Security Analysis and Portfolio Management

By: Avantika Singh

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Sample Preview
of
The Chapter

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SECURITY ANALYSIS AND PORTFOLIO MANAGEMENT

An Overview

Nature and Scope of Investment Decisions

1

INTRODUCTION

Investment is a process of exchanging income for an asset that is expected to produce earnings or returns at a later time. That return may be monthly, half-yearly or yearly. An investor saves in the present in hope of a greater return in the future. Investment cannot occur without saving, which provides funding. Because investment increases an economy's capacity to produce, it is a factor contributing to economic growth. There are some risks attached to every investment. No investment is risk free. Some factors which influence the investment decision are as follows:

(a) **INFLATION:** Inflation means increase in the prices of goods and services in an economy for a particular period.

(b) **TIME VALUE OF MONEY:** It can be explained with an example. The value of 100 rupees is much lower than what it was 10 years back. It shows that the amount which seems to be very big for us today is may be lowered by the effect of time, so, to prevent erosion of their saving people do invest.

(c) **INCOME:** People do invest because investment is also a source of income for them. There are many ways by which individuals invest their savings in the best way and earn good returns. Different people have different views about investment; Investment means "Sacrifice of certain present value for some uncertain future value".

(d) **RATE OF INTEREST:** Rate of interest also affects the savings of the people which use to keep their money in banks for income in the forms of interest.

CHAPTER AT A GLANCE

WHAT IS INVESTMENT

(i) In Finance, investment means the purchase of a financial product or other item of value with a expectation of favorable future returns. In general terms, investment means the use of money in the hope of making more money.

(ii) "Purchase of a financial product or other item of value with an expectation of favorable future returns. In general terms, investment means the use of money in the hope of making more money."

(iii) "Investment is use of capital to create more money, either through income-producing vehicles or through more risk-oriented ventures designed to result in capital gains."

(iv) An investment is a monetary asset purchased with the idea that the asset will provide income in the future or appreciate and be sold at a higher price".

THE DIFFERENCE BETWEEN INVESTMENT AND SPECULATION

1. **Time horizon:** Investment deals with the long term benefits and the persons, who invest, do not expect immediate return on it. But in case of speculation speculators expect short term benefits. For example, a person buys a particular asset at a low price and dispose it off in a short time when price is high. Speculators shift rapidly from one security to another.
2. **Risk:** Another difference between speculation and investment is the risk factor. Speculation is more risky than investment. Speculation is just a guess which may result in a very high profit or a very high loss. But when we talk about investment, it results in loss of profit or low profit than expected. But one thing should be kept in mind that no investment is risk free.
3. **Capital gain:** When the security is purchased with a proper investigation and analysis, to receive stable return, it is called investment. Whereas, buying securities at the low price and selling it at high price is called speculation.
4. **Rate of return:** We all know the rule of the market that higher the risk higher will be the return and lower the risk lower will be the return. In this point speculation is more profitable than the investment, because the speculator's degree of risk is higher than the investors'.

IMPORTANCE OF INVESTMENTS

The importance of investment is listed below:

1. Long life expectancy or preparation for retirement.
2. Increasing rates of taxation.
3. High rate of inflation
4. Larger Incomes.
5. Availability of a complex number of investment outlet.

1. **Long life expectancy:** These days investment decisions have become more important, since with the advancement in the modern day technology the life expectancy has also increased. The earning should be calculated in such a manner that some of it becomes our savings. The savings itself do not strengthen wealth, however they should be invested in a manner that the principal and income will be enough after retirement.
2. **Increasing rates of taxation:** Taxation is another main reason which makes people in the country believe in investment. Many people invest so as to save tax. There are many companies in the market which offer various schemes that will help in bringing down the tax levels by offering deductions in the personal income. Some examples could be ULIP, Life insurance, National Saving Certificates, Post office schemes etc.
3. **High Rate of Inflation:** Investor will also have to consider the rate of inflation which has increased at very high rate in past decade. For making any kind of investment he will have to keep this in mind that it should give him high rate of return in form of investment to cover any decrease due to inflation. Here, the investor will also have to consider whether or not the investment gives him the regular interest or return. There may be a likelihood that invest might give him irregular returns. Along with all this he will also have to consider the taxation angle. The returns should not increase the taxation burden otherwise the benefit derived out of the investment will be offset.
4. **Income:** This is another reason why people invest. The employment opportunities in the country have increased after independence. More incomes and more avenues of investment have led to the ability and willingness of working people to save and invest the funds.
5. **Investment outlets:** The growth and development of the country has led to substantial increase in the investment outlets in country. They have choice of various investment avenues apart from traditional saving in the bank where interest rates are very low. Here, investor will have to try and

achieve proper mix of high rate of return as well as the stability in return.

FEATURES OF AN IDEAL INVESTMENT

(i) **Safety:** There is variety of investment options for an individual. But he/she has to select the best option for investment. When we talk about investment the safety factor of an investor becomes very important. The investor should invest his /her saving very carefully and wisely. For this, the investor should diversify his/her savings. Diversification means to invest your saving at different places rather than doing it at one place, this will cut down the factor of risk to greater extent. If an individual has to face loss from one side, may be from other side he get profit. Through this the risk can be affect to a greater extent.

(ii) **Tax benefit:** Every investor should plan his/her investment by keeping in mind the tax factor. It means that the investor has to pay tax on whatever returns he gets. The return after tax is known as real return. Tax burden on some investments are more and some investments are negligible. So the investor should keep the tax factor in mind while investing their savings.

(iii) **Capital appreciation:** Investment will be called good investment when the right amount of money is invested at the right place and at the right time. The investors should try to forecast which security is going to be appreciated in the near future. This should be done in a very careful and scientific way.

(iv) **Liquidity:** A liquid investment is that which can be converted into cash immediately at full market value at any quantity. Investor should keep a part of his investment in readily saleable securities.

CLASSIFICATION OF INVESTMENT

(i) **Transferable and non-transferable investment:** Transferable investments are those which can be transferred from one person to another and can be converted into cash easily like shares, bonds etc. Non-transferable investments are those which cannot be converted into cash easily like N.S.C. (National Saving Certificate) etc.

(ii) **Marketable and non-marketable investment:** Marketable securities are those which are easily convertible into cash in short period. For example shares, bonds etc. Non-marketable investment are those which cannot be converted in cash in short period like properties, insurance etc.

(iii) **Physical investment:** Physical investments are those investments which are made on the physical assets like building, land, machinery which can be used for further production and capital formation.

(iv) **Financial investment:** Financial investments are those which are used for consumption and production of goods and services for further creation of assets. For example shares, bonds etc.

SCOPE OF INVESTMENT DECISION

The scope of investment decision has the following points.

1. Identification of Investor's Requirement: Different people have different needs and requirements of the investment. Due to this reason, they have different portfolios. It is very difficult to choose different securities for investment because there are various types of securities available in the market. One thing should be kept in mind that higher the risk, higher will be the profit. Keeping this thing in mind, people invest in the securities, but their risk taking ability is also different because some people are able to take higher risk and some are not. Investors have different needs, like some people invest because they want tax rebate, some people invest as they want income out of it, some people invest because they want to protect their money from the effect of changing value of money. So, by seeing the different requirements of the different investors, securities are selected for investment.

2. Formulation of investment policy and strategy: This involves the selection of the securities for building the portfolio, taking into consideration the investors capability of risk. Policy involves the different form of securities in which the investor can invest and strategy involves the formulation of income and capital appreciation.

3. Execution of strategy: After doing all the analysis and judgement, the investment should be made. Portfolio is constructed by keeping in mind the following things that are income, safety, risk etc.

4. Monitoring the portfolio: The portfolio has to be revised from time to time. There are two reasons for doing so, investor or may get higher returns from other securities may be the security which was profitable in the past is not profitable in the present or will not be profitable in the future. So the revision of portfolio is very important.

THE INVESTMENT DECISION PROCESS

The investment decision process has five steps. They are discussed below:

1. Investment Policy: In this stage, investment assets are identified and their features are considered. The formulation of investment policy requires:

(a) Amount to be invested

(b) Investment objective

(c) Various investment assets

(d) Distribution of funds to various investment categories.

It also considers the personal financial affairs and objectives before making investments. It can also be called the preparation before making any investment. This stage is appropriate for analyzing the market for various investment avenues and also considering the features of investments.

2. Investment Analysis: It determines the future risk in holding various combinations of securities. In this stage the individual who has already checked the avenues goes for the comparative analysis of the type of industry he wants to invest in. He also checks the kind of security. The main purpose is to check whether or not the investment would prove fruitful. To determine the effectiveness of portfolio, an expected return is chosen and the assets are substituted until the best level of return is found.

3. Valuation of securities: This is the most important and complex step i.e. valuation of securities. The investor has to keep in mind the value of investment. The investor has to ascertain appropriate set of weights to determine the value of security in future. The difference between the book value and the market value of the asset help us to know about the attractiveness of the asset. The comparison of the value with the current market price allows the investor to know whether the product will be fruitful or not in future.

4. Portfolio construction: The work of the portfolio construction is the utility maximization. The fundamental idea is to maximize the group's return, given a certain level of risk. This requires quantifiable estimates for both the risk and returns. Portfolio construction includes:

(a) Investment Timing

(b) Acquisition of assets

(c) Diversification level

(d) Distribution of funds to investment asset.

(e) Evaluation of portfolio for feedback.

5. Portfolio revision: Portfolio has to be revised to serve the objective of investor in the best way. The investor should compare the cost of moving the new portfolio against the benefit of the revision. If there is no difference in both the terms then that will be the decision of the investor to revise the same portfolio or to move to the new portfolio. Both buying and selling of securities is considered in portfolio revision as expectation of the people changes with time.

THE INVESTMENT ENVIRONMENT

The investment environment can be divided into three parts namely **financial markets, financial financial instruments, institutions.**

1. Financial market: Investment market can be divided into two parts. Primary and secondary market. Primary market is open for everyone that can be Banks, Financial institutions, etc. Any individual who want to invest can be the part of this market. Some guidelines given by Securities Exchange Board of India (SEBI) should be followed. A prospectus is provided to investors which has all the informations about the working of the company then the investor can decide whether to invest or not in that particular company. Secondary market is that which works under framework given by Security Contract Act, 1956.Today all the transactions can be done through computers so it becomes very easy for the investors to get any knowledge about any of their queries.

2. Financial institutions: They play a very important role. They collect funds from the investors and invest them. In simple terms we can say that they invest on behalf of the investors. They act as an intermediate between suppliers and the users of the fund. Some of the examples of financial institutions are Industrial Finance Corporation of India, Industrial Credit and Investment Corporation of India.