

Security analysis in investment decisions



**ASSIGN
BUSTER**

SYLLABUS SECURITY ANALYSIS & INVESTMENT MANAGEMENT MBA-3rd

SEMESTER, M. D. U. , ROHTAK External Marks : 70 Time : 3 hrs. UNIT - I

Internal Marks : 30 Decision Support System : Overview, components and classification, steps in constructing a dss, role in business, group decision support system. UNIT - II Information system for strategic advantage, strategic role for information system, breaking business barriers, reengineering business process, improving business qualities. UNIT - III

Information system analysis and design, information SDLC, hardware and software acquisition, system testing, documentation and its tools, conversion methods. UNIT - IV ZAD Marketing IS, Manufacturing IS, Accounting IS,

Financial IS. 73 SECURITY ANALYSIS & INVESTMENT MANAGEMENT FINANCE :

SPECIALIZATION PAPERS UNIT - I Q. Define Investment. Ans. Meaning of

Investment : Investment involves making of a sacrifice in the present with the hope of deriving future benefits. Investment has many meanings and facets. The two most important features of an investment are current sacrifice and future benefit.

We can now give a simple yet a broad definition of investment. We can define investment as “ postponed consumption”. When you postpone consumption, sacrifice takes place in the present and is certain whereas the benefits occur in future and are uncertain. Therefore, risk and expected return from the investment are the two key determinants of investment process. Investment Process : A typical investment decision undergoes a five step procedure which, in turn, forms the basis of the investment process.

These steps are: (1) Determine the investment objectives and policy
 (2) Undertake Security Analysis. (3) Construct a portfolio. (4) Review the Portfolio. (5) Evaluate the performance of the portfolio.

Investment Attributes/ Factors Influencing Selection of Investment : In choosing specific investments, investors will need definite ideas regarding features which their portfolios should possess. For evaluation of investment avenue, the following attributes are relevant: (1) Returns (2) Capital Appreciation (3) Safety and Security of Funds. (4) Tax Benefits (5) Concealability (6) Adequate Liquidity (7) Stability of Income (8) Risk.

74 SECURITY ANALYSIS & INVESTMENT MANAGEMENT Q. Define Risk. What are the different types of risk influences on investment?

Ans : Meaning of Risk : Risk can be defined as the probability that the expected return from the security will not materialize. Every investment involves uncertainties that make future investment returns risk-prone.

Uncertainties could be due to the political, economic and industry factors.

Types of Investment Risk: Investment Risks are: Types of Investment Risk

Systematic Risk Market Risk Interest Rate Risk Purchasing Power Risk

Exchange Rate Risk Country Risk Non-Systematic Risk Regulation Risk

Regulation Risk Business Risk Bull-Bear Risk Management

Risk Default Risk International Risk Industry Risk Liquidity Risk

Dividing total risk into its two components, a general (market) component and a specific (issuer) component, we have systematic risk and non-systematic risk, which

are additive: Total Risk = General Risk + Specific Risk
 ZAD Market Risk +

Issuer Risk = Systematic Risk + Non -Systematic Risk (A) Systematic Risk :

Variability in a security's total returns that is directly associated with overall

movements in the general market or economy is called systematic risk.

Virtually all securities have some systematic risk because systematic risk directly encompasses interest rate, market, and inflation risks.

Systematic risk is attributable to broad macro factors affecting all securities.

Different types of systematic risk are explained as under: (1)Market Risk :

The variability in a security's returns resulting from fluctuation in the aggregate market is known as market risk. Market risk is sometimes used synonymously with systematic risk. All securities are exposed to market risk including :
ORecession
OWars
OStructural changes in the economy
OTax law Changes
OChanges in Consumer Preferences.
2)Interest Rate Risk : The variability in a security's return resulting from changes in the level of interest rates is referred to as interest rate risk. Such changes generally affect securities inversely; that is, other things being equal, security prices move inversely to interest rates.
(3)Purchasing Power Risk : A factor affecting all securities is purchasing power risk, also known as inflation risk. With uncertain inflation, the real (inflation- adjusted) return involves risk even if the nominal return is safe.

This risk is related to interest rate risk, since interest rates generally rise as inflation increases, because lenders demand additional inflation premiums to compensate for the loss of purchasing power.
(B)Non-Systematic Risk : The variability in a security's total returns not related to overall market variability is called the non-systematic (non-market) risk. Non-systematic risk is specific to an industry or the company individually.

This risk is unique to a particular COMPUTERS security and is associated with such factors as business and financial risk as well as liquidity risk. Different types of non-systematic risks are explained as under: (1)Regulation Risk : Some investments can be relatively attractive to other investments because of certain regulations or tax laws that give them an advantage of some kind. Municipal bonds, for example, pay interest that is exempt from local, state and federal taxation.

As a result of that specific tax exemption, municipals can price bonds to yield a lower interest rate since the net after-tax yield may still make them attractive to investors. (2)Business Risk : The risk of doing business in a particular industry or ZAD environment is called business risk. For example, as one of the largest steel producers, U. S. Stee faces unique problems. (3)Bull-Bear Market Risk : This risk arises form the variability in the market returns resulting from alternating bull and bear market forces.

OWhen security index rises fairly consistently from a low point, this upward trend is called a bull market. The bull market ends when the market index reaches a peak and starts a downward trend. 74 SECURITY ANALYSIS & INVESTMENT MANAGEMENT OThe period during which the market declines, this downward trend is called a bear market. (4)Management Risk : Management, all said and done, is made of people who are mortal, fallible and capable of making a mistake or a poor decision.

Errors made by the management can harm those who invested in their firms.

(5)Default Risk : It is that portion of an investment's total risk that results from changes in the financial integrity of the investment. For example, when

c company that issues securities moves either further away from bankruptcy or closer to it, these changes in the firm's financial integrity will be reflected in the market price of its securities.

The variability of return that investors experience, as a result of changes in the credit worthiness of a firm in which they invested, is their default risk.

(6) International Risk : International risk can include country risk and exchange rate risk. (i) Exchange Rate Risk : All investors who invest internationally in today's increasingly global investment arena face the prospect of uncertainty in the returns after the convert the foreign gains back to their own currency. ii) Country Risk : Country risk, also referred to as political risk, is an important risk for investors today. With more investors investing internationally, both directly and indirectly, the political and therefore economic stability and viability of a country's economy need to be considered. (7) Industry Risk : An industry may be viewed as group of companies that compete with each other to market a homogeneous product.

Industry risk is that portion of an investment's total variability of return caused by events that affect the COMPUTERS products and firms that make up an industry. (8) Liquidity Risk : Liquidity risk is the risk associated with the particular secondary market in which a security trades. An investment that can be bought or sold quickly and without significant price concession is considered liquid.

The more uncertainty about the time element and the price concession, the greater the liquidity risk. Measurement of Risk : There are three methods:

(1) Volatility : Volatility may be described as the range of movement (or price

fluctuation) ZAD from the expected level of return. For example, the more a stock goes up and down in price, the more volatile that stock is. 2) Standard Deviation : Investors and analysts should be at least somewhat familiar with the study of probability distributions. Since the return an investor will earn from investing is not known, it must be estimated. An investor may expect the total return on a particular security to be 10% for the coming year but in truth this is only a " point estimate". The formulas of measuring risk with the help of standard deviation are: 77