Fundamentals of Investment

B. Com 6th Semester

Unit: 1. The Investment Environment

An investment is an asset or item accrued with the goal of generating income or recognition. In an economic outlook, an investment is the purchase of goods that are not consumed today but are used in the future to generate wealth. In finance, an investment is a financial asset bought with the idea that the asset will provide income further or will later be sold at a higher cost price for a profit.

Features of Investment

Risk Factor

Risk is an inherent characteristic of every investment. Risk refers to loss of principal amount, delay or non-payment of capital or interest, variability of return etc. Every investment differs in terms of risk associated with them. However, less risky investments are the most preferred ones by investors.

Return

Return refers to the income expected from investment done. It is the key objective for doing investment by investors. Investment provides benefits to peoples either in the form of regular yields or through capital appreciation.

Safety

It refers to the surety of return or protection of principal amount without any loss. Safety is an important feature of every investment tool that is analyzed before allocating any fund in it.

Liquidity

Liquidity refers to how quickly an investment can be sold or converted into cash. It simply means easiness with which investment can be sold in the market without any loss. Most of the investors want to invest in liquid assets.

Tax Benefits

Tax implications on the income provided by investment programs are seriously taken into consideration by investors. The real return earned by people is one that is left after paying income tax. While deciding an investment option, the burden of taxes on its income is an important determinant analyzed by investors. He should choose such investment securities which put less tax burden and maximize its return.

Legality

Investment securities must be evaluated from legal aspects before selecting them. Only such securities which are approved by law should be chosen as illegal securities will land investor in trouble. The best way is to do investment in securities issued by LIC, UTI, and Post office national saving certificates which are legal and save investors from various troubles.

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Importance of Investment

Generates Income
Investment serves as an efficient tool for providing periodic and regular income to people. Earning return in the form of interest and dividends is one of the important objectives of the investment process. Investors analyses and invest in those that provide a better rate of return at lower risk.

Wealth Creation
Creation of wealth is another important role played by an investment activity. It helps investors in wealth creation through appreciation of their capital over the time. Investment helps in accumulating large funds by selling assets at a much higher price than the initial purchase price.

Economic Development
Investment activities have an efficient role in the overall development of the economy. It helps in efficient mobilization of ideal lying resources of peoples into productive means. Investment serves as a mean for bringing together those who have sufficient funds and one who are in need of funds. It enables in capital creation and leads to economic development of the country.

Meet Financial Goals
Investment activities support peoples in attaining their long term financial goals. Individuals can easily grow their funds by investing their money in long term assets. It serves mainly the purpose of providing financial stability, growing wealth and keeping people on track at their retirement by providing them with large funds.

Types of Investment

1. **Equity**

Equity is the investment media that represent an ownership position, that is, in which the investor in stocks or certain options is an owner of the firm and is thus entitled to a residual share of profits. The equity ownership can be broadly divided into direct equity investment through capital markets and indirect equity investment through institutions.

2. **Debentures**

Investors look forward for secured returns on a regular basis and such instruments are in great demand. One such option is the Non- Convertible Debentures. A NCD is a fixed income debt paper issued by a Company. The issuer agrees to pay a fixed interest on the investment.

3. **Bonds or Fixed Income Securities**

Bonds refer to a long-term investment avenue which has a specified amount or rate of interest and specified maturity date. It is a marketable legal contract that promises to pay its investors a stated rate of interest and to repay the principal at the maturity date. Bonds differ according to their provisions for repayment, security pledged, and other technical aspects. This are Government Bonds, PSU Bonds, Private Sector Bonds etc.

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4. **Non-Marketable Financial Assets**

A significant portion of the investment in financial assets by an individual or a household is parked in non-marketable financial assets such as, bank deposits, post-office deposits, PPF, NSC, etc.

5. **Real Estate**

Real estate is one of the most sought after investments, which the investors are excited about. The rapid rise in real estate prices is very attractive and the investor looks forward this as both an investment avenue and a basic shelter to live in. The real estate investors think it is wise decision to invest in a real estate, since there are numerous advantages of investing in real estate. The investment in real estate may take any of the following form, namely,

(a) Residential House
(b) Commercial Property
(c) Agricultural Land
(d) Suburban Land
(e) Time Share in Holiday Resort

6. **Mutual Funds**

Mutual Fund refers to the trust that pools the savings of investors and forms a common fund. The fund thus created is then invested in financial market instruments like shares, debentures and other securities which also include government securities. The income earned through these investments and the capital appreciation realized are shared among the unit holders in proportion of the units held by them. Investments in securities are spread over a wide cross-section of industries and sectors, thus allowing risk reduction to take place. Diversification reduces the risk because all stocks and instruments may not move in the same direction and in the same proportion and at the same time.

7. **Precious Objects**

Precious objects are those items that are generally small in size, but highly valuable in monetary terms. These are normal physical product or metals that are used as traditional store of wealth. The most important precious objects are gold, silver, precious stones and art objects.

8. Pension Funds

Pension fund is a qualified retirement plan set up by an entity – a corporation, labaur union, government or other organization. Pension fund is a retirement plan, in which an investor makes a contribution into an account periodically. In other words, pension funds are type of retirement plan, wherein an investor pays part of his current income towards retirement income.

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Process of Investment Decisions

The investment process involves a series of activities leading to the purchase of securities or other investment alternatives. The investment process can be divided into five stages:
(1) Framing of the investment policy
(2) Security analysis
(3) Valuation
(4) Portfolio construction
(5) Portfolio evaluation

1. Framing of the Investment Policy

For systematic functioning, the government or investor, formulates the investment policy before proceeding to invest. The essential ingredients of the policy are investible funds, objectives and knowledge about investment alternatives and the market.
(a) Investible funds: The entire investment procedure revolves around the availability of investible funds. Funds may be generated through savings or from borrowings. If the funds are borrowed, the investor has to be extra careful in the selection of investment alternatives. He must make sure that the returns are higher than the interest he pays. Mutual funds invest their stockholders' money in securities.
(**b) Objectives:** The objectives are framed on the premises of the required rate of return, need for regular income, risk perception and the need for liquidity. The risk taker's objective is to earn a high rate of return in the form of capital appreciation, whereas the primary objective of the risk-averse is the safety of principal.
(c) Knowledge: The knowledge about investment alternatives and markets plays a key role in policy formulation. Investment alternatives range from security to real estate. The risk and return associated with investment alternatives differ from each other. Investment in equity is high-yielding but faces more risk than fixed income securities. Tax sheltered schemes offer tax benefits to the investors.

2. Security Analysis

Securities to be bought are scrutinized through market, industry and company analyses after the formulation of investment policy.
(a) Market analysis: The stock market mirrors the general economic scenario. The growth in gross domestic product and inflation is reflected in stock prices. Recession in the economy results in a bear market. Stock prices may fluctuate in the short- run but in the long-run, they move in trends, i.e. either upwards or downwards. The investor can fix his entry and exit points through technical analysis.
(b) Industry analysis: Industries that contribute to the output of major segments of the economy vary in their growth rates overall contribution to economic activity. Some industries grow faster than the GDP and are expected to continue in their growth. For example, the information technology industry has experienced a higher growth rate than the GDP in 1998. The economic significance and the growth potential of the industry have to be analysed.
(**c) Company analysis:** The purpose of company analysis is

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to help the investors make better decisions. The company's earnings, profitability, operating efficiency, capital structure and management have to be screened.
These factors have a direct bearing on stock prices and investor's returns.

3. **Valuation**

Valuation helps the investor determine the return and risk expected from an investment in common stock.
(a) **The intrinsic value** of the share is measured through the book value of the share and price earning ratio. Simple discounting models also can be adopted to value the shares. Stock market analysts have developed many advanced models to value shares. The real worth of the share is compared with the market price, and investment decisions are then made.
(b) Future value: The future value of securities can be estimated by using a simple statistical technique like trend analysis. The analysis of the historical behavior of price enables the investor to predict the future value.

4. Construction Portfolio

A portfolio is a combination of securities. It is constructed in a manner so as to meet the investor's goals and objectives. The investor should decide how best to reach the goals with the securities available. The investor tries to attain maximum return with minimum risk. Towards this end, he diversifies his portfolio and allocated funds among the securities.
Diversification: The main objective of diversification is the reduction of risk in the form of loss of capital and income. A diversified portfolio is comparatively less risky than holding a single portfolio. Several modes are available to diversify a portfolio e.g. Debt and equity diversification, Industry Diversification, Company diversification.

5. **Portfolio Evaluation**

A portfolio has to be managed effectively. Efficient management calls for evaluation of the portfolio. This process consists of portfolio appraisal and revision.
(a) Appraisal: The return and risk performance of security varies from time to time. The variability in returns of securities is measured and compared. Developments in the economy, industry and relevant companies from which stocks are bought have to be appraised. The appraisal warns of the loss and steps can be taken to avoid such losses.
(b) Revision: It depends on the results of the appraisal. Low-yielding securities with high risk are replaced with high-yielding securities with low risk factor. The investor periodically revises the components of the portfolio to keep the return at a level.

Primary Market

Primary Market: The primary market is where companies issue a new security, not previously traded on any exchange. A company offers securities to the general public to raise funds to finance its long-term goals. The primary market may also be called the **New Issue Market (NIM).** In the primary market, securities are directly issued by companies to investors. Securities are issued either by an Initial Public Offer (IPO) or a Further Public Offer (FPO).
A primary market is a marketplace where corporations imbibe a fresh issue of shares for being contributed by the public for soliciting capital to meet their necessary long-term funds like extending

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the current trade or buying a unique entity. It plays a motivational part in the mobilisation of savings in the economy.

Raising Funds from the Primary Market

Below are some of the ways in which companies raise funds from the primary market:

1. Public Issue

This is the most common way to issue securities to the general public. Through an IPO, the company is able to raise funds. The securities are listed on a stock exchange for trading purposes.

2. Rights Issue

When a company wants to raise more capital from existing shareholders, it may offer the shareholders more shares at a price discounted from the prevailing market price. The number of shares offered is on a pro-rata basis. This process is known as a Rights Issue.

3. Preferential Allotment

When a listed company issues shares to a few individuals at a price that may or may not be related to the market price, it is termed a preferential allotment. The company decides the basis of allotment and it is not dependent on any mechanism such as pro-rata or anything else.

Secondary Market

The secondary market is where existing shares, debentures, bonds, etc. are traded among investors. Securities that are offered first in the primary market are thereafter traded on the secondary market. The trade is carried out between a buyer and a seller, with the stock exchange facilitating the transaction. In this process, the issuing company is not involved in the sale of their securities.

A secondary market is a prototype of the capital market where debentures, current shares, options, bonds, treasury bills, commercial papers, etc., of the enterprises are patronised amongst the investors.

The secondary market can be an auction business where the business of bonds is functioned through a dealer market or the stock exchange, usually called over the counter.

Here are some of the major differences between Primary and Secondary Markets-

Basis of Comparison	Primary Market	Secondary Market
Meaning	A marketplace for new shares	A marketplace where formerly issued securities are traded
Another Name	New Issue Market (NIM)	After Market
Products	IPO and FPO	Shares, debentures, warrants, derivatives, etc.
Type of Purchasing	Direct	Indirect
Parties of buying and selling	Buying and selling takes place between the company and investors	Buying and selling takes place between the investors
Intermediaries involved	Underwriters	Brokers
Price Levels	Remains Fixed	Fluctuates with variations in demand and supply
Financing provided to	It provides financing to the existing companies for facilitating growth and expansion.	No Financing is provided
Purchase Process	The purchase process happens directly in the primary market.	The company issuing the shares is not involved in the purchasing process.
Beneficiary	The beneficiary is the company	The beneficiary is the investor
Government involvement	A company issues shares and the government interferes in the process	There is no involvement of the government in the process.

Stock Market Participants

1. Regulator: In the stock market, there is a regulatory body that oversees the functioning and fairness of the stock market and the entities involved that are engaged in financial activity.

The goal of this regulator is to ensure that fraud is prevented, and if taken place is investigated thoroughly. They help keep markets efficient and transparent. And more importantly ensure that investors such as you are treated fairly and honestly.

There are various regulators for different sectors of the financial market like Ministry of Finance, RBI, SEBI (Securities and Exchange Board of India), IRDA (Insurance Regulatory and Development Authority), PFRDA (Pension Fund Regulatory and Development Authority) etc.

2. Stock exchanges: Second participant of the stock market - the stock exchange.

The stock exchange also known as a securities exchange is a trading platform. It facilitates the registered stockbrokers and investors to transact in securities electronically. India has two premier stock exchanges include National Stock Exchange (NSE) and the and BSE Limited (BSE).

3. Companies

Every share that you see available to be purchased or sold in the stock market today are those issued by publicly traded companies. When a company makes an Initial Public Offer (IPO), it becomes publicly traded, which means it introduces itself in the stock exchange.

4. **Investors and traders:** The appeal of the stock market draws both individuals and corporations or organizations from a range of backgrounds. There are a few subgroups that investors are categorized in. Such as: Retail investor , Domestic institutions, Asset management companies: Foreign Institutional Investors etc.

5. **Market intermediaries**

   Intermediaries are entities that are involved in a financial transaction in the market apart from the buyer and seller. These are institutions that help you carry out your investment activity smoothly while ensuring all the rules laid out by the regulator are met. account, deposit money, and even start trading through these intermediaries.

6. **Depositories and Depository Participants (DP) –**

   When you transact in shares, you are provided with a certificate that entitles you as the shareholder. Although these certificates were in paper formats earlier, they went digital in 1996.

This conversion of the certificates digitally is called Dematerialization or Demat. The share ownership certificates are placed in your Demat Account, which works like a vault to keep a count of your stocks. There are only 2 depositories in India – CDSL (Central Depository Services Ltd) and NSDL (National Securities Depository Ltd) – who hold the Demat accounts.

7. **Clearing corporations**

They ensure the fulfilment of your trades and transactions. Basically, they match the debit and credit process at the end to ensure the completion of the trade. The regulatory authorities strictly regulate these companies. Their main objective is to provide you with the right asset – either cash in case you are selling stock or shares in case you are buying – to balance the trade books and ensure smooth clearing activity.

Market Index

A stock market index, also known as a stock index, measures a section of the stock market. In other words, the index measures the change in the share prices of different companies. Stock Market Indices give an insight into the overall trends of the capital markets and sentiment of the investors towards a particular stock or set of stocks in an industry.

Some of the notable indices in India are as follows:

- Benchmark indices like NSE Nifty and BSE Sensex
- Broad-based indices like Nifty 50 and BSE 100
- Indices based on market capitalization like the BSE Smallcap and BSE Midcap
- Sectoral indices like Nifty FMCG Index and CNX IT

Formation of an Index

A stock market index is formed by combining equities with similar market capitalizations, business sizes, or industries. The index is thereafter computed based on the stock pick. However, each stock will have a distinct price, and the price range in one stock will not be the same as the price range in another. As a result, the index value cannot be determined by simply adding the prices of all the stocks.

CNX NIFTY/ NIFTY /NIFTY 50:(NSE)

Also known as the NSE Nifty, this share market index consists of the top 50 largest and most frequently traded stocks within the NSE. First created in 1996, NSE NIFTY is owned and maintained by India Index Services & Products Limited (IISL), which is a joint-venture organization between an Indian credit rating agency CRISIL and the National Stock Exchange. The CNX portion in the CNX NIFTY stands for CRISIL and NSE.

Sensex:(BSE)

Sensex is a blend of the words sensitive and index. It was introduced in 1986 and is the oldest in India. The BSE Sensex consists of the top 30 largest and most frequently traded stocks listed in the Bombay Stock Exchange (BSE).

Risk and Return

Risk: Risk can be defined as the probability that the expected return from the security will not materialize. Every investment involves uncertainties that make future investment returns risk-prone. Uncertainties could be due to the political, economic and industry factors. Risk could be systematic in future depending upon its source. Systematic risk is for the market as a whole, while unsystematic risk is specific to an industry or the company individually.

Types of Risk:

- Systematic and
- Unsystematic

  Systematic: Systematic risk is that part of the total risk that is caused by factors beyond the control of a specific company or individual. Systematic risk is caused by factors that are external to the organization. All investments or securities are subject to systematic risk and, therefore, it is a non-diversifiable risk. Systematic risk cannot be diversified away by holding a large number of securities.

Types of Systematic Risk

Systematic risk includes market risk, interest rate risk, purchasing power risk, and exchange rate risk.

Market Risk

Market risk is caused by the herd mentality of investors, i.e. the tendency of investors to follow the direction of the market. Hence, market risk is the tendency of security prices to move together. If the market is declining, then even the share prices of good-performing companies fall. Market risk constitutes almost two-thirds of total systematic risk. Therefore, sometimes the systematic risk is also referred to as market risk. Market price changes are the most prominent source of risk in securities.

Interest Rate Risk

Interest rate risk arises due to changes in market interest rates. In the stock market, this primarily affects fixed income securities because bond prices are inversely related to the market interest rate. In fact, interest rate risks include two opposite components: Price Risk and

Reinvestment Risk. Both of these risks work in opposite directions. Price risk is associated with changes in the price of a security due to changes in interest rate. Reinvestment risk is associated with reinvesting interest/ dividend income. If price risk is negative (i.e., fall in price), reinvestment risk would be positive (i.e., increase in earnings on reinvested money). Interest rate changes are the main source of risk for fixed income securities such as bonds and debentures.

Purchasing Power Risk (or Inflation Risk)

Purchasing power risk arises due to inflation. Inflation is the persistent and sustained increase in the general price level. Inflation erodes the purchasing power of money, i.e., the same amount of money can buy fewer goods and services due to an increase in prices. Therefore, if an investor's income does not increase in times of rising inflation, then the investor is actually getting lower income in real terms. Fixed income securities are subject to a high level of purchasing power risk because income from such securities is fixed in nominal terms. It is often said that equity shares are good hedges against inflation and hence subject to lower purchasing power risk.

Exchange Rate Risk

In a globalized economy, most companies have exposure to foreign currency. Exchange rate risk is the uncertainty associated with changes in the value of foreign currencies. Therefore, this type of risk affects only the securities of companies with foreign exchange transactions or exposures such as export companies, MNCs, or companies that use imported raw materials or products.

Unsystematic: Unsystematic risk is the risk that is unique to a specific company or industry. It's also known as non-systematic, specific, diversifiable, or residual risk. In the context of an investment portfolio, unsystematic risk can be reduced through diversification—while systematic risk is the risk that's inherent in the market. Unsystematic risk, or company-specific risk, is a risk

- associated with a particular investment. Unsystematic risk can be mitigated through
- diversification, and so is also known as diversifiable risk. Once diversified, investors are still subject to marketwide systematic risk.
- Total risk is unsystematic risk plus systematic risk.

Types of Unsystematic Risk

Business Risk

Both internal and external issues may cause business risk. Internal risks are tied to operational efficiencies. For example, management failing to take out a patent to protect a new product would be an internal risk, as it may result in the loss of competitive advantage.

Financial Risk

Financial risk relates to the capital structure of a company. A company needs to have an optimal level of debt and equity to continue to grow and meet its financial obligations. A weak

capital structure may lead to inconsistent earnings and cash flow that could prevent a company from trading.

Operational Risk

Operational risks can result from unforeseen or negligent events, such as a breakdown in the supply chain or a critical error being overlooked in the manufacturing process. A security breach could expose confidential information about customers or other types of key proprietary data to criminals.

Strategic Risk

A strategic risk may occur if a business gets stuck selling goods or services in a dying industry without a solid plan to evolve the company's offerings. A company may also encounter this risk by entering into a flawed partnership with another firm or competitor that hurts their future prospects for growth.

Legal and Regulatory Risk

Legal and regulatory risk is the risk that a change in laws or regulations will hurt a business. These changes can increase operational costs or introduce legal hurdles. More drastic legal or regulation changes can even stop a business from operating altogether. Other types of legal risk can include errors in agreements or violations of laws.

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