**ANNAI WOMEN’S COLLEGE,**

**KARUR**

***Investment Management***

***(P16MC41)***

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## INTRODUCTION

**UNIT- I**

**Meaning of Investment**

Investment is a monetary asset purchased with the idea that the asset will provide income in the future or will later be sold at a higher price for a profit.

**squareTypes of Investment**

**1. Autonomous Investment**

Investment which does not change with the changes in income level, is called as Autonomous or Government Investment.Autonomous Istment re

**2. Induced Investment**

Investment which changes with the changes in the income level, is called as Induced Investment.

**3. Financial Investment**

Investment made in buying financial instruments such as new shares, bonds, securities, etc. is considered as a Financial Investment.

Howeve,the   
**4. Real Investment**

Investment made in new plant and equipment, construction of public utilities like schools, roads and railways, etc., is considered as Real Investment.

Real investment in new machine tools, plant and equipments purchased, factory buildings, etc. increases

**5. Planned Investment**

Investment made with a plan in several sectors of the economy with specific objectives is called as Planned or Intended Investment.

Planned Investment can also be called as Intended Investment because an investor while making investment make a

**6. Unplanned Investment**

Investment done without any planning is called as an Unplanned or Unintended Investment.

In **7. Gross Investment**

Gross Investment means the total amount of money spent for creation of new capital assets like Plant and Machinery, Factory Building, etc.

**8. Net Investment**

Net Investment is Gross Investment less (minus) Capital Consumption (Depreciation) during a period of time, usually a year.

**Investment management Meaning:**

**Investment management**is the act of  helping oneself or others set and meet long-term financial goals.

**Investment management** is a phrase that refers to the buying and selling of **investments** within a portfolio, and can also include banking and budgeting duties, as well as taxes..

**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.”

**Investment objectives**

**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,

**Tax exemptions**

some other objectives include: 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. While the aforementioned objectives are the most common ones

**NATURE AND SCOPE OF INVESTMENT MANAGEMENT**

Nature and scope of investment can be determined from the meaning of financial investments and how it is different from economic investment. It is also determined from the time period and the risk and its differences with speculation, gambling and arbitrage.

The nature of scope of investment management is:

1. To understand the exact meaning of investment

2. To find out different avenues of investment

3. To maximize return and minimize risk

4. To make a programmed for investment through evaluating securities, constructing a portfolio and reviewing a portfolio

5. To find out a time period for investments to take place

6. To evaluate through various techniques to get the best return for the investor

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Investment Management Process** | | | | | | | | | |
| **Information gathering and initial analysis** | You’ll meet with us to identify and discuss your goals and possible challenges you’ll face in in working toward your financial goals.  Then, we’ll look at where you want to go and how you’ll get there. |  |  |  |  |  |  |  |  |
| **Investment proposal** | We all work together to define appropriate asset allocation and diversification based on your investor profile and prepare an investment proposal to match your objectives. |  |  |  |  |  |  |  |  |
| **Consultation and financial analysis** | We answer any questions you may have and fine-tune the proposal.  After we reach a consensus, we begin the partnership by executing the documents to set your investment strategy in motion. |  |  |  |  |  |  |  |  |
| **Implementation and**  **monitoring** | After the investments are made, we monitor performance and make adjustments to help achieve your goals. |  |  |  |  |  |  |  |  |
| **Annual review** | Each year we will meet and review the previous year’s performance and evaluate any changes in your goals so we can rebalance your portfolio to keep you on track. |  |  |  |  |  |  |  |  |



# Investment process:

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.

# Security:

# A security is an investment. The term is used for many types of investments that include bonds, stocks, and mutual funds. It can be defined as a negotiable financial instrument that has financial value.

# What are the security?

A security is an instrument of promissory note or a method of borrowing or lending or a source of contributing to the funds needed by a corporate body or non-corporate body.

Non-Security form of Investment or non-marketable securities whose ownership is not transferable. The examples can be:

1. National Savings Schemes

2. National Savings Certificate

3. Provident funds

4. Corporate Fixed deposits

5. Life Insurance Policies

6. Unit Schemes of Unit Trust of India (Some are marketable)

7. Post office savings bank account

8. RBI Relief Bonds

9. Kisan Vikas Patra

10. Chit Funds, Nidhis etc.

# non-security

## Definition

A good or [instrument](http://www.investorwords.com/2507/instrument.html) that is not traded in a qualifying [market](http://www.investorwords.com/2962/market.html) (e.g. [Boston Stock Exchange](http://www.investorwords.com/7521/Boston_Stock_Exchange.html)) and is not easily marketable; i.e. it is not freely bought or [sold](http://www.investorwords.com/7717/sold.html) as a [security](http://www.investorwords.com/4446/security.html). It has a [value](http://www.investorwords.com/5209/value.html), but it may be not quickly converted into [cash in](http://www.investorwords.com/772/cash_in.html) a short [period](http://www.investorwords.com/3669/period.html) of time and does not necessarily carry the [backing](http://www.investorwords.com/8911/backer.html) of an [underwriter](http://www.investorwords.com/5134/underwriter.html) or [bank](http://www.investorwords.com/401/bank.html).

Examples of [securities](http://www.investorwords.com/5954/securities.html) are [stocks](http://www.investorwords.com/4725/stock.html), [bonds](http://www.investorwords.com/521/bond.html) and [Treasury](http://www.investorwords.com/5058/Treasury.html) [notes](http://www.investorwords.com/3351/note.html). Non-securities [include](http://www.investorwords.com/9996/include.html) paintings, [precious metals](http://www.investorwords.com/3769/precious_metals.html) and stones like [gold](http://www.investorwords.com/6533/gold.html) or [diamonds](http://www.investorwords.com/1432/Diamonds.html), and [bank guarantees](http://www.investorwords.com/6416/bank_guarantee.html).

**Non-security Forms of Financial Investment**

There are a number of non-security forms of investment opportunities available to an investor in India. Unlike stocks and debentures discussed above, the certificates or notes evidencing these investments are neither transferable nor are they traded in any organized financial market. Hence, the nomenclature 'Non-security form', financial investment media can be classified into (1) National Savings Schemes, (2) Post Office Savings Deposit Schemes, (3) Deposits with Commercial Banks, (4) Corporate Fixed Deposits, and (5) Unit Schemes of UTI.

**National Savings Schemes**

Over the years, the Government of India has floated several national savings schemes with a view to mobilize private savings for public use. These schemes are operated mainly through the Post Offices because of the familiarity of these places to the masses. Some series of National Savings Schemes are operated through the State Bank of India and other nationalized banks. These series are known as ' Bank Series'. Investment in the eighth series of this scheme qualifies for a tax rebate. At present, the rate of return on NSS is 9% p.a. credited annually on April 1. Interest income qualifies for a limited tax deduction.  
  
**Public Provident Fund Scheme**

This was introduced on July 1, 1968 and is primarily meant for self-employed individuals. The salaried individuals are also allowed to make contributions to this scheme over and above their contributions to the recognized provident funds in their organizations. It is a 15-year scheme with a facility to accept the last contribution in the 16th year.

At the option of the investor, the tenure of the account opened under this scheme can be extended by blocks of 5 years each.

A PPF Account can be opened in **a Head Post Office** or in a branch of SBI or its subsidiaries or at specified branches of some other nationalized banks by an individual on his own behalf or on behalf of a minor of whom he is a guardian or on behalf of a Hindu Undivided Family of which he is a member.

  The minimum amount that can be contributed in a year is Rs.100 and the maximum amount is Rs.60000.

The interest is paid annually, but the rate is determined by the **central government** from time to time. The current rate of interest is 9.5% per annum compounded annually. The interest on PPF contributions is tax-free under Section 10 of the Income Tax Act, 1961 and the contributions towards the scheme qualify for 20% tax rebate up to Rs.60000 under Section 88 of the Act.

The investment is exempt from Wealth Tax subject to the overall exemption limit of Rs.15 lakhs.

Besides the tax benefits, the other attractive features of the scheme are as follows:

1. Yearly contributions can be made in one lump sum or in 12 or less installments of varying amounts, in multiples of Rs.5.00.
2. It provides liquidity as loans and withdrawals are permitted. The application for the first loan can be made in the third year from the year of opening the PPF account. That is, if an investor opened the account in say 2000-01, the application for the first loan can be made in the year 2002-03. The loan amount is restricted to 25% of the balance amount to the credit at the end of the preceding financial year.   Also one can withdraw 50% of the balance amount to his credit at the end of the sixth year immediately preceding the year in which the amount is withdrawn. That is on 1-4-07, an investor can withdraw 50% of the balance standing to his credit on 31-3-01. Similar withdrawals can be made subsequently at three year intervals with the amount loanable remaining at the 50% of the amount due to ones credit at the end of the sixth year immediately preceding the year in which the withdrawal is made.
3. A PPF account can be revived by paying a fee of Rs.10 for each year of default along with the arrears of subscripttion of Rs.100 for each year of such default. The credit balance in the PPF account is not subject to attachment under an order or decree of court with respect to any debt or other liability.
4. The facility of nomination is available.   Reply       8 years ago    (Guest)   The interest on public deposits is paid semi-annually on a cumulative or non-cumulative basis. While the interest rates offered on company deposits are attractive vis-a-vis bank deposits, it should be noted that there is no tax benefit neither on the interest income, nor, does the investment in CFD qualify for any tax rebate.

Besides, **company deposits** have a higher degree of default risk than bank deposits. For one thing, these deposits do not enjoy any risk cover from the Deposit Insurance Corporation like bank deposits. Further, these deposits are serviced and finally repaid from the earnings of the company which by nature are uncertain and fluctuate over time. To add to this, these deposits are unsecured and rank paripassu with other unsecured liabilities for repayment in the event of liquidation. Therefore, the decision to invest in public deposits must be necessarily based on a thorough analysis of the financial stability and profitability of the company or on the credit ratings provided by rating agencies like CRISIL and ICRA.

**Units of UTI**

The Unit Trust of India (UTI) in the public sector is the only units investment trust in the country. It was set up in 1964 with a view to mobilize small savings by selling 'units' and invest the proceeds in the corporate stocks and debentures and gilt-edged securities. A unit represents a share in the income earned and in the assets (portfolio of securities) held by the trust under a given scheme. Some important unit schemes offered by UTI are discussed below.

**Unit Scheme, 1964**

One of the major unit schemes of UTI is the Unit Scheme, 1964. Under this scheme which is an open-ended one, units of the face value of Rs.10 each are sold on a continuous basis at a price quoted by the UTI from time to time. During the month of July, for about 3-6 weeks, these units are sold at a special price which normally is lower than the price quoted during the other periods of the year. A unit holder can avail himself of this facility, if so desired, for automatic reinvestment of dividend income in further units at the reduced price.

**Unit Scheme, 1971**

This unit scheme is a unit-linked insurance plan. Under this scheme, the units are not sold on tap. Instead, they are issued to the participants of the plan. It is a contractual savings plan for a target total contribution of Rs.6000 at the minimum and Rs.75000 at the maximum over a period of either 10 years or 15 years. A small amount of the contribution is paid to LIC for the insurance cover and the rest is invested. The total contribution to be made by a participant represents the insurance cover amount and this amount is paid to the nominee or legal heir in the event of the participant's death. The plan also provides for personal accident insurance cover up to Rs.15000 free of cost to the participant.

**Unit Scheme for Charitable and Religious Trusts and Societies**

The units sold under the scheme have a face value of Rs.100 and a participating trust or society is required to buy at least a 100 units. A participant can opt for reinvestment of dividends. The investment, however, cannot be withdrawn for the first three years.

**Children's Gift Growth Fund 1986**

Under this scheme, an irrevocable gift can be given by any adult to any child under 15 years of age. This investment remains with UTI till the child attains the age of 21 years. As it is indicated by the name, its primary aim is to build-up a fund for children. Till the scheme matures, there is an assured dividend of 12.5% p.a. which is automatically reinvested in further units, so the investment grows at a compound rate. Units can be gifted in multiples of 10 subject to a minimum of 50. Units are sold at par at Rs.10 throughout the year.

**Mutual Fund Unit Scheme 1986 (Mastershares)**

This scheme provides an opportunity to the investors to participate in the growing equity market. The funds mobilized through Mastershares are invested in a basket of equities spread over a wide range of industries, thus giving the benefit of diversification and spread of risk to the common investor. Mastershares are quoted on the stock market and so can be bought or sold at any time.   Growing Monthly Income Scheme (GMIS'91)   This scheme is launched to satisfy the growing need of middle class investors for regular income schemes and to cope with the rising cost of living. The scheme offers two options. Option 'A' provides regular monthly income of 14.5% p.a. for the first 3 years and 15% p.a. for the last two years with a minimum 2% capital appreciation on maturity. Under Option 'B' invested amount more than doubles itself in 5 years.  
  
**Security Forms of Financial Investment** We know that the recipient of money in a financial investment issues a document or a piece of paper to the investor (supplier of money), evidencing the liability of the former to the latter to provide returns. This document also outlines the rights of the investor to certain prospects and/or property and sets the conditions under which the investor can exercise his/her rights. This document is variously called 'Security Certificate', 'Note' and so on.    
  
 **There are different types of securities** conferring different sets of rights on the investors and different sets of conditions under which these rights can be exercised. They are gilt-edged securities, corporate debentures, preference shares and equity shares.

**Gilt-Edged Securities**

The debt securities issued by the government and semi-government bodies are called gilt-edged securities. They comprise the treasury bills and the dated securities (also called bonds or dated loans) of the central government, state government, and semi-government bodies like Port Trusts and State Electricity Boards. They are the acknowledgments of debt incurred by the issuing government or semi-government body. Gilt-edged securities thus represent the public borrowings of the issuing government or semi-government bodies. Over the years, the central and state governments and the semi-government bodies have made an extensive use of these securities for meeting their short and long-term resource requirements.  
  
**Treasury Bills:**

These short-term securities are issued by the RBI on behalf of the Central Government. Currently, the T-Bills having a maturity of 91 and 364 days only are being traded. No interest is paid on these bills. Instead they are sold at a discount. In other words, the buyer pays a price less than the face value of the bill and receives the full face value on the last day of maturity. The difference between the discount price and face value represents the interest income to the investor.    
  
**Central Government Dated Securities:**

These securities of the central government have a maturity period longer than one year and carry a fixed rate of interest. The interest is payable semi-annually and the payment is usually made by issuing coupons which can be encashed at any bank. Though these securities are redeemed at par, their issue price can be higher or lower than the face value depending upon the prevailing market conditions.

The market for central government securities is captive in the sense that certain institutions such as commercial banks, Life Insurance Corporation (LIC), General Insurance Corporation (GIC), development financial institutions like the Industrial Development Bank of India (IDBI), recognized/public provident funds, registered trusts, government and semi-government bodies are required by law to invest at least a certain percentage of their investible funds in the central government securities  
 **Semi-Government Dated Securities:**

These are the promissory notes issued by the institutions and corporations set up by the central/state governments. They also include the securities of municipal corporations. The semi-government bodies such as electricity boards, housing boards, port trusts, central and state financial institutions issue securities to meet the financial needs of their developmental activities. Semi-government securities are guaranteed by their respective governments and carry a higher coupon rate or lower issue price than for their counterpart state government dated securities.

**Corporate Debentures**

Corporate debentures are the promissory notes issued by the joint stock companies in the private sector. They are thus the debt obligations of the issuing corporation. Like government securities, they have an issue price at which they are originally issued, a coupon interest rate, and a specified maturity date.

**Debenture Trust Deed**

When a debenture issue is sold to the investing public, the debenture trust deed calls for appointing a trustee. Banks, insurance companies and firms of attorneys usually act as trustees to corporate debenture issues. The main job of the trustee is to look after the interest of debenture holders by ensuring that the company adheres to the provisions of the indenture - the agreement entered into between the issuing company and the debenture holders. To perform their role effectively, the trustees are vested with adequate powers which include the right to appoint a nominee director on the board of the company in consultation with the institutional debenture holders.

**Gilt edged securities meaning:**  
 Government securities are instruments issued by the government to borrow money from the market. They are also known as gilts or gilt edged securities.

“Government security” means a security created and issued by the Government for the purpose of raising a public loan or for any other purpose as may be notified by the Government in the Official Gazette and having one of the forms mentioned in the Government Securities Act, 2006.

Depending upon the expiry date, government securities are divided into short term and long term securities.

Short term government securities are Treasury bills. They have a maturity of less than one year. There are three main treasury bills in India – 91 day, 182 day and 364 day.

Long term government securities are known as government bonds or dated securities. They have a maturity period of five years, ten years, fifteen years etc.

**Following features of government securities earned them the name of gilt edged securities.**

1. They have zero income default
2. There is high rate of return
3. There is cent per cent liquidity

**The first feature** indicates that if we make investment in G secs, we will not loss our money. This is because, government rarely fails financially and there is no risk for losing our money or there is zero income default.

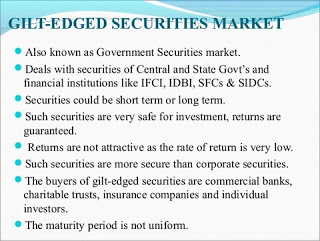
**Second feature** is that they have a reasonably high rate of interest. In India, the G secs are allocated among the buyers through auction method. This auction ensures competitive interest rate for government securities. Given their zero risk default nature, the interest rate is very good for Gsecs.

**Third featur**e of G secs is that they are very liquid. This is because the Gsecs are tradable in the stock m market. This means, to get money, the holder can sell it in the stock market. High marketability and tradability gives high liquidity for Gsecs. For commercial banks, by pledging government securities with RBI, it can avail a one day loan known as repo. Whenever a bank need money it can approach the RBI to take loans by pledging the g secs.

## Limitations of Gilt-Edged Securities

Although gilt-edged securities are offered by reliable government bodies and large corporations, they have some drawbacks. The [bonds](https://www.investopedia.com/terms/b/bond.asp) often fluctuate with interest rates, meaning a rate hike would cause the price of a gilt to decline and vice versa. With global economic conditions improving and rates poised to bounce off near zero levels, gilt funds are in store for a tumultuous ride.

Meanwhile, investors looking to generate somewhat substantial returns can find better value in an index fund. The greatest upside of a gilt-edge security is typically tied to interest rates, making them ideal investments for retirees seeking low risk and constant returns.

  
  
**Sources of Investment Information**

The following sources of investment information are intended as a starting point. They are stepping stones. As you proceed to research, investigate, educate yourself and learn, you will find that one place of information will lead you to the next, and you will find yourself gaining the knowledge that you need in order to become a most successful investor. Becoming investment literate is an on-going process.

**Books**

“The Intelligent Investor”, written by Benjamin Graham - recognized as one of the classic texts on investing, value investing specifically. A comprehensive, essential text for any serious student of investing.

**Financial websites**

MSN Money (moneycentral.msn.com) - up to date financial news, an educational/investing center, stock, bond, and mutual fund research and evaluation resources, help with personal finance and more.

CNNMoney.com (money.cnn.com) - as with MSN Money, a comprehensive financial site including current news affecting the economy and the investment community. The site also provides a very helpful, step-by-step, personal finance money guide, Money 101. Morningstar (www.morningstar.com) - a comprehensive research and evaluation site for stocks, bonds, ETF's (exchange traded funds), and mutual funds, utilizing the Morningstar rating system for investment screening

**Newspapers and periodicals**

Following are the major financial dailies available in Indian news paper industry

I.The Hindu- Business LINE

II.The Economic TIMES

Following are the major financial periodicals available in Indian news paper industry

1.The Business Enterprise

2. Business India

3. Businessworld

4.Business Today (business magazine)

5.Dhanam Magazine

**SECURITY ANALYSIS**

**UNIT-III**

**What is a Security ?**

Assets with some financial value are called securities.

**Characteristics of Securities**

* Securities are tradable and represent a financial value.
* Securities are fungible.

**Classification of Securities**

* **Debt Securities:** Tradable assets which have clearly defined terms and conditions are called debt securities. Financial instruments sold and purchased between parties with clearly mentioned interest rate, principal amount, maturity date as well as rate of returns are called debt securities.
* **Equity Securities:** Financial instruments signifying the ownership of an individual in an organization are called equity securities. An individual buying equities has an ownership in the company’s profits and assets.
* **Derivatives:** Derivatives are financial instruments with specific conditions under which payments need to be made between two parties.

**What is Security Analysis ?**

The analysis of various tradable financial instruments is called security analysis. Security analysis helps a financial expert or a security analyst to determine the value of assets in a portfolio.

**Classification of Security Analysis**

Security Analysis is broadly classified into three categories:

1. Fundamental Analysis
2. Technical Analysis
3. Quantitative Analysis

**What is Fundamental Analysis ?**

Fundamental Analysis refers to the evaluation of securities with the help of certain fundamental business factors such as financial statements, current interest rates as well as competitor’s products and financial market.

**What are Financial Statements ?**

Financial statements are nothing but proofs or written records of various financial transactions of an investor or company.

Financial statements are used by financial experts to study and analyze the profits, liabilities, assets of an organization or an individual.

**What is Technical Analysis ?**

Technical analysis refers to the analysis of securities and helps the finance professionals to forecast the price trends through past price trends and market data.

**What is Quantitative Analysis ?**

Quantitative analysis refers to the analysis of securities using quantitative data.

**Difference between Fundamental Analysis and Quantitative Analysis**

Fundamental analysis is done with the help of financial statements, competitor’s market, market data and other relevant facts and figures whereas technical analysis is more to do with the price trends of securities.

**Fundamental Analysis:**

I.Economy analysis,

II.industry analysis and

III.company analysis,

**I.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.

**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.

## II.Industry Analysis?

Industry analysis is a market assessment tool used by businesses and analysts to understand the competitive dynamics of an industry. It helps them get a sense of what is happening in an industry, i.e., [demand-supply statistics](https://corporatefinanceinstitute.com/resources/knowledge/economics/law-of-supply-economics/), degree of competition within the industry, [state of competition](https://corporatefinanceinstitute.com/resources/knowledge/economics/natural-monopoly/) of the industry with other emerging industries, future prospects of the industry taking into account technological changes, credit system within the industry, and the influence of [external factors](https://corporatefinanceinstitute.com/resources/knowledge/finance/what-is-systemic-risk/) on the industry.

**Types of industry analysis**

There are three commonly used and important methods of performing industry analysis.  The three methods are:

1. [Competitive Forces Model (Porter’s 5 Forces)](https://corporatefinanceinstitute.com/resources/knowledge/strategy/competitive-forces-model/)
2. [Broad Factors Analysis (PEST Analysis)](https://corporatefinanceinstitute.com/resources/knowledge/strategy/broad-factors-analysis/)
3. [SWOT Analysis](https://corporatefinanceinstitute.com/resources/knowledge/strategy/swot-analysis/)

 I. Competitive Forces Model (Porter’s 5 Forces)

One of the most famous models ever developed for industry analysis, famously known as [Porter’s 5 Forces](https://corporatefinanceinstitute.com/resources/knowledge/strategy/competitive-forces-model/), was introduced by Michael Porter in his 1980 book “[Competitive Strategy: Techniques for Analyzing Industries and Competitors.](http://www.hbs.edu/faculty/Pages/item.aspx?num=195)”

According to Porter, analysis of the five forces gives an accurate impression of the industry and makes analysis easier. In our [Corporate & Business Strategy course](https://courses.corporatefinanceinstitute.com/courses/corporate-business-strategy-course), we cover these five forces and an additional force — power of complementary good/service providers.

 1. Intensity of industry rivalry

The number of participants in the industry and their respective market shares are a direct representation of the competitiveness of the industry. These are directly affected by all the factors mentioned above.

#### 2. Threat of potential entrants

This indicates the ease with which new firms can enter the market of a particular industry. If it is easy to enter an industry, companies face the constant risk of new competitors.

#### 3. Bargaining power of suppliers

This refers to the [bargaining power of suppliers](https://corporatefinanceinstitute.com/resources/knowledge/strategy/bargaining-power-of-suppliers/). If the industry relies on a small number of suppliers, they enjoy a considerable amount of bargaining power..

#### 4. Bargaining power of buyers

The complete opposite happens when the bargaining power lies with the customers. If consumers/buyers enjoy market power, they are in a position to negotiate lower prices, better quality or additional services and discounts.

#### 5. Threat of substitute goods/services

The industry is always competing with another industry in producing a similar substitute product. Hence, all firms in an industry have potential competitors from other industries..

II. Broad Factors Analysis (PEST Analysis)

[Broad Factors Analysis](https://corporatefinanceinstitute.com/resources/knowledge/strategy/broad-factors-analysis/), also commonly called the PEST Analysis stands for Political, Economic, Social and Technological.  PEST analysis is a useful framework for analyzing the external environment.

  1. Political

Political factors that impact an industry include specific policies and regulations related to things like taxes, environmental regulation, tariffs, trade policies, labor laws, ease of doing business, and the overall political stability.

#### 2. Economic

The economic forces that have an impact include inflation, exchange rates (FX), interest rates, GDP growth rates, conditions in the capital markets (ability to access capital) etc.

#### 3. Social

The social impact on an industry refers to trends among people and includes things such as population growth, demographics (age, gender, etc), and trends in behavior such as health, fashion, and social movements.

#### 4. Technological

The technological aspect of PEST analysis incorporates factors such as advancements and developments that change that way business operates and the ways which people live their lives (i.e. advent of the internet).

 III. SWOT Analysis

[SWOT Analysis](https://corporatefinanceinstitute.com/resources/knowledge/strategy/swot-analysis/) stands for Strengths, Weaknesses, Opportunities, and Threats.  It can be a great way of summarizing various industry analysis methods and determining their implications for the business in question.

  1. Internal: Internal factors which already exist and have contributed to the current position and may continue to exist.

#### 2. External: External factors which are contingent events. Assess their importance based on the likelihood of them happening and their impact on the company.  Also, consider whether management has the intention and ability to take advantage of the opportunity/avoid the threat.

**Importance of Industry Analysis:**

**1.I**t helps a business understand market conditions.

2.It helps them forecast demand and supply and consequently, financial returns from the business.

3. It indicates the competitiveness of the industry and costs associated with entering and exiting the industry.

4.It is very important when planning a small business.

5.Analysis helps to identify which stage an industry is currently in; whether it is still growing and there is scope to reap benefits, or has it reached its saturation point.

6.With a very detailed study of the industry, entrepreneurs can get a stronghold on the operations of the industry and may discover untapped opportunities.

7.It is also important to understand that industry analysis is a very subjective method and does not always guarantee success.

8. It may happen that incorrect interpretation of data leads entrepreneurs to a wrong path or into making wrong decisions.

**III.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.

**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.

**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.

**I.Liquidity ratios**

These ratios measure the company’s ability to fulfill its short term obligations and reflect its short term financial strength or liquidity. The commonly used liquidity ratios are:

1. Current ratio = Current Assets /Current liabilities

2. Quick ratio (acid test) ratio =current assets –inventory-prepaid expenses/ Current liabilities

**II.Leverage ratios**

These are also known as capital structure ratios. they measure the company’s ability to meet its long-term debt obligations.

1. Debt equity ratio = long term debt/ Share holders equity

2. Total debt ratio or debt to total assets ratio = Total debt /Total assets

3. Proprietary ratio = share holders equity /Total assets

4. Interest coverage ratio = earnings before interest and taxes (EBIT) /Interest

**III.Profitability ratios**

The profitability of the company can be measured by the profitability ratios.

a) Gross profit ratio = Gross profit (sales-cost of goods sold) /Sales

b) Operating profit ratio = EBIT /Sales

c) Net profit ratio = earnings after tax(EAT)/ Sales

d) Administrative expenses ratio = administrative expenses /Sales

e) Selling expenses ratio = selling expenses /Sales

f) Operating expenses ratio = Administrative expenses +selling expenses /Sales

g) Operating ratio = cost of goods sold + operating expenses/ Sales

h) Return on capital employed = EBIT/ Total capital employed

i) Return on equity= EAT /Shareholders’ equity

j) Earning yield = EPS /Market price per share

k) Dividend yield = DPS (dividend per share) /Market price per share

l)dividend payout ratio = DPS/ EPS

**IV.Activity or efficiency ratios**

There are also known as turnover ratios. These ratios measure the efficiency in asset management.

1. Current assets turnover = sales /Current assets

2. Fixed assets turnover = sales /Fixed assets

3. Total assets turnover = sales /Total assets

4. Inventory turnover = sales /Average inventory

5. Debtors turnover = sales /Average debtors

**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 price is 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

## Technical Analysis

Technical analysis is an investment methodology that evaluates investments purely on the market activity surrounding them, with no looking to the actual operations or value of the company itself. Relevant factors that will be looked at include:

* Historical pricing of the shares
* Trading volumes over time
* Industry trading trends

The goal of this analysis is to capitalize on pricing opportunities and trends that can be identified in the market activity around each share. As the methodology is purely based on historical market activity this is considered to be a backward looking methodology.

**Dow Theory**

The theory formulated by Charles H.Dow.dow who the editor of the wall street journal in U.S.A

Charles dow formulated a hypothesis that the stock market does not move on random basis but is influenced by three distinct cyclical trend that guide its direction .

**Dow Theory Definition:**

According to dow theory, the market has three movements and these movements are simultaneous in nature. These movements are the primary movements, secondary reactions and minor movements.

1**.The primary** movement is the long range cycle that carries the entire market up or down. This is the long term trend in the market.

2.**The secondary** reactions act as a restraining force on the primary movement these are in the opposite direction to the primary movement and last only for a short while these are also known as corrections. These are secondary reactions.

3. **The third** movement in the market is the minor movements which are the day to day fluctuations in the market. The minor movements are not significant and have no analytical value as they are of very short duration. The three movements of the market have been compared to the tides, the waves and the ripples in the ocean.

**Bullish trend :**

During the bull market (upward moving market), in the first phase the price would advance with the revival of confidence in the future of business. During the second phase, price would advance due to improvements in corporate earnings, in the third phase, prices advance due to inflation and speculation. According to Dow Theory, the formulation of higher bottoms and higher tops indicates a bullish trend.

**Bearish trend :**

The bear market is also characterized by three phases, in the first phase, price begin to fall due to abandonment of hopes. in the second phase ,companies start to reporting lower profits and lower dividends ,in the final phase, price fall still further due to distress selling .a bearish market would be indicated by the formulation of lower tops and lower bottoms.

**The theory also make certain assumptions** which have been referred to as the hypotheses of the theory.

i.The first hypothesis states that the primary trend cannot be manipulated. It means that no single individual or institution or group of individuals and institutions or group of individuals and institutions can exert influence on the major trend of the market.

ii.The second hypotheses states that the averages discount everything. What means is that the daily prices reflect the aggregate judgement and emotions of all stock market participants. in arriving at the price of a stock the market discounts everything known and predictable about the stock that is likely to affect the demand and supply position of the stock.

iii.The third hypothesis states that the theory is not infallible. the theory is concerned with the trend of the market and has no forecasting value as regards the duration .

**Basic principles of technical analysis**

1. The market value of a security is related to the demand and supply factors operating in the market.

2. There are both rational and irrational factors which surround the supply and demand factors of a security.

3. Security prices behave in a manner that their movement is continuous in a particular direction for some length of time.

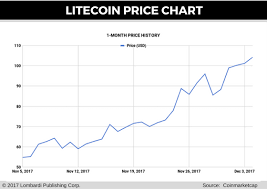
4. Trends in stock prices have been seen to change when there is a shift in the demand and supply factors.

5. The shift in demand and supply can be detected through charts prepared specially to show the market action.

6. Patterns which are projected by charts record price movements and these recorded patterns are used price movements and these recorded patterns are used by analysts to make forecasts about the movement of prices in future.

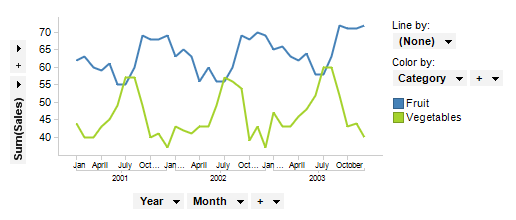
**Price chart :**

Price chart is the basic tool used by the technical analyst to study the share price movement. the prices are plotted on an XY graph where the X axis represents the trading days and Y axis denotes the prices.



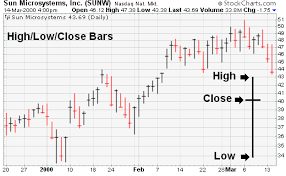
**Line chart:**

It is the simplest price chart. In this chart, the closing prices of a share are plotted on the XY graph on a day to day basic .the closing price of the each day would be represented by a point on the XY graph. All these points would be connected by a straight line which would indicate the trend of the market.

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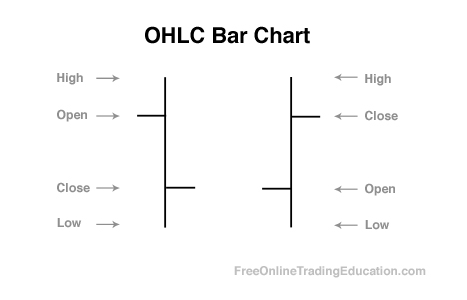
**Bar chart :**

It is the most popular chart used by technical analysts. In this chart the highest price ,the lowest price and the closing price of each day are plotted on a day to day basis .a bar is formed by joining the highest price and lowest price of a particular day by a vertical line.

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**Japanese candlestick charts:**

The Japanese candle stick chart shows the highest price, the lowest price, the opening price and the closing price of shares on a day to day basis. The highest price and the lowest price of a day are joined by a vertical bar. The opening price and closing price of the day which would fall between the highest and the lowest prices would be represented by a rectangle so that the price bar chart looks like a candlestick. Thus, each day’s activity is represented by a candlestick.

**  
Efficient Market Hypothesis**

Efficient Market Hypothesis asserts that financial markets are "informationally efficient". In consequence of this, one cannot consistently achieve returns in excess of average market returns on a risk-adjusted basis, given the information available at the time the investment is made.

**There are three major versions of the hypothesis:**

**i. "weak",ii. "semi-strong", and iii."strong**".

**i. The weak**-form EMH claims that prices on traded assets (e.g., stocks, bonds, or property) already reflect all past publicly available information.

**ii.The semi-strong-form** EMH claims both that prices reflect all publicly available information and that prices instantly change to reflect new public information.

**iii.The strong-form** EMH additionally claims that prices instantly reflect even hidden or "insider" information

**Weak-form efficiency:**

In weak-form efficiency, future prices cannot be predicted by analyzing prices from the past. Excess returns cannot be earned in the long run by using investment strategies based on historical share prices or other historical data.Technical analysis techniques will not be able to consistently produce excess returns, though some forms of fundamental analysis may still provide excess returns.

**Semi-strong-form efficiency**

In semi-strong-form efficiency, it is implied that share prices adjust to publicly available new information very rapidly and in an unbiased fashion, such that no excess returns can be earned by trading on that information. Semi- strong-form efficiency implies that neither fundamental analysis nor technical analysis techniques will be able to reliably produce excess returns.

**Strong-form efficiency**

In strong-form efficiency, share prices reflect all information, public and private, and no one can earn excess returns. If there are legal barriers to private information becoming public, as with insider trading laws, strong-form efficiency is impossible, except in the case where the laws are universally ignored.

[**Random walk theory**](https://www.investopedia.com/terms/r/randomwalktheory.asp)**:**

### “[Random walk theory](https://www.investopedia.com/terms/r/randomwalktheory.asp)” took its name from this book, and it is an attempt to explain the way that the stock market moves. Essentially, the theory states that the past movement or direction of the price of either the overall market or of an individual stock is not a suitable predictor of future movement. The theory was originally described by Maurice Kendall in 1953, and it states that stock price fluctuations are independent of one another, that they have the same probability distribution, and that over a period of time, prices maintain an upward trend. Basic Assumptions of the Random Walk Theory

1. The Random Walk Theory assumes that the price of each security in the stock market follows a random walk.
2. The Random Walk Theory also assumes that the movement in the price of one security is independent of the movement in the price of another security.

### Concept of Random Walk Theory:

1) A perfectly competitive market which according to it operates in an efficient manner in order to bring about the actual stock prices with its present discounted value. This means that the equilibrium value of a stock determined by its demand and supply features represents the value of stock based on the information that the investors have.

(2) It further states that since the market is in its most efficient form the participants in the market have free access to the same information so that the market price which is prevailing reflects the stocks’ present value.

(3) If there is any deviation from this equilibrium theory, it is quickly corrected and the stock find its way back to the equilibrium price. The analyst who is professional in trading of stock takes the advantage of deviations and this forces the stock back to its equilibrium price.

(4) This theory also states that a price change occurs in the value of stock only because of certain changes which affect the company or the stock markets.

### Random Walk Theory Hypothesis:

The Random Walk Theory is based on the efficient market hypothesis which is supposed to take three forms — weak form, semi-strong form and strong form.

#### a. Weak Form:

The weak form of the market says that current prices of stocks reflect all information which is already contained in the past. The weak form of the theory is just the opposite of the technical analysis because according to it the sequence of prices occurring historically does not have any value for predicting the future stock prices.

#### b. Semi-Strong Form:

This form of the market reflects all information regarding historical prices as well as all information about the company which is known to the public. According to the theory, any analyst will find it difficult to make a forecast of stock prices because he will not be able to get superior and consistent information of any company continuously.

#### c. Strong Form:

The strong form of the efficient market hypothesis suggests that it is not useful to any investor or analyst to make any future forecast of prices because he can never make any returns which are superior to others consistently.

Each investor is fully aware of the new pieces of information in the market and so even if the analyst has inside information he cannot continuously earn superior investment returns. The strongly efficient market hypothesis is not found to be fully acceptable.

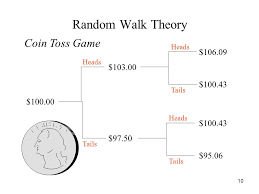
**The random walk theory, therefore, suggests that analysis should be able to look in for superior analysis of the firm by making the following considerations:**

(a) By finding out the risk and return characteristics of each security.

(b) By trying to combine the risk and return characteristics of securities into an adequate portfolio;

(c) By holding a portfolio for a reasonable length of time and making a continuous evaluation of the securities held by him;

(d) By planning a well-diversified portfolio and by revising it, if need be, after consistent evaluation.

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**PORTFOLIO ANALYSIS**

**UNIT-IV**

**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.

**Portfolio**

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**

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.

**Basic Principles of the portfolio investment process are given below:**

**1. It is the portfolio that matters:**

Individual securities are important only to the extent that they affect the aggregate portfolio. For example, a security’s risk should not be based on the uncertainty of a single security’s return but, instead, on its contribution to the uncertainty of the total portfolio’s return.

# Internal Diversification of Investment

Diversification, as expected, reduces the risk and also the covariance between the asset and the market portfolio of all risky assets in the economy. Diversification internationally has become from the point of view of lowering the covariance of the securities.

Securities should be purchased generally from the domestic investments bid international investments diversify assets to a greater extent and help the investor to reduce the systematic risk. Real estate investment has been used by investors for reducing risk.

International diversification is possible by investing in multinational companies or in foreign companies as this will induce investor to make a combination of risk and return in a manner to make the portfolio superior to the stocks which are confined only to one stock market.

International investment of money means to investors to combat inflationary trends because the markets in different countries do not move together. Each market has its own constraints, environmental factors, socio-economic and political factors and the gains in one stock purchase in country A is offset by losses in country B.

There are many constraints in international investments.

**These are:**

(a) Political risks,

(b) Liquidity of markets, and

(c) The currency effects.

**(a) Political Risks:**

The economic environment of a country is usually dominated by the policies taken by the government. A change in government or change in its policies will affect the investments either favourably or unfavourably. When there are a high degree of political risks, then both local and foreign investors are interested in selling the securities and will reach an equilibrium where the investors are happy to hold their securities.

**(b) Liquidity in the Markets:**

Liquidity in the markets also pervade favourable climate for investors. The United States Stock Market is highly liquid but there are many other countries which lack this liquidity. United Kingdom, West Germany, Japan, Australia and India may be considered to be markets having less liquidity and governed by certain political and economic factors. These bring about some constraints in international investment.

**(c) Currency Effects:**

# An investor is faced by different kinds of currencies whose values are constantly revised and they are fluctuating in nature. It is important for him to identify the different kinds of currencies and their rates constantly. If these are not complex in nature, he may plan to diversify and get a better bor Top 6 Features of an Investment Program

1. **Safety of Principal 2. Liquidity 3. Income Stability 4. Appreciation and Purchasing Power Stability 5. Legality and Freedom from Care 6. Tangibility.**

#### 1. Safety of Principal:

The investor, to be certain of the safety of principal, should carefully review the economic and industry trends before choosing the types of investment. Errors are avoidable and, therefore, to ensure safety of principal, the investor should consider diversification of assets.

#### 2. Liquidity:

Even investor requires a minimum liquidity in his investments to meet emergencies. Liquidity will be ensured if the investor buys a proportion of readily saleable securities out of his total portfolio. He may, therefore, keep a small proportion of cash, fixed deposits and units which can be immediately made liquid investments like stocks and property or real estate cannot ensure immediate liquidity.

#### 3. Income Stability:

Regularity of income at a consistent rate is necessary in any investment pattern. Not only stability, it is also important to see that income is adequate after taxes. It is possible to find out some good securities which pay practically all their earnings in dividends.

#### 4. Appreciation and Purchasing Power Stability:

Investors should balance their portfolios to fight against any purchasing power instability. Investors should judge price level inflation, explore the possibility of gain and loss in the investments available to them, limitations of personal and family considerations.

The investors should also try and forecast which securities will possibly appreciate. A purchase of property at the right time will lead to appreciation in time. Growth stock will also appreciate over time. These, however, should be done thoughtfully and not in a manner of speculation or gamble.

**5. Legality and Freedom from Care:**

All investments should be approved by law. Law relating to minors, estates, trusts, shares and insurance be studied. Illegal securities will bring out many problems for the investor. One way of being free from care is to invest in securities like Unit Trust of India, Life Insurance Corporation or Savings Certificates.

#### 6. Tangibility:

Intangible securities have many times lost their value due to price level inflation, confiscatory laws or social collapse. Some investors prefer to keep a part of their wealth invested in tangible properties like building, machinery and land. It may, however, be considered that tangible property does not yield an income apart from the direct satisfaction of possession or property.

rowing and lending on his diversification pattern.

**Objectives of Portfolio Management**

1. Security of Principal Investment: Investment safety or minimization of risks is one of the most important objectives of portfolio management. Portfolio management not only involves keeping the investment intact but also contributes towards the growth of its purchasing power over the period. The motive of a financial portfolio management is to ensure that the investment is absolutely safe. Other factors such as income, growth, etc., are considered only after the safety of investment is ensured.

**2. Consistency of Returns**: Portfolio management also ensures to provide the stability of returns by reinvesting the same earned returns in profitable and good portfolios. The portfolio helps to yield steady returns. The earned returns should compensate the opportunity cost of the funds invested.

**3. Capital Growth**: Portfolio management guarantees the growth of capital by reinvesting in growth securities or by the purchase of the growth securities. A portfolio shall appreciate in value, in order to safeguard the investor from any erosion in purchasing power due to inflation and other economic factors. A portfolio must consist of those investments, which tend to appreciate in real value after adjusting for inflation.

**4. Marketability**: Portfolio management ensures the flexibility to the investment portfolio. A portfolio consists of such investment, which can be marketed and traded. Suppose, if your portfolio contains too many unlisted or inactive shares, then there would be problems to do trading like switching from one investment to another. It is always recommended to invest only in those shares and securities which are listed on major stock exchanges, and also, which are actively traded.

**5. Liquidity**: Portfolio management is planned in such a way that it facilitates to take maximum advantage of various good opportunities upcoming in the market. The portfolio should always ensure that there are enough funds available at short notice to take care of the investor’s liquidity requirements.

**6. Diversification of Portfolio:** Portfolio management is purposely designed to reduce the risk of loss of capital and/or income by investing in different types of securities available in a wide range of industries. The investors shall be aware of the fact that there is no such thing as a zero risk investment. More over relatively low risk investment give correspondingly a lower return to their financial portfolio.

**7. Favorable Tax Status:** Portfolio management is planned in such a way to increase the effective yield an investor gets from his surplus invested funds. By minimizing the tax burden, yield can be effectively improved. A good portfolio should give a favorable tax shelter to the investors. The portfolio should be evaluated after considering income tax, capital gains tax, and other taxes.

**Traditional approach**

The traditional approach basically deals with two major decisions. They are:

(a) Determining the objectives of the portfolio.

(b) Selection of securities to be included in the portfolio.

Normally, this is carried out in four to six steps. Before formulating the objectives, the constraints of the investor should be analysed. Within the given framework of constraints, objectives are formulated. Then based on the objectives, securities are selected. After that, the risk and return of the securities should be studied. The investor has to assess the major risk categories that he or she is trying to minimise. Compromise on risk and non-risk factors has to be carried out. Finally relative portfolio weights are assigned to securities like bonds, stocks and debentures and then diversification is carried out

**Steps in traditional approach**

(a) **Need for current income**: The investor should establish the income which the portfolio should generate. The current income need depends upon the entire current financial plan of the investor. The expenditure required to maintain a certain level of standard of living and all the other income generating sources should be determined. Once this information is arrived at, it is possible to decide how much income must be provided for the portfolio of securities.

(b) **Need for constant income**: Inflation reduces the purchasing power of the money. Hence, the investor estimates the impact of inflation on his estimated stream of income and tries to build a portfolio which could offset the effect of inflation. Funds should be invested in such securities where income from them might increase at a rate that would offset the effect of inflation. The inflation or purchasing power risk must be recognised but this does not pose a serious constraint on portfolio if growth stocks are selected.

2. **Determination of objectives :**

**Portfolios** have the common objective of financing present and future expenditures from a large pool of assets. The return that the investor requires and the degree of risk he is willing to take depend upon the constraints.

The objectives of portfolio range from income to capital appreciation. The common objectives are stated below:

* Current income

• Growth in income

• Capital appreciation

• Preservation of capital

3**. Selection of portfolio** The selection of portfolio depends on the various objectives of the investor. The selection of portfolio under different objectives are dealt subsequently.

**Objectives and asset mix-**

If the main objective is getting adequate amount of current income, sixty per cent of the investment is made on debts and 40 per cent on equities. The proportions of investments on debt and equity differ according to the individual’s preferences. Money is invested in short term debt and fixed income securities. Here the growth of income becomes the secondary objective and stability of principal amount may become the third.

4. **Risk and return analysis**: The traditional approach to portfolio building has some basic assumptions. First, the individual prefers larger to smaller returns from securities. To achieve this goal, the investor has to take more risk. The ability to achieve higher returns is dependent upon his ability to judge risk and his ability to take specific risks. The risks are namely interest rate risk, purchasing power risk, financial risk and market risk. The investor analyses the varying degrees of risk and constructs his portfolio.

5. **Diversification:** Once the asset mix is determined and the risk and return are analysed, the final step is the diversification of portfolio. Financial risk can be minimised by commitments to top-quality bonds, but these securities offer poor resistance to inflation. Stocks provide better inflation protection than bonds but are more vulnerable to financial risks.

# International Capital Asset Pricing Model (CAPM) | Forex Management

The Capital Asset Pricing Model (CAPM) indicates that the investors in a security are compensated only for the systematic risk of the security. And it is assumed that the unsystematic risk can be diversified by the investor by investing in different group of assets. The unsystematic risk is a unique risk pertains to a specific firm, for example, labour strike, non-availability of raw materials, etc.

**According to the international CAPM, the return on a security is given by:**

Ri = rf + βw (rw – rf)

Where rf = World risk-free rate of return

bw = World beta of the security

= Cov (ri, Fw)/Var(rw)

rw = Return on the world-market portfolio

# Capital Asset Pricing Model (CAPM)

### Assumptions of the Capital Asset Pricing Model Theory:

(a) Decision of the investor depends on their judgement of risk and return of securities and these are measured by standard deviations.

(b) All investors are infinitely divisible units and can be freely purchased and sold.

(c) Shares can be sold short at any time in the stock market and without any limit.

(d) Individual investors do not effect the prices of security. All investors operate under perfect competition.

(e) Transaction costs are nil.

(f) The investor makes an investigation of securities without taking into consideration the amount of tax to be paid.

(g) At any time there is a risk-less rate at which investor can buy or lend any quantity of funds.

(h) All investors have the same planning horizons, expectations, expected returns variance and covariance of all securities.

**It is further illustrated in the following example where:**

Rp= XRm + (1-x)Rf

Rp = expected return of portfolio.

X = percentage of funds in risk portfolio.

1-X = percentage of fund in risk – less assets.

Rm= expected return of risk –less assets.

Rf= expected return of risk – less assets.

θp= Xθm

θp= expected standard deviation of risky portfolio.

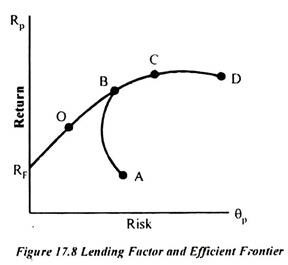
θm= expected standard deviation of risky portfolio

**The following three cases may be considered by an investor:**

(A) when X is = 1;

(B) when X is less than 1;

(C) when X is greater than 1.

**[](http://cdn.yourarticlelibrary.com/wp-content/uploads/2016/05/clip_image002-22.jpg)**

If X is the percentage of amount which is invested then in (A), the investor has put his amount in a manner as to have the highest risk. In (B), the investor put some amount in a risky share portfolio and some amount he has been able to give on loan at the lending rate RFWhen X is greater than it, the theory states that the investor is borrowing funds.

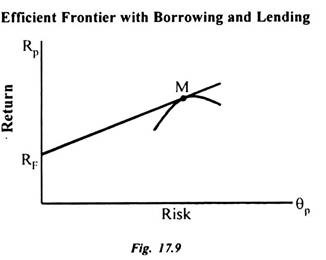
Figure 17.9 shows that the efficiency frontier is new. There is a new combination of securities to combine into the best portfolio. Point ‘M’ shows the best portfolios. In this figure, the investor’s problem of portfolio is simplified.

He has to make a decision with regard to factors of borrowing and lending only because at that point ‘M’ the investment is the most efficient and he has to make his decision of having a complete investment programme at this point. Lending at the risk-less asset by buying it or borrowing is a definite decision which the investor is making.

This particular decision brings out a new theory called the “Separation theorem”. According to this research theory, the efficient set represents the best mix of stocks and all investors belonging to different categories, whether they are conservative or aggressive, have to choose the same combination of stocks selected from the efficient set.

The only method to distinguish the investors is by putting in the technique of lending resources or borrowing them for achieving the category of risk that they belong to.

This is shown in Figure 17.9, all investors are surrounded with the same risky portfolios and they can achieve the ideal combination of securities at point ‘M’ by lending and borrowing in a different manner.

**[](http://cdn.yourarticlelibrary.com/wp-content/uploads/2016/05/clip_image004-19.jpg)**

Since all investors will have the portfolio of risky assets and will hold the same investments the equilibrium will be the market portfolio ‘M’. ‘M’, of all risky assets.

All investors will, therefore, get a chance to choose for a combination of only two portfolios — (a) the market portfolio, (b) the risk-less securities. The straight line at the tangent of the efficient frontier is called the capital market line. On this line, all the efficient portfolios would be lined up.

But there are a large number of portfolios which are not efficient and lie either below or above the capital market line. The capital market line chooses only the most efficient portfolio and this indicates the market price of risk through the following equation: RF

Re= Rf+ Rm – Rf/θm/θm

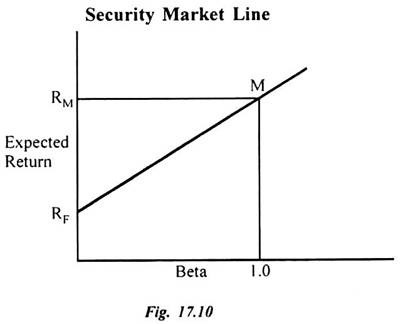
The equation gives the return on efficient portfolios.

**The returns on individual securities and on non-efficient portfolios are studied below:**

### Security Market Line:

The risk and return of securities is determined by beta. All portfolios lie along a straight line on which the beta is measured. The point which is a risk-less asset of beta O is the first point. Beta 1 is the second point on the market line of the portfolio. When these results are combined it gives into consideration the security market line. This draws out the

The security market line is shown in Figure 17.10. The expected return is different on any two different assets.

**[](http://cdn.yourarticlelibrary.com/wp-content/uploads/2016/05/clip_image008-8.jpg)**

This difference is related and measured by the difference in beta. As stated earlier, the expected return will be higher when beta is high in any security because the relationship which is drawn between the expected return and beta is linear.

Beta estimates the systematic proportion of the risk. Systematic risk is perhaps more important than the unsystematic risk because it affects that part of the return which may not be eliminated even by diversification.

### Validity of CAPM:

**The validity of CAPM can be summarized by the following:**

I. The CAPM focuses on the market risk.

II. It helps the individual to select securities and prepare a portfolio.

III. The assumption of CAPM is that investors consider only the market risk. If the risk-free rate, the beta of the firm, stock and the required market rate of return can be estimated, and individual is able to calculate the expected returns for a firm’s security. This expected return is useful to estimate the cost of retained earnings.

IV. CAPM has been regarded as a useful tool to financial analysts but empirical tests and analysis have estimated through ex-post or past data.

V. Betas vary for historical data regarding the market return and risk-free rate of return in different periods.

**To summarize the above discussion:**

I. The CAPM model is based on the assumption that the investors can freely borrow and lend any amount of money at risk-less rate of interest.

II. All investors purchase risk free securities and only those securities on the market portfolio.

III. Market portfolio means the composition of the investments in all securities of the market. The proportion invested in each security is equal to the percentage of the total market capitalization represented by the particular security.

IV. The capital market line depicts the relationship between the expected return and the standard deviation of the portfolio.

V. The risk of an individual security is calculated through its covariance with the market portfolio.

VI. Security market line indicates that there is a linear relationship between the expected returns and betas of the securities.

VII. The asset pricing model assesses and identifies the equilibrium asset price for expected return and risk.

VIII. Arbitrage is possible when the asset prices are not equal.

IX. With the same financial commitment an arbitrage portfolio can be constructed.

X. When arbitrage is possible investors move the price upwards if securities are held long and driving down the price of securities if held in short position. This trade will continue to take place until the arbitrage is eliminated.

XI. Arbitrage model indicates the responsiveness of a security’s return to a particular factor.

#### Validity of CAPM:

I. CAPM focuses on Market Risk. It helps investors to think about risk of assets.

II. CAPM helps in selecting securities and making a portfolio.

III. Securities with high return are undervalued and attractive to buy.

High Return ⇔Under Valued.

Low Return⇔Over Valued

In a situation where the risk is same but return varies.

i. Expected Returns can be found as an estimate of the cost of retained earnings.

### Criticism of CAPM:

I. Model is Ex-Ante. It is based on expectation the inputs are Ex-Post based on Past Data.

II. Historical Data regarding market return risk free rate of return and betas vary differently for different periods.

# Markowitz Theory: Subject Matter, Assumptions and Models

### **Subject Matter of the Markowitz Theory:**

Before the development of Markowitz theory, combination of securities was made through **“simple diversification”.** The layman could make superior returns on his investments by making a random diversification in his investments.

A portfolio consisting of securities of a large number will always bring a superior return than a portfolio consisting of ten securities because the portfolio is ten times more diversified.

The simple diversification would be able to reduce unsystematic or diversifiable risk. In securities, both diversifiable and un-diversifiable risks are present and an investor can expect 75% risk to be diversifiable and 25% to be un-diversifiable.

Simple diversification at random would be able to bring down the diversifiable risk if about 10 to 15 securities are purchased. Unsystematic risk was supposed to be independent in each security. Many research studies were made on diversification of securities. It was found that 10 to 15 securities in a portfolio would bring adequate returns. Too much diversification would also not yield the expected return.

Some experts have suggested that diversification at random does not bring the expected return results. Diversification should, therefore, be related to industries which are not related to each other. Many industries are correlated with each other in such a way that if the stock of ‘X’ increases in price the stock of ‘Y’ also increases and vice versa.

By looking at the trends, industries should be selected in such a way that they are unrelated to each other. A person having on his portfolio about 8 to 10 securities will reduce his risk but if he has too many securities as described above it would not lead to any gain.

If systematic risk is reduced by simple diversification, research studies have shown that an investor should spread his investments but he should not spread himself in so many investments that it leads to “superfluous diversification”. When an investor has too many assets on his portfolio he will have many problems. These problems relate to inadequate return.

It is very difficult for the investor to measure the return on each of the investments that he has purchased. Consequently, he will find that the return he expects on the investments will not be up to his expectations by over- diversifying.

The investor will also find it impossible to manage the assets on his portfolio because the management of a larger number of assets requires knowledge of the liquidity of each investment, return; the tax liability and this will become impossible without specialized knowledge.

An investor will also find it both difficult and expensive to look after a large number of investments. This will also have the effect of cutting into the profits or the return factor on the investments.

If the investor plans to switch over investments by selling those which are unprofitable and purchasing those which will be offering him a high rate of return, he will involve himself in high transaction costs and more money will be spent in managing superfluous diversification.

The research studies have shown that random diversification will not lead to superior returns unless it is scientifically predicted. Markowitz theory is also based on diversification. He believes in asset correlation and in combining assets in a manner to lower risk.

### **Assumption of the Markowitz Theory:**

Markowitz theory is based on the modern portfolio theory under several assumptions.

**The assumptions are:**

#### Assumption under Markowitz Theory:

(1) The market is efficient and all investors have in their knowledge all the facts about the stock market and so an investor can continuously make superior returns either by predicting past behaviour of stocks through technical analysis or by fundamental analysis of internal company management or by finding out the intrinsic value of shares. Thus, all investors are in equal category.

(2) All investors before making any investments have a common goal. This is the avoidance of risk because they are risk averse.

(3) All investors would like to earn the maximum rate of return that they can achieve from their investments.

(4) The investors base their decisions on the expected rate of return of an investment. The expected rate of return can be found out by finding out the purchase price of a security dividend by the income per year and by adding annual capital gains.

It is also necessary to know the standard deviation of the rate of return expected by an investor and the rate of return which is being offered on the investment. The rate of return and standard deviation are important parameters for finding out whether the investment is worthwhile for a person.

(5) Markowitz brought out the theory that it was a useful insight to find out how the security returns are correlated to each other. By combining the assets in such a way that they give the lowest risk maximum returns could be brought out by the investor.

(6) From the above, it is clear that every investor assumes that while making an investment he will combine his investments in such a way that he gets a maximum return and is surrounded by minimum risk.

(7) The investor assumes that greater or larger the return that he achieves on his investments, the higher the risk factor surrounds him. On the contrary, when risks are low the return can also be expected to be low.

(8) The investor can reduce his risk if he adds investment to his portfolio.

(9) An investor should be able to get higher return for each level of risk “by determining the efficient set of securities”.

### Markowitz Model:

Markowitz approach determines for the investor the efficient set of portfolio through three important variables, i.e., return, standard deviation and coefficient of correlation. Markowitz model is called the “Full Covariance Model”.

Through this method the investor can, with the use of computer, find out the efficient set of portfolio by finding out the trade-off between risk and return, between the limits of zero and infinity. According to this theory, the effects of one security purchase over the effects of the other security purchase are taken into consideration and then the results are evaluated.

#### The Effect of Combining Two Securities:

It is believed that holding two securities is less risky than having only one investment in a person’s portfolio. When two stocks are taken on a portfolio and if they have negative correlation, then risk can be completely reduced because the gain on one can offset the loss on the other.

The effect of two securities can also be studied when one security is more risky when compared to the other security. The following example shows a return of 13%. A combination of A and E will produce superior results to an investor rather than if he was to purchase only Stock-A and one-third of stock consists of Stock-B, the average return of the portfolio is weighted average return of each security in the portfolio.

**Markowitz Portfolio Selection**

Markowitz Portfolio Selection Method identifies an investor’s unique risk-return preferences, namely utilities. The Markowitz portfolio model has the following assumptions:

* Investors are risk averse

• Investors are utility maximisers than return maximisers

• All investors have the same time period as the investment horizon

• An investor who is a risk seeker would prefer high returns for a certain level of risk and he is willing to accept portfolios with lower incremental returns for additional risk levels.

* A risk averse investor would require a high incremental rate of return as compensation for every small amount of increase in risk.

# Sharpe Theory of Portfolio Management | Financial Economics

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Markowitz Model had serious practical limitations due to the rigours involved in compiling the expected returns, standard deviation, variance, covariance of each security to every other security in the portfolio. Sharpe Model has simplified this process by relating the return in a security to a single Market index. Firstly, this will theoretically reflect all well traded securities in the market. Secondly, it will reduce and simplify the work involved in compiling elaborate matrices of variances as between individual securities.

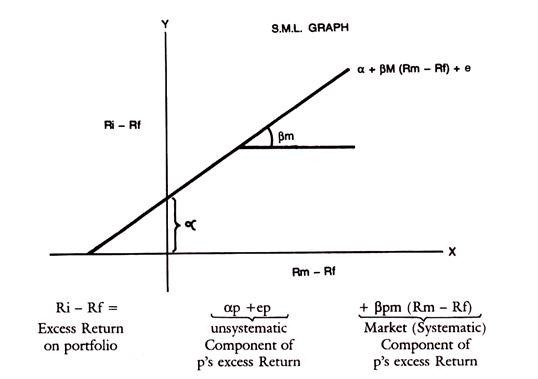
If thus the market index is used as a surrogate for other individual securities in the portfolio, the relation of any individual security with the Market index can be represented in a Regression line or characteristic line. This is drawn below, with the excess return on the security on the y-axis and excess return on the Market Portfolio on the x-axis.

The equation of the characteristic line is Ri – Rf = a + βim (Rm – Rf) + ei

Ri is the holding period return on security i

Rf is the riskless rate of interest

Alpha is the vertical intercept on y-axis representing the return on the security when only unsystematic risk is considered and systematic risk is measured by Beta. ci is the residual component, not captured by the above variables.

**[](http://cdn.economicsdiscussion.net/wp-content/uploads/2017/12/clip_image039_thumb2.jpg)**

**The sharpe equation is as follows:**

Rj = αj + βj + ej

Where αj is some constant, say risk free return

βj is the Beta which is a risk measure of the market called systematic risk

I is the value or return on the stock index.

ej is the residual factor which cannot be specified.

#### Optimal Portfolio of Sharpe Model:

This optimal portfolio of Sharpe is called the Single Index Model. The optimal portfolio is directly related to the Beta. If Ri is expected return on stock i and Rf is Risk free Rate, then the excess return = Ri – Rf This has to be adjusted to Bi, namely,

Ri – Rf/βi which is the equation for ranking Stocks in the order of their return adjusted for risk.

The method involves selecting a cut-off rate for inclusion of securities in a portfolio. For this purpose, excess return to Beta ratio given above has to be calculated for each stock and rank them from highest to lowest. Then only those securities which have Ri – Rf/βi, greater than cut-off point, fixed in advance can be selected.

**INVESTMENT COMPANIES IN INDIA**

**UNIT-V**

**Mutual Fund Meaning:**

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.

# Types of Mutual Funds

**I.MUTUAL FUNDS BASED ON FUND SCHEME:**

There are two key kinds of mutual funds on the basis of the constitution of the fund. This basically affects when investors can buy fund units and sell them.

* **CLOSE-ENDED SCHEMES:**

These schemes have fixed maturity periods. Investors can buy into these funds during the period when these funds are open in the initial issue. Once that window closes, such schemes cannot issue new units except in case of bonus or rights issues.

After that period, you can only buy or sell already-issued units of the scheme on the stock exchanges where they are listed. The market price of the units could vary from the NAV of the scheme due to demand and supply factors, investors' expectations and other market factors.

* **OPEN-ENDED SCHEMES:**  
   These funds, unlike close-ended schemes, do not have a fixed maturity period. Investors can buy or sell units at NAV-related prices from and to the mutual fund, on any business day. This means, the fund can issue units whenever it wants. These schemes have unlimited capitalization, do not have a fixed maturity date, there is no cap on the amount you can buy from the fund and the total capital can keep growing.

These funds are not generally listed on any exchange.   
Open-ended schemes are preferred for their liquidity. Such funds can issue and redeem units any time during the life of a scheme. Hence, unit capital of open-ended funds can fluctuate on a daily basis.

#### **II.MUTUAL FUNDS BASED ON ASSETS INVESTED IN:**

**There three kinds of mutual funds based on the assets invested in. These are as follows:**

#### **EQUITY FUNDS:**

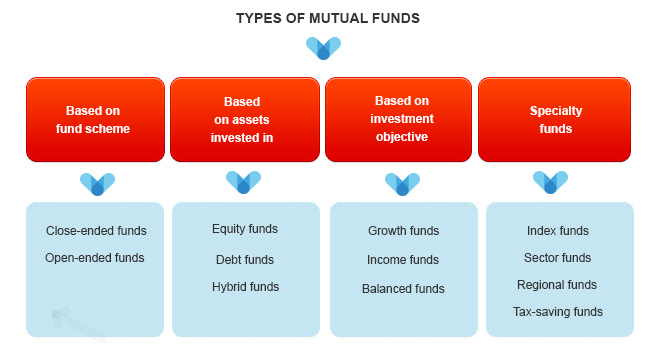
These are funds that invest only in stocks. As a result, they are usually considered high risk, high return funds. Most growth funds – the ones that promise high returns over a long-term – are [equity funds](http://www.kotaksecurities.com/ksweb/Research/Investment-knowledge-Bank/what-is-an-equity-fund).

#### **HYBRID FUNDS:**

These are funds which invest in both equities as well as debt instruments. For this reason, they are less risky than equity funds, but more than debt funds. Similarly, Similarly, they are likely to give you higher returns than [debt funds](http://www.kotaksecurities.com/ksweb/Research/Investment-knowledge-Bank/what-is-a-debt-fund), but lower than equity funds. As a result, they are often called 'balanced funds'.

#### **DEBT FUNDS:**

These funds invest in debt-market instruments like bonds, government securities, debentures and so on. These are called debt instruments because they are a kind of borrowing mechanism for companies, banks as well as the government.



#### **III.MUTUAL FUNDS BASED ON INVESTMENT OBJECTIVE:**

Every investor has a different reason for investing in financial instruments. Some do so for making profits and increasing wealth, while some others do so for a regular secondary source of income. Some others invest in mutual funds for a bit of both. Keeping these requirements in mind, there are three key kinds of mutual funds based on the investment objective.

#### **GROWTH FUNDS:**

These are schemes that promise capital returns in the long-term. They usually invest in equities. As a result, growth funds are usually high risk schemes. This is because the values of assets are subject to lot of fluctuations.

Also, unlike fixed-income schemes, growth funds usually pay lower dividends. They may also prefer to reinvest the dividend money into increasing the assets under management.

#### **BALANCED FUNDS:**

As the name suggests, these schemes try to strike a balance between risk and return. They do so by investing in both equities and debt instruments. As a result, they are a kind of hybrid fund. Their risk is lower than equity or growth funds, but higher than debt or fixed-income funds.

#### **FIXED-INCOME FUNDS:**

These are schemes that promise regular income for a period of time. For this reason, fixed-income funds are usually a kind of debt fund. This makes fixed-income funds low-risk schemes, which are unlikely to give you a large amount of profit in the long-run.

They pay higher dividends than growth funds. As with debt funds, they may be further classified on the basis of the specific assets invested in or on the basis of maturity.

#### **IV.SOME SPECIAL FUNDS:**

These are funds which invest in a specific kind of assets. They may be a kind of equity or debt fund.

#### **INDEX SCHEMES:**

Indices serve as a benchmark to measure the performance of the market as a whole. Indices are also formed to monitor performance of companies in a specific sector. Every index is formed of stock participants. The value of the index has a direct relation to the value of the stocks. However, you cannot invest in an index directly. It is merely an arbitrary number. So, to earn as much returns as the index, investors prefer to invest in an Index fund. The fund invests in the index stock participants in the same proportion as the index.

#### **REAL ESTATE FUNDS:**

These are not a sector-specific fund which invests in realty company shares. Instead, these funds invest directly in real estate. This may be by buying property or funding real estate developers.

#### **GILT FUNDS:**

These schemes primarily invest in government securities. Government debt is usually credit-risk free. Hence, the investor usually does not have to worry about credit risk.

#### **INTERVAL SCHEMES:**

These schemes combine the features of open-ended and closed-ended schemes. They may be traded on the stock exchange or may be open for sale or redemption during pre-determined intervals at NAV based prices.

#### **SECTOR FUNDS:**

These are a kind of equity scheme restrict their investing to one or more pre-defined sectors, e.g. technology sector.

#### **TAX-SAVING SCHEMES:**

Investors are now encouraged to invest in the equity markets through the [Equity Linked Savings Scheme (ELSS)](http://www.kotaksecurities.com/ksweb/Research/Investment-knowledge-Bank/what-is-elss) by offering them a tax rebate. When you invest in such schemes, your total taxable income falls. However, there is a limit of Rs 1 lakh for tax purposes. The crutch is that the units purchased cannot be redeemed, sold or transferred for a period of three years.

However, in comparison with other tax-saving financial instruments like Public Provident Funds (PPF) and Employee Provident Funds (EPF), ELSS funds have the lowest lock-in period. An example of ELSS scheme is the Kotak ELSS scheme.

#### **MONEY MARKET SCHEMES:**

These schemes – a kind of debt fund – invest in short-term instruments such as commercial paper (CP), certificates of deposit (CD), treasury bills (T-Bill) and overnight money (Call).

The schemes are the least volatile of all the types of schemes because of the short-term maturities of the money-market instruments. These schemes have become popular with institutional investors and high-net worth individuals having short-term surplus funds.

**Unit Trust of India:**

Unit Trust of India (UTI) is a statutory public sector investment institution which was set up in February 1964 under the Unit Trust of India Act, 1963.

UTI began operations in July 1964. It provides opportunity for small-savers to invest in areas where their risk is diversified.

The Unit-holders, if necessary, can sell their units to UTI at the prices determined by UTI. One of the attractions is that the investment in UTI has an income-tax rebate and the income from the UTI is exempted; from income-tax subject to certain limits.

**Objectives:**

**The primary objectives of the UTI are:**

(i) To encourage and pool the savings of the middle and low income groups.

(ii) To enable them to share the benefits and prosperity of the industrial development in the country.

**Organisation and Management:**

UTI was established with an initial capital of Rs. 5 crore, contributed by the RBI, LIC, SBI and its subsidiaries and scheduled banks and financial institutions. The initial capital of Rs. 5 crore was divided into 1,000 certificates of Rs. 50,000 each. To supplement its financial resources, the trust can borrow from the Reserve Bank of India, the amount being repayable on demand’ or within a period of 18 months.

UTI is managed by a Board of Trustees, consisting of a chairman and four members nominated by Reserve Bank of India, one member nominated by LIC, one member nominated by the State Bank of India, and two members elected by the contributing institutions.

**Functions of UTI:**

**The UTI functions are discussed below:**

(i) To accept discount, purchase or sell bills of exchange, promissory note, bill of lading, warehouse receipt, documents of title to goods etc.,

(ii) To grant loans and advances.

(iii) To provide merchant banking and investment advisory service.

(iv) To provide leasing and hire purchase business.

(v) To extend portfolio management service to persons residing outside India.

(vi) To buy or sell or deal in foreign exchange dealings.

(vii) To formulate unit scheme or insurance plan in association with or as agent of GIC.

(viii) To invest in any security floated by the Central Government, RBI or foreign bank.

**Activities of UTI:**

The UTI can sell and purchase the units issued by it, investing, acquire, hold or dispose off securities. Keep money on deposit with the scheduled banks and undertake related functions incidental or consequential to that. All the units issued by the UTI are of the value of Rs. 10 each. These units were put on sale at face value and thereafter at prices fixed daily by the UTI. Units can be purchased in ten or multiples of ten.

**Schemes of UTI:**

**The familiar schemes of UTI are given below:**

(i) Unit scheme—1964.

(ii) Unit Linked Insurance Plan—1971.

(iii) Children Gift Growth Fund Unit Scheme—1986.

(iv) Rajyalakhmi Unit Scheme—1992.

(v) Senior Citizen’s Unit Plan—1993.

(vi) Monthly Income Unit Scheme.

(vii) Master Equity Plan—1995.

(viii) Money Market Mutual Fund—1997.

(ix) UTI Growth Sector Fund—1999.

(x) Growth and Income Unit Schemes.

**Advantages of Unit Trust:**

**The advantages of Unit Trust are:**

(i) The investment is safe and the risk is spread over a wide range of securities.

(ii) The Unit-holders will be getting regular and good income, as 90 percent of its income will be distributed.

(iii) Dividends up to Rs. 1,000 received by the individual are exempt from income-tax.

(iv) There is a high degree of liquidity of investment as the units can be sold back to the trust at any time at prices fixed by trust.

## The structure of mutual funds as per SEBI guidelines

The SEBI guidelines define the Guarantor as one who, in his capacity as an individual or in partnership with a different entity or entities, launches a mutual fund. The role of the guarantor is to make revenue by putting together a mutual fund and handing it to the fund manager.

A sponsor sets up the mutual funds as per the guidelines of the Indian Trust Act, 1882, for Public Trust. They are responsible for listing with the SEBI, having provisions for resource management and ensuring the functioning of the fund takes place as per the SEBI guidelines.

The Trustee or Trust is established through a trust deed that is implemented by the sponsors of the funds and is accountable to all the investors of the mutual fund. The trustee company is regulated by the Indian Companies Act 1956, while the firm and the board members are overseen by the Indian Trust Act, 1882.  The Investment management of the trust is done through an Asset Management Company which is to be listed as per the regulations of Companies Act of 1956.

## 3. Role of SEBI in Mutual Fund Regulations

As far as Mutual funds are concerned, SEBI makes the policies for mutual funds and also regulates the industry. It lays guidelines for the mutual funds to safeguard the investors’ interest.

Mutual funds are very distinct in terms of their investment strategy and asset allocation activities. This requires bringing about uniformity in the functioning of the mutual funds that may be similar in schemes. This will assist the investors in taking investment decisions more clearly.

To facilitate this standardization and bringing about uniformity in the similar schemes, the mutual funds have been categorized accordingly as follows.

a. Equity Schemes

b. Debt Schemes

c. Hybrid Schemes

d. Solution Oriented Schemes

e. Other Schemes

## 4. Key Highlights of SEBI guidelines for Mutual Funds

a. Categorization of schemes into five groups – Equity, Debt, Hybrid, Solution Oriented, Others

b. To ensure uniformity, large, mid and small cap has been defined clearly

c. There is a lock-in period specified for solution-oriented schemes

d. Permission of only one scheme in each category, except for Index Funds/ Exchange Traded Funds (ETF), Sectoral/Thematic Funds and Funds of Funds.



## 5. SEBI Guidelines to invest in Mutual Funds

SEBI keeps in place the regulatory framework and guidelines that govern and regulate the financial markets in the country. The guidelines for investors are listed below.

### a) Assessment your personal financial situation

Mutual funds present the most diversified form of investment options and therefore may carry a certain amount of risk factor with it. Investors must be very clear in their assessment of their financial position and the risk-bearing capacity in the event of poor performance of such schemes. Investors must, therefore, consider their risk appetite in accordance with the investment schemes.

### b) Obtain researched information on the mutual funds’ investment schemes

Before venturing into mutual fund investment, it is imperative for you as an investor to obtain detailed information about the mutual fund scheme option. Having the right information when required to make the necessary decision is the key to making good investments. This may help in choosing the right schemes, knowing the guidelines to follow and also be informed of the investors’ rights.

### c) Diversify your portfolios

Diversification of portfolios allows investors to spread out their investments over various schemes thereby increasing chances of maximizing profits or mitigating risk of potentially huge losses. Diversification is crucial to gaining long-term and sustainable financial advantage.

### d) Avoid the clutter of portfolios

Choosing the right portfolio of funds requires managing and monitoring these schemes individually with care. The investor must not clutter the portfolio and decide on the right number of schemes to hold so as to avoid overlap and be able to manage each one of them equally well.

### e) Assign a time dimension to the investment schemes

It is advisable for the investors to assign a time frame to each scheme to encourage the financial growth of the plan. It may help in containing the volatility and fluctuations in the market if the plans are maintained stably over a period of time.

## 6. How will the new categorization Impact me as an investor

a. This may reduce the number of schemes on offer, thereby, making it comparatively easier to choose

b. It may have some schemes get merged with the others

c. It may cause your expense ratio to fall due to the higher AUM per scheme

**List of all stakeholders in Indian mutual fund industry is as follows:**

RBI

• SEBI

• 95 AMFI

• Ministry of Finance

• SROs (in general)

• Income Tax Regulations

**• Investors‘ Associations**

Association of Mutual Funds in India (AMFI) was incorporated on 22nd August, 1995. AMFI is an apex body of all Asset Management Companies (AMC) which has been registered with SEBI. Till date all the AMCs are that have launched mutual fund schemes are its members. It functions under the supervision and guidelines of its Board of Directors.

**Objectives of AMFI:**

To define and maintain high professional and ethical standards in all areas of• operation of mutual fund industry.

To recommend and promote best business practices and code of conduct to be followed by members and others engaged in the activities of mutual fund and asset management including agencies connected or involved in the field of capital markets and financial services.

To interact with the Securities and Exchange Board of India (SEBI) and to represent to SEBI on all matters concerning the mutual fund industry.

To represent to the Government, Reserve Bank of India and other bodies on all matters relating to the Mutual Fund Industry.

To develop a cadre of well trained Agent distributors and to implement a programme of training and certification for all intermediaries and other engaged in the industry.

To undertake nationwide investor awareness programme so as to promote proper understanding of the concept and working of mutual funds.

To disseminate information on Mutual Fund Industry and to undertake studies and research directly and/or in association with other bodies.

**MINISTRY OF FINANCE**

Ministry of Finance is the supervisor of both the RBI and SEBI. Aggrieved parties can make an appeal to MOF on the SEBI or RBI ruling relating to the mutual funds.

**SELF-REGULATORY ORGANIZATION (SRO)**

A self-regulatory organization (SRO) is an organization that exercises some degree of regulatory authority over an industry or profession. The regulatory authority could be applied in addition to some form of government regulation, or it could fill the vacuum of an absence of government oversight and regulation i.e. The stock exchanges are regulated by SEBI, but they are registered SROs. It means SEBI is a frontline regulator and SRO is a sub-regulator that reduces the burden of SEBI. **Objectives of SRO**

1. Promote the investor protection and insure the market operate in a fair manner.

2. Treat all its members in a fair manner.

3.Resolve any possible conflict of interest amongst the member

**INCOME TAX AND MUTUAL FUNDS**

Tax treatment for the Investors (Unit Holders) As per the taxation laws in force and Chapter VII of the Finance (No. 2) Act, 2004 pertaining to Securities Transaction Tax (STT), the tax benefits / consequences as 117 applicable, to the Mutual Fund in respect of its Mutual Fund schemes (being an equity oriented fund / other than equity oriented fund / money market mutual fund / liquid fund) and investors investing in the Units of its Mutual Fund Schemes