Chapter–1: Investment Basics

Investment

The money you earn is partly spent and the rest saved for meeting future expenses. Instead of keeping the savings idle you may like to use savings in order to get return on it in the future. This is called Investment.

Reasons to Invest

One needs to invest to:

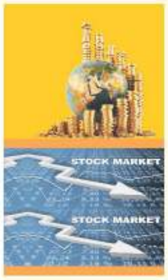
- Earn return on your idle resources
- Generate a specified sum of money for a specific goal in life
- Make a provision for an uncertain future

One of the important reasons why one needs to invest wisely is to meet the cost of Inflation. Inflation is the rate at which the cost of living increases. The cost of living is simply what it costs to buy the goods and services you need to live. Inflation causes money to lose value because it will not buy the same amount of a good or a service in the future as it does now or did in the past. For example, if there was a 6% inflation rate for the next 20 years, Rs. 100 purchase today would cost Rs. 321 in 20 years. That is why it is important to consider inflation as a factor in any long-term investment strategy. Remember to look at an investment's 'real' rate of return, which is the return after inflation. The aim of investments should be to provide a return above the inflation rate to ensure that the investment does not decrease in value. For example, if the annual inflation rate is 6%, then the investment will need to earn more than 6% to ensure it increases in value. If the after-tax return on your investment is less than the inflation rate, then your assets have actually decreased in value that is, they won't buy as much today as they did last year.

Time to Invest

The sooner one starts investing the better. By investing early you allow your investments more time to grow, whereby the concept of compounding (as we shall see later) increases your income, by accumulating the principal and the interest or dividend earned on it, year after year. The three golden rules for all investors are:

- Invest early
- Invest regularly
- Invest for long term and not short term



Precautions to be taken while Investing

Before making any investment, one must ensure to:

1. Obtain written documents explaining the investment
2. Read and understand such documents

3. Verify the legitimacy of the investment
4. Find out the costs and benefits associated with the investment
5. Assess the risk-return profile of the investment
6. Know the liquidity and safety aspects of the investment
7. Ascertain if it is appropriate for your specific goals
8. Compare these details with other investment opportunities available
9. Examine if it fits in with other investments you are considering or you have already made
10. Deal only through an authorized intermediary
11. Seek all clarifications about the intermediary and the investment
12. Explore the options available to you if something were to go wrong, and then, if satisfied, make the investment.

These are called the Twelve Important Steps to Investing.

Meaning of Interest

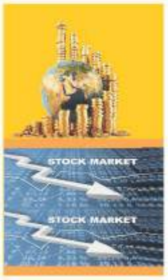
When we borrow money, we are expected to pay for using it and this is known as Interest. Interest is an amount charged to the borrower for the privilege of using the lender's money. Interest is usually calculated as a percentage of the principal balance (the amount of money borrowed). The percentage rate may be fixed for the life of the loan, or it may be variable, depending on the terms of the loan.

Factors that Determine Interest Rates

When we talk of interest rates, there are different types of interest rates–rates that banks offer to their depositors, rates that they lend to their borrowers, the rate at which the Government borrows in the Bond/Government Securities market, rates offered to investors in small savings schemes like NSC, PPF, rates at which companies issue fixed deposits etc.

The factors which govern these interest rates are mostly economy related and are commonly referred to as macroeconomic factors. Some of these factors are:

- Demand for money
- Level of Government borrowings
- Supply of money
- Inflation rate
- The Reserve Bank of India and the Government policies which determine some of the variables mentioned above.



Options available for Investment

One may invest in:

Physical assets like real estate, gold/jewellery, commodities etc.

Financial assets such as fixed deposits with banks, small saving instruments with post offices, insurance/provident/pension fund etc. or securities market related instruments like shares, bonds, debentures etc.

Short - Term Financial Options Available for Investment

Broadly speaking, savings bank account, money market/liquid funds and fixed deposits with banks may be considered as short-term financial investment options:

Savings Bank Account is often the first banking product people use, which offers low interest (4%-5% p.a.), making them only marginally better than fixed deposits.

Money Market or Liquid Funds are a specialized form of mutual funds that invest in extremely short-term fixed income instruments and thereby provide easy liquidity. Unlike most mutual funds, money market funds are primarily oriented towards protecting your capital and then, aim to maximise returns. Money market funds usually yield better returns than savings accounts, but lower than bank fixed deposits.

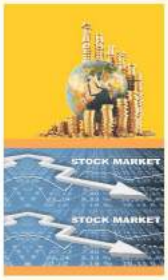
Fixed Deposits with Banks are also referred to as term deposits and minimum investment period for bank FDs is 30 days. Fixed Deposits with banks are for investors with low risk appetite, and may be considered for 6-12 months investment period as normally interest on less than 6 months bank FDs is likely to be lower than money market fund returns.

Long-term financial options available for investment

Post Office Savings Schemes, Public Provident Fund, Company Fixed Deposits, Bonds and Debentures, Mutual Funds etc.

Post Office Savings: Post Office Monthly Income Scheme is a low risk saving instrument, which can be availed through any post office. It provides an interest rate of 8% per annum, which is paid monthly. Minimum amount, which can be invested, is Rs. 1,000/- and additional investment in multiples of 1,000/-. Maximum amount is Rs. 3,00,000/- (if Single) or Rs. 6,00,000/- (if held Jointly) during a year. It has a maturity period of 6 years. A bonus of 10% is paid at the time of maturity. Premature withdrawal is permitted if deposit is more than one year old. A deduction of 5% is levied from the principal amount if withdrawn prematurely the 10% bonus is also denied.

Public Provident Fund: A long term savings instrument with a maturity of 15 years and interest payable at 8% per annum compounded annually. A PPF account can be opened through a nationalized bank at anytime during the year and is open all through the year for depositing money. Tax benefits can be availed for the amount invested and interest accrued is tax-free. A withdrawal is permissible every year from the seventh financial year of the date of opening of the account and the amount of withdrawal will be limited to 50% of the balance at credit at the end of the 4th year immediately preceding the year in which the amount is withdrawn or at the end of the preceding year whichever is lower the amount of loan if any.



Company Fixed Deposits: These are short-term (six months) to medium-term (three to five years) borrowings by companies at a fixed rate of interest which is payable monthly, quarterly, semi-annually or annually. They can also be cumulative fixed deposits where the entire principal along with the interest is paid at the end of the loan period. The rate of interest varies between 6-9% per annum for company FDs. The interest received is after deduction of taxes.

Bonds: It is a fixed income (debt) instrument issued for a period of more than one year with the purpose of raising capital. The central or state government, corporations and similar institutions sell bonds. A bond is generally a promise to repay the principal along with a fixed rate of interest on a specified date, called the *Maturity Date*.

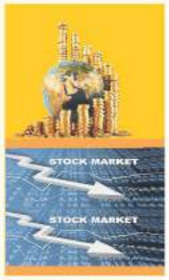
Mutual Funds: These are funds operated by an investment company which raises money from the public and invests in a group of assets (shares, debentures etc.), in accordance with a stated set of objectives. It is a substitute for those who are unable to invest directly in equities or debt because of resource, time or knowledge constraints. Benefits include professional money management, buying in small amounts and diversification. Mutual fund units are issued and redeemed by the *Fund Management Company* based on the fund's net asset value (NAV), which is determined at the end of each trading session. NAV is calculated as the value of all the shares held by the fund, minus expenses, divided by the number of units issued. Mutual Funds are usually long term investment vehicle though there some categories of mutual funds, such as money market mutual funds which are short term instruments.

Stock Exchange: The Securities Contract (Regulation) Act, 1956 [SCRA] defines 'Stock Exchange' as anybody of individuals, whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities. Stock exchange could be a regional stock exchange whose area of operation/jurisdiction is specified at the time of its recognition or national exchanges, which are permitted to have nationwide trading since inception. NSE was incorporated as a national stock exchange.

Equity/Share: Total equity capital of a company is divided into equal units of small denominations, each called a share. For example, in a company the total equity capital of Rs 300,00,000 is divided into 20,00,000 units of Rs 10 each. Each such unit of Rs 10 is called a Share. Thus, the company then is said to have 20,00,000 equity shares of Rs 10 each. The holders of such shares are members of the company and have voting rights.

Debt Instrument: Debt instrument represents a contract whereby one party lends money to another on pre-determined terms with regards to rate and periodicity of interest, repayment of principal amount by the borrower to the lender.

In the Indian securities markets, the term *'bond'* is used for debt instruments issued by the Central and State governments and public sector organizations and the term *'debenture'* is used for instruments issued by private corporate sector.



Derivative: Derivative is a product whose value is derived from the value of one or more basic variables, called underlying. The underlying asset can be equity, index, foreign exchange (forex), commodity or any other asset.

Derivative products initially emerged as hedging devices against fluctuations in commodity prices and commodity-linked derivatives remained the sole form of such products for almost three hundred years. The financial derivatives came into spotlight in post-1970 period due to growing instability in the financial markets. However, since their emergence, these products have become very popular and by 1990s, they accounted for about two-third of total transactions in derivative products.

Mutual Fund: A Mutual Fund is a body corporate registered with SEBI (Securities Exchange Board of India) that pools money from individuals/corporate investors and invests the same in a variety of different financial instruments or securities such as equity shares, Government securities, Bonds, debentures etc. Mutual funds can thus be considered as financial intermediaries in the investment business that collect funds from the public and invest on behalf of the investors. Mutual funds issue units to the investors. The appreciation of the portfolio or securities in which the mutual fund has invested the money leads to an appreciation in the value of the units held by investors. The investment objectives outlined by a Mutual Fund in its prospectus are binding on the Mutual Fund scheme. The investment objectives specify the class of securities a Mutual Fund can invest in. Mutual Funds invest in various asset classes like equity, bonds, debentures, commercial paper and government securities. The schemes offered by mutual funds vary from fund to fund. Some are pure equity schemes, others are a mix of equity and bonds. Investors are also given the option of getting dividends, which are declared periodically by the mutual fund, or to participate only in the capital appreciation of the scheme.

Index: An Index shows how a specified portfolio of share prices are moving in order to give an indication of market trends. It is a basket of securities and the average price movement of the basket of securities indicates the index movement, whether upwards or downwards.

Depository: A depository is like a bank wherein the deposits are securities (viz. shares, debentures, bonds, government securities, units etc.) in electronic form.

Dematerialization: Dematerialization is the process by which physical certificates of an investor are converted to an equivalent number of securities in electronic form and credited to the investor's account with his Depository Participant (DP).