MB FC 01 (SECURITY ANALYSIS & PORTFOLIO MANAGEMENT)

UNIT – 1

"An investment operation is one which, upon thorough analysis promises safety of principal and an adequate return. Operations not meeting these requirements are speculative."

- By Graham and Qadd's Security Analysis

"Investment Management is the process of managing money, including investments, budgeting, banking and taxes, also called as money management."

Investment is putting money into something with the expectation that it will generate income or the value will appreciate in future or profit. The word originates in the Latin "vestis", meaning garment, and refers to the act of putting things (money or other claims to resources) into others' pockets.

The term "investment" is used differently in economics and in finance. Economists refer to a real investment (such as a machine or a house), while financial economists refer to a financial asset, such as money that is put into a bank or the market, which may then be used to buy a real asset.

Financial Meaning of Investment

- Financial investment involves of funds in various assets, such as Stock, Bond, Real Estate, Mortgages etc.
- Investment is the employment of funds with the aim of achieving additional income or growth in value.
- It involves the commitment of resources which have been saved or put away from current consumption in the hope some benefits will accrue in future. Investment involves long term commitment of funds and waiting for a reward in the future.
- From the point of view people who invest their finds, they are the supplier of 'Capital' and in their view investment is a commitment of a person's funds to derive future income in the form of interest, dividend, rent, premiums, pension benefits or the appreciation of the value of their principle capital.
- To the financial investor it is not important whether money is invested for a productive use or for the purchase of secondhand instruments such as existing shares and stocks listed on the stock exchange.
- Most investments are considered to be transfers of financial assets from one person to another.

Economic Meaning of Investment

- Economic investment means the net additions to the capital stock of the society which consists of goods and services that are used in the production of other goods and services. Addition to the capital stock means an increase in building, plants, equipment and inventories over the amount of goods and services that existed.

- The financial and economic meanings are related to each other because investment is a part of the savings of individuals which flow into the capital market either directly or through institutions, divided in 'new' and secondhand capital financing. Investors as 'suppliers' and investors as 'users' of long-term funds find a meeting place in the market.

NEED AND IMPORTANCE OF INVESTMENTS

An investment is an important and useful factor in the context of present day conditions. Some factors are important. They are as outlined below:

• Longer life expectancy or planning for retirement
• Increasing rates of taxation
• High interest rates
• High rate of inflation
• Larger incomes
• Availability of a complex number of investment outlets.

INVESTMENT ACTIVITY

Investment activity includes buying and selling of the financial assets, physical assets and marketable assets in primary and secondary markets. Investment activity involves the use of funds or savings for further creation of assets or acquisition of existing assets.

Investment activity refers to acquisition of assets like:

• Financial Assets
• Physical Assets
• Marketable Assets from the Primary and Secondary Market

Financial Assets are:

• Cash
• Bank Deposits
• P.F.
• LIC Schemes
• Pension Scheme
• Post Office Certificates and Deposits

Physical Assets are:

• House, Land, Building and Flats
• Gold, Silver and other Metals
• Consumer Durables

Marketable Assets are:

• Shares
• Bonds
• Government Securities
• M.F. Schemes
• UTI Units etc.

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CLASSIFICATION OF INVESTMENT

On the Basis of Physical Investments

Physical investments are:

- House
- Land
- Building
- Gold and Silver
- Precious stones

On the Basis of Financial Investment

Financial investments further classified on the basis of:

- Marketable and Transferable investments
- Non-Marketable Investments

Marketable and Transferable Investments

Marketable investments are:

- Shares
- Debentures of Public Limited Companies, particularly the listed company in Stock Exchange
- Bonds of Public Sector Units
- Government Securities, etc.

Non-Marketable Investments

Non-marketable investments are:

- Bank Deposits
- Provident and Pension Funds
- Insurance Certificates
- Post office Deposits
- National Saving Certificates
- Company Deposits
- Private Companies Shares etc.

MODES OF INVESTMENT

Modes of investment consist of:

- Security Forms of Investment
- Non-Security Forms of Investment/Non-Marketable Investment

Security Forms of Investment

Security forms of investment include the following:

- **Corporate Bonds/Debenture**

(a) Convertible
(b) Non-Convertible

- **Public Sector Bonds**

(a) Taxable
(b) Tax Free

- **Preference Shares**
- **Equity Shares**

(a) New Issue
(b) Rights Issue
(c) Bonus Issue

Non-Security Forms of Investment (non transferable)

Non-security forms of investment as outlined below:

• National Savings Scheme
• National Savings Certificates
• Provident Funds
(a) Statutory Provident Fund
(b) Recognised Provident Fund
(c) Unrecognised Provident Fund
(d) Public Provident Fund
• Corporate fixed deposits
(a) Public Sector
(b) Private Sector
• Life insurance policies
(a) Whole Life Policies
(b) Limited-payment Life Policy
(c) Convertible Whole Life Assurance Policy
(d) Endowment Assurance Policy
(e) Jeevan Mitra
(f) The Special Endowment Plan with Profits
(g) Jeevan Saathi
(h) The New Money Back Plan
(i) Marriage Endowment/Educational Annuity Plan with Profits
(j) Bima Sandesh Premium Back Term Insurance Plan
(k) New Children's Deferred Assurance Plan
(l) Jeevan Dhara
(m) New Jana Raksha Plan with Profits
(n) Jeevan Akshay Plan
(o) Jeevan Balya Plan
(p) Jeevan Kishor
(q) Jeevan Griha
(r) Jeevan Sarita and Others
• Unit schemes of Unit Trust of India (Some are marketable among these)
(a) Unit Scheme, 1964
(b) Reinvestment Plan, 1966
(c) Unit Linked Insurance Plan, 1971
(d) Capital Gains Unit Scheme, 1983
(e) Children's Gift Growth Funds, 1986
(f) Parent's Gift Growth Funds, 1987
(g) Monthly Income Unit Scheme with Extra Bonus Plus Growth
(h) Master Shares
(i) Master Gains
(j) Equity Linked Savings Scheme
(k) Growing Monthly Income Unit Scheme
(l) Mastershare Plus etc.

• Post Office Savings Bank Account
(a) Recurring Deposits
(b) Time Deposits
(c) Monthly Income Scheme
(d) Social Security Certificates
• Others
(a) Rahat Patras or Relief Bonds
(b) Kisan Vikas Patra
(c) Deposits in Co-operative Banks
(i) Recurring deposits
(ii) Time deposits, etc.

THE INVESTMENT PROCESS/STAGES

Investment process refers to investment policy, investment analysis, valuation of securities and proper portfolio construction in this way achieve to investment process.
The investment process/stages are outlined below:
• Investment Policy
• Investment Analysis
• Valuation of Securities
• Portfolio Construction

Investment Policy

Investment policy is the first stage of the investment process. It determines the following aspects of the investor:
• Determination of Investable Wealth
• Determination of Portfolio Objectives
• Identification of Potential Investment Assets
• Consideration of Attributes of Investment Assets
• Allocation of Wealth to Asset Categories.

Investment Analysis

Investment analysis is the second stage of the investment process. Investor analysis of the investment is made on the following grounds:
• Equity Stock Analysis
• Screening of Industries
• Analysis of Industries
• Quantitative Analysis of Stocks
• Analysis of the Economy
• Debentures and Bond Analysis
• Analysis of Yield Structure
• Consideration of Debentures
• Quantitative Analysis of Debentures
• Other Asset Analysis
• Qualitative Analysis

• Quantitative Analysis

Valuation of Securities

Valuation of the securities is the third stages of the investment process. This stage involves

• Valuation of Stocks
• Valuation of Debentures and Bonds
• Valuation of Other Assets

Portfolio Construction

Portfolio construction is the last stage of the investment process. It involves the following areas as outlined below that:

• Determination of Diversification Level
• Consideration of Investment Timing
• Selection of Investment Assets
• Allocation of Investable Wealth to Investment Assets
• Evaluation of Portfolio for Feedback

Investment, Speculation & Gambling

Many people do not differentiate between the following terms when they invest their hard-earned money in different asset classes, particularly in stock market and often get confused between;

1. Saving
2. Investment
3. Speculations
4. Gambling

We often use the word savings and investment interchangeably, while both are different and both are necessary to secure our future. Saving is done for purchases and emergencies while investment is being done for creation of wealth. I have heard from most of the people that they are savings for their retired life, we need to understand that if we are saving for our retired life we need to invest that money to create wealth. We need to allocate the money wisely between saving and investment, it depends upon behavior of each individual and allocation can be made accordingly. In general, we shall allocate equivalent of three to six months expenses for savings and any excess over it should be allocated for investment.

There is a razor thin differentiation between investment and speculations, in reality it depends upon our own behavior as an investor to differentiate between investment and speculation. Investment and speculative deals are generally done for real assets.

Investment can be defined as “The employment of funds to acquire certain assets after due diligence for mid to long period of time, with the objective of wealth creation and additional income in future”

Speculative investment can be defined as "The employment of funds to acquire assets for shorter duration of time to take advantage of fluctuations in prices of underlying assets"

However, Gambling can be defined as "The employment of funds for entertainment/fun with the chances of return depends upon probability of certain situation or events". For example, deploying funds on horse racing can be defined as gambling.

Key differential of investment vs speculation vs gambling is;

1. Risk Analysis and Risk appetite: Investor will generally rely on the fundamental analysis of financials and other factors which can affect the price of the asset class and their decision to invest in particular asset is based upon certain fundamental values associated with the asset. Investors do have long term risk and return perspective. While speculators generally rely on the flow of the wind without analysing any fundamentals. Speculators do take higher risk for expects higher returns in short period. Gambler risk entire capital on bet and relay mainly on luck. They are the highest risk takers and ready to lose original investment also.
2. Price of the asset: Investor does not look at the price of the asset rather it looks at the asset itself to determine the decision to allocate some money now to get some money back later on. Investor does not get influenced by daily fluctuations of the asset price, because his/her allocation of money decision is based on the intrinsic value of the assets rather then price. Speculators look at the price of the asset to allocate the money and they do get influenced by the daily fluctuations of the price of the assets, aim of the speculator is to get some quick reward. Gambling is based upon odds and bets are placed only on assumptions.
3. Time Horizon: Investors allocate money for a particular asset for longer period while speculators allocate money for shorter period, on the other hand gambler place bet for immediate gain.
4. Leverages: An investor allocates money from its own resources for investment while and speculators may also rely on borrowed money to allocate. This is applicable mainly to assets belongs to equity market. Gambler generally allocate their own money and place bet for entertainment or fun.

Basic Investment Objectives

Investment triangle – three compromising objectives

Any investment decision will be influenced by three objectives – security, liquidity and yield. A best investment decision will be one, which has the best possible compromise between these three objectives.

Individually these objectives are very powerful in influencing the investors. Collectively they work against each other forcefully, as can be seen below. Hence the acclaim – A best investment decision will be one, which has the best possible compromise between these three objectives. When selecting where to invest our funds we have to analyze and manage these three objectives.

Security:

Central to any investment objective, we have to basically ensure the safety of the principal. One can afford to lose the returns at any given point of time but s/he can ill afford to lose the very

principal itself. By identifying the importance of security, we will be able to identify and select the instrument that meets this criterion. For example, when compared with corporate bonds, we can vouch safe the safety of return of investment in treasury bonds as we have more faith in governments than in corporations. Hence, treasury bonds are highly secured instruments. The safest investments are usually found in the money market and include such securities as Treasury bills (T-bills), certificates of deposit (CD), commercial paper or bankers' acceptance slips; or in the fixed income (bond) market in the form of municipal and other government bonds, and in corporate bonds

Liquidity:

Because we may have to convert our investment back to cash or funds to meet our unexpected demands and needs, our investment should be highly liquid. They should be en cashable at short notice, without loss and without any difficulty. If they cannot come to our rescue, we may have to borrow or raise funds externally at high cost and at unfavorable terms and conditions. Such liquidity can be possible only in the case of investment, which has always-ready market and willing buyers and sellers. Such instruments of investment are called highly liquid investment.

Yield:

Yield is best described as the net return out of any investment. Hence given the level or kind of security and liquidity of the investment, the appropriate yield should encourage the investor to go for the investment. If the yield is low compared to the expectation of the investor, s/he may prefer to avoid such investment and keep the funds in the bank account or in worst case, in cash form in lockers. Hence yield is the attraction for any investment and normally deciding the right yield is the key to any investment.

Relationship:

- There is a tradeoff between risk (security) and return (yield) on the one hand and liquidity and return (yield) on the other.
- Normally, higher the risk any investment carries, the greater will be the yield, to compensate the possible loss. That is why, 'fly by night' operators, offer sky high returns to their investors and naturally our gullible investors get carried away by such returns and ultimately lose their investment. Highly secured investment does not carry high coupon, as it is safe and secured.
- When the investment is illiquid, (i.e. one cannot get out of such investment at will and without any loss) the returns will be higher, as no normal investor would prefer such investment.
- These three points – security (S), liquidity (L) and yield (Y) in any investment – make an excellent triangle in our investment decision-making. Ideally, with given three points of any triangle, one can say the center of the triangle is fixed. In our investment decision too, this center – the best meeting point for S, L and Y – is important for our consideration.
- However, if any one or two of these three points are disturbed – security, liquidity and yield in any investment – the center of the triangle would be disturbed and one may have to revisit the investment decision – either to continue the investment or exit the investment.

- All these points – security, liquidity and yield – are highly dynamic in any market and they are always subject to change and hence our investor has to periodically watch his/her investment and make appropriate decisions at the right time.
- If our investor fails to monitor her / his investment, in the worst circumstances, s/he may lose the very investment.
- Thus, we will return to our original statement - A best investment decision will be one, which has the best possible compromise between these three objectives – security, liquidity and yield.

Secondary Objectives:

Tax Minimization:

An investor may pursue certain investments in order to adopt tax minimization as part of his or her investment strategy. A highly-paid executive, for example, may want to seek investments with favorable tax treatment in order to lessen his or her overall income tax burden.

Marketability / Liquidity:

Many of the investments are reasonably illiquid, which means they cannot be immediately sold and easily converted into cash. Achieving a degree of liquidity, however, requires the sacrifice of a certain level of income or potential for capital gains.

Common stock is often considered the most liquid of investments, since it can usually be sold within a day or two of the decision to sell. Bonds can also be fairly marketable, but some bonds are highly illiquid, or non-tradable, possessing a fixed term. Similarly, money market instruments may only be redeemable at the precise date at which the fixed term ends. If an investor seeks liquidity, money market assets and non-tradable bonds aren't likely to be held in his or her portfolio.

Security Analysis

Security is an instrument of promissory note or a method of borrowing or lending, or a source of contributing to the funds needed by the corporate body or non-corporate body.

Portfolio is a combination of securities with different risk-return characteristics will constitute portfolio of the investor.

Security analysis is the first part of investment decision process involving the valuation and analysis of individual securities. Security Analysis is primarily concerned with the analysis of a security with a view to determine the value of the security, so that appropriate decisions may be made based on such valuation as compared with the value placed on the security in the market.