DSE-3: Fundamentals of Investment

[PREPARED BY TAPAS KUMAR TRIPATHY, COMMERCE DEPARTMENT]

<u>Unit 1: The Investment Environment</u>

The investment decision process, Types of Investments – Commodities, Real Estate and Financial Assets, the Indian securities market, the market participants and trading of securities, security market indices, sources of financial information, Concept of return and risk, Impact of Taxes and Inflation on return.

P. K. COLLEGE, CONTAI STUDY MATERIALS

Investing versus financing

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. But it is useful to make a distinction between real and financial investments. Real investments generally involve some kind of tangible asset, such as land, machinery, factories, etc. Financial investments involve contracts in paper or electronic form such as stocks, bonds, etc. Following the objective as it presented in the introduction this course deals only with the financial investments because the key theoretical investment concepts and portfolio theory are based on these investments and allow to analyze investment process and investment management decision making in the substantially broader context.

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 using 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 too, 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 Investment Analysis and Portfolio Management 9 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: individual investors; Institutional investors. Individual investors are individuals who are investing on their own. Sometimes individual investors are called retail investors. Institutional investors are entities such as investment companies, commercial banks, insurance companies, pension funds and other financial institutions. In recent years the process of institutionalization 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, the changing role of banks. One of important preconditions for successful investing both for individual and institutional investors is the favorable investment. Our focus in developing this course is on the management of individual investors' portfolios. But the basic principles of investment management are applicable both for individual and institutional investors. Direct versus 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 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

P.K. COLLEGE, CONTAI STUDY MATERIS

fluctuations and on their abilities to analyze 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).

Investment environment

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 subchapter the main types of investment vehicles and the types of financial markets will be presented and described. 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 differs from investment in physical assets in those 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.

P. K. COLLEGE, CONTAI STUDY MATERILS

• 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.

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:

- Short term investment vehicles;
- Fixed-income securities;
- Common stock;
- Speculative investment vehicles;
- 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:

- Certificates of deposit;
- Treasury bills;

P.K. COLLEGE, CONTAI STUDY MATERIALS

• 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. Treasury 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. Noncompetitive 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

P.K. COLLEGE, CONTAI STUDY MATERILS

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 with T-bills and hence their market is not liquid. Banker's 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. Banker's 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 standardized, 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 collectivized short-term loan, where collateral is a security. The collateral in a repo may be a Treasury security, 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. Our focus in this course further will be not investment in short-term vehicles but it is useful for investor to know that short term investment vehicles provide the possibility for temporary investing of money/ funds and investors use these instruments managing their investment portfolio. 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

P.K. COLLEGE, CONTAI STUDY MATERILS

• Preferred stocks. Long-term debt securities can be described as long-term debt instruments representing the issuer's contractual obligation. Long term securities have maturity longer than 1 year. The buyer (investor) of these securities is landing 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 is 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 their features important to understand for the investor in Chapter 5, together with the other aspects in decision making investing in bonds. Preferred stocks 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.

Other investment tools:

• Various types of investment funds;

• Investment 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:

P. K. COLLEGE, CONTAI STUDY MATERIALS

• open-end funds (mutual funds) ,

• closed-end funds (trusts).

Open-end 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 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.

AI STUDY MATERILS

Unit 2: Fixed Income Securities

Bond features, types of bonds, estimating bond yields, Bond Valuation types of bond risks, default risk and credit rating.

What Is Bond Valuation?

Bond valuation is a technique for determining the theoretical fair value of a particular bond. Bond valuation includes calculating the present value of a bond's future interest payments, also known as its cash flow, and the bond's value upon maturity, also known as its face value or par value.

Understanding Bond Valuation

A bond is a debt instrument that provides a steady income stream to the investor in the form of coupon payments. At the maturity date, the full face value of the bond is repaid to the bondholder. The characteristics of a regular bond include:

- **Coupon rate**: Some bonds have an interest rate, also known as the coupon rate, which is paid to bondholders semi-annually. The coupon rate is the fixed return that an investor earns periodically until it matures.
- **Maturity date**: All bonds have maturity dates, some short-term, others long-term. When a bond matures, the bond issuer repays the investor the full face

value of the bond. For corporate bonds, the face value of a bond is usually $1,000 and for government bonds, the face value is $10,000. The face value is not necessarily the invested principal or purchase price of the bond.

- **Current price**: Depending on the level of interest rate in the environment, the investor may purchase a bond at par, below par, or above par. For example, if interest rates increase, the value of a bond will decrease since the coupon rate will be lower than the interest rate in the economy. When this occurs, the bond will trade at a discount, that is, below par. However, the bondholder will be paid the full face value of the bond at maturity even though he purchased it for less than the par value.

Zero-Coupon Bond Valuation

A zero-coupon bond makes no annual or semi-annual coupon payments for the duration of the bond. Instead, it is sold at a deep discount to par when issued. The difference between the purchase price and par value is the investor's interest earned on the bond. To calculate the value of a zero-coupon bond, we only need to find the present value of the face value.

Yield-to-Maturity (YTM)

The yield-to-maturity (YTM) of a bond is another way of considering a bond's price. YTM is the total return anticipated on a bond if the bond is held until the end of its lifetime. Yield to maturity is considered a long-term bond yield but is expressed as an annual rate. In other words, it is the internal rate of return of an investment in a bond if the investor holds the bond until maturity and if all payments are made as scheduled. YTM is a complex calculation but is quite useful as a concept evaluating the attractiveness of one bond relative to other bonds of different coupon and maturity in the market.

Unit 3: Approaches to Equity Analysis

Introductions to Fundamental Analysis, Technical Analysis and Efficient Market, Hypothesis, dividend capitalisation models, and price-earnings multiple approach to equity valuation.

Fundamental Analysis:

In the fundamental approach, an attempt is made to analyze various fundamental or basic factors that affect the risk-return of the securities. The effort here is to identify those securities that one perceives as mispriced in the stock market. The assumption in this case is that the 'market price' of security and the price as justified by its fundamental factors called 'intrinsic value' are different and the marketplace provides an opportunity for a discerning investor to detect such discrepancy. The moment such a description is identified, a decision to invest or disinvest is made. The decision rule under this approach is like this: If the price of a security at the market place is higher than the one, which is justified by the security fundamentals, sell that security. This is because, it is expected that the market will sooner or later realize its mistake and price the security properly. A deal to sell this security should be based on its fundamentals; it should be both before the market correct its mistake by increasing the price of security in question. The price prevailing in market is called "market price' (MP) and the one justified by its fundamentals is called 'intrinsic value' (IV) session rules/ recommendations.

1. If IV > MP, buy the security
2. If IV < MP, sell the security
3. If IV > MP, no action

The fundamental factors mentioned above may relate to the economy or industry or company or all some of this. Thus, economy fundamentals, industry fundamentals and company fundamentals are considered while prizing the securities for taking investment decision. In fact, the economy-industry-company framework forms integral part of this approach. This framework can be properly utilized by making suitable adjustments in a regular context.

P. K COLLEGE, CONTAI STUDY MATERILS

Fundamental Analysis and Efficient Market

Before elaborating in detail on the economy-industry-company framework, it is pertinent to mention that doubts are expressed about the utility of this approach in the contest of efficient stock market set-up. Briefly, the market efficiency relates to the speed with which the stock market incorporates the information about the economy,

industry and company, in the share prices, rather instantaneously. The above given view about share market efficiency implies that no one would be able to make abnormal profits given such a set-up. Some research studies in the literature also support the above view. Practitioners, however, do not agree to such conclusions of an empirical nature.

Economy Analysis

In actual practice, you must have noticed that investment decisions of individuals and the institutions made in the economic set-up of a particular country. It becomes essential, therefore, to understand the star economy of that country at the macro level. The analysis of the state of the economy at the macro level incorporates the performance of the economy in the past, how it is performing in the present and how it is expected to perform in future. Also relevant in this context is to know how various sectors of the economy are going to grow in the future.

Macro Economic Analysis

The analysis of the following factors indicates the trends in macroeconomic changes that effect the risk and return on investments.

1. Money supply
2. Industrial production
3. Capacity utilization
4. Unemployment
5. Inflation
6. Growth in GDP
7. Institutional lending
8. Stock prices
9. Monsoons
10. Productivity of factors of production
11. Fiscal deficit

Economy and Industry Analysis

Investment decisions are a part of our economic life, made by almost everybody in different contexts at different times. The highly subjective nature of such decisions and

P. K. COLLEGE, CONTAI STUDY MATERILS

the varying results that they offer therefore, necessitate a further study and analysis into the same.

Long regarded as an art, investment decision-making has only recently been considered as science with an attendant body of literature being developed helping us understand its dynamics. Investment decision-making is now accepted both as an art as well as a science. Decision-makers attempt to update themselves on the characteristics of returns securities, which keep changing. Their understanding needs sustained efforts. Changes in the management of any particular company or changes in government policy at macro level can bring about changes in the attractiveness of certain securities. For example, before 1992-93, the shares of sugar industry in India did not catching the attention of the investing public. But due to changes in the government policy towards this industry around 1999, sugar industry shares became quite attractive. Policy changes made by the government related to hike in the sugar per sold both in open market as well as through public distribution system, increase in the quantity of sugar for sale in the free market etc. played a very important role in making the shares of sugar companies attractive. There may be other factors too, that are more specific to a particular company or industry.

Industry Analysis Factors

The securities analyst will take into consideration the following factors into account in assessing the industry potential in making investments:

1. Post-sales and earnings performance
2. The government's attitude towards industry
3. Labour conditions
4. Competitive conditions
5. Performance of the industry
6. Industry share prices relative to industry earnings
7. Stage of the industry life cycle
8. Industry trade cycle
9. Inventories build-up in the industry
10. Investors' preference over the industry
11. Technological innovations

P.K. COLLEGE, CONTAI STUDY MATERILS

Technical Analysis

Technical analysis is a method of evaluating securities by analyzing the statistics generated by market activity, such as past prices and volume. Technical analysts do not attempt to measure a security's intrinsic value, but instead use charts and other tools to identify patterns that can suggest future activity.

Just as there are many investment styles on the fundamental side, there are also many different types of technical traders. Some rely on chart patterns, others use technical indicators and oscillators, and most use some combination of the two. In any case, technical analysts' exclusive use of historical price and volume data is what separates them from their fundamental counterparts. Unlike fundamental analysts, technical analysts don't care whether a stock is undervalued - the only thing that matters is a security's past trading data and what information this data can provide about where the security might move in the future.

Basic Technical Assumptions Notes

Before we embark on the actual methods themselves, let us review the basic and necessary assumptions regarding the technical analysis:

1. ***The Market Discounts Everything:*** A major criticism of technical analysis is that it only considers price movement, ignoring the fundamental factors of the company. However, technical analysis assumes that, at any given time, a stock's price reflects everything that has or could affect the company - including fundamental factors. Technical analysts believe that the company's fundamentals, along with broader economic factors and market psychology, are all priced into the stock, removing the need to actually consider these factors separately. This only leaves the analysis of price movement, which technical theory views as a product of the supply and demand for a particular stock in the market.

2. ***Price Moves in Trends:*** In technical analysis, price movements are believed to follow trends. This means that after a trend has been established, the future price movement is

P.K. COLLEGE, CONTAI STUDY MATERILS

more likely to be in the same direction as the trend than to be against it. Most technical trading strategies are based on this assumption.

3. ***History Tends to Repeat Itself:*** Another important postulate in technical analysis is that history tends to repeat itself, mainly in terms of price movement. The repetitive nature of price movements is attributed to market psychology; in other words, market participants tend to provide a consistent reaction to similar market stimuli over time. Technical analysis uses chart patterns to analyze market movements and understand trends. Although many of these charts have been used for more than 100 years, they are still believed to be relevant because they illustrate patterns in price movements that often repeat themselves.

Technical vs Fundamental Analysis

With a view to making a broad comparison between technical analysis and fundamental analysis, let us assume that the fundamentalist is a conservative who invests for the long-term and the technician is a trader who buys and sells for short-term profits. Actually, of course, the value of technical analysis lies between these extremes.

Fundamentalists study the cause, not the "should." They make their decisions on quality, value and depending on their specific investment goals, the yield or growth potential of the security.

They are concerned with the basis, the corporation's financial strength, record of growth in sales and earnings, profitability, the investment acceptance and so on. They also take into account the general business and market conditions. Finally they interpret these data inductively to determine the current value of the stock and then to project its future price. Fundamentalists are patient and seldom expect meaningful profits in less than one year. In the long run, the fundamentalist who selects quality stocks when they are undervalued and sells them when they become fully priced will make substantial profits.

Unit 4: Portfolio Analysis and Financial Derivatives

Portfolio and Diversification, Portfolio Risk and Return; Mutual Funds; Introduction to Financial Derivatives; Financial Derivatives Markets in India

P K COLLEGE, CONTAI STUDY MATERILS

Security Analysis

Traditional investment analysis, when applied to securities, emphasizes the projection of prices and dividends. That is, the potential price of a firm's common stock and the future dividend stream are forecasted, then discounted back to the present. This intrinsic value is then compared with the security's current market price. If the current market price is below the intrinsic value, a purchase is recommended, and if vice versa is the case sale is recommended.

Although modern security analysis is deeply rooted in the fundamental concepts just outlined, the emphasis has shifted. The more modern approach to common stock analysis emphasizes return and risk estimates rather than mere price and dividend estimates.

Portfolio Management

Portfolios are combinations of assets. In this text, portfolios consist of collections of securities. Traditional portfolio planning emphasizes on the character and the risk bearing capacity of the investor. For example, a young, aggressive, single adult would be advised to buy stocks in newer, dynamic, rapidly growing firms. A retired widow would be advised to purchase stocks and bonds in old-line, established, stable firms, such as utilities.

Modern portfolio theory suggests that the traditional approach to portfolio analysis, selection, and management may yield less than optimum results. Hence a more scientific approach is needed, based on estimates of risk and return of the portfolio and the attitudes of the investor toward a risk-return trade-off stemming from the analysis of the individual securities.

P. K. COLLEGE, CONTAI STUDY MATERIALS

Asset Classes

Portfolio construction begins with the basic building blocks of asset classes, which are the following major categories of investments:

1. Cash (or cash equivalents such as money market funds)
2. Stocks
3. Bonds

4. Real Estate (including real estate investment trusts)
5. Foreign Securities

Diversification

The insurance principle illustrates the concept of attempting to diversify the risk involved in a portfolio of assets (or liabilities). In fact, diversification is the key to the management of portfolio risk because it allows investors to minimize risk without adversely affecting return.

Random or naïve diversification refers to the act of randomly diversifying without regard to relevant investment characteristics such as expected return and industry classification. An investor simply selects a relatively large number of securities randomly – the proverbial "throwing a dart at The Wall Street Journal page showing stock quotes."

Components of Risk

Total Risk = Systematic Risk + Unsystematic Risk

- **Systematic Risk:** It represents that portion of Total Risk which is attributable to factors that affect the market as a whole. Beta is a measure of Systematic Risk.
- **Unsystematic Risk:** It is the residual risk or balancing figure, i.e. Total Risk Less Systematic Risk.

Standard Deviation of A Portfolio

Standard Deviation as a Measure of Risk:

Risk of a portfolio is not equal to the sum of its parts. This is because all securities are neither correlated with each other to the same extent or in the same manner, nor are relationship expressible in linear or arithmetic terms. Choice of securities in a portfolio can either go about to increase the risk factor which is greater than the sum of the individual risk of securities. It can also be lower than the risk factor of the least risky security in the portfolio.Therefore, Standard Deviation of a Portfolio is not the weighted average of the standard deviation of its individual securities, since it does not consider the correlation between different such securities and a common base, i.e. market return.

Diversification:

Diversification refers to investing in more than one security, i.e. dividing the Portfolio into different stocks and not investing the money in one particular stock. Some of the

P.K. COLLEGE, CONTAI STUDY MATERILS

risks associated with individual assets can be eliminated by forming Portfolios, thereby spreading an investment across assets (and thereby forming a Portfolio). This is called diversification.

Features:

(i) Diversification reduces risks because prices of different stocks do not move exactly together. It helps to reduce Portfolio risk by eliminating unsystematic risk for which investors are not rewarded.

(ii) Investors are rewarded for taking market risk.

(iii) Diversification averages the returns of the assets within the Portfolio, thereby it attenuates the potential highs (and lows).

(iv) Diversification among companies, industries and asset classes, protects against business risk, financial risk and volatility.

C. Diversifiable Risks:

(i) Unsystematic Risk is the risk that can be diversified, because it is the Company-specific risk.

(ii) Unsystematic Risk is that portion of the total risk that arises due to factors which affect the internal working of the Firm. It could include sudden unforeseen event like strikes, fire or something as simple as slumping sales.

(iii) There is no reward for taking on diversifiable risk.

P. K COLLEGE, CONTAI STUDY MATERILS

Mutual Funds

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 and 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.

PROBLEMS OF MUTUAL FUNDS IN INDIA

The following are some of the main problems that are being faced by Indian mutual funds.

1. Liquidity crisis.
2. Lac of innovation.
3. Inadequate research.
4. Conventional pattern of investment.
5. No provision for performance guarantee.
6. Inadequate disclosures.
7. Delays in service.
8. No rural sector investment base.
9. Poor risk management.

P. K. COLLEGE, CONTAI STUDY MATERILS

Derivatives:

The emergence of the market for derivative products, most notably forwards, futures and options, can be traced back to the willingness of risk-averse economic agents to guard themselves against uncertainties arising out of fluctuations in asset prices. By their very nature, the financial markets are marked by a very high degree of volatility. Through the use of derivative products, it is possible to partially or fully transfer price risks by locking-in asset prices. As instruments of risk management, these generally do not influence the fluctuations in the underlying asset prices.

However, by locking-in asset prices, derivative products minimize the impact of fluctuations in asset prices on the profitability and cash flow situation of risk-averse investors.

Derivative products initially emerged, as hedging devices against fluctuations in commodity prices and commodity-linked derivatives remained the sole form of such products for almost three hundred years. The financial derivatives came into spotlight in post-1970 period due to growing instability in the financial markets. However, since their emergence, these products have become very popular and by 1990s, they accounted for about two-thirds of total transactions in derivative products. In recent years, the market for financial derivatives has grown tremendously both in terms of variety of instruments available, their complexity and also turnover. In the class of

equity derivatives, futures and options on stock indices have gained more popularity than on individual stocks, especially among institutional investors, who are major users of index-linked derivatives.

Derivatives are the most modern financial instruments in hedging risk. The individuals and firms who wish to avoid or reduce risk can deal with the others who are willing to accept the risk for a price. A common place where such transactions take place is called the 'derivative market'.

As the financial products commonly traded in the derivatives market are themselves not primary loans or securities, but can be used to change the risk characteristics of underlying asset or liability position, they are referred to as 'derivative financial instruments' or simply 'derivatives.' These instruments are so called because they derive their value from some underlying instrument and have no intrinsic value of their own. Forwards, futures, options, swaps, caps floor collar etc. are some of more commonly used derivatives. The world over, derivatives are a key part of the financial system.

Characteristics of Derivatives

The important characteristics of derivatives are as follows:

1. Derivatives possess a combination of novel characteristics not found in any form of assets.

2. It is comfortable to take a short position in derivatives than in other assets. An investor is said to have a short position in a derivatives product if he is obliged to deliver the underlying asset in specified future date.

3. Derivatives traded on exchanges are liquid and involves the lowest possible transaction costs.

4. Derivatives can be closely matched with specific portfolio requirements.

5. The margin requirements for exchange-traded derivatives are relatively low, reflecting the relatively low level of credit-risk associated with the derivatives.

6. Derivatives are traded globally having strong popularity in financial markets.

7. Derivatives maintain a close relationship between their values and the values of underlying assets; the change in values of underlying assets will have effect on values of derivatives based on them.

8. In a Treasury bond futures contract, the derivatives are straightforward.

P. K. COLLEGE, CONTAI STUDY MATERILS

Derivative Products

Derivative is a product/contract that does not have any value on its own i.e. it derives its value from some underlying.

Forward Contract

A forward contract is an agreement made today between a buyer and seller to exchange the commodity or instrument for cash at a predetermined future date at a price agreed upon today. The agreed upon price is called the 'forward price'. With a forward market the transfer of ownership occurs on the spot, but delivery of the commodity or instrument does not occur until some future date. In a forward contract, two parties agree to do a trade at some future date, at a stated price and quantity. No money changes hands at the time the deal is signed. For example, a wheat farmer may wish to contract to sell their harvest at a future date to eliminate the risk of a change in prices by that date. Such transaction would take place through a forward market.

Forward contracts are not traded on an exchange, they are said to trade over the counter (OTC). The quantities of the underlying asset and terms of contract are fully negotiable. The secondary market does not exist for the forward contracts and faces the problems of liquidity and negotiability.

Futures Contract

The futures contract is traded on a futures exchange as a standardised contract, subject to the rules and regulations of the exchange. It is the standardisation of the futures contract that facilitates the secondary market trading. The futures contract relates to a given quantity of the underlying asset and only whole contracts can be traded, and trading of fractional contracts are not allowed in futures contracting.

The terms of the futures contracts are not negotiable. A futures contract is a financial security, issued by an organised exchange to buy or sell a commodity, security or currency at a predetermined future date at a price agreed upon today. The agreed upon price is called the futures price'.

Types of Futures Contract

Futures contracts may be classified into two categories:

1. ***Commodity Futures:*** Where the underlying is a commodity or physical asset such as

P.K COLLEGE, CONTAI STUDY MATERIS

wheat, cotton, butter, eggs etc. Such contracts began trading on Chicago Board of Trade (CBOT) in 1860s. In India too, futures on soya bean, black pepper and spices have been trading for long.

2. ***Financial Futures:*** Where the underlying is a financial asset such as foreign exchange, interest rates, shares, Treasury bills or stock index.

Options

The growth in organised option markets has resulted with the developments in Option Pricing. A theory, in this regard made by Black and Scholes (1973); and has been modified and extended. The option market is not only extended to stocks dealings but also to foreign currencies, commodities etc. An option is the right but not the obligation to enter into a transaction. An option is the right, to buy or sell something at a stated date at a stated price. An option contract gives the holder of the contracts the option to buy or sell shares at a specified price on or before a specific date in the future. The buyer of the contract pays the writer (or seller) for the right, but not the obligation, to purchase shares etc. or sell shares etc. to the writer at the price fixed by the contract (the striking or exercise price). The right to choose, therefore the option, is sold by the seller (writer) of the option to the purchaser (holder) in return for a payment (premium). The right conveyed by the option only lasts a certain period of time and then the right expires – at its maturity or expiration. The seller of an option has no choice. He must meet his obligation to buy/sell if the right of the purchaser to do so is exercised at the agreed exercise/strike rate. It is the purchaser who has choice, he does not have to exercise the right to buy/sell at the strike rate agreed if it is better from his prospective to buy/sell out spot, he can instead walk away from the option. In this respect, options differ from futures where holders of positions do have the obligation to buy/sell the underlying asset. At worst the purchaser will lose the premium, but can gain substantially if the option is worth exercising. Options come in two varieties – European and American. In the European option, the holder of the option can only exercise his right (if he so desire) on the expiration date. In an American option, he can exercise this right any time between purchase date and the expiration date. Options are categorised into – (a) Call option, and (b) Put option.

Types of Options

Options are classified into two broad categories:

P.K. COLLEGE, CONTAI STUDY MATERILS

1. Call Option, and

2. Put Option

A call option gives the holder the right to buy an underlying asset by a certain date for a certain price. The seller is under an obligation to fulfil the contract and is paid a price of this, which is called “the call option premium or call option price.”

A put option, on the other hand gives the holder the right to sell an underlying asset by a certain date for a certain price. The buyer is under an obligation to fulfil the contract and is paid a price for this, which is called “the put option premium or put option price.”

The price at which the underlying asset would be bought in the future at a particular date is the ‘Strike Price’ or the ‘Exercise Price.’ The date on the options contract is called the ‘Exercise date’ ‘Expiration Date’ or the ‘Date of Maturity.’

There are two kinds of options based on the date. The first is the European Option, which can be exercised only on the maturity date. The second is the American Option, which can be exercised before or on the maturity date.

Markets For Derivatives Derivatives are so called because they are financial instruments whose value is derived from the value of an underlying financial instrument (a treasury bill, a bond or a note) or an individual equity or an equity index or an interest rate or a commodity (e.g.gold) or credit risk. The primitive and simplest form of derivatives is the forward contract (also known as the forefather of the derivatives). We have financial derivatives (e.g.forwards, futures, options, swaps or mix of these), equity derivatives, commodity derivatives, interest rate options and swaps, credit derivatives etc. derivatives have become very common due to the gradual liberalisation, globalisation of business and securities markets all ovr the world in recent years.

(Ref: Hull J.C., *Introduction to Futures & Options Markets*, Prentice Hall, Englewood Cliffs, New Jersey.)

Unit 5: Investor Protection

Role of SEBI and stock exchanges in investor protection; Investor grievances and their redressal system, insider trading, investors’ awareness and activism

Overview of SEBI:

P. K. COLLEGE, CONTAI STUDY MATERILS

The SEBI Act, 1992 was enacted to empower SEBI with statutory powers for (a) protecting the interests of investors in securities, (b) promoting the development of the securities market, and (c) regulating the securities market. Its regulatory jurisdiction extends over corporates in the issuance of capital and transfer of securities, in addition to all intermediaries and persons associated with securities market. The SEBI – can specify the matters to be disclosed and the standards of disclosure required for the protection of investors in respect of issues; –
can issue directions to all intermediaries and other persons associated with the securities market in the interest of investors or of orderly development for securities market; and – can conduct enquiries, audits and inspection of all concerned and adjudicate offences under the Act. In short, it has been given necessary autonomy and authority to regulate and develop an orderly securities market. As per Section 1 of the Act, this Act may be called the Securities and Exchange Board of India Act, 1992. It extends to the whole of India. It shall be deemed to have come into force on the 30th day of January, 1992.

Objectives of SEBI:

- To protect the interests of investors in securities; and
- To promote the development of; and
- To regulate, the securities market and for matters connected therewith or incidental thereto.

FUNCTIONS OF SEBI

1. Protective Functions: As the name suggests, the main focus of this function of SEBI is to protect the interest of investor and security of their investment As protective functions SEBI performs following functions: (i) SEBI checks Price Rigging: Price Rigging means some people manipulate the prices of securities for inflation or depressing the market price of securities. SEBI prohibits such practice to avoid fraud and cheating which can happen to any investor. (ii) SEBI prohibits Insider trading: Any person which is connected with a company such as directors, promoters, workers etc is called Insiders. Due to working in the company they have sensitive information which affects the prices of the securities. Such information is not available to people at large

P. K. COLLEGE, CONTAI STUDY MATERILS

but Insider gets this key full knowledge by working in such company. Insider can use this information for their personal benefits or make a profit from it, such process is known as Insider Trading. For Example - Managers or Directors of a company may know that company will issue Bonus shares to its shareholders at a particular time and they purchase shares from market to make a profit with bonus issue. SEBI always restricts these types of practices when Insiders are buying securities of the company and take strict action to avoid this in future. (iii) SEBI prohibits fraudulent and Unfair Trade Practices: SEBI always restricts the companies which make misleading statements which are likely to induce the sale or purchase of securities by any other person. (iv) SEBI sometimes educate the investors so that become able to evaluate the securities and always invest in profitable securities. (v) SEBI issues guidelines to protect the interest of debenture holders. (vi) SEBI is empowered to investigate cases of insider trading and has provision for stiff fine and imprisonment. (vii) SEBI has stopped the practice of allotment of preferential shares unrelated to market prices. (vii) SEBI has stopped the practice of making a preferential allotment of shares unrelated to market prices. 2. Developmental Functions: Under developmental categories following functions are performed by SEBI: (i) SEBI promotes training of intermediaries of the securities market. (ii) SEBI tries to promote activities of stock exchange by adopting a flexible and adaptable approach in following way: (a) SEBI has permitted internet trading through registered stock brokers. (b) SEBI has made underwriting optional to reduce the cost of issue.

The exchanges of India can be divided into national, regional or local exchanges. A detailed explanation of each is as follows: 5.3.1 National Exchange The **National Stock Exchange of India Limited (NSE),** is a Mumbai-based stock exchange. It is the second largest stock exchange in India in terms of daily turnover and number of trades, for both equities and derivative trading. Though a number of other exchanges exist, NSE and the Bombay Stock Exchange are the two most significant stock exchanges in India, and between them are responsible for the vast majority of share transactions. The NSE's key index is the S&P CNX Nifty, known as the Nifty, an index of fifty major stocks weighted by market capitalisation. NSE is mutually-owned by a set of leading financial institutions, banks, insurance companies and other financial intermediaries in India but its ownership and management operate as separate entities. NSE is the third largest

P.K. COLLEGE, CONTAI STUDY MATERILS

Stock Exchange in the world in terms of the number of trades in equities. It is the second fastest growing stock exchange in the world with a recorded growth of 16.6%. NSE has remained in the forefront of modernization of India's capital and financial markets, and its pioneering efforts include: 1. Being the first national, anonymous, electronic Limit Order Book (LOB) exchange to trade securities in India. Since the success of the NSE, existent market and new market structures have followed the "NSE" model. 2. Setting up the first clearing corporation "National Securities Clearing Corporation Ltd." in India. NSCCL was a landmark in providing innovation on all spot equity market (and later derivatives market) in India. 3. Co-promoting and setting up of National Securities Depository Limited, first depository in India. 4. Setting up of S&P CNX Nifty. 5. NSE pioneered commencement of Internet Trading in February 2000, which led to the wide popularization of the NSE in the broker community

INVESTOR PROTECTION: GRIVANCES AND THEIR REDRESSAL

In India investment risks are very high due to **dishonest practices, frauds and unethical investment culture**. Investors experience a sense of **helplessness and insecurity**, they have hardly any confidence in financial markets. Investors are cheated by companies, by lead managers, by brokers and by everybody, who is capable of cheating them. The Government, the Company Law Board and the SEBI, in recent years have made efforts to protect the investors. “**Investors protection** is a wide term, it encompasses all the measures designed to protect investors from malpractices of brokers, companies managers to issue, merchant bankers, registrar to issues etc. The main complaints are against brokers of stock exchanges, against listed companies and mutual funds.

USUAL GRIEVANCES OF INVESTORS

- **Against Companies.**
- **Against Brokers.**
- **Against depositories.**

USUAL GRIEVANCES AGAINST COMPANIES

1. **Delay in registering transfer of securities.** Registration of transfers should be done by the companies within 30 days of receipt of share transfer instrument but usually it takes many months.
2. **Non-payment or delay in payment of dividend.** Dividends should be distributed within 30 days from the date of declaration but by manipulation of procedures dividends may not be received for months.
3. **Non-repayment or delayed repayment of public deposits**. Thousands of depositors are involved in litigation to get back their deposits from companies.
4. **Non-receipt of rights issue offer.** The letter of offer of rights shares should be sent to all eligible shareholders by registered post and this fact should be prominently advertised in at least two all India newspapers. Shareholders quite often are not informed of rights issue.
5. **Non-receipt of duplicate share certificate.** A company is bound to issue duplicate share certificates if the shares are lost or misplaced by the shareholder, after receiving a request along with the requisite fee and on completion of formalities.
6. **Transmission of shares.** After the death of a shareholder the ownership of shares passes to his legal heirs which is called transmission of shares. The company is bound to transfer the shares in the name of legal heir of the deceased.
7. **Non-receipt of notice of meeting.** Every shareholder whose name appears in the register of members is entitled to receive 21 days advance notice of meeting of shareholders. Non-dispatch of notice of meeting to shareholder is common but serious lapse.

USUAL GRIEVANCES AGAINST BROKERS

1. **Delay or default in payment of securities sold.**A broker has to make payment to client who has sold securities through him within in 48 hours of payout of funds by clearing house of stock exchange or the Clearing Corporation. but brokers, as a rule, retain the sale proceed as long as they can.
2. **Delay or default in delivery of purchased security to the client.** A broker has to deliver the purchased securities to his client within 48 hours of payout of securities by the stock exchange. It never happens so, in practice.

3. **Non-Issue of contract note.** Brokers have to issue a contract note in in prescribed form to all their clients within 24 hours of the transaction but they avoid doing so to earn secret profits.
4. **Charging excess brokerage from clients.**
5. **Non-passing of corporate benefits.** A broker is duty bound to pass all the corporate benefits like rights shares, bonus shares, dividends etc. to the client he is dealing with but, many a times brokers play tricks in this regard.
6. **Overcharging.** he broker should charge or pay only that amount for of sale or purchase of securities at He should not overcharge for purchases or pay less for the sales. In practice, most brokers play tricks about it.

GRIEVANCES AGAINST DEPOSITORY PARTICIPANT

Depository Participant is an institution which holds securities either in certificated or uncertificated form, help in dematerialization of securities etc. of the holder. Various banks and other institutions are doing this work. Every depository participant must forward all the dematerialization or materialization requests of his clients to the concerned company within 7 days of the receipt of the request but delays are quite common.

Main Depositories are:

- NSDL: National Securities Depositories Limited (1996)
- CDSL: Central Depositories Services Limited (1999)

METHODS OF REDRESSAL OF INVESTORS GRIEVANCES

An investor can seek redressal of his grievances from, the following agencies:

1. Grievance cells in stock exchanges
2. SEBI
3. Company Law Board
4. Courts
5. Press

P. K. COLLEGE, CONTAI STUDY MATERILS