Understand the Basics of Securities Markets

Are you aware of the term 'Securities' and 'Securities Markets'?

Securities are financial instruments issued to raise funds. The primary function of the securities markets is to enable to flow of capital from those that have it to those that need it. Securities market help in transfer of resources from those with idle resources to others who have a productive need for them. Securities markets provide channels for allocation of savings to investments and thereby decouple these two activities. As a result, the savers and investors are not constrained by their individual abilities, but by the economy's abilities to invest and save respectively, which inevitably enhances savings and investment in the economy.

Do you know the concept of 'Risk' and 'Return'?

Return refers to the benefit the investor will receive from investing in the security. Risk refers to the possibility that the expected returns may not materialise. For example, a company may seek capital from an investor by issuing a bond. A bond is a debt security, which means it represents a borrowing of the company. The security will be issued for a specific period, at the end of which the amount borrowed will be repaid to the investor. The return will be in the form of interest, paid periodically to the investor, at a rate and frequency specified in the security. The risk is that the company may fall into bad times and default on the payment of interest or return of principal.

Understand the Structure of Indian Securities Markets

The market in which securities are issued, purchased by investors, and subsequently transferred among investors is called the securities market. The securities market has two interdependent and inseparable segments, viz., the primary market and secondary market. The primary market, also called the new issue market, is where issuers raise capital by issuing securities to investors. The secondary market also called the stock exchange facilitates trade in already-issued securities, thereby enabling investors to exit from an investment. The risk in a security investment is transferred from one investor (seller) to another (buyer) in the secondary markets. The primary market creates financial assets, and the secondary market makes them marketable.

Who are the Issuers in Indian Securities Markets?

Issuers are organizations that raise money by issuing securities. They may have short-term and long-term need for capital, and they issue securities based on their need, their ability to service the securities. Some of the common issuers in the Indian Securities Markets are:

Companies issue securities to raise short and long term capital for conducting their business operations.

Central and state governments issue debt securities to meet their requirements for short and long term funds to meet their deficits. Deficit is the extent to which the expense of the government is not met by its income from taxes and other sources.

Local governments and municipalities may also issue debt securities to meet their development needs. Government agencies do not issue equity securities.

Financial institutions and banks may issue equity or debt securities for their capital needs beyond their normal sources of funding from deposits and government grants.

Public sector companies which are owned by the government may issue securities to public investors as part of the disinvestment program of the government, when the government decides to offer its holding of these securities to public investors.

Mutual funds issue units of a scheme to investors to mobilise money and invest them on behalf of investors in securities.

What do Stock Brokers and Sub-brokers do in the Securities Markets?

Stock brokers are registered trading members of stock exchanges. They sell new issuance of securities to investors. They put through the buy and sell transactions of investors on stock exchanges. All secondary market transactions on stock exchanges have to be conducted through registered brokers. Sub-brokers help in reaching the services of brokers to a larger number of investors. Several brokers provide research, analysis and recommendations about securities to buy and sell, to their investors. Brokers may also enable screen-based electronic trading of securities for their investors, or support investor orders over phone. Brokers earn a commission for their services.

What is an Asset Management Company? What is the role of Portfolio Managers?

Asset management company and portfolio managers are investment specialists who offer their services in selecting and managing a portfolio of securities. Asset management companies are permitted to offer securities (called units) that represent participation in a pool of money, which is used to create the portfolio. Portfolio managers do not offer any security and are not permitted to pool the money collected from investors. They act on behalf of the investor in creating and managing a portfolio. Both asset managers and portfolio managers charge the investor a fee for their services, and may engage other security market intermediaries such as brokers, registrars, and custodians in conducting their functions.

What role do Merchant Bankers perform in Securities Markets?

Merchant bankers also called as issue managers, investment bankers, or lead managers help an issuer access the security market with an issuance of securities. They evaluate the capital needs, structure an appropriate instrument, get involved in pricing the instrument, and manage the entire issue process until the securities are issued and listed on a stock exchange. They engage other intermediaries such as registrars, brokers, bankers, underwriters and credit rating agencies in managing the issue process.

What is the role of Underwriters in the Securities Markets?

Underwriters are primary market specialists who promise to pick up that portion of an offer of securities which may not be bought by investors. They serve an important function in the primary market, providing the issuer the comfort that if the securities being offered do not elicit the desired demand, the underwriters will step in and buy the securities. The specialist underwriters in the government bond market are called primary dealers.

Know the role of Credit Rating Agencies in the Securities Markets.

Credit rating agencies evaluate a debt security to provide a professional opinion about the ability of the issuer to meet the obligations for payment of interest and return of principal as indicated in the security. They use rating symbols to rank debt issues, which enable investors to assess the default risk in a security.

What is the role of an Investment Adviser?

Investment adviser work with investors to help them make a choice of securities that they can buy, based on an assessment of their needs, time horizon return expectation and ability to bear risk. They may also be involved in creating financial plans for investors, where they define the goals for which investors need to save money and propose appropriate investment strategies to meet the defined goals.

Know about the various regulators of the Indian Securities Markets.

Securities and Exchange Board of India (SEBI)

The Securities and Exchange Board of India (SEBI), a statutory body appointed by an Act of Parliament (SEBI Act, 1992), is the chief regulator of securities markets in India. SEBI functions under the Ministry of Finance. The main objective of SEBI is to facilitate growth and development of the capital markets and to ensure that the interests of investors are protected. The Securities Contracts Regulation Act, 1956 is administered by SEBI.

SEBI has codified and notified regulations that cover all activities and intermediaries in the securities markets.

The Reserve Bank of India (RBI)

The Reserve Bank of India regulates the money market segment of securities market. As the manager of the government's borrowing program, RBI is the issue manager for the government. It controls and regulates the government securities market. RBI is also the regulator of the Indian banking system and ensures that banks follow prudential norms in their operations. RBI also conducts the monetary, forex and credit policies, and its actions in these markets influences the supply of money and credit in the system, which in turn impact the interest rates and borrowing costs of banks, government and other issuers of debt securities.

Commonly used indicators while investing in Equity Markets.

a) Price Earning Multiple: The price-earnings ratio or the PE multiple is a valuation measure that indicates how much the market values per rupee of earning of a company. It is computed as:

Market price per share/Earnings per share

Earnings per share are the profit after taxes divided by the number of shares. It indicates the amount of profit that company has earned, for every share it has issued. PE is represented as a multiple. When one refers to a stock was trading at 12x, it means the stocks is trading at twelve times its earnings.

b) Price to Book Value (PBV): The PBV ratio compares the market price of the stock with its book value. It is computed as market price per share upon book value per share.

The book value is the accounting value per share, in the books of the company. It represents the net worth (capital plus reserves) per share. If the market price of the stock were lower than the book value and the PBV is less than one, the stock may be undervalued. In a bullish market when prices move up rapidly, the PBV would drop, indicating rich valuation in the market.

c) Dividend Yield: Dividend is declared as a percentage of the face value of the shares. A 40% dividend declared by company will translate into a dividend of Rs.4 per share with a face value of Rs 10 (10*40% =4). If the share was trading in the stock market for a price of Rs.200 per share, this means a dividend yield of 2%.

The dividend declared by a company is a percentage of the face value of its shares. When the dividend received by an investor is compared to the market price of the share, it is called the dividend yield of the share.

Do you know what Zero Coupon Bonds are?

A zero coupon bond does not pay any coupons during the term of the bond. The bond is issued at a discount to the face value, and redeemed at face value. The effective interest earned is the difference between face value and the discounted issue price. A zero coupon bond with a long maturity is issued at a very big discount to the face value. Such bonds are also known as deep discount bonds.

Do you know what Floating Rate Bonds are?

Floating rate bonds are instruments where the interest rate is not fixed, but re-set periodically with reference to a pre-decided benchmark rate. For instance, a company can issue a 5-year floating rate bond, with the rates being reset semi-annually at 50 basis points above the 1-year yield on central government securities. Every six months, the 1-year benchmark rate on government securities is ascertained from the prevailing market prices. The coupon rate the company would pay for the next six months is calculated as this benchmark rate plus 50 basis points.

Floating rate bonds are also known as variable rate bonds and adjustable rate bonds.

Do you know what Callable Bonds and Puttable Bonds are?

Callable bonds allow the issuer to redeem the bonds prior to their original maturity date. Such bonds have a call option in the bond contract, which lets the issuer alter the tenor of the security. For example, a 10-year bond may be issued with call options at the end of the 5th year such as in the SBI bond illustration below. Such options give issuers more flexibility in managing their debt capital. If interest rates decline, an issuer can redeem a callable bond and re-issue fresh bonds at a lower interest rate.

A Puttable bond gives the investor the right to seek redemption from the issuer before the original maturity date. For example, a 7-year bond may have a put option at the end of the 5th year. If interest rates have risen, Puttable bonds give investors the ability to exit from low-coupon bonds and re-invest in higher coupon bonds.

Know about the various Money Market Securities.

a) Repos/reverse repos: A repo is a transaction in which one participant borrows money at a pre-determined rate against the collateral of eligible security for a specified period of time. A reverse repo is a lending transaction; a repo in the books of the borrower is a reverse repo in the books of the lender. Eligible collateral for repos and reverse repos are central and state government securities and select corporate bonds.

b) Collateralized Borrowing and Lending Obligation (CBLO): A Collateralized Borrowing and Lending Obligation (CBLO) is an instrument used to lend and borrow for short periods, typically one to three days. The debt is fully secured against the collateral of government securities. CBLO is a standardized and traded repo.

c) Certificates of Deposits (CDs): Certificates of Deposits (CDs) are short term tradable deposits issued by banks to raise funds. CDs are different from regular bank deposits because they involve creation of securities. This makes the CD transferable before maturity. However, actual trading in CDs is extremely limited with most investors preferring to hold them to maturity.

d) Treasury Bills: The central government borrows extensively in the money market for its daily operations through the issue of short-term debt securities called Treasury bills (T-bills). T-bills are issued for maturities of 91 days, 182 days and 364 days. They are issued through an auction process managed by the RBI and listed soon after issue. Banks, mutual funds, insurance companies, provident funds, primary dealers and FIs bid in these auctions.

e) Commercial Paper: Companies and institutions raise short-term funds in the money market through the issue of commercial paper (CP). Though CPs are required to have a credit rating, they are unsecured corporate loans with a limited secondary market. They can be issued for various maturities of up to 364 days, but the 90-day CP is the most popular.

Know the concept of Time Value of Money.

A rupee in hand today is more valuable than a rupee obtained in future. For example, let us compare receiving Rs.1000 today, and receiving it after 2 years. If today's Rs.1000 is placed in a 2 year bank deposit earning simple interest of 8%, then it will be worth Rs.1080 (principal 1000 + interest 80) at the end of 2 years. This makes today's Rs.1000 more valuable than the future Rs.1000. The value of currently available funds over funds received in the future is due to the return that can be earned by investing current funds. If cash flows that are receivable at different points in time have to be compared, the time value of money has to be taken into account.

How are Bond Yields and prices related?

The bond price is the present value of cash inflows from the bond, discounted by the market yield. So bond price, coupon rate and yield are all connected. Given any two, the third can be easily calculated.

In the bond markets, it is the price of a bond that is known and quoted. Information on coupon rate and redemption are also available. Given the bond price and its coupon, the yield can be computed.

If the investor purchases the bond at a price lower than the face value, then he has acquired it at a price cheaper than the originally issued price. As a result yield will be higher than the coupon rate. If the investor purchases the bond at a price higher than the face value, then he has acquired it at a higher price than the original face value, so his yield will be lower than the coupon rate.

There is an inverse relationship between yield and price of a bond. As bond price falls, the yield to the investor goes up. This is because as the discounting rate (or yield) is increased, the final present value (price) reduces.

What is Yield to Maturity?

The rate which equates the present value of future cash flows from a bond with the current price of the bond is called the Yield to Maturity (YTM) of the bond. As bond price changes, so does the YTM. Thus, YTM is the discount rate implied in the bond value at a point in time. YTM is a popular and widely used method for computing the return on a bond investment. Yield quotations in the debt market usually refer to YTM.

Do you know what an Initial Public Offer (IPO) is?

The first public offer of shares made by a company is called an Initial Public Offer (IPO). When a company makes an IPO the shares of the company becomes widely held and there is a change in the shareholding pattern. The shares which were privately held by promoters are now held by retail investors, institutions, promoters etc. An IPO can either be a fresh issue of shares by the company or it can be an offer for sale to the public by any of the existing shareholders, such as the promoters or financial institutions.

Fresh Issue of Shares

New shares are issued by the company to public investors. The issued share capital of the company increases. The percentage holding of existing shareholders will come down due to the issuance of new shares.

Offer for Sale

Existing shareholders such as promoters or financial institutions offer a part of their holding to the public investors. The share capital of the company does not change since the company is not making a new issue of shares. The proceeds from the IPO go to the existing shareholders who are selling the shares and not to the company. The holding of the existing shareholders in the share capital of the company will reduce.

Do you know what a Follow-on Public Offer (FPO) is?

A follow-on public offer is made by an issuer that has already made an IPO in the past and now makes a further issue of securities to the public. A company can make a further issue of shares if the aggregate of the proposed issue and all the other issues made in a financial year does not exceed 5 times the pre-issue net worth.

When a company wants additional capital for growth or to redo its capital structure by retiring debt, it raises equity capital through a fresh issue of capital in a follow-on public offer.

Do you know what Rights Issue of Shares is?

Whenever a company makes a fresh issue of shares, it has an impact on the existing shareholders since their proportionate holding in the share capital of the company gets diluted. For example, a company may have 10 lakhs shares of Rs.10 each, amounting to an issued and paid-up capital of Rs. 1 crore. If it issues another 10 lakhs shares, to increase its capital, the proportion held by existing shareholders will come down by half, as the issued and paid up capital has doubled. This is called as dilution of holdings. To prevent this, section 81 of the Company's Act requires that a company which wants to raise more capital through an issue of shares must first offer them to the existing shareholders. Such an offer of shares is called a rights issue.

What do you mean by the term ‘Green Shoe Option’?

The Green Shoe Option (GSO) in a public offer is used by companies to provide stability to price of the share in the secondary market immediately on listing. A company, which opts for Green Shoe option can allot additional shares not exceeding 15% of the issue size, to the general public who have subscribed in the issue. The proceeds from this additional allotment will be kept in a separate bank account and used to buy shares in the secondary markets once the shares are listed, in case the price falls below the issue price. This is expected to provide support to the price of the shares. This price stabilization activity will be done by an entity appointed for this purpose.

Do you know what a Mutual Fund is?

Mutual fund is a vehicle to mobilize moneys from investors, to invest in different markets and securities, in line with the investment objectives agreed upon, between the mutual fund and the investors. In other words, through investment in a mutual fund, a small investor can avail of professional fund management services offered by an asset management company.

Are you aware of the Equity Mutual Funds?

Equity funds invest in a portfolio of equity shares and equity related instruments. The return and risk of the fund will be similar to investing in equity. Investors in equity funds seek growth and capital appreciation as the primary objective and should ideally have a long investment horizon that will allow time for the investment to appreciate in value and not be affected by short-term fluctuations.

Diversified equity funds invest across segments, sectors and sizes of companies. An index fund is a passive diversified equity fund, invested in the same stocks in the same weighting as an equity market index. An actively managed diversified equity fund modifies the weights across sectors, and may also choose non-index stocks to outperform the index.

Large- cap equity funds invest in stocks of large, liquid blue-chip companies with stable performance and returns. The performance of a large stock fund is compared with a narrow index such as the Sensex or Nifty, which the fund seeks to beat.

Mid-cap funds invest in mid-cap companies that have the potential for greater growth and returns. However, the risk in the funds is higher because the companies they invest in have a greater risk to their revenues and profits.

Small-cap funds invest in companies with small market capitalisation with intent of benefitting from the higher gains in the price of stocks of smaller companies they may benefit from newer business opportunities. The risks are also higher in small-cap funds.

Sector funds invest in companies that belong to a particular sector such as technology or banking. The risk is higher in sector funds because of lesser diversification since such stocks are by definition concentrated in a particular sector.

Thematic funds invest in stocks of companies which may be defined by a unifying underlying theme. For example, infrastructure funds invest in stocks in the infrastructure sector, across construction, cement, banking and logistics. They are more diversified than sector funds but more concentrated than a diversified equity fund.

Equity funds may also feature specific investment strategies. Value funds invest in stocks of good companies selling at cheaper prices; dividend yield funds invest in stocks that pay a regular dividend; special situation funds invest in stocks that show the promise of a turnaround.

Are you aware of the Debt Mutual Funds?

Debt funds invest in debt securities issued by the government, public sector units, banks and private limited companies. Debt securities may have different features. They may have credit risk or risk of default, short-term or long-term duration. Debt funds are offered in three broad categories:

Short term funds:These funds focus primarily on accrual income and shorter maturity, and have a lower risk and stable return.

Liquid funds can only invest in securities with not more than 91 days to maturity. This is a regulatory requirement. These funds primarily earn coupon income in line with current market rates

Ultra-short term funds hold a portfolio similar to liquid funds but with a slightly higher maturity to benefit from higher coupon income.

Short-term Gilt funds invest in short-term government securities such as treasury bills of the government.

Short-Term Plan invest in a portfolio of short-term debt securities primarily to earn coupon income but may also hold some longer term securities to benefit from appreciation in price.

Long term funds:These funds focus on MTM gains and longer maturity, and have a higher risk and higher return.

Gilt funds invest in a portfolio of long-term government securities. The coupon income earned is lower than corporate bonds of comparable tenor since there is no credit risk in the securities. The MTM gains and losses can be high since these securities have long tenors.

Income funds invest in a combination of corporate bonds and government securities. They earn a higher coupon income from the credit risk in corporate bonds held. The gains or losses from MTM will depend upon the tenor of the securities held.

Dynamic funds: These funds shift their focus between short and long term debt instruments, depending on the expectation for interest rate, and provide moderately higher return than short term funds, at a moderately lower risk than long term debt funds

Do you know what are Fixed Maturity Plans?

Fixed Maturity Plans (FMP) are closed-end funds that invest in securities whose maturity matches the term of the scheme. The scheme and the securities that it holds mature together at the end of the stated tenor. The fund pays out the maturity proceeds of the portfolio on the closing date. Investors who are able to hold the scheme to maturity will be able to benefit from the returns of the FMP that are locked in when the portfolio is created. There is no risk of the value of the securities being lower at the time the fund matures (unless there is a default) since the instruments will also be redeemed at their face value on maturity.

The time for which the investor is willing to invest must match the term of the fund

The primary risk in FMPs is credit risk from a possible default by the issuer.

As closed-end funds these schemes are listed on stock exchanges where they may be traded at prices related to the NAV.

Do you know what Hybrid Funds are?

Hybrid funds hold a portfolio of equity and debt securities. The investment objective of the fund will determine the allocation of the portfolio between the two asset classes. A hybrid fund is a debt and an equity fund, rolled into one. The risk in a hybrid fund will primarily depend upon the allocation between equity and debt, and the relative performance of these asset classes. The higher the equity component in the portfolio, the greater will be the overall risk.

Equity-Oriented Hybrid Funds

Equity-oriented hybrid funds have a greater exposure to equity in their portfolio as compared to debt. Balanced funds are an example of equity-oriented funds. The coupon income from the debt portion will stabilize the risky returns from the equity component. However the higher equity component in the portfolio means the fund's overall returns will depend on the performance of the equity markets and will also fluctuate more.

Debt-Oriented Hybrid Funds

Debt-oriented hybrid funds have a higher proportion of their portfolio allotted to debt. Monthly Income Plans are such funds. The returns are primarily from the debt portion and will depend upon the type debt securities held: short or long term, low or high credit risk. The equity portion augments the return from debt so that the fund is able to generate better returns than a pure debt fund.

Asset Allocation Funds

These funds invest in both equity and debt but without a pre-specified allocation as in the case of other hybrid funds. The fund manager takes a view on which type of investment is expected to do well and will tilt the allocation towards either asset class. Such funds may also hold 100% in equity or debt. Examples of asset allocation fund include life stage funds that invest across asset classes suitable to the age of the investor. Such funds will have a higher allocation to equity in the initial years and reduce equity exposure and increase debt exposure as the age advances.

Do you know what Equity Linked Savings Schemes (ELSS) are?

Equity Linked Savings Schemes (ELSS) are equity funds that provide tax benefits in the form of deductions under section 80 (c) for the amount invested.

The limit for claiming deduction is Rs. One lakh.

ELSS have to hold at least 80% of the investment portfolio in equity securities

Investments are subject to a three-year lock-in on the investments made to get the tax benefit.

30. Do you know what are Exchange Traded Funds?

Exchange traded funds (ETF) are a type of mutual fund that combines features of an open-ended fund and a stock. Following are its features:

Units are issued directly to investors when the scheme is launched.

Post this period, units are listed on a stock exchange like a stock and traded.

Units purchased at the time of launch or bought from the stock markets are credited to the demat account of the investor.

Transactions are done through brokers of the exchange. Investors need a broking account and a demat account to invest in ETFs.

The prices of the ETF units on the stock exchange will be linked to the NAV of the fund, but prices are available on a real-time basis depending on trading volume on stock exchanges.

Do you know what are Gold Exchange Traded Funds?

Gold Exchange Traded Funds (ETFs) are ETFs with gold as the underlying asset. The following are the features:

It provides a way to hold gold in electronic rather than in physical form

Typically each unit of ETF represents one gram of gold

The fund holds physical gold and gold receipts representing the units issued

Price of the units will move in line with the price of gold

Do you know what International Funds are?

International funds invest in securities listed on markets outside India. The type of securities that the fund can invest in is specified by the regulator SEBI and includes equity shares and debt -listed abroad, units of mutual funds and ETFs issued abroad and ADRs and GDRs of Indian companies listed abroad. The funds can also invest part of the portfolio in the Indian markets.

Do you know what are Fund of Funds (FoFs)?

FoFs invests in other funds. The FoF selects funds that meets its investment objectives and invests in them. Its portfolio is not made up of securities, but is a portfolio of other funds. Most FoFs invest in schemes of the same mutual fund. Some FoFs consider schemes across fund houses which meets the FoFs investment objective for inclusion in the portfolio.

Reference:

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