SASURIE COLLEGE OF ENGINEERING

DEPARTMENT OF MASTER OF BUSINESS ADMINISTRATION

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II YEAR – III SEMESTER

BA4302

SECURITY ANALYSIS AND PORTFOLIO MANAGEMENT

BA4001 SECURITY ANALYSIS AND PORTFOLIO MANAGEMENT

UNIT I INVESTMENT SETTING Financial and economic meaning of Investment – Characteristics and objectives of Investment – Investment process -Types of Investment – Investment alternatives – Choice and Evaluation – Risk and return concepts - Valuation of bonds and stock.

UNIT II FUNDAMENTAL ANALYSIS Economic Analysis – Economic forecasting and stock Investment Decisions – Forecasting techniques. Industry Analysis : Industry classification, Industry life cycle – Company Analysis Measuring Earnings – Forecasting Earnings – Applied Valuation Techniques – Graham and Dodds investor ratios.

UNIT III TECHNICAL ANALYSIS Fundamental Analysis Vs Technical Analysis -- Dow theory – Charting methods - Chart Patterns Trend – Trend reversals – Market Indicators -Moving Average – Exponential moving Average Oscillators -RSI -ROC - MACD. Efficient Market theory - Forms of market efficiency -weak, semi-strong, strong form - Empirical tests of market efficiency -its application.

UNIT IV PORTFOLIO CONSTRUCTION AND SELECTION Portfolio analysis - Reduction of portfolio risk through diversification – Portfolio risk - Portfolio Selection - Feasible set of portfolios - Efficient set - Markowitz model - Single index model - Construction of optimum portfolio - Multi-index model.

UNIT V 9 Capital Asset Pricing model - Lending and borrowing - CML - SML - Pricing with CAPM - Arbitrage pricing theory– Portfolio Evaluation - Sharpe's index Treynor's index, Jensen's index – Mutual Funds – Portfolio Revision.

Unit 1: Investment Setting

Introduction:

- **Investment**is putting moneyinto something with the expectation of profit.The word originates in the Latin "vestis", meaning garment, and refers to the act of putting things (money or other claims to resources) into others' pockets.
- The term "investment" is used differently in economics and in finance. Economists refer to a real investment (such as a machine or a house), while financial economists refer to a financial asset, such as money that is put into a bank or the market, which may then be used to buy a real asset.

Financial meaning of investment:

- Financial investment involves of funds in various assets, such as *stock, Bond, Real Estate, Mortgages* etc.
- Investment is the employment of funds with the aim of achieving additional incomeor growth in value.
- It involves the commitment of resources which have been saved or put away from current consumption in the hope some benefits will accrue in future. Investment involves long term commitment of funds and waiting for a *reward in the future.*
- Fromthepointofviewpeoplewhoinvesttheirfinds,theyarethesupplierof Capitaland in their view investment is a commitment of a persons funds to derive future income in the form of interest, dividend, rent, premiums, pension benefits or the appreciation of the value of their principle capital.
- To the financial investor it is not important whether money is invested for a productive use or for the purchase of secondhand instruments such as existing shares and stocks listed on the stock exchange.

- Most investments areconsideredto betransfers of financialassets fromone personto another.

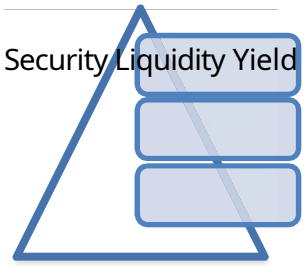
Economic meaning of investment:

- Economicinvestmentmeansthenetadditionstothecapitalstockofthesocietywhich consists of goods and services that are used in the production of other goods and services. Addition to the capital stock means an increase in building, plants, equipment and inventories over the amount of goods and services that existed.
- The financial and economic meanings are related to each other because investment is a part of the savings of individuals which flow into the capital market either directly or through institutions, divided innewand secondhand capital financing. Investorsassuppliersand investors asusersof long-term funds find a meeting place in the market.

Basic Investment Objectives

Investment triangle threecompromisingobjectives

Any investment decision will be influenced by three objectivessecurity, liquidity and yield. A best investment decision will be one, which has the best possible compromise between these three objectives.



- **Security:**

Central to any investment objective, we have to basically ensure the safety of the principal. One can afford to lose the returns at any given point of time but s/he can ill afford to lose the veryprincipal itself. By identifying the importance of security, we will beabletoidentifyandselecttheinstrumentthatmeetsthiscriterion.Forexample,when

compared with corporate bonds, we can vouch safe the safety of return of investment in treasury bonds as we have more faith in governments than in corporations. Hence, treasury bonds are highly secured instruments. The safest investments are usually found in the moneymarket and include such securities as Treasurybills (T-bills), certificates ofdeposit(CD), commercial paper or bankers' acceptance slips; or in the fixed income (bond) market in the form of municipal and other government bonds, and in corporate bonds

- **Liquidity:**

  Because we may have to convert our investment back to cash or funds to meet our unexpected demands and needs, our investment should be highly liquid. They should be en cashable at short notice, without loss and without any difficulty. If they cannot cometo our rescue, we may have to borrow or raise funds externally at high cost and at unfavorable terms and conditions. Such liquidity can be possible only in the case of investment, which has always-ready market and willing buyers and sellers. Such instruments of investment are called highly liquid investment.

- **Yield:**

  Yield is best described as the net return out of any investment. Hence given the level or kind of security and liquidity of the investment, the appropriate yield should encourage the investor to go for the investment. If the yield is low compared to the expectation ofthe investor, s/he may prefer to avoid such investment and keep the funds in the bank account or in worst case, in cash form in lockers. Hence yield is the attraction for any investment and normally deciding the right yield is the key to any investment.

Relationship:

- Thereisatradeoffbetweenrisk(security)andreturn(yield)ontheonehandandliquidity and return (yield) on the other.
- Normally, higher the risk any investment carries, the greater will be the yield, to compensatethe possible loss. Thatis why,flybynightoperators,offerskyhighreturns totheirinvestors andnaturallyourgullible investorsget carriedawaybysuchreturnsand ultimately lose their investment. Highly secured investment does not carry high coupon, as it is safe and secured.

- When the investment is illiquid, (i.e. one cannot get out of such investment at will and without any loss) the returns will be higher, as no normal investor would prefer such investment.
- These three pointssecurity, liquidity and yield in any investmentmake an excellent triangle in our investment decision-making. Ideally, with given three points of any triangle, one can say the center of the triangle is fixed. In our investment decision too,this centerthe best meeting point for S, L and Yis important for our consideration.
- However, if any one or two of these three points are disturbedsecurity, liquidity and yieldin any investmentthe centerof the triangle would be disturbed and one mayhave to revisit the investment decisioneither to continue the investment or exit theinvestment.
- All these pointssecurity, liquidity and yieldare highly dynamic in any market andtheyarealwayssubjecttochangeandhenceourinvestorhastoperiodicallywatchhis/her investment and make appropriate decisions at the right time.
- Ifourinvestorfailstomonitorher/hisinvestment,intheworstcircumstances,s/hemaylose the very investment.
- Thus, we will return to our original statement -A best investment decision will be one, which has the best possible compromise between these three objectivessecurity, liquidity and yield.

Secondary Objectives:

Tax Minimization:

An investor may pursue certain investments in order to adopt tax minimization as part of his or her investment strategy. A highly-paid executive, for example, may want to seek investmentswithfavorabletaxtreatmentinordertolessenhisorheroverallincometax

burden. Making contributions to an IRA or other tax-sheltered retirement plan, such as a 401(k), can be an effective tax minimization strategy.

Marketability / Liquidity:

Manyofthe investmentswehavediscussedare reasonablyilliquid, whichmeans theycannot be immediately sold and easily converted into cash. Achieving a degree of liquidity,however, requires the sacrifice of a certain level of income or potential for capital gains.
Commonstockisoftenconsideredthemostliquidofinvestments,sinceitcanusuallybesold within a day or two of the decision to sell. Bonds can also be fairly marketable, but some bonds are highly illiquid, or non-tradable, possessing a fixed term. Similarly, money market instruments may only be redeemable at the precise date at which the fixed term ends. If an investor seeks liquidity, money market assets and non-tradable bonds aren't likely to be held

CHARACTERISTICS OF GOOD INVESTMENT

a. Objective fulfillment

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

b. Safety

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

c. Return

- The return from any investment is expectedly consistent with the extent of risk assumed bytheinvestor.Riskandreturn gotogether.Highertherisk,higherthechancesofgetting higher return. An investment in a low risk - high safety investment such as investment in government securities will obviously get the investor only low returns.

d. Liquidity

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

e. Hedge against inflation

- Thepurchasingpowerofmoneydeterioratesheavilyinacountrywhichisnotefficientor not well endowed, in relation to another country. Investors, who save for the long term, look for hedge against inflation so that their investments are not unduly eroded; rather they look for a capital gain which neutralizes the erosion in purchasing power and still gives a return.

f. Concealabilty

- If not from the taxman, investors would like to keep their investments rather confidential from their own kith and kin so that the investments made for their old age/ uncertain future does not become a hunting ground for their own lives.Safeguarding of financial instruments representing the investments may be easier than investment made in real estate.Moreover, the real estate may be prone to encroachment and other such hazards.

h. Tax shield

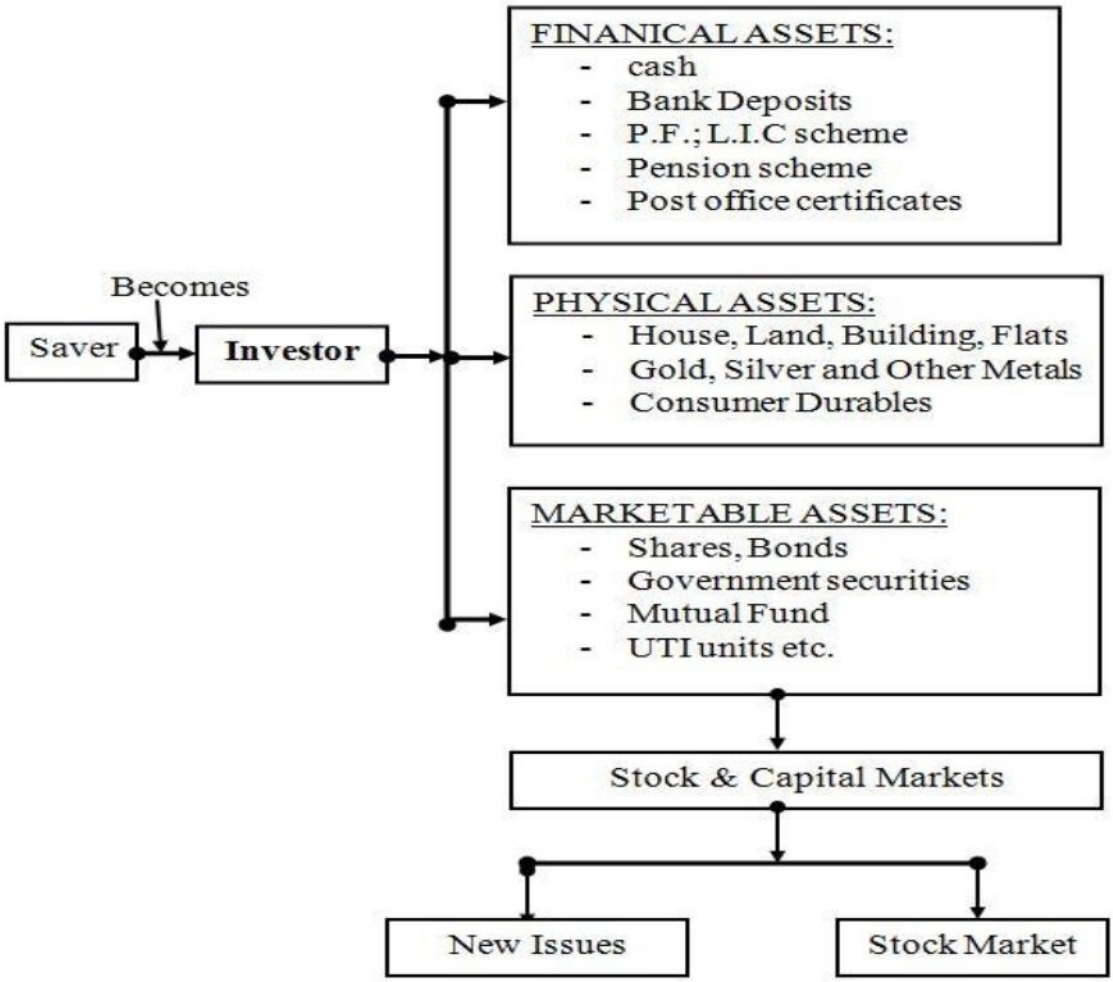
- Investment decisions are highly influenced by the tax system in the country.Investors lookforfront-end taxincentiveswhilemakinganinvestment andalsorear-end taxreliefs while reaping the benefit of their investments. As against taxincentives and reliefs, if investors wereto paytaxes on the income earned frominvestments, theylook for higher

returninsuchinvestmentssothattheiraftertaxincomeiscomparabletothepre-tax equivalent level with some other income whichis free of tax, but is more risky.

Different types of investors:

- ***Conservative***investorsofteninvestincash.THISmeansthattheyputtheirmoneyininterest bearing savings accounts,money market accounts, mutual funds, US Treasury bills, andCertificates of Deposit. These are very safe investments that grow over a long period of time. These are also low risk investments.
- ***Moderate***investors often invest in cash and bonds, and may dabble in the stock market. Moderateinvestingmaybelowor moderaterisks.Moderateinvestors often alsoinvestin real estate, providing that it is low risk real estate.
- ***Aggressive***investors commonly do most of THEIRinvesting in the stock market, which is higher risk. They also tend to invest in business ventures as well as higher risk real estate. For instance, if an aggressive investor puts his or her money into an older apartment building, then invests more money renovating the property, they are running a risk. They expect to be able to rent the apartments out for more money than the apartments are currently worth or to sell the entire property for a profit on their initial investments. In some cases, this works out just fine, and in other cases, it doesn't. It's a risk.

Types of investment: or various investment alternatives /avenues



Non-marketable Financial Assets:

A good portion of financial assets is represented by non-marketable financial assets. A distinguishing feature of these assets is that they represent personal transactions between the investor and the issuer. For example, when you open a savings bank account at a bank you deal with the bank personally. Incontrast when youbuy equity shares in the stock market youdo not know who the seller is and you do not care.These can be classified into the following broad categories:

- Post office deposits
- Company deposits
- Provident fund deposits
- **Bank deposits**

Equity Shares:

- Equities are a type of security that represents the ownership in a company. Equities are traded (bought and sold) in stock markets. Alternatively, they can be purchased via the InitialPublicOffering(IPO) route,i.e.directlyfrom thecompany.Investinginequitiesis a good long-term investment option as the returns on equities over a long time horizonare generally higher than most other investment avenues. However, along with the possibility of greater returns comes greater risk. Equity shares are classified into the following broad categories by stock market analysts:
    - Blue chip shares
    - Growth shares
    - Income shares
    - Cyclical shares
    - Speculative shares

Bonds:

Bondisadebtinstrumentissuedforaperiodofmorethanoneyearwiththepurposeof raising capital by borrowing.

It is certificates acknowledging the money lend by a bondholder to the company. It states it maturity date, interest rate, and par value.

TheFederalgovernment,states,cities,corporations,andmanyothertypes ofinstitutionssellbonds. When aninvestorbuys a bond, he/she becomes a creditorof theissuer. However,thebuyerdoesnotgainanykindofownershiprightstotheissuer,unlikeinthecase ofequities.Onthehand,abondholderhasagreaterclaimonanissuer'sincomethan ashareholderinthe caseof financialdistress (thisis trueforall creditors).The yieldfroma bond is made up of threecomponents:couponinterest,capital gainsand intereston interest (if a bond paysnocouponinterest,theonlyyieldwillbecapitalgains).Abondmightbesoldatabove orbelowpar(theamountpaidoutatmaturity),butthemarketpricewillapproachparvalueas the bond approaches maturity. A riskier bond has to providea higherpayoutto compensate for that additionalrisk.Somebondsare tax-exempt,andthesearetypicallyissuedbymunicipal,

county or stategovernments, whoseinterest payments are notsubject tofederalincome tax,and sometimes also state or local income tax.

Bonds may be classified into the following categories:

- Government securities
- Government of India relief bonds
- Government agency securities
- PSU bonds
- Debentures of private sector companies
- Preference shares

MoneyMarket Instruments:

Debtinstrumentswhichhaveamaturityoflessthanoneyearatthetimeofissuearecalled money market instruments. The important money market instruments are:

- Treasury bills
- Commercial paper
- Certificates of deposits

Mutual Funds:

Instead of directly buying equity shares and/or fixed income instruments, you can participate in variousschemesfloatedbymutualfundswhich, inturn,invest in equitysharesand fixedincome securities.

A mutual fund is made up of money that is pooled together by a large number of investors who give their money to a fund manager to invest in a large portfolio of stocks and / or bonds

Mutual fund is a kind oftrust that manages thepool of money collected from various investors anditismanagedbyateam ofprofessional fundmanagers (usually calledanAsset Management Company)for a small fee.Theinvestmentsby the Mutual Funds are made in equities, bonds, debentures, call money etc., depending on the terms of each scheme floated by the Fund.The current value of such investments is now a day is calculated almost on daily basis and the same is

reflected in the Net Asset Value (NAV) declared by the funds from time to time.This NAV keeps on changing with the changes in the equity and bond market.Therefore, the investments in Mutual Funds is not risk free, but a good managed Fund can give you regular and higher returns than when you can get from fixed deposits of a bank etc.

There are three broad types of mutual fund schemes:

- Equity schemes
- Debt schemes
- Balanced schemes

Life Insurance:

In a broad sense, life insurance may be viewed as an investment. **Life insurance**is a contract betweenthepolicyholder andtheinsurer,wheretheinsurerpromisestopaya designatedbeneficiarya sum of money (the "benefits") upon the death of the insured person. Depending onthecontract, otherevents suchas terminalillnessorcriticalillnessmay also triggerpayment.Inreturn,thepolicyholderagreestopayastipulatedamount(the"premium")at regular intervals or in lump sums. The important types of insurance policies in India are:

- Endowment assurance policy
- Money back policy
- Whole life policy
- Term assurance policy

Real Estate:

For the bulk of the investors the most important asset in their portfolio is a residential house. In addition to a residential house, the more affluent investors are likely to be interested in the following types of real estate:

- Agricultural land
- Semi-urban land

- Time share in a holiday resort

Precious Objects:

Precious objects areitems that aregenerallysmall in size but highlyvaluable in monetaryterms. Some important precious objects are:

Goldandsilver

Preciousstones

Art objects

Financial Derivative:

A financial derivative is an instrument whose value is derived from the value of an underlying asset. It may be viewed as a side bet on the asset. The most important financial derivatives from the point of view of investors are:

- Options
- Futures

Non-financialInstruments Real

estate

- With the ever-increasing cost of land, real estate has come up as a profitable investment proposition.

Gold

- The 'yellow metal' is a preferred investment option, particularly when markets are volatile. Today, beyond physical gold, a number of products which derive their value from the price of gold are available for investment. These include gold futures and gold exchange traded funds.

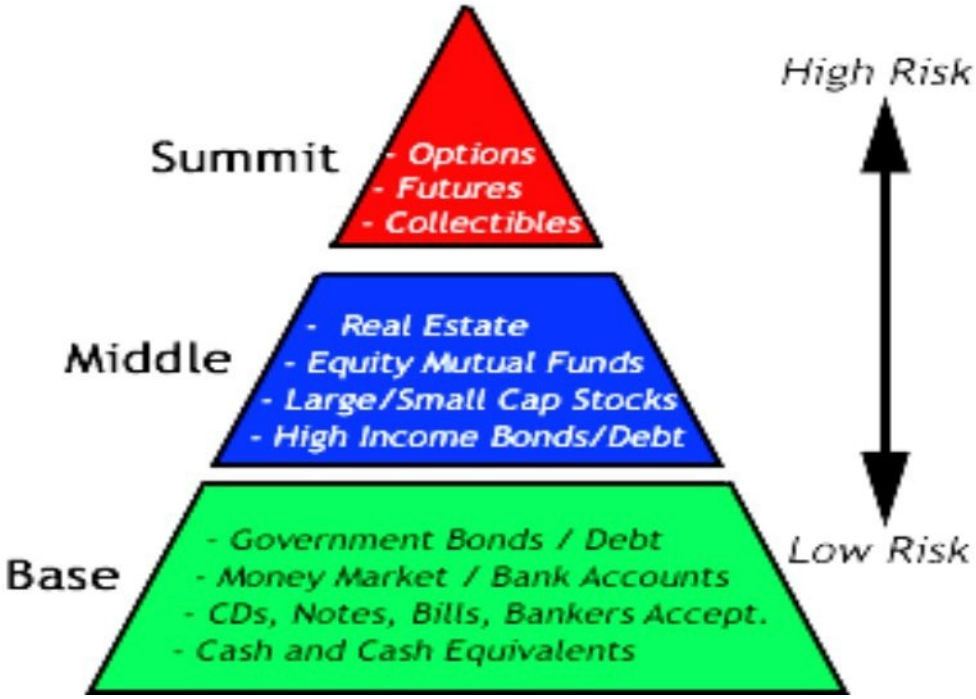
InvestmentRiskandReturn Characteristics

The chart below provides some examples of common types of investments classified accordingto their potential return and investment risk.

Potential Return	InvestmentRisk (Volatility)	Examples of Common Investments
High	High	• Aggressive growth funds • Emerging markets mutual funds • Foreign company stocks • Global,international,sector,andpreciousmetal mutual funds • Penny stocks • Small cap stocks and funds • Variableannuitiesinvestedinaggressivegrowth sub-accounts
Moderate	Moderate	• Convertible bonds • High-yield (junk) bond funds • Large-cap stocks and funds • S&P 500 & Wilshire 5000 stock index funds • Variableannuitiesinvestedinlarge-capstocksub-accounts
L	Low	• Fixed annuities • Government agency securities (e.g., Ginnie Maes) • Highqualityshort-andintermediate-termmunicipal and corporate bonds and bond funds • Money market mutual funds • Treasury bills and notes • U.S. savings bonds (Series I and EE) • Variableannuitiesinvestedinhigh-qualitybond sub-accounts

InvestmentRisk Pyramid

Afterdecidingonhowmuchriskisacceptableinyourportfoliobyacknowledgingyourtime horizon and bankroll, you can use the risk pyramid approach for balancing your assets.



Thispyramidcanbethoughtofas anasset allocationtool thatinvestorscan usetodiversifytheir portfolio investments according to the risk profile of each security. The pyramid, representingthe investor's portfolio, has three distinct tiers:

Base of the PyramidThe foundation of the pyramid represents the strongest portion, which supports everything above it. This area should be comprised of investments that are low in risk and have foreseeable returns. It is the largest area and composes thebulk of your assets.

Middle PortionThis areashould be made up of medium-risk investments that offer a stablereturn whilestill allowingfor capital appreciation. Althoughmoreriskythan the assets creating the base, these investments should still be relatively safe.

SummitReserved specifically for high-risk investments, this is the smallest area ofthe pyramid (portfolio) and should be made up of money you can lose without any serious repercussions. Furthermore, money in the summit should be fairly disposableso that you don't have to sell prematurely in instances where there are capital losses.

1.10 TYPES OF RISKS:

Personal Risks

This category of risk deals with the personal level of investing. The investor is likely to have more control over this type of risk compared to others.

Timing riskis the risk ofbuyingthe rightsecurity at the wrong time. It also refersto selling the rightsecurity at the wrong time. For example, there is the chancethat a few daysafter yousell a stock it will go up several dollars in value. There is no surefire way to time the market.

Tenure risk is the risk of losing money while holding onto a security. During the period of holding, markets may go down, inflation may worsen, or a company may go bankrupt. There is always the possibility of loss on the company-wide level, too.

Company Risks

There are two common risks on the company-wide level. The first, **financial risk** is the danger that a corporation will not be able to repay its debts. This has a great affect on its bonds, which finance the company's assets. The more assets financed by debts (i.e., bonds and money market instruments), the greater the risk. Studying financial risk involves looking at a company's management, its leadership style, and its credit history.

Management risk is therisk thata company'smanagementmayrunthe companyso poorlythat itis unabletogrow invalue orpaydividendstoitsshareholders.This greatlyaffectsthe valueof its stock and the attractiveness of all the securities it issues to investors.

Market Risks

Fluctuation in the market as a whole may be caused by the following risks:

Market riskisthe chancethatthe entiremarketwill decline,thusaffectingthepricesandvalues ofsecurities. Marketrisk, in turn,is influencedbyoutsidefactors suchas embargoesand interest rate changes. See Political risk below.

Liquidity riskis the risk that an investment, when converted to cash, will experience loss in its value.Whenyouwanttosellthestockyouarecurrentlyholding,thereisnobodythere to buy your stock, meaning that there is no volume in that stock.

Interest rate riskistherisk thatinterestrates willrise,resultinginacurrent investment'slossof value. A bondholder, for example, may hold a bond earning 6% interest and then see rates onthat type of bond climb to 7%.

Inflation riskis the danger that the dollars one invests will buyless in the future because prices of consumer goods rise. When the rate of inflation rises, investments have less purchasingpower.Thisis especiallytruewith investmentsthat earnfixedratesof return. Aslongastheyare held at constant rates, they are threatened by inflation. Inflation risk is tied to interest rate risk, becauseinterest rates often riseto compensatefor inflation**. Return of investment (ROI) is less than the market inflation rate.**

e.g. Return of investment (ROI) : 5%; Market Inflation rate (IR) : 8.5%

Exchange rate riskis the chance that a nation's currency will lose value when exchanged for foreign currencies.

Reinvestment riskis the danger that reinvested money will fetch returns lower than thoseearned before reinvestment. Individuals with dividend-reinvestment plans are a group subject to this risk. Bondholders are another.

National And International Risks

National and world events can profoundly affect investment markets.

Economic riskis the danger that the economy as a whole will perform poorly. When the whole economy experiences a downturn, it affects stock prices, the job market, and the prices of consumer products.

Industry riskis the chance that a specific industry will perform poorly. When problems plague oneindustry,theyaffecttheindividualbusinessesinvolvedaswellasthesecuritiesissuedby

those businesses. They may also cross over into other industries. For example, after a national downturn in auto sales, the steel industry may suffer financially.

Tax riskis the danger that rising taxes will make investing less attractive. In general, nations with relatively low tax rates, such as the United States, are popular places for entrepreneurial activities. Businesses that are taxed heavily have less money available for research, expansion, and even dividend payments. Taxes are also levied on capital gains, dividends and interest. Investors continually seek investments that provide the greatest net after-tax returns.

Political riskis the danger that government legislation will have an adverse affect oninvestment. This can be in the form of high taxes, prohibitive licensing, or the appointment of individuals whose policies interfere with investment growth. Political risks include wars,changes in government leadership, and politically motivated embargoes.

Investors and speculators:

Investors:

The investors buy the securities with a view to invest their savings in profitable income earning securities.Theygenerallyretainthesecurities foraconsiderable lengthof time. Theyareassured of a profit in cash. They are also called genuine investors.

Speculators:

The speculators buy securities with a hope to sell them at a profit in future. They do not retain theirholdings fora longer period.Theybuythesecuritieswith the objectof sellingthem andnot to retain them. They are interested only in price differentials. They are not genuine investors.

Differences between investors and speculators:

S.No	Investors	Speculators
1	Aninvestors isinterestedin safety of his investment	A speculators is interested inappreciationofcapitalandearning profits quickly

2	Seeks income from his investment	Seeks profit from sale and purchase of securities
3	Makes payment and takes delivery of the securities on purchasing. Receives payment anddeliversthesecuritieson sales.	He neither delivers nor takes the deliveryof the securities on sale or purchase.
5	Retains holding for longer periodi.e.commitmentisfor longer period of time	Triestosellthesecuritiesquickly iehiscommitmentisforshorter period.
6	Risk is low	Risk is high
7	Stable income	Earnings of profit is uncertain
8	His income depends on the earnings of the enterprise	The profit earned by him depends on the fluctuation/change in the market price of securities.

Speculation:

Speculation refers to the buying and selling of securities in the hope of making a profit from expected change in the price of securities. Those who engage in such activity are known as speculators.

A speculator may buy securities in expectation of rise in price. If his expectation comes true, he sells the securities for a higher price and makes a profit. Similarly a speculator may expect apriceto fall andsell securities atthe currenthighprice to buyagainwhen pricesdecline. He will make a profit if prices decline as expected. The benefits of speculation are:

1. It leads to smooth change and prevents wide fluctuations in security prices at different times and places
2. Speculativeactivityandtheresultingeffectinthe pricesofsecuritiesprovidedaguidance to the public about the market situation.

Differences between speculation and gambling:

S.No	Speculation	Gambling
1	Itisbasedonknowledgeand foresight	Itisbasedonchanceofevents happening.
2	It is a lawful activity	It is an illegal activity
3	It performs economic functions	Ithasnobenefitstooffertothe economy
4	Speculatorsbearstheriskof lossonthebasisoflogical reasoning	Gamblersbeartheriskoflossonthe basis of blind and reckless expectation.

UNIT II
SECURITIES MARKETS

Financial Market- SegmentsTypes - - Participants in financial MarketRegulatory Environment,PrimaryMarketMethodsoffloatingnewissues,BookbuildingRoleofprimary marketRegulationof primary market,Stock exchanges in IndiaBSE,OTCEI, NSE, ISE,and Regulations of stock exchangesTrading system in stock exchangesSEBI.

FINANCIAL MARKETS

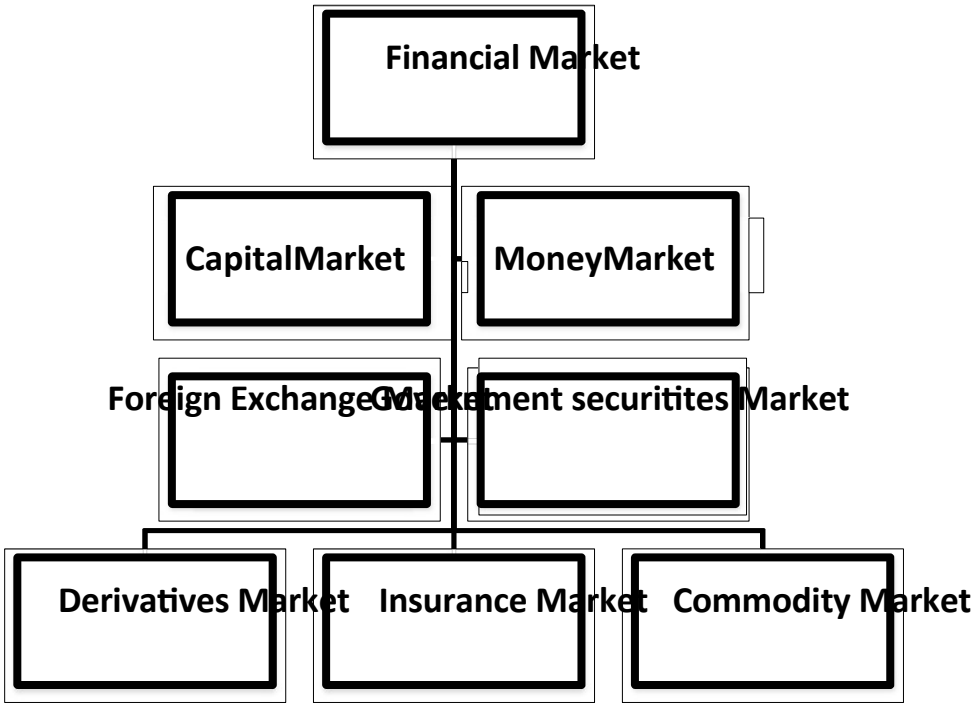
- In economics, a **financial market** is a mechanism that allows people to buy and sell (trade) financial securities (such as stocks and bonds), commodities (such as precious metals or agricultural goods), and other fungible items of value at low transaction costs and at prices that reflect the efficient-market hypothesis. Financial markets can be domestic or they can be international.
- In finance, financial markets facilitate:

    - The raising of capital (in the capital markets)
    - The transfer of risk (in the derivatives markets)
    - International trade (in the currency markets)

-And are used to match those who *want*capital to those who *have*it.

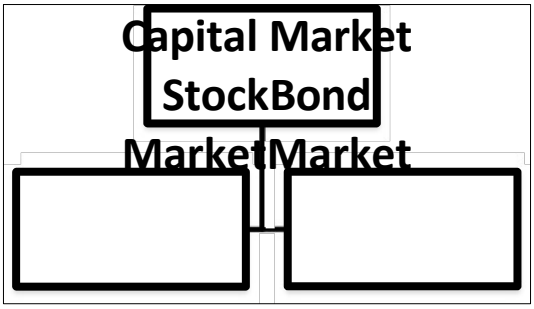
TYPES OF FINANCIAL MARKETS

The financial markets can be divided into different subtypes:



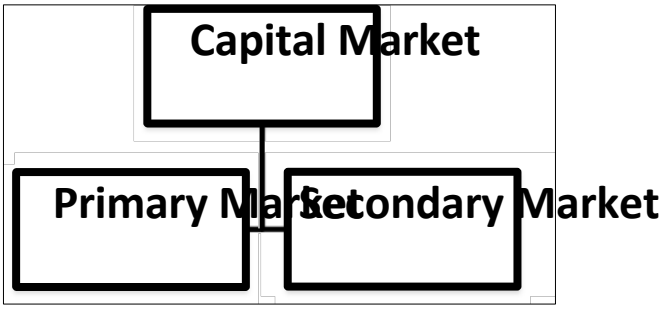
(A) Capital Market:

- Thecapitalmarketdealsinlongtermfunds(sharesanddebentures).Companiesraise their capital through the issue of shares and debentures.
- **Capital** markets which consist of:



- ✓ **Stockmarkets,**whichprovidefinancingthroughtheissuanceofsharesor common stock, and enable the subsequent trading thereof.
- ✓ **Bond markets,** which provide financing through the issuance of **bonds,** and enable the subsequent trading thereof.

Another classification of capital market is as follows:



Primary Market:

- Primary market refers to the sale of shares, directly by the company at the time of promotion and the investors directly buy the shares from the company through application.
- Newly formed (issued) securities are bought or sold in primary markets.
- The share price will be mostly at par.

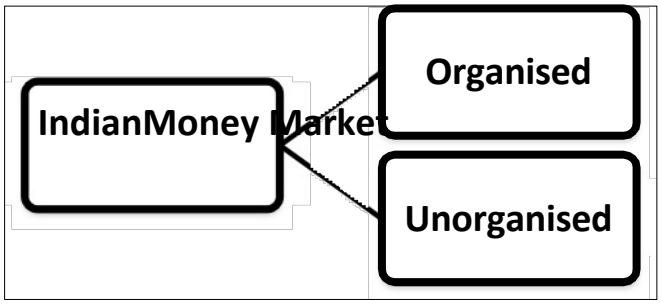
Secondary Market:

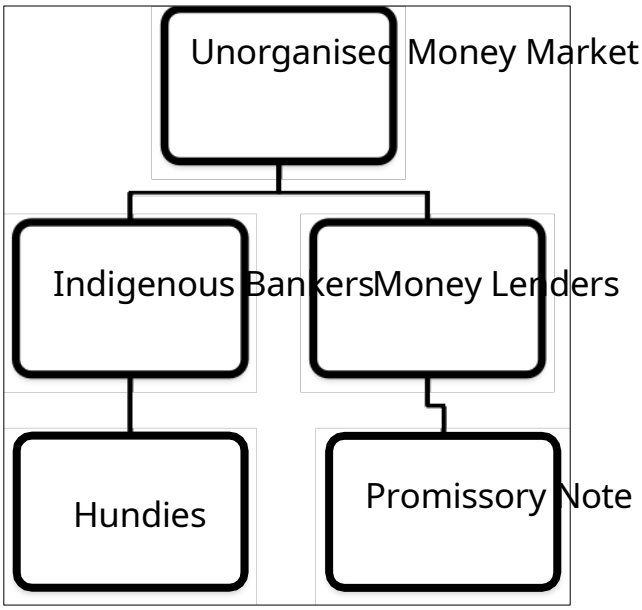
- Secondarymarketsallowinvestorstosellsecuritiesthattheyholdorbuyexisting securities.
- Heresaleandpurchaseofsecuritieswilltakeplacethroughtherecognizedstock exchanges.
- Onlyauthorizedpersonsareallowedtodealinthesecuritiesinthesecondarymarket, who are known as brokers.
- Only listed securities will be traded in the stock exchanges.

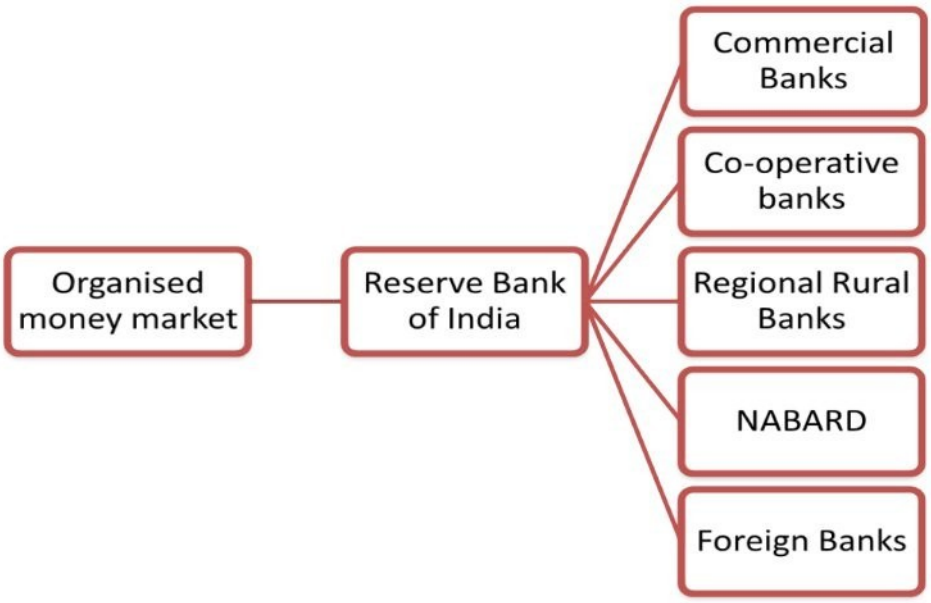
(B) Money markets:

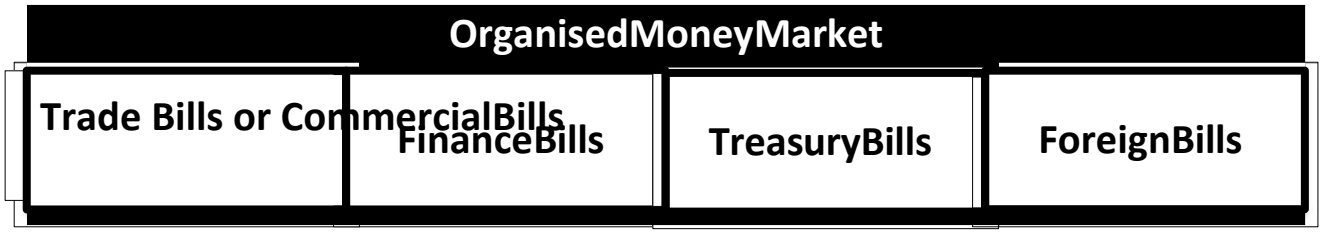
- Moneymarketdealsinshorttermfundswhichprovideshorttermdebtfinancingand investment.
- In fact there is no fixed place as money market.

- Theterm moneymarket refersto acollective namegiven to alltheinstitutions whichare dealing in short term funds.
- Money market provides working capital.









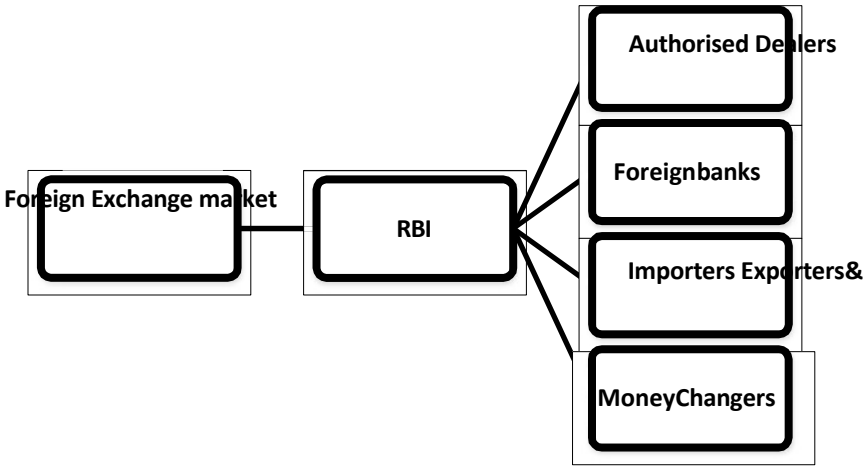
(C) Commodity Market & Derivative market& Insurance Market:

- **Commodity markets,**which facilitate the trading of commodities
- **Derivativesmarkets**, which provideinstruments for themanagement of**financial**risk.
    - **Futuresmarkets,**whichprovidestandardized**forwardcontracts**fortrading products at some future date; see also **forward market.**
- **Insurance markets,**which facilitate the redistribution of various risks.

(D) **Foreign exchange markets**

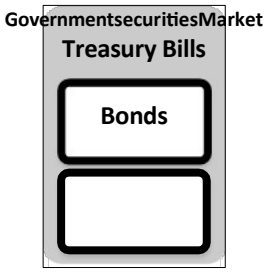
- **Foreign exchange markets,** which facilitate the trading of **foreign exchange. Foreign exchange** is bought and sold and the different forms of foreign currency are dealt. In India,foreignexchangeisheldbyReservebankofIndiawhichistheexchangecontrol

authority. We have then Foreign Exchange Regulation Act which is now renamed as Foreign Exchange Management Act (FEMA) to deal with Foreign exchange.



(E) Government Securities Market:

It can be divided as follows:



When government is in need of funds to meet its budgetary deficits, it goes for the issue of treasury bills and bonds.

Treasury bills and bonds:

Treasury bills are issued for raising short term funds and mainly to meet revenue expenditure. Bonds are issued for raising long term loans and these are repayable over a periodof15or20years.Normallytheyaresubscribedbyfinancialinstitutionsasthese

securities carry attractive interest rates and they can be sold easily in the market. It is for this reason; they are called as liquid assets.

The main functions of financial market are:

1) To facilitate creation and allocation of credit and liquidity.
2) To serve as intermediaries for mobilization of savings
3) To assist process of balanced economic growth;
4) To provide financial convenience

Financial market functions:

Financial markets serve six basic functions. These functions are briefly listed below:

- *Borrowing and Lending:*Financial markets permit the transfer of funds (purchasing power) from one agent to another for either investment or consumption purposes.
- *Price Determination:*Financial markets provide vehicles by which prices are set both for newly issued financial assets and for the existing stock of financial assets.
- *Information Aggregation and Coordination:* Financial markets act as collectors and aggregators of information about financial asset values and the flow of funds fromlenders to borrowers.
- *Risk Sharing:*Financial markets allow a transfer of risk from those who undertake investments to those who provide funds for those investments.
- *Liquidity:*Financialmarketsprovidethe holdersof financialassetswitha chancetoresell or liquidate these assets.
- *Efficiency:*Financial markets reduce transaction costs and information costs.

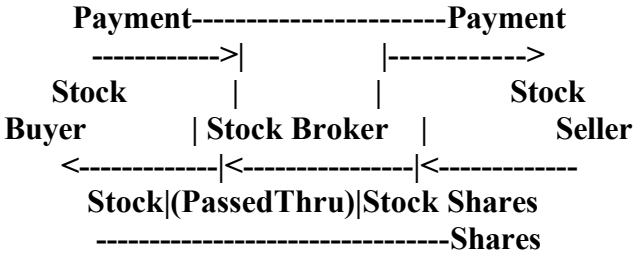
PARTICIPANTS IN FINANCIAL MARKET:

In the financial markets, there is a flow of funds from one group of parties (funds-surplus units) known as investors to another group (funds-deficit units) which require funds. However, often these groups do not have direct link. The link is provided by market intermediaries such as brokers,mutual funds, leasing and finance companies, etc. Inall, there is a very large number of players and participants in the financial market.

Brokers:

A*broker*is a commissioned agent of a buyer (or seller) who facilitates trade by locating a seller (or buyer) to complete the desired transaction. A broker does not take a position in the assets he or she trades -- that is, the broker does not maintain inventories in these assets. The profits of brokersare determined bythecommissionstheychargeto theusers of their services(the buyers, the sellers, or both). Examples of brokers include real estate brokers and stock brokers.

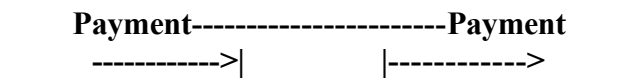
Diagrammatic Illustration of a Stock Broker:

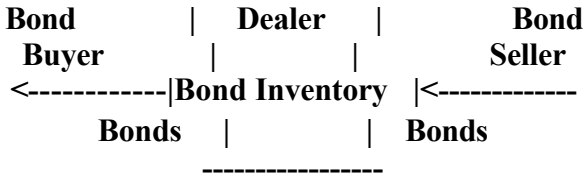


Dealers:

Like brokers, dealers facilitate trade by matching buyers with sellers of assets; they do notengage in asset transformation. Unlike brokers, however, a dealer can and does "take positions" (i.e., maintain inventories) in the assets he or she trades that permit the dealer to sell out of inventory rather than always having to locate sellers to match every offer to buy. Also, unlike brokers,dealers do not receive sales commissions. Rather, dealers make profits by buying assets at relatively low prices and reselling them at relatively high prices (buy low - sell high). Thepriceatwhichadealerofferstosell anasset(the"askedprice")minus thepriceatwhich adealer offers to buy an asset (the "bid price") is called the *bid-ask spread* and represents the dealer's profit margin on the asset exchange. Real-world examples of dealers include car dealers, dealers in U.S. government bonds, and NASDAQ stock dealers.

Diagrammatic Illustration of a Bond Dealer:





Investment Banks:

An*investment bank*assists in the initial sale of newly issued securities (i.e., in IPOs = Initial Public Offerings) by engaging in a number of different activities:

- *Advice*:Advisingcorporationsonwhethertheyshouldissuebondsorstock,and,forbond issues, on the particular types of payment schedules these securities should offer;
- *Underwriting*: Guaranteeing corporations a price on the securities they offer, either individually or by having several different investment banks form a syndicate to underwrite the issue jointly;
- *SalesAssistance*: Assisting in the sale of these securities to the public.

Some of the best-known U.S. investments banking firms are Morgan Stanley, Merrill Lynch, Salomon Brothers, First Boston Corporation, and Goldman Sachs.

Financial Intermediaries:

Unlike brokers, dealers, and investment banks,*financial intermediaries*are financial institutions that engage in financial asset transformation. That is, financial intermediaries purchase one kind of financial asset from borrowers -- generallysome kind of long-term loan contract whose terms areadaptedto thespecificcircumstancesof theborrower(e.g.,a mortgage) -- andsell adifferent kind of financial asset to savers, generally some kind of relatively liquid claim against the financial intermediary (e.g., a deposit account). In addition, unlike brokers and dealers, financial intermediaries typically hold financial assets as part of an investment portfolio rather than as an inventory for resale. In addition to making profits on their investment portfolios, financial intermediaries make profits by charging relatively high interest rates to borrowers and paying relatively low interest rates to savers.

Types of financial intermediaries include:*Depository Institutions*(commercial banks, savings and loan associations, mutual savingsbanks, credit unions);*Contractual SavingsInstitutions*(life insurance companies, fire and casualty insurance companies, pension funds, government retirement funds); and*Investment Intermediaries* (finance companies, stock and bond mutual funds, money market mutual funds).

These can be grouped as follows :

The individuals: These are net savers and purchase the securities issued by corporates. Individuals provide funds by subscribing to these security or by making other investments.

The Firms or corporates: The corporates are net borrowers. They require funds for different projects from time to time. They offer different types of securities to suit the risk preferences of investorsSometimes, the corporates invest excess funds, as individuals do. The funds raised by issue of securities are invested in real assets like plant and machinery. The income generated by these real assets is distributed as interest or dividends to the investors who own the securities.

Government: Government may borrow funds to take care of the budget deficit or as a measure of controlling the liquidity, etc. Government may require funds for long terms (which are raised by issue of Government loans) or for short-terms (for maintaining liquidity) in the moneymarket.Governmentmakesinitialinvestmentsinpublicsectorenterprisesbysubscribingtothe,

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shares,however,theseinvestments(shares)maybesoldtopublicthroughtheprocessof disinvestments.

Regulators: Financial system is regulated by different government agencies. The relationshipsamongotherparticipants,thetradingmechanismandtheoverallflowoffundsaremanaged, supervised andcontrolled bythese statutory agencies. In India,two basic agenciesregulatingthe financialmarketaretheReserveBankofIndia(RBI)andSecuritiesandExchangeBoardof India (SEBI). Reserve Bank of India, being the Central Bank, has the primary responsibility ofmaintainingliquidityinthemoneymarketItundertakesthesaleandpurchaseofT-Billson behalfoftheGovernmentofIndia.SEBIhasaprimaryresponsibilityofregulatingand supervisingthecapitalmarket.IthasissuedanumberofGuidelinesandRulesforthecontrol andsupervisionofcapitalmarketandinvestors protection.Besides,thereisanarrayof legislations and government departments also to regulate the operations in the financial system.

MarketIntermediaries: Thereareanumberofmarketintermediariesknownasfinancial intermediariesormerchantbankers,operatinginfinancialsystem.Thesearealsoknownas investmentmanagersorinvestmentbankers.The objectiveoftheseintermediariesistosmoothen theprocessofinvestmentandtoestablishalinkbetweentheinvestorsandtheusersoffunds. Corporations and Governments do not market their securities directly to the investors. Instead,they hire the services of the market intermediaries to represent them to the investors. Investors,particularly small investors, find it difficult to make direct investment. A small investor desiring to invest may not find a willing and desirable borrower. He may not be able to diversify acrossborrowerstoreducerisk.Hemaynotbeequippedtoassessandmonitorthecreditriskof borrowers. Market intermediaries help investors to select investments by providing investmentconsultancy, market analysis and credit rating of investment instruments. In order to operate insecondarymarket,theinvestorshavetotransactthroughsharebrokers.Mutualfundsandinvestmentco mpaniespoolthefunds(savings)ofinvestorsandinvestthecorpusindifferent investment alternatives. Some of the market intermediaries are:

- Lead Managers
- Bankers to the Issue
- Registrar and Share Transfer Agents
- Depositories
- Clearing Corporations

- Share brokers
- Credit Rating Agencies
- Underwriters
- Custodians
- Portfolio Managers
- Mutual Funds
- Investment Companies

These market intermediaries provide different types of financial services to the investors. They provide expertise to the securities issuers. They are constantly operating in the financial market. Small investors in particular and other investors too, rely on them. It is in their (market intermediaries) own interest to behave rationally, maintain integrity and to protect and maintain reputation, otherwise the investors would not be trusting them next time. In principle, these intermediaries bring efficiency to corporate fund raising by developing expertise in pricing new issues and marketing them to the investors.

REGULATORY ENVIRONMENT:

Financial system is regulated by different government agencies. The relationships among other participants, the trading mechanism and the overall flow of funds are managed, supervised and controlled by these statutory agencies. In India, two basic agencies regulating the financial market are theReserve Bank of India(RBI) and Securities and Exchange Board of India (SEBI). Reserve Bank of India, being the Central Bank, has the primary responsibility of maintaining liquidity in the money marketIt undertakes the sale and purchase of T-Bills on behalf of the Government of India. SEBI has a primary responsibility of regulating and supervising the capital market. It has issued a number of Guidelines and Rules for the controland supervision of capital market and investorsprotection. Besides, there is an array of legislations and government departments also to regulate the operations in the financial system.

METHODS OF FLOATING NEW ISSUES:

Methods of Marketing Securities

Followingarethevariousmethodsbeingadoptedbycorporateentitiesformarketingthe securities in the New Issue Market:

1. Pure Prospectus Method

2. Offer for Sale Method
3. Private Placement Method
4. Initial public Offers (IPOs) Method
5. Rights Issue Method
6. Bonus Issue Method
7. Book-building Method
8. Stock Option Method and
9. Bought-out Deals Method

PureprospectusMethod Meaning

Themethodwherebyacorporateenterprisemopsupcapitalfundsfromthegeneralpublicby means of an issue of a prospectus is calledPure Prospectus Method.It is the most popular method of making public issue of securities by corporate enterprises.

Features

Exclusive subscription:Under this method, the new issues of a company are offered for exclusive subscription of the general public.

Issue Price:Direct officer is made by the issuing company to the general public to subscribe to the securities as a stated price.

Underwriting: Public issuethrough thepure prospectus methodisusuallyunderwritten.This is to safeguard the interest of the issuer in the event of an unsatisfactory response from thepublic.

Prospectus:A document that contains information relating to the various aspects of the issuing company, besides other details of the issue is called aProspectus.The document is circulated to the public.The general details include the companys name and address of its registered office, the names and addresses of the company s promoters, manager, managing director, directors, company secretary, legal adviser, auditors, bankers, brokers, etc.

Advantages

The pure prospectus method offers the following advantages to the issuer and the investors alike:

Benefits to investors: The pure prospectus method of marketing the securities serves as an excellent mode of disclosure of all the information pertaining to the issue.Besides, it also facilitates satisfactory compliance with the legal requirements of transparency, etc.

Benefits to issuers:The pure prospectus method is the most popular method among the larger issuers.In addition, it provides for wide diffusion of ownership of securities contributing to reduction in the concentration of economic and social power.

Drawbacks

Theraisingofcapitalthroughthe pureprospectusmethod isfraughtwith anumberof drawbacks as specified below:

Highissuecosts:Amajordrawbackofthismethodisthatitisanexpensivemodeofraising funds from the capital market.Costs of various hues are incurred in mobilizing capital.

TimeConsuming:Theissueofsecurities throughprospectustakes moretime,asitsrequires the due compliance with various formalities before an issue could take place.

OfferforSaleMethod Meaning

Wherethemarketingofsecuritiestakesplacethroughintermediaries,suchasissuehouses, stockholders and others, it is a case ofOffer for sale Method.

Features

Under this method, the sale of securities takes place in two stages.Accordingly, in the first stage,theissuer companymakesan en-blocksale ofsecuritiestointermediariessuch astheissue housesandsharebrokers ofan agreedprice.Underthesecondstage,the securitiesare re-soldto ultimate investors at a market-related price.

Theissue is alsounderwrittento ensuretotalsubscription ofthe issue.Thebiggest advantage of this method is that it saves the issuing company the hassles involved in selling the shares to the public directly through prospectus.

PrivatePlacementMethod

Meaning

A method of marketing of securities whereby the issuer makes the offer of sale of individualsand institutions privately without the issue of a prospectus is known asPrivate Placement Method.

Features

Under this method, securities are offered directly to large buyers with the help of share brokers. This method works in a manner similar to theOffer for Sale Methodwhereby securities are first sold to intermediaries such as issues houses, etc.

Advantages

Private placement of securities offers the following advantages:

1. Less expensive as various types of costs associated with the issue are borne by the issue houses and other intermediaries.
2. Placement of securities suits the requirements of small companies.
3. The method is also resorted to when the stock market is dull and the public response tothe issue is doubtful.

Disadvantages

The major weaknesses of the private placement of securities are as follows:

1. Concentration of securities in a few hands.
2. Creatingartificialscarcityforthesecuritiesthusjackingupthepricestemporarilyand misleading general public.

3. Deprivingthecommoninvestorsofanopportunitytosubscribetotheissue,thus affecting their confidence levels.

Initial Public Offer (IPO) Method

The public issue made by a corporate entity for the first time in its life is calledInitial public Offer(IPO),Under this methodof marketing,securities areissue to successfulapplicants onthe basis of the orders placed by them, through their brokers.

When a company whose stock is not publicly traded wants to offer that stock to the general public, it takes the form ofInitial public offer.The job of selling the stock is entrusted to a popular intermediary, the underwriter.The underwriters charge a fee for their services.

Stocks are issued to the underwriter after the issue of prospectus which provides details of financial and business information as regards the issuer.

The issuer and the underwriting syndicate jointly determine the price of a new issue.IPO stock atthe releaseprice is usuallynot available to most ofthe public.Goodrelationship between,the broker and the investor is a pre-requisite for the stock being acquired.

Full disclosure of all material information in connection with the offering of new securities must be made as part of the new offerings.A statement and preliminary prospectus (also known as a red herring) containing the following information is to be filled with the Registrar of Companies:

1. Adescriptionoftheissuersbusiness.
2. The names and addresses of the Key company officers, with salary and a 5 yearbusiness history on each.
3. The amount of ownership of the key officers
4. Any legal proceedings that the company is involved in

The essential steps involved in this method of marketing of securities are as follows:

1. **Order:**Brokerreceivesorder fromtheclientandplaces ordersonbehalfoftheclient with the issuer.
2. **Share Allocation**:The issuerfinalizesshare allocation andinformsthebrokerregarding the same.

3. **The Client:**The broker advises the successful clients of the share allocation.Clients then submit the application forms for shares and make payment to the issuer through the broker.
4. **Primary issue account**:The issuer opens a separate escrow account (primary issue account) for the primary market issue.The clearing house of the exchange debits the primary issue account of the broker and credits the issuers account.
5. **Certificates:**Certificates are then delivered to investors.Otherwise depository account may be credited.

Rights issue Method

Where the shares of an existing company are offered to its existing shareholders.It takes the form of rights issue.Under this method, the existing company issues shares to its existing shareholder sin proportion in the number of shares already held by them.

Therelevant guidelinesissued bythe SEBIin thisregard areas follows:

1. Shall be issued only by listed companies.
2. Announcementregardingrightsissueoncemade,shallnotbewithdrawnandwhere withdrawn, no security shall be eligible for listing upto 12 months.
3. Underwriting as to rights issue is optional and appointment of Registrar is compulsory.
4. Appointment of category I Merchant Bankers holding a certificate of registration issued by SEBI shall be compulsory.
5. Rights share shall be issued only in respect of fullypaid share.
6. Letter of Offer shall contain disclosures as per SEBI requirements.
7. Issue shall be kept open for a minimum period of 30 days and for a maximum period of 60 days.
8. ANocomplaintsCertificateistobefiledbytheLegalMerchantBankerwiththeSEBI after 21 days from the date of issue of the document.
9. Obligatory for a company where increase in subscribed capital is necessary after two years of its formation of after one year of its first issue of shares, whichever is earlier(this requirement may be dispensed with by a special resolution).

Advantages

Rights issue offers the following advantages

1. **Economy:** Rights issue constitutes the most economical method of raising fresh capital, as it involves no underwriting and brokerage costs.
2. **Easy:** The issue management procedures connected with the rights issue are easier asonly a limited number of applications are to be handled.
3. **Advantagetoshareholders**: Issueofrightssharesdoesnotinvolveanydilutionof ownership of existing shareholders.

Drawbacks

Themethod suffers from the following limitations:

1. **Restrictive:**Thefacilityofrightsissueisavailableonlytoexistingcompaniesandnotto new companies.
2. **Against society**:the issue of rights shares runs counter to the overall societal consideration of diffusion of share ownership for promoting dispersal of wealth and economic power.

Bonus Issues Method

Where the accumulated reserves and surplus of profits of a company are converted into paid up capital, it takes the form of issue of bonus shares.It merely implied capitalization of existing reserves and surplus of a company.

Issue under Section 205 (3) of the companies Act, such shares is governed by the guidelines issued by the SEBI (applicable of listed companies only) as follows:

SEBIGuidelines

Following are the guidelines pertaining to the issue of bonus shares by a listed corporate enterprise:

1. **Reservation:**InrespectofFCDsandPCDs,bonus sharesmustbereservedinproportion to such convertible part of FCDs and PCDs.Theshares so reserved may be issued at the

time of conversion(s) of such debentures on the same terms on which the bonus issues were made.

2. **Reserves:**the bonus issue shall be made out of free reserves built out of the genuine profits or share premium collected in cash only.
3. **Dividendmode**:the declaration of bonus issue, in lieu of dividend, is not made.
4. **Fully paid:**The bonus issue is not made unless the partly paid shares, if any are made fully paid-up.
5. **No default**:The Company has not defaulted in payment of interest or principal inrespect of fixed deposits and interest on existing debentures or principal on redemption thereof and has sufficient reason to believe that it has not defaulted in respect of the payment of statutory dues of the employees such as contribution to provident fund, gratuity, bonus, etc.
6. **Implementation:**A company that announces its bonus issue after the approval of the Board of Directors must implement the proposal within a period of 6 months from the date of such approval and shall not have the option of changing the decision.
7. **The articles**:The articles of Association of the company shall contain a provision for capitalization of reserves, etc. if there is no such provision in the articles, the company shall pass a resolution at is general body meeting making provision in the Articles of Association for capitalization.
8. **Resolution:**consequenttothe issueofbonus sharesifthesubscribedandpaid-upcapital exceeds the authorized share capital, the company at its general body meeting for increasing the authorized capital shall pass a resolution.

Book-building Method

A method of marketing the shares of a company whereby the quantum and the price of the securities to be issued will be decided on the basis of thebidsreceived from the prospective shareholders by the lead merchant bankers is known asbook-building method.

The option of book-building is available to all body corporate, which are otherwise eligible to make an issue of capital of the public.The initial minimum size of issue through book-building route was fixed at Rs.100 crores.

The book-building process involves the following steps:

1. **Appointment of book-runners**:the first step in the book-building is the appointment by the issuer company, of the book-runner, chosen from one of the lead merchant bankers.The book-runner in the forms a syndicate for the book building.A syndicate member should be a member of National Stock Exchange (NSE) or Over-the-Counter Exchange of India (OTCEI).Offers ofbidsare to be made by investors to the syndicate members, who register the demands of investors.
2. **Drafting prospectus**:The draft prospectus containing all the information except the information regarding the price at which the securities are offered is to be filed with SEBI as per the prevailing SEBI guidelines.The offerof securities through this process must separately be disclosed in the prospectus, under the captionplacement portion category.
3. **Circulating draft prospectus**:A copy of the draft prospectus filed with SEBI is to be circulatedbythe book-runner to the prospective institutional buyerswho are eligible for firm allotment and also to the intermediaries who are eligible to act as underwriters.
4. **Maintain offer records**:The book-runner maintain a record to the offers received. Details such as the name and the number of securities ordered together with the price at which each institutional buyer or underwriter is willing to subscribed to securities under the placement portion must find place in the record.SEBI has the right to inspect such records.
5. **Intimation about aggregate orders**:The underwriters and the institutional investors shall give intimation on the aggregate of the offers received to the book-runner.
6. **Bid analysis**:The bid analysis is carried out by the book-runner immediately after the closure of the bid offer date.An appropriate final price is arrived at after a careful evaluation of demands at various prices and the quantity.
7. **Mandatory underwriting**:Where it has been decided to make offers of shares to public under the category ofNet offer of the Public, it is incumbent that the entire portion offered to the public is fully underwritten.
8. **Filling with ROC:**AcopyoftheprospectusascertifiedbytheSEBIshallbefiledwith the Registrar of Companies within two days of the receipt of the acknowledgement card from the SEBI.

9. **Bank accounts**:Theissuercompanyhastoopentwoseparateaccountsforcollectionof application money, one for the private placement portion and the other for the public subscription.
10. **Collection of completed applications**:The book-runner collects from the institutional buyers and the underwriters the application forms along with the application money to the extent of the securities proposed to be allotted to them or subscribed by them.
11. **Allotment of securities**:Allotment for the private placement portion may be made on the second day from the closure of the issue.The issuer company, however, has the option to choose one date for both the placement portion and the public portion.
12. **Payment schedule and listing**:The book-runner may require the underwriters to the net offer to the publicto pay in advance all moneys required to be paid in respect of their underwriting commitment by the eleventh day of the closure of the issue.
13. **Under-subscription**:In the case of under-subscription in thenet offer to the publiccategory,anyspillovertotheextentofundersubscriptionistobepermittedfromthe placementportioncategorysubjecttotheconditionthatpreferenceisgiventothe individual investors.

Advantages of book-building

Book building process is of immense use in the following ways:

1. Reduction in the duration between allotment and listing
2. Reliable allotment procedure
3. Quick listing in stock exchanges possible
4. No price manipulation as the price is determined on the basis of the bids received.

Stock Option or employees Stock Option Scheme (ESOP)

A method of marketing the securities of a company whereby its employees are encouraged to takeupsharesandsubscribeto itisknown asstockoption.Itis avoluntaryschemeonthe part of the company to encourage employeesparticipation in the company.The scheme also offers an incentive to the employees to stay in the company.

SEBI Guidelines

Company whose securities are listed on any stock exchange can introduce the scheme of employeesstock option.The offer can be made subject to the conditions specified below:

1. **Issue at discount**:Issue of stock options at a discount to the market price would be regarded as another form of employee compensation and would be treated as such in the financial statements of the company regardless the quantum of discount on the exercise price of the option.
2. **Approval:**The issue of ESOPs is subject to the approval by the shareholders through a special resolution.
3. **Maximum limit**:There wouldbe norestriction on themaximumnumber ofshares to be issued to a single employee.
4. **Minimum period**:A minimum period of one year between grant of options and its vesting has been prescribed.After one year, the company would determine the period during which the option can be exercised.
5. **Superintendence:**The operation of the ESOP Scheme would have to be under the superintendenceanddirectionof aCompensation Committeeof theBoard ofDirectorsin which there would be a majority of independent directors.
6. **Eligibility:**ESOP scheme is open to allpermanentemployees and to the directors of the company but not to promoters and large shareholders.
7. **Directorsreport**:TheDirectorsreportshallmakeadisclosureofthefollowing:

    a. Total number of shares as approved the shareholders
    b. The pricing formula adopted
    c. Details as to options grated, options vested, options exercised and options forfeited, extinguishments or modification of options, money realized by exercise of options, total number of options in force, employee-wise details of options granted to senior managerialpersonnel and to any other employee whoreceived a grantin anyone year of options amounting to 5 percent or more of options granted during that year.
    d. Fully diluted EPS computed in accordance with the IAS
8. **IPO:**SEBI s stipulations prohibiting initial public offerings by companies having outstanding options should not apply to ESOP.

Stock Option Norms for Software Companies

The relevant guidelines issued by the SEBI as regardsemployeesstock optionfor software companies are as follows:

1. **Minimum issue**:A minimumissueof 10percent ofits paid-upcapital canbe madebya software company which has already floated American Depository Receipts (ADRs) and Global Depository Receipts (GDRs) or a company which is proposing to float these is entitled to issue ADR/GDR linked stock options to its employees.
2. **Mode of Issue**:Listedstock options canbe issued in foreigncurrencyconvertible bonds and ordinary shares (through depository receipt mechanism) to the employees of subsidiaries of Info Tech Companies.
3. **Permanent employees**:Indian IT companies can issue ADR/GDR linked stock options to permanent employees, including Indian and overseas directors, of their subsidiary companies incorporated in India or outside.
4. **Pricing:**The pricing provisions of SEBIs preferential allotment guidelines would not coverthe scheme.The purposeis to beenable thecompanies to issuestockoptions toits employees at a discount to the market price which serves as another form of compensation.
5. **Approval:**Shareholdersapproval through a special resolution is necessary for issuing the ESOPs.A minimum period of one year between grant of option and its vesting has been prescribed.After one year, the company would determine the period in which option can be exercised.

Bought-outDeals

Meaning

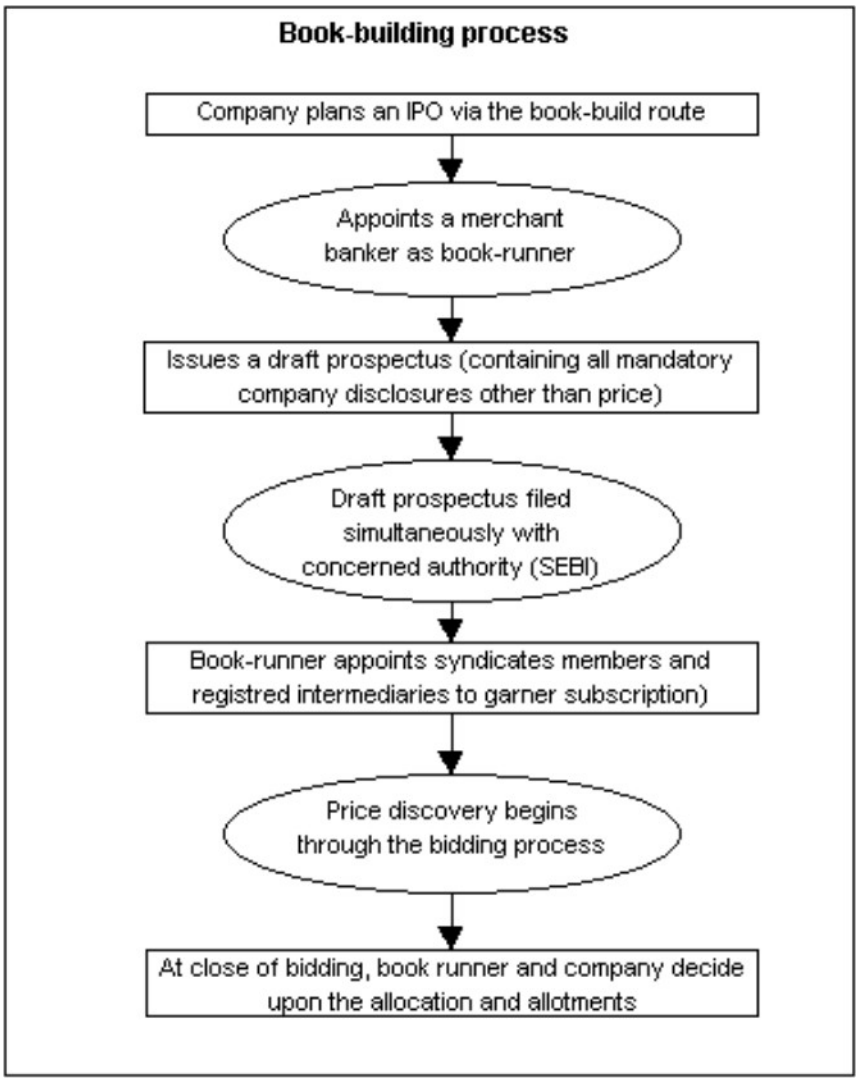
A method for marketing of securities of a body corporate whereby the promoters of an unlisted company make an outright sale of a chunk of equity shares to a single sponsor or the leadsponsor is known asbought-out deals.

Features

1. **Parties:**There arethree partiesinvolved in thebought-out deals.They arepromoters of the company sponsors and co-sponsors who are generally merchant bankers andinvestors.
2. **Outright Sale:**Under this arrangement, there is an outright sale of a chunk of equity shares to a single sponsor or the lead sponsor.
3. **Syndicate:**Sponsor forms a syndicate with other merchant bankers for meeting the resource requirements and for distributing the risk.
4. **Sale price:**Thesalepriceisfinalized throughnegotiationsbetweentheissuingcompany and the purchaser, the sale being influenced by such factors as project evaluation, promotersimage and reputation, current market sentiments, prospects of off-loading these shares at a future date, etc.
5. **Listing:**The investor-sponsor make a profit, when at a future date, the shares get listed and higher prices prevail.Listing generally takes place at a time when the company is performing well in terms of higher profits and larger cash generations from projects.
6. **OTCEI:**Sale of these share at Over-the-Counter Exchange of India (OTCEI) or at a recognized stock exchanges, the time of listing these securities and off-loading them simultaneously are being generally decided in advance.

BOOK BUILDING PROCESS

BookBuilding is basically a capital issuance process used in Initial Public Offer (IPO) which aids price and demand discovery. It is a process used for marketing a public offer of equity shares of a company. Itis a mechanism where, during the period for which the book for the IPO is open, bids are collected from investors at various prices, which are above or equal to the floor price. The process aims at tapping both wholesaleand retail investors.Theoffer/issue priceis then determined afterthe bidclosingdate basedon certain evaluation criteria.



The Process:

- ✓ The Issuer who is planning an IPO nominates a lead merchant banker as a 'book runner'.
- ✓ The Issuer specifies the number of securities to be issued and the price band for orders.
- ✓ TheIssueralsoappointssyndicatemberswithwhomorderscanbeplacedbythe investors.

- ✓ Investorsplacetheirorderwithasyndicatememberwhoinputstheordersintothe 'electronic book'. This process is called 'bidding' and is similar to open auction.

- ✓ A Book should remain open for a minimum of 5 days.

- ✓ Bids cannot be entered less than the floor price.

- ✓ Bids can be revised by the bidder before the issue closes.

- ✓ On the close of the book building period the 'book runner evaluates the bids on the basis of the evaluation criteria which may include -
    - Price Aggression
    - Investor quality
    - Earliness of bids, etc.

- ✓ The book runner the company concludes the final price at which it is willing to issue the stock and allocation of securities.

- ✓ Generally, the numbers of shares are fixed; the issue size gets frozen based on the priceper share discovered through the book building process.

- ✓ Allocation of securities is made to the successful bidders.
- ✓ Book Building is a good concept and represents a capital market which is in the process of maturing.

Book-building is all about letting the company know the price at which you are willing tobuythestock andgetting anallotmentat apricethatamajorityoftheinvestorsare willingto pay. The price discovery is made depending on the demand for the stock.

2.6 Regulations of primary Market

- ✓ Entry Barriers for unlisted companies modified as dividend payment in immediately preceding 3 years

- ✓ A listed company required to meet entry form if post issue net worth ishigher than preissue net worth
- ✓ Full payment before makinga public/ rights issue
- ✓ The promoterscontributionfor public issues made uniformat 20% irrespectiveof the issue size
- ✓ Written consent from shareholders for promoters contribution
- ✓ Appointment of Registrar
- ✓ Promotersandtheirbackground-Promotorsdetails
- ✓ TheSEBIrulesandregulations1993havebeenamendedfortherelationshipbetween issuer and Registrar
- ✓ SEBIallowed debt instruments to the stock exchanges
- ✓ Onlybody corporate to be allowed to function as Merchant bankers-only on entity
- ✓ NBFCs such as Accepting deposits, leasing, bill discounting etc., will not be allowed to be undertaken by a Merchant banker.

STOCK EXCHANGES IN INDIA:

It is an organized market for the purchase and sale of industrial and financial security. It is alsoknown as Secondary market or stock market

FUNCTIONS OF STOCK EXCHANGES

1. Ensure Liquidity of Capital

Thestockexchangesprovideaplacewheresharesandstocksareconvertedinto cash.

2. Continuous Market for securities:

The stock exchanges provide a ready market for securities.

3. Evaluation of securities:

The investors can evaluate the worth of their holdings from the prices quoted at different exchanges for those securities.

4. Mobilizing surplus savings:

Ready market-The investors do not have any difficulty in investing their savings by purchasing shares, bonds etc., from the exchanges.

5. Helpful in raising New capital:

Thenewconcernsraisethecapitalforthefirsttimeandexistingconcerns increase their capital

6. Safety in Dealings:

Rules governed by Securities contract(Regulation) Act, 1956

7. Listing of Securities:

Listed securities can purchase in market

8. Platform for public debt:

Stock exchanges for organized markets of government securities

9. Clearing House of Business Information:

The listed companies must provide financial statements, annual reports etc.,

- Stock Exchanges in India

1. **Bombay stock Exchange (BSE)**

✓ Itis the oldest stock exchange in Asia

✓ It has established as TheNativeshareandstockBrokersin1875

Features of BSE

- ✓ Largest stock Exchange in Asia
- ✓ Fifth largest stock market in the world
- ✓ More than 6, 000 Indian companies are listed in BSE
- ✓ It used BOLT (BSEonline Trading system) as the stock trading system in the world

OTCEI

- ✓ It started in oct 1990
- ✓ ItusesthemodelasNASDAQ(NationalassociationofsecurityDealersautomated Quotations)

Features of OTCEI

Ringless Trading:Screenbasedtrading

National network:wide network and grater liquidity

Totallycomputerized: Transparentand quick market

Exclusive List of companies: Exclude other stock exchangecompanies

Two ways of making a public offer:

Direct offer :offer shares directly to public

Indirect offer:offer shares indirectly to public ie., to sponsors

Fast Transfers:fast settlement called counter receipt

TradingMechanism:ExportandImportShares.ThepartiesareInvestor,counter,settlerregistered custodian, company and bank

Objectives of OTCEI

- ✓ To provide a nation wide investor base to small companies

- ✓ To encourage public issues
- ✓ To enable small companies to raise capital at low cost
- ✓ To offer quick settlement and transparent facilities
- ✓ To provide a single trading platform for investors

BenefitsofOTCEI To

Investors:

- ✓ Easy Accessibility
- ✓ Improved Liquidity
- ✓ Transparency
- ✓ Immediate transfer of shares
- ✓ Speedy settlement of Trades

Benefits for Issuing companies:

- ✓ Low cost of Issuing shares
- ✓ Beneficial for small companies
- ✓ Benefit on account of the image Market maker

NSE(National Stock Exchange)

NSEwaspromotedbyIDBI,ICICI,IFCI,GIC,LIC,StatebankofIndia,SBIcapital markets limited, SHCIL and IL & FSas a joint stock company under the companies Act 1956.

Features of NSE

- ✓ Indiaslargestexchange
- ✓ Equity capital : 25 crores

- ✓ Head quarters in Mumbai and back office in Chennai
- ✓ It is a joint stock companyand taxpaying company
- ✓ Strict in disclosure and listing norms

Advantages of NSE

- ✓ Wider accessibility
- ✓ Screen based trading
- ✓ Non disclosure of trading members identity
- ✓ Transparent of transactions
- ✓ Matching of orders
- ✓ Effective settlement of corporate benefit
- ✓ Trading in dematerializedform
- ✓ SGL (subsidiary General Ledger) facility in debt market

ISE (Inter connected Stock Exchange)

- ✓ It is a national level stock exchange, providing trading, clearing, settlement, risk management and surveillance support to its trading members.
- ✓ Aims to address small companies

Features of ISE

- ✓ Accountability
- ✓ Integrity
- ✓ Innovation
- ✓ Knowledge

- ISE

✓ It has 841 trading members

✓ It has floated ISS (Interconnected Securities & services limited)

✓ TradingmembersofISEcanaccessNSE&BSEbyregisteringthemselvesassubbrokers of ISS

Features of ISE

✓ Accountability

✓ Integrity

✓ Innovation

✓ Knowledge

Functions of ISE

✓ Create a single integrated national level solution by high cost services

✓ Create markets for listed companies and small capital companies in particular

✓ Optimally utilizing the existing infrastructure

✓ Provide clear settlements

Advantages of ISE

✓ Moderate fees

✓ Easy compliance

✓ Improved visibility

✓ Infrastructure

✓ IPO distribution system-Primary market

- ✓ Additional facility
- ✓ Investor Protection
- ✓ Website

Relationship between NSE &OTCEI

Ringless No trading floor

Screen based trading- computerized

Transparency-cancheckthеexactprice

TRADING SYSTEM IN STOCK EXCHANGES

- ✓ Finding a broker
- ✓ Opening an account with broker
- ✓ Placing the order
- ✓ Making the contact
- ✓ Preparing contact note
- ✓ Settlement of transaction

1. **Finding a broker**

The shares are brought through a stock broker whois a licensed member of a recognised stockexchange.

Services

1. **Provideinformations:**capitalstructures,earnings,dividendpoliciesand prospects

2. **SupplyinvestmentLiterature:**Educationtoinvestors,providingfinancial periodicals, prospectus and reports of companies

3. **Availability of competent Representatives:**

appointing sufficient incharges

2. **Opening an account with the broker:**

The brokeropens an account in the name of the protectiveness client only if the brokeris satisfied about the creditworthiness of the investors and his intention to trade in the market.

3. **Placing the orders**

a. Market orders-urgent desire

b. Limit orders: Maximum orminimum priceat whichthe investorsis willingto buy or sell shares

c. Stoplossorders:conditionalmarketorder to

stop loss

d. Cancelorder: Execute immediately

e. Discretionary order: Execution for the best

f. Open order: No time or limit for the execution

g. **Fixed price order:**client specifies the price at which the shares are to be purchased

h. Other orders

- ✓ **Day orders:**Unless registration
- ✓ **GoodTillcancelled(GTC)Order:**Orderremainsopenuntilexecutedor cancelled.
- ✓ **Not held order:**Gives discretion to the floor brokers
- ✓ **Participate but do not Initiate (PNI):** The floor brokers is instructed to participate in trading but not to become aggressive

All or None Order (AON): The order wants to be executed by customer

Fill or kill order(FOK): Complete execution

Immediate or cancel(IOC): Part of the order which is not executed will be cancelled

3. Making the contract : Announcement by slip in a box

4. Preparing Contact note: Parties will record all details in contract

5. Settlement of Transaction: Settlement by the payment of buyers

Contracts:

1. **Ready Delivery contracts:** Immediate delivery of contacts and cash payment

2. Forward Delivery contacts:carrying over the transactions to the next settlement day

- ▪

Settlements:

1. **Fixed settlement:**

Itstartson aparticular dayandends afterfive days

2. Rolling settlement:

fifth working day settlement

Trading on margin

It refers to the use of borrowed funds to supplement the investor's own money. Investors willdo Partial money settlement by own and part from broker

Advantages

- ✓ Itprovidesmoreprofitwithlessinvestment
- ✓ Increases buying power
- ✓ Suitable for experienced traders

Short selling:

Itsthepracticeofsellingborrowedsecurities.

Advantages

- ✓ Profit and price decline
- ✓ It became as highly conservative investment strategy

SEBI SECURITIES EXCHANGE BOARD OF INDIA

- ✓ In1988,SEBIwasestablishedbythegovernmentofIndiathroughan executive resolution.
- ✓ InMay1992,SEBIwasgrantedlegalstatus.SEBIisabodycorporate having a separate legal existence and perpetual succession.

Objectives

1. To regulate the activities of stock exchange.

2. To protect the rights of investors and ensuring safety to their investment.

3. To prevent fraudulent and malpractices by having balance between self regulation of business and its statutory regulations.

4. To regulate and develop a code of conduct for intermediaries such as brokers, underwriters,etc.

Management of the Board

- ✓ Chairman
- ✓ Two members from central government dealing with finance and Law
- ✓ One member from Reserve bank of India
- ✓ Two other members from central government

Functions of SEBI:

a. Protective functions

(i) It Checks Price Rigging

(ii) ItProhibitsInsider trading

(iii) SEBI prohibits fraudulent and Unfair Trade Practices

(iv) SEBI undertakes steps to educate investors

(v) SEBI promotesfair practices and code of conduct

b. Developmental functions

(i) SEBI promotes training of intermediaries of the securities market.

(ii) SEBI has permitted internet trading through registered stock brokers.

(iii) SEBI has made underwriting optional to reduce the cost of issue.

(iv) Eveninitialpublic offerof primarymarket ispermitted throughstock exchange

c. Regulatory functions

i)SEBIhasframedrulesandregulationsandacodeofconducttoregulatetheintermediaries such as merchant bankers, brokers, underwriters, etc.

(ii) SEBIregistersand regulatesthe workingof stock brokers,sub-brokers, sharetransfer agents, trustees, merchant bankers and all those who are associated with stock exchange in any manner.

(iii) SEBI registers and regulates the working of mutual funds etc.

(iv) SEBI regulates takeover of the companies.

(v) SEBI conducts inquiries and audit of stock exchanges.

Powers of SEBI

- ✓ Power to seek information
- ✓ Powers of Inspection
- ✓ Powers of civil court Exercisable by SEBI
- ✓ Powers of SEBI where an enquiry or investigation is ordered
- ✓ Power to issue directions
- ✓ Power of search and seizure
- ✓ Power to order cease and desist
- ✓ Power to SEBI under SCRA*Service members Civil Relief Act*

- **RoleofSEBIinregulatingthecapitalmarket**

Reasons

- ✓ Market index act as a barometer for market behavior
- ✓ Market index is used to benchmark portfolio performance
- ✓ Market index is used in derivative instruments like index futures and index options
- ✓ Market index can be used for passive fund management as in case of index funds.

Roles

- ✓ To make rules for controlling stock exchanges
- ✓ To provide License to dealers and brokers
- ✓ To stop fraud in capital market
- ✓ To control the merger, acquisition and takeover of the companies
- ✓ To audit the performance of stock market
- ✓ To make new rules on carry forward transactions
- ✓ To create relationship with ICAI(Institute of Chartered Accountants of. India)
- ✓ Introduction of derivative contracts on volatility index
- ✓ To require report of portfolio Management activities
- ✓ To educate the investors
- ✓ To integrate the securities Market
- ✓ To diversify the trading products

- **Role of SEBIin secondary market**

- ✓ Providing acentralized redressal mechanism
- ✓ Establishing the separate investment awareness division
- ✓ Displaying the names of defaulting companies on the SEBI website
- ✓ Providing helpline facility for investor assistance

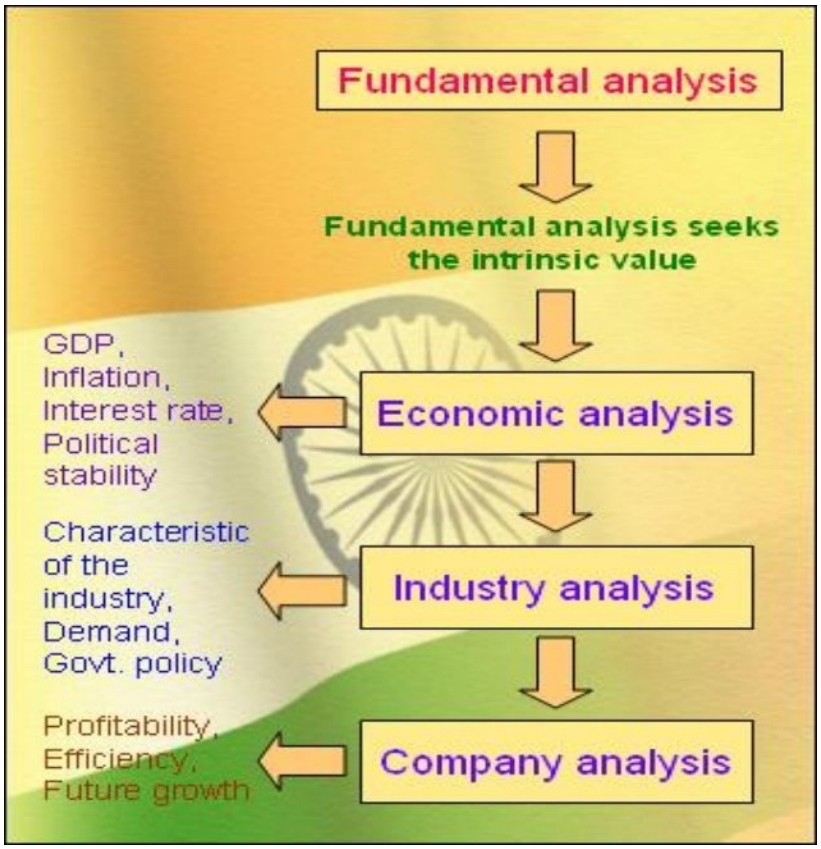
Unit 3

FUNDAMENTAL ANALYSIS

FUNDAMENTAL ANALYSIS:

Fundamental analysis is used to determine the intrinsic value of the share by examining the underlying forces that affect the well being of the economy, Industry groups and companies. Fundamentalanalysisistofirstanalyzetheeconomy,thentheIndustryandfinallyindividual companies. This is called as top down approach.

- ✓ Theactual valueof asecurity, as opposed to its market priceor book value is called intrinsicvalue.Theintrinsicvalueincludesothervariablessuchasbrand name,trademarks, andcopyrightsthat are often difficult tocalculateand sometimes not accurately reflected in themarketprice. One way to look at it is that themarket capitalizationis the price (i.e. whatinvestors are willing topayfor the company and intrinsic value is the value (i.e. what the company is really worth).



The top down approach of fundamental analysis

- Attheeconomylevel,fundamentalanalysisfocusoneconomicdata(suchasGDP, ForeignexchangeandInflationetc.)toassessthepresentandfuturegrowthofthe

economy.

- Attheindustrylevel, fundamental analysis examines thesupplyand demand forces for the products offered.

- At the company level, fundamental analysis examines the financial data (such as balance sheet, income statement and cash flow statement etc.), management, business concept and competition.

ECONOMIC ANALYSIS:

Economicanalysisoccupiesthefirstplaceinthefinancialanalysistopdownapproach.Whenthe economy is having sustainable growth, then the industry group (Sectors) and companies will get benefit and grow faster. The analysis of macroeconomic environment is essential to understand the behavior of the stock prices. The commonly analysed macro economic factors are as follows.

Gross domestic product (GDP):GDP indicates the rate of growth of the economy. GDP represents the value of all the goods and services produced by a country in one year. The higher the growth rate is more favourable to the share market.

Savings and investment: The economic growth results in substantial amount of domestic savings. Stock market is a channel through which the savings of the investors are made available to the industries. The savings and investment pattern of the public affect stock market.

Inflation: Along with the growth of GDP, if the inflation rate also increases, then the real rate of growth would be very little. The decreasing inflation is good for corporate sector.

Interest rates: The interest rate affects the cost of financing to the firms. A decrease in interest rate implies lower cost of finance for firms and more profitability.

Budget: Budget is the annual financial statement of the government, which deals with expected revenues and expenditures. A deficit budget may lead to high rate of inflation and adversely affect the cost of production. Surplus budget may result in deflation. Hence, balanced budget is highly favourable to the stock market.

The tax structure: The tax structure which provides incentives for savings and investments. **The balance of payment:**The balance of payment is the systematic record of all money transferbetweenIndiaandtherestoftheworld.Thedifferencebetweenreceiptsand paymentsmay besurplusordeficit.If thedeficitincreases,therupeemaydepreciateagainst other currencies. This would affect the industries, which are dealing with foreign exchange.

Monsoonandagriculture: Indiaisprimarilyanagriculturalcountry.Theimportanceof agriculturalinIndianeconomyisevident.Agricultureisdirectlyandindirectlylinkedwith

the industries. For example, Sugar, Textile and Food processing industries depend upon agriculture for raw material. Fertilizer and Tractor industries are supplying input to the agriculture. A good monsoon leads better harvesting; this in turn improves the performance of Indian economy.

Infrastructure: Infrastructurefacilitiesare essentialfor growthof Industrialandagricultural sector. Infrastructure facilities include transport, energy, banking and communication. In India even though Infrastructure facilities have been developed, still they are not adequate.

Demographic factors: Thedemographic data provides details about the population by age, occupation, literacy and geographic location. This is needed to forecast the demand for the consumer goods.

Political stability: Astable politicalsystemwouldalsobe necessaryfora goodperformance of the economy. Political uncertainties and adverse change in government policy affect the industrial growth.

ECONOMIC FORECASTING:

Thecommontechniques usedare**analysis of key economicindicators, diffusion index, surveysand econometricmodel building.**Thesetechniqueshelphimtodecidetherighttimeto incest and the type of security he has to purchase i.e. stocks or bonds or some combination of stocks and bonds.

ECONOMIC INDICATORS

The economic indicators are statistics about the economy that indicate the present status,progress or slow down of the economy. They are capital investment, business profits, money supply, GNP, interest rate, unemployment rate, etc. The economic indicators are grouped into leading, coincidental and lagging indicators. The indicators are selected on the following criteria

- Economic significance
- Statistical adequacy
- Timing
- Conformity

The leading indicators:

The leading indicators indicate what is going to happen in the economy. It helps the investor to predict the path of the economy. The popular leading indicators are the fiscal policy, monetary policy, productivity, rainfall, capital investment and the stock indices. The fiscal policy shows what the government aims at and the fiscal deficit or surplus has an effect on the economy.

The coincidental indicators:

The coincidental indicators indicate what the economy is. The coincidental indicators are gross national product, industrial production, interest rates and reserve funds. GDP is the aggregate amount of goods and services produced in the national economy. The gap between the budgeted GDP and the actual GDP attained indicates the present situation. If there is a large gap between theactualgrowth andpotential growth,the economyisslowingdown. Lowcorporateprofits and industrial production show that the economy is hit by recession.

The lagging indicators:

The changes that are occurring in the leading and coincidental indicators are reflected in the laggingindicators.Laggingindicatorsareidentifiedasunemploymentrate,consumerpriceindex and flow of foreign funds. These leading, coincidental and lagging indicators provide an insight into the economys current and future position.

DIFFUSION INDEX

Diffusion index is a composite or consensus index. The diffusion index consists of leading, coincidental and lagging indicators. This type of index has been constructed by the National Bureau of Economic Research in USA. But the diffusion index is complex in nature to calculate and the irregular movements that occur in individual indicators cannot be completely eliminated.

ECONOMETRIC MODEL BUILDING

For model building several economic variables are taken into consideration. The assumptions underlying the analysis are specified. The relationship between the independent and dependent variables is given mathematically. While using the model, the analyst has to think clearly all the inter-relationship between the variables. When these inter-relationships are specified, he can forecast not only the direction but also the magnitude. But his prediction depends on his understanding of economic theory and the assumptions on which the model had been built. The models mostly use simultaneous equations.

Factors affecting Economic Forecasting

- ✓ GDP (Gross Domestic Product)
- ✓ Inflation
- ✓ Interest rates
- ✓ Government revenue, expenditure and deficits
- ✓ Exchange rates
- ✓ Infrastructure
- ✓ Monsoon

- ✓ Economic and political stability

STOCK INVESTMENT DECISION

Look for a stable company : financially strong

Look for a company that can grow and prosper: Profit and success

Lookforacompanythathasgoodmanagementandcorporate structure: Right people in right direction

FORECASTING TECHNIQUES

1. **Anticipatory surveys:**

a. **Expet Opinion Delphi Technique:**

A systematicforecastingmethod that involves structured interaction among a group of experts on a subject

b. Cross-Impact Analysis:

Analysis of high importance and high probability

c. Multiple scenario:building of pictures of alternative futures.

2.Trend Analysis method:based on time series

a. **TrendExtrapolation:**analyzeandfittimeseriesdata(Linearquadraticorsshaped growth curves)

b. **Trend correlation:**It also know as barometric or indicator approach.

Leading Indicators: To know the economic direction in advance eg., rainfall

CoincidentalIndicators: Economicfactorsreachingapproximatelyatthesametimeasthe economy

eg., GNP, Interest rates

Lagging Indicators: Economicfactorsreachingtheirpeaksor troughsaftertheeconomy has already reached its own.

eg.,Unemployment and inventory debtors**.**

3. DiffusionIndexes: Itis anindicator ofspread ofan expansion.

a. **Compositeor consensusIndex:**It combines severalindictors intoone singlemeasure .

Eg: Diffusion Index:

No of members in the set in the same direction / Total no of members in the set

b. Component Evaluation Index: It measures the breadth of the movement within a particular series.

4. MonetaryIndicators: Dealswithmoney supply, corporateprofits,interestrates andstock prices sprinkle observed.

5. EconometricModel: Itexplainspasteconomicactivitybyderivingmathematicalequation. Eg.,

Disposable Income Inventories.

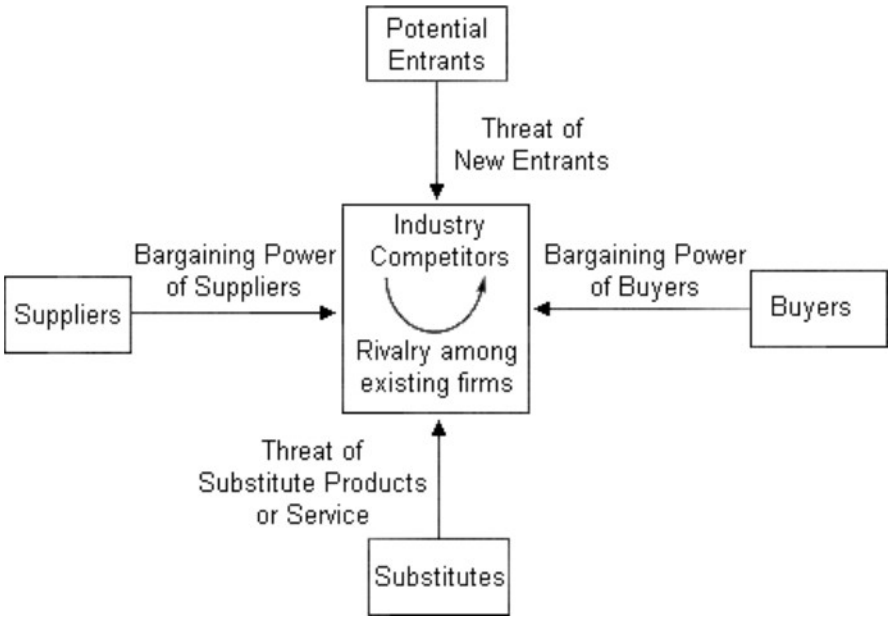
6. Opportunistic model:

a. **Hypothesis of total demand:** Deals with environmental decisions as war or peace

b. **Test of consistency and comparison:** Measure the internal consistency and comparing with other projections.

INDUSTRY OR SECTOR ANALYSIS

The second step in the fundamental analysis of securities is Industry analysis. An industry or sector is a group of firms that have similar technological structure of production and produce similar products. These industries are classified according to their reactions to the different phases of the business cycle. They are classified into growth, cyclical, defensive and cyclical growthindustry.Amarketassessmenttooldesignedto provideabusinesswithanideaof thecomplexityof a particularindustry. Industry analysis involves reviewing the economic, political and market factors that influence the way the industry develops. Major factors can include the power wielded by suppliers and buyers, the condition of competitors and the likelihood of new market entrants. The industry analysis should take into account the following factors.



Characteristics of the industry: When the demand for industrial products is seasonal, their problems may spoil the growth prospects. If it is consumer product, the scale of production and width of the market will determine the selling and advertisement cost. The nature of industry is also an important factor for determining the scale of operation and profitability.

Demand and market: If the industry is to have good prospects of profitability, the demand for the product should not be controlled by the government.

Government policy: The governmentpolicyis announcedin the Industrial policyresolution and subsequent announcements by the government from time to time. The governmentpolicy with regard to granting of clearances, installed capacity, price, distribution of the product and reservation of the products for small industry etc are also factors to be considered for industrial analysis.

Labour and other industrial problems: The industry has to use labour of different categories and expertise. The productivity of labour as much as the capital efficiency would determine the progress of the industry. If there is a labour problem that industry should be neglected by the investor. Similarly when the industries have the problems of marketing, investors have to be careful when investing in such companies.

Management: In case of new industries, investors have to carefully assess the projectreports and the assessment of financial institutions in this regard. The capabilities of management will depend upon tax planning, innovation of technology, modernisation etc. A good management will also insure that their shares are well distributed and liquidity ofshares is assured.

Future prospects: It is essential to have an overall picture of the industry and to study their problems and prospects. After a study of the past, the future prospects of the industry are to be assessed.

When the economy expands, the performance of the industries will be better. Similarly when the economy contracts reverse will happen in the Industry. Each Industryis different from the other. Cement Industry is entirely different from Software Industry or Textile Industry in its products and process.

INDUSTRY CLASSIFICATION

1. **Classification by reporting Agencies**

- ✓ Under Reserve bank of India-industries- 32 groups
- ✓ Under SEBI-10 groups
- ✓ Under Economic times-10 groups
- ✓ Under financial express- 19 groups

2.Classification by Business cycle

a. Cyclic industries : Related to business cycle and changes

b. Defensive industries: Products of having relatively inelastic demand eg., food processing industry

c. Cyclicalgrowthindustries:Basedontechnicalandeconomicalchangeseg.,Airlines industry

3. Industry groups:

a. **Smallsize units**: Small scale industries with a capital of 30 Lac will be listed in OTCEI

b. **Medium size units**: Industrywith acapital of 5 croreswill belistedin theregional stock exchanges like cochin, Coimbatore etc.,

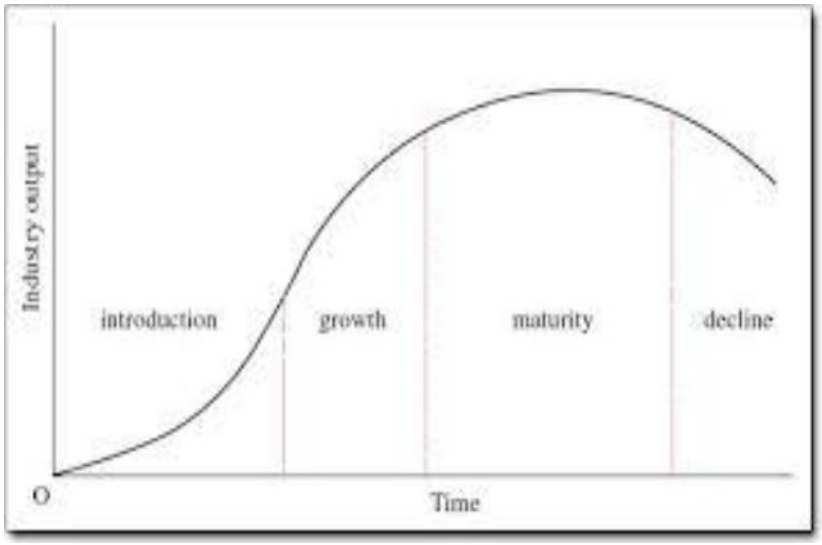
c. Largescale**units**: Industry with a capital of 10 crores will be listed in BSE &NSE.

4. Input based Classification

- ✓ Chemical based products
- ✓ Agro based products
- ✓ Forest based products
- ✓ Metal based products
- ✓ Marine based products

INDUSTRY LIFE CYCLE

1. **Pioneering/ Introduction stage**: Introduction of new product
2. **Expansion/Growthstage**:overcomingtheproblemtoimprovefinanciallyandcompetitively
3. **Stagnation/Maturity stage**: stagnation to have a new life cycle
4. **Decay/Decline stage**:decline death signalsand implement proactively



Industry forecasting Methods

1. **Marketprofile**: no of establishments, geographical locations, value if sales etc.,
2. **Cumulativemethods**: based on statistical measurements.

a. **Surveys:**Carried by researchers, consultants

b. **Correlationand regressionanalysis**: Demandmeasurements

3. Time series:

a. **Trend(T):**Result of basic development in population, capital formation and technology

b. **Cycle(C):**Helps in intermediate range forecasting(wave like movement of sales)

c. **Seasons(S):** Sales movement within a year

d. **Erratic Events:**Unpredictable events as strikes, riots, floods etc.,

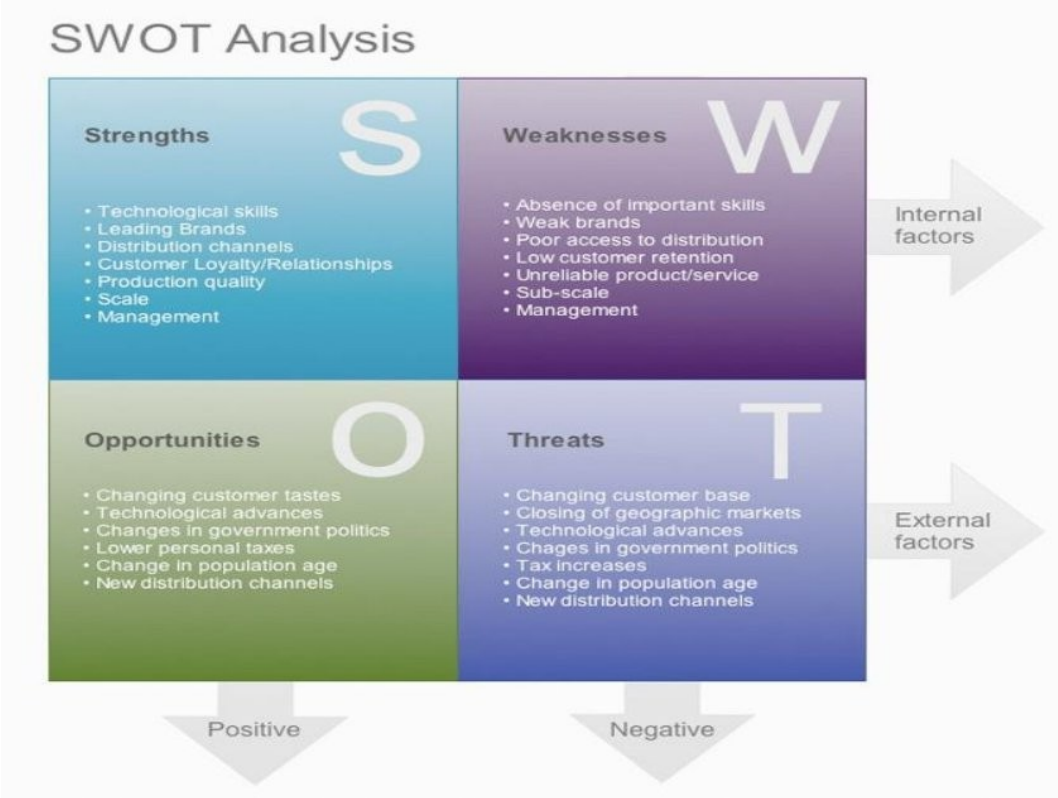
COMPANY OR CORPORATE ANALYSIS

Companyanalysisis astudyofvariablesthatinfluencethefutureofafirm both qualitativelyand quantitatively. It is a method of assessing the competitive position of a firm, its earning and profitability,theefficiencywithwhichit operatesits financialpositionandits futurewithrespect to earning of its shareholders.

The fundamental nature of the analysis is that each share of a company has an intrinsic value which is dependent on the company's financial performance. If the market value of a share is lower than intrinsic value as evaluated by fundamental analysis, then the share is supposed to be undervalued.The basic approach is analysed through the financial statements of an organisation. The company or corporate analysis is to be carried out to get answer for the following two questions.

Howhasthecompanyperformedincomparisonwiththesimilarcompanyinthesame Industry?
How has the company performed in comparison to the early years?

Before making investment decision, the business plan of the company, management, annual report, financial statements, cash flow and ratios are to be examined for better returns.



Measuring Earnings:

a. **Internal Information:**Relating to enterprise

b. **External Information:** Out side the company

Financial Indicators:-

Analyze the financial position of the company.

Tools:

a. Income statement

Itgives pastrecords of thefirm that formsa basefor making predictionsof the firm.

b. Balance sheet

Itshowstheassetsandliabilitiesofafirmalongwithshareholdersequity

c. Statement of Cash flows

Itshows howa company'scash balancechanged fromone yearto the next

d. Ratio Analysis

Itmakesintrafirmandinterfirm comparisons.

1.**Profitability Ratios:**

a. Return on Investment:

$$\frac{\text{Earnings before interest and taxes}}{\text{Total Assets}}$$

b. **Leverage Ratios:**

$$\text{Debt EquityRatio} = \frac{\text{Total Debt}}{\text{Equity}}$$

c. ROE Analysis

ROE= PBT * PAT* NS* TA

—— —— —— ——

NS PBT TA NW

Non Financial Indicators:

1. Business of the company
2. Top Management
3. Product range
4. Diversification
5. Foreign collaboration
6. Availability of cost of inputs
7. Research and development
8. Governmental regulations
9. Pattern of shareholding and listing

Forecasting Earnings

1. **Identification of variables:**

a. **Operations and Earnings**

Operating cycle of a firm starts with cash converted into inventory

ROI=EBIT

——

Investment

b. Financing&Earnings

Debt financing: Provide leverage to common share holders

Equity financing: Equal shares

2. Selectinga Forecasting method:

a. **Traditional method**

Earnings model: Analysis EAt &EBT

Market share: Consists of tracking historical record and net income

Projected Financial statements: Projection of earnings

b. Modern methods:

- ✓ **Regression analysis**

Its the measure of the average relationship between two or more variable in terms of the original units of the data

- ✓ **Correlation analysis**

Its to reduce the range of uncertainty of our prediction

- ✓ **Trend analysis**

Itrefersto collectinginformation andattemptingto spota pattern

- ✓ **Decision trees**

It used to forecast earnings as security values.

APPLIED VALUATION TECHNIQUES:

Although the raw data of the Financial Statement has some useful information, much more canbe understood about the value of a stock by applying a variety of tools to the financial data.

1. **Earnings per Share EPS**
2. **Price to Earnings Ratio P/E**
3. **Projected Earnings Growth PEG**
4. **Price to Sales P/S**
5. **Price to Book P/B**
6. **DividendPayout Ratio**
7. **Dividend Yield**
8. **Book Valueper share**
9. **Return on Equity**

1. Earnings per Share

The overall earnings of a company is not in itself a useful indicator of a stock's worth. Low earnings coupled with low outstanding shares can be more valuable than high earnings with a high number of outstanding shares. Earnings per share is much more useful information than earnings by itself. Earnings per share (EPS) is calculated by dividing the net earnings by the number of outstanding shares.

EPS =Net Earnings / Outstanding Shares

For example: ABC company had net earnings of $1 million and 100,000 outstanding shares for an EPS of 10 (1,000,000 / 100,000 = 10). This information is useful for comparing two companies in a certain industry but should not be the deciding factor when choosing stocks.

2. Price to Earnings Ratio

ThePricetoEarningsRatio(P/E)showstherelationshipbetweenstockpriceandcompany earnings. It is calculated by dividing the share price by the Earnings per Share.

P/E = Stock Price / EPS

In our example above of ABC company the EPS is 10 so if it has a price per share of $50 theP/E is 5(50 / 10= 5).The P/E tells youhow manyinvestors arewillingto payfor thatparticular company's earnings. P/E's can be read in a variety of ways. A high P/E could mean that the company is overpriced or it could mean that investors expect the company to continue to grow and generate profits. A low P/E could mean that investors are wary of the company or it could indicate a company that most investors have overlooked.

Either way, further analysis is needed to determine the true value of a particular stock.

3. Projected Earnings Growth Rate-PEG Ratio

Aratiousedtodetermineastock'svaluewhiletakingintoaccountearningsgrowth.Thecalculation is as follows:

$$\text{PEG Ratio} = \frac{\text{Price/Earnings Ratio}}{\text{Annual EPS Growth}}$$

PEG is a widely used indicator of a stock's potential value. It is favoured by many over the price/earnings ratio because it also accounts for growth.Similar to the P/Eratio, alower PEG means that the stock is more undervalued.

4. Price to Sales Ratio

When a company has no earnings, there are other tools available to help investors judge itsworth. New companies in particular often have no earnings, but that does not mean they are bad investments. The Price to Sales ratio (P/S) is a useful tool for judging new companies. It is calculated by dividing the market cap (stock price times number of outstanding shares) by total revenues. An alternate method is to divide current share price by sales per share. P/S indicatesthe value the market places on sales. The lower the P/S the better the value.

$$PSR = \frac{\text{Share Price}}{\text{Revenue Per Share}}$$

5.Price to Book Ratio

Bookvalue is determined bysubtractingliabilitiesfrom assets.Thevalue ofa growingcompany will always be more than book value because of the potential for future revenue. The price to bookratio(P/B)is thevaluethemarketplaces onthebookvalueof thecompany.Itis calculated by dividing the current price per share by the book value per share (book value / number of outstanding shares). It is also known as the "price-equity ratio".

P/B = Share Price / Book Value per Share

$$P/B\,Ratio = \frac{\text{Stock Price}}{\text{Total Assets - Intangible Assets and Liabilities}}$$

6. Dividend Yield

Some investors are looking for stocks that can maximize dividend income. Dividend yield is useful for determining the percentage return a company pays in the form of dividends. It is calculated by dividing the annual dividend per share by the stock's price per share. Usually it is the older, well-established companies that pay a higher percentage, and these companies also usually have a more consistent dividend history than younger companies. Dividend yield is calculated as follows:

$$= \frac{\text{Annual Dividends Per Share}}{\text{Price Per Share}}$$

7. Dividend payout ratio

Dividend payout ratiois the fraction of net income a firm pays to its stockholders in dividends:

$$\text{Dividend payout ratio} = \frac{\text{Dividends}}{\text{Net Income for the same period}}$$

The part of the earnings not paid to investors is leftfor investment to provide for future earnings growth. Investors seeking high current income and limited capital growth prefer companies with high Dividend payout ratio. However investors seeking capital growth may prefer lower payout ratio because capital gains are taxed at a lower rate. High growth firms in early life generally have low or zero payout ratios. As they mature, they tend to return more of the earnings back to investors. Note that dividend payout ratio is calculated as EPS/DPS.

Calculated as:

$$= \frac{\text{Yearly Dividend per Share}}{\text{Earnings per Share}}$$

or equivalently:

$$= \frac{\text{Dividends}}{\text{Net Income}}$$

The payout ratio provides an idea of how well earnings support the dividend payments. More maturecompaniestendto haveahigher payoutratio.Inthe U.K.thereis asimilarratio,which is known as dividend cover. It is calculated as earnings per share divided by dividends per share.

8. Return on Equity

Return on equity(ROE) is a measure of how much, in earningsa company generates in a time period compared to itsshareholders' equity. It is typically calculated on a full-year basis (either the last fiscal year or the last four quarters).

Expanded Definition

When capital is tied up in a business, the owners of the capital want to see a good return on that capital.Lookingatprofitbyitselfismeaningless.Imean,ifacompanyearns$1millioninnet

income,that'sokay.Butitsgreatifthecapitalinvestedtoearnthatisonly$2.5million(40% return) and terrible if the capital invested is $25 million (4% return).
Return on investmentmeasures how profitable the company is for the owner of the investment.Inthiscase, **returnonequity** measureshowprofitablethecompanyisfortheequityowners, a.k.a. the shareholders.

$$ROE = \frac{Net\ Income}{Average\ Shareholders\ Equity}$$

The"average"istakenoverthetimeperiodbeingcalculatedandisequalto"thesumofthe beginning equity balance and the ending equity balance, divided by two."

9.Book Value per Share

Ameasureusedbyownersofcommonsharesinafirmtodeterminethelevelofsafety associated with each individual share after all debts are paid accordingly.

$$\text{Book Value Per Share} = \frac{\text{Total Shareholder Equity - Preferred Equity}}{\text{Total Outstanding Shares}}$$

Should the company decide to dissolve, the book value per common indicates the dollar value remaining for common shareholders after all assets are liquidated and all debtors are paid. In simple terms it would be the amount of money that a holder of a common share would get if a company were to liquidate.

3.13 Grahm andDodds Investor ratios:

Eg.,

Earnings per share=

$$\frac{\text{Earnings available for the common shares}}{\text{Weighted average common shares outstanding}}$$

UNIT IV

TECHNICALANALYSIS

Fundamental Analysis Vs Technical AnalysisCharting methodsMarket Indicators. Trend Trend reversalsPatterns - Moving AverageExponential moving AverageOscillators Market IndicatorsEfficient Market theory.

TECHNICAL ANALYSIS:

Technical analysis involves a study of market generated data like prices and volumes to determine the future direction of price movement. Martin J.Pring explains asThe technical approach to investing is essentially a reflection of the idea that prices move in trends which are determined by the changing attitudes of investors toward a variety of economic, monetary, political andpsychological forces.Theartof technical analysis-for it is an art-isto identifytrend changes at an early stage and to maintain an investment posture until the weight of the evidence indicates that the trend has been reversed.

Basic assumption

The basic premises underlying technical analysis are as follows.

1. The marketand / oran individual stockact likea barometerratherthan a thermometer.Events are usually discounted in advance with movements as the likely result of informed buyers and sellers at work.
2. Before a stock experiences a mark-up phase, whether it is minor or major, a period of accumulation usually will take place. Accumulation or distribution activity can occur within natural trading trends. The ability to analyseaccumulation or distribution within net naturalprice patterns will be, therefore, a most essential pre-requisite.
3. The third assumption is an observation that deals with the scope and extends of market movements in relation to each other.

DIFFERENCES BETWEEN TECHNICAL ANALYSIS AND FUNDAMENTAL ANALYSIS

Thekeydifferences betweentechnicalanalysis andfundamentalanalysis areas follows:

1. Technicalanalysismainlyseeksto predictshorttermprice movements,whereas fundamental analysis tries to establish long term values.
2. The focus of technical analysis is mainly on internal market data, particularly price and volume data. The focus of fundamental analysis is on fundamental factors relating to the economy, the industry, and the firm.
3. Technical analysis appealsmostlyto short-term traders,whereas fundamentalanalysisappeals primarily to long-term investors.

CHARTING -A TECHNICAL TOOL

Technicalanalysts,while definingtheirowntheoryaboutstockpricebehaviorand criticizingthe fundamental school, do feel that there is some merit in the fundamental analysis also. But according to them, the method is very tedious and it takes a rather long time for the commonman to evaluate stocks through this method. They consider their own techniques and charts as superior to fundamental analysis. Some of their theories, techniques and methods of stock prices are given below:

Concepts Underlying Chart Analysis

The basic concepts underlying chart analysis are: (a) persistence of trends; (b) relationship between volume and trend; and (c) resistance and support levels.

Trends: The key belief of the chartists is that stock prices tend to move in fairly persistenttrends. Stock price behavior is characterized by inertia: the price movement continues along a certain path (up, down or sideways) until it meets an opposing force, arising out of an altered supply-demand relationship.

Relationship between volumeand trends: Chartistsbelievethatgenerallyvolumeandtrendgo hand in hand. When a majorupturn beginsthe volume of tradingincreases as the priceadvances and decreases as the price declines. In a major down turn, the opposite happens; the volume of trading increases as the price declines and decreases as the price rallies.

Supportand Resistance levels: Chartistsassumethatitisdifficultforthepriceofasharetorise aboveacertainlevelcalledtheresistancelevelandfallbelowacertainlevelcalledasupport level. Why? The explanation for the first claim goes as follows. If investors find that prices fall aftertheirpurchases,theycontinuetohangontotheirsharesinthehopeofarecovery.And when the price rebounds to the level of their purchase price, they tend to sell and heave sigh of relief as they break even.

4.11 EFFICIENT MARKET THEORY

The efficient market hypothesis is a central idea of a modern finance that has profound implications. An understanding of the efficient market hypothesis will help to ask the right questions and save from a lot of confusion that dominates popular thinking in finance. An efficient market is one in which the market price of a security is an unbiased estimate of its intrinsic value. Note that market efficiency does not imply that the market price equals intrinsic value at every point in time.

A corollary is that investors will also be less likely to discover great bargains and thereby earn extraordinaryhigh rates ofreturn. Therequirements fora securitiesmarket to beefficientmarket are;

(1) Pricesmustbeefficientsothatnewinventionsandbetterproductswillcauseafirms securitiespricestoriseandmotivateinvestorstosupplycapitaltothefirm(i.e.,buyitsstock);

(2) Information must be discussed freely and quickly across the nations so all investors can react to new information;

(3) Transactions costs such as sales commissions on securities are ignored;

(4) Taxes are assumed to have no noticeable effect on investment policy;

(5) Everyinvestor is allowed to borrow or lend at the same rate; and, finally,

(6) Investors mustberationalandabletorecognizeefficient assetsandthatthey willwantto invest money where it is needed most (i.e., in the assets with relatively high returns).

Forms of Efficient Market Hypothesis

EugeneFamasuggestedthat itisusefultodistinguishthreelevelsofmarketefficiency.Theyare

1) Weak-formefficiency-Pricesreflectallinformationfoundintherecordofpastandvolumes;
2) Semi-strongformefficiency-Pricesreflectnotonlyallinformationfoundintherecordof past prices and volumes but also all other publicly available information;
3) Strongform efficiency -Prices reflect all available information, public as well as private.

Weak form of EMH

The week form of market holds that present stock market prices reflect all known information with respect to past stock prices, trends, and volumes. This form of theory is just the opposite of the technical analysis because according to it, the sequence of prices occurring historically does not have anyvalue for predicting the future stocks prices. The technicalanalysts rely completely on charts and past behavior of prices of stocks.

Threetypesoftestshavebeencommonlyemployedtoempiricallyverifytheweak-formefficient market hypothesis: (a) serial correlation tests; (b) runs tests; and (c) filter rules tests.

SerialCorrelationTest: SerialCorrelationissaidtomeasuretheassociationofaseriesof numbers which are separated by some constant time period. One way to test for randomness instockpricechangesistolookattheirserialcorrelations.Isthepricechangeinoneperiod correlated with the price change in some other period? If such auto-correlations are negligible,the price changes are considered to be serially independent. Numerous serial correlation studies, employing different stocks, different time-lags, and different time-periods, have been conducted to detect serial correlations

RunTest:RenTestwasalsomadebyFamatofindoutitpricechangeswerelikelytobe followedbyfurtherpricechangesofthesamesign.RunTestignoredtheabsolutevaluesof numbersintheseriesandtookintotheresearchonlythepositiveandnegativesigns.Givena seriesofstockpricechanges,eachprice(+)iditrepresentsanincreaseoraminus(-)ifit representsadecrease.Arunoccurswhenthereisnotdifferencebetweenthesignoftwochanges. When the sign of change differs, the run ends and a new run begin. To test a series of pricechangesforindependence,the numberofruns inthat seriesiscomparedtoseewhetherit is statistically different from the number of runs in a purely random series of the same size. Many studies have been carried out, employing the runs test of independence. They did not detect any significantrelationshipbetweenthereturnsofsecurityinoneperiodandthereturnsinprior periods and made a conclusion that the security prices followed a random walk.

FilterRulesTest: Theuseofchartsisessentiallyatechniqueforfilteringouttheimportant information from the unimportant. Alexander and Fama and Blume took the idea that price and volumedataaresupposed totellthe entirestoryweneedtoknowtoidentifytheimportantaction in stock prices. They applied filter rules to see how well price changes pick up both trends and reverses whichchartists claimtheirchartsdo. Ifastockmoves upXper cent,buyitand holdit long; if it then reverses itself by the same percentage, sell it and take a short position in it.

Semi-Strong Form of EMH

The semi strong form of the efficient market hypothesis centers on how rapidly and efficiently market prices adjust to new publiclyavailable information. Inthis state, the market reflects even those forms of information which may be concerning the announcement of a firms most recent earnings forecast and adjustments which will have taken place in the prices of security. The investor in the semi-strong form of the market will find it impossible to earn a return on the portfolio which is based on the publicly available information in excess of the return which may be said to be commensurate with the portfolio risk. Many empirical studies have been made on thesemi-strongform of the efficientmarket hypothesis to study the reaction ofsecurityprices to various types of information around the announcement time of the information. Two studies commonly employed to test semi-strong form efficient market are event study and portfolio study.

Event Study examines the market reactions to and the excess market returns around a specific information event like acquisition announcement or stock split. The key steps involved in an event study are as follows:
1. Identify the event to be studied and pinpoint the date on which the event was announced.
2. Collect returns data around the announcement date. In this context two issues have to be resolved: What should be the period for calculating returnsweekly, daily, or some other interval? For how many periods should returns be calculated before and after the announcement date?
3. Calculate the excess returns, by period, around the announcement date for each firm in the sample. The excess return is calculated by making adjustment for market performance and risk.
4. Compute the average and the standard error of excess returns across all firms
5. Assess whether the excess returns around the announcement date are different from zero. To determine whether the excess returns around the announcement date are different from zero, estimate the T statistic for each day. The results of event studies are mixed. Most event studies support the semi-strong from efficient market hypothesis. Several event studies, however, have cast their shadow over the validity of the semi strong form efficient markets theory.

Portfolio study: In a portfolio study, a portfolio of stocks having the observable characteristic (low price earnings ratio or whatever) is created and tracked over time see whether it earns superior risk-adjusted returns. Steps involved in a portfolio study are as follows:
1. Definethevariable(characteristic)onwhichfirms willbeclassified. Theproposedinvestment strategy spells out the relevant variable. The variable must be observable, but not necessarily numerical.
2. Classify firms into portfolios based upon the magnitude of the variable. Collect data on the variable for every firm in the defined universe at the beginning of the period and use that information for classifying firms into different portfolios.
3. Compute the returns for each portfolio on the returns for each firm in each portfolio for the testingperiod andcalculate thereturn foreach portfolio,assumingthat thestocksincluded inthe portfolio are equally weighted.
4. Calculate the excess returns for each portfolio. The calculation of excess returns earned by a portfolio calls for estimating the portfolio beta and determining the excess returns
5. Assesswhethertheaverageexcessreturnsare differentacrosstheportfolios.Severalstatistical tests are available to test whether the average excess returns differ across these portfolios. Some ofthesetestsareparametricandsomenonparametric.Manyportfoliostudiessuggestthatitis

not possible to earn superior riskadjusted returns by trading on some observable characteristics. However, several portfolio studies have documented inefficiencies and anomalies.

Strong-Form of EMH

The strong-form efficient market hypothesis holds that all available information, public or private, is reflected in the stock prices. The strong form is concerned with whetheror not certain individualsor groupsofindividualspossess insideinformationwhich canbeused tomake above average profits. If the strong form of the efficient capital market hypothesis holds, then and dayis as goodas any other day to buy any stock. This the most extreme form of the efficient market hypothesis. Most of the research work has indicated that the efficient market hypothesis in the strongest form does not hold good.

Market Efficiency and Anomalies

Anomaliesaresituationsthatappeartoviolatethetraditionalviewofmarketefficiency, suggestingthatitmaybepossibleforcarefulinvestorstoearnabnormalreturns.Somestock marketanomaliesareLowPrice-EarningsRatio:Stockthataresellingatpriceearningsratios that are low relative to the market Low Price-Sales Ratio: Stocks that have price-to-sales ratiosthat are lower competed with other stocks in the same industry or with the overall market. LowPrice-to Book value Ratio: Stocks whose stock prices are less that their respective book valuesHighDividentYield:Stocksthatpayhighdividendsrelativetotheirrespectiveshareprices Smallcompanies:Stockofcompanieswhosemarketcapitalizationislessthan100million Neglected Stocks: Stocks followed by only a few analysts and/or stocks with low percentages of institutionalownershipStockswithHighRelativeStrength:Stockswhosepriceshaverisen faster relative to the overall market January Effect: Stock do better during January than duringany other month of the year Day of the Week:

Stock of poorer during Monday than during

other days of the week Most of these anomalies appear to revolve around four themes:

1. Marketstend to overreact to news, both good and bad.
2. Value investing is contrarians in nature and is beneficial because markets overreact.
3. The market consistently ignores certain stocks, especially small stocks.

Letsexaminewhatanomaliesmeanforinvestorsandtheconceptofmarketefficiency.

Financial Market Overreaction: One of the most intriguing issues to emerge in the past few yearsisthe notionofmarketoverreaction tonew information(bothpositiveandnegative). Many practitionershaveinsistedfor yearsthat marketstooverreact.Recentstatisticalevidenceforboth the market as a whole and individual security has shown errors in security prices that are systematic and therefore predictable. Overreactions are sometimes called reversals. Stocks that perform poorly in period suddenly reverse direction and start performing well in a subsequent period, and vice versa. Several studies have found that stock returns over longer time horizons(in excess of one year) display significant negative serial correlation.

Profiting from Reversals: Market overreactions or reversals suggest several possibleinvestment strategies to produce abnormal profits. Some possibilities include buying last year s worst performing stocks, avoiding stocks with high P/E rations, or buying on bad news. At the risk of oversimplifying, any investment strategy based on market overreaction represents a contrarian approach to invest, buying what appears to be out of favour with most investors.

Calendar-Based Anomalies: Are there better times to own stocks than others? Should youavoid stocks on certain days? The evidence seems to suggest that several calendar-based anomalies exist. The two best known, and widely documented, are the weekend effect and the January effect.

WeekendEffect*:*Studiesofdailyreturnsbeganwiththegoaloftestingwhetherthemarkets operate on calendartimeor tradingtime.In otherwords,are returnsforMondays (i.e.,returns over Friday-to-Monday periods) different from the other day of the week returns? The answerto the question turned out to be yes, the trend was called the weekend effect. Monday returns were substantially lower than other daily returns. One study found that Mondays produced a mean return of almost-35 percent. By contrast, the mean annualized returns on Wednesdays was more than +25 per cent.

TheJanuaryEffect:Stockreturnsappeartoexhibitseasonalreturnpatternsaswell.Inother words, returns are systematically higher in some months than in others. Initial studies found that returns were higher in January for all stocks (thus this anomaly was dubbed the January effect)whereaslaterstudiesfoundtheJanuaryeffectwasmorepronouncedforsmallstocksthanfor largeones.OnewidelyacceptedexplanationfortheJanuaryeffectistax-losssellingbythe investors at the end of December. Because this selling pressure depresses prices at the end of the year, it would be reasonable to expect a bounce-back in prices during January. Small stocks, the argument goes, are more susceptible to the January effect because their prices are more volatile, and institutional investors (many of whom are tax-exempt) are less likely to invest in shares of small companies.

Calendar-Based Trading Strategies: Both seasonal and day-of-the-week affects are inconsistent with market efficiencybecauseboth suggestthat historicalinformationcan generate abnormal profits. As will all anomalies, however, a more important issue is whether seasonal and/ or day-of-the-week effects can create profit opportunities for investors.

Small-Firm Effect: Generally the stocks of small companies substantially outperform stocks of large companies. Of course, history has also shown that small stocks have exhibited more year-to-year variation than large stocks. However, even after correcting for differences in risk, some studies suggest that investors can earn abnormal profits by investing in shares of small companies, exploiting the small-firm effect. Two explanations for the small-firm effect seem plausibletous.The firstis thatanalystshaveapplied thewrong riskmeasurestoevaluatereturns from small stocks. Small stocks may well be riskier than these traditional risk measures indicate.

Performance of Investment Professionals: Investment professionals such as mutual fund managers seem to have a difficult time beating the overall market. In a particular year, some professionals will beat the market, whereas others will not. The key question is whether some professionalscan consistentlyoutperformthe market. Some evidencesuggeststhatthe answerto this question may be yes.

UNIT V

PORTFOLIOMANAGEMENT

Portfolio analysisPortfolio SelectionCapital Asset Pricing model Portfolio Revision

Portfolio Evaluation Mutual Funds.

PORTFOLIO ANALYSIS

Security analysis related to the analysis of individual securities within the framework of return and risk. Whereas, Portfolio analysis makes an analysis of securities in the combined form.

The portfolio analysis considers the determination of future risk and return in holding various blends of individual securities. Portfolio expected return is a weighted average of the expected return of individual securities but portfolio variance can be something less than a weighted average of security variances.

Returns

The expected return of a portfolio depends on the expected return of each of the security containedin the portfolio. It alsoseemslogicalthat theamounts investedin each security should be important. Indeed, this is the case. The example of a portfolio with three securities shown in Table-1A illustrates this point. The expected holding period value-relative for the portfolio is clearly:

Rs.23, 100

----------= 1.155

Rs.20, 000

giving an expected holding period return of 15.50%.

Risk

Theprobabilityofloss istheessenceofrisk. Ausefulmeasureofrisktakesinto accountboththe probabilityofvariouspossible bad outcomesandtheirassociatedmagnitudes.Insteadof measuringthe probabilityof anumber ofdifferentpossible outcomes,the measureof riskshould somehow estimate the extent to which the actual outcome is likely to diverge from the expected. Two measures used for this purpose are the mean absolute deviation and the standard deviation.

Efficient Frontier and Portfolio Selection

Theportfolio is selectedbytheintroduction ofa borrowingand lendinglinemaking theefficient frontier a straight line.Illustration 7 showsa risk-free securityof 6% withastandard deviationof 6.90.Thegraphrepresentsaportfolio returnandriskand thebestportfoliois thecornerportfolio of9. The corner which is beyond9and to its left, i.e. from 10 to 17 can be introduced to a greater efficiency and made efficient by selecting9with an addition of the fact of leading.The choice of portfolio which are on the right side of9 i.e.from 1 to 8 are seen to show borrowingandareinsomewaydominatedby99isthestageinwhichthemaximumbenefit canbederivedafterusingtheformula

(RpRt /bp).

risk.Intheselectionofa portfolio, bothnegativeand positivebetasshouldbeconsidered.While assessingaportfolioonbeta,the negativebeta should bepreferred topositive beta.The presence of negative beta in a portfolio if efficient. Also, there is reduced or eliminated amount of risk when the negative betas are present.

Although betas help in selecting stock, care should be taken to select the

stockwiththebetaapproachbecauseselectionofportfoliowithbetaisfollowed only
when the following assumptions are considered:
(a) The market movementin positives and negativesdirections haves tobe carefully analyzedand
(b) Thepasthistoricalconsiderationsofbetamustbeanalyzedforfuture
prediction of beta.
(a) the sensitivity of the security to inflation;
(b) economics events as Market Index causes systematic change and
(c) Risk and return with portfolio.

The fundamental factors are the following:
(a) the earning of a firm;
(b) the movements of the market;
(c) continuous valuation of stock;
(d) surveyofstock,whetheritrepresentslargeorsmallfirms,oldand
established and new firms;
(e) growth of firms historically and
(f) The capital structure of the firm.

5.3.CAPITAL ASSET PRICING MODEL(CAPM)

The capital asset pricing model (CAPM) is used in finance to determine a theoretically appropriate rate of return of an asset, if that asset is to be added to an already well-diversified portfolio, given that asset's non-diversifiable risk. The CAPM formula takes into account the asset's sensitivity to non-diversifiable risk (also known as systematic risk or market risk),referred to as beta (â) in the financial industry, as well as the expected return of the market and the expected return of a theoretical risk-free asset. The model was introduced by Jack Treynor, William Sharpe, John Lintner and Jan Mossin independently, building on the earlier work of Harry Markowitz on diversification and modern portfolio theory.

Formula

The CAPM is a model for pricing an individual security or a portfolio. The security market line (SML) and its relation to expected return and systematic risk (beta) show how the market mustpriceindividualsecuritiesinrelationtotheirsecurityriskclass.Itenablestocalculatethe reward-to-riskratioforanysecurityinrelationtotheoverallmarkets.Therefore,whenthe expected rate of return for any security is deflated by its beta coefficient, the reward-to-risk ratio for any individual security in the market is equal to the market reward-to-risk
ratio, thus:
Individualsecuritys=Marketssecurities(portfolio)
Reward-to-risk ratio Reward-to-risk ratio
,
The market reward-to-risk ratio is effectively the market risk premium and by rearrangingtheaboveequationandsolvingforE(Ri),theCapitalAssetPricing Model (CAPM) is obtained.
Where:
istheexpectedreturnonthecapitalasset is
the risk-free rate of interest

(the*betacoefficient*)thesensitivityoftheassetreturnsto market
returns, or also ,
is the expected return of the market
is sometimes known as the*market premium*or*risk*
premium(thedifferencebetweentheexpectedmarketrateofreturnandthe risk-
free rate of return).
Asset pricing
Oncethe expected return,*E*(*Ri*)-, iscalculated using CAPM, the future
cashflowsoftheassetcanbediscountedtotheirpresentvalueusingthisrate
(*E*(*Ri*)-), to establish the correct price for the asset.
In theory, therefore, an asset is correctly priced when its observed price
isthesameasitsvaluecalculatedusingtheCAPMderiveddiscountrate.Ifthe observed
price is higher than the valuation, then the asset is overvalued

Asset-specific required return
The CAPM returns the asset-appropriate required return or discount rate - i.e. the rate at which future cash flows produced by the asset should be discounted given that asset's relative risk.Betas exceeding one signify more than average "risk"; betas below one indicate lower than average. Thus a more risky stock will have a higher beta and will be discounted at a higher rate; less sensitive stocks will have lower betas and be discounted at a lower rate.

5.5.PERFORMANCE EVALUATION

In order to determine the risk-adjusted returns of investment portfolios,several
eminent authors have worked since 1960s to develop composite
performanceindicestoevaluateaportfoliobycomparingalternativeportfolios
withinaparticularriskclass.Themostimportantandwidelyusedmeasuresof
performance are:
ØTheTreynorMeasure
Ø The Sharpe Measure
Ø Jenson Model
Ø Fama Model

The Treynor Measure
Developed by Jack Treynor, this performance measure evaluates funds on the basis of Treynor's Index.This Indexis aratio ofreturngeneratedbythefundoverand aboverisk freerateof return (generallytakentobethereturnonsecuritiesbackedbythegovernment,asthereisnocreditrisk associated),b during a given period and systematic risk associated with it (beta). Symbolically, it can be represented as:
Treynor's Index **(Ti) = (Ri - Rf)/Bi.**
Where,**Ri** represents return on fund,**Rf**is risk free rate of return and**Bi**
is beta of the fund.

The Sharpe Measure
Inthismodel,performanceofa fundisevaluated onthebasisof SharpeRatio,whichis aratioof returnsgeneratedbythefundoverandaboveriskfreerateofreturnandthetotalriskassociated

with it.According toSharpe, itis thetotal risk ofthe fund that theinvestors are concernedabout. So,themodelevaluatesfundsonthebasisofrewardperunitoftotalrisk.Symbolically,itcan be written as:

Sharpe Index**(Si) = (Ri - Rf)/Si**

Where,**Si**is standard deviation of the fund.

While a high and positive Sharpe Ratio shows a superior risk-adjusted performance of a fund, a low and negative Sharpe Ratio is an indication of unfavorable performance.

Comparison of Sharpe and Treynor

Sharpe and Treynor measures are similar in a way, since they both divide the risk premium bya numerical risk measure. The total risk is appropriate when we are evaluating the risk return relationship for well-diversified portfolios. On the other hand, the systematic risk is the relevant measure of risk when we are evaluating less than fully diversified portfolios or individual stocks.

Jenson Model

Jenson's model proposes another risk adjusted performance measure. ThismeasurewasdevelopedbyMichaelJensonandissometimesreferredtoas theDifferentialReturnMethod.Thismeasureinvolvesevaluationofthereturns that the fund has generated vs. the returns actually expected out of the fund given the level of its systematic risk. The surplus between the two returns is called Alpha, which measures the performance of a fund compared with the actual returns over the period. Required return of a fund at a given level of risk (**Bi**) can be calculated as:

Ri = Rf + Bi (Rm -Rf)

Where,**Rm**is average market return during the given period.

Fama Model

The Eugene Fama model is an extension of Jenson model. This model compares theperformance,measuredintermsofreturns,of afundwiththe requiredreturncommensuratewith the total risk associated with it. The difference between these two is taken as a measure of the performance of the fund and is called net selectivity.

Required return canbe calculated as:

Ri = Rf + Si/Sm*(Rm - Rf)

Where,**Sm**is standarddeviation ofmarket returns.The netselectivityis thencalculatedbysubtractingthisrequiredreturnfromtheactualreturnofthe fund.

5.6 MUTUAL FUNDS:

A**mutual fund** isaprofessionallymanagedtypeof collectiveinvestment thatpools moneyfrom many investors to buystocks,bonds, short-term money marketinstruments,and/or other securities.

Overview

IntheUnitedStates,amutualfundisregisteredwiththe SecuritiesandExchangeCommission (SEC)andisoverseenbyaboardofdirectors (iforganizedasacorporation) orboard of trustees(if organized as a trust). The board is charged with ensuring that the fund is managed in the best interests of the fund's investors and with hiring the fund manager and other service providers to the fund. Thefund manager, also known as the fund sponsor or fund management company,trades(buys and sells) the fund's investments in accordance with the fund'sinvestment objective. Afund managermust be aregisteredinvestment advisor.Funds that aremanagedbythesame fundmanagerandthathavethesame brandname areknownasa"fund family" or "fund complex".

TheInvestment Company Act of 1940(the 1940 Act) established three types of registeredinvestmentcompaniesorRICsintheUnitedStates: open-endfunds,unitinvestmenttrusts(UITs); andclosed-end funds. Recently,exchange-traded funds(ETFs), which are open- end funds or unit investment trusts that trade on an exchange, have gained in popularity. While theterm"mutualfund"mayrefertoallthreetypesofregisteredinvestmentcompanies,itismore commonly used to refer exclusively to the open-end type.

Hedge fundsare not considered a type of mutual fund. While they are another type of commingledinvestmentscheme,theyarenotgovernedbythe InvestmentCompanyActof1940and are not required to register with the Securities and Exchange Commission (though many hedge fund managers now must register as investment advisors).

Mutual funds are not taxed on their income as long as they comply with certain requirements established in the Internal Revenue Code. Specifically, they must diversify their investments, limit ownership of voting securities, distribute most of their income to their investors annually, and earn most of the income by investing in securities and currencies.[2] Mutual funds pass taxableincomeontotheirinvestors.Thetypeofincometheyearnisunchangedasitpasses

through to the shareholders. For example, mutual fund distributions of dividend income are reported as dividend income by the investor. There is an exception: net losses incurred by a mutual fund are not distributed or passed through to fund investors.

Outsideofthe UnitedStates,*mutualfund* isusedasa genericterm forvarioustypesof collective investment vehicles available to the general public, such asunit trusts, open-ended investment companies (OEICs, pronounced "oyks"),unitized insurance funds,UCITS(Undertakings for Collective Investment in Transferable Securities, pronounced "YOU-sits") andSICAVs(*société d'investissement à capital variable*, pronounced "SEE-cavs").

Advantages of mutual funds

Mutual funds have advantages compared to direct investing in individual securities.These include:

- Increased diversification
- Daily liquidity
- Professional investment management
- Ability to participate in investments that may be available only to larger investors
- Service and convenience
- Government oversight
- Ease of comparison

Disadvantages of mutual funds

Mutualfunds have disadvantages as well, which include[

- Fees
- Less control over timing ofrecognition of gains
- Less predictable income
- No opportunity to customize

Leading mutual fund complexes

At the end of 2009, the top 10 mutual fund complexes in the United States were:[14]

1. Fidelity Investments

2. Vanguard Group
3. Capital Research & Management (American Funds)
4. JP Morgan Chase &Co.
5. BlackRock Funds
6. PIMCO Funds
7. Franklin Templeton Investments
8. Federated Investors
9. Bank of New York Mellon
10. Goldman Sachs &Co.

Types of mutual funds

There are three basic types ofregistered investment companiesdefined in theInvestmentCompanyActof1940:open-endfunds,unitinvestmenttrusts(UITs);andclosed-endfunds.exchange-tradedfunds(ETFs)areopen-endfunds orunit investmenttruststhattradeon an exchange.

Open-end funds

Open-end mutual fundsmust be willing to buy back their shares from their investors at the endof every business day at the net asset value computed that day. Most open-end funds also sell shares to the public every business day; these shares are also priced at net asset value. A professional investment manager oversees the portfolio, buying and selling securities as appropriate. The total investment in the fund will vary based on share purchases, redemptionsand fluctuation in market valuation.Closed-end funds

Closed-end funds[15] generally issue shares to the public only once, when they are created through aninitial public offering. Their shares are then listed for trading on astock exchange. Investors who no longer wish to invest in the fund cannot sell their shares back to the fund (as they can with an open-end fund). Instead, they must sell their shares to another investor in the market; the price they receive may be significantly different from net asset value. It may be at a "premium"to net assetvalue(meaning thatit is higher thannetasset value) or,morecommonly, at a "discount" to net asset value (meaning that it is lower than net asset value). A professional investment manager oversees the portfolio, buying and selling securities as appropriate.

Unit investment trusts

Unit investment trusts or UITs issue shares to the public only once, when they are created. Investors can redeem shares directly with the fund (as with an open-end fund) or they may also be able to sell their shares in the market. Unit investment trusts do not have a professional investment manager. Their portfolio of securities is established at the creation of the UIT and does not change. UITs generally have a limited life span, established at creation.

Exchange-traded funds

A relatively recent innovation, the exchange-traded fund or ETF is often structured as an open-end investment company, though ETFs may also be structured as unit investment trusts, partnerships, investments trust, grantor trusts or bonds (as anexchange-traded note).ETFs combine characteristics of both closed-end funds and open-end funds. Like closed-end funds, ETFs are traded throughout the day on astock exchange at a price determined by the market. However, as with open-end funds, investors normally receive a price that is close to net asset value. To keep the market price close to net asset value, ETFs issue and redeem large blocks of their shares with institutional investors.

Money market funds

Moneymarketfundsinvestin moneymarketinstruments, whicharefixedincomesecuritieswith averyshorttimetomaturityandhighcreditquality.Investorsoftenusemoneymarketfundsasa substitute for bank savings accounts, though money market funds are not government insured, unlike bank savings accounts.

Money market funds strive to maintain a $1.00 per share net asset value, meaning that investors earninterest incomefrom thefund but donot experiencecapital gainsor losses. Ifa fundfails to maintainthat$1.00 pershare becauseits securities havedeclined in value, it is saidto "breakthe buck". Only two money market funds have ever broken the buck: Community Banker's U.S. Government Money Market Fund in 1994 and the Reserve Primary Fund in 2008.

At the end of 2009, moneymarket funds accounted for 30% of the assets inall U.S. mutual funds

Bond funds

Bond funds invest in fixed income securities. Bond funds can be subclassified according to the specifictypesofbondsowned(suchashigh-yieldorjunkbonds,investment-gradecorporate

bonds, government bonds or municipal bonds) or by the maturity of the bonds held (short-, intermediate- or long-term). Bond funds may invest in primarily U.S. securities (domestic orU.S. funds), in both U.S. and foreign securities (global or world funds), or primarily foreign securities (international funds).

At the end of 2009, bond funds accounted for 20% of the assets in all U.S. mutual funds.[18]

Stock or equity funds

Stock or equity funds invest in common stocks. Stock funds may invest in primarily U.S. securities(domesticorU.S.funds),inbothU.S.andforeignsecurities(globalor worldfunds),or primarily foreign securities (international funds). They may focus on a specific industry orsector.

A stock fund may be subclassified along two dimensions: (1) market capitalization and (2) investment style (i.e., growth vs. blend/core vs. value). The two dimensions are oftendisplayed in a grid known as a "style box."

Market capitalization or market cap is the value of a company's stock and equals the number of sharesoutstandingtimesthe marketpriceofthestock.Marketcapitalizations aredividedinto the following categories:

- Micro cap
- Small cap
- Mid cap
- Large cap

While the specific definitions of each category vary with market conditions, large cap stocks generally have market capitalizations of at least $10 billion, small cap stocks have market capitalizations below $2 billion, and micro cap stocks have market capitalizations below $300 million.Fundsarealsoclassifiedinthesecategoriesbasedonthemarketcapsofthestocksthatit holds.

Stock funds are also subclassified according to their investment style: growth, value or blend (or core).Growthfundsseektoinvestinstocksoffast-growingcompanies.Valuefundsseekto