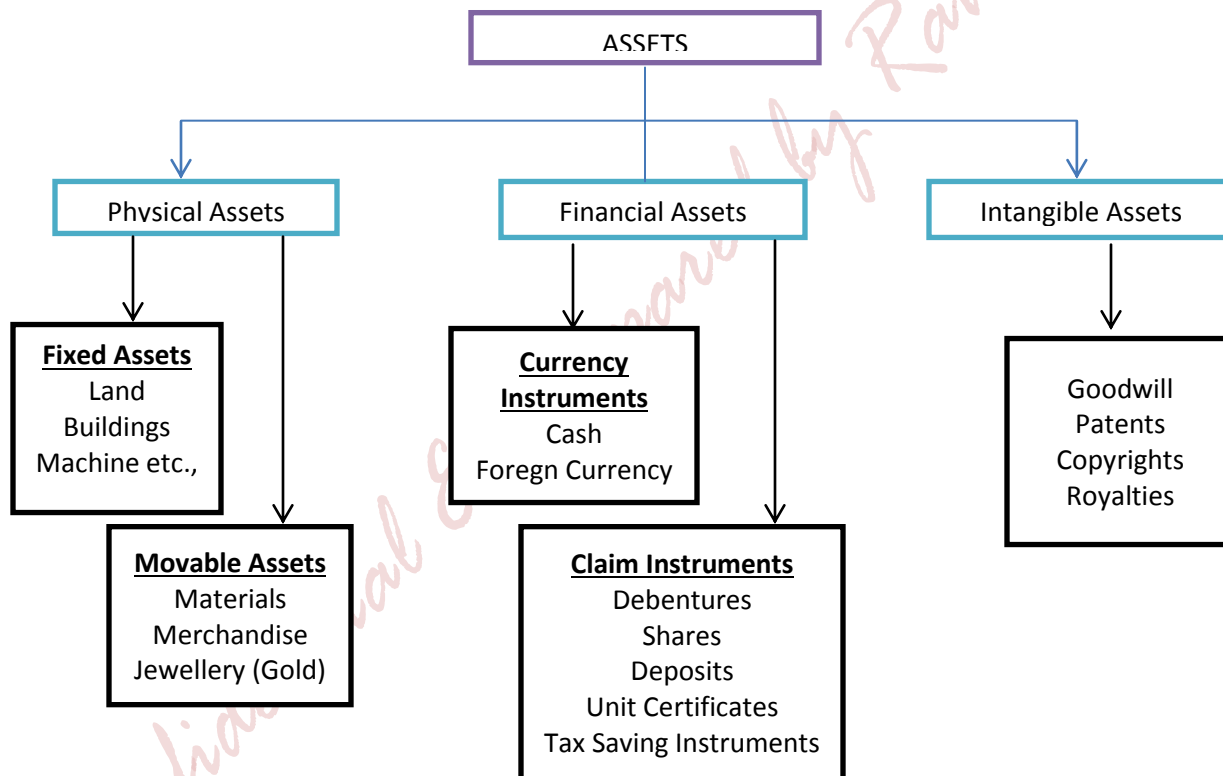


Security Analysis and Portfolio Management (Elective-I)

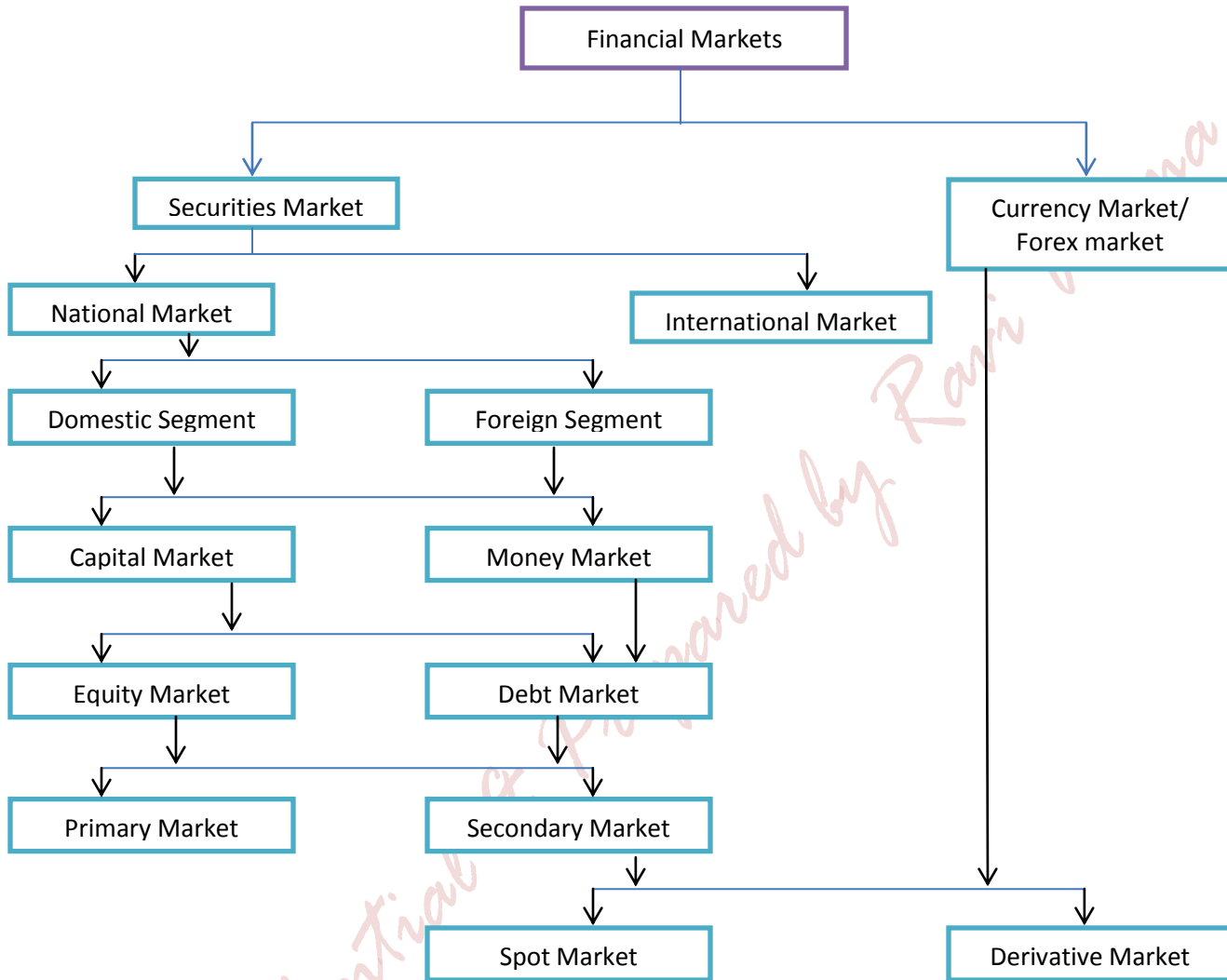
UNIT 1: INVESTMENTS

The investment environment



Source: Investment Analysis and Portfolio Management, M. Ranganatham & R. Madhumathi

Classification of Financial Markets:



Source: Investment Analysis and Portfolio Management, M. Ranganatham & R. Madhumathi

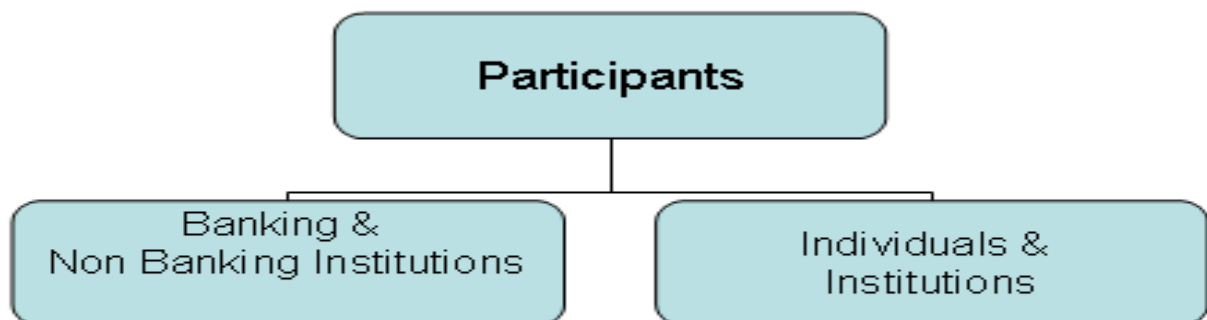
1.2 Classification of Financial Markets

Money Market Instruments

1. Call Market (14 Days)
2. Treasury Bills (Issued by RBI)
3. Certificate of Deposits (RBI)
4. Inter Bank Market
5. Ready Forward Contracts Market (REPO)
6. Commercial Papers
7. Commercial Bills
8. Inter-Corporate Deposit Market

Prepared

1.3 Functions & Participants of Financial Markets



***Main Function of Financial Market is to convert Domestic and Institutional savings into Investments.

Investment

Meaning & Definition: investment is an activity that is engaged in by people who have savings i.e. investments are made from savings.

Investment may be defined as a “commitment of funds made in the expectations of some positive rate of return.”

Characteristics of Investment:

- Return
- Risk
- Safety
- Liquidity

Objectives of Investment:

- Maximisation of Return
- Minimization of Risk
- Hedge against Inflation

Investment Vs Speculation: Traditionally investment is distinguished from speculation with respect to four factors. These are:

- Risk
- Capital Gain
- Time Period
- Leverage

Financial instruments (Investment Avenues available in India):

- Corporate Securities
- Deposits in banks and non-banking companies
- UTI and other mutual fund schemes

- Post office deposits and certificates
- Life insurance policies
- Provident fund schemes
- Government and semi government securities

Regulatory Environment: In India the ministry of finance, the reserve bank of india, the securities and exchange board of India etc. are the major regulatory bodies exercising regulatory control and supervision over the functioning of the financial system in the country.

Primary market or New Issue Market: when a new company is floated, its shares are issued to the public in the primary market as an IPO (shares or debentures). Similarly when a company decides to expand its activities using either equity finance or bond finance, the additional shares or bonds may be floated in the primary market.

Functions of New Issue Market:

- ✓ Origination
- ✓ Underwriting
- ✓ Distribution

Origination: Origination is the preliminary work in connection with the floatation of a new issue by a company. It deals with assessing the feasibility of the project, technical economic and financial as also making all arrangements for the actual floatation of the issue. As part of the origination work, decision may have to be taken on the following issues:

- ✓ Time of floatation of the issue
- ✓ Type of issue
- ✓ Price of the issue

Methods of floating new Issues:

- Public issue
- Rights issue
- Private Placements

Principal steps in floating a public issue: there are three distinct stages in the successful completion of a public issue.

- **Pre issue tasks**
- **Opening and closing of the issue**
- **Post issue tasks**

Pre issue tasks:

- Drafting and finalization of the prospectus
- Selecting the intermediaries and entering in to agreements with them
 - Merchant banker
 - Registrar to an issue: collect applications from investors. Keeping a record of applications and monies received from investors. Assisting the stock issuing company in determining the basis of allotment of securities in consultation with the stock exchanges. Finalizing the list of persons entitled to allotment of securities. Processing and dispatching allotment letters, refund orders certificates and other related documents.
 - Share transfer agent
 - Banker to an issue: acceptance of applications and application monies. Acceptance of allotment or call monies. Refund of application monies. Payment of dividend or interest warrants.
 - Other formalities

Opening and Closing Date of the Issue:

- Earliest closing date: should not be less than three days from the opening date.

- Latest Closing Date: shall not exceed ten days from the opening date.

Post Issue Tasks:

- All application forms have to be scrutinised processed and tabulated
- When the issue is under subscribed, underwriters are liable to subscribe to the shortfall
- When it is oversubscribed, the bases of allotment has to be decided in consultation with the stock exchange
- Allotment letters and certificates have to be dispatched to the allottees. Refunds have to be dispatched to the rejected applications.
- Shares have to be listed in the stock exchanges for trading, for this company has to enter in to a listing agreement with the stock exchange.

Regulation of Primary Market: up to 1992, primary market was controlled by the Controller of Capital Issues (CCI) appointed under the Capital Issues Control Act 1947. During that period, the pricing of capital issues was regulated by CCI. The SEBI was formed under the SEBI Act, 1992 with the prime objective of protecting the interests of investors in securities as well as for promoting and regulating the securities market. All public issues since jan, 1992 are governed by the rules, regulations and guidelines of issued by SEBI.

Book building:

SEBI guidelines defines book building as “A process undertaken by which a demand for the securities proposed to be issued by which a demand for the securities proposed to be issued by a body corporate is elicited and buildup and the price for such securities is assessed for the determination of the quantum of such securities to be issued by means of a notice, circular, advertisement document or information memoranda or offer document.”

Incase the issuing company chooses to issue securities through book building process, then as per SEBI guidelines the issuer company can select any of the following methods.

1. 100% Book Building
2. 75% Book Building and 25% Fixed Price
3. 90% Book Building and 10% Fixed Price

Secondary Market

Stock Exchanges – Definitions:

“A centralized market for buying and selling stocks where the price is determined through supply-demand mechanisms.”

“An organization that provides a facility for buyers and sellers of listed securities to come together to make trades in these securities.”

“Association of brokers and dealers in securities who transact business together.”

“An organized market place for securities featured by the centralization of supply and demand for the transaction of order's by members, brokers for institutional and individual investors.”

According to the Securities Contracts Act 1956, which is the main law governing stock exchanges in India, “Stock exchange means any body of individuals, whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities.”

Functions of Stock exchanges:

- It provides a market place for purchase and sale of securities such as shares, debentures, bonds etc.
- Stock exchanges provide liquidity to the investments in securities i.e. it gives the investors a place to liquidate their holdings.

- The stock exchanges help in the valuation of securities by providing the market quotations of the prices of securities.
- Stock exchanges play the role of a barometer, namely an indicator of the state of health of the nation's economy as a whole.

The stock exchanges provide the linkage between the savings in the household sector and the investments in the corporate sector. They indirectly help in mobilizing savings in channelizing them in to the corporate sector as securities.

No of Stock Exchanges in India and Important Exchanges:

There are 25 stock exchanges in India. In which most of the transactions are carried out by two exchanges namely

- Bombay Stock Exchange (BSE) and
- National Stock Exchange (NSE). Other important exchanges are
- Interconnected Stock Exchange of India (ISE)
- Over The Counter of Exchange of India (OTCEI)

Regulatory Body of Stock Exchanges:

The securities contracts (Regulations) Act 1956 was regulating secondary market till SEBI Act 1992.

Initially the SEBI was constituted as an interim administrative body in 1988 and given a statutory status on 30th Jan, 1992 by an ordinance to provide for the establishment of SEBI. Later in Apr, 1992 the SEBI Act was formed.

Securities trading:

Trading system in stock exchanges are:

- Floor Trading
- Screen Based Trading

The screen based trading systems are of two types:

1. Quote Driven System
2. Order Driven System

Quote Driven System: under the quote driven system the market maker, who is the dealer in a particular security, inputs, two way quotes into system i.e. his bid price (purchase) and offer price (Selling). Then the market participants place their orders based on the bid, order quotes. These are then automatically matched by the system according to certain rules.

Order Driven System: under the order driven system, clients place their buying and sell orders with the brokers. These are then fed in to the system. The buy and sell orders automatically matched by the system according to predetermined rules.

Types of orders:

- ✓ Market Order
- ✓ Limit Order
- ✓ Stop Order
- ✓ Stop Limit Orders
- ✓ Day Orders
- ✓ Week Orders
- ✓ Month Orders
- ✓ Open Orders (GTC Good Till Cancelled Orders)
- ✓ Fill or Kill Orders.

Clearing and settlement procedures: Trading in stock exchanges is carried out in two phases. In the first phase, the execution of the orders submitted by clients takes place between brokers acting on behalf of the clients or investors.

The process of securities, transfer of security and cash is done in the second phase which is known as the settlement of the trade.

The earlier procedure of settlement was accounting period settlement. The stock exchanges now follow a settlement procedure known as "Compulsory Rolling settlement as mandated by SEBI. (T+2)

T = Trade, T+1 = Custodian confirmation, T+2 = pay in / pay out of funds, T+3 = Auction of Shortage, T+4 = _____, T+5 = Pay in/ Pay off of auction shares.

Depositories: NSDL (Nov 6th 1996) & CDSL (July 15th 1999)

Types of Speculators:

Bulls Bears Lame Duck Stags

Calculation of Sensex and NIFTY

Sensex is calculated based on free float market capitalization method

Market cap= total no.of shares*share price

Free float market cap= Market cap of all the openly traded shares

Free float market cap= Market cap * proportion of the shares freely traded

Free float Shares =openly traded shares (Total no of shares - Promoters share)

Once the free float market cap of all the 30 stocks is calculated, it should be summed up and the value of sensed can be calculated based on the SENSEX base.

Thus the value of sensex is obtained

Base year for calculation of SENSEX is 1978-79

Base year for calculation of NIFTY is 1995.

Important Questions:

1. Define investment? Differentiate investment from Speculation? Describe briefly the important investment avenues available to savers in India?
2. What is a financial market? Distinguish between money market and capital market? Who are the participants in the financial markets? Describe their role?
3. Describe the functions of NIM? What is book building? Explain the steps involved in book building process?
4. What is a stock exchange? Describe the functions of Stock Exchanges? Write a short notes on OTCEI, NSE, ISE, BSE?
5. List out peculiarities of the stock exchange as a market? What is meant by settlement? Explain how a transaction is settled under the rolling system?
6. Write a short notes on

- a. Long buy
- b. Short sale
- c. Bull
- d. Bear
- e. Stag
- f. Sensex and Nifty

7. write in brief about calculation procedure of indices SENSEX and NIFTY?

Student Exercises:

- 1. BSE and NSE indices.
- 2. Stock exchanges, their formation and promoters.
- 3. Index model of BSE SENSEX and NSE NIFTY

Confidential & Prepared by Ravi Varma