

INVESTMENT MANAGEMENT

VI SEMESTER

CORE COURSE

BBA

(Specialization - Finance)

(2011 Admission)



UNIVERSITY OF CALICUT

SCHOOL OF DISTANCE EDUCATION

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INVESTMENT MANAGEMENT

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CHAPTER 1

INVESTMENT –AN OVERVIEW

The income that a person receives may be used for purchasing goods and services that he currently requires or it may be saved for purchasing goods and services that he may require in the future. In other words, income can be what is spent for current consumption. Savings are generated when a person or organization abstains from present consumption for a future use. The person saving a part of his income tries to find a temporary repository for his savings until they are required to finance his future expenditure. This results in investment.

Meaning of investment

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

It may mean many things to many persons. If one person has advanced some money to another, he may consider his loan as an investment. He expects to get back the money along with interest at a future date. Another person may have purchased one kilogram of gold for the purpose of price appreciation and may consider it as an investment.

In all these cases it can be seen that investment involves employment of funds with the main aim of achieving additional income or growth in the values. The essential quality of an investment is that it involves something for reward. Investment involves the commitment of resources which have been saved in the hope that some benefits will accrue in the future.

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

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

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

Speculation

Speculation is the practice of engaging in risky financial transactions in an attempt to profit from short or medium term fluctuations in the market value of a tradable good such as a financial instrument, rather than attempting to profit from the underlying financial attributes embodied in the instrument such as capital gains, interest, or dividends. Many speculators pay little attention to the fundamental value of a security and instead focus purely on price movements. Speculation can in principle involve any tradable good or financial instrument. Speculators are particularly common in the markets for stocks, bonds, commodity futures, currencies, fine art, collectibles, real estate, and derivatives.

Difference between Investment and Speculation

1. **Investment** is all about value creation (e.g. manufacturing products and providing services) while **speculation** is concerned about price movement. In the latter, you profit purely from price differences. The price movement is mostly influenced by the psychology of the market.
2. **Investment** has lower risk but needs more capital to generate more value while **speculation** is challenging, has higher risk but requires less capital. This explains why most people are speculating because its entry requirement (capital) is lower.
3. **Investment** is about getting what the market offers you while **speculation** is about trying to get more by doing more in believing that you can beat the market.
4. **Investment** is about doing least since you let the companies or industries work for you by owning a piece of their businesses while **speculation** is about doing the most (unconsciously) and it is more involving because you keep chasing the price movement. You need to keep buying and selling to generate profit.
5. **Investment** is over long term while **speculation** is of shorter term. For the former, the success rate is highest by maximizing the holding period of a position while for the latter; the success rate will peak if the position is kept open for the shortest time possible. This also explains why people like to speculate because it provides "shortcuts" to wealth.
6. **Investment** is about simplicity while **speculation** is about complexity (timing market, predicting market direction, stock picking...). That's why most people fail when speculating. It gives a false sense of simplicity.
7. **Investment** = growing system (like a living organic creature) while **speculation** = zero-sum game (one person's gain is another person's loss). The former will grow over time while the latter remains constant or shrinking over time.

Investment objectives

Investment is made because it serves some objective for an investor. Depending on the life stage and risk appetite of the investor, there are three main objectives of investment: safety, growth and income. Every investor invests with a specific objective in mind, and each investment has its own unique set of benefits and risks. Let us understand these objectives in detail.

Safety

While no investment option is completely safe, there are products that are preferred by investors who are risk averse. Some individuals invest with an objective of keeping their money safe, irrespective of the rate of return they receive on their capital. Such near-safe products include fixed deposits, savings accounts, government bonds, etc.

Growth

While safety is an important objective for many investors, a majority of them invest to receive capital gains, which means that they want the invested amount to grow. There are several options in the market that offer this benefit. These include stocks, mutual funds, gold, property, commodities, etc. It is important to note that capital gains attract taxes, the percentage of which varies according to the number of years of investment.

Income

Some individuals invest with the objective of generating a second source of income. Consequently, they invest in products that offer returns regularly like bank fixed deposits, corporate and government bonds, etc.

Other objectives

While the aforementioned objectives are the most common ones among investors today, some other objectives include:

- **Tax exemptions**
some people invest their money in various financial products solely for reducing their tax liability. Some products offer tax exemptions while many offer tax benefits on long-term profits.
- **Liquidity**
Many investment options are not liquid. This means they cannot be sold and converted into cash instantly. However, some people prefer investing in options that can be used during emergencies. Such liquid instruments include stock, money market instruments and exchange-traded funds, to name a few.

Investment decision process

Investing has been an activity confined to the rich and business class in the past. But today, we find that investment has become a house hold word and is very popular with people from all walks of life .India appears to be slowly but surely closing in some of the top savers among countries in the global peaking order. savings in Indians touched a new high of 31percent of the GDP during2011-2012.chain leads the pack of savers with the saving figure at close to 49 percent of GDP followed by other emerging market economies like Bangladesh 36 percent, Bhutan 48 percent of their GDP. The escalating cost due to ,inflation are decreasing the value of saved money with each passing year .consider the cost buying a home ,of getting admitted in a hospital or paying for the higher education of a child. One's life's savings could vanish in a blink. Knowledgeable investing requires the investing to be aware of his needs the amount of money he can invest and the investment options available to him .These will relate to the investment decision process. A typical investment decision goes through a five step procedure which is known as investment process these steps are:

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

1. Defining the investment objective

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

2. Analyzing securities

The second steps of analyzing securities enable the investor to distinguish between underpriced and overpriced stock. Return can be maximized by investing in stocks which are currently underpriced but have the potential to increase .it might be useful to remember the golden principle of investment; buy low sell high. There are two approaches used for analyzing securities ;technical analysis and fundamental analysis.

3. Construct a portfolio

The actual construction of portfolio, which can be divided into three sub parts.

- a) How to allocate the portfolio across different asset classes such as equities, fixed income securities and real assets
- b) The assets selection decision, this is the step where the stocks make up the equity component, the bonds that make up the fixed income component.
- c) The final component is execution, where the portfolio is actually put together, where investors have to trade off transaction cost against transaction speed.

4. Evaluate the performance of portfolio

The performance evaluation of the portfolio done on the in terms of risk and return. Evaluation measures are to be developed .CAGR(compounded annual growth rate) may be one criteria. Hindustan unilever gave a CAGR of 21 percent in returns to the shareholders for the last 13 years.

5. Review the portfolio

It involves the periodic repetition of the above steps. The investment objective of an investor may change overtime and the current portfolio may no longer be optimal for him. so the investor may form a new portfolio by selling certain securities and purchasing others that are not held in the current portfolio.

Types of Investments

Nonnegotiable securities

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 simplest investment avenue open for the investors. He has to open an account and deposit the money. Traditionally the banks offered current account, Saving account and fixed deposits account. Current account does not offer any interest rate. The drawback of having large amount in saving accounts is that the return is just 4 percent. The saving 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 handled the plain saving account with the fixed account to cater to the needs of the small savers.

b) Post office deposits

Post office also offers fixed deposit facility and monthly income scheme. monthly income scheme is a popular scheme for the retired . an interest rate of 9 percent is paid monthly .the term of the scheme is 6 years, at the end of which a bonus of 10 percent is paid .the annualized 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 one year, a penalty of 5 percent is charged.

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 come under the purview of the RBI. The Act in January 1997, made registration compulsory for the NBFCs

- 1) Period the period ranges from few months to five years.
- 2) Maximum limit the limit for acceptance of deposit has been on the credit rating of the company.
- 3)Interest NBFCs have been debarred from offering an interest rate exceeding 16% per annum and a brokerage fee over 2% on public deposit. The interest rate differs according to maturity period.

Tax sheltered saving scheme

The important tax sheltered saving scheme is

a) public provident fund scheme(PPF)

PPF earn an interest rate of 8.5% per annum compounded annually which is exempted from the income tax under sec80 C. The individuals and Hindu undivided families can participate in this scheme. There is a lock in period of 15years.PPF is not indented for those who are liquidity and short term returns. at the time of maturity no tax is to be given.

b) National saving scheme(NSS)

This scheme helps in deferring the tax payment. Individuals and HUF are eligible to open NSS account in the designated post office.

c) National saving certificate

This scheme is offered by the post office. These certificate come in the denomination of Rs.500,1000,5000 and 10000.the contribution and the interest for the first five years are covered by sec 88.the interest is cumulative at the rate of 8.5%per annum and payable biannually is covered by sec 80 L.

Life insurance

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

- 1) Protection saving through life insurance guarantees full protection against risk of death of the saver. The full assured sum is paid, whereas in other schemes only the amount saved is paid.
- 2) Easy payments for the salaried people the salary saving schemes are introduced. Further there is an installment facility method of payment through monthly, quarterly, half yearly or yearly mode.
- 3) Liquidity loans can be raised on the security of the policy
- 4) Tax relief tax relief in income tax and wealth tax is available for amounts paid by way of premium for life insurance subject to the tax rates in force.

Type of life insurance policy

a) **Endowment policy;**

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

b) **Term policy:**

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

c) **Whole life policy**

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

d) **Money back policy**

The insurance company pays the sum assured at periodical intervals to the policy holder plus the entire sum assured to the beneficiaries in case of the policy holders demise before maturity.

e) **ULIPs:**

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

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

Mutual fund

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

Types of return

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

Type of mutual funds

- **Open ended schemes:**
In this scheme there is an uninterrupted entry and exit into the funds. The open ended scheme has no maturity period and they are not listed in the stock exchanges. The open ended fund provides liquidity to the investors since repurchase is available.
- **Closed ended funds:**
The closed ended funds have a fixed maturity period. The first time investments are made when the closed ended scheme is kept open for a limited period. Once closed, the units are listed on a stock exchange. Investors can buy and sell their units only through stock exchanges.

Other classification

- **Growth scheme:** aims to provide capital appreciation over medium to long term. Generally these funds invest their money in equities.
- **Income scheme:** aims to provide a regular return to its unit holders. Mostly these funds deploy their funds in fixed income securities.
- **Balanced scheme:** a combination of steady return as well as reasonable growth. The fund of this scheme is invested in equities and debt instruments.
- **Money market scheme:** this type of fund invests its money in money market instruments.
- **Tax saving scheme:** this type of scheme offers tax rebates to investors.
- **Index scheme:** Here investment is made on the equities of the Stock index.

Real estate

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

Commodities

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

Gold

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

Silver

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

DEBENTURES/BONDS

A Bond is a loan given by the buyer to the issuer of the instrument. Companies, financial institutions, or even the government can issue bonds. Over and above the scheduled interest payments as and when applicable, the holder of a bond is entitled to receive the par value of the instrument at the specified maturity date.

EQUITY SHARE

Equity, also called shares or scrips, is the basic building blocks of a company. A company's ownership is determined on the basis of its shareholding. Shares are, by far, the most glamorous financial instruments for investment for the simple reason that, over the long term, they offer the highest returns. Predictably, they're also the riskiest investment option.

Concept of risk and return

Any rational investor, before investing his or her investable wealth in the stock, analysis the risk associated with the particular stock. The actual return he receives from a stock may vary from his expected return and is expressed in the variability of return.

Risk

The dictionary meaning of risk is the possibility of loss or injury; risk the possibility of not getting the expected return. The difference between expected return and actual

return is called the risk in investment. Investment situation may be high risk, medium and low risk investment;

1. Buying government securities	low risk
2. Buying shares of an existing Profit making company	Medium risk
3. Buying shares of a new company	High risk

Types of risk

Systematic risk:

The systematic risk is caused by factors external to the particular company and uncontrollable by the company. The systematic risk affects the market as a whole.

Unsystematic risk:

In case of unsystematic risk the factors are specific, unique and related to the particular industry or company.

Sources of risk

- **Interest rate risk:**

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

- **Market risk:**

Jack clark francis has defined market risk as that portion of total variability of return caused by the alternating forces of bull and bear market. This is a type of systematic risk that affects share .market price of shares move up and down consistently for some period of time.

- **Purchasing power risk**

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

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

- **Financial risk**

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

Return

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

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

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

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

$$\text{The rate of return} = \frac{8 + (160 - 140)}{140} \times 100 = 20\text{percent}$$

Investment Analysis

Investment analysis is the analysis of tradable financial instruments called securities. These can be classified into debt securities, equities, or some hybrid of the two. More broadly, futures contracts and tradable credit derivatives are sometimes included. Security analysis is typically divided into fundamental analysis, which relies upon the examination of fundamental business factors such as financial statements, and technical analysis, which focuses upon price trends and momentum. Another form of security analysis is technical analysis which uses graphs and diagrams for price prediction securities. Simply the process of analyzing return and risks of financial securities may be termed as investment analysis.

Fundamental analysis

Fundamental analysis is really a logical and systematic approach to estimating the future dividends and share price. It is based on the basic premise that share price is determined by a number of fundamental factors relating to the economy, industry and company. In other words, fundamental analysis means a detailed analysis of the fundamental factors affecting the performance of companies.

Each share is assumed to have an economic worth based on its present and future earning capacity. This is called its intrinsic value or fundamental value. The purpose of fundamental analysis is to evaluate the present and future earning capacity of a share based on the economy, industry and company fundamentals and thereby assess the intrinsic value of the share. The investor can compare the intrinsic value of the share with the prevailing market price to arrive at an investment decision. If the market price of the share is lower than its intrinsic value, the investor would decide to buy the share as it is

underpriced. The price of such share is expected to move up in the future to match with its intrinsic value.

On the contrary, when the market price of a share is higher than its intrinsic value, it is perceived to be overpriced. The market price of such a share is expected to come down in future and hence, the investor should decide to sell such a share. Fundamental analysis thus provides an analytical framework for rational investment decision making. This analytical framework is known as EIC framework, or economy -industry -company analysis.

Fundamental analysis thus involves three steps:

1. Economic analysis
2. Industry analysis
3. Company analysis

Economy analysis

The performance of a company depends on the performance of the economy. Let us look some of the key economic variables that an investor must monitor as part of his fundamental analysis.

Growth rate of national income

The rate of growth of the national economy is an important variable to be considered by an investor. GNP (gross national product), NNP (net national product), GDP (gross domestic product) are the different measures of the total income or total economic output as a whole.

The estimated growth rate of the economy would be a pointer towards the prosperity of the economy. An economy typically passes through different stages of prosperity known as economic or business cycle. The four stages of an economic cycle are

1. **Depression:** is the worst of the four stages. During a depression, demand is low and declining. Inflation is often high and so are interest rates.
2. **Recovery stage:** The economy begins to receive after a depression. Demand picks up leading to more investments in the economy. Production, employment and profits are on the increase.
3. **Boom:** The phase of the economic cycle is characterized by high demand. Investments and production are maintained at a high level to satisfy the high demand. Companies generally post higher profits.
4. **Recession:** The boom phase gradually slow down .the economy slowly begin to experience a downturn in demand, production employment etc, the profits of companies are also start to decline. This is the recession stage of the economy.

Inflation

Inflation leads to erosion of purchasing power in the hands of consumers, this will result in lower the demand of products Inflation prevailing in the economy has considerable impact on the performance of companies. Higher rate of inflation will upset business plans.

Interest rates

Interest rates determine the cost and availability of credit for companies operating in an economy. a low interest rate stimulates investment by making credit available easily and cheaply. On the contrary, higher interest rates result in higher cost of production which may lead to lower profitability and lower demand.

Government revenue, expenditure and deficits

Government is the largest investor and spender of money, the trend in government revenue and expenditure and deficit have a significant impact on the performance of industries and companies' expenditure by the government stimulates the economy by creating jobs and generating demand. The nature of government spending is of greater importance in determining the fortunes of many companies.

Exchange rates

The performance and profitability of industries and companies that are major importers or exporters are considerably affected the exchange rates of the rupee against major currencies of the world. a depreciation of the rupee improves the competitive position of Indian products in the foreign markets ,thereby stimulating exports .but it would also make import more expensive .a company more depending on imports may find it devaluation of the rupee affecting its profitability adversely.

Infrastructure

The development of an economy depends very much on the infrastructure available. The availability of infrastructure facilities such as power, transportation, and communication systems affects the performance of companies bad infrastructure lead to inefficiencies, lower productivity, wastage and delays.

Monsoon

The Indian economy is essentially an agrarian economy and agriculture forms a very important sector of the Indian economy. The performance of agriculture to a very extent depends on the monsoon; the adequacy of the monsoon determines the success or failure of the agricultural activities in India.

Economic and political stability

A stable political environment is necessary for steady and balanced growth. Stable long term economic policies are what are needed for industrial growth, such stable policies emanate only from stable political systems as economic and political factors are interlinked.

Industry analysis

An industry ultimately invests his money in the securities of one or more specific companies, each company can be characterized as belonging to an industry. the performance of companies would therefore ,be influenced by the fortunes of the industry to which it belongs. an industry “as a group of firms producing reasonably similar products which serve the same needs of common set of buyers.”

Industry life cycle

The industry life cycle theory is generally attributed to Julius grodinsky. According to the industry life cycle theory ,the life of an industry can be segregated into to the pioneering stage the expansion stage, the stagnation stage, and the decay stage .this kind of segregation is extremely useful to an investor because the profitability of an industry depends upon its stage of growth.

➤ **Pioneering stage**

This is the first stage in the industrial life cycle of a new industry where the technology as well as the product are relatively new and have not reached a state of perfection. Pioneering stage is characterized by rapid growth in demand for the output of industry. As a result there is a greater opportunity for profit. Many firms compete with each other vigorously. Weak firms are eliminated and a lesser number of firms survive the pioneering stage. ex; leasing industry.

➤ **Expansion stage**

Once an industry has established itself it enters the second stage of expansion or growth. These companies continue to become stronger. Each company finds a market for itself and develops its own strategies to sell and maintain its position in the market. The competition among the surviving companies brings about improved products at lower prices. Companies in the expansion stage of an industry are quite attractive for investment purposes.

➤ **Stagnation stage**

In this stage the growth of the industry stabilizes. The ability of the industry to grow appears to have been lost. Sales may be increasing but at a slower rate than that experienced by competitive industries or by the overall economy. The transition of an industry from the expansion stages to stagnation stages is very slow. Important reason for this transition is change in social habits and development of improved technology.

Ex: the black and white television industry in India provides s a good example of an industry which passed from the expansion stages to stagnation stage.

➤ **Decay stage**

Decay stage occurs when the products of the industry are no longer in demand. new products and new technologies have come to the market. Customers have changed their habits, style and liking. as a result ,the industry become obsolete and gradually ceases to decay of an industry

Industry characteristics

In an industry analysis there are a number of key characteristics that should be considered by the analyst.

Demand supply gap

The demand for the product usually trends to change at a steady rate, where as the capacity to produce the product tends to change at irregular intervals, depending upon the installation of additional production capacity. As result an industry is likely to experience under supply and over supply of capacity at different times. Excess supply reduces the profitability of the industry through a decline in the unit price realization. On the contrary, insufficient supply tends to improve the profitability through higher unit price realization.

Competitive conditions in the industry

The level of competition among various companies in an industry is determined by certain competitive forces. These competitive forces are: barriers to entry, the threat of substitution, bargaining power of the suppliers and the rivalry among competitors.

Permanence

Permanence is the phenomenon related to the products and the technology used by the industry. if an analyst feels that the need for a particular industry will vanish in a short period ,or that the rapid technological changes would render the products obsolete within short period of time, it would be foolish to invest such industry.

Labour conditions

In our country the labour unions are very power full .if the labour in a particular industry is rebellious and is inclined to resort to strikes frequently, the prospects of that industry cannot become bright.

Attitude of government

The government may encourage certain industries and can assist such industries through favorable legislation. On the contrary, the government may look with disfavor on certain other industries .in India this has been the experience of alcoholic drinks and cigarette industries. A prospective investor should consider the role of government is likely to play in the industry.

Supply of raw materials

This is also one of the important factor determine the profitability of an industry. Some industry may have no difficulty in obtaining the major raw materials as they may be indigenously available in plenty. Other industries may have to depend on a few manufactures within the country or on imports from outside the country for their raw material supply.

Cost structure

The cost structure that is the fixed and variable cost, affect the cost of production and profitability of the firm. The higher the fixed cost component, higher is the sales volume necessary to achieve breakeven point. conversely, the lower the proportion of fixed cost relative to variable cost ,lower would be the breakeven point provides higher margin of safety an analyst would consider favorably an industry that has a lower breakeven point.

Company analysis

Company analysis is the final stage of fundamental analysis. The economy analysis provides the investor a broad outline of the prospects of growth in the economy, the industry analysis helps the investor to select the industry in which investment would be rewarding. Now he has to decide the company in which he should invest his money. Company analysis provides answer to this question.

In company analysis, the analyst tries to forecast the future earnings of the company because there is a strong evidence that the earnings have a direct and powerful effect upon share prices. The level, trend and stability of earnings of a company, however depend upon a number of factors concerning the operations of the company.

Financial statements

The financial statements of a company help to assess the profitability and financial health of the company. The two basic financial statements provided by a company are the balance sheet and the profit and loss account. The balance sheet indicates the financial position of the company on a particular date, namely the last day of the accounting year.

The profit and loss account, also called income statement, reveals the revenue earned, the cost incurred and the resulting profit and loss of the company for one accounting year.

Analysis of financial statements

Financial ratios are most extensively used to evaluate the financial performance of the company, it also help to assess the whether the financial performance and financial strengths are improving or deteriorating, ratios can be used for comparative analysis

either with other firms in the industry through a cross sectional analysis or a time series analysis.

Other variables

The future prospects of the company would also depend upon the number of other factors .some of which is given below:

1. Company's market share
2. Capacity utilization
3. Modernisation and expansion plans
4. Order book position
5. Availability of raw material

Technical analysis

A technical analysis believes that the share prices are determined by the demand and supply forces operating in the market. a technical analysis concentrate on the movement of share prices . He climes that by examining past share price movements future share price can be accurately predicted.

The basic premise of technical analysis is that prices move in trends or waves which may be upward or downward

A rational behind the technical analysis is that share price behavior repeat itself over time and analyst attempt to drive methods to predict this repetition.

Technical Analysis can be defined as an art and science of forecasting future prices based on an examination of the past price movements. Technical analysis is not astrology for predicting prices. Technical analysis is based on analyzing current demand-supply of commodities, stocks, indices, futures or any tradable instrument. Technical analysis involve putting stock information like prices, volumes and open interest on a chart and applying various patterns and indicators to it in order to assess the future price movements. The time frame in which technical analysis is applied may range from intraday (1-minute, 5-minutes, 10-minutes, 15-minutes, 30-minutes or hourly), daily, weekly or monthly price data too many years.

There are essentially two methods of analyzing investment opportunities in the security market viz fundamental analysis and technical analysis. You can use fundamental information like financial and non-financial aspects of the company or technical information which ignores fundamentals and focuses on actual price movements.

The basis of Technical Analysis

What makes Technical Analysis an effective tool to analyze price behavior is explained by following theories given by Charles Dow:

- Price discounts everything
- Price movements are not totally random
- What is more important than why

Price discounts everything

“Each price represents a momentary consensus of value of all market participants – large commercial interests and small speculators, fundamental researchers, technicians and gamblers- at the moment of transaction” – Dr Alexander Elder

Technical analysts believe that the current price fully reflects all the possible material information which could affect the price. The market price reflects the sum knowledge of all participants, including traders, investors, portfolio managers, buy-side analysts, sell-side analysts, market strategist, technical analysts, fundamental analysts and many others. It would be folly to disagree with the price set by such an impressive array of people with impeccable credentials. Technical analysis looks at the price and what it has done in the past and assumes it will perform similarly in future under similar circumstances. Technical analysis looks at the price and assumes that it will perform in the same way as done in the past under similar circumstances in future.

Price movements are not totally random

Technical analysis is a trend following system. Most technicians acknowledge that hundreds of years of price charts have shown us one basic truth – prices move in trends. If prices were always random, it would be extremely difficult to make money using technical analysis. A technician believes that it is possible to identify a trend, invest or trade based on the trend and make money as the trend unfolds. Because technical analysis can be applied to many different time frames, it is possible to spot both short-term and long-term trends.

“What” is more important than “Why?”

It is said that “A technical analyst knows the price of everything, but the value of nothing”. Technical analysts are mainly concerned with two things:

1. The current price
2. The history of the price movement

Technical analysis represents a direct approach. The price is the final result of the fight between the forces of supply and demand for any tradable instrument. The objective of analysis is to forecast the direction of the future price. Fundamentalists are concerned with why the price is what it is. For technicians, the why portion of the equation is too broad and many times the fundamental reasons given are highly suspect. Technicians believe it is best to concentrate on what and never mind why. Why did the price go up? It is simple, more buyers (demand) than sellers (supply). The principles of technical analysis are universally applicable. The principles of support, resistance, trend, trading range and other aspects can be applied to any chart. Technical analysis can be used for any time horizon; for any marketable instrument like stocks, futures and commodities, fixed-income securities, forex, etc

Technical Analysis: The basic assumptions

The field of technical analysis is based on three assumptions:

1. The market discounts everything.
2. Price moves in trends.
3. History tends to repeat itself.

1. The market discounts everything

Technical analysis is criticized for considering only prices and ignoring the fundamental analysis of the company, economy etc. Technical analysis assumes that, at any given time, a stock's price reflects everything that has or could affect the company - including fundamental factors. The market is driven by mass psychology and pulses with the flow of human emotions. Emotions may respond rapidly to extreme events, but normally change gradually over time. It is believed that the company's fundamentals, along with broader economic factors and market psychology, are all priced into the stock, removing the need to actually consider these factors separately. This only leaves the analysis of price movement, which technical theory views as a product of the supply and demand for a particular stock in the market.

2. Price moves in trends

"Trade with the trend" is the basic logic behind technical analysis. Once a trend has been established, the future price movement is more likely to be in the same direction as the trend than to be against it. Technical analysts frame strategies based on this assumption only.

3. History tends to repeat itself

People have been using charts and patterns for several decades to demonstrate patterns in price movements that often repeat themselves. The repetitive nature of price movements is attributed to market psychology; in other words, market participants tend to provide a consistent reaction to similar market stimuli over time. Technical analysis uses chart patterns to analyze market movements and understand trends.

Strengths of Technical Analysis

Not Just for stocks

Technical analysis has universal applicability. It can be applied to any financial instrument - stocks, futures and commodities, fixed-income securities, forex, etc

Focus on price

Fundamental developments are followed by price movements. By focusing only on price action, technicians focus on the future. The price pattern is considered as a leading indicator and generally leads the economy by 6 to 9 months. To track the market, it makes sense to look directly at the price movements. More often than not, change is a subtle beast. Even though the market is prone to sudden unexpected reactions, hints usually develop before significant movements. You should refer to periods of accumulation as evidence of an impending advance and periods of distribution as evidence of an impending decline.

Supply, demand, and price action

Technicians make use of high, low and closing prices to analyze the price action of a stock. A good analysis can be made only when all the above information is present. Separately, these will not be able to tell much. However, taken together, the open, high, low and close reflect forces of supply and demand.

Support and resistance

Charting is a technique used in analysis of support and resistance level. These are trading range in which the prices move for an extended period of time, saying that forces of demand and supply are deadlocked. When prices move out of the trading range, it signals that either supply or demand has started to get the upper hand. If prices move above the upper band of the trading range, then demand is winning. If prices move below the lower band, then supply is winning.

Pictorial price history

A price chart offers most valuable information that facilitates reading historical account of a security's price movement over a period of time. Charts are much easier to read than a table of numbers. On most stock charts, volume bars are displayed at the bottom. With this historical picture, it is easy to identify the following:

- Market reactions before and after important events
- Past and present volatility
- Historical volume or trading levels
- Relative strength of the stock versus the index.

Assist with entry point

Technical analysis helps in tracking a proper entry point. Fundamental analysis is used to decide what to buy and technical analysis is used to decide when to buy. Timings in this context play a very important role in performance. Technical analysis can help spot demand (support) and supply (resistance) levels as well as breakouts. Checking out for a breakout above resistance or buying near support levels can improve returns. First of all you should analyze stock's price history. If a stock selected by you was great for the last three years has traded flat for those three years, it would appear that market has a different opinion. If a stock has already advanced significantly, it may be prudent to wait for a pullback. Or, if the stock is trending lower, it might pay to wait for buying interest and a trend reversal.

Weaknesses of Technical Analysis

Analyst bias

Technical analysis is not hard core science. It is subjective in nature and your personal biases can be reflected in the analysis. It is important to be aware of these biases when analyzing a chart. If the analyst is a perpetual bull, then a bullish bias will overshadow the analysis. On the other hand, if the analyst is a disgruntled eternal bear, then the analysis will probably have a bearish tilt.

Open to interpretation

Technical analysis is a combination of science and art and is always open to interpretation. Even though there are standards, many times two technicians will look at the same chart and paint two different scenarios or see different patterns. Both will be able to come up with logical support and resistance levels as well as key breaks to justify their position. Is the cup half-empty or half-full? It is in the eye of the beholder.

Too late

You can criticize the technical analysis for being too late. By the time the trend is identified, a substantial move has already taken place. After such a large move, the reward to risk ratio is not great. Lateness is a particular criticism of Dow Theory.

Always another level

Technical analysts always wait for another new level. Even after a new trend has been identified, there is always another "important" level close at hand. Technicians have been accused of sitting on the fence and never taking an unqualified stance. Even if they are bullish, there is always some indicator or some level that will qualify their opinion.

Portfolio analysis

Portfolio is a group of financial assets such as shares, stocks, bonds, debt instruments, mutual funds, cash equivalents, etc. A portfolio is planned to stabilize the

risk of non-performance of various pools of investment. Portfolio Management guides the investor in a method of selecting the best available securities that will provide the expected rate of return for any given degree of risk and also to mitigate (reduce) the risks. It is a strategic decision which is addressed by the top-level managers.

Modern Portfolio Theory

Modern portfolio theory (MPT) is a theory of finance that attempts to maximize portfolio expected return for a given amount of portfolio risk, or equivalently minimize risk for a given level of expected return, by carefully choosing the proportions of various assets. MPT is a mathematical formulation of the concept of diversification in investing, with the aim of selecting a collection of investment assets that has collectively lower risk than any individual asset. This is possible, intuitively speaking, because different types of assets often change in value in opposite ways. For example, to the extent prices in the stock market move differently from prices in the bond market, a collection of both types of assets can in theory face lower overall risk than either individually. But diversification lowers risk even if assets' returns are not negatively correlated – indeed, even if they are positively correlated.

More technically, MPT models an asset's return as a normally distributed function (or more generally as an elliptically distributed random variable), defines risk as the standard deviation of return, and models a portfolio as a weighted combination of assets, so that the return of a portfolio is the weighted combination of the assets' returns. By combining different assets whose returns are not perfectly positively correlated, MPT seeks to reduce the total variance of the portfolio return. MPT also assumes that investors are rational and markets are efficient.

MPT was developed in the 1950s through the early 1970s and was considered an important advance in the mathematical modeling of finance. Since then, some theoretical and practical criticisms have been leveled against it. These include evidence that financial returns do not follow a Gaussian distribution or indeed any symmetric distribution, and that correlations between asset classes are not fixed but can vary depending on external events (especially in crises). Further, there remains evidence that investors are not rational and markets may not be efficient. Finally, the low volatility anomaly conflicts with CAPM's trade-off assumption of higher risk for higher return. It states that a portfolio consisting of low volatility equities (like blue chip stocks) reaps higher risk-adjusted returns than a portfolio with high volatility equities (like illiquid penny stocks). A study conducted by Myron Scholes, Michael Jensen, and Fischer Black in 1972 suggests that the relationship between return and beta might be flat or even negatively correlated

CHAPTER 2

MONEY MARKET

The development of trade, commerce and industry depends upon a well-organized money market. The industrial progress of a country is determined by the availability of adequate finance. The introduction of division of labour is very advantageous for industries, and as Adam Smith pointed out, the progress of division of labour in industries is limited by the amount of capital available. The present industrial position of England, America and other Western countries has been achieved to a very great extent by the development of well-organized money and capital markets. Modern industrial structure and organization have become very complex and necessitate highly developed money markets. They have been facilitated by and in turn have facilitated the growth of highly-organized money markets.

Credit plays a very fundamental part in the scheme of industrial production. Businesses cannot be carried on a cash basis alone and credit has become highly indispensable. A highly developed and organized credit system is possible only in a well-developed money market.

Money market, therefore, means all the operations which centre around the commodity money. Thus it refers to those institutions which deal in the borrowing and lending of money. Such institutions are banks of various kinds, discount houses and individuals who deal in the operations connected with money.

The main function of the money market is to supply the producers with the necessary amount of cash and credit for transacting business. There are people who save money, but they cannot use it in business. There are others who possess the necessary business acumen, skill and talent but lack in money. Both these classes of persons are brought into touch with one another by the help of a well-organized money market. It attracts capital from those persons or institutions which save it and puts it into the hands of those who are able to make a good use of it. In Western countries which are industrially well-developed, another function of the money market is the supply of efficient currency so as to secure the relative stability in the purchasing power of money or in the level of prices. This latter function is not clearly grasped by people and by those in charge of the credit policy of a country. This lack of understanding of a proper regulation of efficient currency has been the main cause of the currency disturbances which modern society knows to its cost. There can be no greater service rendered to the cause of economic stability than to understand and explain the forces governing the supply of an efficient system of currency and credit in a country. By a wrong credit and currency policy the whole mechanism of the money market is disorganized and the result is a very great setback to business and production.

Credit plays a very important part in money markets. The most important elements of credit are confidence, amount and time. Credit system implies the transfer of goods from one person to another, the payment for which may be postponed to be made in future, and it also indicates the loan of money for a certain period of time. The most important media of credit are bank notes, Government promissory notes, bills of exchange, cheques, promissory notes of individuals,, Hundis, etc. A study of the money market of a country involves the study of all the operations connected with the creation and supply of such credit instruments.

The main functions of credit are to save the use of metallic money, to finance the producer who is engaged in the production of goods in anticipation of demand, to permit the collection of a multitude of small amounts into banks and to minimize price fluctuations. All these operations are essentially connected with the organization of money markets.

A well- developed credit system and money market are complementary. "A fully coordinated system of credit possessing different types of complementary institutions can never exist without its indispensable concomitant, a well-developed and reasonably planned money market. The development of the one leads to the perfection of the other and vice versa. The money market is the groundwork of the country's national finance whose main flexibility depends on a fine division of labour and capacity for adjustment to changing conditions of society

Meaning of money market

A money market is a market for borrowing and lending of short-term funds. It deals in funds and financial instruments having a maturity period of one day to one year. It is a mechanism through which short-term funds are loaned or borrowed and through which a large part of financial transactions of a particular country or of the world are cleared.

It is different from stock market. It is not a single market but a collection of markets for several instruments like call money market, Commercial bill market etc. The Reserve Bank of India is the most important constituent of Indian money market. Thus RBI describes money market as "the centre for dealings, mainly of a short-term character, in monetary assets, it meets the short-term requirements of borrowers and provides liquidity or cash to lenders".

FUNCTIONS OF MONEY MARKET

- 1) It caters to the short-term financial needs of the economy.
- 2) It helps the RBI in effective implementation of monetary policy.
- 3) It provides mechanism to achieve equilibrium between demand and supply of short-term funds.
- 4) It helps in allocation of short term funds through inter-bank transactions and money market Instruments.

- 5) It also provides funds in non-inflationary way to the government to meet its deficits.
- 6) It facilitates economic development.

PLAYERS OF MONEY MARKET

In money market transactions of large amount and high volume take place. It is dominated by small number of large players. In money market the players are :- Government, RBI, DFHI (Discount and finance House of India) Banks, Mutual Funds, Corporate Investors, Provident Funds, PSUs (Public Sector Undertakings), NBFCs (Non-Banking Finance Companies) etc.

Structure of Indian money market

The **Money market in India** is the money market for short-term and long-term funds with maturity ranging from overnight to one year in India including financial instruments that are deemed to be close substitutes of money. Similar to developed economies the Indian money market is diversified and has evolved through many stages, from the conventional platform of treasury bills and call money to commercial paper, certificates of deposit, repos, forward rate agreements and most recently interest rate swaps

The Indian money market consists of diverse sub-markets, each dealing in a particular type of short-term credit. The money market fulfills the borrowing and investment requirements of providers and users of short-term funds, and balances the demand for and supply of short-term funds by providing an equilibrium mechanism. It also serves as a focal point for the central bank's intervention in the market.

STRUCTURE OF INDIAN MONEY MARKET	
Organized Sector	Unorganized Sector
Call and Notice Money Market	Indigenous Bankers
Treasury Bill Market	Lenders
Commercial Bills	Money
Certificate of Deposits	NBFI
Commercial Papers	
Money Market Mutual Funds	
The REPO Market	
DFHI	

Organized Sector Of Money Market

Organized Money Market is not a single market, it consist of number of markets. The most important feature of money market instrument is that it is liquid. It is characterized by high degree of safety of principal. Following are the instruments which are traded in money market

1) Call and Notice Money Market

The market for extremely short-period is referred as call money market. Under call money market, funds are transacted on overnight basis. The participants are mostly banks. Therefore it is also called Inter-Bank Money Market. Under notice money market funds are transacted for 2 days and 14 days period. The lender issues a notice to the borrower 2 to 3 days before the funds are to be paid. On receipt of notice, borrower have to repay the funds.

In this market the rate at which funds are borrowed and lent is called the call money rate. The call money rate is determined by demand and supply of short term funds. In call money market the main participants are commercial banks, co-operative banks and primary dealers. They participate as borrowers and lenders. Discount and Finance House of India (DFHI), Non-banking financial institutions like LIC, GIC, UTI, NABARD etc. are allowed to participate in call money market as lenders.

Call money markets are located in big commercial centres like Mumbai, Kolkata, Chennai, Delhi etc. Call money market is the indicator of liquidity position of money market. RBI intervenes in call money market as there is close link between the call money market and other segments of money market.

2) Treasury Bill Market (T - Bills)

This market deals in Treasury Bills of short term duration issued by RBI on behalf of Government of India. At present three types of treasury bills are issued through auctions, namely 91 day, 182 day and 364 day treasury bills. State government does not issue any treasury bills. Interest is determined by market forces. Treasury bills are available for a minimum amount of Rs. 25,000 and in multiples of Rs. 25,000. Periodic auctions are held for their Issue.

T-bills are highly liquid, readily available; there is absence of risk of default. In India T-bills have narrow market and are undeveloped. Commercial Banks, Primary Dealers, Mutual Funds, Corporates, Financial Institutions, Provident or Pension Funds and Insurance Companies can participate in T-bills market.

3) Commercial Bills

Commercial bills are short term, negotiable and self liquidating money market instruments with low risk. A bill of exchange is drawn by a seller on the buyer to make payment within a certain period of time. Generally, the maturity period is of three

months. Commercial bill can be resold a number of times during the usance period of bill. The commercial bills are purchased and discounted by commercial banks and are rediscounted by financial institutions like EXIM banks, SIDBI, IDBI etc.

In India, the commercial bill market is very much underdeveloped. RBI is trying to develop the bill market in our country. RBI have introduced an innovative instrument known as "Derivative .Usance Promissory Notes, with a view to eliminate movement of papers and to facilitate multiple rediscounting.

4) Certificate of Deposits (CDs)

CDs are issued by Commercial banks and development financial institutions. CDs are unsecured, negotiable promissory notes issued at a discount to the face value. The scheme of CDs was introduced in 1989 by RBI. The main purpose was to enable the commercial banks to raise funds from market. At present, the maturity period of CDs ranges from 3 months to 1 year. They are issued in multiples of Rs. 25 lakh subject to a minimum size of Rs. 1 crore. CDs can be issued at discount to face value. They are freely transferable but only after the lock-in-period of 45 days after the date of issue.

In India the size of CDs market is quite small.

In 1992, RBI allowed four financial institutions ICICI, IDBI, IFCI and IRBI to issue CDs with a maturity period of. One year to three years.

5) Commercial Papers (CP)

Commercial Papers were introduced in January 1990. The Commercial Papers can be issued by listed company which has working capital of not less than Rs. 5 crores. They could be issued in multiple of Rs. 25 lakhs. The minimum size of issue being Rs. 1 crore. At present the maturity period of CPs ranges between 7 days to 1 year. CPs are issued at a discount to its face value and redeemed at its face value.

6) Money Market Mutual Funds (MMMFs)

A Scheme of MMMFs was introduced by RBI in 1992. The goal was to provide an additional short-term avenue to individual investors. In November 1995 RBI made the scheme more flexible. The existing guidelines allow banks, public financial institutions and also private sector institutions to set up MMMFs. The ceiling of Rs. 50 crores on the size of MMMFs stipulated earlier, has been withdrawn. MMMFs are allowed to issue units to corporate enterprises and others on par with other mutual funds. Resources mobilized by MMMFs are now required to be invested in call money, CD, CPs, Commercial Bills arising out of genuine trade transactions, treasury bills and government dated securities having an unexpired maturity up to one year. Since March 7, 2000 MMMFs have been brought under the purview of SEBI regulations. At present there are 3 MMMFs in operation.

7) The Repo Market

Repo was introduced in December 1992. Repo is a repurchase agreement. It means selling a security under an agreement to repurchase it at a predetermined date and rate. Repo transactions are affected between banks and financial institutions and among bank themselves, RBI also undertake Repo.

In November 1996, RBI introduced Reverse Repo. It means buying a security on a spot basis with a commitment to resell on a forward basis. Reverse Repo transactions are affected with scheduled commercial banks and primary dealers.

In March 2003, to broaden the Repo market, RBI allowed NBFCs, Mutual Funds, Housing Finance and Companies and Insurance Companies to undertake REPO transactions.

8) Discount and Finance House of India (DFHI)

In 1988, DFHI was set up by RBI. It is jointly owned by RBI, public sector banks and all India financial institutions which have contributed to its paid up capital. It is playing an important role in developing an active secondary market in Money Market Instruments. In February 1996, it was accredited as a Primary Dealer (PD). The DFHI deals in treasury bills, commercial bills, CDs, CPs, short term deposits, call money market and government securities.

Unorganized Sector Of Money Market:-

The economy on one hand performs through organized sector and on other hand in rural areas there is continuance of unorganized, informal and indigenous sector. The unorganized money market mostly finances short-term financial needs of farmers and small businessmen. The main constituents of unorganized money market are

1) Indigenous Bankers (IBs)

Indigenous bankers are individuals or private firms who receive deposits and give loans and thereby operate as banks. IBs accept deposits as well as lend money. They mostly operate in urban areas, especially in western and southern regions of the country. The volume of their credit operations is however not known. Further their lending operations are completely unsupervised and unregulated. Over the years, the significance of IBs has declined due to growing organized banking sector.

2) Money Lenders (MLs)

They are those whose primary business is money lending. Money lending in India is very popular both in urban and rural areas. Interest rates are generally high. Large amount of loans are given for unproductive purposes. The operations of money lenders are prompt, informal and flexible. The borrowers are mostly poor farmers, artisans, petty traders and manual workers. Over the years the role of money lenders has declined due to the growing importance of organized banking sector.

3) Non - Banking Financial Companies (NBFCs)

They consist of

1. Chit Funds

Chit funds are savings institutions. It has regular members who make periodic subscriptions to the fund. The beneficiary may be selected by drawing of lots. Chit fund is more popular in Kerala and Tamilnadu. RBI has no control over the lending activities of chit funds.

2. Nidhis

Nidhis operate as a kind of mutual benefit for their members only. The loans are given to members at a reasonable rate of interest. Nidhis operate particularly in South India.

3. Loan or Finance Companies

Loan companies are found in all parts of the country. Their total capital consists of borrowings, deposits and owned funds. They give loans to retailers, wholesalers, artisans and self employed persons. They offer a high rate of interest along with other incentives to attract deposits. They charge high rate of interest varying from 36% to 48% p.a.

4. Finance Brokers

They are found in all major urban markets especially in cloth, grain and commodity markets. They act as middlemen between lenders and borrowers. They charge commission for their services.

Money Market Instruments

Investment in money market is done through money market instruments. Money market instrument meets short term requirements of the borrowers and provides liquidity to the lenders. Common Money Market Instruments are as follows:

Treasury Bills (T-Bills):

Treasury Bills, one of the safest money market instruments, are short term borrowing instruments of the Central Government of the Country issued through the Central Bank (RBI in India). They are zero risk instruments, and hence the returns are not so attractive. It is available both in primary market as well as secondary market. It is a promise to pay a said sum after a specified period. T-bills are short-term securities that mature in one year or less from their issue date. They are issued with three-month, six-month and one-year maturity periods. The Central Government issues T- Bills at a price less than their face value (par value). They are issued with a promise to pay full face value on maturity. So, when the T-Bills mature, the government pays the holder its face value. The difference between the purchase price and the maturity value is the interest income earned by the purchaser of the instrument. T-Bills are issued through a bidding process at

auctions. The bid can be prepared either competitively or non-competitively. In the second type of bidding, return required is not specified and the one determined at the auction is received on maturity. Whereas, in case of competitive bidding, the return required on maturity is specified in the bid. In case the return specified is too high then the T-Bill might not be issued to the bidder. At present, the Government of India issues three types of treasury bills through auctions, namely, 91-day, 182-day and 364-day. There are no treasury bills issued by State Governments. Treasury bills are available for a minimum amount of Rs.25K and in its multiples. While 91-day T-bills are auctioned every week on Wednesdays, 182-day and 364-day T-bills are auctioned every alternate week on Wednesdays. The Reserve Bank of India issues a quarterly calendar of T-bill auctions which is available at the Banks' website. It also announces the exact dates of auction, the amount to be auctioned and payment dates by issuing press releases prior to every auction. Payment by allottees at the auction is required to be made by debit to their/custodian's current account. T-bills auctions are held on the Negotiated Dealing System (NDS) and the members electronically submit their bids on the system. NDS is an electronic platform for facilitating dealing in Government Securities and Money Market Instruments. RBI issues these instruments to absorb liquidity from the market by contracting the money supply. In banking terms, this is called Reverse Repurchase (Reverse Repo). On the other hand, when RBI purchases back these instruments at a specified date mentioned at the time of transaction, liquidity is infused in the market. This is called Repo (Repurchase) transaction.

Repurchase Agreements

Repurchase transactions, called Repo or Reverse Repo are transactions or short term loans in which two parties agree to sell and repurchase the same security. They are usually used for overnight borrowing. Repo/Reverse Repo transactions can be done only between the parties approved by RBI and in RBI approved securities viz. GOI and State Govt Securities, T-Bills, PSU Bonds, FI Bonds, Corporate Bonds etc. Under repurchase agreement the seller sells specified securities with an agreement to repurchase the same at a mutually decided future date and price. Similarly, the buyer purchases the securities with an agreement to resell the same to the seller on an agreed date at a predetermined price. Such a transaction is called a Repo when viewed from the perspective of the seller of the securities and Reverse Repo when viewed from the perspective of the buyer of the securities. Thus, whether a given agreement is termed as a Repo or Reverse Repo depends on which party initiated the transaction. The lender or buyer in a Repo is entitled to receive compensation for use of funds provided to the counterparty. Effectively the seller of the security borrows money for a period of time (Repo period) at a particular rate of interest mutually agreed with the buyer of the security who has lent the funds to the seller. The rate of interest agreed upon is called the Repo rate. The Repo rate is negotiated by the counterparties independently of the coupon rate or rates of the underlying securities and is influenced by overall money market conditions.

Commercial Papers

Commercial paper is a low-cost alternative to bank loans. It is a short term unsecured promissory note issued by corporates and financial institutions at a discounted value on face value. They are usually issued with fixed maturity between one to 270 days and for financing of accounts receivables, inventories and meeting short term liabilities. Say, for example, a company has receivables of Rs 1 lacs with credit period 6 months. It will not be able to liquidate its receivables before 6 months. The company is in need of funds. It can issue commercial papers in form of unsecured promissory notes at discount of 10% on face value of Rs 1 lacs to be matured after 6 months. The company has strong credit rating and finds buyers easily. The company is able to liquidate its receivables immediately and the buyer is able to earn interest of Rs 10K over a period of 6 months. They yield higher returns as compared to T-Bills as they are less secure in comparison to these bills; however chances of default are almost negligible but are not zero risk instruments. Commercial paper being an instrument not backed by any collateral, only firms with high quality credit ratings will find buyers easily without offering any substantial discounts. They are issued by corporates to impart flexibility in raising working capital resources at market determined rates. Commercial Papers are actively traded in the secondary market since they are issued in the form of promissory notes and are freely transferable in demat form.

Certificate of Deposit

It is a short term borrowing more like a bank term deposit account. It is a promissory note issued by a bank in form of a certificate entitling the bearer to receive interest. The certificate bears the maturity date, the fixed rate of interest and the value. It can be issued in any denomination. They are stamped and transferred by endorsement. Its term generally ranges from three months to five years and restricts the holders to withdraw funds on demand. However, on payment of certain penalty the money can be withdrawn on demand also. The returns on certificate of deposits are higher than T-Bills because it assumes higher level of risk. While buying Certificate of Deposit, return method should be seen. Returns can be based on Annual Percentage Yield (APY) or Annual Percentage Rate (APR). In APY, interest earned is based on compounded interest calculation. However, in APR method, simple interest calculation is done to generate the return. Accordingly, if the interest is paid annually, equal return is generated by both APY and APR methods. However, if interest is paid more than once in a year, it is beneficial to opt APY over APR.

Bankers Acceptance

It is a short term credit investment created by a non financial firm and guaranteed by a bank to make payment. It is simply a bill of exchange drawn by a person and accepted by a bank. It is a buyer's promise to pay to the seller a certain specified amount at certain date. The same is guaranteed by the banker of the buyer in exchange for a claim on the goods as collateral. The person drawing the bill must have a good credit rating otherwise the Banker's Acceptance will not be tradable. The most common term for these

instruments is 90 days. However, they can vary from 30 days to 180 days. For corporations, it acts as a negotiable time draft for financing imports, exports and other transactions in goods and is highly useful when the credit worthiness of the foreign trade party is unknown. The seller need not hold it until maturity and can sell off the same in secondary market at discount from the face value to liquidate its receivables

Deficiencies of Indian money market

Indian money market is relatively underdeveloped when compared with advanced markets like New York and London Money Markets. Its' main features / defects are as follows

1. Dichotomy

A major feature of Indian Money Market is the existence of dichotomy i.e. existence of two markets: -Organized Money Market and Unorganized Money Market. Organized Sector consist of RBI, Commercial Banks, Financial Institutions etc. The Unorganized Sector consist of IBs, MLs, Chit Funds, Nidhis etc. It is difficult for RBI to integrate the Organized and Unorganized Money Markets. Several segments are loosely connected with each other. Thus there is dichotomy in Indian Money Market.

2. Lack of Co-ordination and Integration

It is difficult for RBI to integrate the organized and unorganized sector of money market. RBI is fully effective in organized sector but unorganized market is out of RBI's control. Thus there is lack of integration between various sub-markets as well as various institutions and agencies. There is less co-ordination between co-operative and commercial banks as well as State and Foreign banks. The indigenous bankers have their own ways of doing business.

3. Diversity in Interest Rates

There are different rates of interest existing in different segments of money market. In rural unorganized sectors the rate of interest are high and they differ with the purpose and borrower. There are differences in the interest rates within the organized sector also. Although wide differences have been narrowed down, yet the existing differences do hamper the efficiency of money market.

4. Seasonality of Money Market

Indian agriculture is busy during the period November to June resulting in heavy demand for funds. During this period money market suffers from Monetary Shortage resulting in high rate of interest. During slack season rate of interest falls & there are plenty of funds available. RBI has taken steps to reduce the seasonal fluctuations, but still the variations exist.

5. Shortage of Funds

In Indian Money Market demand for funds exceeds the supply. There is shortage of funds in Indian Money Market an account of various factors like inadequate banking facilities, low savings, lack of banking habits, existence of parallel economy etc. There is also vast amount of black money in the country which has caused shortage of funds. However, in recent years development of banking has improved the mobilization of funds to some extent.

6. Absence of Organized Bill Market

A bill market refers to a mechanism where bills of exchange are purchased and discounted by banks in India. A bill market provides short term funds to businessmen. The bill market in India is not popular due to overdependence of cash transactions, high discounting rates, problem of dishonour of bills etc.

7. Inadequate Banking Facilities

Though the commercial banks, have been opened on a large scale, yet banking facilities are inadequate in our country. The rural areas are not covered due to poverty. Their savings are very small and mobilization of small savings is difficult. The involvement of banking system in different scams and the failure of RBI to prevent these abuses of banking system shows that Indian banking system is not yet a well organized sector.

8. Inefficient and Corrupt Management

One of the major problems of Indian Money Market is its inefficient and corrupt management. Inefficiency is due to faulty selection, lack of training, poor performance appraisal, faulty promotions etc. For the growth and success of money market, there is need for well trained and dedicated workforce in banks. However, in India some of the bank officials are inefficient and corrupt.

CHAPTER 3

CAPITAL MARKET

Introduction to capital Market

Capital is a crucial factor in the development of an economy. The pace of economic development is conditioned, among other things, by the rate of capital formation. And capital formation is conditioned by the mobilisation and channelization of investible funds. The role of the financial system is to channel funds from surplus sectors to deficit sectors. Facilitating such flows on a national level increases the level of investment and effective demand and thus accelerates economic development. Capital market development has been closely related to an economy's overall development. At low levels of development, commercial banks tend to dominate the financial system. As an economy develops, the indirect lending by savers to investors tend to become more efficient. As economy grows further, specialised financial intermediaries and securities markets develop. As securities markets mature, investors, especially individual investors, can invest their funds directly in financial assets issued by firms.

Meaning of capital market

Capital markets are the financial markets in which corporate equity and long term debt are issued and traded. Capital market works as a conduit for demand and supply of long term debt and equity capital. Capital Markets are the means through which small and scattered savings of the investors are directed into productive activities of corporate entities. Capital markets are financial markets for the buying and selling of long-term debt- or equity-backed securities. These markets channel the wealth of savers to those who can put it to long-term productive use, such as companies or governments making long-term investments.

Capital markets typically involve issuing instruments such as stocks and bonds for the medium-term and long-term. In this respect, capital markets are distinct from money markets, which refer to markets for financial instruments with maturities not exceeding one year.

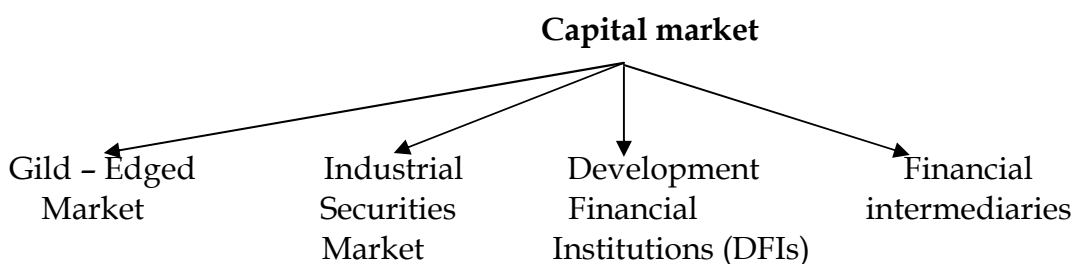
Capital markets have numerous participants including individual investors, institutional investors such as pension funds and mutual funds, municipalities and governments, companies and organizations and banks and financial institutions. Suppliers of capital generally want the maximum possible return at the lowest possible risk, while users of capital want to raise capital at the minimum possible cost.

The size of a nation's capital markets is directly proportional to the size of its economy. The United States, the world's largest economy, has the biggest and deepest capital markets. Capital markets are increasingly interconnected in a globalized economy,

which means that ripples in one corner can cause major waves elsewhere. The drawback of this interconnection is best illustrated by the global credit crisis of 2007-09, which was triggered by the collapse in U.S. mortgage-backed securities. The effects of this meltdown were globally transmitted by capital markets since banks and institutions in Europe and Asia held trillions of dollars of these securities.

Capital market structure in India

Capital market in India structured in following ways



a) Gilt - Edged Market:-

Gilt - Edged market refers to the market for government and semi-government securities, which carry fixed rates of interest. RBI plays an important role in this market.

b) Industrial Securities Market:-

It deals with equities and debentures in which shares and debentures of existing companies are traded and shares and debentures of new companies are bought and sold.

c) Development Financial Institutions:-

Development financial institutions were set up to meet the medium and long-term requirements of industry, trade and agriculture. These are IFCI, ICICI, IDBI, SIDBI, IRBI, UTI, LIC, GIC etc. All These institutions have been called Public Sector Financial Institutions.

d) Financial Intermediaries:-

Financial Intermediaries include merchant banks, Mutual Fund, Leasing companies etc. they help in mobilizing savings and supplying funds to capital market.

Functions of capital market in India.

Capital market has a crucial significance to capital formation. For a speedy economic development adequate capital formation is necessary. The significance of capital market in economic development is explained below:-

1. Mobilization Of Savings And Acceleration Of Capital Formation

In developing countries like India the importance of capital market is self evident. In this market, various types of securities help to mobilize savings from various sectors of population. The twin features of reasonable return and liquidity in stock exchange are definite incentives to the people to invest in securities. This accelerates the capital formation in the country.

2. Raising Long - Term Capital

The existence of a stock exchange enables companies to raise permanent capital. The investors cannot commit their funds for a permanent period but companies require funds permanently. The stock exchange resolves this dash of interests by offering an opportunity to investors to buy or sell their securities, while permanent capital with the company remains unaffected.

3. Promotion Of Industrial Growth

The stock exchange is a central market through which resources are transferred to the industrial sector of the economy. The existence of such an institution encourages people to invest in productive channels. Thus it stimulates industrial growth and economic development of the country by mobilizing funds for investment in the corporate securities.

4. Ready And Continuous Market

The stock exchange provides a central convenient place where buyers and sellers can easily purchase and sell securities. Easy marketability makes investment in securities more liquid as compared to other assets.

5. Technical Assistance

An important shortage faced by entrepreneurs in developing countries is technical assistance. By offering advisory services relating to preparation of feasibility reports, identifying growth potential and training entrepreneurs in project management, the financial intermediaries in capital market play an important role.

6. Reliable Guide To Performance

The capital market serves as a reliable guide to the performance and financial position of corporates, and thereby promotes efficiency.

7. Proper Channelization Of Funds

The prevailing market price of a security and relative yield are the guiding factors for the people to channelize their funds in a particular company. This ensures effective utilisation of funds in the public interest.

8. Provision Of Variety Of Services

The financial institutions functioning in the capital market provide a variety of services such as grant of long term and medium term loans to entrepreneurs, provision of underwriting facilities, assistance in promotion of companies, participation in equity capital, giving expert advice etc.

9. Development Of Backward Areas

Capital Markets provide funds for projects in backward areas. This facilitates economic development of backward areas. Long term funds are also provided for development projects in backward and rural areas.

10. Foreign Capital

Capital markets makes possible to generate foreign capital. Indian firms are able to generate capital funds from overseas markets by way of bonds and other securities. Government has liberalised Foreign Direct Investment (FDI) in the country. This not only brings in foreign capital but also foreign technology which is important for economic development of the country.

11. Easy Liquidity

With the help of secondary market investors can sell off their holdings and convert them into liquid cash. Commercial banks also allow investors to withdraw their deposits, as and when they are in need of funds.

12. Revival Of Sick Units

The Commercial and Financial Institutions provide timely financial assistance to viable sick units to overcome their industrial sickness. To help the weak units to overcome their financial industrial sickness banks and FIs may write off a part of their loan.

Segments of Securities Market

The securities market has two interdependent segments: the primary (new issues) market and the secondary market. The primary market provides the channel for sale of new securities while the secondary market deals in securities previously issued.

Primary Market

The primary market provides the channel for sale of new securities. Primary market provides opportunity to issuers of securities; Government as well as corporates, to raise resources to meet their requirements of investment and/or discharge some obligation. They may issue the securities at face value, or at a discount/premium and these securities may take a variety of forms such as equity, debt etc. They may issue the securities in domestic market and/or international market.

Secondary market

Secondary market refers to a market where securities are traded after being initially offered to the public in the primary market and/or listed on the Stock Exchange. Majority of the trading is done in the secondary market. Secondary market comprises of equity markets and the debt markets. For the general investor, the secondary market provides an efficient platform for trading of his securities. For the management of the company, Secondary equity markets serve as a monitoring and control activity –by facilitating value-enhancing control activities, enabling implementation of incentive-based management contracts, and aggregating information (via price discovery) that guides management decisions.

Different kinds of issues

Primarily, issues can be classified as a Public, Rights or Preferential issues (also known as private placements). While public and rights issues involve a detailed procedure, private placements or preferential issues are relatively simpler. The classification of issues is illustrated below:

Initial Public Offering (IPO)

When an unlisted company makes either a fresh issue of securities or an offer for sale of its existing securities or both for the first time to the public. This paves way for listing and trading of the issuer's securities.

A follow on public offer

When an already listed company makes either a fresh issue of securities to the public or an offer for sale to the public, through an offer document.

Rights Issue

It is when a listed company which proposes to issue fresh securities to its existing shareholders as on a record date. The rights are normally offered in a particular ratio to the number of securities held prior to the issue. This route is best suited for companies who would like to raise capital without diluting stake of its existing shareholders.

A Preferential issue

It is an issue of shares or of convertible securities by listed companies to a select group of persons under Section 81 of the Companies Act, 1956 which is neither a rights issue nor a public issue. This is a faster way for a company to raise equity capital.

Initial Public Offer (IPO)

An Initial Public Offer (IPO) is the selling of securities to the public in the primary market. It is when an unlisted company makes either a fresh issue of securities or an offer for sale of its existing securities or both for the first time to the public. This paves way for

listing and trading of the issuer's securities. The sale of securities can be either through book building or through normal public issue.

Difference between money market and capital market

	Money Market	Capital Market
Definition	Is a component of the financial markets where short-term borrowing takes place	Is a component of financial markets where long-term borrowing takes place
Maturity Period	Lasts anywhere from 1 hour to 90 days.	Lasts for more than one year and can also include life-time of a company.
Credit Instruments	Certificate of deposit, Repurchase agreements, Commercial paper, Eurodollar deposit, Federal funds, Municipal notes, Treasury bills, Money funds, Foreign Exchange Swaps, short-lived mortgage and asset-backed securities.	Stocks, Shares, Debentures, bonds, Securities of the Government.
Nature of Credit Instruments	Homogenous. A lot of variety causes problems for investors.	Heterogeneous. A lot of varieties are required.
Purpose of Loan	Short-term credit required for small investments.	Long-term credit required to establish business, expand business or purchase fixed assets.
Basic Role	Liquidity adjustment	Putting capital to work
Institutions	Central banks, Commercial banks, Acceptance houses, Nonbank financial institutions, Bill brokers, etc.	Stock exchanges, Commercial banks and Nonbank institutions, such as Insurance Companies, Mortgage Banks, Building Societies, etc.
Risk	Risk is small	Risk is greater
Market	Commercial banks are closely regulated to	Institutions are regulated to

Regulation	prevent occurrence of a liquidity crisis.	keep them from defrauding customers.
Relation with Central Bank	Closely related to the central banks of the country.	Indirectly related with central banks and feels fluctuations depending on the policies of central banks.

Instruments in the Secondary Markets

Following are the main financial products/instruments dealt in the Secondary market which may be divided broadly into Shares and Bonds:

Shares

Equity Shares

An equity share, commonly referred to as ordinary share, represents the form of fractional ownership in a business venture.

Rights Issue/ Rights Shares

The issue of new securities to existing shareholders at a ratio to those already held, at a price. For e.g. a 2:3 rights issue at Rs. 125, would entitle a shareholder to receive 2 shares for every 3 shares held at a price of Rs. 125 per share.

Bonus Shares

Shares issued by the companies to their shareholders free of cost based on the number of shares the shareholder owns.

Preference shares

Owners of these kinds of shares are entitled to a fixed dividend or dividend calculated at a fixed rate to be paid regularly before dividend can be paid in respect of equity share. They also enjoy priority over the equity shareholders in payment of surplus. But in the event of liquidation, their claims rank below the claims of the company's creditors, bondholders/debenture holders.

Bond

It is a negotiable certificate evidencing indebtedness. It is normally unsecured. A debt security is generally issued by a company, municipality or government agency. A bond investor lends money to the issuer and in exchange, the issuer promises to repay the loan amount on a specified maturity date. The issuer usually pays the bond holder periodic interest payments over the life of the loan. The various types of Bonds are as follows:

Zero Coupon Bond:

Bond issued at a discount and repaid at a face value. No periodic interest is paid. The difference between the issue price and redemption price represents the return to the holder. The buyer of these bonds receives only one payment, at the maturity of the bond.

Convertible Bond

A bond giving the investor the option to convert the bond into equity at a fixed conversion price.

Debenture

A debenture is a document that either creates a debt or acknowledges it, and it is a debt without collateral. In corporate finance, the term is used for a medium- to long-term debt instrument used by large companies to borrow money. In some countries the term is used interchangeably with bond, loan stock or note. A debenture is thus like a certificate of loan or a loan bond evidencing the fact that the company is liable to pay a specified amount with interest and although the money raised by the debentures becomes a part of the company's capital structure, it does not become share.

Debentures are generally freely transferable by the debenture holder. Debenture holders have no rights to vote in the company's general meetings of shareholders, but they may have separate meetings or votes e.g. on changes to the rights attached to the debentures. The interest paid to them is a charge against profit in the company's financial statements.

There are two types of debentures:

1. **Convertible debentures**, which are convertible bonds or bonds that can be converted into equity shares of the issuing company after a predetermined period of time. "Convertibility" is a feature that corporations may add to the bonds they issue to make them more attractive to buyers. In other words, it is a special feature that a corporate bond may carry. As a result of the advantage a buyer gets from the ability to convert, convertible bonds typically have lower interest rates than non-convertible corporate bonds.
2. **Non-convertible debentures**, which are simply regular debentures, cannot be converted into equity shares of the liable company. They are debentures without the convertibility feature attached to them. As a result, they usually carry higher interest rates than their convertible counterparts.

Stock Exchange

A **stock exchange** is a form of exchange which provides services for stock brokers and traders to trade stocks, bonds, and other securities. Stock exchanges also provide facilities for issue and redemption of securities and other financial instruments, and capital events including the payment of income and dividends. Securities traded on a

stock exchange include stock issued by companies, unit trusts, derivatives, pooled investment products and bonds.

To be able to trade a security on a certain stock exchange, it must be listed there. Usually, there is a central location at least for record keeping, but trade is increasingly less linked to such a physical place, as modern markets are electronic networks, which gives them advantages of increased speed and reduced cost of transactions. Trade on an exchange is by members only.

The initial offering of stocks and bonds to investors is by definition done in the primary market and subsequent trading is done in the secondary market. A stock exchange is often the most important component of a stock market. Supply and demand in stock markets are driven by various factors that, as in all free markets, affect the price of stocks (see stock valuation).

There is usually no compulsion to issue stock via the stock exchange itself, nor must stock be subsequently traded on the exchange. Such trading is said to be off exchange or over-the-counter. This is the usual way that derivatives and bonds are traded. Increasingly, stock exchanges are part of a global market for securities.

Role and functions of stock exchange

1. Providing a ready market

The organization of stock exchange provides a ready market to speculators and investors in industrial enterprises. It thus, enables the public to buy and sell securities already in issue.

2. Providing a quoting market prices

It makes possible the determination of supply and demand on price. The very sensitive pricing mechanism and the constant quoting of market price allow investors to always be aware of values. This enables the production of various indexes which indicate trends

etc.

3. Providing facilities for working

It provides opportunities to Jobbers and other members to perform their activities with all their resources in the stock exchange.

4. Safeguarding activities for investors

The stock exchange renders safeguarding activities for investors which enables them to make a fair judgment of a securities. Therefore directors have to disclose all material facts to their respective shareholders. Thus innocent investors may be safeguard from the clever brokers.

5. Operating a compensation fund

It also operate a compensation fund which is always available to investors suffering loss due due the speculating dealings in the stock exchange.

6. Creating the discipline

Its members controlled under rigid set of rules designed to protect the general public and its members. Thus this tendency creates the discipline among its members in social life also.

7. Checking functions

New securities checked before being approved and admitted to listing. Thus stock exchange exercises rigid control over the activities of its members.

8. Adjustment of equilibrium

The investors in the stock exchange promote the adjustment of equilibrium of demand and supply of a particular stock and thus prevent the tendency of fluctuation in the prices of shares.

9. Maintenance of liquidity

The bank and insurance companies purchase large number of securities from the stock exchange. These securities are marketable and can be turned into cash at any time. Therefore banks prefer to keep securities instead of cash in their reserve. Thus it facilitates the banking system to maintain liquidity by procuring the marketable securities.

10. Promotion of the habit of saving

Stock exchange provides a place for saving to general public. Thus it creates the habit of thrift and investment among the public. This habit leads to investment of funds incorporate or government securities. The funds placed at the disposal of companies are used by them for productive purposes.

11. Refining and advancing the industry

Stock exchange advances the trade, commerce and industry in the country. It provides opportunity to capital to flow into the most productive channels. Thus the flow of capital from unproductive field to productive field helps to refine the large scale enterprises.

12. Promotion of capital formation

It plays an important part in capital formation in the country. its publicity regarding various industrial securities makes even disinterested people feel interested in investment.

13. Increasing Govt. Funds

The govt. can undertake projects of national importance and social value by raising funds through sale of its securities on stock exchange.

According to MARSHAL "Stock exchange are not merely the chief theaters of business transaction, they are also barometers which indicate the general conditions of the atmosphere of business."

National Stock Exchange of India

National Stock Exchange (NSE) is stock exchange located in Mumbai, India. National Stock Exchange (NSE) was established in the mid 1990s as a demutualised electronic exchange. NSE provides a modern, fully automated screen-based trading system, with over two lakh trading terminals, through which investors in every nook and corner of India can trade. NSE has played a critical role in reforming the Indian securities market and in bringing unparalleled transparency, efficiency and market integrity.

The National Stock Exchange of India was incorporated in 1992 and recognized as a stock exchange in 1993, at a time when PV Narasimha Rao was the Prime Minister of India and Dr. Manmohan Singh was the finance minister. It was set up to bring in transparency in the markets. Promoted by leading financial institutions essentially led by IDBI at the behest of the Government of India, it was incorporated in November 1992 as a tax-paying company. In April 1993, it was recognized as a stock exchange under the Securities Contracts (Regulation) Act, 1956. NSE commenced operations in the Wholesale Debt Market (WDM) segment in June 1994. The Capital market (Equities) segment of the NSE commenced operations in November 1994, while operations in the Derivatives segment commenced in June 2000

NSE has a market capitalization of more than US\$989 billion and 1,635 companies listed as on July 2013. Though a number of other exchanges exist, NSE and the Bombay Stock Exchange are the two most significant stock exchanges in India, and between them are responsible for the vast majority of share transactions. NSE's flagship index, the **CNX NIFTY 50**, is used extensively by investors in India and around the world to take exposure to the Indian equities market.

NSE was started by a clutch of leading Indian financial institutions. It offers trading, clearing and settlement services in equity, debt and equity derivatives. It is India's largest exchange, globally in cash market trades, in currency trading and index options. NSE has diversified shareholding. There are many domestic and global institutions and companies that hold stake in the exchange. Some of the domestic investors include LIC, GIC, State Bank of India and IDFC Ltd. Foreign investors include MS Strategic (Mauritius) Limited, Citigroup Strategic Holdings Mauritius Limited, Tiger Global Five Holdings and Norwest Venture Partners X FII-Mauritius, who have a stake in NSE. As on June 2013, NSE has 1673 VSAT terminals and 2720 leaselines, spread over more than 2000 cities across India.

The National Stock Exchange (NSE) changed the way the Indian markets functioned, in the early nineties, by replacing floor based trading with nationwide screen based electronic trading, which took trading to the doorstep of the investor. The exchange was mainly set up to bring in transparency in the markets. Instead of trading membership being confined to a group of brokers, NSE ensured that anyone who was qualified, experienced and met minimum financial requirements was allowed to trade. In this context, NSE was far ahead of its times, when it separated ownership and management in the exchange under SEBI's supervision. The price information which could earlier be accessed only by a handful of people could now be seen by a client in a remote location with the same ease. The paper based settlement was replaced by electronic depository based accounts and settlement of trades was always done on time. One of the most critical changes was that a robust risk management system was set in place, so that settlement guarantees could protect investors against broker defaults.

OTC Exchange of India

OTC Exchange of India (OTCEI) also known as Over-the-Counter Exchange of India based in Mumbai, Maharashtra. It is the first exchange for small companies. It is the first screen based nationwide stock exchange in India. It was set up to access high-technology enterprising promoters in raising finance for new product development in a cost effective manner and to provide transparent and efficient trading system to the investors. OTCEI is promoted by the Unit Trust of India, the Industrial Credit and Investment Corporation of India, the Industrial Development Bank of India, the Industrial Finance Corporation of India and others and is a recognized stock exchange under the SCR Act. OTC Exchange Of India was founded in 1990 under the Companies Act 1956 and got recognized by the Securities Contracts Regulation Act, 1956 as a stock exchange.

Trading Mechanism of stock exchange

Trading System provides a fully automated trading environment for screen-based, floor-less trading on a nationwide basis and an online monitoring and surveillance mechanism. The system supports an order driven market and provides complete transparency of trading operations.

Orders, as and when they are received, are first time stamped and then immediately processed for potential match. If a match is not found, then the orders are stored in different 'books'. Orders are stored in price-time priority in various books in the following sequence:

- Best Price
- Within Price, by time priority.

Order Matching Rules

The best buy order will match with the best sell order. An order may match partially with another order resulting in multiple trades. For order matching, the best buy

order is the one with highest price and the best sell order is the one with lowest price. This is because the computer views all buy orders available from the point of view of a seller and all sell orders from the point of view of the buyers in the market. So, of all buy orders available in the market at any point of time, a seller would obviously like to sell at the highest possible buy price that is offered. Hence, the best buy order is the order with highest price and vice-versa.

Members can pro actively enter orders in the system which will be displayed in the system till the full quantity is matched by one or more of counter-orders and result into trade(s). Alternatively members may be reactive and put in orders that match with existing orders in the system. Orders lying unmatched in the system are 'passive' orders and orders that come in to match the existing orders are called 'active' orders. Orders are always matched at the passive order price. This ensures that the earlier orders get priority over the orders that come in later.

Order Conditions

A Trading Member can enter various types of orders depending upon his/her requirements. These conditions are broadly classified into 2 categories: time related conditions and price-related conditions.

Time Conditions

DAY - A Day order, as the name suggests, is an order which is valid for the day on which it is entered. If the order is not matched during the day, the order gets cancelled automatically at the end of the trading day.

IOC - An Immediate or Cancel (IOC) order allows a Trading Member to buy or sell a security as soon as the order is released into the market, failing which the order will be removed from the market. Partial match is possible for the order, and the unmatched portion of the order is cancelled immediately.

Price Conditions

Limit Price/Order - An order that allows the price to be specified while entering the order into the system.

Market Price/Order - An order to buy or sell securities at the best price obtainable at the time of entering the order.

Stop Loss (SL) Price/Order - The one that allows the Trading Member to place an order which gets activated only when the market price of the relevant security reaches or crosses a threshold price. Until then the order does not enter the market.

A sell order in the Stop Loss book gets triggered when the last traded price in the normal market reaches or falls below the trigger price of the order. A buy order in the Stop Loss book gets triggered when the last traded price in the normal market reaches or exceeds the trigger price of the order.

E.g. If for stop loss buy order, the trigger is 93.00, the limit price is 95.00 and the market (last traded) price is 90.00, then this order is released into the system once the market price reaches or exceeds 93.00. This order is added to the regular lot book with time of triggering as the time stamp, as a limit order of 95.00

Settlement Process

There are basically three tasks that are performed in the process of buying and selling of securities. They are:

- **Trading**
- **Clearing**
- **Settlement**

Trading basically deals with putting an order and its execution. Clearing deals with determination of obligations, in terms of funds and securities. Settlement means that the trade will be completed and NSCCL acts as a counter party and takes an obligation for the same. It has created a faith in the investors that all the trades would be settled and in no case any investor will have to face any problem of insufficient funds and securities. NSCCL acts as a buyer to every seller and a seller to every buyer. This principle is called novation. In case of default by any party, the NSCCL takes action against the defaulter.

National Securities Clearing Corporation Limited (NSCCL)

The NSCCL, a wholly owned subsidiary of NSE, was incorporated in August 1995. NSCCL commenced clearing operations in April 1996. It was set up for the following purposes:

- To bring and sustain confidence in clearing and settlement of securities;
- To promote and maintain, short and consistent settlement cycles;
- To provide counter-party risk guarantee, and
- To operate a tight risk containment system.

Dematerialized settlement [rolling settlement]

NSCCL follows a **T+2 rolling settlement** cycle. For all trades executed on the T day, NSCCL determines the cumulative obligations of each member on the T+1 day and electronically transfers the data to Clearing Members (CMs). All trades concluded during a particular trading date are settled on a designated settlement day i.e. T+2 day. In case of short deliveries on the T+2 day in the normal segment, NSCCL conducts a buy -in auction on the T+2 day itself and the settlement for the same is completed on the T+3 day, whereas in case of W segment there is a direct close out. For arriving at the settlement day all intervening holidays, which include bank holidays, NSE holidays, Saturdays and Sundays are excluded.

Online trading

Trading with the help of computer having internet connection and online trading account is called Online Stock Trading. Basically people use online stock trading who want to trade themselves.

Essentials of online trading

- Online trading account - You have to open an online trading account with any of the bank or financial trading system like ICICIdirect.com, 5paisa.com, Stockkhan.com etc. There will be nominal annual charges. These charges vary from bank to bank but should not be more than Rs.1000.
- A computer with internet connection or can do trading in internet cafe.
- After successfully opening the online account you will receive the **username and password** with the help of which you can login in online trading system and trade yourself.
- The trading system executive (with whom you opened trading account) will help you initially about how to use the online trading system.
- Once you get familiar with the system then you can trade yourself at your home or in the internet cafe.
- Nowadays you can get internet enabled on your cell (which is called GPRS) whose speed will be sufficient to do trading and also the charges of GPRS are very nominal.

Advantages of Online Trading

- No need to depend on any broker or anybody else to place the order or to square off the order. In short you are the boss of yourself to do trading of stocks.
- Its reliable, convenient and you can take your own decisions yourself by actual selling or analyzing the market on the computer screen instead of calling broker all the time and getting news about the market.
- Its not possible or practical for a broker to update you about each and every news about the market or any news which will influence or affect the stock market. Because he may be having many other customers like you and even if he updates you by that time the news have been affected the concerned sector or stock. So if you are doing online trading yourself, then you may save yourself from big disaster. You will get news and updates on various websites and also on your online trading system and most of the information will be free of cost.
- By doing online trading yourself, you can see and judge where market (or your stock) is heading by seeing different graphs online yourself, which is not possible if you're trading through broker. Some online trading systems have graphs integrated in their system, so your job is to just add those graphs and check the status of current market (or stock)

(graphs will be discussed later). And depending on your analysis you can take steps towards your successfully trading. (How to analyze graphs will be mentioned later).

- All your transactions and related documents can be seen online and can also be downloaded to your PC without depending on your broker. You can also check the status of your amount on daily basis through you online trading system.

Disadvantages of Online Trading

- In online trading system you may face problem of disconnection to internet due to which you will not be able to login to your online trading system and hence you can't do trading yourself. At such critical times you have to call trading system executive and do trading or square off your transactions.
- If may face other problems such as electricity cut-off, PC problem etc during online trading then immediately you have to contact your trading system executive and place orders or do trading.

Scripless trading

Scripless trading is a term used to describe a procedure of trading in shares, where actual share certificates are not traded but shares are traded in electronic forms, the share traded being adjusted by accounting by an organization known as depository. In India scripless trading first started with the emergence of OTCEI. But it was very limited. The advent of online automated trading in India brought with it several associated benefits such as transparency in trading and equal opportunity for market players all over the country but the problems related to settlement of trades such as high instances of bad deliveries and long settlement cycles continued. As an answer to these settlement problems and in order to provide a safe and efficient system of trading and settlement, Depositories Act, 1996 was enacted. SEBI notified Regulations in order to provide the regulatory framework for the depositories. Depositories gave a new dimension and a new scope for conducting transactions in capital market primary as well as secondary, in a more efficient and effective manner, in a paperless form on an electronic book entry basis. It provided electronic solution to the aforementioned problems of bad deliveries and long settlement cycles. Only after the scripless trading our capital market has come up to international level.

DEPOSITORY SYSTEM

A vibrant and efficient capital market, which ensures an orderly development and contains measures for protection of the investor's interest, is the most important parameter for evaluating health of any economy. The practice of physical trading imposed limits on trading volumes and hence the speed with which new information was incorporated into prices system.

Dematerialization is the processes by which a client can get physical certificates converted into electronic balances maintained in its account with the participant in the depository system securities held in dematerialization form are fungible, i.e., they do not

bear any distinguishing features. The financial market exists to facilitate sale and purchase of financial instruments and comprises of two major markets namely the capital Market and the money market. The capital market mainly deals in medium and long – term investments (maturity more than a year) while the money market deals in short-term investments (maturity up to a year).

A major problem however continued to plague the market. The Indian markets were literally weighed down by the need to deal with shares in the paper form. There were problems galore with handling documents-fake and stolen shares, fake signatures and signatures mismatch, duplication and mutilation of shares, and transfer problems etc. so the institutions and the stock exchanges experiences that the paper certificates are the main cause of investor disputes and arbitration cases.

Thus, the Government of India decided to setup a fully automated and high technology based model exchanges, which could offer screen, based trading and depositories as the ultimate answer to all such reforms. Therefore, the government of India promulgated the Depository Ordinance in 1995. However, both houses of Parliament passed the Depositories Act in 1996. the unparalleled success of the introduction of the depository concept in Indian capital markets is reflected in the on-going successful reaction in the period between trading and settlement.

MEANING OF DEPOSITORY

“A Depository is a file or a set of files in which data is stored for the purpose of safe keeping or identity authentication”, defined by Germany Depository.

In India, the Depositories Act, 1996 defines a depository to mean “A Company formed and registered under the Companies Act, 1956 and which has been granted a certificate of registration under sub-section (1A) of section 12 of the Securities and Exchanges Board of India Act, 1992”.

As per The Bank for International settlements (BIS), depository is “a facility for holding securities which enables securities transactions to e processed by book entry, physical securities may be immobilized by the depository or securities may be dematerialized (so that they exist only as electronic records)”.

Depository Participant (DP)

A DP is an agent of the depository through which it interfaces with the investor and provides depository services. Public financial institutions, scheduled commercial banks, foreign banks operating in India with the approval of the Reserve Bank of India, state financial corporations, custodians, stock-brokers, clearing corporations / clearing houses, NBFCs and registrar to an issue or share transfer agent complying with the requirements prescribed by SEBI can be registered as DP.

Dematerialisation (demat)

Dematerialization is the process by which physical certificates of an investor are converted to an equivalent number of securities in electronic form.

Services provided by a Depository

- Opening a demat account;
- Dematerialization, i.e. converting physical securities into electronic form;
- Rematerialisation, i.e. converting electronic securities into physical form;
- Maintaining record of securities held by the beneficial owners in the electronic form;
- Settlement of trades by delivery or receipt of securities from / in BO accounts;
- Settlement of off-market transactions between BOs;
- Receiving electronic credit in respect of securities allotted by issuers under IPO or otherwise on behalf of demat account holders;

*Receiving non cash corporate benefits such as allotment of bonus and rights shares or any other non cash corporate benefits given by the issuers in electronic form on behalf of its demat account holders;

- Pledging of dematerialized securities & facilitating loans against shares;
- Freezing of the demat account for debits, credits, or both

Benefits of availing depository services

- A safe and convenient way to hold securities;
- Immediate transfer of securities;
- No stamp duty on transfer of securities;
- Elimination of risks associated with physical certificates such as bad delivery, fake securities, delays, thefts etc.
- Reduction in paperwork involved in transfer of securities;
- Reduction in transaction cost;
- No odd lot problem, even one share can be traded;
- Nomination facility;
- Change in address recorded with DP gets registered with all companies in which investor holds securities electronically eliminating the need to correspond with each of them separately;

- Transmission of securities is done by DP eliminating correspondence with companies;
- Automatic credit into demat account of shares, arising out of bonus/split/consolidation/merger etc;
- Holding investments in equity and debt instruments in a single account.

SEBI-Role and Functions

The securities and exchange board of India [SEBI] was constituted as a regulatory authority over various constituents of the capital market in the year 1988.though legally SEBI came into existence in 1988; it was made operational and effective from 1992 when it was empowered to secure an autonomous position.

Functions of SEBI

1. To protect the interest of investors in securities and to promote the development of and to regulate the securities market by such measures it thinks fit.
2. Regulating the business in stock exchanges and any other securities markets.
3. Registering and regulating the working of stock brokers, sub brokers, share transfer agents, bankers to issue, trustees of trust deed, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisors, and other such intermediaries who may be associated with securities market in any manner.
4. Registering and regulating the working of collective investment schemes including mutual funds.
5. Promoting and regulating self regulatory organizations.
6. Prohibiting fraudulent and unfair trade practices relating to securities markets.
7. Promoting investor education and training of intermediaries of security market.
8. Prohibiting insider trading in securities.
9. Regulating substantial acquisition of shares and takeover of companies.
10. Calling for information form, undertaking inspection, conducting inquiries and audits of the stock exchanges and intermediaries, and regulatory organization in security market.
11. Levying fees or other charges for carrying out the purposes of this section.
12. Conducting research for the above purposes.
13. Performing other such functions as may be prescribed.
14. Promoting fair practices and code of conduct for all SROs.

CHAPTER 4

MUTUAL FUNDS

There are various investment avenues available to an investor such as real estate, bank deposits, post office deposits, shares, debentures, bonds etc. A mutual fund is one more type of investment avenue available to investors. There are many reasons why investors prefer mutual funds. Buying shares directly from the market is one way of investing. But this requires spending time to find out the performance of the company whose share is being purchased, understanding the future business prospects of the company, finding out the track record of the promoters and the dividend, bonus issue history of the company etc. An informed investor needs to do research before investing. However, many investors find it cumbersome and time consuming to pore over so much of information, get access to so much of details before investing in the shares. Investors therefore prefer the mutual fund route. They invest in a mutual fund scheme which in turn takes the responsibility of investing in stocks and shares after due analysis and research. The investor need not bother with researching hundreds of stocks. It leaves it to the mutual fund and its professional fund management team. Another reason why investors prefer mutual funds is because mutual funds offer diversification. An investor's money is invested by the mutual fund in a variety of shares, bonds and other securities thus diversifying the investors portfolio across different companies and sectors. This diversification helps in reducing the overall risk of the portfolio. It is also less expensive to invest in a mutual fund since the minimum investment amount in mutual fund units is fairly low (Rs. 500 or so). With Rs. 500 an investor may be able to buy only a few stocks and not get the desired diversification. These are some of the reasons why mutual funds have gained in popularity over the years.

A mutual fund is a professionally managed type of collective investment scheme that pools money from many investors and invests it in stocks, bonds, short-term money market instruments and other securities. Mutual funds have a fund manager who invests the money on behalf of the investors by buying / selling stocks, bonds etc.

Definition of Mutual Fund

An investment vehicle that is made up of a pool of funds collected from many investors for the purpose of investing in securities such as stocks, bonds, money market instruments and similar assets. Mutual funds are operated by money managers, who invest the fund's capital and attempt to produce capital gains and income for the fund's investors. A mutual fund's portfolio is structured and maintained to match the investment objectives stated in its prospectus.

HISTORY OF MUTUAL FUNDS

The origin of pooled investing concept dates back to the late 1700s in Europe, when "a Dutch merchant and broker invited subscriptions from investors to form a trust to provide an opportunity to diversify for small investors with limited means." The emergence of "investment pooling" in England in the 1800s brought the concept closer to the US shores.

The enactment of two British laws, the Joint Stock Companies Acts of 1862 and 1867, permitted investors to share in the profits of an investment enterprise and limited investor liability to the amount of investment capital devoted to the enterprise. Shortly thereafter, in 1868, the Foreign and Colonial Government Trust was formed in London.

It resembled the US fund model in basic structure, providing "the investor of moderate means the same advantages as the large capitalists by spreading the investment over a number of different stocks." More importantly, the British fund model established a direct link with the US securities markets, helping finance the development of the post-Civil War US economy.

The Scottish American Investment Trust, formed in February 1873, by fund pioneer Robert Fleming, invested in the economic potential of the US, chiefly through American railroad bonds. Many other trusts followed them, who not only targeted investment in America, but led to the introduction of the fund investing concept on the US shores in the late 1800s and the early 1900s. The first mutual or 'open-ended' fund was introduced in Boston in March 1924. The Massachusetts Investors Trust, which was formed as a common law trust, introduced important innovations to the investment company concept by establishing a simplified capital structure, continuous offering of shares, and the ability to redeem shares rather than holding them until dissolution of the fund and a set of clear investment restrictions as well as policies.

The stock market crash of 1929 and the Great Depression that followed greatly hampered the growth of pooled investments until a succession of landmark securities laws, beginning with the Securities Act, 1933 and concluded with the Investment Company Act, 1940, reinvigorated investor confidence. Renewed investor confidence and many innovations led to relatively steady growth in industry assets and number of accounts.

THE MUTUAL FUND INDUSTRY IN INDIA

The mutual fund industry in India started in 1963 with the formation of Unit Trust of India (UTI) at the initiative of the Reserve Bank of India (RBI) and the Government of India. The objective then was to attract small investors and introduce them to market investments. Since then, the history of mutual funds in India can be broadly divided into six distinct phases.

Phase I (1964-87): Growth Of UTI

In 1963, UTI was established by an Act of Parliament. As it was the only entity offering mutual funds in India, it had a monopoly. Operationally, UTI was set up by the Reserve Bank of India (RBI), but was later delinked from the RBI. The first scheme, and for long one of the largest launched by UTI, was Unit Scheme 1964.

Later in the 1970s and 80s, UTI started innovating and offering different schemes to suit the needs of different classes of investors. Unit Linked Insurance Plan (ULIP) was launched in 1971. The first Indian offshore fund, India Fund was launched in August 1986. In absolute terms, the investible funds corpus of UTI was about Rs 600 crores in 1984. By 1987-88, the assets under management (AUM) of UTI had grown 10 times to Rs 6,700 crores.

Phase II (1987-93): Entry of Public Sector Funds

The year 1987 marked the entry of other public sector mutual funds. With the opening up of the economy, many public sector banks and institutions were allowed to establish mutual funds. The State Bank of India established the first non-UTI Mutual Fund, SBI Mutual Fund in November 1987. This was followed by Canbank Mutual Fund, LIC Mutual Fund, Indian Bank Mutual Fund, Bank of India Mutual Fund, GIC Mutual Fund and PNB Mutual Fund. From 1987-88 to 1992-93, the AUM increased from Rs 6,700 crores to Rs 47,004 crores, nearly seven times. During this period, investors showed a marked interest in mutual funds, allocating a larger part of their savings to investments in the funds.

Phase III (1993-96): Emergence of Private Funds

A new era in the mutual fund industry began in 1993 with the permission granted for the entry of private sector funds. This gave the Indian investors a broader choice of 'fund families' and increasing competition to the existing public sector funds. Quite significantly foreign fund management companies were also allowed to operate mutual funds, most of them coming into India through their joint ventures with Indian promoters.

The private funds have brought in with them latest product innovations, investment management techniques and investor-servicing technologies. During the year 1993-94, five private sector fund houses launched their schemes followed by six others in 1994-95.

Phase IV (1996-99): Growth And SEBI Regulation

Since 1996, the mutual fund industry scaled newer heights in terms of mobilization of funds and number of players. Deregulation and liberalization of the Indian economy had introduced competition and provided impetus to the growth of the industry.

A comprehensive set of regulations for all mutual funds operating in India was introduced with SEBI (Mutual Fund) Regulations, 1996. These regulations set uniform standards for all funds. Erstwhile UTI voluntarily adopted SEBI guidelines for its new schemes. Similarly, the budget of the Union government in 1999 took a big step in exempting all mutual fund dividends from income tax in the hands of the investors. During this phase, both SEBI and Association of Mutual Funds of India (AMFI) launched Investor Awareness Programme aimed at educating the investors about investing through MFs.

Phase V (1999-2004): Emergence of a Large and Uniform Industry

The year 1999 marked the beginning of a new phase in the history of the mutual fund industry in India, a phase of significant growth in terms of both amount mobilized from investors and assets under management. In February 2003, the UTI Act was repealed. UTI no longer has a special legal status as a trust established by an act of Parliament. Instead it has adopted the same structure as any other fund in India - a trust and an AMC.

UTI Mutual Fund is the present name of the erstwhile Unit Trust of India (UTI). While UTI functioned under a separate law of the Indian Parliament earlier, UTI Mutual Fund is now under the SEBI's (Mutual Funds) Regulations, 1996 like all other mutual funds in India.

The emergence of a uniform industry with the same structure, operations and regulations make it easier for distributors and investors to deal with any fund house. Between 1999 and 2005 the size of the industry has doubled in terms of AUM which have gone from above Rs 68,000 crores to over Rs 1,50,000 crores.

Phase VI (From 2004 Onwards): Consolidation and Growth

The industry has lately witnessed a spate of mergers and acquisitions, most recent ones being the acquisition of schemes of Allianz Mutual Fund by Birla Sun Life, PNB Mutual Fund by Principal, among others. At the same time, more international players continue to enter India including Fidelity, one of the largest funds in the world.

ADVANTAGES OF MUTUAL FUNDS

Mutual fund investments in stocks, bonds and other instruments require considerable expertise and constant supervision, to allow an investor to take the right decisions. Small investors usually do not have the necessary expertise and time to undertake any study that can facilitate informed decisions. While this is the predominant reason for the popularity of mutual funds, there are many other benefits that make mutual funds appealing.

Diversification Benefits

Diversified investment improves the risk return profile of the portfolio. Optimal diversification has limitations due to low liquidity among small investors. The large corpus of a mutual fund as compared to individual investments makes optimal diversification possible. Due to the pooling of capital, individual investors can derive benefits of diversification.

Low Transaction Costs:

Mutual fund transactions are generally very large. These large volumes attract lower brokerage commissions and other costs as compared to smaller volumes of the transactions that individual investors enter into. The brokers quote a lower rate of commission due to two reasons. The first is competition for the institutional investors business. The second reason is that the overhead cost of executing a trade does not differ much for large and small orders. Hence for a large order these costs spread over a large volume enabling the broker to quote a lower commission rate.

Availability of Various Schemes

There are four basic types of mutual funds: equity, bond, hybrid and money market. Equity funds concentrate their investments in stocks. Similarly bond funds primarily invest in bonds and other securities. Equity, bond and hybrid funds are called long-term funds. Money market funds are referred to as short-term funds because they invest in securities that generally mature in about one year or less. Mutual funds generally offer a number of schemes to suit the requirement of the investors.

Professional Management

Management of a portfolio involves continuous monitoring of various securities and innumerable economic variables that may affect a portfolio's performance. This requires a lot of time and effort on part of the investors along with in-depth knowledge of the functioning of the financial markets. Mutual funds are managed by fund managers generally with knowledge and experience whose time is solely devoted to tracking and updating the portfolio. Thus investment in a mutual fund not only saves time and effort for the investor but is also likely to produce better results.

Liquidity

Liquidating a portfolio is not always easy. There may not be a liquid market for all securities held. In case only a part of the portfolio is required to be liquidated, it may not be possible to see all the securities forming a part of the portfolio in the same proportion as they are represented in the portfolio; investing in mutual funds can solve these problems. A fund house generally stands ready to buy and sell its units on a regular basis. Thus it is easier to liquidate holdings in a Mutual Fund as compared to direct investment in securities.

Returns

In India dividend received by investors is tax-free. This enhances the yield on mutual funds marginally as compared to income from other investment options. Also in case of long-term capital gains, the investor benefits from indexation and lower capital gain tax.

Flexibility

Features of a MF scheme such as regular investment plan, regular withdrawal plans and dividend reinvestment plan allows investors to systematically invest or withdraw funds according to the needs and convenience.

Well Regulated

All mutual funds are registered with SEBI and they function within the provisions of strict regulations designed to protect the interest of investors. The SEBI regularly monitors the operations of an AMC.

Disadvantages of Mutual funds

1. **No Insurance:** Mutual funds, although regulated by the government, are not insured against losses. That means that despite the risk-reducing diversification benefits provided by mutual funds, losses can occur, and it is possible (although extremely unlikely) that you could even lose your entire investment.
2. **Dilution:** Although diversification reduces the amount of risk involved in investing in mutual funds, it can also be a disadvantage due to dilution. For example, if a single security held by a mutual fund doubles in value, the mutual fund itself would not double in value because that security is only one small part of the fund's holdings. By holding a large number of different investments, mutual funds tend to do neither exceptionally well nor exceptionally poorly.
3. **Fees and Expenses:** Most mutual funds charge management and operating fees that pay for the fund's management expenses (usually around 1.0% to 1.5% per year for actively managed funds). In addition, some mutual funds charge high sales commissions, 12b-1 fees, and redemption fees. And some funds buy and trade shares so often that the transaction costs add up significantly. Some of these expenses are charged on an ongoing basis, unlike stock investments, for which a commission is paid only when you buy and sell .
4. **Poor Performance:** Returns on a mutual fund are by no means guaranteed. In fact, on average, around 75% of all mutual funds fail to beat the major market indexes, like the S&P 500, and a growing number of critics now question whether or not professional money managers have better stock-picking capabilities than the average investor.
5. **Loss of Control:** The managers of mutual funds make all of the decisions about which securities to buy and sell and when to do so. This can make it difficult for you when

trying to manage your portfolio. For example, the tax consequences of a decision by the manager to buy or sell an asset at a certain time might not be optimal for you. You also should remember that you are trusting someone else with your money when you invest in a mutual fund.

6. **Trading Limitations:** Although mutual funds are highly liquid in general, most mutual funds (called open-ended funds) cannot be bought or sold in the middle of the trading day. You can only buy and sell them at the end of the day, after they've calculated the current value of their holdings.
7. **Size:** Some mutual funds are too big to find enough good investments. This is especially true of funds that focus on small companies, given that there are strict rules about how much of a single company a fund may own. If a mutual fund has \$5 billion to invest and is only able to invest an average of \$50 million in each, then it needs to find at least 100 such companies to invest in; as a result, the fund might be forced to lower its standards when selecting companies to invest in.
8. **Inefficiency of Cash Reserves:** Mutual funds usually maintain large cash reserves as protection against a large number of simultaneous withdrawals. Although this provides investors with liquidity, it means that some of the fund's money is invested in cash instead of assets, which tends to lower the investor's potential return.
9. **Too Many Choices:** The advantages and disadvantages listed above apply to mutual funds in general. However, there are over 10,000 mutual funds in operation, and these funds vary greatly according to investment objective, size, strategy, and style. Mutual funds are available for virtually every investment strategy (e.g. value, growth), every sector (e.g. biotech, internet), and every country or region of the world. So even the process of selecting a fund can be tedious.

Classification of Mutual Funds

Open-End Mutual Fund

An Open-ended Mutual funds are those funds in which the company can issue always more outstanding shares. It can help to add on the net assets of the company. These types of funds do not have a fixed maturity period. Investors can buy and sell units of these funds at Net Asset Value (NAV) related prices which are published on a daily basis. Open-end schemes are more liquid in nature.

Close-End Mutual Fund

Close Ended mutual fund or generally termed as traded mutual fund is the one that can be bought and sold like a normal share. In it, the number of shares always stays fixed. These funds also have commission which brokers get since the shares of these funds are traded over the counter, like the shares are traded. Close-ended funds has a stipulated maturity period like 5-7 years. It is open for subscription only during the time of launch. Investors can invest in the close ended mutual funds at the time of the initial public issue

and thereafter can be brought or sold units of the scheme on the exchanges where the units are listed. Close-ended funds give an option for the investor of selling back the units to the mutual fund through periodic repurchase at NAV related prices. But the commissions will incur for this selling and buying.

Growth Funds

These type funds are those which invest in the stocks of well-established, blue chip companies. Dividends and steady income are not only goal of these types of funds. But, they are focussed on increasing in capital gains.

Growth and Income funds

These type of mutual funds are focussed on increased capital gains and steady income. Less volatile than Aggressive Growth funds.

Equity Funds

These funds allow an investor to own a portion of the company that they have invested in, its like having shares of a certain company. Stocks that have proven historically to be the best investment. Also which have already outperformed all other types of investments in long term, but the risk is high. These funds produce a greater level of current income by investing in equity securities of companies with solid reputation and have a good record of paying dividends.

Balanced Funds

Balanced mutual funds have a portfolio mix of bonds, preferred stocks and common stocks. Balanced mutual funds aim to conserve investors' initial investment, to pay an income and to aid in the long-term growth of both the principle and the income.

Fixed-Income Funds

Fixed-income mutual funds are safer than equity funds, but as always, do not yield as high returns as the latter do. These types of mutual funds are geared towards the investor who is approaching old age and doesn't have many earning years left. Many investors hope to draw a steady income from these types of mutual funds. Bond funds fall into the category of fixed-income funds.

Money-Market Funds

These are generally the safest and most secure of mutual fund investments. They invest in the largest, most stable securities, including Treasury bills. The chances of your capital being eroded are very minimal. Money-market funds are risk-free. If you invest a thousand rupees, you will get that money back. It is simply a matter of when you get it back. When investing in a money-market fund, you should pay attention to the interest rate that is being offered, along with the rules regarding check-writing. Money-markets

have allowed investors to reap high yields on their deposits, and have made the entire investment process more accessible to people.

The interest rates on money-market funds are changing nearly day to day. In times of inflation, these funds have had high yields.

Index Funds

They invest in the portfolio of a index such as BSE Sensitive index (SENSEX) , S&P NSE 50 index (Nifty), etc. The investment is done in the securities in the same weightage comprising of an index. You can see that the NAVs of such schemes would rise or fall in accordance with the rise or fall in the index. It may not be exactly by the same percentage due to “tracking errors”.

CHAPTER 5

DERIVATIVES

The term 'Derivative' stands for a contract whose price is derived from or is dependent upon an underlying asset. The underlying asset could be a financial asset such as currency, stock and market index, an interest bearing security or a physical commodity. Today, around the world, derivative contracts are traded on electricity, weather, temperature and even volatility. According to the Securities Contract Regulation Act, (1956) the term "derivative" includes:

- (i) A security derived from a debt instrument, share, loan, whether secured or unsecured, risk instrument or contract for differences or any other form of security;
- (ii) A contract which derives its value from the prices, or index of prices, of underlying securities.

Types of Derivative Contracts

Derivatives comprise four basic contracts namely Forwards, Futures, Options and Swaps. Over the past couple of decades several exotic contracts have also emerged but these are largely the variants of these basic contracts. Let us briefly define some of the contracts

Forward Contracts

These are promises to deliver an asset at a pre- determined date in future at a predetermined price. Forwards are highly popular on currencies and interest rates. The contracts are traded over the counter (i.e. outside the stock exchanges, directly between the two parties) and are customized according to the needs of the parties. Since these contracts do not fall under the purview of rules and regulations of an exchange, they generally suffer from counterparty risk i.e. the risk that one of the parties to the contract may not fulfill his or her obligation. A forward contract is an agreement to buy or sell an asset on a specified date for a specified price. One of the parties to the contract assumes a long position and agrees to buy the underlying asset on a certain specified future date for a certain specified price. The other party assumes a short position and agrees to sell the asset on the same date for the same price. Other contract details like delivery date, price and quantity are negotiated bilaterally by the parties to the contract. The forward contracts are normally traded outside the exchanges.

Features of forward contracts

- They are bilateral contracts and hence exposed to counter-party risk.
- Each contract is custom designed, and hence is unique in terms of contract size, expiration date and the asset type and quality.
- The contract price is generally not available in public domain.

- On the expiration date, the contract has to be settled by delivery of the asset.
- If the party wishes to reverse the contract, it has to compulsorily go to the same counterparty, which often results in high prices being charged.

Limitations of forward markets

Forward markets world-wide are posed by several problems:

- Lack of centralization of trading,
- Illiquidity
- Counterparty risk

In the first two of these, the basic problem is that of too much flexibility and generality. The forward market is like a real estate market, in which any two consenting adults can form contracts against each other. This often makes them design the terms of the deal which are convenient in that specific situation, but makes the contracts non-tradable. Counterparty risk arises from the possibility of default by any one party to the transaction. When one of the two sides to the transaction declares bankruptcy, the other suffers. When forward markets trade standardized contracts, though it avoids the problem of illiquidity, still the counterparty risk remains a very serious issue.

Futures Contracts:

A futures contract is an agreement between two parties to buy or sell an asset at a certain time in future at a certain price. These are basically exchange traded, standardized contracts. The exchange stands guarantee to all transactions and counterparty risk is largely eliminated. The buyers of futures contracts are considered having a long position whereas the sellers are considered to be having a short position. It should be noted that this is similar to any asset market where anybody who buys is long and the one who sells in short. Futures contracts are available on variety of commodities, currencies, interest rates, stocks and other tradable assets. They are highly popular on stock indices, interest rates and foreign exchange. It is a standardized contract with standard underlying instrument, a standard quantity and quality of the underlying instrument that can be delivered, (or which can be used for reference purposes in settlement) and a standard timing of such settlement. A futures contract may be offset prior to maturity by entering into an equal and opposite transaction. The standardized items in a futures contract are:

- Quantity of the underlying
- Quality of the underlying
- The date and the month of delivery
- The units of price quotation and minimum price change
- Location of settlement

Distinction between Futures and Forwards

Futures	Forwards
Trade on an organized exchange	OTC in nature
Standardized contract terms	Customized contract terms
More liquid	Less liquid
Requires margin payments	No margin payment
Follows daily settlement	Settlement happens at end of period

Futures Terminology

- **Spot price:** The price at which an underlying asset trades in the spot market.
- **Futures price:** The price that is agreed upon at the time of the contract for the delivery of an asset at a specific future date.
- **Contract cycle:** It is the period over which a contract trades. The index futures contracts on the NSE have one-month, two-month and three-month expiry cycles which expire on the last Thursday of the month. Thus a January expiration contract expires on the last Thursday of January and a February expiration contract ceases trading on the last Thursday of February. On the Friday following the last Thursday, a new contract having a threemonth expiry is introduced for trading.
- **Expiry date:** is the date on which the final settlement of the contract takes place.
- **Contract size:** The amount of asset that has to be delivered under one contract. This is also called as the lot size.
- **Basis:** Basis is defined as the futures price minus the spot price. There will be a different basis for each delivery month for each contract. In a normal market, basis will be positive. This reflects that futures prices normally exceed spot prices.
- **Cost of carry:** Measures the storage cost plus the interest that is paid to finance the asset less the income earned on the asset.
- **Initial margin:** The amount that must be deposited in the margin account at the time a futures contract is first entered into is known as initial margin.
- **Marking-to-market:** In the futures market, at the end of each trading day, the margin account is adjusted to reflect the investor's gain or loss depending upon the futures closing price. This is called marking-to-market.

Options Contracts

Options give the buyer (holder) a right but not an obligation to buy or sell an asset in future. Options are of two types - **calls and puts**. Calls give the buyer the right but not the obligation to buy a given quantity of the underlying asset, at a given price on or before a given future date. Puts give the buyer the right, but not the obligation to sell a given quantity of the underlying asset at a given price on or before a given date. One can buy and sell each of the contracts. When one buys an option he is said to be having a long position and when one sells he is said to be having a short position. It should be noted that, in the first two types of derivative contracts (forwards and futures) both the parties (buyer and seller) have an obligation; i.e. the buyer needs to pay for the asset to the seller and the seller needs to deliver the asset to the buyer on the settlement date. In case of options only the seller (also called option writer) is under an obligation and not the buyer (also called option purchaser). The buyer has a right to buy (call options) or sell (put options) the asset from / to the seller of the option but he may or may not exercise this right. In case the buyer of the option does exercise his right, the seller of the option must fulfill whatever is his obligation (for a call option the seller has to deliver the asset to the buyer of the option and for a put option the seller has to receive the asset from the buyer of the option). An option can be exercised at the expiry of the contract period (which is known as European option contract) or anytime up to the expiry of the contract period (termed as American option contract).

Option Terminology

- **Index options:** Have the index as the underlying. They can be European or American. They are also cash settled.
- **Stock options:** They are options on individual stocks and give the holder the right to buy or sell shares at the specified price. They can be European or American.
- **Buyer of an option:** The buyer of an option is the one who by paying the option premium buys the right but not the obligation to exercise his option on the seller/ writer.
- **Writer of an option:** The writer of a call/put option is the one who receives the option premium and is thereby obliged to sell/buy the asset if the buyer exercises on him.

There are two basic types of options, call options and put options.

- **Call option:** It gives the holder the right but not the obligation to buy an asset by a certain date for a certain price.
- **Put option:** A It gives the holder the right but not the obligation to sell an asset by a certain date for a certain price.
- **Option price/premium:** It is the price which the option buyer pays to the option seller. It is also referred to as the option premium.

Expiration date: The date specified in the options contract is known as the expiration date, the exercise date, the strike date or the maturity.

- **Strike price:** The price specified in the options contract is known as the strike price or the exercise price.
- **American options:** These can be exercised at any time up to the expiration date.
- **European options:** These can be exercised only on the expiration date itself. European options are easier to analyze than American options and properties of an American option are frequently deduced from those of its European counterpart.
- **In-the-money option:** An in-the-money (ITM) option would lead to a positive cash flow to the holder if it were exercised immediately. A call option on the index is said to be in-the money when the current index stands at a level higher than the strike price (i.e. spot price > strike price). If the index is much higher than the strike price, the call is said to be deep ITM. In the case of a put, the put is ITM if the index is below the strike price.
- **At-the-money option:** An at-the-money (ATM) option would lead to zero cash flow if it were exercised immediately. An option on the index is at-the-money when the current index equals the strike price (i.e. spot price = strike price).
- **Out-of-the-money option:** An out-of-the-money (OTM) option would lead to a negative cash flow if it were exercised immediately. A call option on the index is out-of-the-money when the current index stands at a level which is less than the strike price (i.e. spot price < strike price). If the index is much lower than the strike price, the call is said to be deep OTM. In the case of a put, the put is OTM if the index is above the strike price.
- **Intrinsic value of an option:** The option premium has two components - intrinsic value and time value. Intrinsic value of an option at a given time is the amount the holder of the option will get if he exercises the option at that time.
- **Time value of an option:** The time value of an option is the difference between its premium and its intrinsic value. Both calls and puts have time value. The longer the time to expiration, the greater is an option's time value, all else equal. At expiration, an option should have no time value.

Swaps

Swaps are private agreements between two parties to exchange cash flows in the future according to a prearranged formula. They can be regarded as portfolios of forward contracts.

The two commonly used swaps are:

- **Interest rate swaps:** These entail swapping only the interest related cash flows between the Parties in the same currency.

- **Currency swaps:** These entail swapping both principal and interest between the parties, with the cash flows in one direction being in a different currency than those in the opposite direction

Participants in a Derivative Market

The derivatives market is similar to any other financial market and has following three broad Categories of participants:

Hedgers

These are investors with a present or anticipated exposure to the underlying asset which is subject to price risks. Hedgers use the derivatives markets primarily for price risk management of assets and portfolios.

Speculators

These are individuals who take a view on the future direction of the markets. They take a view whether prices would rise or fall in future and accordingly buy or sell futures and options to try and make a profit from the future price movements of the underlying asset.

Arbitrageurs

They take positions in financial markets to earn riskless profits. The arbitrageurs take short and long positions in the same or different contracts at the same time to create a position which can generate a riskless profit.

History of Derivatives Markets in India

Derivatives markets in India have been in existence in one form or the other for a long time. In the area of commodities, the Bombay Cotton Trade Association started futures trading way back in 1875. In 1952, the Government of India banned cash settlement and options trading. Derivatives trading shifted to informal forwards markets. In recent years, government policy has shifted in favour of an increased role of market-based pricing and less suspicious derivatives trading. The first step towards introduction of financial derivatives trading in India was the promulgation of the Securities Laws (Amendment) Ordinance, 1995. It provided for withdrawal of prohibition on options in securities. The last decade, beginning the year 2000, saw lifting of ban on futures trading in many commodities. Around the same period, national electronic commodity exchanges were also set up. Derivatives trading commenced in India in June 2000 after SEBI granted the final approval to this effect in May 2001 on the recommendation of L. C Gupta committee. Securities and Exchange Board of India (SEBI) permitted the derivative segments of two stock exchanges, NSE and BSE, and their clearing house/corporation to commence trading and settlement in approved derivatives contracts. Initially, SEBI approved trading in index futures contracts based on various stock market indices such as, S&P CNX, Nifty and Sensex. Subsequently, index-based trading was permitted in options as well as individual securities. The trading in BSE Sensex options commenced on

June 4, 2001 and the trading in options on individual securities commenced in July 2001. Futures contracts on individual stocks were launched in November 2001. The derivatives trading on NSE commenced with S&P CNX Nifty Index futures on June 12, 2000. The trading in index options commenced on June 4, 2001 and trading in options on individual securities commenced on July 2, 2001. Single stock futures were launched on November 9, 2001. The index futures and options contract on NSE are based on S&P CNX. In June 2003, NSE introduced Interest Rate Futures which were subsequently banned due to pricing issue.

Stock index futures and options

A futures or options contract based on a set of underlying securities is called a 'Stock Index Futures or Options Contract'. When trading takes place in stock index futures, it means that the participants are taking a view on the way the index will move. By trading in index-based futures and options, you buy or sell the 'entire stock market' as a single entity.

S&P CNX Nifty is a scientifically developed index of which top 50 bluechip companies form a part. The index covers more than 25 industry sectors and is professionally managed by India Index and Services Ltd. IISL has a licensing and co-branding arrangement with Standard & Poor's (S&P), the world's leading provider of investible equity indices, for co-branding IISL's equity indices. Daily derivatives trading based on S&P 500 index is over \$50 billions. S&P CNX Nifty can be used for the purpose of speculation, hedging as well as an arbitrage tool.

Currency future

A currency future, also FX future or foreign exchange future, is a futures contract to exchange one currency for another at a specified date in the future at a price (exchange rate) that is fixed on the purchase date; see Foreign exchange derivative. Typically, one of the currencies is the US dollar. The price of a future is then in terms of US dollars per unit of other currency. This can be different from the standard way of quoting in the spot foreign exchange markets. The trade unit of each contract is then a certain amount of other currency, for instance €125,000. Most contracts have physical delivery, so for those held at the end of the last trading day, actual payments are made in each currency. However, most contracts are closed out before that. Investors can close out the contract at any time prior to the contract's delivery date.
