of these financial instruments. Though all different types of investment vehicles can be compared using characteristics of risk and return and the most risky as well as less risky investment vehicles can be defined, however the risk and return on investment are close related, and only using both important characteristics, we can really understand the differences in investment vehicles.

The main types of financial investment vehicles are:

1. Short term investment vehicles
2. Fixed income securities;
3. Common stock;
4. Speculative investment vehicles;
5. Other investment tools.

Short-term Investment Vehicles are all those which have a maturity of one year or less. Short term investment vehicles often are defined as money) market instruments, because they are traded in the money market which presents the financial market for short term (up to one year of maturity) marketable financial assets. The risk as well as the return on investments of short-term investment vehicles usually is lower than for other types of investments. The main short-term investment vehicles are:

- Certificate of deposit;
- Treasury bills;
- Commercial paper;
- Bankers' acceptances;
- Repurchase agreements.
- **Certificate of Deposit** is debt instrument issued by bank that indicates a specified sum of money has been deposited at the issuing depository institution. Certificate of deposit bears a maturity date and specified interest rate and can be issued in any denomination. Most certificates of deposit cannot be traded and they incur penalties for early withdrawal. For large money market investors, financial institutions allow their large denomination certificates of deposits to be traded as negotiable certificates of deposits.
- **Treasury Bills** (also called T-bills) are securities representing financial obligations of the government. T-bills have maturities of less than one year. They have the unique feature of being issued at a discount from their nominal value and the difference between nominal value and discount price is the only sum which is paid at the maturity for these short term securities because the interest is not paid in cash, only accrued. The other important feature of T-bills is that they are treated as risk)free securities ignoring inflation and default of a government, which was rare in developed countries, the T-bill will pay the fixed stated yield

with certainty. But, of course, the yield on T-bills changes over time influenced by changes in overall macroeconomic situation. T-bills are issued on an auction basis. The issuer accepts competitive bids and allocates bills to those offering the highest prices. Non-competitive bid is an offer to purchase the bills at a price that equals the average of the competitive bids. Bills can be traded before the maturity, while their market price is subject to change with changes in the rate of interest. But because of the early maturity dates of T-bills, large interest changes are needed to move T-bills prices very far. Bills are thus regarded as high liquid assets.

- **Commercial Paper** is a name for short-term unsecured promissory notes issued by corporation. Commercial paper is a means of short-term borrowing by large corporations. Large, well) established corporations have found that borrowing directly from investors through commercial paper is cheaper than relying solely on bank loans. Commercial paper is issued either directly from the firm to the investor or through an intermediary. Commercial paper, like T-bills, is issued at a discount. The most common maturity range of commercial paper is 30 to 60 days or less. Commercial paper is riskier than T-bills, because there is a larger risk that a corporation will default. Also, commercial paper is not easily bought and sold after it is issued, because the issues are relatively small compared to T-bills and hence their market is not liquid.
- **Bankers' Acceptances** are the vehicles created to facilitate commercial trade transactions. These vehicles are called bankers' acceptances because a bank accepts the responsibility to repay a loan to the holder of the vehicle in case the debtor fails to perform. Bankers' acceptances are short-term fixed-income securities that are created by non-financial firm whose payment is guaranteed by a bank. This short-term loan contract typically has a higher interest rate than similar short–term securities to compensate for the default risk. Since bankers' acceptances are not standardised, there is no active trading of these securities.
- **Repurchase Agreement** (often referred to as a repo) is the sale of security with a commitment by the seller to buy the security back from the purchaser at a specified price at a designated future date. Basically, a repo is a collectivised short-term loan, where collateral is a security. The collateral in a repo may be a treasury security or other money market security. The difference between the purchase price and the sale price is the interest cost of the loan, from which repo rate can be calculated. Because of concern about default risk, the length of maturity of repo is usually very short. If the agreement is for a loan of funds for one day, it is called overnight repo; if the term of the agreement is for more than one day, it is called a term repo. A reverse repo is the opposite of a repo. In this transaction a corporation buys the securities with an agreement to sell them at a specified price and time. Using repos helps to increase the liquidity in the money market.
- **Fixed Income Securities** are those which return is fixed, up to some redemption date or indefinitely. The fixed amounts may be stated in money terms or indexed to some measure of the price level. This type of financial investments is presented by two different groups of securities:
  - Long-term debt securities
  - Preferred stocks.
- **Long-term Debt Securities:** These can be described as long)term debt instruments representing the issuer's contractual obligation. Long- term securities have maturity longer

than one year. The buyer (investor) of these securities is lending money to the issuer, who undertake obligation periodically to pay interest on this loan and repay the principal at a stated maturity date.

Long-term debt securities are traded in the capital markets. From the investor's point of view these securities can be treated as a "safe" asset. But in reality the safety of investment in fixed, income securities is strongly related with the default risk of an issuer. The major representatives of long-term debt securities are bonds, but today there are a big variety of different kinds of bonds, which differ not only by the different issuers (governments, municipals, companies, agencies, etc.), but by different schemes of interest payments which is a result of bringing financial innovations to the long-term debt securities market.

As demand for borrowing the funds from the capital markets is growing the long-term debt securities today are prevailing in the global markets. And it has really become the challenge for investor to pick long-term debt securities relevant to his/her investment expectations, including the safety of investment. We examine the different kinds of long)term debt securities and together with the other aspects in decision making investing in bonds.

- **Preferred Stocks:** These are equity security, which has infinitive life and pay dividends. But preferred stock is attributed to the type of fixed income securities, because the dividend for preferred stock is fixed in amount and known in advance. Though, this security provides for the investor the flow of income is very similar to that of the bond. The main difference between preferred stocks and bonds is that for preferred stock the flows are forever, if the stock is not callable.

  The preferred stockholders are paid after the debt securities holders but before the common stock holders in terms of priorities in payments of income and in case of liquidation of the company. If the issuer fails to pay the dividend in any year, the unpaid dividends will have to be paid if the issue is cumulative.

  If preferred stock is issued as non-cumulative, dividends for the years with losses do not have to be paid. Usually, same rights to vote in general meetings for preferred stockholders are suspended. Because of having the features attributed for both equity and fixed income securities preferred, stocks is known as hybrid security. A most preferred stock is issued as non-cumulative and callable. In recent years the preferred stocks with option of convertibility to common stock are proliferating.

The Common Stock is the other type of investment vehicles which is one of most popular among investors with long-term horizon of their investments. Common stock represents the ownership interest of corporations or the equity of the stock holders. Holders of common stock are entitled to attend and vote at a general meeting of shareholders to receive declared dividends and to receive their share of the residual assets, if any, if the corporation is bankrupt. The issuers of the common stock are the companies which seek to receive funds in the market and though are "going public". The issuing common stocks and selling them in the market enables the company to raise additional equity capital more easily when using other alternative sources. Thus many companies are issuing their common stocks which are traded in financial markets and investors have wide possibilities for choosing this type of securities for the investment.

Speculative Investment Vehicles

The term "speculation" could be defined as investments with a high risk and high investment return.

Using these investment vehicles, speculators try to buy low and to sell high. Their primary concern is with anticipating and profiting from the expected market fluctuations. The only gain from such investments is the positive difference between selling and purchasing prices. Using short-term investment strategies, investors can use for speculations other investment vehicles, such as common stock, but here we try to accentuate the specific types of investments which are more risky than other investment vehicles because of their nature related with more uncertainty about the changes influencing their price in the future. Speculative investment vehicles could be presented by these different vehicles:

- Options;
- Futures;
- Commodities, traded on the exchange (coffee, grain metals, other commodities, etc.).
- **Options** are the derivative financial instruments. An options contract gives the owner of the contract the right, but not the obligation, to buy or to sell a financial asset at a specified price from or to another party. The buyer of the contract must pay a fee (option price) for the seller. There is a big uncertainty about whether the buyer of the option will take the advantage of it and what option price would be relevant, as it depends not only on demand and supply in the options market, but on the changes in the other market where the financial asset included in the options contract are traded. Though, the option is a risky financial instrument for those investors who use it for speculations instead of hedging.
- **Futures** are the other type of derivatives. A futures contract is an agreement between two parties where they agree to transact with respect to some financial asset at a predetermined price at a specified future date. One party agree to buy the financial asset, while the other agrees to sell the financial asset. It is very important, that in futures contract case, both parties are obligated to perform and neither party charges the fee.

  There are two types of people who deal with options (and futures) contracts: speculators and hedgers. Speculators buy and sell futures for the sole purpose of making a profit by closing out their positions at a price that is better than the initial price. Such people neither produce nor use the asset in the ordinary course of business. In contrary, hedgers buy and sell futures to offset an otherwise risky position in the market. Transactions using derivatives instruments are not limited to financial assets. There are derivatives, involving different commodities (coffee, grain, precious metals, and other commodities). But in this course the target is on derivatives where underlying asset is a financial asset.
- **Commodities traded on the exchange:** A commodity exchange is an organised, regulated market that facilitates the purchase and sale of contracts whose values are tied to the price of commodities (e.g., corn, crude oil and gold). Typically, the buyers of these contracts agree to accept delivery of a commodity, and the sellers agree to deliver the commodity.

  Most commodity markets across the world also trade in agricultural products and other raw materials (like wheat, barley, sugar, maize, cotton, cocoa, coffee, milk products, pork bellies, oil, metals, etc.) and contracts based on them. These contracts can include spot prices, forwards, futures and options on futures.

Other Investment Tools

- Investment in life insurance;
- Pension funds;
- Hedge funds.

Investment Companies/Investment Funds: They receive money from investors with the common objective of pooling the funds and then investing them in securities according to a stated set of investment objectives. Two types of funds:

- **Open-end Funds (Mutual Funds):** These funds have no pre-determined amount of stocks outstanding and they can buy back or issue new shares at any point. Price of the share is not determined by demand, but by an estimate of the current market value of the fund's net assets per share (NAV) and a commission.
- **Closed-end Funds Trusts:** These funds are publicly traded investment companies that have issued a specified number of shares and can only issue additional shares through a new public issue. Pricing of closed-end funds is different from the pricing of open-end funds. The market price can differ from the NAV.

Insurance Companies: They are in the business of assuming the risks of adverse events (such as fires, accidents, etc.) in exchange for a flow of insurance premium. They are investing the accumulated funds in securities (treasury bonds, corporate stocks and bonds), real estate, etc. Three types of Insurance Companies: life insurance; non-life insurance (also known as property casualty insurance and re-insurance. During recent years, investment life insurance became very popular investment alternative for individual investors, because this hybrid investment product allows to buy the life insurance policy together with possibility to invest accumulated life insurance payments or lump sum for a long time selecting investment program relevant to investor‘s future expectations.

Pension Funds: They are an assets pool that accumulates over an employee's working years and pays retirement benefits during the employee's non-working years. Pension funds are investing the funds according to a stated set of investment objectives in securities (treasury bonds, corporate stocks and bonds), real estate, etc.

Hedge funds are unregulated private investment partnerships, limited to institutions and high net-worth individuals, which seek to exploit various market opportunities and thereby to earn larger returns than are ordinarily available. They require a substantial initial investment from investors and usually have some restrictions on how quickly investor can withdraw their funds. Hedge funds take concentrated speculative positions and can be very risky. It could be noted that originally, the term "hedge" made some sense when applied to these funds. They would by combining different types of investments, including derivatives, try to hedge risk while seeking higher return. But today the word "hedge' is misapplied to these funds because they generally take an aggressive strategies investing in stock, bond and other financial markets around the world and their level of risk is high. Investment generally involves commitment of funds in two types of assets:

- **Real assets:** Investment in this sense includes the information of new productive capital in the form of new construction, plant and machinery; inventories, etc. Such investment generate real assets. Real assets are tangible material things like building, automobiles, land, gold, etc.

- **Financial assets:** In the financial sense, investment is the commitment of a person's funds to derive future income in the form of interest, dividend, premiums, pension's benefits or appreciation in the value of their capital. Purchasing of shares, debentures, post offices savings certificates and insurance policies are all investments in the financial sense. Such investments generate financial assets.

In the economic sense, investment means the net addition to the economy's capital stock which consists of goods and services that are used in the production of other goods services that are used in the production of other goods and services. Financial assets are piece of paper representing an indirect claim to real assets held by someone else. These pieces of paper represent debt or equity commitment in the form of IOUs or stock certificates. Investments in financial assets consist of:

- Securities (i.e., security forms of) investment
- Non-securities investment

The term 'securities' used in the broadest sense, consists of those papers which are quoted and are transferable. Under section 2(h) of the Securities Contract (Regulation) Act, 1956 (SCRA), 'securities' include:

1. Shares, scrips, stocks, bonds, debentures, debenture stock and other marketable securities of a like nature in or of any incorporated company or other body corporate.
2. Government securities.

FINANICIAL ASSETS			**REAL ASSETS**	
Marketable Assets			REAL ASSETS	
•	Shares	**SAVER**	•	House
•	Mutual Fund Schemes		•	Land
•	Bonds		•	Buildings
•	UTI Units	↕	•	Flats
•	Government Securities			
Non-Marketable Assets			Bullion	
•	Bank Deposit	**INVESTOR**	•	Gold
•	PF and LIC Schemes		•	Silver
•	Pension Schemes		•	Diamond
•	PO Deposits			
			Art Instruments	
			•	Paintings
			•	Sculptures
			Consumer Durables	

3. Such other instruments as may be declared by the Central Government as securities.

Objectives of Investments

The main investment objectives are increasing the rate of return and reducing the risk. Other objectives like safety, liquidity and hedge against inflation can be considered as subsidiary objectives.

Return: Investors always expects a good rate of return from their investments. Rate of return could be defined as the income the investor receives during the holding period stated as a percentage of the purchasing price at the beginning of the holding period.

Investors wish to earn a return on their money. Cash has an opportunity cost. By holding cash, you forego the opportunity to earn a return on that cash. Furthermore, in an inflationary environment, the purchasing power of cash diminishes, with high rates of inflation bringing a relatively rapid decline in purchasing power. In investments, it is critical to distinguish between an expected return (the anticipated return for some future period) and a realised return (the actual return over some past period). Investors invest for the future for the returns they expect to earn but when the investing period is over, they are left with their realised returns. What investors actually earn from their holdings may turn out to be more or less than what they expected to earn when they initiated the investment. This point is the essence of the investments process; Investors must always consider the risk involved in investing.

Return = End Period Value- Beginning Period Value + Dividend/Beginning Period Value × 100

Return = Sale Price Value – Purchasing Price Value + Dividend Yield/Purchasing Price Value × 100

Return = Capital Gains or Price changes or Capital appreciation + Dividend Yield.

Risk: Risk is inherent in any investment. Risk may relate to loss of capital, delay in repayment of capital, non-payment of return or variability of returns. The risk of an investment is determined by the investments, maturity period, repayment capacity, nature of return commitment and so on. Risk and expected return of an investment are related. Theoretically, the higher the risk, higher is the expected returned. The higher return is a compensation expected by investors for their willingness to bear the higher risk.

Risk of holding securities is related with probability of actual return becoming less than the expected return. The word risk is synonymous with the phrase variability of return. Investment' risk is just as important as measuring its expected rate of return because minimising risk and maximising the rate of return are interested objectives in the investment management. An investment whose rate of return varies widely from period to period is risky than whose return that does not change much.

Safety: The safety of investment is identified with the certainty of return of capital without loss of time or money. Safety is another feature that an investor desires from investments. Every investor expects to get back the initial capital on maturity without loss and without delay. The selected investment avenue should be under the legal regulatory framework. If it is not under the legal framework, it is difficult to represent the grievances, if any approval of the law itself adds a flavour of safety. Even though approved by law, the safety of the principal differs from one mode of investment to another.

Liquidity: An investment that is easily saleable without loss of money or time is said to be liquid. A well-developed secondary market for security increase the liquidity of the investment. An investor tends to prefer maximisation of expected return, minimisation of risk, safety of funds and liquidity of investment. Marketability of the investment provides liquidity to the investment. The liquidity depends upon the marketing and trading facility

Hedge against inflation: Since there is inflation in almost all the economy, the rate of return should ensure a cover against the inflation. The return rate should be higher than the rate of inflation; otherwise the investor will have loss in real terms. Growth stocks would appreciate in their values over time and provide a protection against inflation. The return thus earned should assure the safety of the principal amount, regular flow of income and be hedge against inflation.

Tax Planning: In practice, many investors are taxpaying individuals. As the income tax rates vary from 10% to 30% with a surcharge, the tax liability of those with higher income brackets is somewhat heavy. The interest earned by the investor from his investment is a taxable income, and in certain cases, tax is to be deducted at source of interest income (TDS). An investor generally prefers liquidity for his investment along with safety of his funds and a good return with minimum stock.

Securities

Security forms of investments include Equity shares, preference shares, debentures, government bonds, units of UTI and other mutual funds, and equity shares and bonds of Public Sector Undertakings (PSUs). Non-security forms of investments include all those investments, which are not quoted in any stock market and are not freely marketable. viz., bank deposits, corporate deposits, post office deposits, National Savings and other small savings certificates and schemes, provident funds, and insurance policies. Another popular investment in physical assets such as gold, silver, diamonds, real estate, antiques, etc. Indian investors have always considered the physical assets to be very attractive investments. There are a large number of investment avenues for savers in India. Some of them are marketable and liquid, while others are non-marketable, Some of them are highly risky while some others are almost risk less. The investor has to choose proper avenues from among them, depending on his specific need, risk preference, and return expectation. Investment avenues can be broadly classified under the following heads.

Classification of Securities

Joint stock companies in the private sector issue corporate securities. These include equity shares, preference shares, and debentures. Equity shares have variable dividend and hence belong to the high risk high return category. Preference shares and debentures have fixed returns with lower risk.

Equity Shares: By investing in shares; investors basically buy the ownership right to that company. When the company makes profits, shareholders receive their share of the profits in the form of dividends. In addition, when a company performs well and the future expectation from the company is very high, the price of the company's shares goes up in the market. This allows shareholders to sell shares at profit, leading to capital gains. Investors can invest in shares either through primary market offerings or in the secondary market. Equity shares can be classified in different ways but we will be using the terminology of investors. It should be noted that the line of demarcation between the classes are not clear and such classification are not mutually exclusive.

Growth Stocks: Growth stocks are companies whose earnings per share is grows faster than the economy and at a rate higher than that of an average firm in the same industry. Often, the earnings are ploughed back with a view to use them for financing growth. They invest in research and development and diversify with an aggressive marketing policy. They are evidenced by high and strong EPS. Examples are ITC, Dr. Reddy's Bajaj Auto, Satyam Computers and Infosys Technologies, etc. The high growth stocks are often called 'GLAMOUR STOCK' or HIGH FLYERS'.

Income Stocks: A company that pays a large dividend relative to the market price is called an income stock. They are also called defensive stocks. Drug, food and public utility industry shares are regarded as income stocks. Prices of income stocks are not as volatile as growth stocks.

Cyclical Stocks: Cyclical stocks are companies whose earnings fluctuate with the business cycle. Cyclical stocks generally belong to infrastructure or capital goods industries such as general engineering, auto, cement, paper, construction etc. Their share prices also rise and fall in tandem with the trade cycles.

Discount Stocks: Discount stocks are those that are quoted or valued below their face values. These are the shares of sick units.

Undervalued Stock: Undervalued shares are those, which have all the potential to become growth stocks, have very good fundamentals and good future, but somehow the market is yet to price the shares correctly.

Turnaround Stocks: Turnaround stocks are those that are not really doing well in the sense that the market price is well below the intrinsic value mainly because the company is going through a bad patch but is on the way to recovery with signs of turning around the corner in the near future. Examples are East India distilleries (EID) Parry Limited in 80s, Tata Tea (Tata Finlay), SPIC, Mukand Iron and Steel, etc.

Preference Shares: These shares refer to a form of shares that lie in between pure equity and debt. They have the characteristic of ownership rights while retaining the privilege of a consistent return on investment. The claims of these holders carry higher priority than that of ordinary shareholders but lower than that of debt holders. These are issued to the general public only after a public issue of ordinary shares.

Debentures and Bonds: These are essentially long-term debt instruments. Many types of debentures and bonds have been structured to suit investors with different time needs. Though having a higher risk as compared to bank fixed deposits, bonds, and debentures do offer higher returns. Debenture investment requires scanning the market and choosing specific securities that will cater to the investment objectives of the investors.

Depository Receipts (GDRs/ADRs): Global Depository Receipts are instruments in the form of a depository receipt or certificate created by the overseas depository bank outside India and issued to non-resident investors against ordinary shares or Foreign Currency Convertible Bonds (FCCBs) of an issuing company. A GDR issued in America is an American Depository Receipt (ADR). Among the Indian companies, Reliance Industries Limited was the first company to raise funds through a GDR issue. Besides GDRs, ADRS are also popular in the capital market. As investors seek to diversify their equity holdings, the option of ADRs and GDRs are very lucrative. While investing in such securities, investors have to identify the capitalisation and risk characteristics of the instrument and the company's performance in its home country (underlying asset).

Warrants: A warrant is a certificate giving its holder the right to purchase securities at a stipulated price within a specified time limit or perpetually. Sometimes, a warrant is offered with debt securities as an inducement to buy the shares at a later date. The warrant acts as a value addition because the holder of the warrant has the right but not the obligation of investing in the equity at the indicated rate. It can be defined as a long-term call option issued by a company on its shares.

A warrant holder is not entitled to any dividends; neither does he have a voting right. But the exercise price of a warrant gets adjusted for the stock dividends or stock splits. On the expiry date, the holder exercises an option to buy the shares at the predetermined price. This enables the investor to decide whether or not to buy the shares or liquidate the debt from the company. If the market price is higher than the exercise price, then it will be profitable for the investor to exercise the warrant. On the other hand, if the market price falls below the exercise price, then the warrant holder would prefer to liquidate the debt of the firm.

Derivatives: The introduction of derivative products has been one of the most significant developments in the Indian capital market. Derivatives are helpful risk-management tools that an investor has to look at for reducing the risk inherent in as investment portfolio. The first derivative product that has been offered in the Indian market is the index future. Besides index futures, other derivative instruments such as index options and stock options have been introduced in the market. Stock futures are traded in the market regularly and in terms of turnover, have exceeded that of other derivative instruments. The liquidity in the futures market is concentrated in very few shares. Theoretically, the difference between the futures and spot price should reflect the cost of carrying the position to the future of essentially the interest. Therefore, when futures are trading at a premium, it is an indication that participants are bullish of the underlying security and *vice versa*. Derivative trading is a speculative activity. However, investors have to utilize the derivative market since the opportunity of reducing the risk in price movements is possible through investments in derivative products.

Deposits: Among non-corporate investments, the most popular are deposits with banks such as savings accounts and fixed deposits. Savings deposits carry low interest rates whereas fixed deposits carry higher interest rates, varying with the period of maturity, Interest is payable quarterly or half-yearly or annually. Fixed deposits may also be recurring deposits wherein savings are deposited at regular intervals. Some banks have reinvestment plans whereby savings are re-deposited at regular intervals or reinvested as the interest gets accrued. The principal and accumulated interests in such investment plans are paid on maturity.

Savings Bank Account with Commercial Banks: A safe, liquid, and convenient investment option. A savings bank account is an ideal investment avenue for setting aside funds for emergencies or unexpected expenses. Investors may prefer to keep an average balance equal to three months of their living expenses. A bank fixed deposit is recommended for those looking for preservation of capital along with current income in the short-term. However, over the long-term, the returns may not keep pace with inflation.

Company Fixed Deposits: Many companies have come up with fixed deposit schemes to mobilise money for their needs. The company fixed deposit market is a risky market and ought to be looked at with caution. RBI has issued various regulations to monitor the company fixed deposit market. However, credit rating services are available to rate the risk of company fixed deposit schemes.

The maturity period varies from three to five years. Fixed deposits in companies have a high risk since they are unsecured, but they promise higher returns than bank deposits. Fixed deposit in non-banking financial companies (NBFCs) is another investment avenue open to savers. NBFCs include leasing companies, hire purchase companies, investment companies, chit funds, and so on. Deposits in NBFCs carry higher returns with higher risk compared to bank deposits.

Post Office Deposits and Certificates: The investment avenues provided by post offices are non-marketable. However, most of the savings schemes in post offices enjoy tax concessions. Post offices accept savings deposits as well as fixed deposits from the public. There is also a recurring deposit scheme that is an instrument of regular monthly savings. National Savings Certificates (NSCs) is also marketed by post office to investors. The interest on the amount invested is compounded half-yearly and is payable along with the principal at the time of maturity, which is six years from the date of issue. There are a variety of post office savings certificates that cater to specific savings and investment requirements of investors and is a risk-free, high yielding investment opportunity. Interest on these instruments is exempt from income tax. Some of these deposits are also exempt from wealth tax.

Life Insurance Policies: Insurance companies offer many investment schemes to investors.These schemes promote savings and additionally provide insurance cover. LIC is the largest life insurance company in India. Some of its schemes include life policies, convertible whole life assurance policies, endowment assurance policies, Jeevan Saathi, Money Back Plan, Jeevan Dhara, and Marriage Endowment Plan. Insurance policies, while catering to the risk compensation to be faced in the future by investors, also have the advantage of earning a reasonable interest on their investment insurance premiums. Life insurance policies are also eligible for exemption from income tax.

Provident Fund Scheme: Provident fund schemes are deposit schemes, applicable to employees in the public and private sectors. There are three kinds of provident funds applicable to different sectors of employment, namely, Statutory Provident Fund, Recognised Provident Fund, and Unrecognised Provident Fund. In addition to these, there is a voluntary provident fund scheme that is open to any investor, employed or not. This is known as the Public Provident Fund (PPF). Any member of the public can join the PPF, which is operated by the State Bank of India.

Equity Linked Savings Schemes (ELSSs): Investing in ELSSs gets investors a tax rebate of the amount invested. They are basically growth mutual funds with a lock-in period of three years. They have a risk higher than PPF and NSCs, but have the potential of giving higher returns.

Pension Plan: Certain notified retirement/pension funds entitle investors to a tax rebate. UTI, LIC and ICICI are some financial institutions that offer retirement plans to investors.

Government and Semi-government Securities: Government and semi-government bodies such as the public sector undertakings borrow money from the public through the issue of government securities and public sector bonds. These are less risky avenues of investment because of the credibility of the government and government undertakings. The government issues securities in the money market and in the capital market.

Money market instruments are traded in the Wholesale Debt Market (WDM) trades and retail segments. Instruments traded in the money market are short-term instruments such as treasury bills and repos. The government also introduced the privatisation programmes in many corporate enterprises and these securities are traded in the secondary market. These are the semi-government securities. PSU stocks have performed well during the years 2003-04 in the capital market.

Mutual Fund Schemes: The Unit Trust of India is the first mutual fund in the country. A number of commercial banks and financial institutions have also set up mutual funds. Mutual funds have been set up in the private sector also. These mutual funds offer various investment schemes to investors. The number of mutual funds that have cropped up in recent years is quite large. Though, on an average, the mutual fund industry has not been showing good returns, select funds have performed consistently, assuring the investor better returns and lower risk options.

Real Assets: Investments in real assets are also made when the expected returns are very attractive. Real estate, gold, silver, currency, and other investments such as art are also treated as investments since the expectation from holding of such assets is associated with higher returns.

Real Estate: Buying property is an equally strenuous investment decision. Real estate investment is often linked with the future development plans of the location. It is important to check the value while deciding to purchase a movable/immovable property other than buildings. Besides making a personal assessment from the market, the assistance of government-approved values may also be sought. A valuation report indication the value of the each of the major assets and also the basis and manner of valuation can be obtained from an approved value against the payment of a fee. In case of a plantation, a valuation report may also be obtained from recognised private values.

Bullion Investment: The bullion market offers investment opportunity in the form of gold, silver, and other metals. Specific categories of metals are traded in the metals exchange. The bullion market presents an opportunity for an investor by offering returns and end value in future. It has been observed that on several occasions, when the stock market failed, the gold market provided a return on investments. The changing pattern of prices in the bullion market also makes this market risky for investors. Gold and Silver prices are not consistent and keep changing according to the changing local/global demands in the market. The fluctuation prices, however, have been compensated by real returns for many investors who have followed a buy and hold strategy in the bullion market.

Types of Goals Related to Investor's Approach

Near-term High Priority Goals: These are goals which have a high emotional priority to the investor, and he wishes to achieve these goals within a few years at the most. For example, a new house. As a result, investment vehicles for these goals tend to be either in the forms equivalent to "cash or as fixed income" instruments with maturity dates in correspondence with the goal dates. Because of the high emotional importance, these goals have, investor, especially the one with moderate means will not go for any other form of investment which involves more risk especially where his goal is just in sight.

Long-term High Priority Goals: For most people, this goal is an indication of their need for financial independence at a point some, years ahead in the future. For example, Financial independence at the time of retirement or starting a fund for the higher education of a three year old child. Normally, we find that either because of personal preference or because the discounted present value is larger in relation to their resources, the time of realisation for such goals is set around 60 years of age for people of moderate means. Because of the long-term nature of such goals, there is no tendency to adopt more aggressive investment approaches except perhaps, in the last 5 to 10 years before retirement. Even then, investors usually prefer a diversified approach using different classes of assets.

Low Priority Goals: These goals are much lower down in the scale of priority and are not particularly painful achieved. For people with moderate to substantial wealth, these could range from a world tour to donating funds for charity. As a result, investors often invest in speculative kinds of investment either for the fun of it or just to try out some particular aspect of the investment process.

Entrepreneurial or Money Making Goals: These goals pertain to individuals who want to maximise wealth and who are not satisfied by the conventional saving and investing approach. These investors usually put all the spare money they have into stocks preferably of the company in which they are working/owing and leave it there until it reaches some level which either the individual believes is enough or is scared of losing what has been built up over the years.. Even then, the process of diversification and building up a conventional portfolio usually takes him a long time involving a series of opportunities and sales spread over many years.

Investment Process

An organised view the investment process involves analysing the basic nature of investment decisions and organising the activities in the decision process. A share market needs both investment and speculative activities. Speculative activity adds to the market liquidity. A wider distribution of shareholders makes it necessary for a market to exist. Investment process is governed by the two important facets of investment-they are risk and return.

Therefore, we first consider these two basic parameters that are of critical importance to all investors and the trade-off that exists between expected return and risk. Given the foundation for making investment decisions the trade-off between expected return and risk − we next consider the decision process in investments as it is typically practiced today. Although numerous separate decisions must be made for organisational purposes, this decision process has traditionally been divided into a two-step process: security analysis and portfolio management. Security analysis involves the valuation of securities, whereas portfolio management involves the management of an investor's investment selections as a portfolio (package of assets), with its own unique characteristics.

These parts of the process are summarised and we will return to this figure 1.1 to emphasize the steps in the process as we move through the book. The book is built around the same structure. It begins with a chapter that provides an overview of investment management as a business. The first major section is on understanding client needs and preferences, where we look at not only how to think about risk in investing but also at how to measure an investor's willingness to take risk. The second section looks at the asset allocation decision, while the third section examines different approaches to selecting assets. The fourth section takes a brief look at the execution decision, and the fifth section develops different approaches to evaluating performance.

The investment process involves a series of activities leading to purchase of securities of other investment alternatives. The investment process can be divided into five stages. They are:

1. Framing of investment policy or knowledge about investments
2. Investment Analysis
3. Portfolio Selection
4. Portfolio construction
5. Portfolio Evaluation (Appraisal)
6. Portfolio Revision

The Investment Process Activities

1. **Investment Policy:** The government or the investor before proceeding into the investment formulates the policy for the system functioning. The essential ingredients of the policy are the investible funds, objective and knowledge about investment alternatives and market.
2. **Security Analysis:** After formulating the investment policy, the securities to be bought have to be scrutinised through the market industry and company analysis
3. **Valuation:** The valuation helps the investor to determine the return and risk expected from an investment in the common stock. The intrinsic value of the share is measured through the book value of the share and price earnings ratio. Simple discounting models should also be adopted to value the shares. The stock market analysis has developed many advanced models to value the shares. The real worth of the share is compared with the market price and then investment decisions are made.
4. **Portfolio Construction:** A portfolio is a combination of securities. The portfolio is constructed in such a manner to meet the investor goals and objectives. The investor should decide how best it meets the goals with the securities available. The investor tries to attain maximum return with minimum risk. Towards this end, he diversifies his portfolio and

allocates funds among the securities. The main objective of diversification is the reduction of risk in the loss of capital and income. A diversified portfolio is comparatively less risky than holding a single portfolio.

- **Debt and equality diversification:** Debt instrument provides assured return with limited capital appreciation. Common stock provide income and capital gain but with the Undesirable flavor of uncertainty. Both debt instruments and equity are combined to complement each other.
- **Industry diversification:** The growth of industry and their reaction to government policies differ from each other. Banking industry shares may provide regular returns but with limited capital appreciation. The IT stock yields high return and capital appreciation. The IT stock yields high return and capital appreciation. The IT stock yields high return and capital appreciation but their growth potential after the Terrorists on WTC Building at New York is not predictable.
- **Company diversification:** When securities from different companies are purchased, the risk is reduced. Technical analyst suggests the investors to buy securities based on the price movement. Fundamental analyst suggests the selection of financially sound and investor-friendly companies.
- **Selection:** Based on the diversification level, industry and company analyses the securities have to be selected. Funds are allocated for the selected securities and allocation of funds will help the managers to construct sound portfolio management process.

5. **Evaluation of Portfolio:** The portfolio has to be managed efficiently. The efficient management calls for evaluation of the portfolio. This process consists of portfolio appraisal and revision.
   - **Appraisal:** The return and risk performance of the security may vary from time to time. The variability in returns of the securities is measured and compared. The developments in the economy, industry and relevant companies from which the stocks are brought have to be appraised. The appraisal may predict the loss and steps can be taken to avoid such losses.
6. **Revision:** Revision depends on results of the appraisal. The low yielding securities with high risk are replaced with high yielding securities with low risk factor. To keep the return at a particular level necessitated the investor to revise the components of the portfolio periodically.

Various types of securities are traded in the market. According to the Securities Contracts Regulation Act, securities include shares, scripts, stocks, bonds, debentures or other marketable securities of any incorporated company or other body corporate, or government. Securities are classified on the basis of return and the sources of issue. Based on the income, they may be classified as fixed or variable income securities. Sources of issue may be government, semi government and corporate. Corporate houses generally raise funds through fixed or variable income securities. Sources of issue may be government, semi-government and corporate. Corporate houses, generally raise funds through fixed and variable income securities like equity shares, preference shares and debentures.

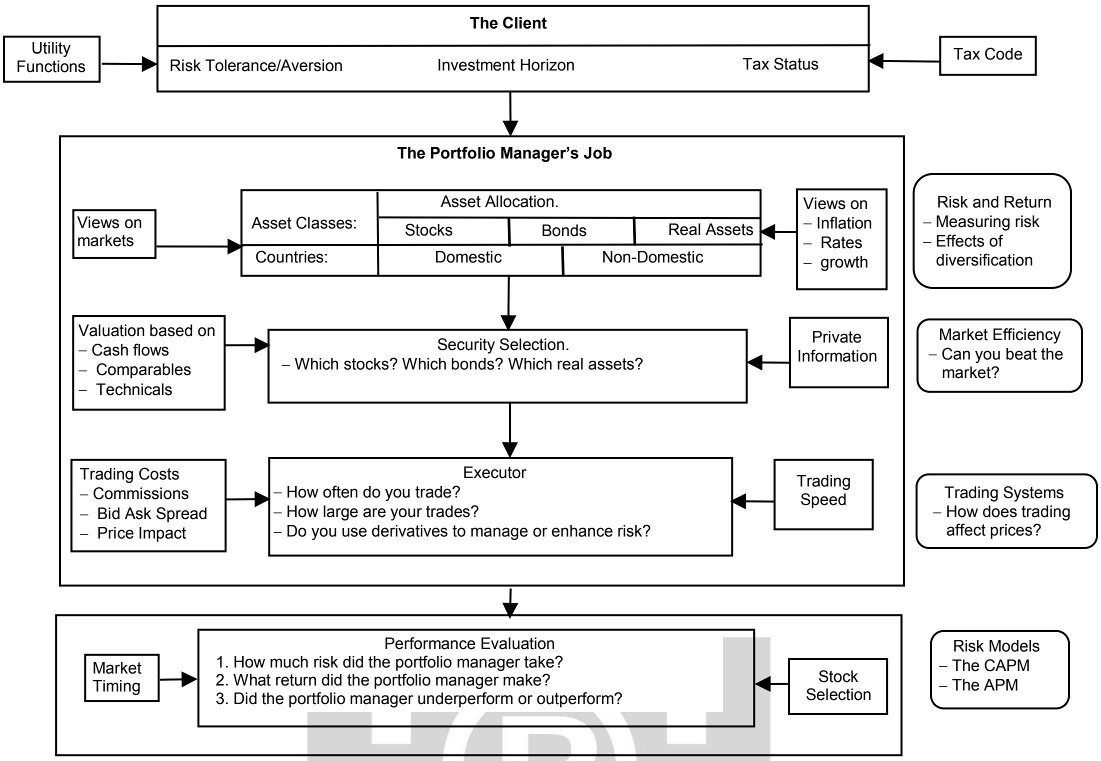

Fig. 1.1: The Investment Process

Speculator

An investor has a longer planning horizon. His holding period is usually at least one year. A speculator has a relatively short planning horizon. His holding may be a few days to a few months. Risks disposition an investor is normally not willing to assume more than moderate risk. Rarely does he assume high risk. A speculator is ordinarily willing to assume high risk.

Return expectation: An investor usually seeks a modest rate of return, which is commensurate with the limited risk assumed by him. A speculator looks for a high rate of return in exchange for the high risk borne by him. Basis of decisions and investor attaches greater significance to fundamental factors and attempts a careful evaluation of the prospects of the firm. A speculator relies more on hearsay, technical charts and market psychology.

Leverage: Typically, an investor uses his own funds and eschews borrowed funds. A speculator normally resorts to borrowings, which can be very substantial, to supplement his personal resources.

Role of Speculator

- The speculator seeks opportunities promising very large returns earned quickly and is the prepared to take higher risk.
- The speculator is interested in getting abnormal return i.e., extremely high rate of return than the normal return in the short run.

- Speculator investments are made for short-term trade gains through buying and selling investments.
- The speculator is more interested in the market action and its price movement.
- The speculator would like to assure greater risk than the investors. The negative short-term fluctuations affect the speculators in worse manner then the investors.

Speculation means taking up the business risk in the hope of getting short term gain. Speculation essentially involves buying and selling activities with the expectation of getting profit from the price fluctuations. The speculator is more interested in the action and its price movement. The investor constantly evaluates the worth of security whereas the speculator evaluates the price movement. He is not worked out about the fundamental factors like his counterpart, the investor.

Difference between Investor and Speculator

	Investor	Speculator
Time	Plans for a longer time horizon. His holding period may be from one year to few years.	Plans for a very short period. Holding period varies from few days to months.
Risk	Assumes moderate risk.	Willing to undertake high risk.
Return	Likes to have moderate of return associated with limited risk.	Likes to have high return for assuming high risk.
Decision	Considers fundamental factors and evaluates the performance of the company regularly.	Considers inside information, here says and market behaviour.
Funds	Uses his own funds and avoids borrowed funds.	Uses borrowed funds to supplement these personal resources.

Investment vs. Speculation

Investment vs. Speculation

Basis	Investment	Speculation
Type of contract	Creditor	Ownership
Basis of acquisition	Usually by outright purchase	Often, on margin
Length of commitment	Comparatively long term	For a short time only
For a short time only	Earnings of enterprise	Change in market price
Quantity of risk	Small	Large
Stability of income	Very stable	Uncertain and erratic
Psychological attitude of Participants	Daring and careless reasons for purchase Scientific analysis of intrinsic worth Hunches, tips, "inside dope", etc.	Cautious and conservative

Investment and speculation are somewhat different and yet similar because speculation requires an investment, and investment are at somewhat speculative. Probably, the best way to make a distinction between investment and speculation is considering the role of expectation. Investments are usually made with the expectation that a certain stream of income or a certain price that has existed will not change in the future. Whereas speculation are usually based on the expectation that some change will occur in future, thereby resulting in a return. Thus an expected change is the basis for speculation but not for investment.

An investment also can be distinguished from speculation by the time horizon of the investor and often by the risk return characteristic of investment. A true investor is interested in a good and consistent rate of return for a long period of time. In contrast, the speculator seeks opportunities promising very large return earned within a short period of time due to changing environment. Speculation involves a higher level of risk and a more uncertain expectation of returns, which is not necessarily the case with investment.

The identification of these distinctions of these distinctions helps to define the role of the investor and the speculator in the market. The investor can be said to be interested in a good rate of return of a consistent basis over a relatively longer duration. For this purpose, the investor computes the real worth of the security before investing in it. The speculator seeks very large returns from the market quickly. For a speculator, market expectations and price movements are the main factors influencing a buy or sell decision.

Speculation, thus, is more risky than investment in any stock exchange. There are two main categories of speculators called the bulls and bears. A bull buys shares in the expectation of selling them at a higher price. When there is a bullish tendency in the market, share prices tend to go up since the demand for the shares is high. A bear sells shares in the expectation of a fall in price with the intention of buying the shares at a lower price at a future date. These bearish tendencies result in a fall in the price of shares. A share market needs both investment and speculative activities. Speculative activity adds to the market liquidity. A wider distribution of shareholders makes it necessary for a market to exist.

Gambling

Gambling is the wagering of money or something of material value on an event with an uncertain outcome with the primary intent of winning additional money and/or material goods. Gambling thus requires three elements be present: consideration, chance and prize. Typically, the outcome of the wager is evident within a short period. Betting (wagering) that must result either in a gain or a loss. Gambling is neither risk taking in the sense of speculation (assumption of substantial short-term risk nor investing (acquiring property or assets for securing long-term capital gains).

Investment has also to be distinguished from gambling. Typical examples of gambling are horse races, card games, lotteries etc. Gambling involves taking high risks not only for high return but also for thrill and excitement. Gambling is unplanned and nonscientific, without knowledge of the nature of the risk involved. It is surrounded by uncertainty and is based on tips and rumors. In gambling artificial and unnecessary risks are created for increasing the returns.

Investment is an attempt of careful planning, evaluation and allocation of funds to various investments outlets which offer safety of principal with moderate and continuous return over a long period of time. It also differs from insurance which may reduce or eliminate the risk of loss but offers no legitimate chance of gain Gambling is defined as ‘the act of betting on an uncertain outcome’. Investing means committing money in order to earn a financial return. The definitions seems to indicate a higher element of chance or randomness in gambling, while investing appears to be more rational.

Investment vs. Gambling

One look at the dictionary will tell us that investing and gambling are, at their core, startlingly different. But there are still plenty of so-called investors who behave far more like gamblers, especially when it comes to the expectation of profit with associated risk.

According to the Oxford Dictionary, a gambler is "a fraudulent gamer who habitually plays for money, especially high stakes. By its very nature, gambling involves a voluntary, deliberate assumption of risk with a negative expected value."

An investor, on the other hand, is defined as "a person who commits capital to a business endeavor for positive returns. Investing includes the amount of time you put into the study of a prospective company, especially since time is money."

Spreading Your Risk

One of the key differences between investing and gambling is diversification. Investing provides you with the opportunity to spread your risk across all asset classes, whereas gamblers throw their capital into a single pot with no loss mitigation strategy.

As an investor, you can also prevent total loss of your capital by selling when you need to, or when you believe it is a sound investment decision. In gambling, you cannot stop your losses on a bet and get part of your money back. This is because investing is based on ownership of something tangible and gambling is not.

Diversification

Diversification means the existence or the development of a very wide variety of financial institutions, markets, instruments, services and practices in the financial system. It also refers to the presence of opportunities for investors to minimize the risk for a given rate of return or they can maximise the return for a given risk.

Sources of Investment Information

Security analysis calls for collection of vast information relating to industry, company and market. The market for securities can be regarded as perfect when demand and supply forces determine the prices of securities. Availability of money and flow of information into market largely affect the demand and supply forces determine the prices of securities. Availability of money and flow of information into market largely affect the demand and supply forces. Besides the market price, the investors are interested in knowing the intrinsic value of shares. Intrinsic value of shares means the value of net assets available per equity share of the company. Intrinsic value always revolves around the market price. When the intrinsic value is less than the market price, it is advisable to sell the shares. The sources and types of information are:

1. **World Affairs:** International factors such as international political developments, wars, foreign markets, etc. influence domestic income, output, employment and investment for domestic market. Besides, financial journals like Economic Times, Financial Express and Business Line, etc. report on world economic affairs.
2. **Domestic Economic and Political Factors:** Domestic economic and political factors relate to gross domestic products (GDP), agricultural output, monsoon, money supply, inflation,

government policies, taxation etc., besides the leading newspapers, financial dailies like Economic Times, Financial Express, Business Line. etc.

3. **Industry Information:** Industry information is quite essential for investment decision-making. It includes market demand, installed capacity, capacity utilisation, competitor's activities and their share in the market, market leaders, prospects of the industry, and requirements of foreign buyers, inputs and capital goods in foreign countries, etc.
4. **Company Information:** Company information relates to the corporate data, annual reports, Stock Exchange publications, Department of company Affair's circulars, press releases on corporate affairs by government industry, chamber etc. Financial papers, fortnightly journals of Capital Markets, Dalal Street and Business India furnish information about the companies listed on recognised stock exchanges. They also publish the results of equity and market research. Weekly reviews and monthly reviews of Bombay Stock Exchange provide useful information required for security analysis
5. **Security Market Information:** Investment management needs information about security market. The credit rating of companies, market analysis, market reports, equity research reports, trade and settlement data, listing and delisting records, book closures, BETA factors, etc. are called security market information.
6. **Security Price Quotations:** Generally, technical analysis is based on security price quotations. These include price indices, price and volume data, breadth, daily volatility, etc. Each stock exchange publishes daily prices, and also low and closing quotations of securities traded in it. It is also publishes volume of trade for securities.
7. **Data on Related Markets:** Government securities market, money market and forex market are closely related to security market. Publications of RBI, DFHI, Indian Banks Associations' Securities Trading Corporation, banks and NSE give data on such related markets. RBI Publications, Foreign Exchange Dealers' Associations and foreign banks particularly report on forex market.
8. **Data on Mutual Fund:** Various schemes of mutual funds and their performance, net asset value (NAV) and repurchase prices are useful in analysing various investments avenues available to modern investors. Daily financial papers, Investment Weekly and Investors' Guide publish data on mutual funds. They contain information on current mutual fund schemes, NAV of each scheme, repurchase price, redemption rate of close-ended funds, daily purchase and sale prices for open-ended funds. Most of the mutual funds are quoted on the stock exchanges. In addition, Capital Market, Dalal Street and Business India also gives information on mutual funds.
9. **New Issue Market:** New issue market is primary market for securities. In this market, companies issue securities to the investors directly for raising long-term capital. Reports of the merchant bankers and SEBI have firsthand information on the various new issues floated in the market. They get draft prospectus for vetting. A magazine called Prime Publication publishes all information relating to the new issues that are the pipeline. Merchant bankers, underwriters and brokers in the new issue market analyse the performance of the issuing companies. Cable operators, financial journals, etc. give write-ups on forthcoming issues. Reserve Bank of India and Department of Company Affairs publish periodically data on new issues in the primary market.

10. **Financial Information:** The balance sheet analysis done by stock markets is based on the financial data furnished by financial statements of a company. The term 'financial statements' refer to the balance sheet, or other statements of financial position of a company and the income and expenditure statement or the profit and loss statement. In addition, the profit allocations statement reconciles the balance in this account at the end of the period with that at the beginning. Thus, financial statements contain a summary of the accounts of a company over a period of one year, i.e., one financial year (from 1st April to 31 March). The balance sheets show the assets, liabilities and capital at the end of the year. The financial statements of a company help financial analysts to know the financial soundness of the company and its management. Financial statements help the investors in ascertaining whether it is profitable to invest in securities of a particular company.

Investment Planning

Investors like to invest through the instinct and want to gain profit from the market by investing. However, while financial institutions are undoubtedly a part of the process of investing. As investors, it is not surprising that we focus so much of our energy and efforts on investment philosophies and strategies, and so little on the investment process. It is far more interesting to read about how Peter Lynch picks stocks and what makes Warren Buffett a valuable investor, than it is to talk about the steps involved in creating a portfolio or in executing trades. Though it does not get sufficient attention, understanding the investment process is critical for every investor for several reasons:

1. Investment planning centrally depends upon the portfolio of the investor. As a result, the primary step of the investment process is to make a portfolio. By emphasising the sequence, it provides for an orderly way in which an investor can create his or her own portfolio or a portfolio for someone else.
2. The investment process provides a structure that allows investors to see the source of different investment strategies and philosophies. By doing so, it allows investors to take the hundreds of strategies that they see described in the common press and in investment newsletters, and to trace them to their common roots.
3. The investment process emphasises the different components that are needed for an investment strategy but strategies that look good on paper never work for those who use them.

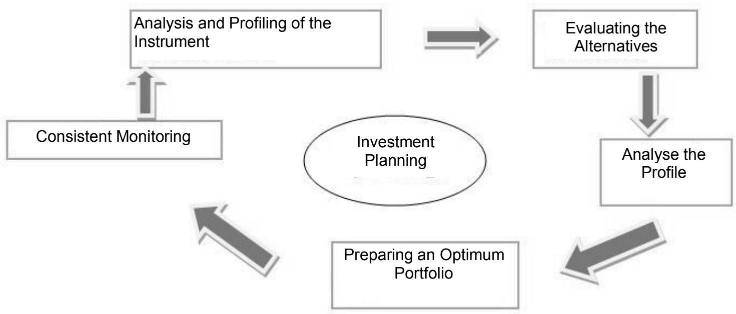

Fig. 1.2: Steps Involved in Investment Planning

Steps Involved in Investment Planning

Investment is not only prediction, but it also its own reasons behind every up and down in the market. So, it is has its own theory to move in particular directions. To get into the market, investors must go through the following process.

- **Analysis and profiling of the instrument:** The first step is performing a Need Analysis check. The requirements and expectations of the investor should be met by the instrument. During profiling the investor should consider their age, their profession, the number of dependents and their income. By doing this check, the risk profile of the investor should be designed.
- **Evaluating the alternatives:** The next step would be evaluating the needs. Other investment instruments and options should be analysed. The risk-return profile of investment products is evaluated in this step. Every investment product varies according to its return potential and riskiness. Investment products giving a high rate of return are generally risky and volatile. The products giving a lower rate of return usually are less risky.
- **Analyse the profile:** The next step would be to analyse the risk-return profile of the investor on to the investment portfolio. The investment instruments are matched with the risk-return profile of the investor. All the investment alternatives that offer expected rate of return are evaluated for consideration.
- **Preparing an optimum portfolio:** Then according to the risk appetite and return pattern, an optimum portfolio is designed for the investor. The basket of investment instrument selected in the previous step are given due weightage and appropriate amount of money is invested in each of the investment avenue so as to get maximum return with minimum possible risk.
- **Consistent monitoring:** Finally, a continuous watch on the portfolio is extremely important. Fundamental analysis of the investment products done in the previous stages would only help in selecting the right product, but the right time of entry or exit from a particular stream is evaluated by doing a technical analysis.

Factors to be Considered in Investment Decision

The main investment objectives are increasing the rate of return and reducing the risk. Other objectives like safety, liquidity and hedge against inflation can be considered as subsidiary objectives. Investors always expects a good rate of return from their investments. Rate of return could be defined as the total income the investor receives during the holding period stated as a percentage of the purchasing price at the beginning of the holding period. The objectives of investment can be understood in terms of as return, risk, safety, liquidity, hedge against inflation, etc.

Summary

1. Investment environment can be defined as the existing investment vehicles in the market available for investor and the places for transactions with these investment vehicles.
2. The most important characteristics of investment vehicles on which bases the overall variety of investment vehicles can be assorted are the return on investment and the risk which is defined as the uncertainty about the actual return that will be earned on an investment. Each type of investment vehicles could be characterised by certain level of profitability and risk because of the specifics of these financial instruments. The main types of financial

investment vehicles are: short-term investment vehicles, fixed income securities, common stock, speculative investment vehicles, other investment tools, etc.

3. Financial market, in which only short-term financial instruments are traded, is money market, and financial market in which only long-term financial instruments are traded is Capital Market.
4. The investment management process describes how an investor should go about making decisions. Investment management process can be disclosed by five-step procedure, which includes following stages (1) Framing of investment policy or knowledge about investments, (2) Investment Analysis, (3) Portfolio Selection, (4) Portfolio construction, (5) Portfolio Evaluation, (Appraisal), (6) Portfolio Revision.
5. Investment policy includes setting of investment objectives regarding the investment return requirement and risk tolerance of the investor. The other constraints which investment policy should include and which could influence the investment management are any liquidity needs, projected investment horizon and preferences of the investor.
6. Investment portfolio is the set of investment vehicles, formed by the investor seeking to realise its defined investment objectives. Selectivity, timing and diversification are the most important issues in the investment portfolio formation. Selectivity refers to micro forecasting and focuses on forecasting price movements of individual assets. Timing involves macro forecasting of price movements of particular type of financial asset relative to fixed income securities in general. Diversification involves forming the investor's portfolio for decreasing or limiting risk of investment.

Case Study No. 1

Mr. Rajesh is an electrical engineer having a fairly long experience of working in various types of industries in India. For quite some time, he has been planning to set up his own enterprise. He has been looking for suitable investment opportunities and has been collecting information from various sources. However, he has been skeptical in deciding on any specific idea because of the following reasons.

Any investment in an industrial enterprise will require an expenditure of substantially high amount of funds. Given the fact that he will set up his own business for the first time and has limited funds for investment, such a decision will be crucial for his own financial well-being. Any investment in an industrial enterprise will be irreversible once taken. Hence, a wrong decision taken cannot be subsequently changed in order to stop the losses from taking place. In his search for information he has come across a wide range of ideas for new venture, each having its own merits and demerits. Though each idea looked to be attractive to him initially, he is in a state of confusion. In spite of the above problems in decision-making, he is eager to set up his own venture and wants to make the right investment before it gets too late, i.e., before other potential competitors exploit the opportunity.

Give suitable advice to Mr. Rajesh, which will help him in identifying suitable investment opportunities.

Case Study No. 2

Consider two situations, a young man 'X' in early twenties and another young man 'Y' in late thirties. X and Y earn same amount of money. Mr. Y has a family, a house, a car and all the encumbrances related with the marital status. Both of them like to invest in securities. What would be their constraints and objectives of investment?

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Questions

I. Fill in the Blanks

1. An investor with a higher tolerance of risk should tilt his portfolio in favour of __________.
2. Risk can be referred as the __________ in the return with respect to the expected return.
3. A security represents evidence of __________.
4. Investments could be made in retail government securities through __________.
5. What is the objective of Portfolio Management?
6. Current liabilities include all liabilities due in the next __________ and provisions.
7. S&P NSE 50 index is known as __________.
8. __________ measures the profitability of equity funds invested in the firms.
9. Risk can be referred as the __________ in the return with respect to the expected return.
10. How would you rate a portfolio with 90% investment in stocks?
11. __________ absorbs the excess demand or supply generated by hedgers and assume the risk of price fluctuations.
12. Investing in this avenue enable you participate in the equity market indirectly __________.
13. What is the objective of an income fund?
14. What is a technical approach to investment?
15. Question Risk can be referred as the __________ in the return with respect to the expected return.
16. What is the objective of Portfolio Management?

17. __________ deal in futures to offset a pre-existing risk.
18. A security analysis is done __________
19. Secured Premium Notes are __________.
20. Kisan Vikas Patra are issued through __________.
21. The return which the company pays on borrowed funds is termed as __________.
22. Assets and liabilities in the Balance Sheet are shown at __________ prices.

Ans.: 1. stocks, 2. volatility, 3. a property right, 4. primary dealers, 5. to minimise risk and maximise return, 6. 12 months, 7. NIFTY, 8. Return on equity, 9. Volatility, 10. Highly aggressive, 11. Speculators, 12. mutual funds, 13. To provide regular and steady income, 14. A reflection of the idea that prices move in trends which are determined by various factors, 15. volatility, 16. To minimise risk and maximise return, 17. Hedger, 18. for decision-making for investments, 19. debentures, 20. Post Offices, 21. interest, 22. historical

II. True or False

1. Investment decisions can be viewed as an integrated process to which security analysis makes its unique contribution.
2. A firm uses a combination of equity and debt for financing its assets.
3. Risk on a portfolio of assets is always same as the risk on individual asset.
4. Debt is less risky source of finance than equity
5. Post office monthly schemes have a 10 year tenure.
6. With the introduction of online trading by NSE and BSE, the role of regional stock exchanges have diminished.
7. Risk on a portfolio of assets is always same as the risk on individual asset.
8. Investors in high tax bracket would benefit by investing in equity schemes.
9. Certificate of Deposits offers high rate of interest than Treasury Bills.
10. Banks issue Guarantees on behalf of their clients.

Ans.: 1. True, 2. True, 3. False, 4. False, 5. False, 6. True, 7. False, 8. False, 9. True, 10. True.

III. Multiple Choice Questions

1. Investment made on a house property is a __________.
   (a) Financial Investment (b) Economic analysis
   (c) Non Negotiable financial investment (d) Non- Financial investment
2. Investment means __________.
   (a) Employment of funds on assets to earn returns
   (b) Persons commitment to buy a flat or house
   (c) Net additions made to the national capital stocks
   (d) None of the above
3. Speculator is person __________.
   (a) Who uses his own funds only
   (b) Who considers here says and market behaviours
   (c) Who is willing to take high risk for high returns.
   (d) None of the above
4. The stock is __________.
   (a) Fully paid up and partly paid up shares (b) Expressed in terms of money
   (c) Expressed in terms of money (d) None of the above

5. To frame the investment policy the investor should have __________.
   (a) knowledge about the company and brokers
   (b) Investible funds
   (c) Knowledge about the investment alternatives.
   (d) Knowledge about the markets with funds

Ans.: 1. (d), 2. (c), 3. (c), 4. (c), 5. (d).

IV. Short Answer Questions

1. Define Investment.
2. What is Investment Management?
3. What are the Investment Process?
4. Define direct investing.
5. What are the financial institutions?
6. What is financial intermediaries?
7. Define financial investments.
8. Explain financial markets.
9. Define indirect investing.
10. What is Institutional investors?
11. What is Investment environment?
12. What are Investment vehicles?
13. What are Investment funds?
14. Define Hedge funds.
15. What is Investment portfolio?
16. What is Real investments?
17. What is financial investments?
18. Define Speculation.
19. Who is Individual investors?
20. Who is Institutional investors?
21. Differentiate Direct investing vs. Indirect investing.

V. Essay Type Questions

1. What is Investment and investment process? Describe briefly the different steps involved in investment decisions.
2. Define investment. What are the characteristics of investment and also explain the criteria for evaluating the investment?
3. What is an investment? Explain the scope, importance and features of investment programmer.
4. How investment differs from gambling?
5. Explain the concept of liquidity, return and risk related to investment decisions.
6. Explain various approaches to investment decisions.
7. Distinguish between Financial and Real assets.
8. Distinguish investment and speculation.
9. Explain the difference between direct and indirect investing.
10. How could you describe the investment environment?

11. Comment the differences between investment in financial and physical assets using following characteristics:

    (a) Divisibility, (b) Liquidity, (c) Holding period and (d) Information ability.
12. Why preferred stock is called hybrid financial security?
13. Why Treasury bills considered being a risk free investment?
14. What factors might an individual investor take into account in determining his/her investment policy?
15. Think about your investment possibilities for 3 years holding period in real investment environment.
16. What could be your investment objectives?
17. What amount of funds you could invest for 3 years period?
18. What investment vehicles could you use for investment? (What types of investment vehicles are available in your investment environment?)
19. What type (s) of investment vehicles would be relevant to you? Why?
20. What factors would be critical for your investment decision making in this particular investment environment?

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