STUDY MATERIAL

FUNDAMENTALS OF INVESTMENT

CORE COURSE

B.Com

(V Semester)

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CHAPTER 1

INVESTMENT ENVIRONMENT

The income that a person receives may be used for purchasing goods and services that he currently requires or it may be kept for some future use. The portion of income that is consumed to meet out the current needs is called consumption and the another part that is kept for future use is the savings that are generated when a person or organization abstain from present consumption for a future use .The person saving a part of his income always tries to find a temporary repository for his savings so that these savings are safe and generate return and this result in investment.

Meaning of investment

Investment is an activity that is engaged in by people who have savings, i.e. investments are made from savings or in other words, people invest their savings. But all savers are not investors, investment is an activity which is different from saving.

Investment as a generic idea means sacrificing something today in order to generate benefit in future. But as an economic activity investment involves creation of assets or exchange of assets with profit motive.

Thus investment may be defined as “a commitment of funds made in the expectation of some positive rate of return “since the return is expected to realize in future, there is a possibility that the return actually realized is lower than the return expected to be realized. This possibility of variation in the actual return from the expected return is known as investment risk. Thus every investment involves return and risk.

F. Amling defines investment as “purchase of financial assets that produces a yield that is proportionate to the risk assumed over some future investment period.”

According to sharpe, ”investment is sacrifice of certain present value for some uncertain future values”.

Investment decision process

Investing has been an activity confined to the rich and business class in the past. But today, we find that investment has become a house hold word and is very popular with people from all walks of life .India appears to be slowly but surely closing in some of the top savers among countries in the global peaking order. Savings in Indians touched a new high of 32.4 percent of the GDP during 2018-2019. Chain leads the pack of savers with the saving figure at close to 49 percent of GDP. The escalating cost due to inflation are decreasing the value of saved money with each passing year. Consider the cost buying of a home, or getting admitted in a hospital or paying for the higher education of a child, one's life's savings could vanish in a blink. Knowledgeable investing requires the investor to be aware of his needs, the amount of money he can invest and the investment options available to him .These will relate to the investment decision process. A typical investment decision goes through a five step procedure which is known as investment process these steps are:

1. Defining the investment objective
2. Analyzing securities
3. Valuation of securities
4. Construct a portfolio
5. Evaluate the performance of portfolio and revision

1. Defining the investment objective

Investment objective may vary from person to person. It should be stated in terms of both risk and return. In other words, the objective of an investor is to make money accepting the fact of risk will be there. The typical objectives of investor include the current income, capital appreciation and safety of principal. More over constrains arising due to liquidity, the time horizon, tax and other special circumstances, if any must also be considered in this step of investment process. It also involves identification of the potential financial assets that may be included in the portfolio based on the investment objectives.

2. Analyzing securities

The second step of analyzing securities enables the investor to distinguish between underpriced and overpriced stock. Return can be maximized by investing in stocks which are currently underpriced but have the potential to increase. Actually the future price behavior, expected rate of return and associated risk is studied. There are two main approaches used for analyzing securities; technical analysis and fundamental analysis.

3. **Valuation of securities**

   The most important and complex step is the valuation of securities. Investment value is generally taken to be the present value of the owners future benefits from investment.

   Comparison of the value with the current market price of the asset allows the determination of the relative attractiveness of assets.

4. **Construct a portfolio**

Portfolio simply means a range of investments held by an investor. Portfolio construction requires knowledge of several aspects of securities like growth of principal, liquidity of assets etc. portfolio construction involves the following steps:

a) Deciding the diversification level.

b) Considering the investment timing

c) Selection of investment timing

d) Allocation of investible funds to investment assets

e) Acquisition of assets/securities

5. **Portfolio evaluation and revision:**

Portfolio management is a continuous process. The primary motive of evaluation and revision is to improve performance of portfolio. Effective portfolio evaluation requires an investor to balance what he has against available alternatives and Portfolio has also to be revised from time to time so as to best serve investors objective.

Types of Investment/ Avenues of Investment

The main avenues of investment that are available to the investors include; financial assets, Real Estate, Commodities etc

Financial Assets

A financial asset is a tangible liquid asset that gets its value from some contractual claim. Unlike land, property, commodities or other tangible assets, financial assets does not necessarily have inherent physical worth. Different financial assets as avenues of investment include:

- Shares
- Debentures/bonds
- Government securities
- Money market instruments (treasury bills, commercial papers etc)
- Mutual funds

- Insurance policies
- Derivatives

Some of these instruments are explained as under:

Life insurance

Life insurance is a contract for payment of a sum of money to the person assured on the happening of event insured against. Usually the contract provides for the payment of an amount on the date of maturity or at a specified date or if death occurs. The major advantage of life insurance is given below;

1) Life insurance guarantees full protection against risk of death of the saver. The full assured sum is paid, whereas in other schemes only the amount saved is paid.

2) Easy payments for the salaried people, the salary saving schemes are available. Further there is an installment facility method of payment through monthly, quarterly, half yearly or yearly mode.

3) Liquidity loans can be raised on the security of the policy

4) Tax relief in income tax and wealth tax is available for amounts paid by way of premium for life insurance subject to the tax rates in force.

Type of life insurance policy

a) Endowment policy;

The objective of this policy is to provide an assured sum, both in the event of the policy holder's death or at the expiry of the policy.

b) Term policy:

In a term policy investor pays a small premium to insure his life for a comparatively higher value. The objective behind the scheme is not to get any amount on the expiry of the policy. But simply to secure the financial future of the investors dependents.

c) Whole life policy

It is a low cost insurance plan where the sum assured is payable on the death of the life insured and premium are payable throughout life.

d) ULIPs:

Unit Linked Insurance Policies are a combination of mutual fund and life insurance. Investments in ULIPs have two component-one part is used as a premium for life insurance while the other part acts s the investment fund.

The investment component works exactly like mutual fund money and is invested in stocks, bonds; government securities etc., an investor receive money in return.

Mutual fund

Investing directly in equity shares and debt instruments may be difficult task for a large number of customers because they want to know more about the company, promoter, prospects, competition for the product etc. In such a case, investor can go for investing in financial assets indirectly through mutual fund. A mutual fund is a trust that pools the savings of a number of investors who share a common financial goal. Each scheme of a mutual fund can have different character and objectives.

Types of return

- Capital appreciation: an increase in the value of the units of the fund is known as capital appreciation
- Dividend distribution: the profit earned by the fund is distributed among unit holders in the form of dividends.

Type of mutual funds

- **Open ended schemes:**

  In this scheme there is an uninterrupted entry and exit into the funds. The open ended scheme has no maturity period and they are not listed in the stock exchanges. The open ended fund provides liquidity to the investors since repurchase available.

- **Closed ended funds**:

  The closed ended funds have a fixed maturity period. The first time investments are made when the close ended scheme is kept open for a limited period. Once closed, the units are listed on a stock exchange .investors can buy and sell their units only through stock exchanges.

Other classification

- **Growth scheme**: aims to provide capital appreciation over medium to long term. Generally these funds invest their money in equities.
- **Income scheme**: aims to provide a regular return to its unit holders. Mostly these funds deploy their funds in fixed income securities.
- **Balanced scheme**: a combination of steady return as well as reasonable growth. The fund of this scheme is invested in equities and debt instruments.

- **Money market scheme**: this type of fund invests its money to money market instruments.
- **Tax saving scheme**: this type of scheme offers tax rebates to investors.
- **Index scheme**: Here investment is made on the equities of the Stock index.

Real estate

The word real estate simply means land and buildings. Real estate market offers a high return to the investors and there is a normal notion that the price of the real estate has increased by more than 12% over the past ten years. But Liquidity is a problem as Real estate investments cannot be enchased quickly. Real estate investment also involves high transaction cost. The asset need to be managed, i.e. painting, repair, maintenance etc.

Commodities

Commodities have emerged as an alternative investment option now a days and investors make use of this option to hedge against rising inflation- commodities may be broadly divided into three. Metals, petroleum products and agricultural commodities .Metals can be divided into precious metals and other metals. Gold and silver are the most preferred once for beating inflation.

Gold

Off all the precious metals gold is the most popular as an investment. Investors generally buy gold as a hedge against economic, political, social fiat currency crisis. Gold prices are soaring to the new highs in recent years comparing to the previous decades because whenever the signs of an economic crisis arises in the world markets may find shelter in gold as safest asset class for investors all around the world.

Silver

Yellow metal is treated as safe haven but silver is used abundantly for industrial applications. Investment in silver has given investor, super returns than what gold has given.

Concept of risk and return

Investment involves purchasing an asset that yields a return which is proportionate to the risk assumed over some future period of time showing that risk and return go hand in hand. We know that every rational investor likes the return but on the other hand abhors the risk. Investment decision involves trade of between risk and return. These two elements are considered to be central point in the investment process and therefore need to be analysed.

Risk

The dictionary meaning of risk is the possibility of loss or injury. In finance risk is related to the variability in return i.e. the deviation of actual return from the expected return. The difference between expected return and actual return is called the risk in investment. Risk involved in an investment depends upon various factors like; maturity period,

creditworthiness of borrower, type of security/asset etc

Types of risk

- **Systematic risk: (market risk)**

  It is the portion of risk that is attributed by economy wide factors like growth rate of GDP, Money supply, Inflation etc. Systematic risk affects the market as a whole. This risk can't be reduced or avoided by diversification so it is also known as non-diversifiable risk

- **Unsystematic risk: (Unique risk)**

  Unique risk arises from firm specific factors like labor strike, emergence of new competitor etc.This risk can be washed away by combining it with other stocks (diversification) hence it is also known as diversifiable risk.

TOTAL RISK= SYSTEMATIC RISK + UNSYSTEMATIC RISK

Sources of risk

- **Interest rate risk:**

  Interest rate risk is the variation in the single period rates of return caused by the fluctuations in the market interest rate. Most commonly the interest rate risk affects the debt securities like bond, debentures.

- **Market risk:**

  Jack clarkfrancis has defined market risk as the portion of total variability of return caused by the alternating forces of bull and bear market.

- **Purchasing power risk**

  Another type of systematic risk is the purchasing power risk. It refers to the variation in investor return caused by inflation.

- **Business risk**: Every company operates with in a particular operating environment, operating environment comprises both internal environment (within the firm) and external environment (outside the firm). Business risk is thus a function of the operating conditions faced by a company and is the variability in operating income caused by the operating conditions of the company.

- **Financial risk**

  It refers to the variability of the income to the equity capital due to the debt capital. Financial risk in a company is associated with the capital structure of the company. The debt in the capital structure creates fixed payments in the form of interest this creates more variability in the earning per share available to equity share holders. This variability of return is called financial risk and it is a type of unsystematic risk.

Return

Return is the reward for investment and is primary motivating force for investment. The major objective of an investment is to earn and maximize the return. Return on investment may be because of income, capital appreciation or a positive hedge against inflation. Income may be either interest on bonds or debenture , dividend on equity, etc

Rate of return :The rate of return on an investment for a period is calculated as follows:

$$\text{Rate of return} = \frac{\text{annual income} + (\text{Ending price} - \text{Beginning price})}{\text{Beginning Price}}$$

{Total Return = Current Return+ Capital Return}

Ex: Ajay brought a share of a co.for Rs.140 from the market on 1/6/2012.the co. paid dividend of Rs.8 per share .later ajay sold the share at Rs.160 on 1/6/2013.

The rate of return= 8+ (160-140)x100 = 20percent 140

Security Market Indices

Stock market indices are the barometers of the stock market. They mirror the stock market behavior. With some 7,000 companies listed on the Bombay stock exchange, it is not possible to look at the prices of every stock to find out whether the market movement is upward or downward. The indices give a broad outline of the market movement and represent the market. Some of the stock market indices are BSE Sensex, BSE-200, Dollex, NSE-50, CRISIL-500, MCX-SX 40 etc.

Usefulness of Indices

1. Indices help to recognize the broad trends in the market.

2. Index can be used as a bench mark for evaluating the investor's portfolio.

3. Indices function as a status report on the general economy. Impacts of the various economic policies are reflected on the stock market.

4. The investor can use the indices to allocate funds rationally among stocks. To earn returns on par with the market returns, he can choose the stocks that reflect the market movement.

5. Index funds and futures are formulated with the help of the indices. Usually fund managers construct portfolios to emulate any one of the major stock market index. ICICI has floated ICICI index bonds. The return of the bond is linked with the index movement.

6. Technical analysts studying the historical performance of the indices predict the future movement of the stock market. The relationship between the individual stock and index predicts the individual share price movement

Value of the index dependents upon the value of the stock included in the index. Formula used for index (based on market capitalization) value calculation is:

INDEX VALUE =

$$\frac{\text{Free Float Market Capitalisation of Grouped stock}}{\text{Base Market Capitalisation}} * \text{Base Index Value}$$

NSE - 50 Index – (NIFTY)

NIFTY index is the security market index of National Stock Exchange[NSE]. It comprises of 50 leading stocks from different sectors of the listed companies on NSE. This index is built by India Index Services Product Ltd (IISL and Credit Rating Information Services of India Ltd. (CRISIL).The CRISIL has a strategic alliance with Standard and Poor rating Services. Hence, the index is named as S & P CNX Nifty. NSE - 50 index was introduced on April 22,1996 with the objectives given below :

* Reflecting market movement more accurately

* Providing fund managers a tool for measuring portfolio returns vis-market return.

* Serving as a basis for introducing index based derivatives.

Bse Sensex

The S&P BSE SENSEX (S&P Bombay Stock Exchange Sensitive Index), also-called the BSE 30 or simply the SENSEX, is a free float market weighted index of 30 well-established and financially sound companies listed on Bombay Stock Exchange. The 30 component companies which are some of the largest and most actively traded stocks, are representative of various industrial of the Indian economy. Published since 1 January 1986, the S&P BSE SENSEX is regarded as the pulse of the domestic stock markets in India. The base value of the S&P BSE SENSEX is taken as100 on 1 April 1979, and its base year as *1978–79*. On 25 July 2001 BSE launched DOLLEX-30, a dollar-linked version of S&P BSE SENSEX.

Information sources

Learning about investing means learning how money makes money. No one will watch over your investments more closely or carefully as you yourself, and this is as good a reason as any to learn as much as you can and become as knowledgeable and savvy about investing as possible. This holds true even if you determine to have a financial planner or advisor manage your investment funds.

Becoming "Investment Literate"

It is important to be an informed investor. Financial websites, periodicals, investment books and publications will keep you up to date and educated about investing, about what is going on in the economy, what influences your money, your invested funds, and where your money can be placed so that it will work hardest for you. These sources contain valuable information about business in general, as well as current economic and financial trends, news of the stock market and related news stories, all those things that affect the investment community in general, and most importantly, that affect your investments and investment decisions.

Sources of Investment Information

The following sources of investment information are intended as a *starting point*. They are stepping stones. As you proceed to research, investigate, educate yourself and learn, you will find that one place of information will lead you to the next, and you will find yourself gaining the knowledge that you need in order to become a most successful investor. Becoming investment literate is an on-going process.

Books

Several books like that of "The Intelligent Investor", written by Benjamin Graham - are recognized as the important sources of investment information.

Financial websites

MSN Money (moneycentral.msn.com)

CNNMoney.com (money.cnn.com)

Morningstar (www.morningstar.com) and many more.

Newspapers and periodicals

Following are the major financial dailies available in Indian news paper industry

- The Hindu- Business LINE
- The Economic TIMES

Following are the major financial periodicals available in Indian news paper industry

- The Business Enterprise
- Business India
- Business Today (business magazine)
- Business world