As per CBCS Syllabus

FUNDAMENTALS OF INVESTMENT

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PREFACE

This book on ‘Fundamentals of Investment’ has been written as an introduction to a reader to be aware of the different types of securities in the market and to construct a portfolio of their funds. The investor has to select the right avenue for investments because savings must be utilized in a suitable manner. In India, several changes can be seen in the stock markets. It is dynamic in nature and changes are very frequent. It is fascinating and exciting and students find the world of investments very interesting as they think that they will become ‘super rich’ in a shortwhile through trading on the stock market. This book is for those investors who not only want to trade but also to save money and plan for a long-term period of time. Such investors are required to calculate risk and return framework and hold the investments over a period of time to get good returns.

This book explains to the investors the pitfalls of investments and makes them aware of different kinds of available investments opportunities. It discusses the different theories of investment which they should know before making an investment. They should also understand *that no one investor can constantly outperform the market*.

The book explains the importance of risk and return and how risk should be measured to match the expectation level of the investor. It explains the functions of the financial markets, the interlinking between the new issue market and stock exchange and a basic understanding of how to manage a portfolio through careful risk and return analysis.

This book provides the theories of fundamental analysis, technical analysis and efficient market theory to analyze investments. The work of the pioneers like Harry Markowitz and William Sharpe have been discussed for making an analysis of the portfolio and to diversify it, to get the maximum return.

This book has been written for students of management, commerce, accounting and finance who would like an exposure to the investment environment in India. It is a simple, student-friendly book with many examples, solved illustrations, objective type questions, important points, concepts and latest developments in Indian stock markets. The book has thirteen chapters and has been divided into five Units.

- **Unit One** discusses the Investment Environment, consisting of four Chapters. These are Introduction to Investment Management, The Indian Securities Market, Trading of Securities and Risk and Return.
- **Unit Two** explains valuation of Fixed Income Securities in Chapter 5.
- **Unit Three** consists of four chapters. It gives the different approaches to Equity Analysis. Chapters 6, 7, 8 and 9 give the investor various techniques of investing into equities based on theories for equity analysis. Chapter 6 gives the valuation techniques

of equity shares as an Investment. Fundamental Analysis is the subject matter of Chapter 7 while Chapter 8 shows the technical analysis focused mainly on Dow Theory of analyzing stocks through charts, bar diagrams and moving averages. Chapter 9 discusses the efficient market theory and in particular the Random Walk Theory.

- **Unit Four** covers basic portfolio management, mutual funds and other investment alternatives and financial derivatives.
- **Unit Five** is on investor protection measures by Securities and Exchange Board of India (SEBI) which plays the role of a regulator and develops the new issue and stock market

This book has been incorporated according to the new syllabus of Orissa University.

Finally, I would like to acknowledge the constant encouragement of my publishers M/s Himalaya Publishing House particularly Mr. Niraj Pandey and production coordinator Nimisha Kadam.

I would like to thank Brajendra Kumar for the secretarial assistance in preparing the manuscript of this book.

Finally, I would like to thank all my students who have supported my work and given suggestions and feedback. I welcome comments and suggestions by all the readers and students.

Dr. Preeti Singh

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UNIT I

INVESTMENT ENVIRONMENT

1 INTRODUCTION TO INVESTMENT MANAGEMENT

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1.1 INTRODUCTION

Money does not have any value unless it is invested. If a person has a large sum of money and he keeps it in his cupboard it will not grow. It has to be invested in some financial asset to get a return. There can be no return without risk. It is within this framework of risk and return that investment has to be made. It is assumed that a person is risk averse and at the same time he expects a good return on the money that he invests. Therefore, an investor has to trade-off between risk and return. This chapter is an introduction to the terms investment, speculation and gambling. It also presents the media for investments and explains the investment process.

1.2 UNDERSTANDING THE TERM INVESTMENT

Investment is the commitment of funds with a long-term time framework the objective being additional income to regular receipts and growth in the value of funds of an investor. Investment involves 'waiting' for a future reward in terms of income through regular interest, dividends, premiums, or appreciation in the value of the principal capital. The term 'Investment' is understood differently by economists and financial experts. Economists consider it as new and productive capital and financial experts emphasize on allocation and transfer of resources from one person to another. It is also different to the terms speculation and gambling and they differ in terms of risk, time frame-work and gains.

- It must be clearly established that investment involves long-term commitment.
- Financial and Economic meaning of investment are different and must be understood in terms of use of capital.
- Investment speculation and gambling can be distinguished from each other through their risk, time period of commitment and gains.

1.3 FINANCIAL AND ECONOMIC MEANING OF INVESTMENT

Financial Investments are the allocation of monetary resources ranging from risk free to risky investments and with the expectation of a good return that varies with risk. The investor has to aim at a trade-off between risk and return. The investors are the suppliers of '*capital*' and in their view, investment is a commitment of a person's funds to derive future income in the form of interest, dividends, rent, premiums, pension benefits or the appreciation of the value of their principal capital. To the financial investor, it is not important whether money is invested for a productive use or for the purchase of secondhand instruments such as existing shares and stocks listed on the stock exchanges. ***Most investments are considered to be transfers of financial assets from one person to another.***

The economist understands the term ***'Investment' as net additions to the economy's capital stock*** which consists of goods and service that are used in the production of other goods and services. For them, the term investment implies the formation of new and productive capital in the form of new construction, new producers' durable equipment such as plant and equipment, including inventories and human capital.

The financial and economic meaning of investment cannot be separated because the term draws a relationship with the economists and financial experts. Investment is a part of the savings of individuals which flow into the capital market either directly or through institutions; they may be divided in '*new*' or '*secondhand*' capital financing. ***Investors as 'suppliers'*** and ***investor as 'users'*** of long-term funds find a meeting place in the market.

In this book, however, investment will be used in its ***'financial sense'*** and investment will include those instruments and institutional media into which savings are placed.

1.4 INVESTMENT AND SPECULATION

Investment is distinguished from speculation in three ways which are based on the factors of risk, time period and gains.

1. Risk

The term 'risk' has significance in the financial meaning of investment. Whatever amount is invested has the probability of incurring a gain or a loss in a financial transaction. Investment is not considered to involve high risk but it has limited risk and risk can be calculated through different techniques and the capital can be invested in avenues where the principal is safe. 'Speculation' is correlated with '*high risk*' and short commitment. There are degrees of risk, and arbitrary judgements are made between high risk and low risk. An investor cannot have completely risk-free investments because there are certain non controllable risks that cannot be calculated. The purchasing power risk or the fall in the real value of the interest and principal is beyond the control of a person. The money rate risk or the fall in market value, with the rise in interest rates also cannot be controlled.

These risks affect both the speculator and the investor. High risk and low risk are, therefore, general indicators to help an understanding between the terms investment and speculation.

2. Capital Gain

Speculation is buying low and selling high in a short time to make large capital gains. The motive in ***speculation*** is primarily to achieve profits through price changes. This can be distinguished from ***investment*** where securities are purchased by an investor through proper evaluation, analysis and review with the view of receiving a stable return over a long-term period of time.

3. Time

Time period explains the difference between investment and speculation. A fund allocation over a long-term period is called ***investment***. A short-term holding is associated with trading for the 'quick turn' and is called ***speculation***. The speculator is not interested in holding a security for current income but for high short-term gains.

The distinctions between investment and speculation help to identify the role of the investor and speculator. To summarize the above discussion:

The investor constantly evaluates the worth of a security through fundamental analysis, whereas the speculator is interested in market action and price movement.

1. There is a very fine line of division between investment and speculation. There are no established rules and laws that identify securities which are permanently for investment. There has to be a constant review of securities to find out whether it is a suitable investment for long-term or for quick turn of speculative profit. Long-term commitment becomes investment of the same security which if sold immediately on purchase only for profit becomes speculation.

2. Some financial experts have called investment ***'a well grounded and carefully planned speculation'***, or good investment is a successful speculation. Speculation is planned short term investment based on haunches and beliefs. Investment is planned, evaluated and analyzed long-term commitment of funds.

3. Speculation is to achieve high returns though risk of loss is high. Investments are for minimizing risk of investors with the expectation of high returns. Therefore, investment and speculation are a planning of risks.

4. A speculator expects high return for his investment and to make gains he can commit his own funds as well as use borrowed funds. An investor is cautious by nature and usually uses his own funds for investing in securities.

The distinction between investment and speculation is given in Table 1.

TABLE 1: Distinction between Investment and Speculation

	Investment	*Speculation*
Time Horizon	Long-term time framework beyond 12 months.	Short term planning holding assets even for one day.
Risk	It has limited risk.	High Returns though risk of loss is high.
Return	It is consistent and moderate over a long period.	There are high profits and gains as well as high losses. It is not consistent.
Use of funds	The investor uses his own funds through savings.	Speculation is through own and borrowed funds.
Decisions	Safety, liquidity, profitability and stability considerations and performance of companies.	Market behavior information, judgments on movement in the stock market. Haunches and beliefs.

1.5 INVESTMENT AND GAMBLING

Gambling is artificial and unnecessary risk created for increased expected returns. The difference between investment and gambling is very clear. From the above discussion, it is established that ***investment*** is an attempt to carefully plan, evaluate and allocate funds in various investment outlets which offers safety of principal, moderate and continuous returns and long-term commitment.

Gambling is quite the opposite of investment. It connotes high risk and the expectation of high returns. It consists of uncertainty and high stakes for thrill and excitement. Typical examples of gambling are horse racing, game of cards, lottery, etc. Gambling is based on tips, rumors and hunches, it is unplanned, non-scientific and without knowledge of the exact nature of risk.

The distinctions between investment, speculation and gambling give us a basic idea of their nature, purpose and role.

1.6 INVESTMENT AND ARBITRAGE

Investment is planned commitment of funds from a person savings into different outlets with the expectation of safe, stable and fare return. ***Arbitrage*** is the mechanism of minimizing risk through hedging and taking advantage of price differences in different markets. An arbitrage transaction is the simultaneous purchase of the same or similar security in two different markets. Short-term gains can be expected through such transactions. An investor can also be an arbitrageur if he buys and sells securities in more than one stock exchange to take advantage of the price differentials in such exchanges. Derivatives introduced in the Indian market have a great potential for arbitrage transactions. Arbitrage transactions help in enhancing efficiency and liquidity in the stock market and in increasing the volume of trade.

Hedgers, speculators and arbitrageurs can minimize risks and make profits through the arbitrage process.

1.7 REAL AND FINANCIAL ASSETS

Real assets are tangible goods in possession of a person. Financial securities represent papers that are dependant on real assets for creating wealth.

1. Real Assets

Real assets are used to produce goods or services. They are tangible assets that have a physical form. Some examples of real assets are land and buildings, furniture, gold, silver, diamonds, or artifacts. They may be marketable or nonmarketable. They may also have the feature of being moveable or non-moveable.

2. Financial Assets

Financial assets are called ***paper securities***. Some examples of these assets are shares, bonds, debentures, bills, loans, lease, derivatives and fixed deposits. Financial assets represent a claim by securities, on the income generated by real assets of some other parties. Such assets can be easily traded, as they are marketable and transferable. Financial assets are transactions between two or more parties for example if a person takes an insurance policy of ₹ 1,00,000 of Life Insurance Corporation. The contract is a liability of LIC but an asset of the person insuring himself because he has a claim over the insurance company to receive the principal sum with interest on the happening of an event or on the completion of a certain number of years.

TABLE 2 : Distinction between Real and Financial Assets

Real Assets	***Financial Assets***
Land and building, furniture, machinery	Shares, debentures, bonds, derivatives, fixed deposits, bills, loans
Tangible assets moveable, immoveable, marketable and non – marketable.	These are called *paper securities* as they deal with claims generated on the issuer.
Theses assets are used for production of goods and services	These assets are financial claims represented by securities

3. Commodity Assets

Commodities are a new form of investment in India. Examples of commodity assets are wheat, sugar, potatoes, rubber, coffee and other grains. Commodities are also in the form of metal like gold, silver, aluminum and copper. Cotton, crude oil and foreign currency are other examples of commodities. Importers and exporters invest in commodities to diversify their portfolios. Traders hedge or transact in commodities to make gains. A National Commodity and Derivatives Exchange Ltd. (NCDEX) has been setup in India in 2003 as a public limited company to transact in commodities.

The promoters of NCDEX were ICICI Bank Ltd., National Bank for Agriculture and Rural Development (NABARD), Life Insurance Corporation of India, Punjab National Bank, Canara Bank, CRISIL Ltd., Indian Farmers Fertilizer, Cooperative Ltd. (IFFCO) and National Stock Exchange of India Ltd. (NSE). All these institutions subscribed to the equity shares of NCDEX.

The above explanations of the terms of investment have provided a background to the meaning of investment, this chapter now presents the importance of investments, opportunities conducive to investment, media available for investment, investment features and the process of investment.

1.8 WHY ARE INVESTMENTS IMPORTANT?

Investments are important due to increase in life expectancy of a person, planning for retirement income, high planning for additional income due to high rates of taxation and inflationary pressure in an economy, the expectation of continuous stable income in the form of regular dividends, interests and other receipts. The following discussion provides an explanation of these issues.

1. Longer Life Expectancy

Investment decisions have become significant because statistics show that life expectancy has increased with good medical care. People usually retire between the ages of 60 and 65. The income shrinks at the time of retirement because the annual inflow of earnings from employment stops. If savings are invested at the right age and time wealth increases if the principal sum is invested adequately in different saving schemes.

The importance of investment decisions is enhanced by the fact that there is an increasing number of women are working in organizations. Men and women are responsible for planning their own investments during their working life so that after retirement they are able to have a stable income through balanced investments.

2. Taxation

Taxation introduces an element of compulsion in a person’s savings. Every country has different tax saving schemes for bringing down taxation levels of a person. Since investments provide regular and stable income and also give relief in taxation they are considered to be very important and useful if investments are made by proper planning.

3. Interest Rates

Interest rates vary according to the choice of investment outlet. Investors prefer safe investments with a good return. A risk-less security will bring low rates of return. Government securities are risk free. However, market risk is high with high rates of return. Before allocations of any amount the different types of securities must be analyzed to calculate their benefits and their disadvantages. The investor should make his portfolio with several kinds of investments. Stability of interest is as important as receiving a high rate of interest. This book is concerned with determining that the investor is getting an acceptable return commensurate with the risks that are taken.

4. Inflation

In a developing economy there are rising prices and inflationary trends. A rise in prices has several problems coupled with a falling standard of living. Before funds are invested, they must be evaluated to find the right choice of investments to tide over inflationary situations. The investor will look at different investment outlets and compare the rate of return/interest to cover the risk of inflation. Security and safety of capital is important therefore he/she should invest in those securities that have an assured and regular return. An investor has to consider the taxation benefit decides the safety of capital and its continuous return.

5. Income

Investment decisions are important due the general increase in employment opportunities and an understanding of investment channels for saving in India. New and well paying job opportunities are in sectors like software technology; business processing offices, call centres, exports, media, tourism, hospitality, manufacturing sector, banks, insurance and financial services. The employment opportunities gave rise to increasing incomes. Higher income has increased a demand for investments and earnings above the regular income of people. Investment outlets can be selected to make investments for supporting the regular income. Awareness of financial assets and real assets has led to the ability and willingness of working people to save and invest their funds for return in their lean period leading to the importance of investments.

6. Investment outlets

The availability of a large number of investment outlets has made investments useful an important. Apart from putting aside savings in savings banks where interest is low, investors have the choice of a variety of instruments. The question to reason out is which is the most suitable channel? Which investment will give a balanced growth and stability of return? The investor in his choice of investment has the objective of a proper mix between high rate of return and stability of return to get the benefits of both types of investments.

Thus, the objectives of investment are to achieve ***a good rate of return in the future, reducing risk to get a good return, liquidity in time of emergencies, safety of funds by selecting the right avenues of investments and a hedge against inflation.***

1.9 FACTORS FAVOURABLE FOR INVESTMENT

The investment market should have a favourable environment to function effectively. Business activities are marked by social, economic and political considerations. It is important that the economic and political factors are favourable. Generally, there are four basic considerations which foster growth and bring opportunities for investment. These are legal safeguards, stable currency and existence of financial institutions to aid savings and forms of business organization.

1. Legal Safeguards

A stable government which frames adequate legal safeguards encourages accumulation of savings and investments. Investors will be willing to invest their funds if they have the assurance of protection of their contractual and property rights.

In India, the investors have the dual advantage of free enterprise and control. Freedom, efficiency and growth are ensured from the competitive forces of private enterprises. Statutory control exerts discipline and curtails some element of freedom. In India, the political climate is conducive to investment. In fact the new economic reforms were brought in the country in 1991 for liberalization and globalization and for extending investments in other countries.

2. A Stable Currency

A well organized monetary system with definite planning and proper policies is a necessary prerequisite to an investment market. Most of the investments such as bank deposits, life insurance and shares are payable in the currency of the country. A proper monetary policy will give direction to the investment outlets. The monetary policy should be made to bring growth to industries and development to the economy as a whole. If there is an inflationary pressure or deflation in an economy, it should be controlled.

Inflation reduces the purchasing power of investments. When interests after taxes is received by the investor it should be evaluated and if it is less than the rise in the price level, the investor should plan to shift his investments in other outlets. Inflation occurs generally in unstable conditions like war or floods but it is also discernible in peace conditions especially in developing countries because of huge government deficit in creating infrastructure. Deflation is equally disastrous because the nominal values of inventories, plant and machinery and land and building tend to shrink. An example of the recent financial crisis that started in 2007 may be cited its effects become global and many countries had a shrunk market in investments and disasters in jobs. In India the market is improving in August 2009 but it is not stable yet. A reasonable stable price level which is produced by wise monetary and fiscal management contributes towards proper control, good government, economic well-being and a well disciplined growth oriented investment market and protection to the investor.

3. Existence of Financial Institutions and Services

The presence of financial institutions and financial services encourage savings, direct them to productive uses and helps the investment market go grow. The financial institutions in existence in India are mutual funds, development banks, commercial banks, life insurance companies, investment companies, investment bankers, mortgage bankers. The financial services include venture capital, factoring and forfaiting, leasing, hire purchase and consumer finance, housing finance, merchant bankers and portfolio management. Investment bankers are merchants of securities. They buy bonds and stocks of companies for re-sale to investors. The investment bankers are distinguished from security brokers who act as agents in buying and selling already issued securities for commission. Mortgage bankers sometimes act as merchants and sometimes as agents on mortgage loans generally on residential properties. They serve as middlemen between investors and borrowers and perform collateral service in connection with loans. Commercial banks and financial institutions also act as mortgage bankers in giving mortgage loans and servicing the loans.

In India, there are a large number of financial institutions under Central Government, State Government, rural bodies and private financial institutions that have encouraged the growth of savings and investment. Life insurance companies and mutual funds offer a wide variety of schemes for savings and give tax benefits also. Banks offer a wide variety of schemes for encouraging savings and investment. These institutions lend an element of strength to the capital market and promote discipline while encouraging growth.

Since 1991 there has been a development of the private corporate sector. Many new financial institutions have emerged in the private sector. Insurance companies, mutual funds, and venture capitalists leasing companies have been opened up to private financing agencies. Foreign banks have been allowed to do business.

Thus, there is the presence of a large number of institutions and services which act as a channel for the funds in productive directions.

4. Form of Business Organization

The form of business organization which is permanent in existence promotes savings and investment. The public limited companies are considered to be the best form of organization. The three characteristics of the corporation which have been very useful for investors are limited liability of shareholders, perpetual life and transferability and divisibility of stocks and shares. The public limited company with the ability to continue its business irrespective of members comprising it, gives longevity and soundness to its business activity. In contrast to a public limited company whose shareholders have limited liability, the sole proprietor or a partner in a partnership firm is liable for all the debts of the firm to the full extent of his personal wealth. In these conditions, investors are hesitant to risk their savings in these forms of organizations. Besides unlimited liability, the partnership and proprietor also suffer from short life of the organization. With the death or retirement of any of the partners, a partnership firm is dissolved. Similarly, a sole proprietor carries on business only during his lifetime. In these unstable and unsure conditions, investors would not like to make their investments. Finally, the public limited company lends an element of liquidity to its shares. In contrast, partnership restricts stability and transferability freely from person to person. The public limited company, therefore, is a popular form for investment as the investors benefit from liquidity, convenience and longevity.

In India since 1991 there is the existence of large corporate organizations. There have been many mergers and amalgamations and consolidation has taken place. Business has become more permanent in nature. Family businesses have expanded and are now stable and well organized. Indian business is taking new forms and being recognized in the world. With increased awareness and stability the investor has many favorable outlets for making investments.

5. Choice of Investment

The growth and development of the country leading to greater economic activity has led to the introduction of a vast array of investment outlets. Apart from putting aside savings in banks investors have the choice of a variety of instruments. The question to reason out is which is the most suitable channel? Which media will give a balanced growth and stability of return? The investor in his choice of investment will have to try and achieve a proper mix between high rate of return and stability of return. Some of the instruments available are equity shares, bonds, financial engineering securities, provident fund, life insurance, fixed deposits, and mutual funds schemes.

1.10 RISK-LESS VS. RISKY INVESTMENTS

Most investors are risk averse but they expect maximum return from their investments. Every investment must be analyzed because there is some risk in it. Only government securities are risk-less. The Indian investment scene has many schemes to offer to an individual. On an analysis of these schemes, it appears that the investor has a wide choice. A vast range of investments is in the government sector. These are mostly risk free but low return yielding. Several incentives are attached to it. The private sector investments consist of equity and preference shares, debentures and financial engineering securities. These have the features of high risk. Ultimately, the investor must make his investment decisions.

The dilemma faced by the Indian investor is the reconciliation of profitability, liquidity and risk of investments. Government securities are risk free and the investor is secured. However, to him the return or yield is very important as he has limited resources and would like to plan an appreciation of the investments for his future requirements. Government securities give low returns, and do not fulfil his objective of money appreciation.

Private sector securities are attractive though, risky. Reliance, Infosys, Wipro, Tatas give to the investor the expectation of future appreciation of investment by several times. The multinational and blue chip companies offer very high rates of return and also give bonus shares to their shareholders.

Real Estate and Gold have the advantage of eliminating the impact of inflation, since the price rises experienced by them have been very high. The Indian investor in this context cannot choose his investments very easily.

An investor can maximize returns with minimum risk involved if he carefully analyses the information published in the prospectuses of private companies. Contents as the past performance, name of promoters and board of directors, the main activities, its business prospects and selling arrangements should be assessed before the investor decides to invest in the company.

From the point of view of an investor, convertible bonds may under proper conditions, prove an ideal combination of high yield, low risk and potential of capital appreciation.

1.11 INVESTMENT ALTERNATIVES / MEDIA

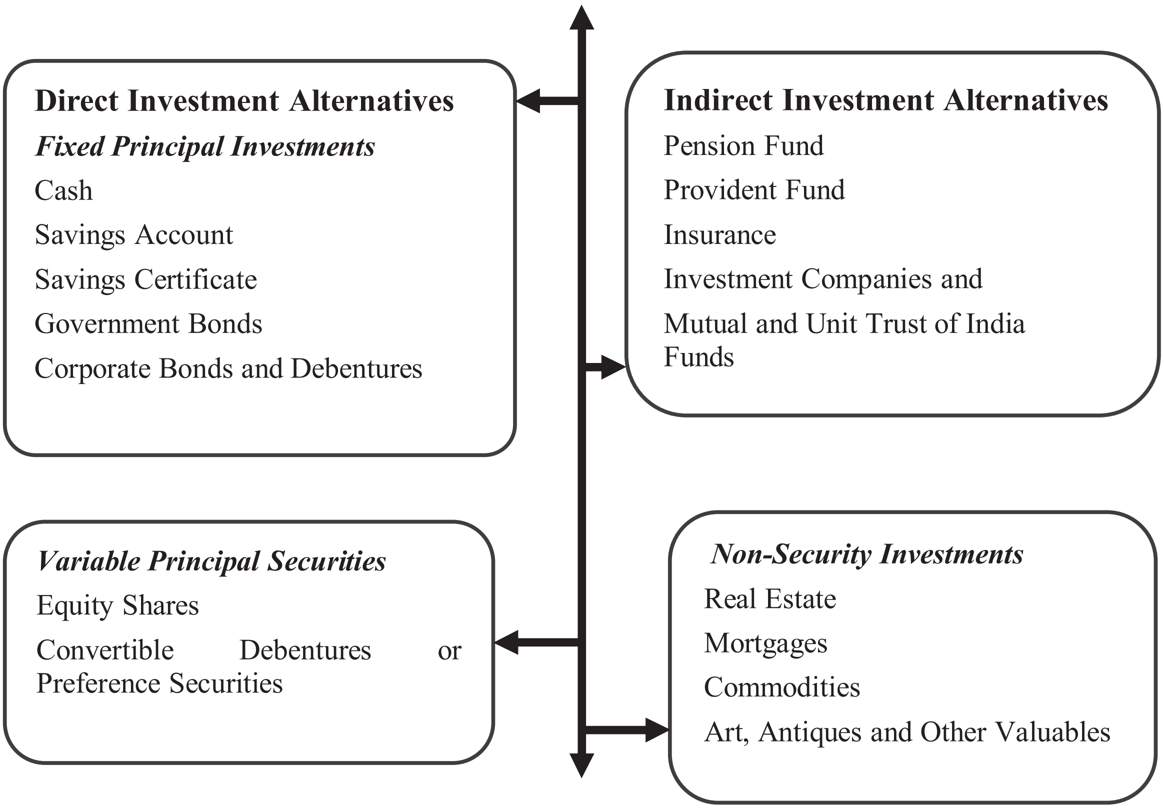
Many types of investment alternatives or channels for making investments are available. A sound investment programme can be constructed if the investor familiarizes himself with the various alternative investments available. Investment media are of several kinds – some are simple and direct, others present complex problems of analysis and investigations. Some investments are appropriate for one type of investor and another may be suitable to another person.

The ultimate objective of the investor is to derive a variety of investments that meet this preference for risk and expected return. The investor will select the portfolio, which will maximize his utility. Securities present a wide range of risk-free instruments to highly speculative shares and debentures. From this broad spectrum, the investor will have to select those securities that maximize his utility. The investor, in other words, has an optimization problem. He has to choose the security, which will maximize his expected returns subject to certain considerations. The investment decision is an optimization problem but the objective function varies from investor to investor. It is not only the construction of a portfolio that will promise the highest expected return but it is the satisfaction of the need of the investor. For instance, one investor may face a situation when he requires extreme liquidity. He may also want safety of securities. Therefore, he will have to choose a security with low returns. Another investor would not mind high risk because he does not have financial problems but he would like a high return. Such an investor can put his savings in growth shares, as he is willing to accept risk. Another important consideration is the temperament and psychology of the investor. Some investors are temperamentally suited to take risks; there are others who are not willing to invest in risky securities even if the return is high. One investor may prefer safe government bonds whereas another may be willing to invest in blue chip equity shares of at company.

Many alternative investments exist. These can be categorized in many ways. The investment alternatives are given below in Table 3.

TABLE 3:

Investment Media



The media alternatives have been categorized as direct and indirect investment alternatives. Direct investments are those where the individual makes his own choice and investment decision. Indirect investments are those in which the individual has no direct hold on the amount he invests. He contributes his savings to certain organizations like Life Insurance Corporation (LIC) or Unit Trust of India (UTI) and depends upon them to make investments on his and other people's behalf. So there is no direct responsibility or hold on the securities.

An individual also makes indirect investment for retirement benefits, in the form of provident funds and pension, life insurance policy, investment company securities and securities of mutual funds. Individuals have no control over these investments. They are entrusted to the care of the particular organization. The organizations like Life Insurance Corporation or Unit Trust of India, provident funds are managed according to their investment policy by a group of trustees on behalf of the investor. The examples of indirect investment alternatives are an important and rapidly growing segment of our economy. In choosing specific investments, investors will need definite ideas regarding a number of features that their portfolio should have. To summarize:

- Direct investments are those where the individual has a direct hold on his investment decision.
- Indirect investments are those where the investor is dependent on another organization.

2. Fixed and Variable Principal Securities

Fixed principal investments are classified as those whose principal amount and the terminal value are known with certainty. Cash has a definite and constant rupee value, whether it is deposited in a bank or kept in a cash box. It does not earn any return. Savings accounts have a fixed return; they differ only in terms of time period. The principal amount is fixed plus interest is earned on the deposit. Savings certificates are classified as national savings certificates, bank savings certificates and postal savings certificates. Government bonds, corporate bonds and debentures are sold having a fixed maturity value and a fixed rate of income overtime.

The variable principal securities differ from the fixed principal securities because their terminal values are not known with certainty. The price of preference shares is determined by demand and supply forces even though preference shareholders have a fixed return. Equity shares also have no fixed return or maturity date. Convertible securities such as convertible debentures or preference shares can convert themselves into equity shares according to certain prescribed conditions and thus have features of fixed principal securities supplemented by the possibility of a variable terminal value. Debentures, preference shares and equity shares are examples of securities sold by companies to investors to raise necessary funds. To summarize:

- Fixed securities terminal values are certain with fixed return and maturity dates.
- Variable principal securities terminal values uncertain. Their price is determined by demand and supply mechanism.

3. Non-Security Investments

'Non-Security Investments' differ from securities in other categories. Real estate may be the ownership of a single home or include residential and commercial properties. The terminal value of real estate is uncertain but generally there is a price appreciation, whereas depreciation can be claimed in tax. Real estate is less liquid than corporate securities. Mortgages represent the financing of real estate. It has a periodic fixed income and the principal is recovered at a stated maturity date. Commodities are bought and sold in spot markets; contracts to buy and sell commodities at a future date are traded in future markets. Business ventures refer to direct ownership investments in new or growing business before firms sell securities on a public basis. Art, antiques and other valuables such as silver, fine china and jewels are also another type of specialized investments which offer aesthetic qualities also.

These features should be consistent with the investors' objectives and in addition should have additional conveniences and advantages. The following features are suggested for a successful selection of investments.

1.12 FEATURES OF AN INVESTMENT PROGRAM

The features of an investment program consists of safety of principal, liquidity, income stability, adequate income, purchasing power stability, appreciation, freedom from management of investments, legality and transferability.

1. Safety of Principal

The investor, to be certain of the safety of principal, should carefully review the economic and industry trends before choosing the types of investment. To ensure safety of principal, the investor should consider diversification of assets. Adequate diversification involves mixing investment commitments by industry, geographically, by management, by financial type and by maturities. A proper combination of these factors would reduce the risk of loss. Diversification in proper investment programmes must be reasonably accomplished.

2. Liquidity

An investor requires a minimum amount of liquidity in his investments to meet emergencies. Liquidity will be ensured if the investor buys a proportion of readily saleable securities out of his total portfolio. He may therefore, keep a small proportion of cash, fixed deposits and units which can be immediately made liquid. Investments like stocks and property or real estate cannot ensure immediate liquidity.

3. Income Stability

Regularity of income at a consistent rate is necessary in any investment pattern. Not only stability, it is also important to see that income is adequate after taxes. It is possible to find out some good securities which pay practically all their earnings in dividends.

4. Appreciation and Purchasing Power Stability

Investors should balance their portfolios to fight against any purchasing power instability. Investors should judge price level inflation, explore the possibility of gain and loss in the investments available to them, limitations of personal and family considerations. The investors should also try and forecast which securities will appreciate. A purchase of property at the right time will lead to appreciation in time. Growth stock will also appreciate overtime. These, however, should be done through analysis and not as speculation or gamble.

5. Legality and Freedom from Care

All investments should be approved by law. Law relating to minors, estates, trusts, shares and insurance be studied. Illegal securities will bring out many problems for the investors. One way of being free from care is to invest in securities like Unit Trust of India, Life Insurance Corporation, mutual funds or savings certificates. The management of securities is then left to the care of the Trust who diversifies the investments according to safety, stability and liquidity with the consideration of their investment policy. The identity of legal securities and investments in such securities will also help the investor in avoiding many problems.

6. Tangibility

Intangible securities have many times lost their value due to price level inflation, confiscatory laws or social collapse. Some investors prefer to keep a part of their wealth invested in tangible properties like building, machinery and land. It may, however, be considered that tangible property does not yield an income apart from the direct satisfaction of possession or property.

TABLE 4: Features of Investment Avenues

Particulars	*Risk*	*Return / Current Yield*	*Capital appr.*	*Liquidity / marketability*	*Tax benefit*
Equity Shares	High	Low	High	High	High
Debentures	Low	High	Very low	Very low	Nil
Bank Deposit	Low	Low	Nil	High	Nil
Public Provident Fund	Nil	Nil	Low	Low	Moderate
Life Insurance Policies	Nil	Nil	Low	Low	Moderate
Real Estate	Low	Low	High in Long-term	Moderate	Changes according to rules
Gold and Silver	Low	Nil	High in long-term	Moderate	Nil

1.13 THE INVESTMENT PROCESS – STAGES IN INVESTMENT

The investment process is generally described in four stages. These stages are investment policy, investment analysis, valuation of securities and portfolio construction.

1. Investment Policy

The first stage determines and involves personal financial affairs and objectives before making investments. It may also be called preparation of the investment policy stage. The investor has to be able to create an emergency fund, an element of liquidity and quick convertibility of securities into cash. This stage may, therefore, be considered appropriate for identifying investment assets and considering the various features of investments.

2. Investment Analysis

When an individual has the types of investments that he requires on his portfolio, the next step is to analyze the securities available for investment. He must make a comparative analysis of the type of industry, kind of security and fixed vs variable securities. The primary concerns at this stage would be to form beliefs regarding future behaviour or prices of stocks and the expected returns and associated risk.

3. Valuation of Securities

The third step is the most important consideration of the valuation of investments. Investment value, in general, is taken to be the present worth to the owners of future benefits from investments. An appropriate set of weights have to be applied with the use of forecasted benefits to estimate the value of the investment assets. Comparison of the value with the current market price of the asset allows a determination of the relative attractiveness of the asset. Each asset must be valued on its individual merit. Finally, the portfolio should be constructed.

4. Portfolio Construction

As discussed earlier under features of an investment programme, portfolio construction requires knowledge of the different aspects of securities. These are briefly recapitulated here, consisting of safety and growth of principal, liquidity of assets after taking into account the stage involving investment timing, selection of investment, allocation of savings to different investments and feedback of portfolio as given in Table 5*.

While evaluating securities, the investor should realize that investments are made under conditions of uncertainty. These cannot be a magic formula which will always work. The investor should be concerned with concepts and applications that will satisfy his investment objectives and constantly evaluate the performance of his investments. If need be, the investor may consider switching over to alternate proposals.

* Refer Page 12, Keith V. Smith and David I. Eiterman (for a more elaborate discussion), Modern Strategy for Successful Investment, Dow Jones Irvin Inc., Illinois 1978, pp. 11-20.

TABLE 5: The Process of Investing

INVESTMENT POLICY Determination of investment wealth Determination of portfolio objectives Identification of potential investment assets Consideration of attributes of investment assets Allocation of wealth to asset categories
INVESTMENT VALUATION Valuation of debentures and bonds Valuation of equity shares
INVESTMENT ANALYSIS ***Equity Stock Analysis*** Analysis of the Economy Screening of Industries Analysis of yield structure Qualitative analysis
Debentures and Bond Analysis Consideration of debentures Quantitative analysis
OTHER ASSETS ***Land, Building, Gold, Silver*** Quantitative analysis Qualitative analysis
PORTFOLIO CONSTRUCTION Determination of diversification level Consideration of investment timing Selection of investment assets Allocation of investible wealth to investment assets Evaluation of portfolio for feedback

The next chapters, Chapter 2 and Chapter 3, discuss the structure of the financial market and the secondhand securities market. This will help the investor to understand the working of the securities markets and how to participate in them.

SUMMARY

- Investment is employment of funds for achieving additional income and growth in value.
- Investment must be distinguished from speculation and gambling in terms of time horizon, risk. Return and decision making process. Investment is usually planned whereas speculation and gambling depend on immediate decisions with also the element of 'luck'.
- Investments are transfers of financial assets from one person to another. They range from low risk to high risk.
- Investments are usually long-term and low risk. Speculation is high risk and high return and for short-term period of time.
- Investments may be financial claims or real and tangible assets the land and buildings, plant, gold antiques etc.
- Investment may be direct and indirect of securities like shares and debentures. Investments in provident funds, pension funds and mutual funds are forms of indirect investments.
- An investment programme should consist of safety of the principal amount liquidity income and purchasing power stability and appreciation.
- The investment process consists of four stages. These are investment policy investment analysis Valuation of securities and Portfolio construction.

QUESTIONS

1. Why do people invest? What are the factors which are favourable for making investments in an economy?
2. What is the meaning of investment? Discuss the different channels or alternatives available to an investor for making investments?
3. Describe the features of an investment programme? What steps should an investor follow to make an investment?
4. Distinguish between investment, speculation and gambling. What is the usefulness of a sound investment plan?
5. Writes notes on (i) commodity assets (ii) process of investment (iii) investment alternatives.
6. Distinguish between (i) direct and indirect assets (ii) real and financial assets (iii) investment and arbitrage.

Objective Type Questions

State whether the following statements are True (T) or False (F).

(i) Investments are concerned with risk and return.

(ii) Investments involve long-term commitments.

(iii) Speculation brings about stable return for long-term period of time.

(iv) Speculation is considered with review and analysis and investments with capital gain.

(v) Investments are based on portfolio construction, valuation, identification and analysis.

(vi) The variable investments consist of cash, bonds and savings certificates.

(vii) The investment objective is high risk and high return.

(viii) Arbitrage is a long-term investment.

(ix) The commodity investment is through saving bank.

(x) Indirect securities consist of mutual fund and life insurance securities.

Answers: (i) T; (ii) T; (iii) F; (iv) F; (v) T; (vi) F; (vii) F; (viii) F; (ix) F; (x) T.

Multiple Choice Questions

1. Investment means
   (a) Commitment of funds for future income.
   (b) Net additions to economy capital stock.
   (c) Short-term commitment of funds.
   (d) Capital gain.
2. Speculation can be distinguished from investment in the following way
   (a) Investment is high risk speculation is low risk
   (b) Investment is short term period of time speculation covers long-term period
   (c) Investment is based on planning of funds for safety liquidity profitability Speculation on haunches and benefits
   (d) Investment is your own funds, speculation consists of other peoples funds.
3. A gambler is one who makes planned investment
   (a) Believes in low risk
   (b) Considers high risk and high profits
   (c) Expects other people to plan his resources in one best security
   (d) Buying government securities with safety of return.

Answers: 1. (a); 2. (c); 3. (b).