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1. LEARNING OUTCOMES

After studying this module, you shall be able to

- Know the meaning of Investment
- Learn the process of Investment analysis
- Understand the elements of Investment
- Analyse the relevance and need for Investment analysis.

2. INTRODUCTION

MEANING OF INVESTMENT

The growth of economy depends on the capital formation process which is dependent on the amount invested by the household sector, industries, private sector etc. Therefore, every country tries to provide a conducive environment to promote investment. An individual sacrifices his present consumption to generate saving, which they investment in various assets to generate income. So, investment refers to employment of saving to earn income or return. Every investor expects a rate of return which is higher than the inflation rate.

Investment can be defined as commitment of funds that is expected to generate additional money. It may also be described as a mechanism into which funds are placed with expectation of higher returns than inflation. An investor who buys shares of a company expects dividend and capital appreciation of his investment. When he invests in debentures of a company, he expects a fixed interest stream during the holding period. Similarly, when an individual purchases some immovable asset like house earns capital gain when he transfers this asset and also he can earn rental income. In all these cases some features are basic, which have been stated as under:

(i) There is a commitment of funds (Savings)

(ii) There is an expectation of higher earnings than inflation rate.

(iii) There is always some risk involved in respect of return and the amount invested.

Investment and speculation: In speculation, investment is made with an expectation of some return in the form of capital profit resulting from the price change and sale of investment. It is relatively short term investment. An investor has a relatively longer planning horizon. His holding period is usually at least one year and he is not willing to assume more than moderate risk. But in case of speculation, the risk level is high.

Investment and gambling: The result of gambling is known more quickly. For example, the outcome of a roll of dice is known almost immediately which is not possible in case of speculation and investment. The objective behind gambling is fun not income. But in case of both investment and speculation, the motive is to earn income and quick gains respectively.

3. INVESTMENT ANALYSIS/DECISION PROCESS

In the context of investment, the term **investment analysis** is defined as the process of evaluating an investment for profitability and risk. Here, the ultimate purpose is to measure how the given investment is good fit for a portfolio.

Steps in Investment Analysis:

(a) Setting the amount of investible wealth along with investment objectives- An investor decides the amount to be invested and his objectives of investment besides knowledge of various investment alternatives. The amount to be invested may be past savings or borrowed funds. The objective of the investor is to have recurring source of income or gain through capital appreciation.

(b) Analysis of different investment alternatives according to needs of investors- After having decided about the amount to be invested along with investment objectives, the investor is required to conduct analysis of economy of the country, various industries and the companies operating within them. An investor refers to various factors such as growth rate in GDP< inflation rate, rate of interest etc to assess the state of economy. Finally, an investor chooses the best companies by analyzing various qualitative and quantitative factors. The values of securities are also assessed. For this purpose, current market price is compared with the prices obtained by discounting future earnings of the company.

(c) Constructing a portfolio of investment and determining the amount to be invested in each one.- The next step is allocation of the funds available for investment in different securities depending upon the risk bearing capacity of the investor. If the investor is willing to take high risk, more of his funds will be put in the securities having higher risk and proportionately less amount is invested in the low risk securities.

(d) Periodic repetition of the above three steps to improve portfolio performance in view of changing market conditions. This includes evaluation of risk and return of the portfolio.- This is the last step in investment analysis approach. The performance of portfolio is compared with the market performance. If the investor has earned more than other capital assets having same risk level, the investor would be satisfied. In case he has earned lesser than what could have been earned by investing in same risk class assets, he must revise his portfolio.

4. ELEMENTS OF INVESTMENT

For evaluating an investment avenue, the following elements are important.

(i) Rate of return

(ii) Risk

(iii) Marketability

(iv) Tax-shelter

(v) Convenience

(i) RATE OF RETURN

A return may be from yield such as dividend, interest or through capital appreciation. Capital appreciation is the difference between the purchase price and sale price of the investment. The formula for calculation of rate of return is as follows:

$$\text{Return} = \frac{(\text{Maturity value} - \text{Initial investment value}) + \text{Dividend}}{\text{Initial investment value}}$$

For example Mr X purchased a share of tata company for 100 rs in the year 2013-2014. He received 10 Rs. Dividend each year and finally sold the share for 105 Rs in 2014-15. His return would be : $\frac{(105-100)+10}{100}$

= 15%

(ii) RISK

The risk of an investment refers to the variability of its rate of return: that is how much individual outcome deviates from the expected value. For example, if an investor expects to earn 18% return but he actually earns 15%, then it means he has failed to minimize his risk. This risk can be minimized be formulating portfolios. A simple measure of dispersion is the range of values, which is the difference between the highest and lowest value. Other measures used in finance are as follows:

(a) Variance: It is the mean of the squares of deviations of individual returns around their mean value.

(b) Standard deviation: It is the square root of variance.

(c) Beta: This reflects the volatility of return in response to market swings.

(iii) MARKETABILITY

An investment would be termed highly marketable or liquid if:

(a) It can be transacted quickly. In other words, it should be readily convertible into cash.

(b) The transaction cost is low.

(c) The price change between two successive transactions is negligible.

The liquidity of a market may be judged in terms of its **depth**, **breadth**, and **resilience**. **Depth** refers to the existence of buyers as well as sellers at current market price. **Breadth** implies the presence of buying as well as selling orders in substantial volume. **Resilience** means that new orders emerge in response to price changes. Generally, large and well established companies enjoy high marketability of its shares whereas small companies have low marketability in their formative years. High marketability is a desirable characteristic and low marketability is, of course, an undesirable one.

(iv) TAX SHELTER

The investor plans his investment considering his tax status as well as tax benefits provided by some investments. Tax benefits can be of following three kinds.

(a) Initial tax benefits: It refers to the tax relief enjoyed at the time of making the investment. For example, an investment in Public Provident Fund gets tax benefit under section 80C of the Income tax act.

(b) Continuing tax benefit: It is tax shield associated with the periodic returns from the investment. For example, dividend paid by Indian companies is tax free in the hands of recipients in India.

(c) Terminal tax benefit: A terminal tax benefit refers to the relief when an investment is realized or liquidated. For example, LTCG is exempt if shares are sold through recognized stock exchange and where security transaction tax is paid.

(v) CONVENIENCE

It refers to the ease with which investment can be made (readily) and looked after (easily). The degree of convenience associated with investments varies widely. For example, investment in a saving bank account can be made readily and it does not require any maintenance effort. But if investment is to be made by purchasing a house, there may be legal hassles and maintenance efforts are also required.

5. INVESTMENT AVENUES

A wide range of investment alternatives are available to the investors. These can be classified as follows:

Investment alternatives

Non-marketable financial assets-------------------------------

- equity shares

Bonds-------------------------------- money market instruments

Mutual funds schemes-------------------------------- life insurance policies

Real estate--------------------------------- precious objects

Financial Derivatives

i. **Non-marketable financial assets**- A big portion of financial assets is represented by non-marketable financial assets like bank deposits, post office deposits, provident fund deposits

ii. **Equity shares**- It carries ownership rights. It is often known as ownership capital. This means the shareholder has residual interest in income and wealth of the organization. It can be broadly classified into the following broad categories:
   - Blue chip shares
   - Growth shares
   - Income shares
   - Cyclical shares
   - Speculative shares
   - Preference shares

iii. **Bonds**- It represents long-term debt instruments. The issuer of a bond promises to pay a stipulated stream of cash flows during the period of holding. These may be classified into the following types:
   - Government securities
   - Saving bonds
   - Government agency securities
   - PSU bonds
   - Debentures of private sector companies

iv. **Money market instruments**- It represents those debt instruments which have a maturity of less than one year at the time of issue. Some of the important money market instruments could be:

- Treasury bills
- Commercial papers
- Certificates of deposits

v. **Mutual funds**- Mutual funds represents pooled investment by small investors. This means instead of buying equity and debt directly, investors invest their money in mutual funds which, in turn, invest in equity shares and fixed income securities. Broadly, mutual funds can be classified as:

- Equity schemes
- Debt schemes
- Balanced schemes

vi. **Life insurance**- Life insurance policies are also non-marketable financial assets but these are considered as an investment. Insurance premium represents the sacrifice, and the sum assured is considered as the benefit. The important types of insurance policies in India are:

- Endowment assurance policy
- Money back policy
- Whole life policy
- Term insurance policy
- Pension plans

vii. **Real estate**- For every investor, the most important asset in their portfolio is an own residential house. The more affluent investors also invest in residential house but they also invest in the following type of real estate:

- Agriculture land
- Semi-urban land
- Commercial property

viii. **Precious objects-** These items are generally small in size but highly valuable in monetary terms. These are also considered as investment which can be readily converted into cash. For example, one can sell gold at any time as when need arises. Some of the other precious items are:

- Silver and Gold
- Precious stones
- Art objects

ix. **Financial derivatives-** It 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. From the point of view of investors, the most important financial derivatives are:

- Options
- Futures

All these investment avenues can be compared in terms of key elements/attributes of investment. A **summary evaluation of various investment avenues** is given below

	Return		Risk	Marketability	Tax-shelter	convenience
	Current yield	Capital appreciation				
Equity shares	Low	High	High	Fairly high	High	High
Non-convertible debenture	High	Negligible	Low	Average	Nil	High
Equity schemes	Low	High	High	High	High	Very high
Debt schemes	Moderate	Low	Low	High	No tax on dividends	Very high
Bank deposits	Moderate	Nil	Negligible	High	Nil	Very high
Public provident fund	Nil	Moderate	Nil	Average	80C benefit	Very high
Life insurance policies	Nil	Moderate	Nil	Average	80C benefit	Very high

Residential house	Moderate	Moderate	Negligible	Low	High	Fair
Gold and silver	Nil	Moderate	Average	Average	Nil	Average

6. RELEVANCE OF INVESTMENT ANALYSIS

Individuals as well as institutions are increasingly making investments now a day. The capital markets are also growing and it is evident by the fact that the number of mutual funds, private players in insurance sector, real estate investment etc all are increasing regularly. Even the interest of small investors is increasing day by day. They are investing their money through mutual fund portfolios. Institutions also invest their employees' provident fund money and their idle funds. Sometimes, corporate houses face short-term liquidity issues and for this they park their funds in money market instruments generally. So, now a day, study of investment is becoming more and more relevant.

A careful and systematic investment helps investors to earn better returns in relation to the risk assumed. Investment analysis can provide a sound framework for both the management of wealth and increasing the wealth. It also helps the investor to find suggestion to some or all of the following issues:

(i) The types of financial assets available in the market.

(ii) The risk and return relationship of these financial assets.

(iii) The difference between rate of return and yield.

(iv) The use of diversification to reduce risk.

(v) The use of fundamental and technical analysis in taking financial decisions.

(vi) Selection of mutual funds for investment.

Summary

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