Chapter 1: Investment Landscape

Learning Objectives

This chapter will equip you with essential knowledge and skills to navigate the world of investments effectively. You will learn to align your investments with financial goals, differentiate between saving and investment, and explore diverse asset classes for portfolio diversification.

Identifying and managing investment risks, understanding behavioral biases in decision-making, and conducting risk profiling will enhance your ability to make informed investment choices. You will also grasp the significance of asset allocation and evaluate the benefits of DIY investing versus seeking professional help.

Chapter 1.1 Investors and their Financial Goals

1.1.1 Why Investments?

Frequently, people ask questions like "What are some good investments?" or "Which mutual funds are best?" These inquiries often focus solely on the investments themselves, neglecting the investor's needs. This overlooks a crucial aspect highlighted by leadership expert Simon Sinek: the "why" behind investments. Understanding the purpose of investing is essential.

Consider the below financial situations:

1. Maya, a ten-year-old girl living in a small town, is passionate about environmental conservation. Inspired by recent documentaries on wildlife preservation, she dreams of becoming a wildlife biologist. Her parents, Mr. and Mrs. Patel, are eager to support her pursuit of this dream.

2. Rohan, a 35-year-old software engineer in a metropolitan city, is concerned about his family's financial security. With the rising cost of living and uncertainties in the job market, he's exploring ways to build a robust financial plan for his family's future.

3. Priya, a recent college graduate, has landed her first job in a fast-paced startup. Despite enjoying her work, she's struggling to manage her expenses and save for the future. She's seeking advice on how to create a budget and start investing wisely.

4. Ajay, a 50-year-old marketing executive, is nearing retirement age. He's worried about funding his children's education and ensuring a comfortable retirement for himself and his spouse. Ajay is looking for investment options that provide stable returns and long-term growth.

1.1.2: Financial Goals

In our everyday lives, we encounter situations that involve financial goals, whether it's funding a child's education, buying a house, or planning for retirement (examples shared in your previous reading). These objectives, when quantified with timelines, become financial goals. Goal setting is crucial as it ensures we allocate resources properly. While some goals can be anticipated and planned for, others may arise unexpectedly, like medical emergencies. Prioritizing goals helps us focus on what's important. Assigning timelines and funding amounts enables us to plan effectively, distinguishing between short-term and long-term goals.

1.1.3 Short term needs versus Long Term Goals

Consider the examples we looked at in the previous chapter, Maya's parents want to plan for their child's education, whereas Priya is concerned about Personal finance, Rohan is looking to build a long term financial plan for his family while Ajay is planning for his retirement. The goals can be broken down into two parts - Saving a nest egg for retirement and subsequently withdrawing income from the accumulated corpus. Upon reevaluation, we can categorize these goals into the following matrix:

	Critical/High priority	Dream planning	Good to have
Intermediate term			
Near term			
Medium term			
Long term			

In his book "The Seven Habits of Highly Effective People," Stephen Covey introduced the concept of the time management matrix, which categorizes tasks based on urgency and importance. This matrix, divided into four quadrants, helps individuals prioritize their activities:

Time Management Matrix	Urgent	Not urgent
Important	I	II
Not important	III	IV

- Quadrant I: Urgent and Important
- Quadrant II: Important but Not Urgent
- Quadrant III: Urgent but Not Important
- Quadrant IV: Not Urgent and Not Important

Covey emphasizes that focusing solely on Quadrant I tasks can lead to overwhelm and neglect of important but less urgent activities. By prioritizing Quadrant II tasks, which are crucial but not immediately pressing, individuals can prevent important matters from becoming urgent crises. This principle applies to financial goals as well, highlighting the importance of planning for both urgent and non-urgent events in life.

1.1.4
Financial Goals, Time Horizon for their achievement and Inflation
Assigning amounts to financial goals is crucial in the planning process. For instance, consider Maya's aspiration to become a Wildlife biologist. Estimating the cost of her education for college entry in a decade is essential. However, it's vital to consider inflation, which impacts the rising costs associated with goals over time. Failure to adjust for inflation can disrupt the entire planning process, especially considering the rapid increase in expenses like education and healthcare in recent decades.

1.1.5 The Pool Approach
While some individuals rely on a pool of savings or investments to fulfill their financial needs, this approach lacks clarity regarding investment horizons. Understanding your investment horizon is crucial for making informed investment decisions.
Lets use Maya's above example in this scenario:

Suppose Maya's parents aim to save Rs. 60 lakhs for her college education, expecting her to start college in 10 years. Assuming an annual inflation rate of 8%, they would actually need approximately Rs. 1,29,53,550 to cover the anticipated expenses. This demonstrates the significant impact of inflation on long-term financial goals. Additionally, consider a scenario where a family's monthly expenses are currently Rs. 35,000. With a 6% annual inflation rate, these expenses would escalate to roughly Rs. 62,545 after 10 years and Rs. 1,12,712 after 20 years. This underscores the importance of factoring in inflation when planning for future financial needs.

Welldone! You have just completed your first step of learning Unit 1,
Lets have a quick quiz on this chapter.

1. What should be the starting point of investment discussions, according to Simon Sinek?

A) What
B) Where
C) When
D) Why

2. What is the primary purpose of identifying financial goals?

A) To increase spending
B) To reduce consumption
C) To achieve financial independence
D) To avoid investments

Answers:

1. D) Why
2. C) To achieve financial independence

Chapter 1.2 Savings or Investments?

Understanding Saving and Investment

Before delving into investment options, it's vital to clarify the distinction between "saving" and "investment." While saving emphasizes capital preservation, investment aims for profitability, albeit with associated risks. Saving precedes investing as the initial step in the financial process.

Factors to Evaluate Investments

When evaluating investments, several key factors come into play:

Safety:Assessing capital preservation and income certainty is paramount.

Liquidity: Evaluating the ease of converting investments into cash is crucial.

Returns: Consider both regular income and capital appreciation.

Convenience: Assess the ease of investment, withdrawal, and monitoring investment value and income.

Minimum Investment Requirements: Evaluate the minimum amount required for investment, aligning it with financial capacity and goals.

Tax Considerations: Assess tax implications, deductions, and lock-in periods to optimize post-tax returns.

Evaluating investment options requires a holistic consideration of these factors, aligned with the investor's unique circumstances and financial objectives.

1. What is the main difference between saving and investing?

A) Saving aims to earn profits, while investing involves reducing consumption
B) Saving and investing are the same
C) Saving involves reducing consumption, while investing aims to earn profits
D) Saving is riskier than investing

2. Which of the following is NOT a factor to evaluate investments?

A) Safety
B) Returns
C) Tax deduction
D) Liquidity

Answers:
1. C) Saving involves reducing consumption, while investing aims to earn profits
2. D) Liquidity

1.3 Different Asset Classes

Investment avenues are organized into distinct categories known as asset classes, each sharing similar traits. These encompass four primary categories: Real estate, Commodities, Equity, and Fixed income, each containing numerous subcategories.

1.3.1 Real Estate

Real estate stands out among asset classes, with its popularity driven largely by personal housing needs rather than investment objectives. While often perceived as an expense, real estate purchases for personal use should be distinguished from investment endeavors, as their sale could adversely affect lifestyle. Real estate encompasses diverse categories like residential, commercial, and land holdings. Key characteristics include:

1. **Expense vs. Investment:** Often perceived as a personal expense due to homeownership, which may not align with traditional investment goals.
2. **Diverse Categories:** Real estate includes residential, commercial, and land holdings, each offering unique investment opportunities.
3. **Location Sensitivity:** The value of real estate investments is heavily influenced by their geographical location.
4. **Illiquidity:** Real estate assets can be challenging to convert into cash quickly due to their physical nature and market dynamics.
5. **Indivisibility:** Unlike financial assets, real estate investments typically cannot be divided into smaller units for trading.
6. **Investment Forms:** Investors can choose between physical property ownership or financial instruments like Real Estate Investment Trusts (REITs).
7. **Rental Income:** Besides capital appreciation, real estate can generate ongoing income through rent payments from tenants.
8. **High Transaction and Maintenance Costs:** Expenses such as brokerage fees, registration charges, and property maintenance can significantly impact investment returns. It's crucial to account for these costs when evaluating the overall performance of real estate investments.

1.3.2 Commodities
- Commodities encompass various everyday goods like spices, petroleum products, and metals.
- However, investing in most commodities is impractical due to perishability or storage constraints.
- Commodities derivatives exist but involve high risk and short-term contracts, not suitable for long-term investing.

- Gold and silver stand out as popular investment choices due to their global acceptance and historical value.
- Prices of gold and silver are globally synchronized, making them universally recognized assets.
- Both have been historically valued for their role in storing wealth and as safe haven assets.
- Investors rely on capital appreciation since gold and silver don't generate current income.
- Purity levels vary, and determining purity without a certificate can be challenging, potentially impacting investment quality and cost.

1.3.3 Fixed Income

Fixed income investments involve borrowing money, with the borrower obligated to repay the principal along with interest in the future. Bonds and debentures are common forms of such borrowing. These financial instruments are issued by various entities, including companies, governments (at the Union, State, and Municipal levels), banks, financial institutions, and public sector enterprises.

Investors in bonds typically receive regular interest payments, providing them with a steady stream of current income. However, if an investor holds a bond until its maturity date, capital gains are usually minimal. Trading bonds on the secondary market, whether during purchase or sale, may result in capital gains or losses.

While bonds are generally considered safer than equity investments, they are not entirely risk-free. The specific risks associated with bonds will be discussed in detail later in this chapter.

Bonds can be further classified based on the issuer type (government or corporate) and maturity date. Short-term bonds are suitable for liquidity needs, while medium-term and long-term bonds are more suitable for income generation purposes.

1.3.4 Equity

Equity investments involve ownership in a business, where shareholders share the risks and rewards of the company's performance. Historically, equity investments have outpaced inflation, providing significant long-term returns. Despite short-term price fluctuations, equity prices generally reflect the company's performance over time, with potential for capital appreciation and dividends.
Key Points:
- Equity shares represent ownership in a company.
- Returns from equity investments can exceed inflation over the long term.
- Share prices are influenced by company performance and market dynamics.
- Dividends may provide additional income to shareholders.

Asset Categories:

- Equities: Ownership in a company.
- Bonds: Debt instruments providing fixed income.
- Real Estate: Physical property for investment or personal use.
- Commodities: Tangible goods like gold, silver, and agricultural products.

Differences:
- Real estate and commodities can be bought for investment or personal use.
- Equities and bonds provide potential for periodic income, while commodities do not.
- Equity, real estate, and commodities involve ownership, while bonds represent lending.

International Investments:
Investors can diversify into international assets, exposing themselves to different currencies and markets. However, understanding the impact of currency fluctuations is crucial.

Note: Sensex is a benchmark index representing shares of 30 large companies in India, often used as an indicator of market performance.

Various investment options can be classified into distinct asset categories, as demonstrated in the table:

Equity	Fixed Income
• Blue-chip Companies • Mid-sized companies • Small-sized companies • Unlisted Companies • Foreign Stocks • Equity Mutual Funds • Exchange Traded Funds • Index Funds	• Fixed deposit with a bank • Recurring deposit with a bank • Endowment Policies • Money back Policies • Public Provident Fund • Sukanya Samruddhi Yojana (SSY) • Senior Citizens' Savings Scheme (SCSS) • Post office Monthly Income Scheme • Recurring deposit with a post office • Company fixed deposit • Debentures/bonds • Debt Mutual Funds
Real Estate/Infrastructure	Commodities
• Physical Asset • Residential/ Commercial Financial Asset • Real Estate Mutual Funds(REMF) • Real Estate Investment Trusts (ReIT) • Infrastructure Investment Trust (InvIT)	• Gold • Silver • Gold Funds • Commodity ETFs
Hybrid asset classes	Others
• Hybrid Mutual funds or Multi Asset Fund	• Rare coins

	• Art • Rare stamps

Quiz:
1. Which of the following is an example of a fixed-income asset?
   A) Stocks
   B) Bonds
   C) Real Estate
   D) Commodities

2. What is the primary characteristic of a commodity asset class?
   A) High liquidity
   B) Stability
   C) Tangibility
   D) Low risk

Answers:
1. B) Bonds
2. C) Tangibility

Chapter 1.4 Investment Risks

To dive deeper into investment opportunities, let's explore the diverse risks associated with each option.

1.4.1 Inflation Risk
Let's talk about inflation – it's like a sneak attack on our purchasing power, causing prices to climb steadily. Check out the table below to see how inflation chips away at the value of our money.

How much money would you need to buy the goods you can buy with Rs. 10,000 today	**If inflation is assumed at 8% p.a**
After 5 years	Rs. 14,693
After 10 years	Rs. 21,589
After 20 years	Rs. 46,610

After 30 years	Rs. 1,00,627

Note: The numbers are arrived at by using the future value equation, i.e., $A = P * (1 + r) ^ n$, where A is the future value (the values in the right-side column); P is the present value (Rs. 10,000 in the example); r is the rate of inflation (8% p.a. in the example); n is the number of years(the periods in the first column in thistable).

The table illustrates how inflation diminishes the value of money over time, posing a risk to long-term financial goals if not addressed in investment plans. For example, if you could buy 100 units of something for Rs. 10,000 today, inflation of 8 percent annually means you'd only afford 68 units after 5 years and 46 units after 10 years.

To counteract this loss of purchasing power, investments should ideally yield returns equal to or higher than the inflation rate. However, investments offering total safety and liquidity often yield returns lower than inflation. For instance, if you earn 7 percent interest on a fixed deposit with 8 percent inflation, your investment grows slower than the increase in prices. This discrepancy between investment returns and inflation is crucial to consider when evaluating investment choices.

1.4.2 Liquidity Risk

Investments in fixed income assets, especially government securities, are often seen as safer. But to reap full benefits, investors typically must hold until maturity. Needing funds before maturity could incur charges or lack liquidity. For instance, a five-year fixed deposit must be held for the entire term for promised returns. Lack of liquidity also affects real estate, where selling could take time. Some investments offer quick access to funds, but their value may fluctuate, as seen with stock shares.

1.4.3 Credit Risk

When lending money or investing in bonds, there's a risk of the borrower not repaying. Issuers may honor commitments on time, with delays, or not at all. The borrower's ability and intention to repay affect credit risk. Stable companies pose lower risk, but new or smaller ones may carry higher risk. Government bonds are considered safest, offering lower interest rates, while other bonds offer higher returns due to higher risk.

1.4.4 Market Risk and Price Risk

Market and price risks stem from changes in opinions rather than facts. Market-wide factors, like economic concerns, can affect all stocks. Company-specific risks arise from internal factors like sales decline. Industry-specific factors affect all firms in an industry, like policy changes or technological advancements. Diversification helps reduce security-specific risks but not market-wide risks.

1.4.5 Interest Rate Risk

Interest rate risk affects bond values inversely to interest rate changes. Bonds issued at fixed rates lose value when interest rates rise. Longer-maturity bonds are more sensitive to rate changes. Investors holding bonds until maturity receive the agreed amount, but selling before maturity depends on market prices influenced by interest rate changes. Interest rate risk affects all bonds in the market.

Quiz on Investment Risks

1. Which of the following is an example of systematic risk?
   A) Business risk
   B) Interest rate risk
   C) Market risk
   D) Inflation risk

2 . What type of risk is specific to a particular investment and can be reduced through diversification?
   A) Market risk
   B) Systematic risk
   C) Unsystematic risk
   D) Credit risk

Answers:
1. C) Market risk
2 . C) Unsystematic risk

1.5 Risk Measures and Management Strategies:
Total Cards: 3, total read time: 15 mins.
Risk Management Strategies

- Risks are inherent in investing and cannot always be eliminated.
- To earn returns, investors must accept some level of risk.
- However, it's crucial to manage these risks effectively.
- Strategies include avoiding certain investments, seizing opportunities, and diversifying portfolios.

1. Avoid

Consider avoiding investments if you're uncomfortable with the associated risks. However, this could mean missing out on potential gains. Experts advise avoiding investments you don't understand.

2. Take Advantage of Opportunities
Anticipate market developments to benefit from investment positions. For instance, if you expect interest rates to drop, switch from short to long-term bonds. While this can lead to significant gains, it's risky and requires advanced market knowledge.

3. Diversify
Diversification is key for most investors. Spread your investments across various options to reduce the risk of losing everything. Even if one investment underperforms, others may compensate. This is a safer approach for those without extensive market expertise.

Before managing risks, they must be measured. Credit risk is assessed through credit ratings and spreads, while volatility risks are measured using metrics like variance, standard deviation, beta, and modified duration.

Quiz on Risk Measures and Management Strategies

1. Which of the following measures assesses the variability of investment returns?
   A) Standard deviation
   B) Beta
   C) Sharpe ratio
   D) Alpha

2. What is the primary purpose of risk management strategies?
   A) To eliminate all risks
   B) To increase risk
   C) To minimize or mitigate risks
   D) To ignore risks

Answers:
1. A) Standard deviation
2. C) To minimize or mitigate risks

Chapter 1.6 Behavioral Biases in Investment Decision Making

Understanding Behavioral Biases in Investment:

Before delving into asset allocation, it's crucial to acknowledge the impact of behavioral biases on investment decisions. These biases stem from emotions and can affect how investors manage their money.

1. Availability Heuristic:
   - Investors rely on immediate examples or experiences, often neglecting thorough research on investment options, leading to oversight of critical information.

2. Confirmation Bias:
   - Investors seek information that confirms their existing beliefs, potentially overlooking contrary evidence and risks.

3. Familiarity Bias:
   - Preferring familiar investments may hinder exploration of better opportunities and meaningful diversification.

4. Herd Mentality:
   - The desire to follow the crowd in financial markets can lead to poor decision-making, as profitable strategies often go against the herd.

5. Loss Aversion:
   - People tend to avoid losses more than acquiring gains, often missing out on profitable opportunities due to perceived high risks.

6. Overconfidence:
   - Overestimating one's abilities can lead to excessive risk-taking without proper assessment.

7. Recency Bias:
   - Recent events strongly influence decision-making, causing investors to extrapolate recent experiences into future expectations, potentially leading to risky behavior.

8. Behavioral Patterns:
   - Personal factors influence saving and investing habits, with behavioral tests aiding in understanding individuals' tendencies.

9. Investor Interest:
   - Investment decisions sometimes prioritize personal interests over suitability, leading to concentrated and risky portfolios.

10. Ethical Standards:
   - Adherence to ethical principles fosters disciplined investing and long-term wealth building, contrasting with shortcut-seeking behavior.

These biases can limit information gathering and risk evaluation. It's prudent for investors to conduct thorough analysis and seek advice from Registered Investment Advisors or Mutual Fund Distributors to mitigate behavioral biases in investment decisions.

Quiz: Behavioral Biases in Investment Decision Making:

1. What behavioral bias involves placing too much emphasis on recent events?
   A) Overconfidence bias
   B) Anchoring bias
   C) Recency bias
   D) Confirmation bias

2. Which behavioral bias involves the tendency to follow the crowd?
   A) Herding bias
   B) Loss aversion bias
   C) Availability bias
   D) Endowment bias

Answers:
1. C) Recency bias
2. A) Herding bias

Chapter 1.7 Risk Profiling

The risk profilers try to ascertain the risk appetite of the investor so that one does not sell mutual fund schemes that carry a higher risk than what the investor can handle. In order to ascertain the risk appetite, the following must be evaluated:

• The need to take risks
• The ability to take risks, and
• The willingness to take risks

Out of the above, the need to take risks arises when the investor needs higher returns to reach one's goals. The ability to take risk refers to the financial ability, and the investment horizon, whereas the willingness is linked to the psychological capacity to handle risk. The distributor has to evaluate these three, and strike a balance between them, whenever there is a conflict. There are various approaches to creating the risk profile of the investor. The distributor is free to choose from these options. Alternatively, one can also design one's own method or tools for the same, based on the brief discussion mentioned above.

Quiz : 1.7 Risk Profiling

1. What is the purpose of risk profiling?
   A) To increase risk
   B) To ignore risk
   C) To assess risk tolerance and suitability
   D) To avoid investments

2. Which factor is NOT typically considered in risk profiling?
   A) Investment goals
   B) Time horizon
   C) Risk aversion
   D) Investment returns

Answers:
1. C) To assess risk tolerance and suitability
2. D) Investment returns

1.8 Understanding Asset Allocation
Asset allocation involves dividing an investment portfolio among different asset categories like stocks, bonds, and cash. The allocation depends on the investor's risk tolerance, time horizon, and financial goals. The primary objective of asset allocation is to optimize the risk-return tradeoff based on an individual's specific needs. Strategies for asset allocation include:

Strategic Asset Allocation: Setting target allocations and periodically rebalancing the portfolio to maintain these targets.
Tactical Asset Allocation: Allowing for short-term deviations from the strategic allocation to take advantage of market opportunities.
Dynamic Asset Allocation: Continuously adjusting the portfolio based on changing market conditions and the investor's risk profile.
Asset allocation is a critical component of portfolio management and significantly influences the overall performance of an investment portfolio.

Quiz Questions:

What does asset allocation aim to achieve?

A. Maximizing tax benefits
B. Balancing risk and return
C. Reducing investment costs
Answer: B
Which factor influences asset allocation decisions?

A. Investor's favorite companies
B. Investor's time horizon
C. Market rumors

Answer: B

1.9 Do-it-yourself versus Taking Professional Help

Investors can choose to manage their own investments (Do-it-yourself or DIY) or seek help from financial advisors. DIY investing involves conducting one's own research, selecting investments, and managing the portfolio. This approach requires significant knowledge, time, and effort. On the other hand, professional help involves hiring financial advisors who provide expertise, personalized advice, and ongoing management of investments. Advisors can help with financial planning, asset allocation, and risk management.

Advantages of DIY investing include lower costs and greater control over investment decisions. However, it may lead to suboptimal decisions due to lack of expertise or emotional biases. Professional help can provide valuable guidance and potentially better investment outcomes, though it may come with higher fees.

Quiz Questions:

What is a potential advantage of taking professional help for investments?

A. Lower fees
B. Expert guidance
C. Guaranteed returns
Answer: B
What is a key consideration for DIY investing?

A. Investment in only one asset class
B. Extensive market knowledge
C. Dependence on financial advisors
Answer: B