CHAPTER 1

INTRODUCTION TO INVESTMENT

Investment in various types of assets is an interesting activity that attracts people from all walks of life, irrespective of their occupation, economic status, education and family ground.

WHO IS A POTENTIAL INVESTOR?

All the income that a person receives may be used for purchasing goods and services that he currently requires or partly it may be saved for purchasing goods and services that he may require in the future. In other words, income can be spent for current consumption or partly saved for future consumption. Savings are generated when a person or an organization abstains from present consumption for a future use. Thus these savings are resulting in investment. In simple words, a person who has more money than he needs for immediate consumption can be said to be a potential investor.

INVESTMENT

1. In broad sense, “an investment is a sacrifice of current money or other resources for future benefits”.
2. Investment is the employment of funds on assets with the aim of earning income or capital appreciation”.
3. To economist, investment is the net addition made to the nation’s capital stock that consists of goods and services that are used in the production process. A net addition to the capital stock means an increase in buildings, equipment or inventories. These capital stocks are used to produce other goods and services.
4. Financial investment is the allocation of money in assets that are expected to yield some gains over a period of time. It is an exchange of financial claims such as stocks and bonds for money. They are expected to yield returns and experience capital growth over the years.

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 because he expects to get back his money along with interest at a future date. Likewise, one can deposit money in a bank account or purchase a long term Govt. Bond or invest in equity shares of a company or but gold or acquire a piece of land or invest in some other form.

In all these cases, it can be seen that investment involves employment of funds with the aim of earning additional income or growth in values.

The two key aspects of any investment are **time and risk**. The sacrifice takes place now and is certain. The benefit expected in the future and tends to be uncertain. In some investments (like bank deposits, Govt. bonds) the time element is the dominant attribute. In some other investments (like equity shares) both time and risk are important.

CHARACTERISTICS OF INVESTMENT

All investments are characterized by certain features. Let us analyze these characteristic features of investments.

Return

All investments are characterized by the expectation of a return. In fact, investments are made with the primary objective of deriving a return. The return may be received in the form of yield or capital appreciation or both. The difference between the sale price and the purchase price is called capital appreciation. The dividend of interest received from the investment is the yield. Different types of investments promise different rates of return. The return from an investment depends upon the nature of the investment, the maturity period and a host other factors.

Risk

Risk is inherent in any investment. This risk may relate to loss of capital, delay in repayment of capital, non-payment of interest, or variability of returns. While some investments like government securities and bank deposits are almost riskless, others are more risky. The risk of an investment depends on the following factors.

1. The longer the maturity period, the larger the risk.
2. The lower the credit worthiness of the borrower, the higher is the risk.
3. Risk varies with the nature of investment. Investments in ownership securities like equity shares carry high risk compared to investments in debt securities like debentures and bonds.

Risk and return of an investment are related. Normally, the higher the risk, the higher is the return.

Liquidity

An investment which is easily saleable or marketable without loss of time and money is said to possess liquidity. Most of the investments on financial assets are liquid in nature. Some investments like company deposits and bank deposits are not marketable but they can be withdrawn when required with some penalty.

OBJECTIVES OF INVESTMENT

An investor has various alternative avenues of investment for his savings to flow to. Savings kept as cash are barren and do not earn anything. Hence, savings are invested in assets depending on their risk and return characteristics.

The objectives of an investor can be stated as:

1. Maximization of return
2. Minimization of risk
3. Hedge against inflation

Maximization of return and Minimization of risk:

Investors, in general, desire to earn as large returns as possible with the minimum of risk. Minimizing risk and maximizing the return are interrelated objectives in investment management. Risk here may be understood as the probability that actual returns realized from an investment may be different from the expected return. If we consider the financial assets available for investment, we can classify them into different risk categories. Government securities would constitute the low risk category as they are practically risk free. Debentures and preference shares of companies may be classified as medium risk assets. Equity shares of companies would from the high risk category of financial assets. There is a trade-off between risk and return.

Every investor tries to maximize his welfare by choosing optimum combination of risk and expected return in accordance with his preference and capacity.

Hedging against inflation

The rate of return should ensure a cover against inflation to protect against a rise in prices and fall in the purchasing value of money. The rate of return should be higher than the rate of inflation; otherwise, the investor will experience loss in real terms. For example, if inflation is at an average rate of 8%, then the rate of return from an investment should be more than 8 % to induce savings flow into investment.

INVESTMENT vs SPECULATION

Investment and speculation are two terms which are closely related. Both involve purchase of financial assets like shares and securities. Speculation is taking up the business risk in the hope of achieving short-term gain. Speculation essentially involves buying and selling activities with the expectation of making a profit from price fluctuations.

The time factor involved in speculation and investment is different. The investor is interested in a consistently good rate of return for a longer period. He is primarily concerned with the direct benefits provided by securities in the long-run. The speculator is interested in getting an abnormal return in the short-run.

Differences between Investor and Speculator:

Factor	Investor	Speculator
Time factor	Invests for a longer period usually from one year to few years	Invests for short period usually few days to months(less than 6 months)
Risk	Assumes moderate risk	Willing to undertake high risk
Return	Likes to have moderate rate of return associated with limited risk. Mostly interested in income from investments.	Likes to have high returns for assuming high risk. Mostly interested in capital gains rather than income on investments.
Decision	Considers fundamental factors and evaluates performance of the company regularly before investing.	Considers technical factors and market behavior rather than fundamental factors and company performance.
Funds	Generally uses his own funds and avoids borrowed funds.	Uses borrowed funds to supplement his personal resoures.

INVESTMENT vs GAMBLING

Gambling is quite opposite of investment. Typical examples of gambling are horse races, Buying lottery tickets, card games, betting etc. Firstly, the time horizon involved in gambling is very shorter than in speculation and investment. The results are known immediately or some days in gambling. Secondly, people gamble to entertain themselves. Earning an income from gambling is a secondary factor. In gambling artificial and unnecessary risks are created for increasing the returns. Gambling mostly is unplanned and non-scientific.

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

INVESTMENT ALTERNATIVES

There are many investment avenues or alternatives are available investors. They fall into two broad categories, viz. financial assets and real assets. Financial assets are paper (or electronic) claims on the issuer such as Bank or Government or a corporate body. The important financial assets are equity shares, corporate debentures, government securities, deposits with banks, mutual funds, insurance policies etc.

Real assets represent tangible assets like residential house, commercial property, agricultural land, gold, precious stones etc.

Financial Assets:

1. **Deposits:** A good portion of the financial assets of individuals is held in the form of deposits. They are

- **Bank deposits**
- **Company fixed deposits**

Bank deposits:

- They are very safe because of the regulations of the central bank of the country
- Bank deposits enjoy exceptionally high liquidity. Premature withdrawals are possible, with some penalty.
- Loans can be raised against bank deposits

Company deposits: Many companies, large and small, manufacturing and non-banking financial institutions, solicit deposits from the public. These deposits are generally regulated by the Company's Act and Central bank of a country.

- Interest rates on company deposits are higher than those of bank fixed deposits.
- Companies offer some incentives like premature withdrawals or free personal accident insurance coverage to attract deposits.

2. **Money market instruments:** In simple words, Debt instruments which have a maturity of less than one year at the time of issue are called money market instruments. These instruments are highly liquid and have negligible risk. Major money market instruments are:

- **Treasury bills**
- **Commercial paper**
- **Certificates of deposits**
- **Repos**

Treasury Bills:

- Treasury bills are the obligations of government which are issued generally for a period between 91 days and 364 days.
- They do not carry interest rate; instead they are issued at discount and redeemed at par.
- Treasury bills are readily transferred in the secondary market.
- They carry negligible risk.

Commercial Paper:

- Commercial papers are issued by corporations, financial institutions, primary dealers etc.
- Commercial papers can be issued for maturities between 7 days and one year.
- They are issued at discount and redeemed at par like treasury bills.

Certificates of deposits:

- Issued by banks or eligible financial institutions.
- Banks issue for 7 days to one year.
- Financial institutions issue for one year to three years.
- Mutual fund agencies and companies generally purchase these certificates.
- Interest rate is higher than term deposits and treasury bills.

Repos: A “repo” involves a simultaneous “sale and re-purchase” agreement. A repo works as follows. Party “A” needs short term funds and Party “B” wants to make a short investment. Party “A” sells securities to Party “B” at a certain price and simultaneously agrees to re=purchase the same after a specified time at a slightly higher price.

The difference between the sale price and the re-purchase price represents the interest expense to party “A” and interest revenue to Party “B”.

3. **Bonds and Debentures:** Bonds or debentures represent long-term debt instruments. The issuer of a bond promises to pay a stipulated steam of cash flows (interest). The following are the various categories of long-term debt instruments:

- **Government securities**
- **Public sector unit bonds**
- **Debentures of Private sector companies**

Government securities:

- These are issued by the Governments (Central or States) for a long period (2 to 30 years).
- On these securities, interest rate is fixed and pay interest semi-annually
- These securities are generally held by banks, financial institutions, insurance companies, provident fund and mutual fund agencies etc.

Public sector units bonds:

- Public sector undertakings issue debentures that are referred to as public sector bonds.
- Public sector units are free to set the interest rates on taxable bonds
- They cannot offer more than certain interest on tax free bonds
- They are transferable by mere endorsement and delivery
- They are traded on the stock exchanges.

Private sector debentures: Debentures are instruments meant for raising long term debt. The obligation of a company towards its debenture holders is similar to that of a borrower who promises to pay interest and principal at specified time. The important features of debentures are as follows:

- Interest rate on debenture is fixed. Interest is to be paid by the company on debentures irrespective its profits or losses.
- When a debenture issue is sold to the investing public, a trustee is appointed through a deed. The trustee is usually a bank or a financial institution. This trustee protects the interests of debenture holders and is responsible for ensuring that the borrowing firm fulfils its contractual obligations.
- Typically, debentures are secured by a charge on the immovable properties, both present and future, of the company by way of an equitable mortgage.
- Debentures are issued generally for a long period (18 months to 20 years)
- Debentures are paid back after the maturity period.
- Debentures may have a convertible clause which gives the debenture holder the option of conversion to equity shares on certain terms and conditions that are pre-specified.

4. **Preference shares:** Preference share represent a hybrid security because it has the characteristics of both equity share and debentures.

- Preference shares carry a fixed rate of dividend
- Dividend on preference shares is generally cumulative because dividend skipped in one year has to be paid in the subsequent years before equity dividend can be paid
- Preference shares are redeemable – the redemption period is usually 7 to 12 years.

5. **Equity shares:** Equity capital represents ownership capital. Equity shareholders collectively own the company. They bear risk and enjoy the rewards of ownership. While fixed income securities may be more important to most of the investors, equity shares seem to capture their interest the most because of the rewards and penalties associated with them. No wonder, equity investment is a favorite topic of conversation in parties and get- togethers.

- The par value is stated in the memorandum and written on the share scrip
- Generally the par value of equity shares is Birr 1, or Birr 10. Sometimes par value of equity share may b Birr 5 or 50 or 100 or 1000.
- The issue price is the price at which the equity share is issued
- When the issue price exceeds par value, it is referred to as the share premium
- Book value of equity share is equal to:

$$\frac{\text{Paid-up-capital + Retained Earnings}}{\text{No. of outstanding equity shares}}$$

- Market value of an equity share is the price at which it is traded in the market.

Stock Market classification of equity shares;

1. **Blue chip shares:** Shares of large, well established, and financially strong companies with an impressive record of earnings and dividends.

2. **Growth shares:** Share of companies that enjoy an above average rate of growth as well as profitability.
3. **Income shares:** shares of companies that have fairly stable operations, relatively limited growth opportunities, and high dividend payout ratios.
4. **Cyclical shares:** Shares of those companies whose sales and profits rise and fall regularly and not completely predictable.
5. **Defensive shares:** Shares of companies that are relatively unaffected by the ups and downs in general business conditions.
6. **Speculative shares:** Share that tend to fluctuate widely because there is a lot of speculative trading in them.

Note: Above classification is only an indicator. In fact, many shares fall into two or even more than two categories.

6. **Mutual Funds:** If you find it difficult to invest directly into securities and shares, you invest in financial assets through a mutual fund. A mutual fund represents a vehicle for collective investment.

- Mutual funds invest their funds in mixer of financial assets i.e., shares, bonds, and money market instruments.
- No guarantee of return is provided by the mutual funds but generally high rate of return is achieved by the investor through a mutual fund.
- Mutual funds invest the funds in High risk schemes, Medium risk schemes, and Low risk schemes according to the taste and choice of the investor.

7. **Insurance Products:** Insurance policies offer both the protection and savings.

- Term insurance policy provides only protection
- Endowment and whole life insurance policies provide both protection and savings
- Annuities offer income after retirement and in old age.

Real Assets: In addition to the financial assets, investors are likely to be interested in the following types of real estate.

- Residential and Commercial property
- Semi- urban land
- Agriculture land (Farm house)
- Share in a holiday resort

Precious Objects:

- **Precious Metals**
- **Precious Stones**
- **Art objects and collections**

Precious Metals:

- Gold
- Silver
- Platinum

Precious Stones:

- Diamonds
- Others precious stones

Art objects and collections:

- Paintings
- Sculptures
- Antiques etc.

SECURITIES MARKET: Different types of securities are traded in the securities market. These may include ownership securities, Long-term debt securities, and short-term debt securities. The nature of return and risk involved in short-term securities is vastly different from that of long-term securities.

Hence, on the basis of the maturity period of securities traded in the market, the securities market is categorized into:

- Money market
- Capital market

Money Market: *Money market* is the market for short-term financial assets with maturities of one year or less than one year. It comprises of Treasury bills, commercial paper, certificates of deposit, repo market etc. Since these instruments being close substitutes for money, the market for their trading is known as money market.

Money market is the main source of working capital funds for business and Industry. It provides a mechanism for evening out short-term surpluses and deficits. The short-term requirements of borrowers can be met by the creation of money market securities, which can be purchased by lenders with short-term surpluses to park their funds for short-term durations.

The participants in the money market are few institutions like Banks, financial institutions, companies, and governments. It works in between web of borrowers and lenders, linked by telephones and computers, dealing with short-term debt funds.

Capital market: *Capital market*, on the other hand, is the market segment where securities with maturities of *more than one year* are bought and sold. Equity share, preference shares, debentures, and bonds are the long-term securities traded in the capital market. The capital market is the source of long-term funds for business and industry.

Capital market may be classified as primary market or secondary market depending on whether the securities traded are newly issued securities or securities already outstanding and owned by investors.

- **Primary market**
- **Secondary market**

Primary market: The market mechanism for buying and selling of new issues of securities is known *primary market*. This market is also known as *new issues market* because it deals in new issues of securities.

When a new company is floated, its shares are issued to the public in the primary market as an *Initial public offer* (IPO). If the company subsequently decides to include debt in its capital structure by issuing bonds or debentures, these may also be floated in the primary market.

Similarly, when an existing company decides to expand its activities using either equity finance or bond finance, the additional shares or bonds may be floated in the primary market.

Methods of floating new issues:

- **Public issue**
- **Rights issue**
- **Private placement**

Secondary Market: The *secondary market,* on the other hand, deals with securities which have already been issued and are owned by investors, both individuals and institutions. These outstanding and owned securities are traded among investors. The buying and selling of these securities take place in stock exchanges. Hence, stock exchanges constitute the secondary market in securities.

Information sake:

Stock Exchanges in the world: It is instructive to have a glimpse into the leading stock markets abroad.

Stock Market in the USA: The two largest stock exchanges in the US, as well as the world, are the New York Stock Exchange (NYSE) and the NASDAQ (National Association of Securities Dealers Automated Quotation system).

Stock Market in the UK: The stock market in the UK underwent a radical reform, referred to popularly as the *big bang*, which led to the amalgamation of all the exchanges in UK and Ireland into the "International Stock Exchange of UK and Ireland" headquartered in London.

Stock Market in Japan: The "Tokyo Stock Exchange is the dominant stock exchange in Japan and it impact is felt on world stock markets.

Emerging Stock Markets:

a) **Hong Kong, South Korea, and Singapore** stock markets are more mature markets and are comparable to those in the west markets.
b) **Fairly developed markets** in countries like Brazil, India, Philippines, China, and Pakistan.
c) **Early stages of development in countries** like Hungary and Poland(Eastern Europe), Kenya, Zimbabwe (Africa), Belarus and Ukraine (former soviet union).