SECURITY ANALYSIS AND PORTFOLO MANAGEMNT: UNIT-1

Dr. Asma Khan

Associate Professor

School of Business Studies

Shobhit Institute of Engineering and Technology

(Deemed to be University) Meerut

UNIT - 1

INTRODUCTION OF INVESTMENT

CONTENTS:

1.Meaning and Objective of/Investment

2. Investment Decision Process

3.Categories of Investment

4.Phases of Portfolio Management

MEANING OF INVESTMENT

Investment is the allocation of monetary resources to assets that are expected to yield some returns over a period of time. It involves the commitment of resources which have been saved with the expectation that some benefits will accrue in future.

In other words, Investment is a commitment of funds to derive the future income in the form of interest, dividend, rent, premium or appreciation in the value of principal capital .

Definitions

- Generally, *"investments"* refers to financial assets and in particular to marketable securities.
- *Financial assets* are paper or electronic claims on some issuer, such as the government or a company.
- *Marketable securities* financial assets that are easily and cheaply tradable in organized markets
- *Real assets* are tangible assets such as gold, silver, diamonds, real estate.

Why to invest?

- Investment increases future consumption possibilities

  - By foregoing consumption today and investing the savings, investors expect to increase their future consumption possibilities by increasing their wealth

If we do not invest, then?

- If we have savings and we do not invest, we can't earn anything on our savings.
- Second, the purchasing power of cash diminishes in inflation
- This means that if savers do not invest their savings, they will not only lose possible return on their savings, but will also lose value of their money due to inflation

But investment has problems

- **Investment has the following three problems:**
- **A. Sacrifice**
- While investing, investor delay their current consumption (delaying consumption is kind of sacrifice)
- **B. Inflation -** Investment loses value in periods of inflation
- **C. Risk -** giving your money to someone else involves risk

Compensation to investors

- Due to the three problems, investors will not invest until they are compensated for these problems

- Required rate of return = compensation for (sacrifice , inflation, risk)
- RRR= opportunity cost + risk premium

FEATURES OF INVESTEMENT

- Liquidity
- Safety of principal
- Tax benefits
- Income stability
- Purchasing power
- Capital growth

IMPORTANCE OF INVESTMENT

- Minimum comforts
- Future return or income
- Capital appreciation
- Choice of investment

INVESTMENT ALTERNATIVES

- **Non – Marketable Financial Assets:-**

  - Bank Deposits (Savings account, Current account, Fixed Deposits, Recurring Deposits etc.)
  - Post office Savings Accounts.
  - Post office Time Deposits.
  - Monthly Income Scheme of the Post Office.
  - National Savings Certificate (NSC).
  - Company Deposits.
  - Employee Provident Fund Scheme.
  - Public Provident Fund Scheme.

INVESTMENT ALTERNATIVES

- **Money Market Instruments** :-
  - Treasury Bills
  - Certificates of Deposits
  - Commercial Paper
  - Repos
- **Bonds or Debentures and Preference Shares**
  - Government Securities
  - Savings Bonds
  - Private Sector Debentures
  - Public Sector Undertaking Bonds
  - Preference Shares

INVESTMENT ALTERNATIVES

- <u>Equity Shares</u>
- <u>Mutual Fund Schemes</u>
- <u>Life Insurance</u>
- <u>Financial Derivatives</u>

MEANING OF SPECULATION

It is considered as an involvement of funds of high risk and more uncertain expectation of returns. It is basically a short term phenomenon where people tend to buy assets with the hope that a profit can be earned from a subsequent price change. It is based on the expectation that some change will occur.

The stock brokers may be cited as an example. Some brokers buy shares with a view to make quick profit by selling within few days, when the prices of such shares shoot up.

INVESTMENT Vs SPECULATION

BASIS	SPECULATION	INVESTMENT
Contract Type	Ownership	Creditor
Source of income	Change in market price	Earning of enterprise
Objective of purchase	Tips, Hunches etc.	Higher Return
Stability of income	Uncertain	Stable
Risk involved	High	Low
Duration	Short	Long
Acquisition	On margin	Outright purchase
Attitude	Aggressive	Conservative

INVESTOR Vs SPECULATOR

BASIS	INVESTOR	SPECULATOR
Planning Horizon	An investor has a relatively longer planning horizon.	A speculator has a very short planning horizon.
Time	His holding period is usually at least one year.	His holding period may be a few days to a few months.
Risk disposition	An investor is normally not willing to assume more than moderate risk.	A speculator is ordinarily willing to assume high risk.
Return expectation	An investor usually seeks a moderate rate of return.	A speculator looks for a high rate of return.
Basis of decisions	An investor attaches greater significance to fundamental factors and attempts a careful evaluation of the prospects of the firm.	A speculator relies more on technical charts and market psychology.
Leverage	An investor uses his own funds and eschews borrowed funds.	A speculator normally resorts to borrowings, which can be very substantial, to supplement his personal resources.

GAMBLING

A gamble is a very short term investment in a game of chance. Gambling involved high risk and the expectations of high returns. It consists of uncertainty and high stackers for thrill and excitement.

The example of gambling are horse racing, card game, lottery etc.

GAMBLING Vs SPECULATION AND INVESTMENT

- Compared to investment and speculation, the result of gambling is known more quickly.
- Rational people gamble for fun, not for income.
- Gambling does not involve a bet on an economic activity. It is based on risk that is created artificially.

ARBITRAGE

Arbitrage is a planned methods of putting the savings safely into different investments to get a better return. An investor can also be an arbitrageur if he buys and sells securities in more than one stock exchange to take advantage of the price differentials in such exchanges. Derivative market is an example of Arbitrage transactions.

Characteristics and Types of Investments

Objective fulfillment

An investment should fulfil the objective of the savers. Every individual has a definite objective in making an investment. When the investment objective is contrasted with the uncertainty involved with investments, the fulfilment of the objectives through the chosen investment avenue could become complex.

Safety

- The first and foremost concern of any ordinary investor is that his investment should be safe.
- That is he should get back the principal at the end of the maturity period of the investment.
- There is no absolute safety in any investment, except probably with investment in government securities or such instruments where the repayment of interest and principal is guaranteed by the government.

Return

The return from any investment is expectedly consistent with the extent of risk assumed by the investor. Risk and return go together. Higher the risk, higher the chances of getting higher return. An investment in a low risk - high safety investment such as investment in government securities will obviously get the investor only low returns.

Liquidity

Given a choice, investors would prefer a liquid investment than a higher return investment. Because the investment climate and market conditions may change or investor may be confronted by an urgent unforeseen commitment for which he might need funds, and if he can dispose of his investment without suffering unduly in terms of loss of returns, he would prefer the liquid investment.

Hedge against inflation

The purchasing power of money deteriorates heavily in a country which is not efficient or not well endowed, in relation to another country. Investors who save for the long term, look for hedge against inflation so that their investments are not unduly eroded; rather they look for a capital gain which neutralises the erosion in purchasing power and still gives a return.

Tax shield

Investment decisions are highly influenced by the tax system in the country. Investors look or front-end tax incentives while making an investment and also rear-end tax reliefs while reaping the benefit of their investments.

Types of Investments

1.Growth investments

These are more suitable for long term investors that are willing and able to withstand market ups and downs.

Shares

Shares are considered a growth investment as they can help grow the value of your original investment over the medium to long term.

If you own shares, you may also receive income from dividends, which are effectively a portion of a company’s profit paid out to its shareholders.

Of course, the value of shares may also fall below the price you pay for them. Prices can be volatile from day to day and shares are generally best suited to long term investors, who are comfortable withstanding these ups and downs.

Also known as equities, shares have historically delivered higher returns than other assets, shares are considered one of the riskiest types of investment.

Property

Property is also considered as a growth investment because the price of houses and other properties can rise substantially over a medium to long term period.
However, just like shares, property can also fall in value and carries the risk of losses.
It is possible to invest directly by buying a property but also indirectly, through a property investment fund.

2.Defensive investments

These are more focused on consistently generating income, rather than growth, and are considered lower risk than growth investments.

Cash

Cash investments include everyday bank accounts, high interest savings accounts and term deposits. They typically carry the lowest potential returns of all the investment types.
While they offer no chance of capital growth, they can deliver regular income and can play an important role in protecting wealth and reducing risk in an investment portfolio.

Fixed interest

The best known type of fixed interest investments are bonds, which are essentially when governments or companies borrow money from investors and pay them a rate of interest in return.

Bonds are also considered as a defensive investment, because they generally offer lower potential returns and lower levels of risk than shares or property.

They can also be sold relatively quickly, like cash, although it’s important to note that they are not without the risk of capital losses.

Understanding the investment decision process

- The basis of all investment decisions is to earn **return** and assume **risk**
- By investing, investors expect to earn a return (expected return)

Different approaches to investment decision making

- Fundamental Approach: Believed that there is an intrinsic value of a security that can be company, industry and economy.
- Psychological Approach: This approach based on the premises that stock prices are guided by the emotions. It is more important to analyse that how investor tend to behave as the market is swept by the waves of optimism and pessimism.

Different approaches to investment decision making

- Academic Approach: Suggest that:

  -Stock market is efficient in reacting quickly and rationally hence it reflects intrinsic value fairly well.

  -Stock price behavior correspond to the random walk, hence past price behavior can not be used to predict the future price.

  - There is positive relationship between risk and return.

Different approaches to investment decision making

- Electric Approach: This approach draws on all the three approaches.

  -Fundamental analysis is helpful in establishing basic standard benchmarks.

  - Technical analysis is useful in broadly gauging the mood of the investor.

  - there is a strong correlation between risk and return.

Investment Decision Process

There are 5 investment process steps that help you in selecting and investing in the best asset class according to your needs and preferences.

Step 1- Understanding the need

The first and the foremost step of investment process is to understand the client or the investor his/her needs, his risk taking capacity and his tax status. After getting an insight of the goals and restraints , it is important to set a benchmark for the one’s portfolio management process which will help in evaluating the performance and check whether the objectives are achieved or not.

Step 2- Asset allocation decision

This step involves decision on how to allocate the investment across different asset classes, i.e. fixed income securities, equity, real estate etc. It also involves decision of whether to invest in domestic assets or in foreign assets. The investor will make this decision after considering the macroeconomic conditions and overall market status.

Step 3- Portfolio strategy selection

Third step in the investment process is to select the proper strategy of portfolio creation. Choosing the right strategy for portfolio creation is very important as it forms the basis of selecting the assets that will be added in the portfolio management process. The strategy that conforms to the investment policies and investment objectives should be selected.

There are two types of portfolio strategy-

1. Active Management
2. Passive Management

Active portfolio management process refers to a strategy where the objective of investing is to outperform the market return compared to a specific benchmark by either buying securities that are undervalued or by short selling securities that are overvalued. In this strategy, risk and return both are high. This strategy is a proactive strategy it requires close attention by the investor or the fund manager.

Passive portfolio management process refers to the strategy where the purpose is to generate returns equal to that of the market. It is a reactive strategy as the fund manager or the investor reacts after the market has responded.

Step 4- Asset selection decision

The investor needs to select the assets to be placed in the portfolio management process in the fourth step. Within each asset class, there are different sub asset-classes. For example, in equity, which stocks should be chosen? Within the fixed income securities class, which bonds should be chosen?

Also, the investment objectives should conform to the investment policies because otherwise the main purpose of investment management process would become meaningless.

Step 5- Evaluating portfolio performance

This is the final step in the investment process which evaluates the portfolio management performance. This is an important step as it measures the performance of the investment with respect to a benchmark, in both absolute and relative terms. The investor would determine whether his objectives are being achieved or not.

After all the above points have been followed, the investor needs to keep monitoring the portfolio management performance at an appropriate interval. If the investor finds that any asset is not performing well, he/she should ‘re balance’ the portfolio. Re balancing means adding or removing (or better call it adjusting) some assets from the portfolio to maintain the target level. Re balancing helps the investor to maintain his/her level of risk and return.

Phases of Portfolio Management

Phases of Portfolio Management

Portfolio Management comprises of many activities that are targeted at optimizing the investment of client's funds. There are basically five phases in the portfolio management and each of these phases makes up an integral part of the Portfolio Management and the success of it depends on the effectiveness in implementing these phases.

Security Analysis:

There are many types of securities available in the market including equity shares, preference shares, debentures and bonds. Apart from it, there are many new securities that are issued by companies such as Convertible debentures, Deep Discount bonds, floating rate bonds, flexi bonds, zero coupon bonds, global depository receipts, etc.

It forms the initial phase of the portfolio management process and involves the evaluation and analysis of risk return features of individual securities. The basic approach for investing in securities is to sell the overpriced securities and purchase underpriced securities. The security analysis comprises of Fundamental Analysis and technical Analysis.

Portfolio Analysis:

A portfolio refers to a group of securities that are kept together as an investment. Investors make investment in various securities to diversify the investment to make it risk averse. A large number of portfolios can be created by using the securities from desired set of securities obtained from initial phase of security analysis.

By selecting the different sets of securities and varying the amount of investments in each security, various portfolios are designed. After identifying the range of possible portfolios, the risk-return characteristics are measured and expressed quantitatively. It involves the mathematically calculation of return and risk of each portfolio.

Portfolio Selection

During this phase, portfolio is selected on the basis of input from previous phase Portfolio Analysis. The main target of the portfolio selection is to build a portfolio that offer highest returns at a given risk. The portfolios that yield good returns at a level of risk are called as efficient portfolios. The set of efficient portfolios is formed and from this set of efficient portfolios, the optimal portfolio is chosen for investment.

The optimal portfolio is determined in an objective and disciplined way by using the analytical tools and conceptual framework provided by Markowitz's portfolio theory.

Portfolio Revision

- After selecting the optimal portfolio, investor is required to monitor it constantly to ensure that the portfolio remains optimal with passage of time. Due to dynamic changes in the economy and financial markets, the attractive securities may cease to provide profitable returns. These market changes result in new securities that promises high returns at low risks.
- In such conditions, investor needs to do portfolio revision by buying new securities and selling the existing securities. As a result of portfolio revision, the mix and proportion of securities in the portfolio changes.
- **Portfolio Evaluation**
- This phase involves the regular analysis and assessment of portfolio performances in terms of risk and returns over a period of time. During this phase, the returns are measured quantitatively along with risk born over a period of time by a portfolio. The performance of the portfolio is compared with the objective norms. Moreover, this procedure assists in identifying the weaknesses in the investment processes.
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Thank you!