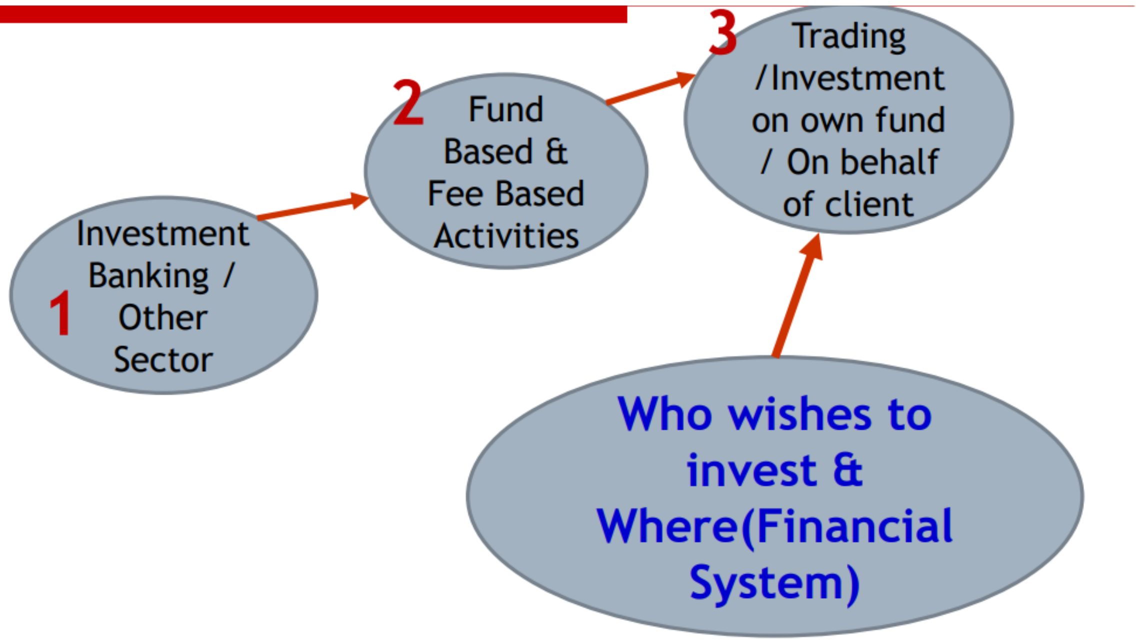
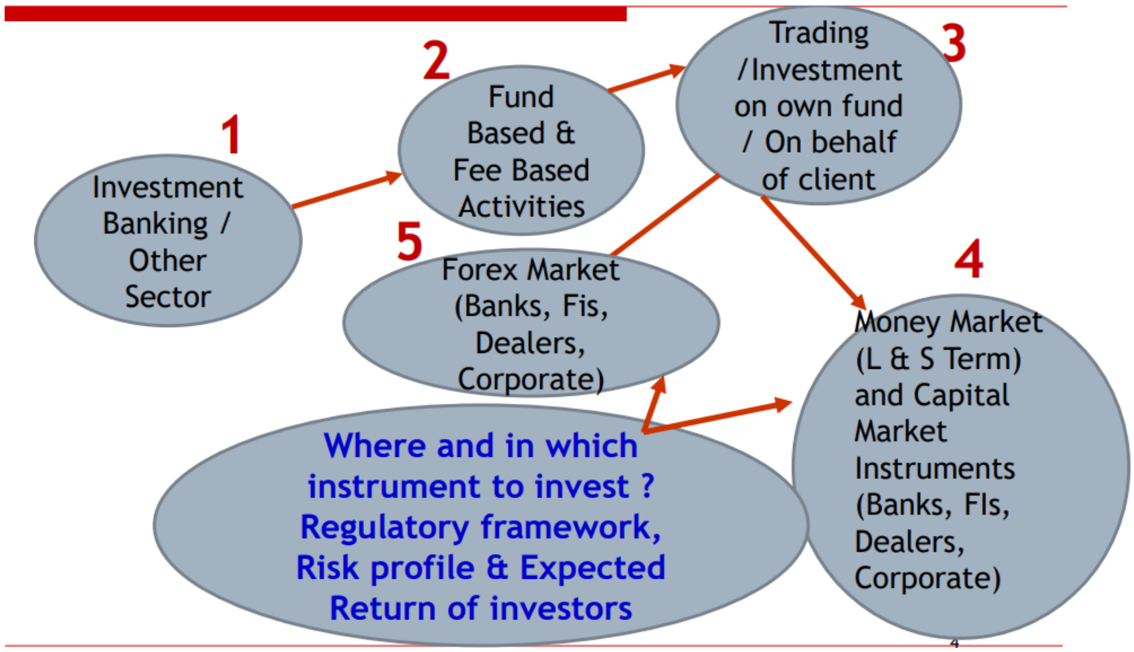
Lecture 1

- It is important to learn FOFA as it is the foundation for other financial subjects
- It is the fundamentals of
    - Finance
        - Finance markets
        - Concepts
        - Instruments
        - Market participants and those using the instruments
        - Risk and return of the instruments or the pricing
    - Accounts
        - Concepts
        - Process
            1. Record transactions
            2. Reporting
        - Outcomes or Financial Statements or Annual Report of a company
            1. Analyze the financial health of a company using many tools and techniques
- Investment banks, consulting, or other banks



- Investment banks earn mostly from fee-based activities
  - The bank provides consultancy and earns from it so this is a fee-based activity
  - The return or the earnings on providing services to the clients
  - Banks like Credit Suisse, Nomura, or UBS
    1. Invest their own money
    2. Provide loans to clients and also invest on behalf of the clients
    3. Trade on behalf of the clients and charge a fee for it or invest their own money
    4. Provide consultancy services for IPO launching, strategic analysis
    5. Revenue is much higher in fee-based activities
    6. Clients are those interested in investing with the bank in financial markets
- Other banks earn from fund-based activities
  - The bank gives a loan so this is a fund-based activity
- Most banks in India earn from fund-based activities

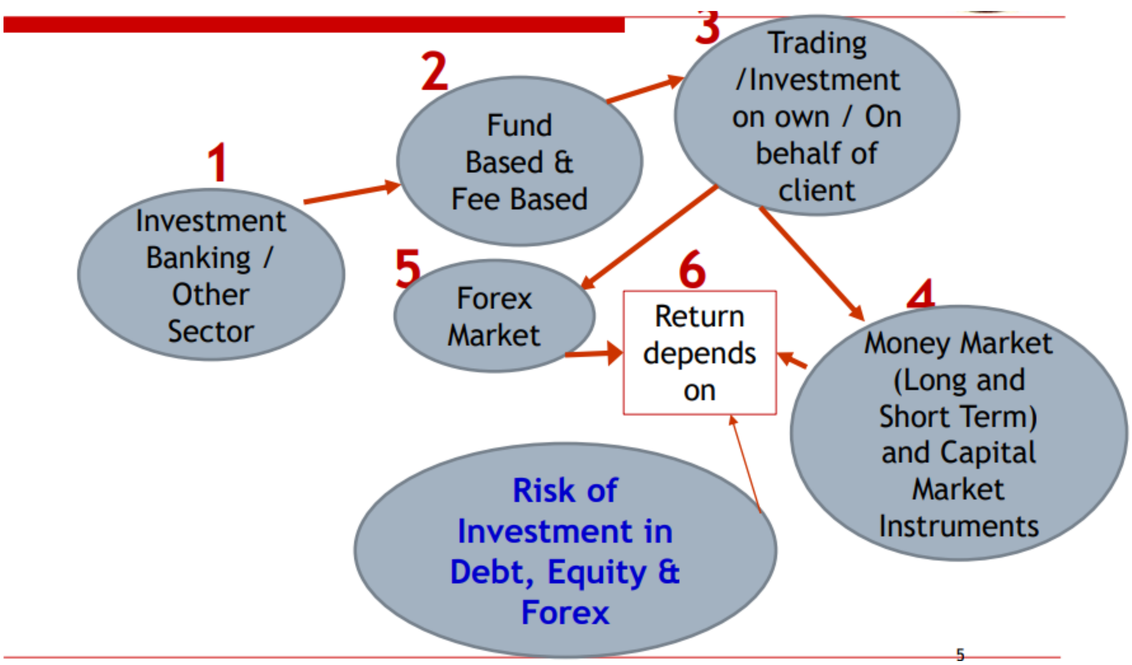
- The different types of financial markets include



  - The money market has banks and dealers as participants
    1. Long term
       a. More than a year
    2. Short term
       a. Less than a year
  - Capital market
    1. Financial instruments
       a. Equity shares
       b. Bonds
       c. Debentures
    2. Participants
       a. Banks
       b. Financial insurers
       c. Dealers

d. Corporate

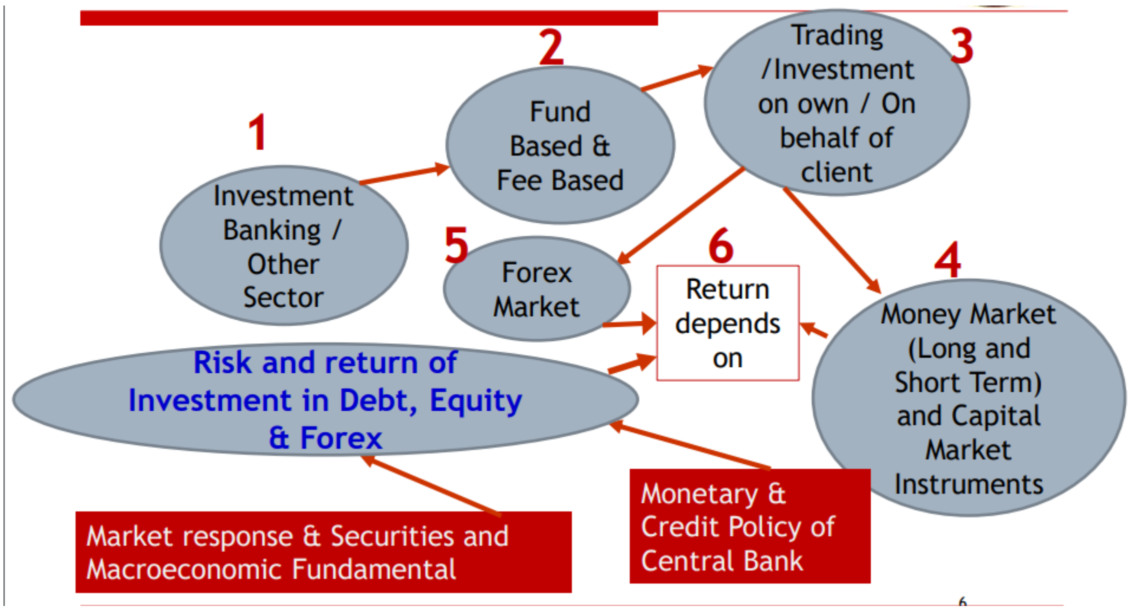
- Foreign exchange or Forex is a good source of revenue
  - Banks
  - Financial insurers
  - Dealers
  - Corporate
- The market and the timing of investment depends on the
  - Risk and return of the instruments
  - Risk and return of the clients when the client's funds are invested
  - Expected rate of return
- The rate of return depends on the risk and return of investment in



  - Debt
    1. Long term
    2. Short term
  - Equity

- Forex

◦ The risk and return depends on



- Monetary and credit policy of the central bank
  1. The central bank of India is the Reserve Bank of India or the RBI along with a group of bankers
- Market response to security and macroeconomic fundamentals
  1. Market's response to shares and debentures
  2. The economy of the country

◦ There are different correlations

- The market's response to security fundamentals is due to
  1. Market efficiency is important to understand the response of the market to different conditions
     a. Fully strong
        i. The market response is instantaneous to fundamentals or macroeconomic updates
     b. Semi-strong

        i. The market response takes time to address the fundamentals or macroeconomic updates

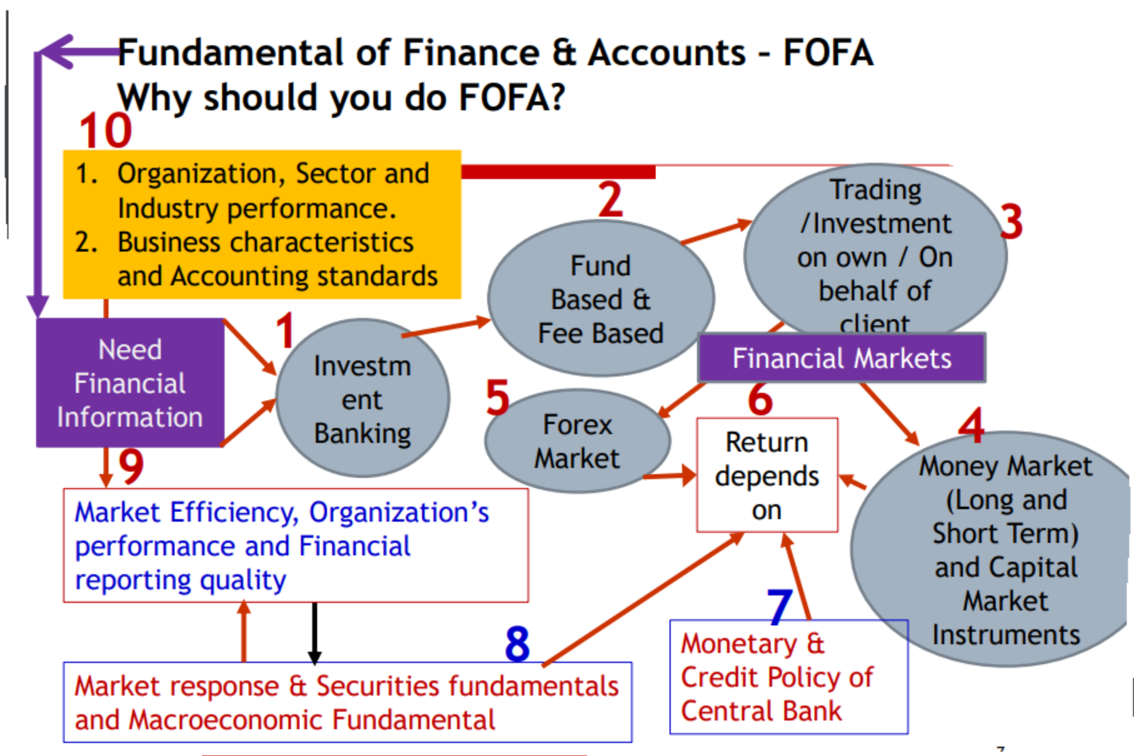
    c. Weak

        i. The market response is negligible to fundamentals or macroeconomic updates

2. Organization performance
3. Financial reporting quality

    a. Done by corporate at the end of the year
    b. Audited financial statements
    c. Response to the reporting figures

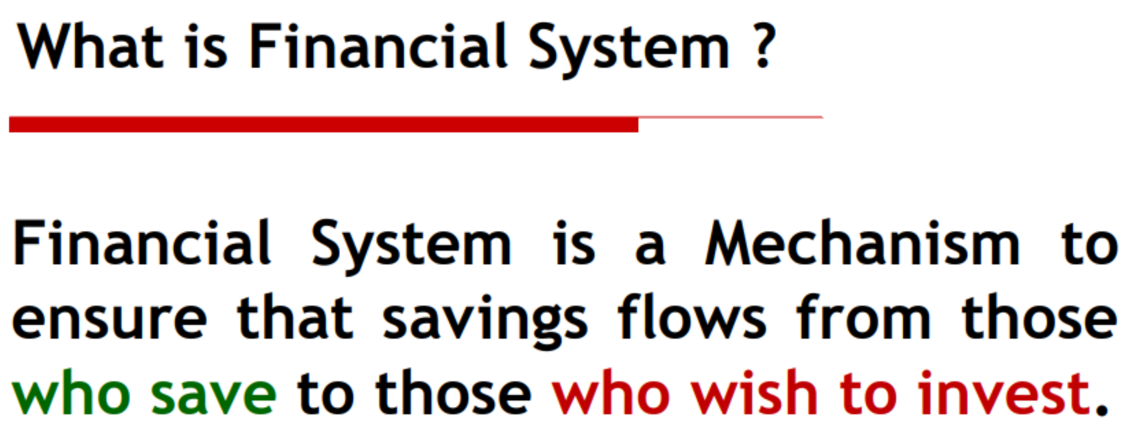
- As an investor or financial analyst



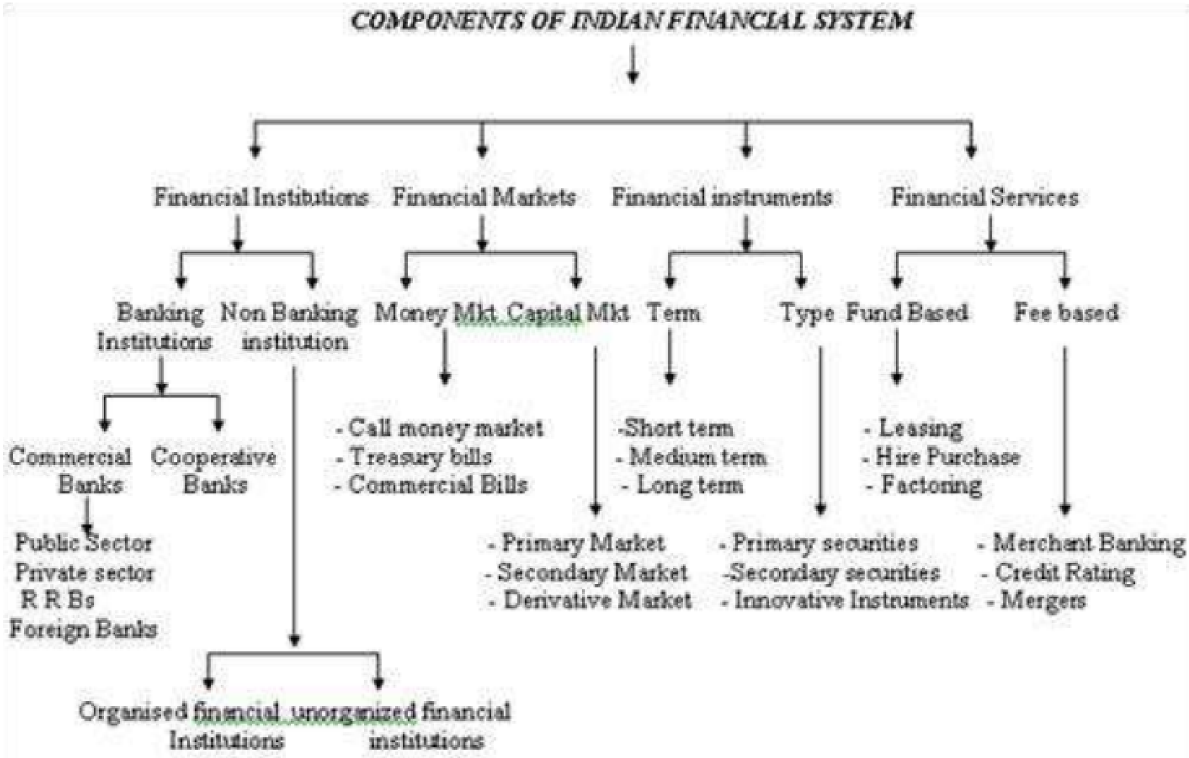
  - Advice on the sector to invest in, the timing of investment, the quantity of investment
  - Financial information is needed

1. Organization, industry, and sector performance
    a. Doctor Reddy Laboratory or DRL
        i. Industry is pharma
        ii. Sector is healthcare
            → Pharma + Biotech + Chemical ⇒ Healthcare sector
    b. A sector has many industries and industry has many organizations
    c. The company’s performance concerning itself, the industry, and the sector
2. Business and accounting standards
    a. Financial statements tell about business performance and these are prepared as per certain accounting standards
    b. Flexibility in accounting standards makes a difference in financial statements

- Financial system

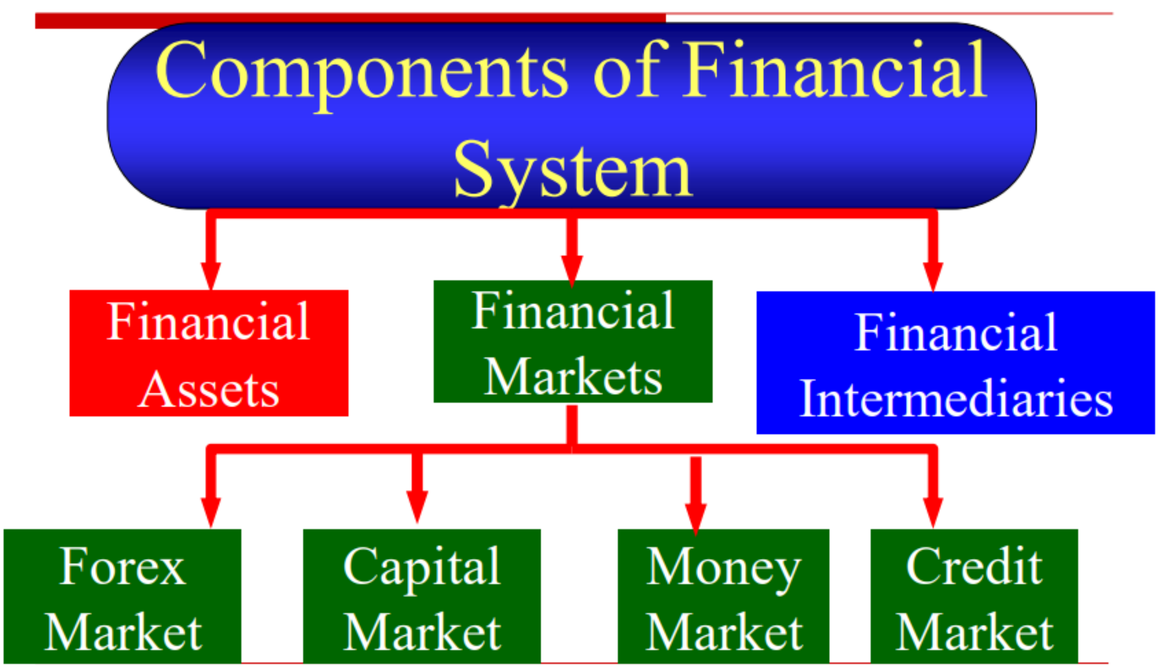


    - It is the mechanism to ensure that savings flow from those who save to those who wish to invest
    - The movement of surplus or savings to investment
- Components of the Indian financial system

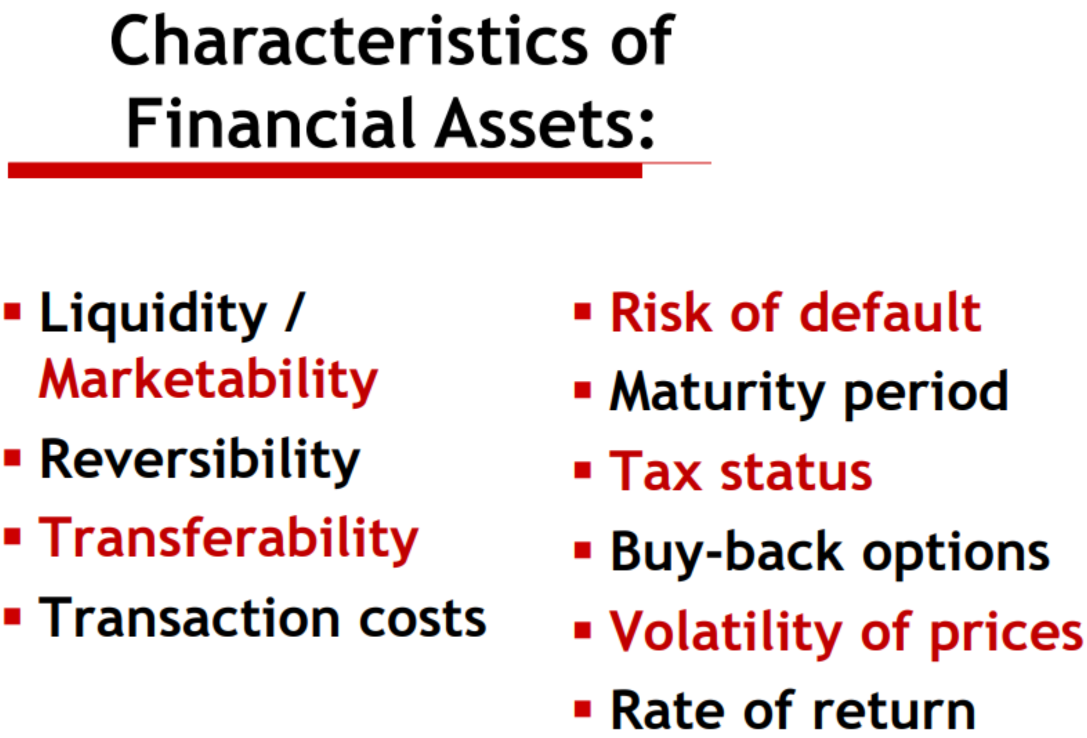


- RRB or the Regional Rural Banks
- Structured products are also a type of Financial Instruments

- Components of the Financial System

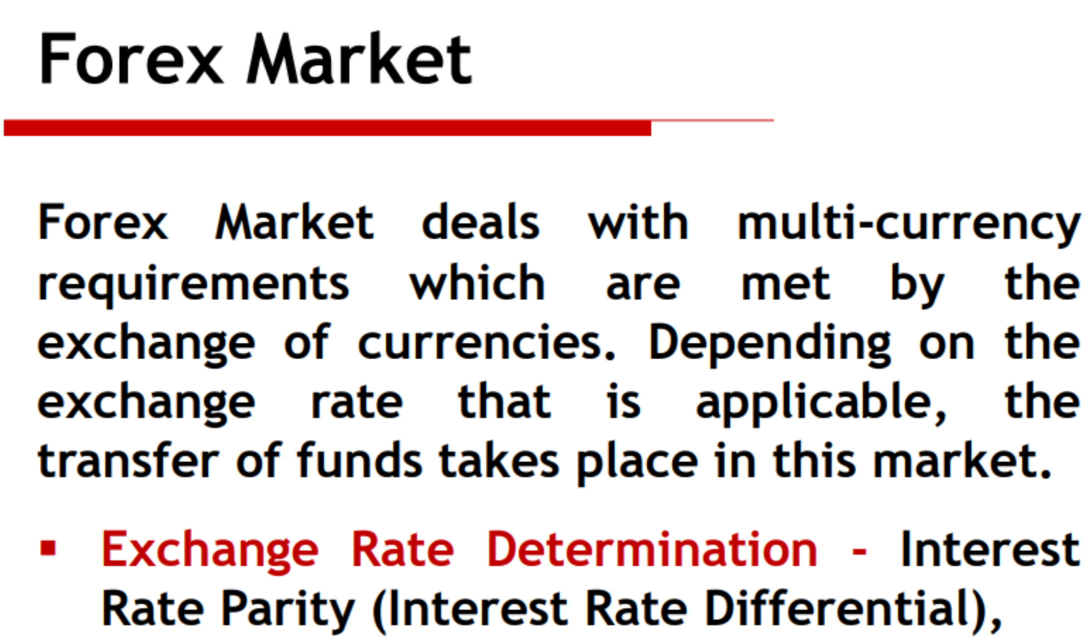


- Characteristics of Financial Assets



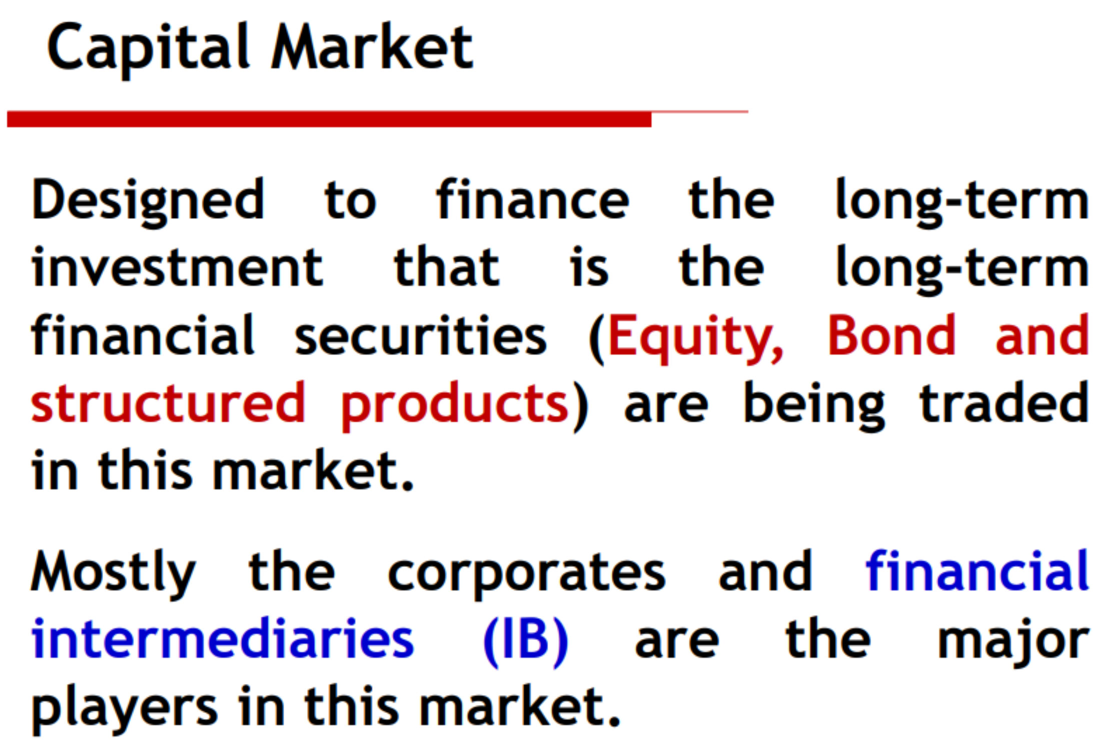
  - An investment is made in financial assets
  - To analyze the risk and return, it is important to understand
    - Liquidity and marketability
      1. Sell an investment to convert it into cash is liquidity
    - Reversibility
      1. Convert debt to equity is reversibility
    - Transferability
    - Transaction cost
      1. It has an impact on return
    - Risk of default
      1. An investment in debt security leads to credit risk or default risk as the investor is a lender to an organization in debt

        - Maturity period
            1. Return has a relation with the maturity period as it is the period of impact
        - Tax status
            1. Return is after tax deduction
        - Buy-back options
        - Volatility of price
        - Rate of return
- Forex Market



    - It deals with
        - Multi-currency requirements which are met by the exchange of currencies
    - Depending on the applicable exchange rate
        - Funds transfer occurs in this market
    - The exchange rate is determined by

        - Interest Rate Parity (Interest Rate Differential)
        - Comparison takes place between fully convertible currencies and the difference between the exchange rates is the Interest Rate Differential
    - The higher the interest rate, the higher it appreciates till the extent of the differential in the spot market but depreciates by the extent of the differential in the forward market
        - The rate of interest in the United States of America is 4%
        - The rate of interest in the United Kingdom is 6%
        - The differential is given by $\Delta = 6\% - 4\% = 2\%$
        - The pound (currency of the UK) is going to appreciate 2% in the spot market but depreciate 2% in the forward market
- Capital Market



    - This is designed to finance long-term investments using long-term financial securities being traded like

        - Equity
        - Bond
        - Debentures
        - Other structured products
    - Major players in this market
        - Corporates
        - Financial Institutions
        - Financial Intermediaries
        - Investment Banks (IB)
    - India has a retail capital market
- Money Market

    - The money market is a wholesale debt market for
        - Low-risk

    - High-liquid
    - Short-term investments
  - Funds are available in this market for periods ranging from a single day to up to a year (Treasury Bills)
  - This market is dominated mostly by
    - Government
    - Banks
    - Financial Institutions (FIs)
  - Output includes
    - Yield Curve
    - Interest Rate Term Structure
  - It is much bigger than the capital market
- Pricing of securities like equity, derivatives, any financial assets, or its representatives involves
  - Calculation of risk-free rate which is found in the money market
  - Yield curve which can also give the risk-free rate
- Interest rate is a function of maturity which is given by $\text{Value of Interest Rate} \propto \text{Term of Maturity}$
  - A bank like the State Bank of India gives a loan for a year, 5 years, and 10 years
    - More the years, more is the risk that the bank is exposed to
    - This risk is balanced by charging a high Rate of Interest increasing the Rate of Return for the bank
    - The risks include
      1. Credit risk or Default risk
      2. Reinvestment risk
- Credit Market

Credit Market

Is a short-term/long-term finance and is a place where banks, FIs and NBFCs purvey short-term, medium and long-term loans to corporate and individuals.

- It is short-term or long-term finance
- Participants include
  - Banks
  - Financial Institutions (FIs)
  - Non-banking Financial Companies (NBFCs)
- Extra funds are used as loans given to corporations or individuals for different periods like
  - Short-term
  - Medium-terms
  - Long-term
- The lenders are not allowed to borrow

- Market Efficiency

Market Efficiency.

A market is considered as perfect if it has the following characteristics:

All players in the market are price takers.

All players have all information about the securities and market price of the securities.

No significant regulations on the transfer of funds exists.

The flow of funds within the market and between the market should not be restricted by the govt. Regulations.

Market Efficiency.

- Risk and Return depends on market efficiency (EMH - Fully Strong, Semi Strong and Weak Form).
- Market Volatility

Broadly who does it and how does it happen?

- The market's reaction to

        - Company fundamentals
        - Economic fundaments
    - For the market to be perfect and strong
        - There should be no asymmetric information
        - There should be no significant regulations on the transfer of funds from one security to another
    - The three types of market efficiency are
        - Fully strong
            1. The market response is instantaneous to fundamentals or macroeconomic updates
        - Semi-strong
            1. The market response takes time to address the fundamentals or the macroeconomic updates
        - Weak
            1. The market response is negligible to fundamentals or macroeconomic updates
    - It is important to understand the market volatility
        - The behaviour of the market and its cause is essential to know
- Responsible for macro-economical fundamentals

Objectives of Monetary & Credit Policy are to:

Nirmala Sitharaman - Growth

Shaktikanta Das - Confidence

Krishnamurthy Subramaniar Advise

Regulate the Price of Capital. Interest Rate

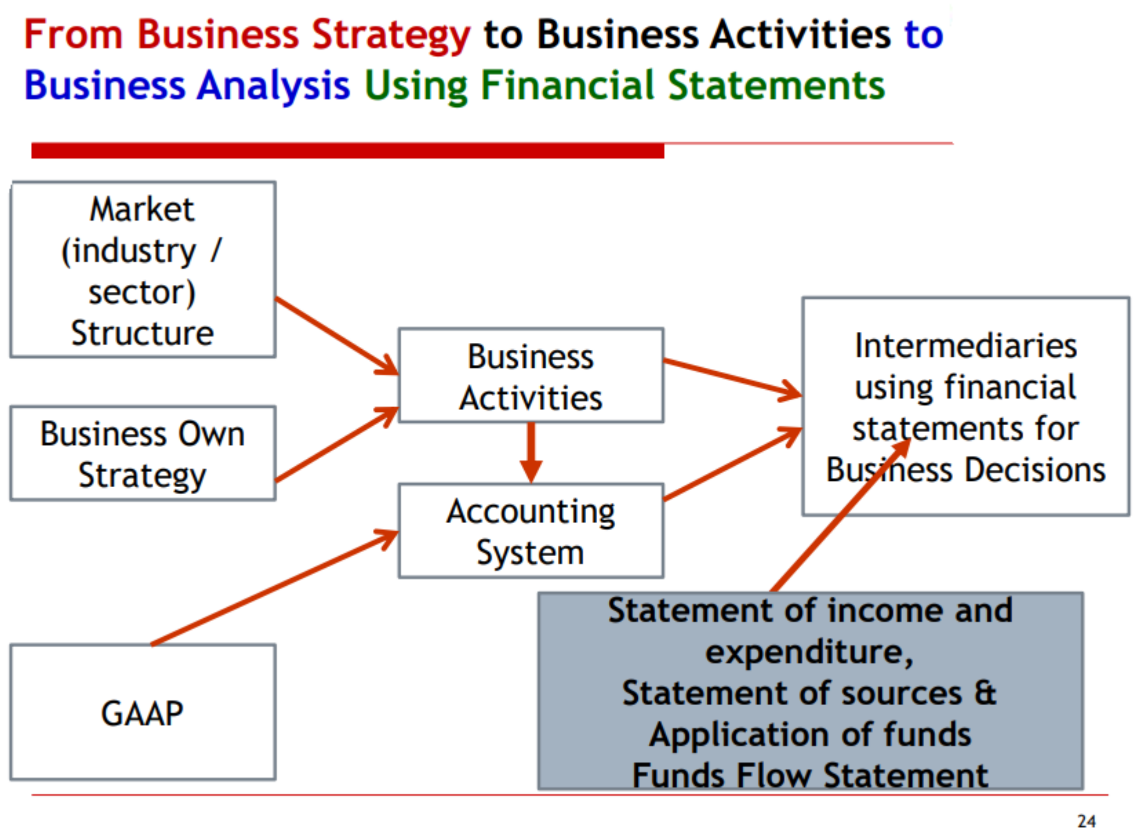
Regulate the Price of Goods & Services. Inflation

Regulate the Price of Forex. Forward Premia or Discount

To Improve the Credit Flow to the Corporates.

- Finance Minister
    - They drive the growth of the economy
- Reserve Bank of India (RBI)
    - Retain or build interest in financial markets
        1. Regulatory framework
        2. Safe investment
    - Announce credit and monetary policy twice a year
- Adviser
    - The chief economic adviser has a major role as an adviser to the chairman of RBI
- The four objectives of the credit and monetary policy are to regulate
    - The price of capital which is determined by the interest rate
    - The price of goods and services which is determined by the inflation

            1. Price is increasing due to
                a. Increase in demand and production
                b. This reduces money supply and keeps money in the market
        - The price of forex which is determined by the exchange rate or the forward premia and discount
        - The credit flow to corporates
            1. The credit flow needs to be increased
    - Regulation is to control whereas Management involves market
        - The price of capital which is determined by the interest rate is decided by the market to manage its value
        - The price of goods and services which is determined by inflation is decided by the market to manage its value
    - An increase in the interest rate reduces the money flow in the market
        - This helps in controlling or regulating inflation
    - Inflation is due to more money chasing fewer goods and services
        - Increasing more goods and services or the supply can reduce and therefore manage inflation
            1. Extra money gets absorbed
- Overview of Finance



- If there is a business, it has some activities
  - It is influenced by the market structure which includes the industry and sector
  - Understand the industry and the sector of the business and their structure
  - For a company like Doctor Reddy Laboratory (DRL), it is important to understand the
    1. Pharma Industry
    2. Healthcare Sector
    3. Install capacity and utilization
    4. Product Manufacturing
    5. Revenue, expenditure, cost structure
    6. Demand-Supply gap in the sector

- A company is the function of its strategy
  - Goals and vision
  - Influence of the market on its activities