SECURITY ANALYSIS AND PORTFOLIO MANAGEMENT

UNIT I: INVESTMENT

1. OVERVIEW

Investment is the commitment of funds on assets with an ultimate objective of getting a return. The return on investment is in the form of regular income (interest or dividend) and capital gain or both.

Speculation means committing funds in business activities with an objective of getting short term capital gain. For example, if a person buys a stock for Rs.100 and sell the same stock for Rs.120 within very short period (say 1 month) he can be termed as a speculator. In this transaction he made a profit of Rs.20 as short term capital gain. However, there is every chance of incurring capital loss also. Thus speculation involves high degree of risk and return.

2. DIFFERENCE BETWEEN SPECULATION AND INVESTMENT

Differentiating factor	Speculation	Investment
Holding period	The period is very short, ranging from few days to few months.	The period is long and generally it is more than one year
Risk and return	The degree of risk and return are very high.	The degree of risk and return are moderate.
Determinants	The buying and selling is mostly based on technical analysis, gossips and rumors.	The investments is based on fundamental analysis of the economy industry and company
Source of funds	The speculator employs his own funds and borrowed amount.	The investor employs his own funds and borrowed amount.

Objectives of the investment:

a. **RETURN**

b) Risk

The risk can be defined as the deviation of the actual return from the expected rate of return. Every investor would like to reduce the degree of risk by constructing a sound portfolio. The degree of risk will be less in government securities and fundamentally sound company stocks. At the same time the return from such investments would be reasonable.

c) Liquidity

The Liquidity means the possibility of encashing the investment without losing much of it's value within very short period. In other words it's the marketability of the investment. The investor prefers an investment outlet which has high liquidity. The equity share of fundamentally sound companies offers more liquidity, than the bonds and debentures.

d) Safety of the principal

The safety of the principal amount is another important objective of any investor while committing founds in an investment outlet. The safety of the capital is based on various factors like; legal and regulatory frame work, the performance of the company and the type of investment outlet.

Investment Vs Gambling

Investment has also to be distinguished from gambling.

Typical examples of gambling are horse races, card games, lotteries, etc. Gambling consists in taking high risks not only for high returns, but also for thrill and excitement. Gambling is unplanned and non-scientific, without knowledge of the nature of the risk involved. It is surrounded by uncertainty and is based on tips and rumours. In gambling artificial and unnecessary risks are created for increasing the returns.

Investment is an attempt to carefully plan, evaluate and allocate funds to various investment outlets which offer safety of principal and moderate and continuous return over a long period of time. Gambling is quite the opposite of investment.

Types of Investors Investors may be individuals and institutions.

Individual investors operate alongside institutional investors in the investment arena. However, their characteristics are different. Individual investors are large in number but their investable resources are comparatively smaller. They generally lack the skill to carry out extensive evaluation and analysis before investing. Moreover, they do not have the time and resources to engage in such an analysis.

Institutional investors, on the other hand, are the organizations with surplus funds who engage in investment activities.

Mutual funds, investment companies, banking and non-banking companies, insurance corporations, etc. are the organizations with large amounts of surplus funds to be invested in various profitable avenues.
These institutional investors are fewer in number compared to individual investors, but their investable resources are much larger. The institutional investors engage professional fund managers to carry out extensive analysis and evaluation of different investment opportunities. As a result, their investment activity tends to be more rational and scientific. They have a better chance of maximizing returns and minimizing risk. The professional investors and the unskilled individual investors combine to make the investment arena dynamic.

Investment Avenues There are a large number of investment avenues for savers in India. Some of them are marketable and liquid while others are non-marketable. Some of them are highly risky while some others are almost riskless.
The investor has to choose proper avenues from among them depending on his preferences, needs and ability to assume risk.
The investment avenues can be broadly categorized under the following heads
: 1. Corporate securities
2. Deposits in banks and non-banking companies
3. UTI and other mutual fund schemes
4. Post office deposits and certificates
5. Life insurance polices
6. Provident fund schemes
7. Government and semi-government securities.

Variable Income Securities:

Equity Shares

Fixed Income Securities

Government Securities

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

Non-Negotiable Securities:

Deposits: Bank deposits

Post Office Deposits

NBFC Deposits

Tax Sheltered Savings Scheme Tax sheltered savings schemes are of great importance to the investors in the taxpaying category. The tax sheltered savings schemes offer tax relief to those who participate in their schemes according to the income tax laws. The important tax sheltered savings schemes are:

Public Provident Fund Scheme

National Savings Scheme

National Savings Certificate VIII series

Life Insurance

Mutual Funds

Real Assets

Gold and Silver

Art and Antiques

G Securities:

Government securities, or G-Secs, are debt instruments issued by governments (either central or state) to raise capital. They are essentially loans that investors make to the government, and in return, the government promises to pay interest and repay the principal amount at maturity. G-Secs are generally considered very safe investments due to the government's ability to raise funds through taxation or other means, making them a popular choice for risk-averse investors.

P Notes investment:

Participatory Notes (P-Notes) are financial instruments that allow foreign investors to indirectly invest in Indian securities without needing to register with the Securities and Exchange Board of India (SEBI). They are issued by registered foreign institutional investors (FPIs) to overseas investors who want exposure to the Indian stock market.

Concepts of risks and returns:

Risk, often measured by standard deviation and variance, reflects the uncertainty of an investment's returns. A higher standard deviation or variance indicates greater volatility and thus, higher risk. The relationship between risk and return is generally positive:

higher risk is associated with the potential for higher returns, and vice versa, though this is not always guaranteed.

Types of risks: The distinction between different types of risks is elaborated as under - 1) **Unsystematic risk**: Also known as specific risk, it is a measure of risk associated with a particular security; also known as diversifiable risk. It is the type of uncertainty that comes with the company with which you invest or the industry where you invest. This risk can be mitigated by holding a diversified portfolio of many different stocks in many different industries.

2) **Systematic risk/ market risk**: It is a risk faced by all investors due to market volatility and this risk cannot be diversified away. This is the type of risk most people are referring to when they casually use the term 'risk' when discussing investments.

3) **Political risk**: It is the risk to an investment due to changes in the law or political regime. Potential changes in tax law or changes in a country's structure of governance are sources of political risk.

4) **Inflation risk**: Stocks, bonds and cash are all subject to the risk that one's investment will not keep pace with inflation. This risk can be mitigated by investing in inflation protected Treasury bonds.

5) **Financial risk**: This risk is due to the capital structure of a firm. Corporate debt magnifies financial risk to a company's stocks and bonds.

6) **Management risk**: Investors using actively managed funds are exposed to the risk that fund or portfolio managers will under-perform benchmarks due to their management decisions or style. Investors can avoid this risk by selecting passively-managed index funds.

7) **Interest rate risk**: It is the risk associated with changes in asset price due to changes in interest rates. Bonds and bond funds face this type of risk. As interest rates rise, prices on existing bonds decline and vice versa. Interest rate risk is greater for bonds with longer maturities, and vice versa.

8) **Credit Risk / Default Risk**: It is the risk of default on account of non-payment. Holders of corporate and municipal bonds face this risk.

9) **Call risk**: It is the risk that a bond issuer, after a decline in interest rates, may redeem a bond early, forcing the bond holder to find a replacement investment that may not pay as well as the original bond.

10) **Reinvestment risk:** The risk that earnings from current investments will not be reinvested at the same rate of return as current investment yields. Coupon payments

from a bond may suffer reinvestment risk if they cannot be reinvested at the same rate as the bond's yield.

11) **Currency risk**: Investors in international stocks and bonds are also exposed to the risk caused from changes in currency exchange rates. Investments in currencies other than the one in which the investor purchases most goods and services are subject to currency risks.

12) **Longevity risk**: It is the risk an investor will outlive his/her money.

13) **Shortfall risk:** It is the risk the portfolio will not provide sufficient returns to meet the investor's goal

14) **Diversifiable Risk**: This risk is Company Specific or Non Systematic and is connected with the random events of respective company whose stocks are being purchased. Diversification can reduce diversifiable risk. The good random events influencing one stock will be cancel out by the bad random events that influence another stock of the portfolio.

15) **Market Risk:** This risk is also called Beta Risk or Non-Diversifiable Risk and is connected with socio-political and macro-economic events that occur on global basis such as Macro Market Interest Rates, Inflation, War and Recession etc. Market risk can never reduce through diversification.

Measurement of Risk and Return: Risk is the uncertainty of future returns. Risk can be measured as the difference between expected return and actual return. Expected returns are the anticipated returns for a future period. Risk is measured as the difference between expected return and actual realized return.

There are different techniques/tools of measuring risk –

1. **Volatility**: Volatility is the range of price fluctuations as compared to the expected level of return. The more the changes in price the more volatile a stock is. Volatility brings uncertainty and hence greater risk. The past volatility data provides an insight into the risk of a stock.

2. **Standard Deviation**: This is the most common measure of risk in investments in terms of variance or standard deviation. Standard Deviation indicates the likely volatility in the returns from the mean value of returns. It can be either in the form of an increase or a decrease from the mean.

3. **Probability Distribution**: Probabilities indicate the likelihood of different outcomes and are in the form of decimals. Past occurrences are taken to estimate the probability with consideration for any changes expected in the future. To determine the single most

outcomes from a specific probability distribution, the expected value is computed. Expected return or Ex-ante return is the mean return found by using probability distribution of expected return. Diversification of Risk : Risk can be reduced through diversification.

a) The risk of investing in a single risky security, such as a stock or corporate bond, is very high due to the company-specific risks. Any number of unfortunate events could impact the rate of return. In the worst possible case, the company could go bankrupt, and the investor could lose the entire value of the investment.

b) Company-specific risk is generally referred to as unsystematic risk or non-systematic risk. Other names are unique-risk, firm-specific risk, or diversifiable risk.

c) Unsystematic risk can be eliminated by holding a broad portfolio of risky assets; e.g., many different securities in many different industries. This is easy to accomplish by owning a

total market stock or bond index fund. Unsystematic risk is risk that can be diversified away. d) The risk that remains after diversifying away unsystematic risk is systematic risk. Other names are market risk or non-diversifiable risk.

A total stock or bond market fund has systematic risk. In an efficient market, assets with known systematic risks will be priced lower and thereby compensate investors through higher expected returns. This expected relationship only applies to systematic risks. There is no reward for incurring unsystematic risk, and investors may therefore seek broad diversification without reducing the expected return of their portfolio. After diversification, the next step in managing portfolio risk is asset allocation.