CHAPTER 1

INTRODUCTION TO INVESTMENT AND SECURITIES

Investing in various types of assets is an interesting activity that attracts people from all walks of life irrespective of their occupation, economic status, education and family background. When a person has more money than he requires for current consumption, he would be coined as a potential investor. The investor who is having extra cash could invest it in securities or in any other assets like gold or real estate or could simply deposit it in his bank account. The companies that have extra income may like to invest their money in the extension of the existing firm or undertake new venture. All of these activities in a broader sense mean investment.

INVESTMENT

Investment is the employment of funds on assets with the aim of earning income or capital appreciation. Investment has two attributes namely time and risk. Present consumption is sacrificed to get a return in the future. The sacrifice that has to be borne is certain but the return in the future may be uncertain. This attribute of investment indicates the risk factor. The risk is undertaken with a view to reap some return from the investment. For a layman, investment means some monetary commitment. A person's commitment to buy a flat or a house for his personal use may be an investment from his point of view. This cannot be considered as an actual investment as it involves sacrifice but does not yield any financial return.

To the economist, investment is the net addition made to the nation's capital stock that consists of goods and services that are used in the production process. A net addition to the capital stock means an increase in the buildings, equipments or inventories. These capital stocks are used to produce other goods and services.

Financial investment is the allocation of money to assets that are expected to yield some gain over a period of time. It is an exchange of financial claims such as stocks and bonds for money. They are expected to yield returns and experience capital growth over the years.

The financial and economic meanings are related to each other because the savings of the individual flow into the capital market as financial investments, to be used in economic investment. Even though they are related to each other, we are concerned only about the financial investment made on securities.

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investment is also limited. After studying the factors related ... tor buys it and hence the risk exposure is limited. The investor likes to invest in securities where his principal would be safe.

Table 1.1 The Difference Between the Investor and the Speculator

	Investor	***Speculator***
Time horizon	Plans for a longer time horizon. His holding period may be from one year to few years.	Plans for a very short period. Holding period varies from few days to months.
Risk	Assumes moderate risk.	Willing to undertake high risk.
Return	Likes to have moderate rate of return associated with limited risk.	Like to have high returns for assuming high risk
Decision	Considers fundamental factors and evaluates the performance of the company regularly.	Considers inside information, heresays and market behaviour.
Funds	Uses his own funds and avoids borrowed funds.	Uses borrowed funds to supplement his personal resources.

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beginning of the holding period.

$$\text{Return} = \frac{\text{End period value} - \text{Beginning period value} + \text{Dividend}}{\text{Beginning period value}} \times 100$$

Rate of return is stated semi-annually or annually to help comparison among the different investment alternatives. If it is a stock, the investor gets the dividend as well as the capital appreciation as returns. Market return of the stock indicates the price appreciation for the particular stock. If a particular share is purchased in 1998 at Rs.50, disposed at Rs.60 in 1999 and the dividend yield is Rs.5, then the return would be calculated as follows.

$$\text{Return} = \frac{\text{Capital appreciation \& dividend}}{\text{Purchase price}} \times 100$$

$$\text{Return} = \frac{10 + 5}{50} \times 100 = 30\%$$

Risk Risk of holding securities is related with the probability of actual return becoming less than the expected return. The word risk is synonymous with the phrase variability of return. Investments' risk is just as important as measuring its expected rate of return because minimising risk and maximising the rate of return are interrelated objectives in the investment management. An investment whose rate of return varies widely from period to period is risky than whose return that does not change much. Every investor likes to reduce the risk of his investment by proper combination of different securities.

Liquidity Marketability of the investment provides liquidity to the investment. The liquidity depends upon the marketing and trading facility. If a portion of the investment could be converted into cash without much loss of time, it would help the investor meet the emergencies. Stocks are liquid only if they command good market by providing adequate return through dividends and capital appreciation.

Hedge against inflation Since there is inflation in almost all the economy, the rate of return should ensure a cover against the inflation. The return rate should be higher than the rate of inflation, otherwise the investor will have loss in real terms. Growth stocks would appreciate in their values overtime and provide a protection against inflation. The return thus earned should assure the safety of the principal amount, regular flow of income and be a hedge against inflation.

... investment avenue should be under the legal and regulatory frame work. If it is not ... Approval of the law itself adds

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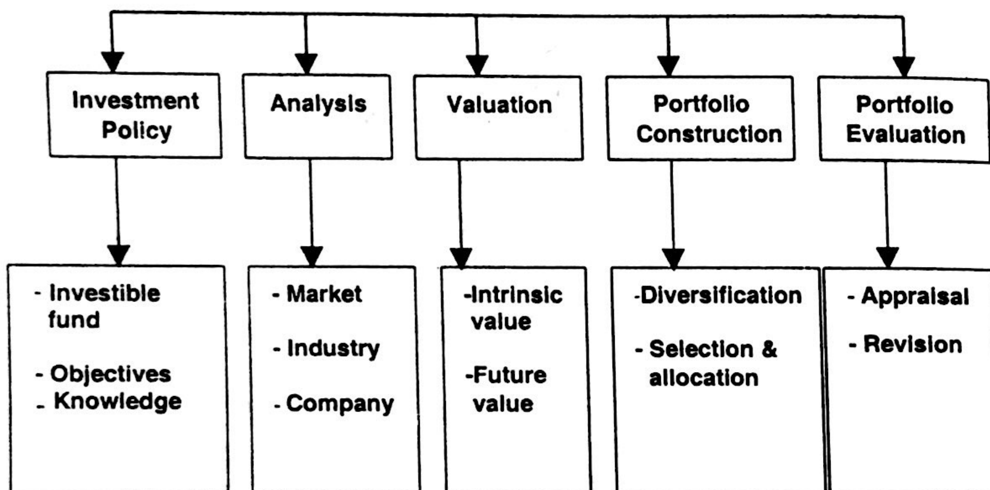
investment to another. Investments done with the government assure more safety than with the private party. From the safety point of view investments can be ranked as follows: bank deposits, government bonds, UTI units, non-convertible debentures, convertible debentures, equity shares, and deposits with the non-banking financial companies.

THE INVESTMENT PROCESS

The investment process involves a series of activities leading to the purchase of securities or other investment alternatives. The investment process can be divided into five stages (i) framing of investment policy (ii) investment analysis (iii) valuation (iv) portfolio construction (v) portfolio evaluation. The flowchart 1.1 explains the stages and factors connected thereof.

Flowchart 1.1

Investment Process



INVESTMENT POLICY

The government or the investor before proceeding into investment formulates the policy for the systematic functioning. The essential ingredients of the policy are the investible funds, objectives and the knowledge about the investment alternatives and market.

Investible funds The entire investment procedure revolves around the availability of investible funds. The fund may be generated through savings or from borrowings. If the funds are borrowed, the investor has to be extra careful in the selection of investment alternatives. The return should be higher than the interest he pays. Mutual funds invest their owners' money in securities.

Objectives The objectives are framed on the premises of the required rate of return, need for regularity of income, risk perception and the need for liquidity. The risk taker's objective is to earn high rate of return in the form of capital appreciation, whereas the primary objective of the risk averse is the safety of the principal.

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Knowledge The knowledge about the investment alternatives and markets plays a key role in the policy formulation. The investment alternatives range from security to real estate. The risk and return associated with investment alternatives differ from each other. Investment in equity is high yielding but has more risk than the fixed income securities. The tax sheltered schemes offer tax benefits to the investors.

The investor should be aware of the stock market structure and the functions of the brokers. The mode of operation varies among BSE, NSE and OTCEI. Brokerage charges are also different. The knowledge about the stock exchanges enables him to trade the stock intelligently.

SECURITY ANALYSIS

After formulating the investment policy, the securities to be bought have to be scrutinised through the market, industry and company analysis.

Market analysis The stock market mirrors the general economic scenario. The growth in gross domestic product and inflation are reflected in the stock prices. The recession in the economy results in a bear market. The stock prices may be fluctuating in the short run but in the long run they move in trends i.e. either upwards or downwards. The investor can fix his entry and exit points through technical analysis.

Industry analysis The industries that contribute to the output of the major segments of the economy vary in their growth rates and their overall contribution to economic activity. Some industries grow faster than the GDP and are expected to continue in their growth. For example the information technology industry has experienced higher growth rate than the GDP in 1998. The economic significance and the growth potential of the industry have to be analysed.

Company analysis The purpose of company analysis is to help the investors to make better decisions. The company's earnings, profitability, operating efficiency, capital structure and management have to be screened. These factors have direct bearing on the stock prices and the return of the investors. Appreciation of the stock value is a function of the performance of the company. Company with high product market share is able to create wealth to the investors in the form of capital appreciation.

VALUATION

The valuation helps the investor to determine the return and risk expected from an investment in the common stock. The intrinsic value of the share is measured through the book value of the share and price earning ratio. Simple discounting models also can be adopted to value the shares. The stock market analysts have developed many advanced models to value the shares. The real worth of the share is compared with the market price and then the investment decisions are made.

Future value Future value of the securities could be estimated by using a simple statistical technique like trend analysis. The analysis of the historical behaviour of the price enables the investor to predict the future value.

CONSTRUCTION OF PORTFOLIO

A portfolio is a combination of securities. The portfolio is constructed in such a manner to meet the investor's goals and objectives. The investor should decide how best to reach the goals with the securities available. The investor tries to attain maximum return with minimum risk. Towards this end he diversifies his portfolio and allocates funds among the securities.

Diversification The main objec... income. A diversified portfolio is comparatively less risky than holding a single portfolio. There are several ways to diversify the portfolio.

Debt and equity diversification Debt instruments provide assured return with limited capital appreciation. Common stocks provide income and capital gain but with the flavour of uncertainty. Both debt instruments and equity are combined to complement each other.

Industry diversification Industries' growth and their reaction to government policies differ from each other. Banking industry shares may provide regular returns but with limited capital appreciation. The information technology stock yields high return and capital appreciation but their growth potential after the year 2002 is not predictable. Thus, industry diversification is needed and it reduces risk.

Company diversification Securities from different companies are purchased to reduce risk. Technical analysts suggest the investors to buy securities based on the price movement. Fundamental analysts suggest the selection of financially sound and investor friendly companies.

Selection Based on the diversification level, industry and company analyses the securities have to be selected. Funds are allocated for the selected securities. Selection of securities and the allocation of funds and seals the construction of portfolio.

EVALUATION

The portfolio has to be managed efficiently. The efficient management calls for evaluation of the portfolio. This process consists of portfolio appraisal and revision.

Appraisal The return and risk performance of the security vary from time to time. The variability in returns of the securities is measured and compared. The developments in the economy, industry and relevant companies from which the stocks are bought have to be appraised. The appraisal warns the loss and steps can be taken to avoid such losses.

Revision Revision depends on the results of the appraisal. The low yielding securities with high risk are replaced with high yielding securities with low risk factor. To keep the return at a particular level necessitates the investor to revise the components of the portfolio periodically.

SECURITIES

Various types of securities are traded in the market. Broadly securities represent evidence to property right. Security provides a claim on an asset and any future cash flows the asset may generate. Commonly we think of securities as shares and bonds. According to the Securities Contracts Regulation Act 1956, securities include shares, scrips, stocks, bonds, debentures or other marketable like securities of any incorporated company or other body corporate, or government. Securities are classified on the basis of return and the source of issue. On the basis of income they may be classified as fixed or variable income securities. In the case of fixed income security, the income is fixed at the time of issue itself. Bonds, debentures and preference shares fall into this category. Sources of issue may be government, semi government and corporate. The incomes of the variable securities vary from year to year. Dividends of the equity shares of companies' can be cited as an example for this. Corporate generally raises funds through fixed and variable income securities like equity shares, preference shares and debentures.

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EQUITY SHARES

Equity shares are commonly referred to common stock or ordinary shares. Even though the words shares and stocks are interchangeably used, there is a difference between them. Share capital of a company is divided into a number of small units of equal value called shares. The term stock is the aggregate of a member's fully paid up shares of equal value merged into one fund. It is a set of shares put together in a bundle. The "stock" is expressed in terms of money and not as many shares. Stock can be divided into fractions of any amount and such fractions may be transferred like shares.

Share certificate means a certificate under the common seal of the company specifying the number of shares held by any member. Share certificate provides the prima facie evidence of title of the members to such shares. This gives the shareholder the facility of dealing more easily with his shares in the market. It enables him to sell his shares by showing marketable title.

Equity shares have the following rights according to section 85 (2) of the Companies Act 1956.

1. Right to vote at the general body meetings of the company.
2. Right to control the management of the company.
3. Right to share in the profits in the form of dividends and bonus shares.
4. Right to claim on the residual after repayment of all the claims in the case of winding up of the company.
5. Right of pre-emption in the matter of issue of new capital.
6. Right to apply to court if there is any discrepancy in the rights set aside.
7. Right to receive a copy of the statutory report, copies of annual accounts along with audited report.
8. Right to apply the central government to call an annual meeting when a company fails to call such a meeting.
9. Right to apply the Company Law Board for calling an extraordinary general meeting.

In a limited company the equity shareholders are liable to pay the company's debt only to the extent of their share in the paid up capital. The equity shares have certain advantages. The main advantages are

- ⇒ Capital appreciation
- ⇒ Limited liability
- ⇒ Free tradeability
- ⇒ Tax advantages (in certain cases) and
- ⇒ Hedge against inflation

SWEAT EQUITY

Sweat equity is a new equity instrument introduced in the Companies (Amendment) Ordinance, 1998. Newly inserted Section 79A of the Companies Act, 1956 allows issue of sweat equity. However, it should be issued out of a class of equity shares already issued by the company. It cannot form a new class of equity shares. Section 79A (2) explains that all limitations, restrictions and provisions applicable to equity shares are applicable to sweat equity. Thus, sweat equity forms a part of equity share capital.

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The definition of sweat equity has two different dimensions:

- Shares issued at a discount to employees and directors.
- Shares issued for consideration other than cash for providing know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called.

In its first form, issue of sweat equity may be priced at a discount to the preferential pricing or at a discount to face value. Issue of sweat equity falls in the category of preferential issue under Section 81 (1A) of the Companies Act, 1956. Agreed upon price of shares of the company is derived in accordance with preferential pricing norm, which may be called as normal price.

The level of discount to normal price may be decided on the basis of the valuation of the intangibles to be acquired. Discount is the difference between the normal price and price at which sweat equity is issued.

Discount may also mean any issue of sweat equity below the par value. This eases the restriction on issue of shares at discount as stated in Section 79. This route can be used by a company whose share price is 10 20% above the par value. Issue of shares at discount under Section 79 can be carried at 10% discount. In case of sweat equity, it becomes imperative to decide the maximum level of discount that can be offered to the employees and directors.

The second type of sweat equity can be issued at par or above par. In other words, the sweat equity can be issued against know-how, intellectual property rights or in recognition of value additions. Issue of sweat equity for consideration other than cash should be at the normal preferential price.

Reasons for issuing sweat equity Directors and employees contribute intellectual property rights to the company. This may be in the form of providing technical know-how captured by way of research contributing to the company in the form of strategy, software developed for the company, or adding profit.

- Traditional way of recognising the employees and directors in the form of monetary and non-monetary benefit is deficient. Even incentive bonus on the basis of performance fails to reward them adequately. Rather in the matter of intellectual property right, the contributing employees/directors are not well protected.
- In case a director/employee leaves the company or is asked to leave, his contribution which will generate cash flows to the company for an unidentified future period does bring adequate return to him.

Sweat equity is for

- Directors/employees who designed strategic alliance
- Directors/employees worked for strategic market penetration and helped the company attain sustainable market share.

In the service industry, sweat equity has a special relevance. The major industries where the directors and employees can be rewarded through sweat equity are:

- Computer hardware and software development
- Management consultancy where a standard strategy is issued to earn a fee, like Enterprise Resource Planning (ERP) solution
- NBFCs where product design is crucial

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- Other non-traditional financial service industries like custodians, depositories and credit rating wherein basic service design is important
- In the life insurance segment, commission-based business can be converted into sweat equity with development officers and branch managers (sales)

NON-VOTING SHARES

Non-voting shares carry no voting rights. They carry additional dividends instead of the voting rights. Even though the idea was widely discussed in 1987, it was only in the year 1994 that the Finance Ministry announced certain broad guidelines for the issue of non voting shares.

They have right to participate in the bonus issue. The non-voting shares also can be listed and traded in the stock exchanges. If non-voting shares are not paid dividend for two years, the shares would automatically get voting rights. The company can issue this to a maximum of 25 per cent of the voting stock. The dividend on non voting shares would have to be 20 percent higher than the dividend on the voting shares. All rights and bonus share for the non-voting shares have to be issued in the form of non-voting shares only.

RIGHT SHARES

Shares offered to the existing shareholders at a price by the company are called right shares. They are offered to the shareholders as a matter of legal right. If a public company wants to increase its subscribed capital by way of issuing shares after two years from its formation date or one year from the date of first allotment, whichever is earlier, such shares should be offered first to the existing shareholders in proportion to the capital paid up on the shares held by them at the date of such offer. This pre-emptive right can be forfeited by the shareholders through a special resolution. The shareholder can renounce the right shares in favour of his nominee. He may renounce all or part of the shares offered to him. The right shares may be partly paid. Minimum subscription limit is prescribed for right issues. In the event of company failing to receive 90% subscription, the company shall have to return the entire money received. At present, SEBI has removed this limit. Right issues are regulated under the provisions of the Companies Act and SEBI.

BONUS SHARES

Bonus share is the distribution of shares in addition to the cash dividends to the existing shareholders. Bonus shares are issued to the existing shareholders without any payment of cash. The aim of bonus share is to capitalise the free reserves. The bonus issue is made out of free reserves built out of genuine profit or share premium collected in cash only. The bonus issue could be made only when all the partly paid shares, if any, existing are made fully paid up.

The declaration of the bonus issue used to have favourable impact on the psychology of the shareholders. They take it as an indication of higher future profits. Bonus shares are declared by the directors only when they expect a rise in the profitability of the concern. The issue of bonus shares enables the shareholders to sell the shares and get capital gains while retaining their original shares.

PREFERENCE STOCK

The characters of the preferred stock are hybrid in nature. Some of its features resemble the bond and others the equity shares. Like the bonds, their claims on the company's income are limited and they receive fixed

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dividend. In the event of liquidation of the company their claims on the assets of the firm are also fixed. At the same time like the equity, it is a perpetual liability of the corporate. The decision to pay dividend to the preferred stock is at the discretion of the Board of Directors. In the case of bonds, payment of interest rate is mandatory.

The dividend received by the preferred stock is treated on par with the dividend received from the equity share for the tax purposes. These shareholders do not enjoy any of the voting powers except when any resolution affects their rights.

Cumulative preference shares Here, the cumulative total of all unpaid preferred dividends must be paid before dividends are paid on the common equity. The unpaid dividends are known as arrearages. The arrearages do not earn interest. The non payment of the dividend only continues to grow. The arrearages accrue only for a limited number of years and not indefinitely. Generally three years of arrears accrue and the accumulative feature ceases after three years. But the dividends in arrears continue if there is no such provision in the Articles of Association. In the case of liquidation, no arrears of dividends are payable unless there is a provision for them in the Articles of Association.

Non-cumulative shares As the name suggests, the dividend does not accumulate. If there is no profit or inadequate profit in the company in a particular year, the company does not pay it. In the winding up of a company if the preference and equity shares are fully paid, they have no further rights to have claims in the surplus. If there is a provision in the Articles of Association for such claims, then they have the rights to claim.

Convertible preference shares The convertibility feature makes the preference share a more attractive investment security. The conversion feature is almost identical with that of the bonds. These preference shares are convertible as equity shares at the end of the specified period and are quasi-equity shares. This gives the additional privilege of sharing the potential increase in the equity value, along with the security and stability of income.

Redeemable preference shares If there is a provision in the Articles of Association, redeemable preference shares can be issued. But redemption of the shares can be done only when

a) The partly paid up shares are made fully paid up.

b) The fund for redemption is created from the profits, which would otherwise be available for distribution of dividends or out of the proceeds of a fresh issue of shares for the purpose.

c) If any premium has to be paid on redemption, it should be paid out of the profits or out of the company's share premium account.

d) When redemption is made out of profits, a sum equal to the nominal value of the redeemed shares should be transferred to the capital redemption reserve account.

Irredeemable preference shares This type of shares is not redeemable except on occasions like winding up of the business. In India, this type of shares was permitted till 15th June1988. The introduction of section 80A in the Companies Act 1956 put an end to it.

Cumulative Convertible Preference Shares (CCPS) This CCPS was introduced by the government in 1984. This preference share gives a regular return of 10% during the gestation period from three years to five years and then converted into equity as per the agreement. According to the guidelines CCPS can

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be issued for any of the following purposes (a) setting up of new projects (b) expansion or diversification of existing projects (c) normal capital expenditure for modernisation and (d) working capital requirements. CCP failed to attract the interest of the investors because the rate of interest is very low and the gain that could be received from the conversion into equity also depends on the profitable functioning of the equity.

DEBENTURE

According to Companies Act 1956 "Debenture includes debenture stock, bonds and any other securities of company, whether constituting a charge on the assets of the company or not". Debentures are generally issued by the private sector companies as a long-term promissory note for raising loan capital. The company promises to pay interest and principal as stipulated. Bond is an alternative form of debenture in India. Public sector companies and financial institutions issue bonds.

Characteristic Features of Debentures

Form It is given in the form of certificate of indebtedness by the company specifying the date of redemption and interest rate.

Interest The rate of interest is fixed at the time of issue itself which is known as contractual or coupon rate of interest. Interest is paid as a percentage of the par value of the debenture and may be paid annually, semi annually or quarterly. The company has the legal binding to pay the interest rate.

Redemption As stated earlier the redemption date would be specified in the issue itself. The maturity period may range from 5 years to 10 years in India. They may be redeemed in instalments. Redemption is done through a creation of sinking fund by the company. A trustee incharge of the fund buys the debentures either from the market or owners. Creation of the sinking fund eliminates the risk of facing financial difficulty at the time of redemption because redemption requires huge sum.

Buy back provisions help the company to redeem the debentures at a special price before the maturity date. Usually the special price is higher than the par value of the debenture.

Indenture Indenture is a trust deed between the company issuing debenture and the debenture trustee who represents the debenture holders. The trustee takes the responsibility of protecting the interest of the debenture holders and ensures that the company fulfills the contractual obligations. Financial institutions, banks, insurance companies or firm attorneies act as trustees to the investors. In the indenture the terms of the agreement, description of debentures, rights of the debenture holders, rights of the issuing company and the responsibilities of the company are specified clearly.

Types of Debentures

Debentures are classified on the basis of the security and convertibility

1. Secured or unsecured
2. Fully convertible debenture
3. Partly convertible debenture
4. Non-convertible debenture

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debentures are rated by the credit rating agencies.

Fully convertible debenture This type of debenture is converted into equity shares of the company on the expiry of specific period. The conversion is carried out according to the guidelines issued by SEBI. The FCD carries lower interest rate than other types of debentures because of the attractive feature of convertibility into equity shares.

Partly convertible debenture This debenture consists of two parts namely convertible and non-convertible. The convertible portion can be converted into shares after a specific period. Here, the investor has the advantage of convertible and non-convertible debentures blended into one debenture. Ex. Procter and Gamble had issued PCD of Rs 200 each to its existing shareholders. The investor can get a share for Rs 65 with the face value of Rs 10 after 18 months from allotment.

Non-convertible debenture Non-convertible debentures do not confer any option on the holder to convert the debentures into equity shares and are redeemed at the expiry of the specified period.

BOND

Bond is a long term debt instrument that promises to pay a fixed annual sum as interest for specified period

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rates change according to the prefixed norms. For example in Dec 1993 State Bank of India issued floating interest rate bonds worth of Rs 500 Cr. pegging the interest rate with its own three and five years fixed deposit rates to provide built in yield flexibility to the investors.

Zero coupon bonds These bonds sell at a discount and the face value is repaid at maturity. The origin of this type of bond can be traced in the U.S. Security Market. The high value of the U.S.Government security prevented the investors from investing their money in the government security. Big brokerage companies like Merril Lynch, Pierce and others purchased the government securities in large quantum and resold them in smaller denomination - at a discounted rate. The difference between the purchase cost and face value of the bond is the gain for the investor. Since the investor does not receive any interest on the bond, the conversion price is suitably arranged to protect the interest loss to the investor. The discounted value is calculated using the formula

$$\text{Present value} = \frac{\text{Face value of the bond}}{(1+R)^n}$$

R = interest rate and n = number of years.

For example a zero coupon bond that matures in 20 years time with the face of Rs 50,000 would be sold at Rs 5185 to give a return of 12 per cent per annum.

The merit of this bond is that the company does not have the burden of servicing the debt during the execution period of the project. The repayment could be adjusted to fall after the completion of the project. This could result in considerable cost savings for the company.

Deep discount bonds Deep discount bond is another form of zero coupon bond. The bonds are sold at large discount on their nominal value; interest is not paid for them and they mature at par value. The difference between the maturity value, and the issue price serves as an interest return. The deep discount bonds' maturity period may range from 3 years to 25 years or more. IDBI was the first to issue deep discount bonds in India in 1992 with varying maturity period options. ICICI also issued deep discount bonds with four optional maturity periods in 1997. Early redemption option is provided at the end of the 6th, 12th and 18th year.

Capital indexed bonds In the capital indexed bond, the principal amount of the bond is adjusted for inflation for every year. For example, an investment of Rs.1000 in the inflation indexed bonds earn the investor a semi annual interest income for the five years' period. The reselling of the principal amount is done semi annually based on the WPI movements. The principal amount of the bond is adjusted for inflation for each of the years.On the inflation-adjusted principal, the coupon rate of 6 per cent is worked.

The benefit of the bond is that it gives the investor an increase in return by taking inflation into account. The investor enjoys the benefit of a return on his principal, which is equal to the average inflation between the issue (purchase) and maturity period of the instrument. To avail the benefit of inflated principal, the investor needs to hold the instrument for the entire 5 year period.

If the investor wants to exit early, he can do it through the secondary market. The value of the principal repayment will be adjusted by the Index Rate (IR), which will be announced by the RBI two weeks prior to the repayment of the principal. The IR is worked out as follows IR = Reference WPI as in Aug 2002, Base WPI (as in August 1997).

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In the Indian situation indexed bonds offer more scope since the economy is highly sensitive to the inflation. According to the study conducted by the Development Research Group (DRG) of the RBI, during the period 1972-93, the real rate of interest was negative for most of the years. Average value over the period is minus 1.84 per cent.

This situation warrants an inflation hedge. The inflation protection provided by the bond guarantees real rate of return which means that with the rise in inflation, the return from the inflation protected bond will rise. In 1997 capital indexed bond is introduced.

WARRANTS

A warrant is a bearer document of title to buy specified number of equity shares at a specified price. Usually warrants can be exercised over a number of years. The life periods of warrants are long. Warrants are generally offered to make the bond or preferred stock offering more attractive. Bonds may bear low interest rate but the warrants offered along with them helps the investor to enjoy the equity appreciation value. Warrants are detachable. The investor can sell the warrants separately and they are traded in the market.

The person who is holding the warrant cannot enjoy the benefits of the equity holder before the conversion of the warrant. The price at which the warrants are converted is called exercise price. The exercise price is always greater than the current market price of the respective equity at the time of issue of warrant. When warrants are issued along with host securities and detachable, they are known as detachable warrants. In some cases the warrants can be sold back to the company before the expiry date, such type is known as puttable warrants. Naked warrants are issued separately and not with any host securities. The investor has the option to convert it into equity or bond.

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Table 1.2 Difference Between Share Warrants and Share Certificate

	Warrants	Share certificate
1.	Issued by public limited company	Issued by public and private companies
2.	Need for provision in the Articles of Association	No need to be contained in the Articles of Association
3.	Should be approved by the central government	Central government approval is not needed
4.	Share warrants are issued to fully paid up shares	Share certificates are issued to fully and partly paid shares
5.	Transfer of share warrant requires no registration	Transfer of shares would be complete only if it is registered
6.	It is considered as a negotiable instrument	Share certificate is not considered like that

INVESTMENT INFORMATION

In the investment process we have seen that the investor should have knowledge about the investment alternatives and the markets. He has to analyse the economy, industry and the company. For all these, he needs adequate flow of information. The source of information varies with the type of information required.

International affairs With increasing globalisation, international events affect the economy of the nation. Nations are economically and politically linked with each other. The economic crisis of one nation has a contagion effect on the other. The depreciation of the peso value in Mexico affects the trade in Asia. The South-East Asian crisis has affected Asia, United States and Europe. Indian capital market reacted to the crisis and there was a fall in the sensex for a brief period. The policies of the IMF and the World Bank also affect the volume of loan for the development purpose. Not only the economic events but political events and wars also affect the stock market. U.S. air raids on Iraq affected the Indian economy and the capital market. Almost all the daily news papers carry the international news. Some foreign journals like London Economist, Far East Economic Review and Indian magazines like Business World and Fortune India review the international events. International financial institution like IMF, World Bank and Asian Development Bank publish their own survey reports periodically.

National affairs The growth of the national economy and political events within the nation influence the investment decisions. The political events are provided by the news papers, magazines like India Today, Out Look, Fortune India, The Week etc. The economic events and their implication on the securities markets are analysed in Financial Express, Economic Times and Business Line. RBI Bulletin and annual reports give a wide range of information regarding macro economic indicators like GDP, GNP, inflation, agricultural and industrial production, capital market, development in the banking sectors and the balance of payment. Center for Monitoring Indian Economy also publishes reports about the macro economic factors. The Economic Survey of India and reports of companies also provide information regarding the economy, industry and other sectors.

Industry information Information about the industry is required to identify the industries that perform better than the national economy as a whole. Financial news papers regularly bring out industrial studies for

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the benefit of the investors. Experts' opinions about the industries are available in Business India, Business Today and Dalal Street. CMIE also publishes data regarding the industries. Bombay Stock Exchange publishes the Directory of Information that contains industry and company information.

Company information A source of company information must be developed to facilitate the company analysis. The BSE, NSE and OTCEI provide details about the listed companies in the web sites. Almost all the financial journals carry out the company analysis and even suggest enter, exit and stay hints for the particular company stock. The Annual Reports of the companies and the un-audited quarterly and half-yearly results also provide an insight into the performance of the company. Software companies also sell details regarding the financial performance of the companies in the floppies.

Stock Exchange Directory comes in eighteen volumes. It gives information about all listed public companies and major public sector corporations. Kothari's Economic and Industry Guide of India gives relevant financial information about the public limited companies. Times of India Directory gives detailed information about many industrial groups and companies.

Stock market information All the financial dailies and investment related magazines publish the stock market news. Separate News Bulletins are issued by BSE, NSE and OTCEI providing information regarding the changes that take place in the stock market. SEBI news letter gives the changes in the rules and regulations regarding the activities of the stock market. Reserve Bank of India Bulletin also carries the information about the stock markets.

SUMMARY

- Financial investment is the allocation of funds to assets and securities after considering their return and risk features.
- Investor plans for a long horizon after considering the fundamental factors and assumes moderate risk.
- Speculators are interested in short term gains and their buying and selling are based on the market price movement.
- The main objectives of rational investors are maximising returns and minimising risk. Safety of the principal, tradeability and liquidity are his subsidiary objectives.
- The investor should have knowledge about the economy, the company and the market structure.
- Equity shares have the right to receive dividend and residual claim.
- Sweat equity is issued to employees or directors at a discount for their contributions in technical know how or other specified area.
- Right shares are issued to the existing shareholders at a price, on the pro-rata basis.
- Bonus shares are issued to the existing shareholders freely in addition to the dividend from the company's reserves.
- Preference stocks have fixed dividends but have a perpetual liability on the companies.

QUESTIONS

1. What is investment? Is investment different from speculation? Explain.
2. State the economic and financial meaning of investment. In the stock market, can you differentiate the investor from the speculator?

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3. Investment and speculation are somewhat different and yet similar in certain respect. Explain.
4. Discuss the factors that differentiate the investor from speculator and gambler.
5. What are the investor's objectives in investing his funds in the stock market?
6. Explain the primary and subsidiary objectives of investment.
7. "The investment process involves a series of activities starting from the policy formulation" Discuss.
8. What are the five different aspects of investment?
9. Explain the process of investment undertaken by the investor.
10. Define securities. Give a brief account of different types of securities.
11. How do common stocks differ from preference stocks?
12. Specify the characterestic features of equity stocks.
13. If you buy Satyam Computer stocks what are the rights and benefits you would enjoy?
14. What are the different types of preference shares? Explain them in detail.
15. Define sweat equity. What are the reasons for issuing sweat equity?
16. Sweat equity is the best form of reward for those who contribute to the growth of a company. Discuss.
17. What are the new innovations in the bond market?
18. Discuss the features of various types of debentures.
19. Why are warrants issued? What are the advantages of warrants?
20. What is meant by warrant? How do warrants differ from share certifictes?
21. "Without adequate information the investor cannot carry out his investment programme." Elucidiate.
22. What are the sources of investment information?
23. "The 16.50 per cent non-convertible debenture issue of Sterlite Industry was traded around Rs 485. The face-value of the debenture is Rs 450. It is to be redeemed in three equal instalments of Rs 150 each starting from March 2000." News paper report. What are the special characteristic features of this debenture? How does it differ from Sterlite Industry stock?

MULTIPLE CHOICE QUESTIONS

1. Investments is the

   a) net additions made to the nations capital stocks
   b) person's commitment to buy a flat or a house
   c) employment of funds on assets to earn returns
   d) employment of funds on goods and services that are used in production process

[Ans c]

2. Speculator is a person

   a) who evaluates the performance of the company
   b) who uses his own funds only

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CHAPTER 2

INVESTMENT ALTERNATIVES

The problem of surplus gives rise to the question of where to invest. In the past, investment avenues were limited to real assets, schemes of the post office and banks. At present, a wide variety of investment avenues are open to the investors to suit their needs and nature. A knowledge about the different avenues enables the investors to choose investment intelligently. The required level of return and the risk tolerance level decide the choice of the investor. The investment alternatives ranges from financial securities to traditional non-security investments. The financial securities may be negotiable or non-negotiable.

The negotiable securities are financial securities that are transferable. The negotiable securities may yield variable income or fixed income. Securities like equity shares are variable income securities. Bonds, debentures, Indra Vikas Patras, Kisan Vikas Patras, Government securities and money market securities yield a fixed income.

The non-negotiable financial investment as the name itself suggests is not transferable. This is also known as non-securitised financial investments. Deposit schemes offered by the post offices, banks, companies, and non-banking financial companies are of this category. The tax-sheltered schemes such as public provident fund, national savings certificate and national savings scheme are also non-securitised financial investments.

Mutual fund is another investment alternate. It is of recent origin in India. Within a short span of time several financial institutions and banks have floated varieties of mutual funds. The investors with limited funds can invest in the mutual funds and can have the benefits of the stock market and money market investments as specified by the particular fund.

The real assets always find a place in the portfolio. They are gold, silver, arts, property and antiques. These are non-financial investment.

NEGOTIABLE SECURITIES

Variable Income Securities

Equity shares The equity shares attract the interest of many. In the early nineties, the stock market was the best and safest place for the common individual to invest. Since 1996 the share market prices have been low. This made the retail investors to turn away from the stock market. The characteristic features of the equity are given in the previous chapter.

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The stock market classifies shares into Growth shares, Income shares, Defensive shares, Cyclical shares and Speculative shares.

i) ***Growth shares*** The stocks that have higher rate of growth than the industrial growth rate in profitability are referred to as growth shares. For example, the list of major gainers for 1999 is dominated by software sector stocks. The HCL and Infosystems share prices increased sharply.

ii) ***Income shares*** These stocks belong to companies that have comparatively stable operations and limited growth opportunities. The bank shares and some of the fast moving consumer goods stocks such as Cadburys, Nestle and Hindustan Lever may be termed as income shares.

iii) ***Defensive shares*** Defensive stocks are relatively unaffected by the market movements. For example, a host of pharmaceutical stocks posted returns in excess of 50 per cent in 1998. The pharmaceutical industry owing to its inherent nature of demand is not affected by the down turn in the economy.

iv) ***Cyclical shares*** The business cycle affects the cyclical shares. The upward and downward movements of the business cycle affect the business prospects of certain companies and their stock prices. Such shares provide low to moderate current yield. Capital gain may be highly variable. For example, the automobile sector stocks are affected by the business cycles.

v) ***Speculative shares*** Shares that have lot of speculative trading in them are referred to as speculative shares. During the bull and bear phases of the market, this type of shares attracts the attention of the traders.

The stocks, which fall under one category in one period may switch over to another category in another period. The classification should not be considered rigid. For example, growth shares may be speculative shares.

Fixed Income Securities

a) ***Preference shares*** A detailed description of the preference shares is given in chapter 1. Preference shares are no longer regarded as inferior to the equity capital. Corporate like Siemens has placed Rs.150 Cr. worth of preference shares. High tax paying companies or investors prefer to subscribe to the preference shares and investors with a low tax burden would prefer to go in for debt instruments. The conversion options provided in the by preference shares also make it attractive. The biggest advantage is the tax-exempt status of the preference share's dividend.

b) ***Debentures*** Corporate debentures are an option available to the investors who are willing to sacrifice liquidity for higher return. Manufacturing companies like Gujarat Industries Power and TISCO have issued debentures. If the debentures are not actively traded in the debt segment of the capital market, the investors may have to hold the instrument till maturity. If the instruments were actively traded in the secondary market, it would have perhaps changed hands at a considerable premium, thereby lowering the yield on par with the present interest rate. These reasons contribute towards high coupon rates on debentures.

c) ***Bonds*** Bonds are similar to the debentures but they are issued by the public sector undertakings. The value of the bond in the market depends upon the interest rate and the maturity. The coupon rate is the

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nominal interest rate offered on the bonds. The coupon rate is contractual involving the terms and conditions of the issuance of the debt security. Being contractual it cannot be changed during the tenure of the instrument. The investors are not affected by lowering of the bank rates. When the bank rates are lowered, actually, the value of the bonds, which are carrying interest rates above the bank rate would appreciate. IDBI and ICICI have issued various bonds to suit the needs of the investors. Some of them are deep discount bond, education benefit bond, retirement benefit bond and index bond.

d) ***IVPs and KVPs*** These are saving certificates issued by the post office with the name Indira Vikas Patra (IVP) and Kisan Vikas Patra (KVP). The IVPs are in the face value of Rs. 500, 1000 and 5000. The KVPs are in the denomination of Rs. 1000; 5000 and 10000. The capital is doubled in 5.5 years with the return of 13.47%. IVPs are like bearer bonds, transferable by hand delivery and therefore are attractive to the persons who prefer cash transactions. No income tax concession is available for this type of investment.

e) ***Government securities*** The securities issued by the Central, State Government and Quasi Government agencies are known as Government securities or gilt edged securities. As Government guaranteed security is a claim on the Government, it is a secured financial instrument, which guarantees the income and the capital. The rate of interest on these securities is relatively lower because of their high liquidity and safety.

f) ***Money market securities*** Money market securities have very short term maturity say less than a year. Common money market instruments are:

⇒ Treasury bills
⇒ Commercial paper
⇒ Certificate of deposit

i) ***Treasury bills*** A treasury bill is basically an instrument of short term borrowing by the Government of India. To develop the treasury bill market and provide investors with financial instruments of varying short-term maturities and to facilitate the cash management requirements of various segments of the economy, in April 1997 treasury bills of varied maturities were introduced. 14-day treasury bill on a weekly basis was introduced from June 6, 1997. In the second half of 1997-98, treasury bill of 28-day was introduced on auction basis. Further, it was decided to reintroduce 182-day treasury bills through auctions. Generally, treasury bills are of 91-days. Since the interest rates offered on the treasury bills are very low, individuals very rarely invest in them.

ii) ***Commercial papers*** Commercial paper is a short-term negotiable instrument with fixed maturity period. It is an unsecured promissory note issued by the company either directly or through bank/ merchant banks. The maturity period of commercial paper was originally three (minimum) to six (maximum) months from the date of issue. In Oct 1993, the maximum period was extended to one year. The commercial papers are sold at a discount and redeemed at their face value. The discounted value implicates the interest rate. The denomination of commercial paper is high. Mostly the companies and institutional investors favour them. The minimum maturity of CP was brought down from 3 months to 30 days.

iii) ***Certificate of deposit*** The certificate of deposit is a marketable receipt of funds deposited in a bank for a fixed period at a specified rate of interest. They are bearer documents and readily negotiable.

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The denominations of the CD and the interest rate on them are high. It is mainly preferred by institutional investors and companies rather than the individuals. The minimum size of the certificate is Rs 10 lakh. The additional amount is issued in multiples of Rs 5 lakh.

NON-NEGOTIABLE SECURITIES

Deposits

Deposits earn fixed rate of return. Even though bank deposits resemble fixed income securities they are not negotiable instruments. Some of the deposits are dealt subsequently.

a) **Bank deposits** It is the simple investment avenue open for the investors. He has to open an account and deposit the money. Traditionally the banks offered current account, savings account and fixed deposit account. Current account does not offer any interest rate. The drawback of having large amounts in savings accounts is that the return is just 4.5 per cent. The savings account interest rate is regulated by the Reserve Bank of India and kept low because of the high cost of servicing them. The savings account is more liquid and convenient to handle. The fixed account carries high interest rate and the money is locked up for a fixed period. With increasing competition among the banks, the banks have bundled the plain savings account with the fixed account to cater to the needs of the small savers. Some of the hybrid accounts are given below in the Table 2.1.

Table 2.1 Hybrid Accounts Offered by Some Banks

Bank	*Product*	*Nature*	*Min. Dep (Rs.)*	*Other benefits*

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Bank	*Product*	*Nature*	*Min. Dep (Rs.)*	*Other benefits*
IndusInd Bank	2-in-1 Account	Savings account with link to FD.	25,000	Cheque book and overdraft facility.
	Cluster Deposits	Savings linked FD with Auto-sweep and Reverse-sweep.	25,000	Cheque book.
HDFC Bank	Super saver account	Savings linked to FD.	25,000	Overdraft, cheque book, ATM and phone banking.
	Sweep-in-account	Savings linked to FD with Reverse-Sweep and add-on-deposit.	25,000	ATM, Cheque book and phone banking.

The deposits in the banks are considered to be safe because of the RBI regulation. The risk averse investors prefer the bank deposits.

a) ***Post office deposits*** Like the banks, post office also offers fixed deposit facility and monthly income scheme. Post office Monthly Income Scheme is a popular scheme for the retired. An interest rate of 13% is paid monthly. The term of the scheme is 6 years, at the end of which a bonus of 10% is paid. The annualised yield to maturity works out to be 15.01% per annum. After three years, premature closure is allowed without any penalty. If the closure is after one year, a penalty of 5% is charged.

b) ***NBFC deposits*** In recent years, there has been a significant increase in the importance of non-banking financial companies in the process of financial intermediation. The NBFC comes under the purview of the RBI. The amendment of RBI Act in Jan 1997, made registration compulsory for the NBFCs.

i) ***Period*** The maturity period ranges from few months to five years. It varies from company to company. For example, the Birla Global Finance, the company belonging to Aditya Birla group accepts deposits with maturity from 3-5 years.

ii) ***Maximum limit*** The limit for acceptance of deposit has been based on the credit rating of the company. The NBFCs not having net owned funds of Rs 25 lakh are not entitled to accept deposits.

iii) ***Internet*** NBFCs offer interest rate higher than the commercial bank on public deposit. The interest rate differs according to maturity period. There is a disparity in the interest rate among the companies in accordance with the credit ratings and policies of the companies. Even the companies with similar credit ratings provide different interest rates for their deposits. Generally, companies with

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Company	1 year	2 years	3 years	Amount
Bajaj Auto Finance	—	—	6.50	25,000
Birla Home Finance	6.00	6.25	6.50	20,000
Canbank Factors	6.79	7.04	—	25,000
Can Fin Homes	5.25	5.50	5.75	5,000
Chola Finance	6.50	7.00	7.50	10,000
Dewan Housing Finance	6.10	6.35	6.60	10,000
HUDCO	6.25	6.50	6.75	50,000
HDFC	5.55	5.80	6.05	10,000
IDBI	5.50	5.75	6.25	25,000
Lakshmi General Finance	6.00	6.50	7.00	10,000
M&M Financial Services	6.50	7.00	7.50	10,000
PNB Housing Finance	5.75	6.00	6.00	20,000
SRF	7.00	7.00	7.00	10,000
Sundaram Finance	6.00	6.50	7.00	10,000
Sundaram Home	6.00	6.25	6.50	10,000
TN Power Finance	–	6.54	7.23	10,000

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