UNIT 1 INTRODUCTION TO INVESTMENT

Objectives

After reading this unit, you should be able to:

- Explain the concept of investment;
- Understand the difference between speculation and gambling;
- Explain the investment environment;
- Know different types of investment.

Structure

1.1 Introduction

1.2 Concept of investment

1.3 Speculation and Gambling

1.4 Investment Objectives

1.5 Investment Environment

1.6 Types of Investments

1.7 Investment Process

1.8 Summary

1.9 Key words

1.10 Self Assessment Questions

1.11 Further Readings

1.1 INTRODUCTION

Individuals like you invest money for various reasons. It could be:

- You or your family may be earning more than what is required for monthly expenses and thus would like to keep the money in a safe place and also allow the savings to earn a return during the period.
- You may not have regular surplus but may get occasional one-time surplus earnings such as annual bonus from your employer or sale of some family property. You would like to keep such money for some time, when you don't required, in some safe place and also allow such savings to earn a return during the period.

We also invest money on education of our children like our parents did. Just as individuals do, organizations too invest to increase revenue. For example, you might have read news items like X Industries investing ₹1000 Cr. for expansion of its petrochemical division.

ignou
THE PEOPLE'S
UNIVERSITY

The above examples underline the following characteristics of an 'investment' decision: One, it involves the commitment of funds available with you or that you would be getting in the future. Two, the investment leads to acquisition of a plot, house, or shares and debentures. Three, the physical or financial assets you have acquired is expected to give certain benefits in the future periods. The benefits may be in the form of regular revenue over a period of time like interest or dividend or sales or appreciation after some point of time as normally happens in the case of investments in land or precious metals.

The investment decisions relate to financial assets bulk of which comprises pieces of paper evidencing a claim of the holder (i.e., investor) over the issuer (i.e., user of funds). For example, when you buy shares of, say, A or B organization, the share certificate that is handed over to you is a piece of paper which testifies your ownership of the number of shares stated in the certificate. It represents your financial claim (as a holder of the said shares) over A or B, (as issuers of the shares). The same can be said for any security like a debenture, a warrant a convertible, etc., of an organization. Unlike promoters of organizations, several buyers of these securities hold them for limited period and then sell them. The reasons for selling the financial assets could vary from person to person. If an investor needs money for other expenditure like marriage or education, s/he could sell some of the financial assets like shares/ bonds. Similarly, if an investor finds that her/his expected return for the financial asset is realized, s/he can sell the same and use the money to buy some other securities. It is also possible that some of these high-risk takers speculate in financial securities. Investors of different kinds look out for investments, which can be sold in organized markets with ease and at best obtainable prices. Financial assets, which are tradable with ease and at best prices in organized markets, are known as 'marketable securities'. In this unit we are going to study various aspects of investment.

1.2 CONCEPT OF INVESTMENT

It may be appropriate at this juncture to define the term 'investment' in a general sense. Investment takes place when an investor postpones her/his consumption, which is initially converted into savings and subsequently into investments. By not spending the entire amount of your salary, you are saving a part of your salary income for the future needs. Savings of this kind run into risk of loss of value because of inflation. In order to prevent erosion of value of your savings, the amount saved has to be invested at least by depositing the amount in savings bank account. You have several options if the money you are saving is not required in the near future and the number of options increases further, if you are willing to assume a bit of risk in your investment. Remember without taking risk, it is not possible to expect a higher return. Some of the investment options available to you are time deposit (fixed deposit) of bank, bonds and debenture of financial institutions or organizations, mutual funds, futures, options, etc.

It is interesting to observe that all investment decisions arise from a 'trade-off' between current and future consumption. An example would make this idea clear. We can assume an individual who has ₹ 50,000, which s/he can either spend on current consumption or invest, say, for one year at 11 per cent interest. This person's current consumption (Co) can range from ₹ zero (when s/he invests the whole of ₹ 50,000) to ₹ 50,000 (when s/he does not invest a single rupee).

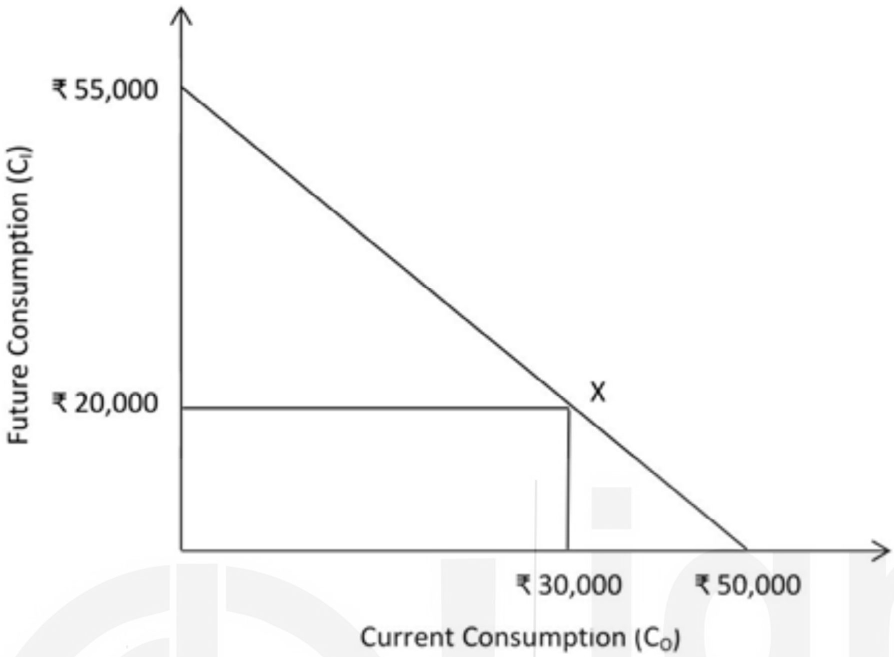

Figure 1.1: Trade-off between present and future consumption

Similarly, her/his future consumption (C_1) can be as high as ₹ 55,500 (when s/he invests the whole of ₹ 50,000 at 11 per cent per annum and ends up with a total wealth of ₹ 50,000 + ₹ 5,500 = ₹ 55,500 at the end of the year, ₹ 5,500 being interest earnings on ₹ 50,000 at 11 per cent) to as low as ₹ zero (when s/he consumes the whole of ₹ 50,000 right now).

In most such cases, individuals would consume a part and invest the rest. Such a situation is called a 'trade-off' between current and future possibilities for our hypothetical individual on the trade-off function. Our investor is on point `X' which suggests that 's/he spends ₹ 30,000 today and invests the balance ₹ 20,000 to get a total sum of ₹ 22,000, which includes interest of ₹ 2,000, at 11 per cent after one year.

Having defined 'investment' in terms of 'postponed consumption' we must get ready to answer an inescapable question viz., why should a person postpone her/his present consumption? This question acquires added significance because we know that individuals generally prefer current consumption to future consumption. And if they are required to invest or postpone current consumption there must be commensurate inducement. This underlines the need for a positive rate of return on all potential investment without which a person would prefer to consume all her/his income today rather than tomorrow. Such an investment /consumption behaviour is based on an important concept known as 'time value of money'. This concept signifies 'a rupee today is worth more than tomorrow'. The 'tomorrow' must promise a larger wealth to give incentive to forego current consumption. The next natural question is how much the return should s/he larger to attract investment?

You will readily notice that a nominal rate of return may well be fully swallowed away by the inflation. For example, if you earn an interest rate (nominal) of 11 per cent for one year on your investment and face the threat of 11 per cent price rise (inflation) too during that year, where do you stand in terms of purchasing power of your money? What happens in a situation like this is that the 11 per cent nominal return is neutralized by 11 per cent inflation and you remain after one year where you were a year ago. It is, therefore, natural that an investor would be induced to postpone consumption today only if her/his command over goods and services does not get diluted over time. Thus, if s/he gets 11 per cent nominal interest and 11 per cent is the rate of inflation, her/his real rate of return would be zero. In the event of inflation what induce investors to postpone current consumption are the real rate of return and not just the monetary rate of return. There is yet another dimension to the rate of return as an incentive to invest. For example, if a person buys, say, government securities s/he is completely assured of all payments viz., interest and principal. In such cases, a relatively lower rate of return is adequate as an incentive. But if the avenue of investment is an organization's debenture, the probability of default does exist even if the rate of interest and the repayment schedules are known in advance. The investor here perceives some risk and would insist upon an additional compensation. In other words, the investor requires a risk premium over and above the risk free rate.

This extra reward or risk premium would have to be substantially greater in the case of shares of organizations where the dividend rates are not ascertainable in advance and where payment of such dividends and invested sums are not at all assured. What we are trying to underline through these examples is the 'risk' factor which affects the expected rates of return by investors. In all these cases, investors demand a risk premium. It would thus be seen that the investor's required rate of return would be an aggregate of the risk-free real rate, expected rate of inflation, and risk premium.

Investments in securities on average offer adequate return to compensate the risk assumed by the investors. But one has to wait for a longer period to realize such extra return for the additional risk assumed particularly in case of investments in stocks. In other words, if the holding period of an investment is short, then high-risk securities may not offer adequate return to compensate the risk, you have assumed. You might have recognized the existence of 'speculators' in the securities markets. They invest in high risk securities for a short period and hence exposed to high level of risk.

1.3 SPECULATION AND GAMBLING

Speculation and gambling are two distinct ways of increasing wealth in the face of risk or uncertainty. However, in the world of investing, these two terms are very different. Gambling is the act of putting money into an event with an uncertain outcome in the hope of winning more money, whereas speculation is the act of taking a calculated risk in an uncertain outcome. Speculation involves some sort of expected positive return on investment, even if the end result is a loss. While the expected return on gambling is negative for the player, some people may be fortunate and win.

Speculation

Before engaging in a financial transaction, speculators calculate risk and conduct research. A speculator buys or sells assets in the hope of making a larger profit than he risks. A speculator takes risks, knowing that the more risk they take, the greater is their potential gain. They are also aware that they may lose more than they gain.

An investor, for example, may speculate that a market index will rise due to strong economic data by purchasing one contract in one market futures contract. If their analysis is correct, they may be able to sell the futures contract for a higher price than they paid in the short to medium term. However, if they are incorrect, the investor may suffer a loss greater than expected.

Speculator vs Investor

Speculators may lose their entire wealth or become rich in a short period of time. How are they different from that of normal investors? We can distinguish the two operators as follows:

i) The time-horizon of a speculator is short while that of the investor is long.

ii) The investor expects a 'good' return and a consistent performance over time but the speculator expects abnormal returns earned quickly over short periods.

iii) The investor generally sticks to her/his investment, but the speculator makes rapid shifts to greener pastures. S/he moves from one stock to other for a small profit.

iv) The investor is risk-averse but the speculator takes greater risks. Often, speculators take risk by entering into margin trading (i.e. use borrowed funds) to increase the volume and her/his exposure in the market.

If speculation is high-risk game, why do exchanges allow such trading? They essentially provide liquidity for the securities and often match the demand and supply of the market.

For example, positive news on an organization may attract a large demand for the stock. In the absence of any sellers, the price will shoot up. Some speculators may take a different view and are willing to sell the stock to meet the excess demand of the market. Similarly, a mutual fund may wants to sell 1 lakh shares of an organization. If there are limited buyers for the stock, the stock price would crash. Again, speculators would buy the stock in anticipation of selling the same at a small profit once the demand for the stock picks up in the market.

Gambling

Gambling, in contrast to speculation, is a game of chance. The odds are generally stacked against gamblers. When gambling, the chances of losing an investment are usually greater than the chances of winning more than the investment. Gambling, as opposed to speculation, carries a higher risk of loss.

For example, a gambler opts to play a game of American roulette instead of speculating in the stock market. Only single numbers are bet on by the gambler. The payout, however, is only 35 to 1, while the odds against them winning are 37 to 1. So, if a gambler bets $2 on a single number, their potential gambling income is $160 (80*$2), but their chances of winning are about 1/37.

Key Differences

Although there are some superficial similarities between the two concepts, a strict definition of both speculation and gambling reveals the fundamental differences. A standard dictionary defines speculation as a risky type of investment, whereas investing means to invest money in something that offers profitable returns, particularly interest or income. According to the same dictionary, gambling is defined as participating in any stakes game. To stake or risk money or anything of value on the outcome of something involving chance; bet; wager is gambling.

The act of conducting a financial transaction that has a significant risk of losing value but also holds the expectation of a significant gain or other major value is referred to as speculation. The risk of loss in speculation is more than offset by the possibility of a large gain or other recompense. Some market professionals regard speculators as gamblers, but a healthy market includes not only hedgers and arbitrageurs, but also speculators. A hedger is a risk-averse investor who purchases positions that are diametrically opposed to those already held. If a hedger owned 500 shares of Marathon Oil and was concerned that the price of oil would soon fall significantly, they could short sell the stock, purchase a put option, or use one of the other options of hedging strategies.

While speculation is risky, it frequently has a positive expected return, even if that return never materialises. Gambling, on the other hand, always has a negative expected return—the house always wins. Gambling tendencies go much deeper than most people realise and far beyond the standard definitions. Gambling can take the form of feeling the need to socially prove oneself or acting in a way to be socially accepted, which leads to action in a field one knows little about.

Market gambling is frequently seen in people who do it primarily for the emotional high they get from the excitement and action of the markets. Finally, relying on emotion or a must-win attitude to generate profits rather than trading in a methodical and tested system indicates that the individual is gambling in the markets and is unlikely to succeed over a long period of time.

Activity 1

i) A young couple buys a flat for ₹ 30 lakh with a 25 per cent down payment and the balance in 100 equal monthly instalments. Would you consider the investment a case of postponed consumption? Justify.

....

....

....

....

ii) Distinguish between a speculator and an investor.

....

....

....

....

1.4 INVESTMENT OBJECTIVES

Asset managers use investment objectives to determine the best portfolio mix for a client. The investment objective guides the selection of investments. An investor questionnaire frequently defines financial goals and objectives and determines portfolio asset allocation based on an individual's time horizon, risk tolerance, and financial situation. Features of investment goals are as follows:

- A set of goals that determines an investor's financial portfolio is known as an investment objective.
- Using an investment objective, a financial advisor determines the best strategy for achieving the client's objectives.
- The risk tolerance and time horizon of an investor aid in determining an investment goal.

Understanding an Investment Goal

An individual's investment objective, which is typically based on one of four strategies that include income, growth, and income, growth, or trading, clarifies investment ideas to help achieve an individual's financial goals.

Individuals may provide information such as annual income and net worth, average annual expenses, timeline for withdrawing funds, and the maximum decrease in the value of the portfolio with which the investor is comfortable. The portfolio is tailored based on the answers to these questions, and a strategy is defined as an investment goal.

Tolerance for Risk

Risk tolerance is the level of risk that an investor is willing to accept given the volatility of an investment's value. A client with a high risk tolerance who is looking for growth may have a short-term aggressive portfolio comprised of stocks and trading opportunities. A balanced portfolio of growth and income instruments, including stocks and bonds, may be appropriate for a moderate-risk investor. A conservative investor with a low risk tolerance may concentrate on an income-producing portfolio comprised of dividends and bonds.

Factors Influencing a Person's Investment Goal

Other factors that influence an individual's investment decisions, in addition to time horizon and risk profile, include income, capital gains tax, dividend tax, commission and fees for actively managed portfolios, and total wealth, which may include assets such as Social Security benefits, expected inheritance, and pension value.

Questionnaire on Investment Objectives

Investors can find a variety of free questionnaires on brokerage websites. When deciding not to use a personal advisor, however, it is critical to review the questionnaire's assumptions and limitations as well as accept the organization's terms and conditions. Because the information that will be provided is highly sensitive, an investment objective is typically not formally completed until a client has decided to use the services of a financial planner or advisor.

When an investor's financial circumstances or goals change, it may be beneficial to re-complete an investment objective questionnaire and reallocate investments in a portfolio.

Types of investment objectives

There are two types of investiment objectives viz.a.viz. primary and secondary investment objectives. There are discussed below.

Primary Investment Objectives

Safety

Everyone wants their money to be safe and secure. If you are a conservative investor who wants to receive their initial capital investment on time and without losses, then the safety objective is critical to you. However, you should be aware that no investment is completely risk-free. However, if your primary goal is safety, you can make investments with low or reduced risks. Naturally, the returns on these investments will be low and may not keep pace with rising inflation. Government bonds, bank securities, and money market instruments are examples of safe investment objectives.

Capital Gain

When you want to grow your wealth, capital gain or capital appreciation is an important investment goal. While safety is critical, many people invest heavily in order for it to grow. Capital gains can be obtained through conservative growth, aggressive growth, or speculation.

Conservative growth refers to the process by which investors construct an investment portfolio that will generate wealth over time. When investors make a risky investment in stocks, they are looking for both short and long-term gains. Speculation occurs when investors attempt to maximise returns by trading shares and securities through share price speculation. Capital gains necessitate a great deal of forecasting and determining which stock to buy when. They also attract taxes.

Income

The income investment objective, as the name implies, means investing to generate a source of income for you. Dividends, interest, and yields are all forms of income. These investment goals have a high level of risk and low stability, but they also have higher returns. Income objectives are popular among conservative investors due to their attractive returns and ability to keep up with inflation. The stock market is an example of an income investment objective; it has high risks and high returns.

Secondary Investment Objectives

Liquidity

Another investment goal is the liquidity of the investment you make. The ability to instantly trade/sell/convert assets into cash with ease in the market and with minimal risk of loss is referred to as liquidity. While some securities are easier to liquidate than others, this is not always the case. Most investors prefer to invest in securities that are easy to liquidate and use in an emergency. They try to keep a portion of their total investments in readily marketable securities, if not entirely. If liquidity is one of your primary goals, you should consider investing in such securities as well.

Tax Savings

Did you know that capital gains income is taxed differently than ordinary income? Yes, taxes on such income are lower than taxes on interest or salary-based income. As a result, tax savings are a popular investment goal for many people. Tax-free savings accounts and the National Pension Scheme are two examples of tax-saving investments. Furthermore, life insurance policies and tax-saving mutual funds are popular ways to save taxes while earning good returns. Actual returns on investment are after-tax returns. As a result, before making an investment decision, it is best to research and learn about all tax considerations and exemptions available to you in order to reduce your tax burden.

1.5 INVESTMENT ENVIRONMENT

A reading of the earlier sections has provided some understanding on the basic principles of investment. Suppose you are able to frame your investment objective and also identified securities that are to be purchased. Now you need to deal with the market for the purchase and sale of securities. An understanding of the operational details of the market would be useful. Investment decisions to buy/sell securities taken by individuals and institutions are carried through a set of rules and regulations. There are markets - money and capital - that function subject to such rules and established procedures and are, in turn, regulated by legally constituted authority. Then there are securities or financial instruments which are the objects of purchase and sale. Finally, the mechanism, which expedites transfers from one owner to another, comprises a host of intermediaries. All these elements comprise the investment environment. Investors have to be fully aware of this environment for making optimal investment decisions.

The **three elements** of the investment environment are as follows:

FINANCIAL INSTRUMENTS

Financial assets or instruments can be classified in a variety of ways. We will classify them into creditorship and ownership securities on the basis of the nature of the buyer's commitment. The description will then be split into public and private issues differentiating the two major forms of issuance.

Creditorship Securities

Debt instruments furnish an evidence of indebtedness of the issuer to the buyer. Periodic payments on such instruments are generally mandatory and all of them provide for the eventual repayment at maturity of the principal amount. Securities may also be sold at a price below the eventual redemption price, the difference between the redemption price and the sale price constituting the interest. For example, a buyer of a ₹ 100 bond/debenture may receive an interest at 6 per cent for one year in one of the following ways:

a) s/he pays ₹ 100 at the time of investment and receives ₹ 106 at the end of one year, or

b) s/he pays ₹ 94:30 at the beginning and receives ₹ 100 at maturity i.e., s/he receives 6 per cent of ₹ 94.30 that is equal to the difference between ₹ 100 (redemption price) and ₹ 94.30 (issue price).

The latter arrangements are known as zero-interest bonds. The interest amount in rupees measured as a percent of the par value of a debt instrument is known as nominal or coupon rate of interest. For example, ₹ 28 payable per year on a debenture whose face/par value is ₹ 200 yields a coupon rate of 14 per cent per annum.

Debt instruments can be issued by public bodies and governments and also by private business organizations.

Public Debt Instruments: Government issues debt instruments for long and short periods. They are rated the best in terms of quality and are risk-free. A common term used to designate them is 'gilt-edged-securities'. The 182-day treasury bills issued by the Government of India are examples of short-term instruments. State governments and local bodies also issue series of loans and bonds. Banks, insurance, pension and provident funds, and several other organizations buy government debt instruments in compliance with their statutory obligations. Such debt instruments are usually over-subscribed. You can refer money market page of any one of the financial dailies, where you can find the list of short-term and long-term securities that were bought and sold on a particular day.

Private Debt Instruments: These are issued by private business organizations, which are incorporated as organizations under the Organizations Act, 1956. Generally these instruments are secured by a mortgage on the fixed assets of a organization. In addition to plain debt instruments, there are several variations. A very popular variety of such debentures are'convertible' whereby either the whole or a part of the par value of a debenture is convertible (either automatically or at the option of investors) on the expiry of a stipulated period after issue. The terms of conversion are stated in advance. There may be a series of conversions and conversion price may differ from period to period.

The PSU bonds are issued to the general public and financial institutions by public sector undertakings, usually with tax incentive. It is interesting to note that a large proportion of PSU bonds are privately placed with banks, their subsidiaries, and financial institutions. Certificates of Deposits (CDs) were introduced in June 1989. Commercial banks are permitted to issue CDs within a ceiling equal to 2 per cent of their fortnightly average outstanding aggregate deposits. The maturity of 3 months at the short-end and one-year at the longer end was generally popular with investors. Interest rates for CDs are normally higher than the interest rate offered by the bank for similar maturity period deposits.

Ownership Securities: These instruments are called 'equities' because investors who invest in them get a right to share residual profits. Equity investment may be acquired indirectly or directly or even through a hybrid instrument known as preference shares. They are discussed in this order.

Indirect Equities: The investor acquires special instruments of institutions, who take the buy-sell decisions on behalf of investors. Such institutions are Unit Trust or Mutual Funds. An individual who buys Units gets a dividend from the income of the Trust/Mutual Fund after meeting all expenses of management. The Units can be bought from and sold to the institution at sale and repurchase prices announced from time to time (on a daily basis). Many mutual funds schemes are also listed in stock exchanges and investors can also sell and purchase the Units through secondary markets. The objective of Trusts and Mutual Funds is to use their professional expertise in portfolio construction and pass on the benefits to the small investor who cannot repeat such a performance if left alone to subscribe to equity shares directly.

Direct Equities: The investor can subscribe directly to the equity issues placed on the market by the new organizations or by the existing organizations. If s/he is already a shareholder of an existing organization, which enters the capital market for additional issue of equity shares, such an investor would get a pro rata right to subscribe, on a pre- emptive basis, to the new issue. Such offerings are known as 'rights shares'. Established organizations reward their shareholders in the form of 'bonus shares' also. They are given out of the accumulated reserves and shareholders need not pay any cash consideration as happens in the case of `right shares'. For example, an organization may announce a bonus issue on a one-for-one basis. This amounts to a 100 per cent bonus issue (or, loosely stock dividend) so that the number of shares held by a shareholder after the bonus would be doubled. The chances for an increase in the potential dividend income become very bright and this would happen unless the organization imposes a proportionate cut in future dividends. Thus, a shareholder, who held 100 shares of ₹ 100 each in an organization, got a dividend income of ₹ 2000, the dividend announced being 20 per cent. His shareholding after a 100 per cent bonus now increases to 200. Now, if the organization maintaining the same rate of dividend as last year viz., 20 per cent, the dividend income of the shareholder would go up to ₹ 4000.

A less popular instrument is called ‘preference share’. It is neither full debt nor full equity and is, therefore, recognized as a ‘hybrid security’. Such a shareholder would have certain preference over equity shareholder. They may relate to dividends, redemption, participation, and conversion, etc. The most common is with regard to dividends which, when not paid for any particular year, get accumulated and no equity dividend would be payable in future until such accumulated areas of preference dividend are cleared. The dividend rate on these shares is normally less than the one on equity shares but greater than interest rate.

Activity 2

Study the main trends and conclusions with regard to the size and relative popularity of various instrument of finance from different sources. Note down top 20 stocks in term of trading volume in NSE from the NSE website for a day. Collect data with regard to the dividend and earnings record of any 10 organizations.

....

....

....

....

FINANCIAL INTERMEDIARIES

Financial intermediaries perform the intermediary function i.e., they bring the users of funds and the suppliers of funds together. Many of them issue financial claims against themselves and use cash proceeds to purchase the financial assets of others. The Unit Trust of India and other mutual funds belong to this category.

Most financial institutions underwrite issues of capital by non-governmental public limited organizations in addition to directly subscribing to such capital either under a public issue or under a private placement.

The financial institutions engaged in intermediary activities include the Industrial Development Bank of India, Industrial Finance Corporation of India, Industrial Credit and Investment Corporation of India, Unit Trust of India, Life Insurance Corporation, and General Insurance Corporation. Two institutions, which have broadened financial services activities in India, deserve a special mention. They are: The Credit Rating Information Services of India Ltd., (CRIS1L) and other credit rating agencies, and the Stockholding Corporation of India Ltd. (SHCIL).

CRISIL, the first credit rating agency of the country, was set up jointly by ICICI, UTI, LIC, GIC, and Asian Development Bank. It started operations in January 1988 and has rated a large number of debt instruments and public deposits of organizations. CRISIL ratings provide a guide to investors as to the risk of timely payment of interest and principal on a particular debt instruments and preference shares on receipt of request from a organization. Ratings relate to a specific instrument and not to the organization as a whole. They are based on factors like industry risk, market position and operating efficiency of the organization, track record of management, planning and control system, accounting, quality and financial flexibility, profitability and financial position of the organization, and its liquidity management.

The SHCIL was sponsored by IDBI, IFCI, ICICI, UTI, LIC, GIC and IRBI to introduce a book entry system for the transfer of shares and other types of scripts replacing the present system that involves voluminous paper work. The corporation commenced its operations in August 1988.

FINANCIAL MARKETS

Securities markets can be seen as primary and secondary. The primary market or the new issues market is an informal forum with national and even international boundaries. Anybody who has funds and the inclination to invest in securities would be considered a part of this market. Individuals, trusts, banks, mutual funds, financial institutions, pension funds, and for that matter any entity can participate in such markets. Organizations enter this market with initial and subsequent issues of capital. They are required to follow the guideline prescribed by the regulating agencies like SEBI from time to time unless they are expressly exempted from doing so. A prospectus or a statement-in-lieu of prospectus is a necessary requirement because this contains all material information on the basis of which the investor would form judgment to put or not to put his money. Concealment and misrepresentations in these documents have serious legal implications including the annulment of the issue.

Some organizations would use the primary market by using their 'in house' skill but most of them would employ brokers, broking and underwriting organizations, issue managers, lead managers for planning and monitoring the new issue. New guidelines are periodically issued by the Securities & Exchange Board of India (SEBI).

Secondary markets or stock exchanges are set up under the Securities Contracts (Regulation) Act, 1956. They are known as recognized exchanges and operate within precincts that possess networks of communication, automatic information scans, and other mechanized systems. Members are admitted against purchase of a membership card whose official prices vary according to the size and seniority of the exchange. Membership cards generally command high unofficial premia because the number of members is not easily expandable. Business was earlier transacted on the trading floor within official working hours under the open bid system. Today, all exchanges in India have introduced screen-based trading where the members of the exchange transact the business (purchase and sale of securities) through computer terminals.

1.6 TYPE OF INVESTMENTS

You have a lot of options for where to put your money as an investor. It is critical to carefully consider the various types of investments. Within each bucket, there are numerous investment options.

Here are six types of investments to consider for long-term growth, along with information about each. We won't discuss cash equivalents, such as money markets, certificates of deposit, or savings accounts, because those types of investment accounts are more concerned with keeping your money safe than with growing it.

- Stocks
- Bonds
- Mutual funds
- Index funds
- Exchange-traded funds (ETFs)
- Options

Stocks

A stock is a financial investment in a particular organization. When you buy a stock, you are purchasing a share — a small portion of the organization's earnings and assets. Organizations sell shares of stock in their businesses to raise cash; investors can then buy and sell those shares among themselves. Stocks can produce high returns, but they also carry a higher level of risk than other investments. Organizations' values can fall or they can go out of business. Read our complete stock explanation.

How investors profit: Stock investors profit when the value of the stock they own rises and they can sell it for a profit. Some stocks also pay dividends, which are regular distributions of profits to shareholders.

Bonds

Bonds are loans made to organizations or governments. When you buy a bond, you are giving the bond issuer permission to borrow your money and pay you back with interest.

Bonds are considered less risky than stocks, but they may provide lower returns. As with any loan, the primary risk is that the issuer will default. Government bonds issued by the United States are backed by the country's "full faith and credit," effectively eliminating that risk. State and local government bonds are generally thought to be the least risky option, followed by corporate bonds. In general, the lower the interest rate, the less risky is the bond.

Investors anticipate regular income payments. Investors typically receive interest in regular installments, typically once or twice a year ,and the total principal is paid off when the bond matures.

Mutual funds

If picking and choosing individual bonds and stocks doesn't appeal to you, you are not alone. In fact, there is an investment specifically designed for people like you: the mutual fund.

Mutual funds enable investors to buy a diverse range of investments in a single transaction. These funds pool money from multiple investors and then hire a professional manager to invest it in stocks, bonds, or other assets.

Mutual funds adhere to a specific strategy — for example, a fund may invest in a specific type of stock or bond, such as international stocks or government bonds. Some mutual funds hold both stocks and bonds. The mutual fund's risk level is determined by the investments it holds. Learn more about mutual funds and how they work.

How investors make money: When a mutual fund earns money, such as through stock dividends or bond interest, a portion of it is distributed to investors. When the value of the fund's investments rises, the value of the fund rises as well, implying that you could sell it for a profit. To invest in a mutual fund, you must pay an annual fee known as an expense ratio. the investments within the fund. Learn more about mutual funds and how they work.

ETFs are short for exchange-traded funds.

ETFs are index funds that track a benchmark index and attempt to replicate its performance. They, like index funds, are less expensive than mutual funds because they are not actively managed.

The major difference between index funds and ETFs is how ETFs are purchased. They trade on an exchange like stocks, so you can buy and sell ETFs at any time, and their prices fluctuate throughout the day. Mutual funds and index funds, on the other hand, are priced once per trading day and remain the same regardless of when you buy or sell. Bottom line: For many investors, this distinction is insignificant, but if you want more control over the fund's price, an ETF may be preferable. Here's more information on ETFs.

How investors make money: As with mutual funds and index funds, your hope as an investor is that the fund's value will rise and you will be able to sell it for a profit. Investors may also receive dividends and interest from ETFs.

Options

An option is a contract to buy or sell a stock at a predetermined price and by a predetermined date. Because the contract does not obligate you to buy or sell the stock, options provide flexibility. As the name suggests, this is an option. The majority of option contracts are for 100 shares of a stock.

When you purchase an option, you are purchasing the contract rather than the stock. You can then buy or sell the stock at the agreed-upon price and time; sell the options contract to another investor; or let the contract expire.

1.7 INVESTMENT PROCESS

A lot of planning is required while investing your hard-earned money in securities. Often investors lose money when they make investments without any planning. They make hasty investment decision when the market and economy was at its peak based on some recommendation. Many investors who invested before the stock market crash are yet to recover their losses. This is a result of lack of planning and to an extent greed. Both are not good for making a decent return on investment. A typical investment decision undergoes a five-step procedure, which in turn forms the basis of the investment process. These steps are:

1) Determine the investment objectives and policy

2) Undertake security analysis

3) Construct a portfolio

4) Review the portfolio

5) Evaluate the performance of the portfolio

You may note at the very outset that this five-step procedure is relevant not only for an individual who is on the threshold of taking his own investment decisions but also for individuals and institutions who have to aid and work out investment decisions for others i.e., for their clients. The investment process is a key-process entailing the whole body of security analysis and portfolio management. Let us, now, discuss the steps involved in the investment process in detail:

1. **Investment objectives and Policy**

The investor will have to work out her/his investment objectives first and then evolve a policy with the amount of investible wealth at her/his command. An investor might say that his objective is to have 'large money'. You will agree that this would be a wrong way of stating the objective. You would recall that the pursuit of 'large-money' is not possible without the risk of 'large losses'. The objective should be in clear and specific terms. It can be expressed in terms of expected return or expected risk. Suppose, an investor can aim to earn 12% return against the risk-free rate of 9%. It means the investor is willing to assume some amount of risk while making investment. Alternatively, the investor can set her or his preference on risk by stating that the risk of investment should be below market risk. In specific terms, she or he can say that beta of the portfolio has to be 0.80. If the investor defines one of the two parameters of investment (return or risk), it is possible to find the other one because a definite relationship exists between the two in the market. It may not be possible for you to define both return and risk because it may not be achievable. For example, if you want to earn a return of 12% with zero risk when government securities offer a return of 9%, it would not be possible to develop an investment for you. Thus, it is desirable to set one of the two parameters (risk or return) and find the other one from the market. If necessary, an investor can revise the objective if sheik finds the risk is too high for her/him to bear a desired return. Though setting an investment objective is good, many investors fail to do the same and blindly invest their money without bothering the risk associated with such investments. Investments are bound to fail if an investor ignores this point.

The next step in formulating the investment policy of an investor would be the identification of categories of financial assets he/she would be interested in. It is obvious that this in turn, would depend on the objectives, amount of wealth and the tax status of the investor. For example, a tax-exempt investor with large investible wealth like a pension/provident fund would invest in anything but tax-exempt securities unless compelled by law to do so. Some investors may entirely avoid derivatives because of high risk associated with such investments. Some investors may invest more in equities to earn higher return but use derivatives to reduce additional risk. As in consumer products, financial products also come With different colours and flavors and one has to be highly knowledgeable before selecting appropriate securities.

2. **Security Analysis**

After defining the investment objective and broadly setting the proportion of wealth to be invested under different categories, the next step is selecting individual securities under each category. For instance, if an investor sets 50% of her/his wealth to be invested in government securities, the next question is which of the government securities that the investments should be made. It should be noted that not all government securities are one and the same. A long-term government bond is much riskier than short-term bonds. Similarly, investment in equities requires identification of organizations stocks, in which the investment can be made. Security analysis is often performed in two or three stages. The first stage, called economic analysis, would be useful to set broad investment objective. If the economy is expected to do well, investor can invest more in stocks. On the other hand, if the economic slowdown is expected to continue, investor can invest less in stocks and more in bonds. In stage two, investors typically examine the industries and identify the industries, in which investment can be made. There are several classifications of industry, which we will discuss in a separate unit. Investments need not be made in any one specific industry because many of the stocks may be overpriced in a growth industry. It is better to look for three to five industries and it depends on individual's choice. The issue is an analysis of broad trends of industry and future outlook is essential to proceed further on security analysis.

As the last step, one has to look into the fundamentals of specific organizations and find whether the stock is desirable for investment. At this stage, investors need to match the risk-return objective she/he has set in the previous stage. Organization specific analysis includes examination of historical financial information as well as future outlook. Using historical performance and future outlook, specifically the future cash flows are projected and discounted to present value. Through such analysis, analysts quantify the intrinsic value of the stock and compare the same with current market price. If the intrinsic value is greater than the current market price, the stock qualifies for investment.

3. **Portfolio Construction**

In the previous stage, bonds and stocks, which fulfill certain conditions, are identified for investments. Under portfolio construction stage, the investor has to allocate the wealth to different stocks. A couple of principles guide such allocation of wealth. Investors need to appreciate that the risk of portfolio comes down if the portfolio is diversified. Diversification here doesn't mean more than one stock but stocks whose future performance is not highly correlated. Further, too much diversification or too many stocks may also create problem in terms of monitoring. For example, if the investor decides to invest 10% of the wealth in software sector, it would be desirable to restrict the investment in two or three stocks based on the amount of investment. On the other hand, if s/he invests in 20 software stocks, the portfolio will become too large and create practical problem of monitoring. While including stocks in the portfolio, the investor has to watch its impact on the overall portfolio return and risk and also examine whether it is consistent with the initial investment objective.

Portfolio construction is not done once for all. Since investors saving take place over a period of time, portfolios are also constructed over a period of time. It is a continuous exercise. Sometime, timing of investment may be critical. For instance, if an investor saves ₹ 30,000 during the first quarter and the desired portfolio includes both bonds and stocks, the issue before the investor is whether the amount has to be used for bonds or stocks or both. It requires some further analysis at that point of time. However, over the years, when the accumulated investments grow to certain level, subsequent yearly investments as a proportion of total investments will become smaller and hence the timing issue will become minor decision.

4. **Portfolio Revision**

Under portfolio construction, investor is matching the risk-return characteristics of securities with the risk-return of investment objective. In two conditions, the securities, in which investment was made earlier, require liquidation and investing the amount in a new security. The risk or expected return of the security might have changed over a period of time when the business environment changes. The stock might also become less risky but offer lower return. That is, when the risk-return characteristics of securities change, it will affect the desired risk-return characteristics of portfolio and hence calls for a revision of portfolio of stocks. Another reason for selling some of the securities in the portfolio and buying a new one in its place is a change in investment objective. For instance, when you are young and have less family commitments, then your investment objective may aim for higher return even if it amounts to higher risk. You may invest more of your savings in equity stocks and derivatives. When your family grows, you might want to reduce the risk and change the investment objective. Portfolio of securities has to be revised to reflect your new investment objective. There is yet another reason for revision, which we discussed earlier. When the macro-economic condition changes, you may want to shift part of your investment from equity to debt or vice versa depending on the future economic outlook.

5. **Portfolio Performance Evaluation**

The value of your investment changes over a period of time and it reflects the current market value of the securities in the portfolio. For instance, if you have made some investment in A some 10 years back, when you first started investing, the value of A today is several times more than its value some 10 years back. Few stocks could have resulted in a loss and it would be difficult to construct a portfolio of stocks only with winner stocks. Portfolio return reflects the net impact of positive and negative returns of individual securities in the portfolio. At the end of each period, you may like to compute the portfolio return and risk and compare the same with your investment objective as well as certain benchmark risk-return. The objective of this exercise is to evaluate the efficiency in construction and management of portfolio.

1.8 SUMMARY

Individuals save a part of their earnings to meet their future cash flow needs. Such savings are often invested in securities since money has a time value. Investments normally offer a positive return, which often is more than rate of inflation. Such a positive return is an incentive for individuals to increase the level of savings and help the country by creating new capital. Individuals before making investments need to understand the basic principles of investments.

- Securities are of different types and the expected return from such securities differs considerably. Government securities offer lowest return but they are also risk- free. Equities offer maximum return but they are too risky. Risk and return of securities go together.
- The starting point of investment process is clearly defining the investment objectives. Investment objectives are expressed in terms of expected return or risk and period of holding.
- Security analysis is performed to identify securities, which qualify for investments. Following the principles of portfolio management, securities are combined to achieve diversification. Portfolios are periodically revised and performance of managing the portfolio is also periodically evaluated.
- In addition to knowing the basic principles of investments, an investor is also required to know the operations of securities market. Different types of securities are traded in the market and they are broadly classified into debt and equity instruments. They are bought and sold through a set of intermediaries, which include brokers, stock exchanges, etc. All stock market intermediaries are regulated by the SEBI to ensure orderly functioning of the market.

1.9 KEY WORDS

Financial Assets : Documentary evidence of financial claim of the holder, say of shares on debentures, over the issuer.

Financial intermediation : A function, which brings the savers and users of funds together, usually performed by specialized agencies and institutions like banks and underwriters for art agreed/stipulated commission.

Investment	:	Commitment of funds for a period usually exceeding one year in expectation of a required rate of return.
Investment decision	:	The decision to acquire, hold, or dispose asset by rational and risk-averse individuals/ organizations.
Marketable securities	:	Financial claims, which are tradable in organized markets at the best prices.
Portfolio	:	A collection of two or more assets, generally employed in the context of financial assets.
Portfolio construction	:	Building up a portfolio of financial assets with consideration of selectivity, timing, and diversification or raising a portfolio with rational selection criteria, at the right time, and in a way that the risk is reduced to the minimum for a given level of expected return.
Portfolio revision	:	A review of an existing portfolio in the light of changes in risk- return dimensions.
Portfolio evaluation	:	Assessing the performance of a portfolio on the basis of some aptly developed norms or yardsticks.
Real assets	:	Physical assets held to perform an activity with an expected income/pay off profile.
Risk	:	The probability that the realized return would be different from the anticipated return of an investment.
Securities market	:	Organized and recognized trading centres, where financial claims are bought and sold as per established rules and procedures.
Zero-interest bonds	:	Creditorship securities on which a coupon rate is not made explicit but the compensation is provided through a discount on the purchase price or a premium on redemption.

1.10 SELF-ASSESSMENT QUESTIONS/EXERCISES

1. Define investment.
2. Describe the steps involved in the investment process.
3. What do you understand by investment environment
4. Explain different types of investment.

1.11 FURTHER READINGS

Chandra, P. (2018). *Investment Analysis & Portfolio Management* (5e). Tata McGraw Hill.

D Ambrosio, Charles A.(1976). *Principles of Modern Investments*, Chicago : SRA, Inc.

Fischer, D. E., Jordan, R. J., & Pradhan, A. K. (2018). *Security Analysis Portfolio Management* (7th ed.). Pearson Education.

Frank K. (1979) *Investment Analysis* & Portfolio Management, Hinsdale, Illinois : The Dryden Press.

Fuller, Russell J., and Farrell, James L. (1987). *Modern Investments and Security Analysis,* New York : McGraw-Hill Book Co. Reilly,

IIT Kharagpur [nptelhrd]. (2012). *Mod-01 Lec-01 Introduction to Investment Management* [Video]. YouTube. https://www.youtube.com/watch?v=ope5Y3Mrsaw

Jones, Charles P., Futtle, Donald L., and Heaton, Cherill P. (1977). *Essentials of Modem Investments*, New York Ronald Press.

Kevin S.(2000)., *Portfolio Management, Prentice-Hall of lndia* Pvt. Ltd., NewDelhi.

Pandian Punithavathy.(2001). *Security Analysis and Portfolio Management*, Vikas Publishing House Pvt. Ltd., New Delhi.

Reilly, F. K., Brown, K. C., Gunasingham, B., Lamba, A., &Elston, F. (2019). *Investment Analysis & Portfolio Management*. Cengage AU.

Rustagi, R. (2021). *Investment Analysis & Portfolio Management*. Sultan Chand & Sons.

Tripathi, V. (2023). *Taxmann's Fundamentals of Investments.* Taxmann Publications Private Limited.