Unit - I
Investment avenues

Meaning:

An investment is an asset or item that is purchased with the hope that it will generate income or will appreciate in the future. In finance, an investment is a monetary asset purchased with the idea that the asset will provide income in the future or will be sold at a higher price for a profit.

Investment is the employment of funds with the aim of achieving additional income or growth in value. The essential quality of an investment is that, it involves 'waiting' for a reward. It involves the commitment of resources which have been saved or put away from current consumption in the hope that some benefits will accrue in future.

ELEMENTS OF INVESTMENTS

The Elements of Investments are as follows:

a) Return: Investors buy or sell financial instruments in order to earn return on them. The return on investment is the reward to the investors. The return includes both current income and capital gain or losses, which arises by the increase or decrease of the security price.

b) Risk: Risk is the chance of loss due to variability of returns on an investment. In case of every investment, there is a chance of loss. It may be loss of interest, dividend or principal amount of investment. However, risk and return are inseparable. Return is a precise statistical term and it is measurable. But the risk is not precise statistical term. However, the risk can be quantified. The investment process should be considered in terms of both risk and return.

c) Time: time is an important factor in investment. It offers several different courses of action. Time period depends on the attitude of the investor who follows a 'buy and hold' policy. As time moves on, analysis believes that conditions may change and investors may revaluate expected returns and risk for each investment.

d) Liquidity: Liquidity is also important factor to be considered while making an investment. Liquidity refers to the ability of an investment to be converted into cash as and when required. The investor wants his money back any time. Therefore, the investment should provide liquidity to the investor.

e) Tax Saving: The investors should get the benefit of tax exemption from the investments. There are certain investments which provide tax exemption to the investor. The tax saving investments increases the return on investment. Therefore, the investors should also think of saving income tax and invest money ,in order to maximize the return on investment.

Importance of Investment:

a. Longer Life Expectancy:

Men and women will be responsible for planning their own investments during their working life so that after retirement they are able to have a stable income. Increase in the working population, proper planning for life span and longevity have ensured the need for balanced investments.

b. Taxation:

Taxation is one of crucial factors in any country which introduces an element of compulsion in a person's savings. There are various forms of savings outlets in our country in the form of investments which help in bringing down the tax level.

c. Interest Rates:

Interest rates vary between one investment and another. These may vary between risky and safe investments; they may also differ due to different benefit schemes offered by the investments.

These aspects must be considered before allocating any amount in investments. A high rate of interest may not be the only factor favoring the outlet for investment. The investor has to include in his portfolio several kinds of investments.

d. Inflation:

Every developing economy is phased with the problem of rising prices and inflationary trends. In these years of rising prices, several problems are associated coupled with a falling standard of living.

e. Income:

Awareness of financial assets and real assets has led to the ability and willingness of working people to save and invest their funds for return in their lean period leading to the importance of investments. Thus, the objectives of investment are to achieve a good rate of return in the future, reducing risk to get a good return, liquidity in time of emergencies, safety of funds by selecting the right avenues of investments and a hedge against inflation.

Capital Appreciation

Capital appreciation is concerned with long-term growth. This strategy is most familiar in retirement plans where investments work for many years inside a qualified plan. However, investing for capital appreciation is not limited to qualified retirement accounts.

Current Income

If your objective is current income, you are most likely interested in stocks that pay a consistent and high dividend. You may also include some top-quality real estate investment trusts (REITs) and highly-rated bonds. All of these products produce current income on a regular basis. Many people who pursue a strategy of current income are retired and use the income for living expenses. Other people take advantage of a lump sum of capital to create an income stream that never touches the principal, yet provides cash for certain current needs (college, for example).

Speculation

The speculator is not a true investor, but a trader who enjoys jumping into and out of stocks as if they were bad shoes. Speculators or traders are interested in quick profits and used advanced trading techniques like shorting stocks, trading on the margin, options and other special equipment. They have no love for the companies they trade and, in fact may not know much about them at all other than the stock is volatile and ripe for a quick profit. Speculators keep their eyes open for a quick profit situation and hope to trade in and out without much thought about the underlying companies. Many people try speculating in the stock market with the misguided goal of getting rich. It doesn’t work that way. If you want to try your hand, make sure you are using money you can afford to lose. It’s easy to get addicted, so make sure you understand the real possibilities of losing your investment.

Marketability/Liquidity:

Many of the investments we have discussed are reasonably illiquid, which means they cannot 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.

Factors Favourable for Investment:

i. Legal Safeguards:

A stable government which frames adequate legal safeguards encourages accumulation of savings and investments. Investors will be willing to invest their funds if they have the assurance of protection of their contractual and property rights.

ii. A Stable Currency:

A well-organized monetary system with definite planning and proper policies is a necessary prerequisite to an investment market. Most of the investments such as bank deposits, life insurance and shares are payable in the currency of the country. A proper monetary policy will give direction to the investment outlets. As far as possible, the monetary policy should neither promote acute inflationary pressures nor prepare for a deflation model. Neither condition is satisfactory.

A reasonable stable price level which is produced by wise monetary and fiscal management contributes towards proper control, good government, economic well-being and a well-disciplined growth oriented investment market and protection to the investor.

iii. Existence of Financial Institutions and Services:

The presence of financial institutions and financial services encourage savings, direct them to productive uses and helps the investment market go grow. The financial institutions in existence in India are mutual funds, development banks, commercial banks, life insurance companies, investment companies, investment bankers and mortgage bankers.

The financial services include venture capital, factoring and forfaiting, leasing, hire purchase and consumer finance, housing finance, merchant bankers and portfolio management. Investment bankers are merchants of securities. They buy bonds and stocks of companies for re-sale to investors.

iv. Form of Business Organization:

The form of business organization which is permanent in existence aides savings and investment. The public limited companies have been said to be the best form of organization. The three characteristics of the corporation which have been very useful for investors are limited liability of shareholders, perpetual life and transferability and divisibility of stocks and shares.

v. Choice of Investment:

The growth and development of the country leading to greater economic activity has led to the introduction of a vast array of investment outlets. Apart from putting aside savings in savings banks where interest is low, investors have the choice of a variety of instruments.

The investor in his choice of investment will have to try and achieve a proper mix between high rate of return and stability of return to reap the benefits of both. Some of the instruments available are equity shares and bonds, provident fund, life insurance, fixed deposits and mutual funds schemes.

vi. Risk-Less Vs. Risky Investments:

Most investors are risk averse but they expect maximum return from their investment. Every investment must be analysed because there is definitely some risk in it.

A vast range of investments is in the government sector. These are mostly risk free but low return yielding. Several incentives are attached to it. The private sector investments consist of equity and preference shares, debentures and public deposits with companies. These have the features of high risk. Ultimately, the investor must make his investment decisions.

FEATURES OF AN INVESTMENT PROGRAM

1. Safety of Principal:

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

Adequate diversification involves mixing investment commitments by industry, geographically, by management, by financial type and by maturities. A proper combination of these factors would reduce losses. Diversification to a great extent helps in proper investment programmes but it must be reasonably accomplished and should not be carried out to extremes.

2. Liquidity:

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

3. Income Stability:

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

4. Appreciation and Purchasing Power Stability:

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

5. Legality and Freedom from Care:

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

6. Tangibility:

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

Difference between Investment and Speculation

Investment refers to the acquisition of the asset, in the expectation of generating income. In a wider sense, it refers to the sacrifice of present money or other resources for the benefits that will arise in future. The two main element of investment is time and risk

Speculation is a trading activity that involves engaging in a risky financial transaction, in expectation of making enormous profits, from fluctuations in the market value of financial assets. In speculation, there is a high risk of losing maximum or all initial outlay, but it is offset by the probability of significant profit. Although, the risk is taken by speculators is properly analysed and calculated.

Basis for Comparison	Investment	Speculation
Meaning	The purchase of an asset with the hope of getting returns is called investment.	Speculation is an act of conducting a risky financial transaction, in the hope of substantial profit.
Basis for decision	Fundamental factors, i.e. performance of the company.	Hearsay, technical charts and market psychology.
Time horizon	Longer term	Short term
Risk involved	Moderate risk	High risk
Intent to profit	Changes in value	Changes in prices
Expected rate of return	Modest rate of return	High rate of return

Funds	An investor uses his own funds.	A speculator uses borrowed funds.
Income	Stable	Uncertain and Erratic
Behavior of participants	Conservative and Cautious	Daring and Careless

Various Avenues and Investments Alternative

Different avenues and alternatives of investment include share market, debentures or bonds, money market instruments, mutual funds, life insurance, real estate, precious objects, derivatives, non-marketable securities. All are differentiated based on their different features in terms of risk, return, term etc.

Equity Shares

Equity investments represent ownership in a running company. By ownership, we mean share in the profits and assets of the company but generally, there are no fixed returns. It is considered as a risky investment but at the same time, they are most liquid investments due to the presence of stock markets. Equity shares of companies can be classified as follows:

- Blue chip scrip
- Growth scrip
- Income scrip
- Cyclical scrip
- Speculative scrip

Debentures or Bonds

Debentures or bonds are long term investment options with a fixed stream of cash flows depending on the quoted rate of interest. They are considered relatively less risky. An amount of risk involved in debentures or bonds is dependent upon who the issuer is. For example, if the issuer is government, the risk is assumed to be zero. Following alternatives are available under debentures or bonds:

- Government securities
- Savings bonds
- Public Sector Units bonds
- Debentures of private sector companies
- Preference shares

Money Market Instruments

Money market instruments are just like the debentures but the time period is very less. It is generally less than 1 year. Corporate entities can utilize their idle working capital by investing in money market instruments. Some of the money market instruments are

- Treasury Bills
- Commercial Paper
- Certificate of Deposits

Mutual Funds

Mutual funds are an easy and tension free way of investment and it automatically diversifies the investments. A mutual fund is an investment mix of debts and equity and ratio depending on the scheme. They provide with benefits such as professional approach, benefits of scale and convenience. In mutual funds also, we can select among the following types of portfolios:

- Equity Schemes
- Debt Schemes
- Balanced Schemes
- Sector Specific Schemes etc.

Life Insurance and General Insurance

They are one of the important parts of good investment portfolios. Life insurance is an investment for the security of life. The main objective of other investment avenues is to earn a return but the primary objective of life insurance is to secure our families against unfortunate event of our death. It is popular in individuals. Other kinds of general insurances are useful for corporates. There are different types of insurances which are as follows:

- Endowment Insurance Policy
- Money Back Policy
- Whole Life Policy
- Term Insurance Policy
- General Insurance for any kind of assets.

Real Estate

Every investor has some part of their portfolio invested in real assets. Almost every individual and corporate investor invest in residential and office buildings respectively. Apart from these, others include:

- Agricultural Land
- Semi-Urban Land
- Commercial Property
- Raw House
- Farm House etc

Precious Objects

Precious objects include gold, silver and other precious stones like the diamond. Some artistic people invest in art objects like paintings, ancient coins etc.

Derivatives

Derivatives means indirect investments in the assets. The derivatives market is growing at a tremendous speed. The important benefit of investing in derivatives is that it leverages the investment, manages the risk and helps in doing speculation. Derivatives include:

- Forwards
- Futures
- Options
- Swaps etc

Non-Marketable Securities

Non-marketable securities are those securities which cannot be liquidated in the financial markets. Such securities include:

- Bank Deposits
- Post Office Deposits
- Company Deposits
- Provident Fund Deposits

	Return	**Safety**	**Liquidity**
Equity	Moderate to High	Low	Low to high
Bonds	Moderate to High	High	Moderate
Bank Deposits	Low to High	High	High
PPF	Moderate	High	Moderate
Life Insurance	Low to Moderate	High	Low
Gold	Moderate	High	Moderate
Real Estate	Low to High	Moderate	Low
Mutual Funds	Moderate to High	High	High

Equity Shares:

Equity shares were earlier known as ordinary shares. The holders of these shares are the real owners of the company. They have a voting right in the meetings of holders of the company. They have a control over the working of the company. Equity shareholders are paid dividend after paying it to the preference shareholders.

The rate of dividend on these shares depends upon the profits of the company. They may be paid a higher rate of dividend or they may not get anything. These shareholders take more risk as compared to preference shareholders.

Equity capital is paid after meeting all other claims including that of preference shareholders. They take risk both regarding dividend and return of capital. Equity share capital cannot be redeemed during the life time of the company.

Features of Equity Shares:

(i) Equity share capital remains permanently with the company. It is returned only when the company is wound up.

(ii) Equity shareholders have voting rights and elect the management of the company.

(iii) The rate of dividend on equity capital depends upon the availability of surplus funds. There is no fixed rate of dividend on equity capital.

Advantages of equity shares:

I. Long-tern and Permanent Capital: It is a good source of long-term finance. A company is not required to pay-back the equity capital during its life-time and so, it is a permanent sources of capital.

II. No Fixed Burden: Unlike preference shares, equity shares suppose no fixed burden on the company's resources, because the dividend on these shares are subject to availability of profits and the intention of the board of directors. They may not get the dividend even when company has profits.

III. Credit worthiness: Issuance of equity share capital creates no change on the assets of the company. A company can raise further finance on the security of its fixed assets.

IV. Risk Capital: Equity capital is said to be the risk capital. A company can trade on equity in bad periods on the risk of equity capital.

V. Dividend Policy: A company may follow an elastic and rational dividend policy and may create huge reserves for its developmental programmes.

Advantages to Investors: Investors or equity shareholders may enjoy the following advantages:

I. More Income: Equity shareholders are the residual claimant of the profits after meeting all the fixed commitments. The company may add to the profits by trading on equity. Thus equity capital may get dividend at high in boom period.

II. Right to Participate in the Control and Management: Equity shareholders have voting rights and elect competent persons as directors to control and manage the affairs of the company.

III. Capital profits: The market value of equity shares fluctuates directly with the profits of the company and their real value based on the net worth of the assets of the company. an appreciation in the net worth of the company's assets will increase the market value of equity shares. It brings capital appreciation in their investments.

IV. An Attraction of Persons having Limited Income: Equity shares are mostly of lower denomination and persons of limited recourses can purchase these shares.

V. Other Advantages: It appeals most to the speculators. Their prices in security market are more fluctuating.

Disadvantages of equity shares:

Disadvantages to company: Equity shares have the following disadvantages to the company:

I. Dilution in control: Each sale of equity shares dilutes the voting power of the existing equity shareholders and extends the voting or controlling power to the new shareholders. Equity shares are transferable and may bring about centralization of power in few hands. Certain groups of equity shareholders may manipulate control and management of company by controlling the majority holdings which may be detrimental to the interest of the company.

II. Trading on equity not possible: If equity shares alone are issued, the company cannot trade on equity.

III. Over-capitalization: Excessive issue of equity shares may result in over-capitalization. Dividend per share is low in that condition which adversely affects the psychology of the investors. It is difficult to cure.

IV. No flexibility in capital structure: Equity shares cannot be paid back during the lifetime of the company. This characteristic creates inflexibility in capital structure of the company.

V. High cost: It costs more to finance with equity shares than with other securities as the selling costs and underwriting commission are paid at a higher rate on the issue of these shares.

VI. Speculation: Equity shares of good companies are subject to hectic speculation in the stock market. Their prices fluctuate frequently which are not in the interest of the company.

Disadvantages to investors: Equity shares have the following disadvantages to the investors:

I. Uncertain and Irregular Income: The dividend on equity shares is subject to availability of profits and intention of the Board of Directors and hence the income is quite irregular and uncertain. They may get no dividend even three are sufficient profits.

II. Capital loss During Depression Period: During recession or depression periods, the profits of the company come down and consequently the rate of dividend also comes down. Due to low rate of dividend and certain other factors the market value of equity shares goes down resulting in a capital loss to the investors.

III. Loss on Liquidation: In case, the company goes into liquidation, equity shareholders are the worst suffers. They are paid in the last only if any surplus is available after every other claim including the claim of preference shareholders is settled. It is evident from the advantages and disadvantages of equity share capital discussed above that the issue of equity share capital is a must for a company, yet it should not solely depend on it. In order to make its capital structure flexible, it should raise funds from other sources also.