

Basic Concepts in Investments

Financial System can be compared to a spider's web, sprawled into financial markets, financial Institutions and financial intermediaries. The Regulators such as Securities and Exchange Board of India (SEBI), Reserve Bank of India (RBI) and Insurance Regulatory and Development Authority (IRDA) try to ensure that the entire system works in cohesion with each other, in a smooth manner and in the best interest of the country and public. Stronger the regulatory framework of a country, better the chances of economic system of a country running without hiccups and road blocks. If, however, the system leaves lot of loopholes and scope for individual interpretation, it will have a rough ride, occasionally giving rise to frauds, manipulations, scams and system breakdowns. Lesser the number of break downs in the system, good for the economy and the country as a whole.

The financial system helps to move funds from where they are surplus to where there is need for the funds. The movement can take any form, including money, financial assets and securities such as debt instruments like bonds and debentures having a fixed, short/long term maturity or equity instruments which have neither maturity nor any fixed assured return. These basic instruments give rise to more instruments such as mutual fund units, warrants, derivatives, preference shares, ADR/GDR, convertible/non-convertible debentures etc. Investors in India have wide choice of instruments to choose from to suit their liquidity needs, risk appetite and requirement of the return. Some of the instruments are described below.

Money: Asset in money form is the most liquid asset. However, money in liquid form does not yield any return; on the contrary, it erodes in value with passing of time due to inflation. Besides it is risky to hold money since it can be easily taken away unless securely kept. Due to these shortcomings funds are held in the form of "near money assets" which do not require much space, are easy to hold, are in paper form and have no risk of being stolen, apart from the fact that they can easily be converted into cash whenever there is a need for liquidity.

Financial assets: Financial assets are those assets which are represented by a document or certificate of ownership. They include fixed deposits, RBI bonds, National Savings Certificates etc. They also include 'securities' as defined in Securities Contracts (Regulation) Act, 1956. They are,

1. Shares, scrips, stocks, warrants, bonds, debentures, money market instruments and other marketable securities of like nature;
2. Derivatives;
3. Units of mutual funds;
4. Government securities;
5. Such other instruments as may be declared by the Central Government to be securities and;
6. Rights or interest in securities.

The difference between instruments such as fixed deposits, National Savings certificates and the securities is that while fixed deposits and NSCs can not be traded nor they can they be sold or otherwise endorsed and transferred, the securities as defined in Securities Contract Act can be bought and sold in secondary market anytime during their tenure at a price which may be at par, below the face value or above the face value depending on interest rate movement, demand and supply and economic conditions prevailing on the day of the transaction. Two major classifications of financial instruments are - debt instruments and equity instruments.

Debt: Debt instruments represent financial obligation incurred by one party against another. This obligation may be in the nature of borrowing the funds for a fixed tenure repayable after this term, either in lump sum or in installments, at a specific rate of interest payable along with the principal

or at monthly, quarterly, half yearly or yearly frequency. The borrower or debtor may offer a security for the amount raised to the lender or creditor. In case of default (in repayment of principal or payment of interest) by the debtor or the borrower, the lender gets a right to dispose off the security for recovery of the debt. Bonds, debenture, commercial papers etc are typical debt instruments which create the obligation described above. When the borrowing party is a sovereign body like Central Government, they are called Government Securities. Government also borrows on short term basis through the issue of treasury bills which form part of money market instruments.

Equity: Also referred to as shares (stock, scrip), by buying equity in a company the buyer becomes the owner of the company. This means that you get a right to share the profits (through receipt of dividend) and enjoy other rights of the ownership such as receiving notice of Annual General Meeting, receipt of annual reports on performance of the company and voting for and against the resolutions placed before the share holders. He also enjoys the benefit of appreciation in the value of shares if the company is performing well. In case it is a company listed on stock exchange, share holder has an 'exit option' meaning, he can sell the share through exchange and dissociate from the company. The shares are bought either in primary market i.e. by way of applying in IPO (Initial Public Offering), or through secondary market i.e. buying on the stock market.

Primary market is referred to that part of the market where a company issues shares or a debt instrument like bond or debenture for the first time and invites the public to subscribe to the issue at a specific price (which may be fixed or decided through a method called 'book building' i.e. by calling bids). Once the shares or bonds, debenture are issued to the subscribing public, company arranges to list these securities on the specific stock exchanges (in terms of offer document) where they could be sold or bought at the prices prevailing on the date of the transaction. This subsequent buying or selling on the stock exchange is called secondary market transaction. The prices of these instruments is subject to price fluctuations depending upon demand and supply of shares on any particular day, performance of the company, market sentiments and economic barometers such as interest rate movements, inflation, Government stability etc.

Apart from basic form of financial instruments viz. debt and equity, there are several other instruments in the market such as some hybrid instruments like preference shares, convertible debenture etc (which have some features of debt as well as equity) and instruments like derivatives and mutual fund units etc which are derived from both these basic instruments.

Risk and Return: Every investment has an element of risk. The risk may vary according to the nature of instrument, for example, equity instrument has more risk as compared to debt instrument. Risk would also depend on market conditions, economic indicators and liquidity in the system, demand and supply; but most importantly upon how much broad based and deep are the secondary markets for those securities. In undeveloped and emerging economies, markets tend to be very volatile and unpredictable unlike in developed countries where markets are stable and therefore forecasting becomes easy. Apart from market risk, instruments are also subject to other risks such as credit risk (risk of default), counter party risk, liquidity risk, interest rate fluctuations, operational risk, exchange rate risk etc.

Different instruments have different capacity to generate returns. But distinctly, there is a direct relationship between risk in any instrument and return it can generate. Normally, risk and return in instruments in an ascending order can be shown as below.

- Government securities (includes treasury bills)
- Bank fixed deposits
- Bonds issued by Public Sector Undertakings
- Debentures issued by companies in private sector
- Fixed Deposits accepted by companies in private sector

- Equity shares (includes derivatives, ADRs / GDRs)

Financial Markets: Traditionally there are three important types of markets in any financial system.

- Equity market
- Wholesale Debt market
- Foreign exchange market

Apart from above we also have a Commodities market which is gaining lot of prominence in recent times, which deals in futures and options in specified commodities such as cotton, pulses, food grains, oil seeds etc.

Equity market: This market deals in shares, stocks and other listed securities. The various securities traded on this market are given below:

- **Shares**
 - Ordinary shares
 - Partly paid shares
- **Hybrid securities**
 - Preference shares
 - Convertible debentures
- **Mutual funds**
 - Income Oriented Mutual Funds
 - Equity Oriented Mutual Funds
 - Exchange Traded Funds
- **Derivatives**
 - Futures
 - Options
 - Warrants
- **Debt securities**
 - Bonds
 - Debentures
 - Government securities

Wholesale debt market: In wholesale debt market, normally securities are bought and sold through negotiated deals directly between the parties. The parties involved are mostly financial institutions, banks, mutual funds, insurance companies, primary dealers etc. There is no requirement of fixed market place unlike equity market and deals are negotiated with or without the assistance of brokers. Since these deals are concluded directly without intervention of intermediary like stock exchange, the parties run the risk of default by one of the parties. As against this, in equity markets the risk of default is absent since all the transactions are governed by rules and regulations of stock exchange and they are carried out through their members (brokers) who are bound to honour their respective commitments. The transactions in wholesale debt market are typically of large volume; each transaction some times running into crores of rupees. The transactions are concluded through an account maintained with RBI by each participant; which affords some kind of comfort and safety to the parties to the deal.

Money market: Money market is a market where call money and similar short term instruments are traded. They include treasury bills, government securities approaching maturity, commercial papers and certificate of deposits. This market is meant to help the banks and financial institutions to adjust their temporary liquidity needs. The instruments traded are typically of short duration (having maturity ranging from a day to 1 year). As in case of wholesale debt market the deals in money market are entertained on telephone by direct negotiations. Again, transactions are subject to counter party risk since there is no authorized mechanism to enforce the terms of contract. While no intervention of brokers is permitted by RBI in call money transactions, brokers are allowed to intermediate in other security deals. As compared to equity markets, this market suffers from lack of depth and therefore RBI has been constantly trying to broad base the market by introducing new instruments and allowing the entry of new intermediaries. Simultaneously, RBI desires that call money market should be restricted to banks as borrowers and lenders, allowing other participants to deal in instruments other than call money.

Foreign exchange market: Foreign exchange transactions involve buying and selling currencies of different countries. They, however, do not fall in the category of securities as defined in Securities Contract Act. RBI has the responsibility of supervising, developing and promoting foreign exchange market and monitoring operations of commercial banks in India. The forex operations cannot be done without the approval and authorization of RBI. Buying and selling foreign exchange from and to unauthorized entity is a punishable offence. Each authorized bank is given a limit for net open overnight position for foreign exchange exposure. Apart from banks some large Indian companies have fully equipped and having well qualified staff for their dealing room operations.

Banks till few years back had separate dealing rooms for domestic operations and forex operations. It was, however, realized by them that these markets have a close link and separating them would be disadvantageous. Most of the public and private sector banks have, therefore, integrated their domestic and forex operations and brought them under one roof.

Intermediaries are an integral part of any financial system. Indian financial system has a rich and expert contingent of intermediaries just as it has plethora of financial instruments to suit the diverse needs of the investors. With globalization and integration of our markets with global markets, the need for more instruments and intermediaries would be ever increasing. Our regulators are trying their best to ensure that the markets do not suffer on account of depth and stability. The regulations are getting tighter to plug the possible loop holes to make the system well regulated and in turn safe and secured for the participants. The Indian markets are certainly on a path of progress and prosperity..