

CHAPTER 1

Investment Background

1.1. INVESTMENT

1.1.1. Concepts of Investment

An investment is the expenditure which is made for the purpose of future consumption or for the creation of future wealth. In finance, an investment denotes the monetary asset which is purchased with intent of providing income in the future. It may also be acquired with the purpose of capital appreciation and selling it later at a higher price. In this way, investment is the process where an advance or a loan is provided. It may also involve offering equity or debt capital to a business unit.

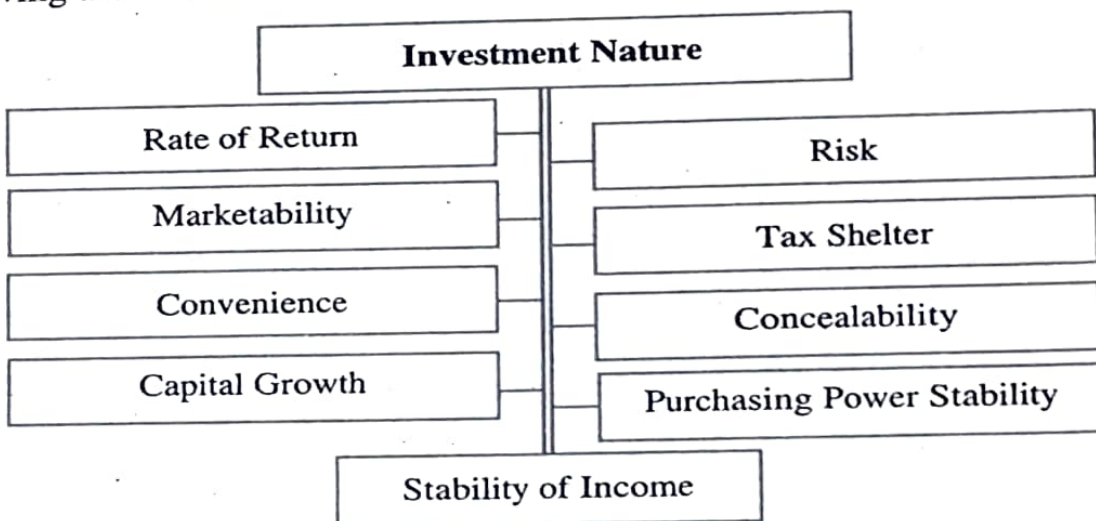
Investment is an activity which offers funds with the intent of reaping the benefits in the form of capital appreciation or interest in the future.

According to Oxford Dictionary, "Investment means the investing of money".

According to Keynes, Investment is defined as, "The addition to the value of the capital equipment which has resulted from the productive activity of the period".

1.1.2. Investment Nature

Following are the nature/evaluation criteria of an investment process:



1) **Rate of Return:** The rate of return on an investment can be defined by the following formula:

$$\text{Rate of return} = \frac{\text{Annual income} + (\text{Ending Price} - \text{Beginning Price})}{\text{Beginning Price}}$$

- 2) **Risk:** The risk of an investment is measured through the variability in return. An investment with greater variability in its return is deemed to be more risky.

Total Risk of a Security = Unsystematic risk + Systematic risk

The **unsystematic risk** is measured through the **standard deviation**. This component of total risk is unique to every company and thus may be reduced by diversifying the portfolio. **Systematic risk**, on the other hand, is common to all the investments and thus may not be avoided through diversification. It can be measured by **Beta**.

- 3) **Marketability:** An investment is considered liquid or marketable if it has the following attributes:

- i) It is capable of being transacted at a short notice.
- ii) The transaction costs are low.
- iii) The price fluctuation between two successive transactions is minimum.

A good investment product has high marketability and *vice-versa*.

- 4) **Tax Shelter:** The government may promote one type of investments over another by offering tax benefits. Following are the tax benefits an investment may have:

- i) **Initial Tax Benefit:** This type of benefit accrues when the investment is made.
- ii) **Continuing Tax Benefit:** Such type of tax benefit accrues as long as the entity retains the investment.
- iii) **Terminal Tax Benefit:** Such type of tax benefit occurs when the investment is liquidated.

- 5) **Convenience:** This is one of the defining characteristics of a good investment. Such investments are convenient to make and to operate. The main example of such investment is a bank account which offers relative ease on both the fronts. On the other hand, is investment in fixed assets such as real estate which involves long legal procedure and generally expensive process.

- 6) **Concealability:** This factor includes characteristics such as safeguards against possible encroachments. Such encroachments may come from private parties, regulators or governments. Some investments such as gold or precious metals have these characteristics as these may be easily concealed. Other investments such as real estate lack this quality.

- 7) **Capital Growth:** A good investment should provide reasonable capital growth prospects. Capital growth means the increase in the value of the investment over a period of time.

- 8) **Purchasing Power Stability:** A good investment prospect offers purchasing power stability which means that the current funds are used for generating larger cache of future funds.

- 9) **Stability of Income:** The investment instrument should be able to provide consistent returns. In case the returns show a large amount of fluctuation, such investment is not deemed desirable. It is important to ensure that the investment shows the characteristic of stable return.

1.3. Investment Objectives

Following are the main objectives of an investment:

Maximize Current Income: Since future is always uncertain, a good investment puts more emphasis on current income. The factor of ensuring maximum current income is generally one of the most important criterions.

Preservation of Capital: While generating income, it is important to ensure that the initial capital is preserved. The investments should be planned in such a way so that the risk of any fall in capital value is within reasonable limits.

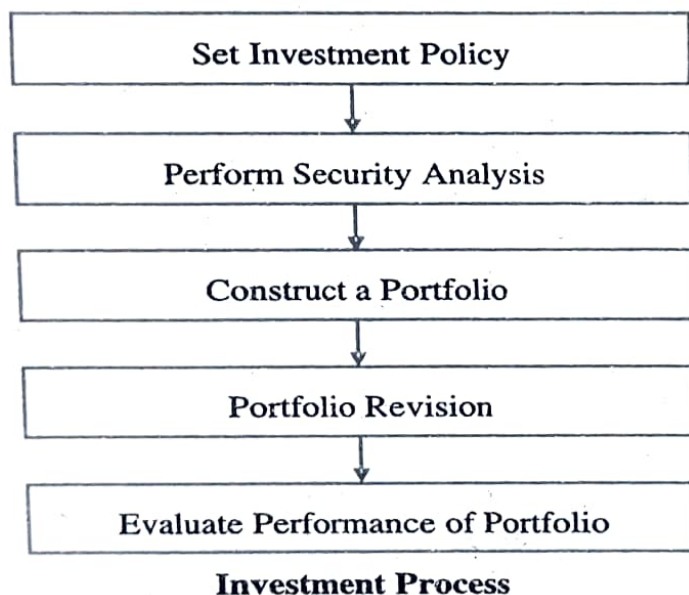
Reasonable Current Income with Moderate Capital Growth: This objective aims to find a balance between current capital outlay and future income.

Long Term Capital Growth: This objective is long term in nature as it seeks to ensure that the capital invested grows in its volume over a period of time. This is especially important for investors who are not particular about generating current income and has long term investment horizon.

Aggressive Capital Growth: This is the risky type of investment in which increasing the capital is the main investment objective.

1.4. Investment Process

The investment process details various steps which need to be undertaken in order to make an informed decision about making an investment. Following are the main stages involved in the process of an investment:



- 1) **Set Investment Policy:** It involves determining the purpose of making the investment as well as the corpus available for this process. Ideally, the required rate of return and risk should be clearly laid out. This is done because investment products generally show direct link between return and risk.
- 2) **Perform Security Analysis:** While designing a portfolio it is important to pay attention to each individual component. This also helps in identifying the securities which may be mispriced. The investors tend to derive their

profits by the identification of such mispriced securities. Such analysis may be 'technical analysis' which is the first classification and 'fundamental analysis' which is the second classification. The person who uses technical analysis is known as **technical analyst or technician** and the person who uses fundamental analysis is known as **fundamentalist, or fundamental analyst**. However, it is recommended to use both the types of analysis to reach at the proper conclusion.

- 3) **Portfolio Construction:** This step involves identifying the securities and then determining the quantities of such instruments to be included in the portfolio. Following three factors should be kept in mind while constructing a portfolio:
 - i) **Selectivity:** The proper analysis of each and every instrument should be done to ensure that it fits the overall objective of the portfolio. It is also known as micro forecasting.
 - ii) **Timing:** This process is known as macro-forecasting and it entails the forecast of security price in relation to other fixed income securities.
 - iii) **Diversification:** This step includes the construction of investor's portfolio so that the risk is minimised.
- 4) **Portfolio Revision:** Portfolio should be revised on periodical basis to see that its various constituents still confirm to the overall portfolio objective. If a security has met its investment objective, then it may be replaced by a new one.
- 5) **Evaluate Performance of Portfolio:** Portfolio performance should be taken into account to see that it is up to set standards. It is done to ensure that the objectives of portfolio investments are achieved.

1.1.5. Investment Planning

Investment planning is the process of identifying financial goals and converting them through building a plan. Investment planning is the main component of financial planning. The investment planning begins with identification of goals and objectives. Then a person's need is matched with those goals and his available financial resources. Nowadays, there are many investment vehicles to invest in, most common being cash, equities, bonds and property. So according to the funds available a person can invest in these vehicles to obtain his goals and objectives.

It focuses on identifying effective investment strategies according to an investor's risk appetite and financial goals. There is a wide variety of investment options, including shares, bonds, mutual funds, bank deposits, real estate and futures and options. Through investment planning, one can identify the most appropriate portfolio mix. Hence, investment planning also helps in striking a balance between risk and returns. By prudent planning, it is possible to arrive at an optimal mix of risk and returns, which suits particular needs and requirements.

1.6. Investment Importance

Investment is an important and useful factor in the context of present day conditions. Some factors are important. They are as explained below:

Longer Life Expectancy: As the life expectancy increases, the number of years to be lived post retirement also increases, which provides more fund after retirement. It is important to carefully invest the savings to ensure proper income during the retirement time.

To Save Tax: Various tax exemptions make certain investments more worthwhile. Investing funds in ULIP, Pension Fund or National Savings Certificates provide higher effective return.

To Earn Interest: It is important to ensure that the investments earn appropriate amount of interest. Different investments provide different rate of return. The interest rate will be different because of different benefit schemes given by the institutions. It is not necessary that high rate of interest will favour the investment. The stable interest is an important way for receiving a high rate of interest.

Fear of Inflation: Inflation is said to be on-going process. Inflation involves the fall in purchasing power of the money over a period of time. It is important to ensure that the investments generate adequate returns after taking inflation into account. There are various problems which are related in lowering the standard of living.

Income: It is important to generate sufficient income to ensure proper amount of investment for future use. The government provides jobs to unemployed person to ensure the increase in the saving of the people. The more incomes and avenues of investment offers the people to save and invest.

1.7. Investment Constraints

Following are the main factors which may act as constraints while making investments:

Liquidity: Liquidity may be a constraining factor as the investment may not be made in the instruments which are not liquid in nature. In these cases, the investor may lose out higher returns provided by the instruments lacking liquidity. As more number of liquid investments is considered safer, they also provide relatively lower return. Thus, the requirement for liquidity may limit the returns as well.

Investment Horizon: This term shows the time for which the funds are available for investment. If a person is able to park the funds for one year or more, it may be considered a long term investment horizon. It is important to keep investment horizon in mind while selecting an investment tool.

Taxes: Investments and returns thereon attract taxes on them, which may deplete the returns. It is important to plan the portfolio in such a way that the impact of tax is minimised.

- 4) **Regulations:** Investments are covered by legal regulations. Some investments may be deemed legal in one country, while illegal in another country. It is important to check the local regulations in this regard. It is also important to ensure that the rules are appropriately met. Like India, the mutual funds are only allowed to hold 10% of the equity shares of a public company.
- 5) **Unique Circumstances:** The investors generally have their own unique circumstances. For example, a person may only be able to invest in short-term instruments. In such cases, these circumstances should be taken into consideration.

1.1.8. Investment Vs Speculation

Basis of Difference	Investment	Speculation
1) Meaning	Investment refers to the investing of money.	Speculation refers to trading done in risky securities for earning more returns.
2) Types of Contract	Investor acts as a creditor of the investment.	Speculator acts as an owner of the speculation.
3) Length of Commitment	Investment entails long-term commitment.	In the case of speculation the length of commitment is for short term only.
4) Source of Income	The source of income is earning from the enterprise.	The income of speculation is from the fluctuation in market price.
5) Quantity of Risk	It has low risk.	The speculation involves high risk.
6) Stability of Income	Offers stable income.	Income is uncertain and erratic in its nature.
7) Behaviour of Participants	The investor has the cautious and conservative behaviour.	The speculator has the daring and careless behaviour.
8) Reasons for Purchase	It involves scientific analysis of intrinsic worth.	It is based on unscientific analysis of intrinsic worth.

1.1.9. Investment Vs Gambling

Basis of Difference	Investment	Gambling
1) Risk Creation	The investors deal in the already existing risk in the investment.	The gambler in gambling creates risk.
2) Risk Transfer	The risk is transferred to insurance company in the investment.	There is no way of transferring the risk in gambling.
3) Expected Return	In investment, there is a chance of a positive expected return.	In gambling, there is a chance of a negative expected return.

The two classification of investment alternatives are **financial form investment/financial instrument** and **non-financial form of investment**. The features and use of various alternatives should be study properly for the investment.

The investment alternatives can be classified as follows:

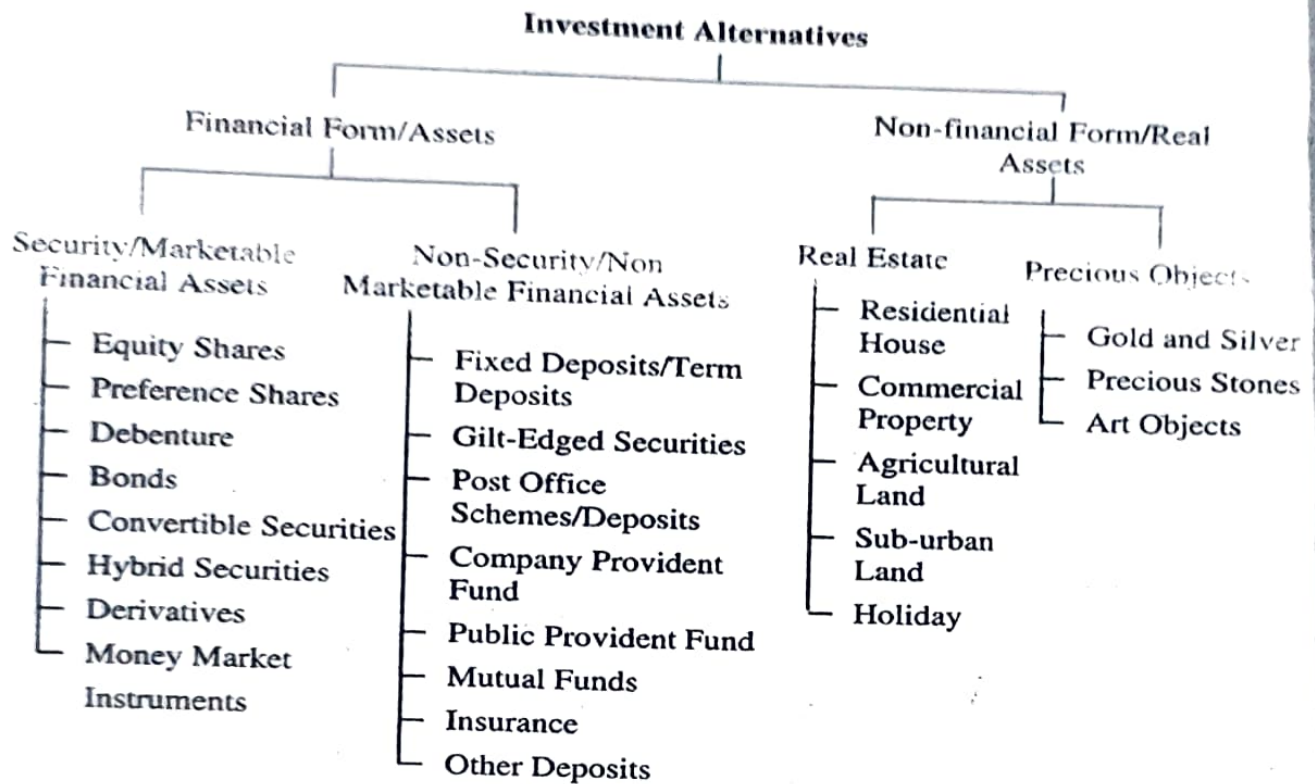


Figure 1.1: Investment Alternatives

1.1.11.1. Financial Forms of Investment/Financial Assets

The financial forms of investments or financial assets can be claimed on paper from some issuer, like the government or corporate body. The different type of financial assets are equity shares, corporate debentures, government securities, deposit with banks, mutual fund shares, insurance policies, and derivative instruments.

1) **Security/Marketable Financial Assets:** The security forms of investment or marketable financial assets can be moved and traded in different structure of financial market. The different types of financial assets are as follows:

i) **Equity Shares:** Equity shares are also termed as ordinary shares or common shares. Holders of the equity shares are the owners of a company as they have invested in the company. They have the voting rights and part of decision-making process on major issues relating to the affairs of the company.

ii) **Preference Shares:** Preference shares exhibit the following characteristics:

- The rate of dividend on preference shares is generally fixed.
- Preference shareholders get a priority over the claim of equity shareholders.
- Preference shareholders generally do not have the right to vote.

- iii) **Debentures:** A debenture is an instrument through which an Indian company can raise funds from the market. It is signed by the company with its seal, to acknowledge the debt of the person(s), ensuring the advanced amount of debt. So this is a security issued by a company against debt.
 - iv) **Bond:** A bond is a debt security, in which the authorized issuer owes the holder a debt and is obliged to repay the principal and interest (the coupon) at a later date, termed maturity. A bond is simply a loan in the form of a security with different terminology; the issuer is equivalent to the borrower, the bondholder to the lender, and the coupon to the interest.
 - v) **Convertible Securities:** A convertible security is the security which can be converted into common stock by the holder in certain condition by the issuer based on certain rules like the convertible bonds and convertible preferred stock. There are certain numbers of stock which are received by the holder of the convertible security at the time they do the exchange.
 - vi) **Hybrid Securities:** The hybrid security refers the security which has the characteristics of equity and debt.
 - vii) **Derivatives:** This type of security derives its value from the underlying asset. The value of the backing asset determines the value of the derivative security. A derivative security is mainly used for the purpose of risk management. The risks arising out of price fluctuation may be managed with the help of derivative securities.
 - viii) **Money Market Instruments:** The money market is an important segment of the financial market, wherein funds are either lend or borrowed for a short-term tenure, usually for a period not exceeding one year. It is done through the financial instruments of rather a short-term maturity. **Examples** of money instruments are bill of exchange, call & notice money market, treasury bills, certificate of deposits, commercial papers, etc.
- i) **Non-Security/ Non-Marketable Financial Assets:** The non-security type of investment cannot be moved or traded in the structured financial market which are as follows:
- i) **Fixed Deposits/Term Deposits:** Such accounts have fixed tenure ranging from a few months to a couple of years. The withdrawal is not allowed before the expiry of the time period. Such accounts pay higher interest rate than other accounts. The interest rate varies with the tenure as the longer accounts generally have higher interest rate attached to them. These deposits are also known as **term deposits** or **time deposits**. Premature withdrawal of such accounts has certain amount of penalty.
 - ii) **Gilt-Edged Securities:** The **government security** or **gilt-edged security** or **stock** are the marketable debt which are delivered by the government or semi-government bodies which shows the claim on the government. They are used for refunding the maturing securities, for pre-funding the securities before maturity and for cash financing for issuing new cash resources.

- iii) **Post Office Schemes/Deposits:** The government has made the post office as the banks also which will accept savings. The post office give various services. They are not only involved in delivering mail but also accept deposits, deliver retail service like sale of forms, bill collection etc. provide savings schemes, life insurance cover etc. Some of the schemes are:
- Post Office Saving Account:** The post office saving account is similar to the various saving account in the commercial banks. It is a small investment and the investors will deposit that money which they may require for liquidating it fully or partially at very short notice.
 - Post Office Time Deposit:** In this the investors deposit, some amount for a fixed time period. The function of post office time deposit is same as the fixed deposit accounts.
 - Recurring Deposit Account:** The recurring deposit is the organised method for saving money. This scheme is for those investors who save the fixed amount regularly or periodically.
 - Post Office Monthly Income Scheme:** The post office monthly income account is for the investors who want to invest some amount and get interest on it on the monthly basis for fulfilling their basic requirement.
 - Public Provident Fund:** Public Provident Fund (PPF) is a type of saving which also gives the tax benefit. It acts as the retirement planning tool for those investors who do not have any structured pension plan for them.
- iv) **Company Provident Fund:** It is the retirement benefit plan by the Government of India in which the fixed percentage of salary is deducted and the fixed percentage is given by the company. This money is kept in an account and is given after retirement. The specific amount from the salary of the employee is deducted which is contributed in the fund.
- v) **Public Provident Fund:** The PPF deposit is done which have monthly installments of minimum ₹500 and maximum ₹1,00,000. They have cumulative interest of 7.9% which is fully exempted from the tax according to Section 80C.
- vi) **Mutual Funds:** A mutual fund is a pool of money representing the savings made by a number of investors. The funds so collected are managed by professionals by investing in equity as well as debt instruments like stocks, debentures, bonds, money market and other financial instruments.
- vii) **Insurance:** Insurance is the contract between the company known as **insurer** and the customers known as **insured**. It is a financial service which is very common in India. The insurance is done for giving financial help at the time of sudden tragic events like death. The insurance requires proper planning and execution.

There are mainly two types of insurance in India, i.e., life insurance and general insurance.

- a) **Life Insurance:** According to the Insurance Act, 1938, the life insurance business refers to the business in which there is contract made on the life of the human. The contract says the payment will be given to the assured on the death or the happening of any event. It can also be said that the life insurance contract is a contract where the insurer agrees to pay the premium in lump-sum or in periodic form to the assured or to other beneficial person at the decided amount either on the death of insured or on the expiry of a specified period of time.
- b) **General Insurance:** 'General insurance' is the contract in which the insurer assumes to compensate the insured in case of any loss or damage. There is regular payment given of the sum of money known as premium. It is type of protection contract not an investment contract. It means that the money given as premium will be repaid to the insurer only when there is certain specified event happens which result in loss or damage to the insured. There are various insurances which are compulsory like Motor Insurance and Public Liability Insurance.

viii) **Other Deposits:** The other deposits includes the following:

- a) **National Savings Certificate:** There are two types of NSC provided by the post office which are of 5 year and 10 year. The rate of interest offered is 7.9%. The taxation benefits are same as PPF which means it is also exempted under Section 80C.
- b) **Indira Vikas Patra:** According to Section 2(14) of Income-tax Act, 1961 the Indira Vikas Patras are referred to as capital assets. The tax on these types can be converted or traded in the assets before the maturity according to the capital gain tax head for the investors.
- c) **Company Deposits:** The various large and small companies take fixed deposits from the public. The mobilisation of fixed deposits is done by the manufacturing companies which are according to the Company Law Board. The RBI regulates the fixed deposits which are mobilised by the finance companies.
- d) **Employee Provident Fund Scheme:** It is an important method of saving for the salaried employees. The employees have the separate PF account in which both the employer and employee need to deposit some amount on the monthly basis. The employees can also add extra amount but they have some conditions.
- e) **Monthly Income Scheme of the Post Office (MISPO):** It is the popular method of the post office which provides the monthly income to the depositors.

1.1.11.2. Non-Financial Forms of Investment/Real Assets

The non-financial form of investment or real assets is shown by the help of intangible assets. **For example**, a residential house, a commercial property, an agricultural farm, gold, precious stones and art objects.

- 1) **Real Estate:** The real estate consists of bricks, cement and mud used for constructing land and building. The land refers to the wind above and the ground below and any building or structure present on the grounds. It includes the residential houses, commercial offices, trading spaces such as theaters, hotels and restaurants, retail outlets, industrial buildings, factories and also government buildings. The transaction consists of:

- i) Purchase,
- ii) Sale, and
- iii) Development of land (both residential and non-residential buildings).

The real estate refers to the space-time product which helps in making income for certain time period in lieu of the space provided. **For example** apartments, stadiums, party halls, residential units, commercial complexes etc. The real estate refers to the immovable property which can be land or building or both. Real estate also includes the different structure on land like fences, swimming pools, flagpoles and the products growing on the soil naturally without any cultivation. While transferring the ownership of their property, the property owner shows all the features of real estate in the agreement done excluding the certain part of real estate.

The basic players of real estate market cover the following:

- i) The landlords,
- ii) The builders,
- iii) The developers,
- iv) Real estate agents,
- v) Tenants, and
- vi) Buyers.

- 2) **Precious Objects:** The precious objects are small in size and have high monetary value. The various important precious items include:

- i) **Gold and Silver:** The gold and silver are referred to most widely used metal which is used by all the type of investors for certain reasons like:
 - a) They are good hedges against inflation.
 - b) They have high liquidity with low trading commissions.
 - c) They are attractive.
 - d) They have a high number of monetary value.

According to Jack Clark Francis, "A substance possesses moneyness when it is:

- a) A store of value,
- b) Durable,
- c) Easy to own anonymously,
- d) Easy to subdivide into small pieces that are also valuable,
- e) Easy to authenticate, and
- f) Interchangeable, that is, homogeneous".

2.1. FINANCIAL MARKETS

2.1.1. Concept of Financial Markets

Finance is considered to be one of the most important ingredients of the contemporary business. **Financial markets** comprise of the entire institutional set-up in place, which primarily deals with various financial instruments including credits extended in the form of cash, cheques, bank deposits, bills, etc.

A financial market offers a platform for individuals, various entities, and institutions to enter into trading activities in respect of different financial instruments (such as equities, debentures, bonds, etc.), commodities (such as gold, silver, and other precious metals, or agricultural produces) and other items/goods of fungible nature. Such offer is made available at a reasonable transaction cost, which represents an efficient-market hypothesis.

Financial market is a meeting ground for the market players, viz. the buyers and the sellers interested in trading in various financial instruments and commodities are gathered together.

2.1.2. Features of Financial Markets

Financial markets are characterised by the following features:

- 1) **Large Volume of Transactions:** One of the salient features of the financial markets pertains to the high level of transaction volumes, and the pace at which various financial resources can move between different markets.
- 2) **Various Segments:** Financial markets are composed of a number of sub-divisions, e.g. equities market, debts/bonds market, derivatives market, etc. Each of such sub-divisions may be further divided into the primary market and secondary market. Investment decisions are generally taken by the savers on the basis of risk perception and benefits accrued there from.
- 3) **Instant Arbitrage:** Due to the fact that there are a number of markets and a number of financial instruments in existence, there is enough opportunity for quick arbitrage, if a proper check is kept on the market movements.
- 4) **Volatility:** Movements of financial markets are unpredictable, as they are quite sensitive to any political/economic development, either domestic or global. Any negative/positive development in the political/economic arena or even in respect of a specific company/group of companies may impact the markets either way. Instances of distress selling or panic buying are common place news in markets.

- 5) **Dominated by Financial Intermediaries:** Most of the major/big players in markets are financial intermediaries; they take investment decisions on behalf of their clients. At times, the risks involved in those investment decisions are also borne by such intermediaries.

2.1.3. Functions of Financial Markets

Financial markets are expected to perform the following functions:

- 1) **Mobilisation of Savings and their Channelisation into more Productive Uses:** Financial markets encourage people to save more, as they act as a conduit for channelising household savings. Appropriate use of idle cash is ensured by deploying them at places where they are required most. They also provide suitable returns to the investors. This process is carried out through the help of a number of financial instruments, which are designed to cater the needs of various categories of investors.
- 2) **Facilitates Price Discovery:** The determinants of the price of any goods or services are the market forces, viz. demand of a specific product or service and supply thereof in the market. The same principle is applicable in the cases of financial instruments, i.e. their price is also determined by their demand and their availability. An investor may, therefore, make an attempt from time to time to ascertain the price of the financial instruments held by him. The financial markets are facilitators of such price discovery in respect of goods, services, and securities.
- 3) **Provides Liquidity to Financial Assets:** Markets are the places where the market players (traders in various commodities, including securities) are present for entering into appropriate actions, i.e. buying or selling commodities/securities. In view of the above, securities continue to be liquid; it means they can be bought or sold easily. This factor elevates the confidence of the existing as well as potential investors.
- 4) **Reduces Transactions Cost:** At the time of taking a trading decision (buying or selling), a host of data/information is required by the trader. Gathering such data/information from different independent sources is a challenging task, requiring a lot of time and money. However, such data/information are readily available in the financial markets, which can be obtained without much loss of time and money. As a result, the cost of transaction is kept at the minimum possible level.
- 5) **Assist in Maintaining Balanced Economic Growth:** Financial markets are important links between the investors on one hand, and savers on the other. Therefore, they facilitate economic growth of a country in a balanced manner. They are also an effective medium through which resources are distributed amongst those who require them. In the process, technological up-gradation for the purpose of growth takes place on a regular and sustainable basis.

2.1.4. Types of Financial Markets

Financial markets may be classified into the following four categories. Such categorisation has been made on the basis of the tenure of credit requirements and the functions carried out by such markets:

- 1) **Capital Market:** Capital market is an important segment of any financial market. Financial assets/instruments having long-term maturity, generally more than one year, are dealt with in this segment. Financial instruments having maturity of less than one year are referred to as money market instruments, and are dealt with in another segment of financial market, i.e. money market. Capital market may be divided into two components, viz. primary market and secondary market.
 - i) **Primary Market:** This denotes the New Issue Market i.e. where the shares are issued for the very first time. In other words, the same were never issued before in the market. Under this, the existing companies and the new entrants can bring the new issues. The basic objective is to procure funds from the investors and transfer the same to the new and existing entrepreneurs who are either establishing a new set-up or expanding the existing one.
 - ii) **Secondary /Stock Market:** The secondary market is also known as the 'after-market'. It refers to the financial market to buy and sell financial instruments and securities which have been previously issued. These financial instruments include stock, bonds, futures and options. The term also refers to the market for any previously used assets or goods. It includes alternative use of the commodity. **For example**, corn is generally used as a foodstuff, however its secondary market involves the use of corn for producing ethanol. Other names used for such markets are **Stock Market or Stock Exchange**.
- 2) **Money Market:** Money market is another segment of the financial market, in which the financial instruments characterised by their high liquidity and short maturities, are traded. The participants of this market use it for short-term borrowing and lending; the short-term being in the range of 'overnight' to 'under one year'.
- 3) **Derivative Market:** Derivatives markets are markets that are based upon another market, which is known as the underlying market. Derivatives markets can be based upon almost any underlying market, including individual stock markets (e.g. the stock of company XYZ), stock indices (e.g. the Nasdaq 100 stock index), and currency markets (i.e. the forex markets).
- 4) **Foreign Exchange Market:** The Foreign exchange (currency or FOREX or FX) market refers to the market for currencies. Transactions in this market typically involve one party purchasing a quantity of one currency in exchange for paying a quantity of another. The FX market is the largest and most liquid financial market in the world, and includes trading between large banks, central banks, currency speculators, corporations, governments, and other institutions.

- 4) Securities are traded by the current investors to other investors.
- 5) The proposing buyer and seller can purchase and sell securities via brokers.
- 6) Stock exchange delivers liquidity to the investment and augments the marketability of securities.
- 7) Stock exchange simply transmits existing securities between buyers and sellers.
- 8) Stock exchanges are not considered as the direct source of generating capital.

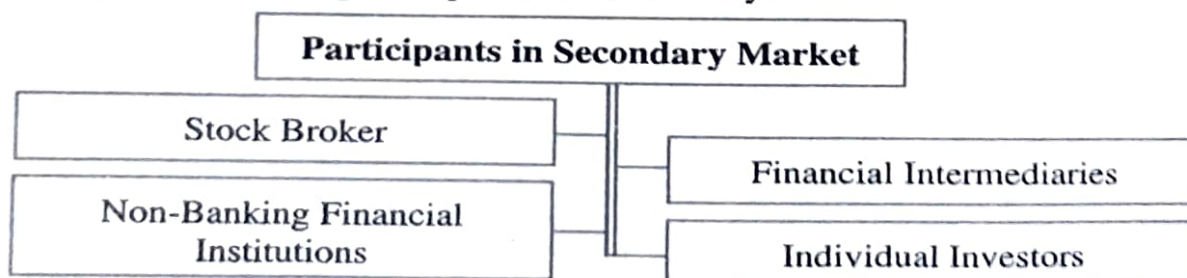
2.4.3. Functions of Secondary Market

Following are the main functions of a secondary market:

- 1) **Ensure Liquidity of Capital:** The stock exchanges help to convert shares and stocks into cash. These exchanges ensure that there is always a ready market for the sale and purchase of securities. It helps in converting stock holding into hard cash as and when required by the holder. In the absence of stock exchanges, many investors would have hesitated in blocking their money.
- 2) **Evaluation of Securities:** The investors can determine the true value of their holding by using the price quotations offered by stock exchanges. These prices are determined by free demand and supply forces and thus are according to the rules of free market.
- 3) **Mobilising Surplus Savings:** Stock exchanges facilitate free exchange of securities, making it easier for people with surplus funds to invest in securities and financial instruments. In the absence of stock exchanges, such people will not have a proper avenue for investing their surplus.
- 4) **Helpful in Raising New Capital:** Capital is required by both new as well as existing business concerns. New concerns require capital for starting their business while existing concerns require funds for their diversification and expansion.
- 5) **Safety in Dealings:** Stock exchanges are governed by Securities Contract (Regulation) Act, 1956 and thus the chances of frauds and manipulations are minimised. All the contracts are executed as per the given procedures. So, no parties have any doubt regarding the deals

2.4.4. Participants in Secondary Market

Following are the main participants in secondary market:



- 1) **Stock Broker:** A stock broker is a professional with proper qualifications and regulatory knowledge. This professional deals in stocks and other securities on behalf of their clients. Brokers are also responsible for

providing advisory services to their clients, so that their funds are properly allocated. There are different types of stock brokers such as jobber, commission broker, odd lot dealer, security dealers and taraniwalla, etc.

- 2) **Financial Intermediaries:** Financial intermediaries are all those participants which intermediate and enable financial transactions. They assist individual as well as corporate clients.

Financial intermediaries can help in facilitating the movement of funds as they can accept funds from one organization and lend it to another. Thus, it acts as a mediator between net borrowers and the net savers of funds in an economy. These institutions borrow from the net savers and lend the funds to the net borrowers. Following are the main financial intermediaries which facilitate the flow of funds:

- i) **Commercial Banks:** Commercial Banks are also known as joint stock banks as they have the same constitution such as joint stock companies. Commercial banks are the banks which carry out all the banking functions including accepting deposits, disbursing loans, granting credit facility and also performing agency functions.
- ii) **Development Financial Institutions:** After independence, the country felt a strong need for development financial institutions. These institutions are required for supporting and accelerating the pace of industrialization. The existing firms needed funds for expansion, modernisation and diversification while new firms had massive investment requirements. Development Financial Institutions were required to fill the gap between requirements and existing banking system.
- iii) **Insurance Companies:** Insurance may be defined as a social instrument for reducing or eliminating risk related to the loss of life or property. It implies collective undertaking of risk. Insurance companies help in spreading the risks and losses of few people among a large number of people. This is based on the assumption that people prefer to have a small fixed liability instead of large and uncertain liability. It is economic co-operation for sharing unavoidable risks.
- iv) **Mutual Fund:** A mutual fund is a form of collective investments which are managed by professionals. These professionals pool money from a large number of investors and invest them in various instruments such as stocks, bonds, money market instruments and others. Fund's underlying securities are traded by the fund manager or the portfolio manager. The fund grows through capital gains or losses, interest income and dividend.

- 3) **Non-Banking Financial Institutions:** These institutions perform a variety of banking functions; however, as they do not hold the banking licence, these are not called banks. Such non-banking financial institutions are the companies which are registered under the Companies Act, 1956 and are directed by the Reserve Bank of India. Such companies deal in loans, leases, housing finance, hire purchase, investments, etc. but exclude stock broking companies, stock exchanges or insurance.

- 3) **Adequate Availability of Credit Instruments:** Availability of a variety of various credit instruments such as promissory notes, bill of exchange, treasury bills, short-period government bonds, etc. is yet another feature of a developed money market.
- 4) **Number of Dealers:** The dealers and brokers play an important role in facilitating the trading activities (buying and selling of financial instruments) in a money market. Adequate number of such dealers/brokers as well as that of financial instruments is an absolute necessity for a market to be considered as a developed one. Lack of sufficient number of dealers in a money market is an indication that the market is yet to be developed.
- 5) **Existence of a Large Number of Sub-Markets:** A well-established money market is characterised by the presence of a number of sub-markets, e.g. call money market, bill market, collateral market, acceptance market, etc., which specialises in facilitating specific activities. More the number of such specialised sub-markets, higher are the level of development of the money market.

2.6.3. Functions of Money Market

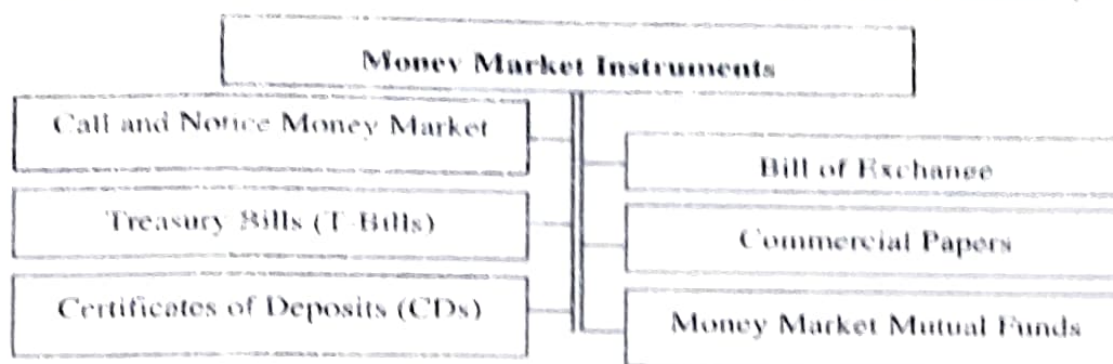
Money markets play an important role in monetary and economic arena of a country, as evident from the following:

- 1) Maintenance of monetary stability in the system by keeping a balance between the demand for money and its supply for the monetary transactions of short-term nature;
- 2) Money market acts as a stimulant for the economic growth by ensuring that adequate funds are made available to entrepreneurs engaged in various economic activities in different sectors, like agriculture, MSME, etc.;
- 3) Supporting trade and industry by extending provisions of sufficient funds to them, including credit facilities in the form of bill-discounting;
- 4) Money market is a facilitator of implementing the Monetary Policy of the country's central bank. It has got an inbuilt mechanism of ensuring implementation of the monetary policy in an efficient manner; and
- 5) In the process of capital formation, money market plays a vital role. It channelises the household savings and investments for short-term investments in its financial instruments, such as treasury bills, commercial papers, certificate of deposits, etc.

2.6.4. Money Market Instruments

Financial instruments, which are generally common in the Indian money market, have been depicted in the following table:

- 1) **Call and Notice Money Market:** Call money market is a place where borrowings and lending take place for a very short period, ranging between overnight and fortnight. The amounts lent or borrowed in this market are considered to be highly liquid, as they can be recalled/repaid at the option of either the lender or the borrower.



Features of Call Money Market

The salient features of call money market are as under:

- i) Banks and other non-bank financial institutions can manage their funds through the call money market by deploying surplus funds or by borrowing for meeting their short-term financial requirements;
- ii) Banks, including the primary dealers are permitted to access the market for borrowing or lending in order to manage their statutory obligation, i.e. Cash Reserve Requirement (CRR);
- iii) Certain financial entities like specified All-India Financial Institutions (AIFI), mutual funds, LIC, GIC, etc. are entitled to participate in the market only as lender (they can't borrow from the market);
- iv) Interest rates in the call money market are fast-changing and decided on day-to-day basis by the market forces;

- 2) **Bill of Exchange:** Bill of exchange is also a money market instrument, which is in the form of an order in writing by the drawer of the bill to the drawee for the payment of money to the payee. A typical bill of exchange is the cheque, drawn by a customer (drawer), defined as bill of exchange, on his banker (drawee) and payable by the banker to the payee on demand. Bills of exchange are mostly used in international trade.

They are in the shape of written orders by a bank's constituent to his bank directing it to pay the bearer of the bill of exchange an amount as specified in that order on a date indicated in the said order. A bill of exchange, also referred to as a **commercial bill**, is characterised by its short tenure, negotiability, and self-liquidating nature.

Features of Bill of Exchange

A bill of exchange is expected to exhibit the following salient features:

- i) **It must be in Writing:** A bill of exchange needs to be necessarily in writing.
- ii) **Order to Pay:** Bill of exchange is an order from the drawer to the drawee to pay money to the payee. This is the basic characteristic of a bill of exchange. Here the term 'order' need not be taken in a literal sense to be a command. It is a sort of request or direction, indicating the drawer's intent to ensure payment to the payee by the drawee. In this regard, a moderate level of politeness is acceptable, but excessive politeness is unwarranted, as it may lack the element of 'order'.

- iii) **Unconditional Order:** No condition should be associated with the order to pay in a bill of exchange. Whatever may be the circumstances, the bill must be paid to the payee by the drawee as per the order of the drawer. Any condition attached with a bill of exchange makes the instrument null and void.
 - iv) **Signature of the Drawer:** A bill of exchange must be signed by its drawer. In the absence of a proper signature of the drawer, an instrument is rendered invalid/unacceptable in law. However, if the signature is obtained even subsequent to the issue of a bill of exchange, it is acceptable.
 - v) **Drawee:** A bill of exchange must contain the name of a drawee/acceptor, who is responsible for the payment to the payee. In the absence of drawee's name, the instrument is considered flawed.
- 3) **Treasury Bills (T-Bills):** Treasury bills are finance bills issued in the form of promissory notes by the Government of India on discount for a fixed short period (not more than one year). They contain a promissory clause to pay the amount stated in the instrument to the bearer thereof. By their very nature they are highly liquid, as they can be bought and sold freely in the "**Treasury Bills Market**". Treasury Bills issued by the Government of India are of three types according to their tenures; they are 91-day, 182-day and 364-day. T-Bills are issued through the process of auction on weekly basis. Whereas the auction of 91 day T-Bills takes place on every Wednesday, T-Bills of 182 day and 364 day duration are auctioned on Wednesdays of every alternate week.

Features of T-Bills

The salient features of treasury bills (T-Bills) are as under:

- i) **Issuer:** Government of India resort to the issue of T-Bills with a view to manage a temporary mismatch between its receipts (revenue as well as capital) and expenditure. Subscribers of such bills are individuals and institutions, who find such instruments attractive enough to invest their surplus funds for a short period.
 - ii) **Finance Bills:** Treasury Bills do not represent any genuine trade transactions. They are, therefore, purely finance bills.
 - iii) **Liquidity:** Although Treasury Bills are highly liquid, they are not self-liquidating (which is the characteristics of genuine trade bills).
 - iv) **Vital Source:** Treasury Bills are one of the most preferred routes for the Government of India for raising short-term funds.
- 4) **Commercial Papers (CPs):** Commercial Papers (CPs) are money market debt instruments in the form of unsecured promissory notes, which can be issued by distinguished corporates with good market reputation. Generally, banks, insurance companies, unit trust and firms are the potential investors in CPs. Minimum face value of a commercial paper is kept at ₹5 lac. Such papers are issued by the companies with a view to meet the demand arising out of seasonal/working capital requirements, which are of short-term nature. The issuer of Commercial Papers has an option to sell them directly or indirectly (through some agency).

Features of Commercial Papers

The salient features of commercial papers are as follows:

- i) **Market:** CPs issued by top-rated corporates (private as well as public sectors) are viewed as preferred investment opportunities by prospective investors. The 'Commercial Papers Market' is considered a well-developed one. With effect from September 1996, Primary Dealers (PDs) were also allowed by RBI to issue CPs for supplementing their resources. As a result of this initiative taken by RBI, CP market gained further popularity.
 - ii) **Rating:** The issuing companies are required to grade their CPs as per the instructions of RBI. It facilitates the decision making exercise to be taken by the prospective investors as per the grade allocated by the issuer; higher the grading, better is the quality of the instrument.
 - iii) **Interest Rates:** As the interest rates are decided by the market forces, they keep on changing frequently. The factors responsible for determining the interest rates include rating of the instrument, economic phase, the present rate of interest in CPs market and call money market, conditions prevailing in the foreign exchange market, etc.
 - iv) **Maturity:** With a view to making the Commercial Papers more attractive and giving a boost to CP market, the minimum maturity period of CPs was brought down in phases from 3 months to the present 15 days.
- 5) **Certificates of Deposits (CDs):** Certificates of Deposits (CDs) are yet another money market instrument issued by Commercial Banks (CBs) and Development Financial Institutions (DFIs). They are unsecured, negotiable and short-term in nature, which are payable to the bearer. CDs are different from the Term Deposit in as much as they involve creation of paper and are transferable between various owners before maturity. Further, they generally bear a higher rate of interest, when compared with the FDs. There exists a market for trading in CDs, which is termed as 'Certificate of Deposit Market'.

Features of Certificate of Deposits

The salient features of Certificate of Deposits (CDs) are as follows:

- i) **Negotiable Instruments:** Certificates of Deposits are issued at discount to the face value at market rates by Commercial Banks (CBs) and Development Financial Institutions (DFIs). Due to the negotiable nature of CDs, various provisions of Negotiable Instruments Act, 1881 are applicable to them.
- ii) **Maturity:** The minimum and maximum maturity periods of CDs are 15 days and one year respectively.
- iii) **Nature:** CDs are promissory notes with fixed maturity period, and as such they can be negotiated by endorsement and delivery.
- iv) **Ideal Source:** CDs offer a good and safe investment opportunity for prospective investors, as their issuers, viz. commercial banks/specified financial institutions are responsible for their timely payments.