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Security Analysis & Portfolio Management

UNIT – I

Q: What do you mean by investment? What are the objectives of investment in securities? *(www.prepNext.com)*

Ans:

Investment is the process of 'sacrificing something now for the prospect of gaining something later'.

Sharpe/ Alexander, "Sacrifice of certain present value for some uncertain future value".

F. Amling, "Purchase of a financial asset that produces a yield that is proportional to the risk assumed over some future investment period".

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Objectives of Investment in Securities:

The major objectives of investment in securities are:

1. Income: The main objective of every investment is to earn income in the form of dividend, yield or interest. The investment should earn reasonable and expected return on the investments.

2. Capital Appreciation: The other important objective of investment is appreciation in the capital invested over the period of investment. The value or the price of investment should increase over time. Capital appreciation may be in the form of short term or long term capital gains.

3. Hedging: There may be a fall in the purchasing power, when the investor receives back the amount invested, because of inflation. The rate of return on investment should be higher than the rate of inflation so as to compensate for the fall in the purchasing power. Otherwise, the investors will lose in real terms.

4. Safety of the Capital: Amount invested should be safe and secure. The investor should be able to get back the capital as and when the amount becomes due.

5. Risk: One of the major objectives of investment is to minimise the risk involved in investment, and to get maximum returns with minimum risk.

6. Liquidity: Certain securities are liquid and some securities are not so liquid. The investor should consider the degree of liquidity required, before making the investment. The investments should be capable of being redeemed as and when the amount is needed by the investors.

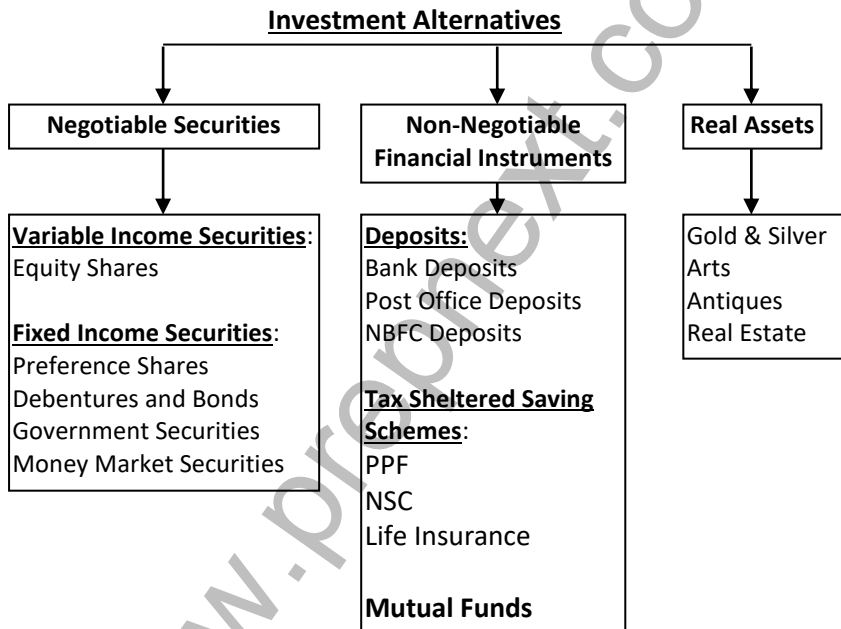
7. Tax Considerations: One of the crucial objectives of investment is also to avail all the tax benefits and exemptions available to the investors so as to minimise the tax burden of the investors.

Q: What are the different modes of investment? Explain.

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Ans.:

Investors have many modes or avenues of making investments available to them. A few of these investment alternatives are mentioned below:



NEGOTIABLE SECURITIES

The negotiable securities are financial securities that are transferable. The negotiable securities may yield variable income or fixed income. Securities like equity shares are variable income securities. Bonds, debentures, Government securities and money market securities yield a fixed income.

VARIABLE INCOME SECURITIES:

Equity Shares: Equity shares are commonly referred to as common stock or ordinary shares. Share capital of a company is divided into a number of small units of equal value called shares. The holders of equity shares are the real owners of the company. They have voting rights in the meetings of the company. They have a control over the working of the company. Equity shareholders get dividend after paying it to the preference shareholders.

FIXED INCOME SECURITIES:

Preference Shares: Preference share is hybrid in nature. Some of its features resemble the bond and others the equity shares. Preference shares have two preferences as compared to equity shares. There is a preference for payment of dividend when the company has distributable profits. The second preference is regarding repayment of capital at the time of liquidation of the company. Preference shareholders do not have voting rights but they are paid a fixed rate of dividend.

Debentures and Bonds: A debenture is an acknowledgement of a debt. An investment in debentures fetches a fixed and regular rate of interest. Corporate debentures are an option available to the investors who are willing to sacrifice liquidity for higher return. Bonds are similar to the debentures but they are issued by the public sector undertakings.

Government Securities: The securities issued by the Central, State Government and Quasi Government agencies are known as Government securities or gilt edged securities. As Government guaranteed security is a claim on the Government, it is a secured financial instrument, which guarantees the income and the capital. The rate of interest on these securities is relatively lower because of their high liquidity and safety.

Money Market Securities: Money market instruments are debt instruments of very short term maturity, say less than a year. Common money market instruments are:

Treasury Bills: A treasury bill is basically an instrument of short term borrowing by the Government of India. These are sold at a discount and redeemed at par. The difference between purchase price and face value is the income of the investor.

Commercial Papers: Commercial paper is a short-term negotiable instrument with fixed maturity period. It is an unsecured promissory note issued by a company. The commercial papers are sold at a discount and redeemed at their face value.

Certificate of Deposit: A certificate of deposit is a marketable receipt of funds that have been deposited in a bank for a fixed period of time. They are bearer documents and readily negotiable. The denomination of these certificates is high.

NON-NEGOTIABLE FINANCIAL INSTRUMENTS

The non-negotiable financial instruments, as the name itself suggests, are not transferable. Some of these financial securities are:

DEPOSITS: Deposits earn fixed rate of return. The rate of return depends upon the time of deposits. The deposits can be with banks, post office or NBFCs.

Bank Deposits: A bank deposit can be made by opening an account with a bank. There are three types of bank accounts: current account, saving account and fixed deposit account.

Post Office Deposits: Just like commercial bank deposits, amounts can be deposited with post offices also.

NBFC Deposits: In recent years, there has been a significant increase in the importance of non-banking financial companies. The NBFC comes under the purview of the RBI. The maturity period of the deposits ranges from few months to five years. NBFCs offer interest rate higher than the commercial banks on public deposits.

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TAX SHELTERED SAVING SCHEMES: The tax sheltered saving schemes offer tax relief to those who participate in their schemes according to the income tax laws. The important tax sheltered saving schemes are:

Public Provident Fund Scheme

National Saving Certificate

Life Insurance

ELSS (Equity Linked Saving Schemes) of Mutual Fund

MUTUAL FUNDS: A mutual fund is an institutional device through which the investors pool their funds to invest in a diversified portfolio of securities, thus spreading and reducing risk. Mutual funds have devised varied schemes to suit different investors. The investors investing in ELSS schemes of mutual funds also get tax benefits under Income Tax Act.

REAL ASSETS

Another investment avenue is the real assets. The investments can be in residential property, commercial property, agricultural land, gold and silver, precious stones, art objects, etc. People in the upper strata of the society invest more in such assets.

Q: “The investment process involves a series of activities starting from policy formulation to portfolio evaluation”. Discuss.

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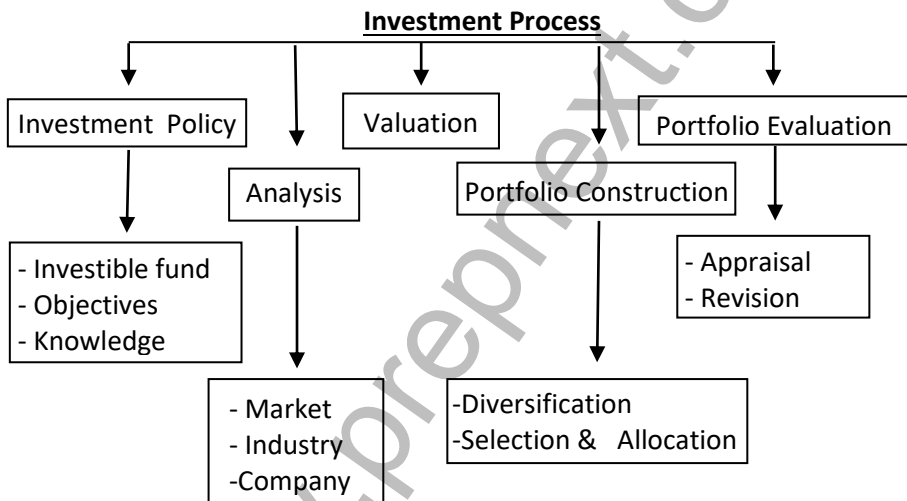
Ans:

Investment is the employment of funds on assets with the aim of earning income or capital appreciation. The investment process involves a series of activities leading to the purchase of securities or other investment alternatives. The investment process can be divided into five stages:

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- (i) Framing of investment policy
- (ii) Investment analysis
- (iii) Valuation
- (iv) Portfolio construction
- (v) Portfolio evaluation.

The flowchart given below explains the stages and factors connected thereof.



1) Investment Policy:

The investor before proceeding into investment formulates the policy for the systematic functioning. The essential ingredients of the policy are the investible funds, objectives and the knowledge about the investment alternatives and market.

Investible funds: The entire investment procedure revolves around the availability of investible funds. The fund may be generated through savings or from borrowings. If the funds are borrowed, the return should be higher than the interest he pays.

Objectives: The objectives are framed on the premises of the required rate of return, need for regularity of income, risk perception and the need for liquidity. The risk taker's objective is to earn high rate of return in the form of capital appreciation, whereas the primary objective of the risk averse is the safety of the principal.

Knowledge: The knowledge about the investment alternatives and markets plays a key role in the policy formulation. The investment alternatives range from security to real estate. The risk and return associated with investment alternatives differ from each other. The tax sheltered schemes offer tax benefits to the investors. The investor should also be aware of the stock market structure and the functions of the brokers. The knowledge about the stock exchanges enables him to trade the stock intelligently.

2) Security Analysis:

After formulating the investment policy, the securities to be bought have to be scrutinised through the market, industry and company analysis.

Market Analysis: The stock market mirrors the general economic scenario. The growth in gross domestic product and inflation are reflected in the stock prices. The recession in the economy results in a bear market. In the long run, the stock prices move in trends i.e. either upwards or downwards.

Industry Analysis: The industries that contribute to the output of the major segments of the economy vary in their growth rates and their overall contribution to economic activity. Some industries grow faster than the GDP and are expected to continue in their growth. The economic significance and the growth potential of the industry have to be analysed.

Company analysis: The company's earnings, profitability, operating efficiency, capital structure and management have to be screened. These factors have direct bearing on the stock prices and the return of the investors.

3) Valuation:

The most important and complex step is valuation of securities. Investment value is generally taken to be the present worth (to the owners) of future benefits from investment. The real worth of the share is compared with the market price and then the investment decisions are made.

4) Construction of Portfolio:

A portfolio is a combination of securities. The investor tries to attain maximum return with minimum risk. Towards this end he **diversifies his portfolio and allocates funds** among the securities.

Diversification: A diversified portfolio is comparatively less risky than holding a single portfolio. There are several ways to diversify the portfolio:

i) *Debt and equity diversification*

ii) *Industry Diversification*

iii) *Company Diversification.*

Selection & Allocation: Based on the diversification level, industry and company analyses the securities have to be selected. Investment timing is decided, funds are allocated for the selected securities, and then the securities are acquired. This seals the construction of portfolio.

5) Portfolio Evaluation:

The efficient management of the portfolio calls for evaluation of the portfolio. This process consists of **portfolio appraisal and revision**.

Appraisal: The variability in returns of the securities is measured and compared from time to time. The developments in the economy, industry and relevant companies from which the stocks are bought have to be appraised. The appraisal warns the loss and steps can be taken to avoid such losses.

Revision: Revision depends on the results of the appraisal. The low yielding securities with high risk are replaced with high yielding securities with low risk factor.

Q: What are the features of an ideal investment programme?

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Ans.:

An ideal investment programme has following features:

- 1. Safety:** The principal amount invested should be safe. Safety of principal can be ensured by adequate diversification.
- 2. Liquidity:** An ideal investment has a minimum level of liquidity to meet contingencies and emergencies. To ensure liquidity, the investor should keep a part of his total investment in the form of readily saleable securities.
- 3. Regular and Stable Income:** In a good investment programme, there is regularity of income at a stable and consistent rate.
- 4. Capital Appreciation:** Capital appreciation is a very important feature of any investment. The investors should try to forecast which securities will appreciate in future. This is a very difficult job and should be done carefully in a scientific manner.
- 5. Stability of Purchasing Power:** Money loses its value with the rise in prices. The money invested should atleast earn as much as rise in prices or inflation.
- 6. Tax Benefits:** An ideal investment programme reduces the overall tax burden of the investors. Tax burden on some investments are more whereas some investments are tax free. Investments should be planned in such as way that the tax liability is the minimum.
- 7. Legal:** Legal aspect of investments should be kept in mind. The investments made should be legal beyond doubt.

Q: Differentiate between Investment and Speculation.

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Ans.: Difference Between Investment and Speculation

<u>Basis</u>	<u>Investment</u>	<u>Speculation</u>
Time Horizon	Relatively long holding period	Very short holding period of a few days to a few months
Risk	Moderate, rarely high risk	Very high risk
Returns	Moderate returns at limited risk	High return at high risk
Basis for decisions	Fundamental factors, careful evaluation of proposed investment and performance of the company	Relies on inside information, rumours, hearsay, tips, hunches, technical charts and market psychology.
Safety	Investor seeks to protect his principal (as it yields a moderate return)	Speculator sacrifices the safety of his principal in hopes of receiving a large, rapid return.
Psychological Attitude of Participants	Cautious and conservative	Daring and careless
Market	Deployment of funds is prevalent in both primary and secondary equity market.	Deployment of funds is generally prevalent in secondary equity market.
Source of Funds	Normally owned funds are utilised and borrowed funds are avoided.	Borrowed funds are used to have additional/ supplement funds.
Stability of income	Very stable	Uncertain and erratic
Motive	Stable return over a period of time	Profits through price changes (Capital Gains).
Basis of Acquisition	Usually by outright purchase	Often-on-margin
Source of Income	Earnings of enterprise/ companies	Change in market price

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Q: What do you understand by Risk? What are the different types of Risk? *(www.prepNext.com)*

Ans:

Risk of an investment is the variance associated with its return. It is the possibility of not realising return or realising less return than expected.

Emmett J. Vaughan, "Risk is a condition in which there is a possibility of an adverse deviation from a desired outcome that is expected or hoped so far."

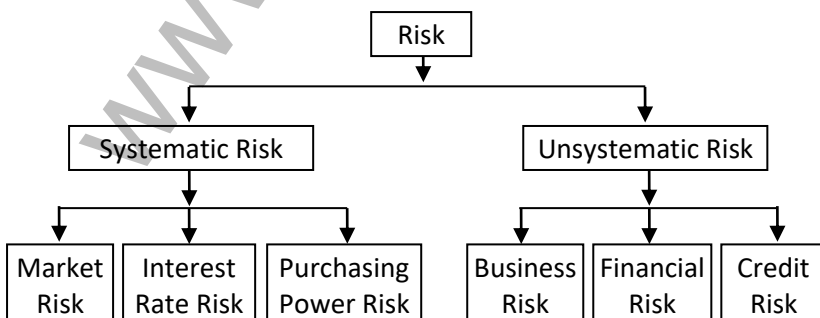
Blomkvist defined risk as "the possible loss of something of value."

Causes of Risk

A number of factors which can cause risk in an investment arena are given below:

1. Wrong methods of investment
2. Wrong timing of investment
3. Wrong quantity of investment
4. Interest rate risk
5. Nature of investment instruments
6. Nature of industry in which the company is operating
7. Creditworthiness of the issuer
8. Maturity period or Length of investment
9. Terms of Lending
10. National and International Factors
11. Natural Calamities etc.

Types of Risk



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The risk is broadly classified into two types:

1. **Systematic Risk** and
2. **Unsystematic Risk.**

SYSTEMATIC RISK

Systematic risk refers to that portion of variation in return caused by factors that affect the market as a whole. The effect causes the entire market to move in a particular direction either downward or upward. These factors are beyond the control of the corporate and the investor. They cannot be entirely avoided by the investor.

The systematic risk is further sub-divided into:-

- i. Market Risk
- ii. Interest Rate Risk
- iii. Purchasing Power Risk

i. Market Risk: Variations in prices sparked off due to real social, political and economic events are referred to as market risk. Market risk arises out of changes in demand and supply pressures in the market following the changing flow of news or expectations. Thus, any untoward political or economic event would lead to a fall in the price of the security.

ii. Interest Rate Risk: Interest Rate Risk is the variation in the returns caused by the fluctuations in the market interest rate. The fluctuations in the interest rates are caused by the changes in the government monetary policy, credit policy and the changes that occur in the interest rates of treasury bills and the government bonds. Generally price of securities tend to move inversely with changes in the rate of interest.

iii. Purchasing Power Risk: Purchasing Power Risk is the probable loss in the purchasing power of the returns to be received. Inflation is the reason behind the loss of purchasing power. There is a possibility of prices of desired goods and services going up due to inflation, during the holding period of the investment, as a consequence of which the investor loses the real purchasing power.

UNSYSTEMATIC RISK

Unsystematic Risk refers to that portion of the risk which is caused due to factors unique and peculiar to a firm or an industry. This risk is a company specific risk and can be controlled if proper measures are taken. Broadly, unsystematic risk can be classified into:-

- i. Business Risk
- ii. Financial Risk
- iii. Credit or Default Risk

i. Business Risk: Business risk is that portion of the unsystematic risk which is caused by the operating environment of the business. Business risk can be divided into internal business risk and external business risk.

Internal Business Risk: Internal risk is associated with the efficiency with which a firm conducts its operations within the broader environment thrust upon it. Internal risk is caused due to reasons, such as Fluctuations in the Sales, Higher Fixed Cost component, producing a Single Product, Improper product mix, non-availability of raw materials, incompetence to face competition, absence of strategic management, etc.

External Business Risk: External business risk arises due to change in operating conditions, thrust upon the firm by circumstances beyond its control. Some of the external factors are Social and Regulatory Factors, Political Risk, Business Cycle, etc.

ii. Financial Risk: Financial Risk refers to the variability of the income to the equity capital due to the debt capital. A company with no debt financing has no financial risk. The presence of debt and preference capital results in a commitment of paying interest or pre fixed rate of dividend. The residual income alone would be available to the equity investors. As long as the earnings of a company are higher than the cost of borrowed funds, shareholders' earnings are increased. At the same time when the earnings are low, returns of equity holders take a hit.

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iii. Credit or Default Risk: Credit or default risk deals with the probability of meeting with a default. It is probable that a borrower will default and will not pay up. The borrower's credit rating might have fallen suddenly and he became default prone and in its extreme form it may lead to insolvency. In such cases, the investor may get no return or negative returns.

Q: Differentiate between Systematic Risk and Unsystematic Risk.

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Ans.:

Differences Between Systematic Risk and Unsystematic Risk

1) Cause: Systematic risk is caused by factors that affect the price of all securities such as inflation. Unsystematic risk is caused due to factors unique or related to a firm or industry such as management policies, shortage of power, etc.

2) Mitigation: Systematic risk is beyond the control of investors and cannot be mitigated. In contrast to this, the unsystematic risk can be mitigated through portfolio diversification. It is a risk that can be avoided.

3) Presence in Diversified Portfolio: Unsystematic risk is not present in a well diversified portfolio. A well diversified portfolio has only systematic risk.

4) Types: Market risk, interest rate risk and purchasing power risk are the various types of systematic risk, whereas business risk, financial risk and default risk are the types of unsystematic risk.

5) Risk Premium: Market does not compensate for taking unsystematic risks, but market does compensate for taking exposure to systematic risks. Systematic risk earns a risk premium, while unsystematic risk does not earn a risk premium.

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Q: Differentiate between Risk and Uncertainty.

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Ans.:

Differences between Risk and Uncertainty

Risk is associated with the possibility of not realising return or realising less return than expected. Both 'risk and uncertainty' talk about future losses or hazards. Though risk and uncertainty go together, but they differ in perception. The differences between risk and uncertainty are discussed below:

- 1) Risk refers to a situation where the decision maker knows the possible consequences of a decision and their related likelihoods (probability). Uncertainty involves a situation, about which the likelihood (probability) of possible outcome is not known.
- 2) Risk can be quantified and measured. The degree of risk depends upon the features of assets, investment instruments, mode of investment etc. On the other hand, uncertainty cannot be quantified.
- 3) It is possible to minimise risk in investment by proper diversification. However one cannot remove uncertainty.

Q: What do you understand by Fundamental Analysis? What are its weaknesses?

(www.prepNext.com)

Ans.:

Fundamental Analysis is primarily concerned with determining the intrinsic value or true value of a security. The intrinsic value is then compared with the security's current market price to determine whether the security is overpriced or underpriced.

Fundamental analysis maintains that markets may misprice a security in the short run but that the "correct" price will eventually be reached. Profits can be made by trading the mispriced security and then waiting for the market to recognise its "mistake" and reprice the security.

Weaknesses of Fundamental Analysis:

- **Time Constraints:** Fundamental analysis is very time-consuming.
- **Industry/ company specific:** Valuation techniques vary depending on the industry group and the specifics of each company. For this reason, a different technique and model is required for different industries and different companies. This can get quite time-consuming and limit the amount of research that can be performed.
- **Subjectivity:** Fair value is based on a number of assumptions. Any changes to growth or multiplier assumptions can greatly change the ultimate valuation.
- **Analyst Bias:** The majority of the information that goes into the fundamental analysis comes from the company itself. Companies can manipulate information that is released and ultimately used by analysts. Also, most of the analysis is done by analysts who work for the big brokers who are in turn involved in underwriting and investment banking for the companies. Even though there are safeguards in place to prevent a conflict of interest, the brokers have an ongoing relationship with the company under analysis. So, there may be biases involved.

Q: What are the different types of fundamental analysis?

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Ans:

Fundamental Analysis includes

1. Economic Analysis,
2. Industry Analysis, and
3. Company Analysis

Q: What is economic analysis? Discuss the important economic forces within which the factors of investment operate.

(www.prepNext.com)

Ans.:

It is very important for the investor to assess the state of the economy and its implications for the stock market. Economic analysis involves a study of economic trends and economic policies in the economy. The level of economic activity has an impact on investment in many ways. When the level of economic activity is low, stock prices are low and when the level of economic activity is high, stock prices are high reflecting the prosperous outlook for sales and profits of the firms. The analysis of macro-economic environment is essential to understand the behaviour of the stock prices. The commonly analysed macro economic factors are as follows:-

1. Population: In countries, like India, which have a huge population, the labour intensive industries grow at a faster rate. Investors also prefer to invest in industries which are labour intensive and such industries bring better rates of return.

2. Performance of Agriculture: In a country, like India, performance of agriculture is a very important force to be considered. Around 70% of the Indian population is dependent on agriculture and agriculture contributes about 35% of the output of the economy. However, agriculture in India is still dependent on monsoons. The stock prices depend upon monsoons and agriculture in our economy to a large extent.

3. Technological Development: Investments also depend upon the amount of resources spent by the government on a particular technological development affecting the future. The industries, which get a large amount of share in the funds of the development of the country, attract a lot of investors. For example, investors prefer to invest in IT industry, automobile industry, etc.

4. Natural Resources: Untapped or recently tapped resources would produce very high investment opportunities. Investors generally prefer to invest in such industries which are making use of latest technological advancements like recycling of materials, nuclear and solar energy, etc.

5. Role of Government: In countries, like India, government is the biggest investor and spender. A study of the major policies of the government and their impact on stock market is a very important force in economic analysis.

6. Business Conditions: General business conditions, in the form of business cycles or the level of business activity, influence to a large extent the demand for industrial products and the performance of the industry.

7. Political Stability: Political stability is indicated by stable and long term economic policies and a stable political system with no uncertainty. Political uncertainties adversely affect the industrial growth and in turn the stock market. Thus, political and economic factors are interlinked.

8. Balance of Trade: Balance of trade and the price of the currency in the foreign exchange market also affect the security market. A deficit in trade and balance of payments position depreciate the currency in foreign exchange markets and has a negative influence on the economy and securities market.

9. Gross Domestic Product (GDP): GDP indicates the rate of growth of the economy. It represents the aggregate value of the goods and services produced in the economy. The growth rate of economy points out the prospects for the industrial sector and the return investors can expect from investment in shares. The higher growth rate is more favourable to the stock market.

10. Savings and Investments: It is obvious that growth requires investment which in turn requires substantial amount of domestic savings. Savings are distributed over various assets like equity shares, deposits, mutual fund units, real estate and bullion. The saving and investment patterns of the public affect the stock to a great extent.

11. 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. More money is available at a lower interest rate for the brokers who are doing business with borrowed money. Availability of cheap fund encourages speculation and rise in the price of shares.

12. The Tax Structure (Taxation System): Concessions and incentives given to a certain industry encourage investment in that particular industry. Tax reliefs given to savings encourage savings. The type of tax exemption has impact on the profitability of the industries.

13. Fiscal Budget: 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.

14. Infrastructure Facilities: Infrastructure facilities are essential for the growth of industrial and agricultural sector. A wide network of communication system is a must for the growth of the economy. Regular supply of power without any power cut would boost the production. Banking and financial sectors also should be sound enough to provide adequate support to the industry and agriculture. Good infrastructure facilities affect the stock market favourably.

An examination of the above mentioned variables will help an investor interpreting the direction of the economy and the stock market, and thus leading to the establishment of a sound investment policy.

Q: What is industrial analysis? What are the key characteristics in industrial analysis? (www.prepNext.com)

Ans.:

An industry is a group of firms that have similar technological structure of production and produce similar products. Industries vary in their growth rates and their overall contribution to the economy. Successful investors are those who analyse the economic significance of industries and invest in those industries that offer continued success, measured by the industry's ability to compete for its appropriate share of the GNP. **The purpose of industry analysis is to seek industries that are expected to grow faster than the real rate of GNP.**

The most important characteristics/ factors that are to be evaluated in an industry analysis are listed below:

1. Sales Trends and Earnings: For forecasting the future trends the historical sales records and earnings performance play a very crucial role. From the observation of these factors, the analyst will be able to judge the stability of the performance in terms of sales and earnings as well as the growth rates.

2. Labour Conditions: An industry, whether it is labour intensive or capital intensive, has to use labour of different categories and expertise. An analyst should examine the various provisions of the labour laws and also go into the possible reasons that may disrupt the production process. If there are problems of labour, strikes, lockouts and poor productivity, the industry would be unwelcome for the investors.

3. Cost Structure: Higher the fixed costs, higher will be the break-even point and higher will be the sales volume to be achieved. The lower the fixed cost, the easier it is for a firm to achieve and surpass its break-even point.

4. Technology: An investor must keep a check on product with frequent technological changes as product obsolescence may erode his investment. If he feels that the need for a particular industry will vanish in a short period of time, he should not invest in such industry.

5. Government's Attitude towards Industry: The analyst should be aware of the various government policies and regulation with reference to the industry in which he is planning to invest. The government policy with regard to granting of clearances, installed capacity, reservations of products for small scale sector etc. should be considered for industrial analysis.

6. Economic Environment of the Country: The kind of economic environment in a country also affects the industry analysis. If the country is poverty stricken, it would have an economic climate where cheaper products would be sold. An economically advanced country will have more demand for higher price and better quality products.

7. Installed and Utilised Capacity: The Planning Commission and Government estimate the demand for industrial products in the economy and units are given licensed capacity on the basis of these estimates. If the demand is rising as expected and the market is good for the products, the utilisation of capacity will be higher and the profitability will also be more. If the situation is reverse, the utilisation of capacity will be low and profitability will also be poor.

8. Competitive Pressure: The analyst must consider the type of competitive pressure that an industry faces in the country. Profits are expected to be more in an industry which has less pressure of competition.

9. Pollution Standards: Pollution standards are very high and strict in the industrial sector. For some industries it may be heavier than others. For example, in leather, chemical and pharmaceutical industries the industrial effluents are more, and so the pollution standards are also very strict.

10. Demand for the Product: Those industries will have good prospects of profitability, demand for whose products is expanding. Industries having export demand for the products are more profitable.

11. Raw Materials: An industry which has a limited supply of raw materials domestically and where imports are restricted will have very dim growth prospects.

12. Research and Development: For any industry to survive the competition in the national and international markets, product and production process have to be technically competitive. This depends on the R & D in the particular company or industry. Economies of scale and new market can be obtained only through R & D. The percentage of expenditure made on R & D should be studied diligently before making an investment.

13. Industry Life Cycle: The lifecycle of the industry is separated into four well defined stages such as pioneering stage; rapid growth stage; maturity and stabilisation stage; and Declining stage. Investment also depends on the stage of the industry life cycle.

14. Industry Characteristics: The prospects of growth of an industry will depend upon whether the industry is cyclical, fluctuating or stable. The growth prospects would depend upon raw materials, easy access to inputs, particularly power, transport and infrastructural facilities. The scale of production and width of the market would determine the selling and advertisement costs. The nature of the industry would, thus, be an important factor for determining the scale of operations and the level of profitability.

Q: Explain company analysis in the context of investment planning. What important factors should be considered in this analysis?

(www.prepNext.com)

Ans.:

Company analysis is a method of assessing the competitive position of a firm, its earning and profitability, the efficiency with which it operates, its financial position and its future aspects with respect to the earnings of its shareholders.

Even though an industry might be doing well, yet some companies in the industry may not be doing so well or rather may be doing poorly. To identify those companies which are doing relatively well in the industry, an analysis of the financial and non-financial strengths and weaknesses is to be made. **Important financial and non-financial indicators are discussed as follows.**

FINANCIAL INDICATORS

The best source of financial information about a company is its own financial statements. The basic financial statements that are required for analysis are:

- (i) the income statement, and (ii) the balance sheet.

Income Statement: The income statement reports the flow of funds from business operations that takes place in between two points of time. It is a key financial statement for judging management performance.

The Balance Sheet: Balance sheet is a statement indicating the financial position of a company on a given date. It shows the assets, liabilities and owner's equity in a company. It is the analyst's primary source of information on the financial strength of the company.

The balance sheet provides an account of the capital structure of the company. The net worth and the outstanding long term debt are known from the balance sheet. From the balance sheet, liquidity position of the company can also be assessed with the information on current assets and current liabilities. The overall ability to pay its short-term obligations can be found out.

Analysis of Financial Statements:

The investor determines the financial position and the progress of the company through analysis of financial statements. The investor is interested in the yield and safety of his capital. He cares much about the profitability and the management's policy regarding the dividend. Towards this end, he can use the following tools of analysis:

- Comparative Financial Statements
- Trend Analysis
- Common size analysis
- Fund Flow Analysis
- Cash Flow Analysis
- Ratio Analysis

NON- FINANCIAL INDICATORS:

In addition to the financial parameters, the investor has to analyse some non financial indicators also. Some important non-financial indicators are explained below:

1. Business of the company: The investor should know whether the company is a well established one. The industry or industries in which the company is operating should have good growth prospects. The product should be in continuous demand.

2. Management: The management should be efficient and experienced. They should have honesty, integrity and vision for expansion and growth. The competence and commitment of the management matter a lot in shaping the future of the company.

3. Market Share of the Company: The market share of the company should be substantial. The larger the share the better the prospects of controlling the market, and expanding the operations.

4. Product Range: A company will have good prospects if it launches new products with regular frequency. Investors must examine whether the company under review belongs to this group or not.

5. Diversification: A company must be well diversified so as to reduce the degree of business risk and improve profitability. A well diversified company like Hindustan Lever is a good prospect.

6. Expansion Policy: Growth helps the company to increase its earnings. The company's policy of expansion should be consistent and have a long term perspective.

7. Dividend Distribution Policy: The company under review should have a stable and consistent distribution policy. It should distribute a reasonable portion of its profits as dividends and bonuses.

8. Foreign Collaboration: Where a company has entered into technical collaboration with a foreign company, the investor must find out more about the nature of the collaboration agreement.

9. Availability of Inputs: It is important to assess the raw material position because any shortage of raw material or escalation in the cost of raw material will adversely affect the profitability.

10. Research and Development: The company should spend adequate sums of money on Research and Development activities to upgrade their existing products, introduce new products, achieve import substitution etc. Such companies have bright future prospects.

11. Government Policy: The prospects of the company would also depend upon the government policy and whether it is subject to price and distribution control or any restrictions or regulations.

12. Growth of Sales: The rapid growth in sales would keep the shareholder in a better position than one with the stagnant growth rate. Growth in sales is usually followed by the growth in profits.

13. Stability of Sales: If a firm has stable sales revenue, other things being remaining constant, it will have more stable earnings. Wide variation in sales leads to variations in capacity utilisation, financial planning and dividend.

Q: What do you understand by Technical Analysis? What are its assumptions? *(www.prepNext.com)*

Ans:

Technical analysis is directed towards predicting the price of a security. According to it, the price of stock depends on demand and supply in the market place. It has little correlation with the intrinsic value.

Technical analysis maintains that all financial data and market information of a given stock is already reflected in its market price. It does not care what the value of a stock is. The price predictions are only extrapolations from historical price patterns.

Technical analysts have developed tools and techniques to study past patterns and predict future price. With the help of several indicators they analyse market generated data like prices and volumes to determine the future direction of price movement. Thus, the technical analysis provides a simplified and comprehensive picture of what is happening to the price of a security.

Assumptions of Technical Analysis:

1. The market value of a security is solely determined by the interaction of demand and supply factors operating in the market.
2. The demand and supply factors of a security are surrounded by numerous factors; these factors are both rational as well as irrational.
3. The security prices move in trends or waves which can be both upward or downward depending upon the sentiments, psychology and emotions of operators or traders.
4. The present trends are influenced by the past trends and the projection of future trends is possible by an analysis of past price trends.

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5. Except for minor variations, stock prices tend to move in trends which continue to persist for an appreciable length of time.
6. Changes in trends in stock prices are caused whenever there is a shift in the demand and supply factors.
7. Shifts in demand and supply, no matter when and why they occur, can be detected through charts prepared specially to show market action.
8. Some chart trends tend to repeat themselves. Patterns which are projected by charts record price movements and these patterns are used by technical analyst for making forecasts about the future patterns.
9. The market discounts everything. The price of the security quoted represents the hopes, fears and inside information received by the market players.

Q: How is technical analysis different from fundamental analysis?

(www.prepnxt.com)

Ans.:

Differences between Technical Analysis and Fundamental Analysis

1. Technical analysts try to predict short term price movements whereas fundamental analysts try to establish long term values.
2. The focus of technical analysis is mainly on internal market data, particularly price and volume data whereas the focus of fundamental analysis is on the factors relating to the economy, industry and the company.

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3. Speculators who want to make quick money mostly use results of technical analysis whereas investors who invest on long term basis use the results of fundamental analysis.
4. Fundamental analysis involves compilation and analysis of huge amount of data and is, therefore, complex, time consuming and tedious in nature. On the other hand, technical analysis is a simple and quick method on forecasting behaviour of stock prices.
5. Fundamental analysis is based on financial statements which themselves are plagued by certain deficiencies like subjectivity, inadequate disclosure etc. But, technical analysis is free from all such limitations as it is not based on financial statements.
6. Fundamental analysis is a longer term approach. Even if an analyst identifies an under priced security, market may take time to bid its price up. The techniques of technical analysis are comparatively quicker.
7. Fundamental analysts study the financial strength of corporate, growth of sales, earnings and profitability. They also take into account the general industry and economic conditions. The technical analysts mainly focus the attention on the past history of prices. Generally technical analysts choose to study two basic market data – price and volume.
8. Fundamentalists are of the opinion that supply and demand for stocks depend on various business, economic, social, political and other factors. Technicians opine that they can forecast supply and demand by studying the prices and volume of trading.
9. Technical analysis appeals mostly to short-term traders, whereas fundamental analysis appeals primarily to long-term investors.

Q: What are charts? What are the various types of commonly used charts? *(www.prepNext.com)*

Ans.:

Charts are the valuable tools in the technical analysis, which provide visual assistance in detecting changing pattern of price behaviour. The technical analyst is sometimes called the Chartist because of the importance of this tool. The graphic presentation of the data helps the investor to find out the trend of the price without any difficulty.

The essence of Chartism is the belief that share prices trace out patterns over time. It is assumed that history tends to repeat itself in the stock market. A certain pattern of activity that in the past produced certain results is likely to give rise to the same outcome should it reappear in the future.

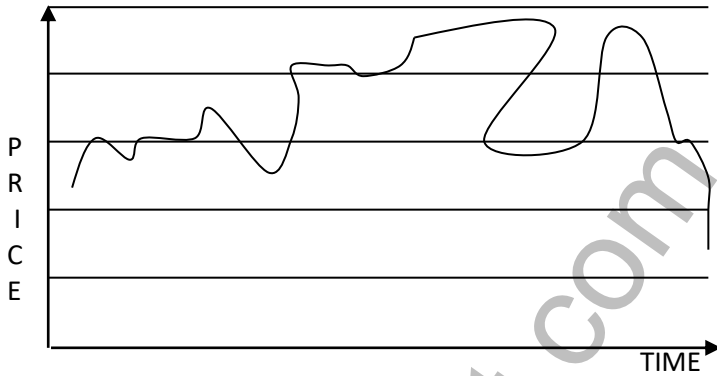
The charts also have the following uses:

- i) Spots the current trend for buying and selling.
- ii) Indicates the probable future action of the market by projection.
- iii) Shows the past historic movement.
- iv) Indicates the important areas of support and resistance.

TYPES OF COMMONLY USED CHARTS

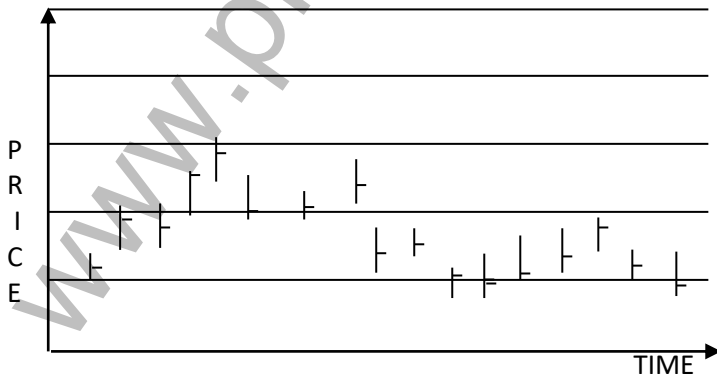
The various types of commonly used charts are:-

1. Line Charts: A line chart is the simplest form of chart. It is a simple graph drawn by plotting the closing price of the stock on a given day and connecting the points thus plotted over a period of time. It takes no notice of the highs and lows of stock prices for each period. The following figure presents a typical line chart:



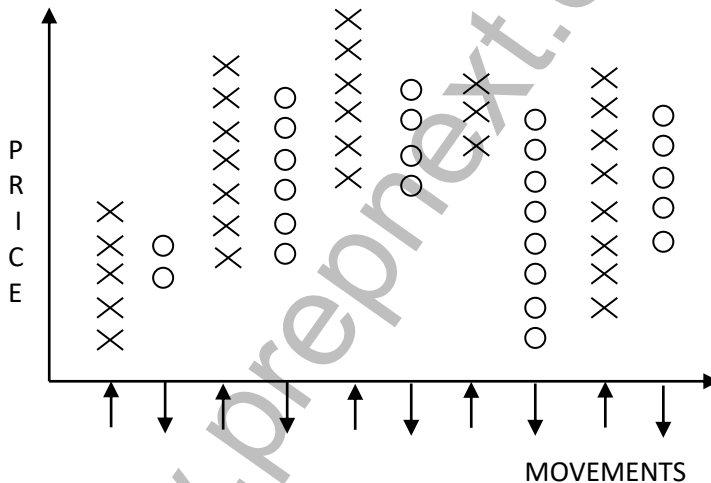
LINE CHART

2. Bar Charts: It is a simple charting technique. In this chart, prices are indicated on the vertical axis and the time on horizontal axis. The market or price movement for a given session (usually a day) is represented on one line. The vertical part of the line shows the high and the low prices at which the stock was traded or the market moved. A short horizontal tick on the vertical line indicates the price or level at which the stock or market closed. The following figure shows a bar chart:



BAR CHART

3. Point and Figure Chart (PFC): In Point and Figure Chart there is no time scale and only price movements are plotted. As the price of a share rises, a vertical column of crosses is plotted. When it falls, a circle is plotted in the next column and this is continued downward while the price continues to fall. When it rises again, a new vertical line of crosses is plotted in the next column and so on. A point and figure chart that changes column on every price reversal is cumbersome and may show a reversal only for price changes of a few units or more (a unit of plot may be a price change of say one rupee). The following figure shows a point and figure chart:



POINT AND FIGURE CHART

LIMITATIONS OF CHARTS

- 1) Interpretation of charts is prone to subjective analysis. This factor is a major cause of often contradictory analysis being derived from the same charts.
- 2) The changes in charts are quite frequent in the short term perspective leading to a host of buy and sell recommendations which are not in the best interest of the investor.
- 3) Another disadvantage is that decisions are made on the basis of chart alone and other factors are ignored.

Q: What do you mean by Efficient Market Hypothesis? Bring out its various forms. *(www.prepNext.com)*

Ans:

Efficient Market Hypothesis accords supremacy to market forces. Market efficiency signifies how quickly and accurately does relevant information has its effect on the security prices. A market is treated as efficient when all known information is immediately discounted by all investors and reflected in share prices. No single investor has an information edge over the others as everyone knows all possible to know information simultaneously. Moreover, every investor interprets the information similarly and behaves rationally. In such a situation, the only price changes that occur are those resulting from new information. Since new information is generated on a random basis, the subsequent price changes also happen on a random basis.

In an efficient market scenario, all instruments in the market will be correctly priced as all the available information is perfectly understood and absorbed by all the investors, present as well as prospective. No excess profits are possible in this scenario.

For the capital market efficiency theory to operate, the following **assumptions** are made:

- Information must be free and quick to flow so that all the investors can react to the new information.
- Transaction costs such as brokerage on sale and purchase of securities are not there.
- Taxes have no noticeable impact on investment policy.
- Every investor can borrow or lend at the same rate.
- Investors are rational and make investments in the securities providing maximum yield.
- Market prices are efficient, and not sticky, and respond to new technology, new trends, changes in tastes etc. efficiently and quickly.

The efficient market hypothesis (EMH) is based on the assumption that all the securities markets are efficient. To have efficient markets, it is essential that both internal and external efficiency must be there:-

Internal Efficiency: Internally efficient markets refer to the markets where the transaction costs are low and transactions move at a very high speed.

External Efficiency: Markets are considered to be externally efficient if they absorb all the information in an unbiased manner. In such markets, the new information is immediately reflected in the security market.

The efficiency of markets depends on the extent of absorption of information, the time taken for absorption and the type of information absorbed. Based on the degree of absorption of information by the markets, the efficient-market theory is considered as having **three forms**:

1. **Weak Form,**
2. **Semi-strong Form, and**
3. **Strong Form.**

Weak Form Theory:

According to it, the current stock values fully reflect all the historical information. Thus, past data cannot be used to predict future prices.

In the words of Adam Smith "Prices have no memory, and yesterday has nothing to do with tomorrow."

The weak form of EMH states that all past prices, volumes and other market statistics cannot provide any information that would prove useful in predicting future stock price movements.

Semi-strong Form Theory:

This form says that market absorbs quickly and efficiently all the publicly available information, as well as the information regarding historical prices. It maintains that as soon as the information becomes publicly available, it is absorbed and reflected in current prices. As prices adjust to the information quickly and accurately, abnormal/ superior profits cannot be earned on a consistent basis.

Strong Form Theory:

The strong form of EMH (Efficient Market Hypothesis) represents the most extreme case of market efficiency possible. According to this form, the prices of securities fully reflect all available information, both public and private. If this form is true, prices reflect the information that is available to the select groups like the management, financiers, stock exchange officials, etc. Thus, according to this form, no information, whether public or inside information can be used to consistently earn superior returns than the market. This implies that not even security analysts and portfolio managers, who have access to information more quickly than the general public are able to use this information to earn superior returns.

The strong form of EMH suggests that stock prices reflect all information, whether it be public (say in SEBI filings) or private (in the minds of the CEO and other insiders). So even with material non-public information, EMH asserts that stock prices cannot be predicted with any accuracy.

Q: What is time value of money? Explain various techniques for computing the time value of money. (www.prepNext.com)

Ans.:

Time value of money means that money has time value. A rupee received today is more valuable than a rupee received tomorrow. For example, a rupee received now can be deposited in a bank at, say, 10 percent rate to receive Rs.1.10 after one year. The time value of money suggests that earlier receipts are more desirable than later receipts, because earlier receipts can be invested to generate additional returns before the later receipts come in. The investor will postpone current consumption only if he could earn more future consumption opportunities through investment. Individuals generally prefer current consumption to future consumption. If there is inflation in the economy, a rupee today will represent more purchasing power than a rupee at a future date.

A rupee today is more valuable than rupee after a year due to several reasons:

- 1. Risk:** There is uncertainty about the receipt of money in future. The future is always uncertain and involves risk. An individual can never be certain of getting cash inflow in future and hence he will like to receive money today instead of waiting for the future.
- 2. Preference for present consumption:** People generally prefer current consumption over future consumption. The present needs are considered urgent as compared to future needs. Moreover, there may also be a fear in one's mind that he may not be able to use the money in future for fear of illness or death.
- 3. Inflation:** In an inflationary period a rupee today represents a greater real purchasing power than a rupee a year hence.
- 4. Investment Opportunities:** Most of the persons and companies have a preference for present money because of availabilities of opportunities of investment for earning additional cash flow. Money received at earlier dates can be invested to generate positive returns. An investment of one rupee today would grow to $(1 + r)$ a year hence (r is the annual rate of return earned on the investment).

Techniques for Computing Time Value of Money

There are two techniques for adjusting/ computing the time value of money:

- (A) Compounding Technique
- (B) Discounting or Present Value Technique

(A) COMPOUNDING TECHNIQUE:

Compounding technique is used to calculate the future value of money. Future value or compounded value is the value at some future time of a present amount of money, or a series of payments, evaluated at a given interest rate.

(a) Future Value of a Single Cash Flow:

For a given present value (PV) of money, future value of money after a period 'n' (FV_n) for which compounding is done at an interest rate of 'r', is given by the equation

$$FV_n = PV (1+r)^n$$

Note: Such calculations can also be made with the help of Compound Factor Tables. Using the Compound Factor Tables, the future value of money can be calculated as below:

$$FV_n = PV (CF_{r,n})$$

(where $CF_{r,n}$ is compound factor at (r) percent and 'n' periods)

(b) Future Value of a Series of Payments:

Future value of a series of payments made at different time periods can be calculated as below:

$$FV_n = CF_1*(1+r)^{n-1} + CF_2*(1+r)^{n-2} + \dots + CF_{n-1}*(1+r)^1 + CF_n$$

Where, FV_n = Future value at period n

CF_1 = Payment/ Cash Flow after period 1

CF_2 = Payment/ Cash Flow after period 2

CF_n = Payment/ Cash Flow after period n

r = Rate of Interest

(c) Future/ Compounded Value of an Annuity:

An annuity is a series of equal cash flows/ payments lasting for some specified duration. When the cash flows occur at the end of each period the annuity is called a regular annuity or a **deferred annuity**. If the cash flows occur at the beginning of each period, the annuity is called an **annuity due**.

Since the payments are equal in an annuity –

$$CF_1 = CF_2 = CF_3 \dots = CF_n = CF$$

(i) Future value when Annuity occurs at the end of each period (Immediate Annuity):

The future value (FV_n) of a uniform cash flow (CF) made at the end of each period till the time of maturity 'n' for which compounding is done at the rate 'r' is calculated as follows:

$$FV_n = CF * (1+r)^{n-1} + CF * (1+r)^{n-2} + \dots + CF * (1+r)^1 + CF$$

***Note:** Compound Value of an annuity can also be calculated with the help of Annuity Compound Factor Tables. Making use of the annuity compound factor tables, we can calculate the future value of an annuity as:*

$$FV_n = CF * (ACF_{r,n})$$

(where $ACF_{r,n}$ is Annuity compound factor at (r) percent and 'n' periods)

(ii) Future value when Annuity occurs at the beginning of each period (Annuity Due):

The future value of an annuity due can be calculated as below:

$$FV_n = CF * (1+r)^n + CF * (1+r)^{n-1} + \dots + CF * (1+r)^1$$

Making use of the annuity compound factor tables, we can calculate the future value of an annuity due as:

$$FV_n = CF * (ACF_{r,n}) * (1 + r)$$

(where $ACF_{r,n}$ is Annuity compound factor at (r) percent and 'n' periods)

(B) DISCOUNTING OR PRESENT VALUE TECHNIQUES:

Present value is the exact opposite of compound or future value. While future value shows how much a sum of money becomes at some future period, present value shows what the value is today of some future sum of money.

Present value of a sum of money to be received at a future date is determined by discounting the future value at the interest rate that the money could earn over the period.

(a) Present Value of a Single Cash Flow

Present value of (PV) of the future sum (FV_n) to be received after a period 'n' for which discounting is done at an interest rate of 'r', is given by the equation

$$PV = FV / (1+r)^n$$

Note: As n becomes large the calculation of $(1+r)^n$ becomes difficult. To calculate the present values in such cases we can make use of Present Value or Discount Factor Tables. Making use of the Discount factor tables, we can calculate the present value of money as

$$PV = FV_n * DF_{r,n}$$

(where $DF_{r,n}$ is discount factor for (r) percent interest and 'n' periods)

(b) Present Value of a Series of Payments:

Present value of several sums of money, each occurring at different point of time can be calculated as below:

$$PV = CF_1 / (1+r) + CF_2 / (1+r)^2 + \dots + CF_{n-1} / (1+r)^{n-1} + CF_n / (1+r)^n$$

Where, PV = Present value

CF₁ = Payment/ Cash Flow after period 1

CF₂ = Payment/ Cash Flow after period 2

CF_n = Payment/ Cash Flow after period n

r = Rate of Interest

(c) Present Value of an Annuity

An annuity is a series of equal payments lasting for some specific period. The present value of annuity is the sum of the present values of all the cash inflows of this annuity.

(i) Present value when Annuity occurs at the end of each period (Immediate Annuity):

The present value (PV) of a uniform cash flow (CF) made at the **end** of each period till the time of maturity 'n' for which discounting is done at the rate 'r' is calculated as follows:

$$PV = CF/(1+r)^1 + CF/(1+r)^2 + \dots + CF/(1+r)^n$$

Using the Annuity Discount Factor Tables, the present value of annuity can be calculated by multiplying the annuity payment with the annuity discount factor:

$$PV = CF * ADF_{r,n}$$

(ii) Present value when Annuity occurs at the beginning of each period (Annuity Due):

The present value of an annuity due, i.e. if the cash flows occur at the beginning of each year can be calculated as:

$$PV = CF + CF/(1+r)^1 + CF/(1+r)^2 + \dots + CF/(1+r)^{n-1}$$

Using the Annuity Discount Factor Tables, the present value of annuity can be calculated as below:

$$PV = CF + CF * (ADF_{r,n-1})$$

(iii) The present value of an **infinite life annuity** can be calculated as:

$$PV = CF / r$$

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Q: Explain Yield to Maturity in brief. (www.prepNext.com)

Ans:

The yield measure most commonly used for bonds is **yield to maturity (YTM)** – the percentage yield that will be earned on the bonds from purchase date to maturity date. The yield to maturity puts bonds income into a common denominator that permits investors to make yield comparisons

The YTM is the discount rate that equals the present value of all cash flows from a bond to the cost (current market price).

$$P_0 = \sum_{t=1}^n I_t / (1+r)^t + P_t / (1+r)^n$$

P_0 = Cost of bond;

P_t = Terminal price or value

I_t = Annual interest in rupees;

r = Discount rate which is the YTM

t = Time Period

The formula for approximating the YTM is:-

$$\frac{\text{Annual Coupon Interest} + (\text{Face Value} - \text{Price}) / \text{No. of Years to Maturity}}{(\text{Current Price} + \text{Face Value}) / 2}$$

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