UNIT II

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Investment in Shares and Debuntures

Share is the capital of the company, but Debenture is the debt of the company. The shares represent ownership of the shareholders in the company. On the other hand, debentures represent indebtedness of the company. The income earned on shares is the dividend, but the income earned on debentures is interest.

Shares

Shares are small divisions of a company’s capital. When a company goes public for the first time and gets listed on the stock exchanges to raise capital from the market, investors buy a share or number of shares in the company.

Purchasing the shares gives shareholders entitlement to the ownership of the company. In other words, the shareholders become owners of the company in proportion to the percentage of shares you own. Shareholding of 50% or more makes the shareholders the biggest owners of the company whereas other shareholders get an entitlement to the ownership.

As shareholders of the company, they are entitled to dividend payouts given in a certain regular fashion. The dividend payouts can come only if the company is recording profits. Otherwise, shareholders can participate in trading in the stock market to get some value out of their investment.

Shareholders are part owners of the company. They got voting rights in the company, a share of the profits in the form of dividends however being the owners in the company they do stand to lose if the company is in debt or has to go for liquidation as the owners of the company, no matter their contribution is paid out last.

Types of shares

There are primarily three types of shares that a company issues:

Equity shares: Equity shares are the shares that are traded on the stock exchange. They are also called ordinary shares. The owners of these shares have voting rights, entitled to dividends, and are the most common type of shares that are traded.

Preference shares: Preference shares are shares that give ‘preference’ to its shareholders to the dividends of the company ahead of equity shareholders. The amount of dividend is fixed however these shares do not carry voting rights like equity shares. Preference shareholders get priority over equity shareholders in the event of company liquidation as well. There are also convertible preference shares that can be converted into equity shares at a later date.

However, these limitations are applied only on preference shares issued by public companies or private companies which have a public subsidiary. A private company through its articles of association can issue preference shares with similar voting rights as well.

Debentures

Debentures are long term debt instruments that a company issues under its seal. One difference between share and debentures is that debentures become borrowed capital for the company. It is like a loan that a company has taken from the debenture holders which is supposed to pay back with interest in due time.

If you have invested in the company's long term debt instruments and in effect lending money to the company, you get paid in the form of interest in regular intervals. The interest payments come over and above the company's profit so they won't get held back if the company is running in losses.

Debenture holders are creditors to the company. The money invested by debenture holders is basically borrowed capital for the company that it has to pay back with regular interest. This makes debenture holders creditors to the company and at a higher status than shareholders.

This means that if the company runs into major debts and is going under liquidations, the creditors of the company including banks, debenture holders, and others will be paid off first. Shareholders are given the last priority. However, unlike shareholders, debenture holders do not get voting rights. This is a major feature that can help you distinguish between shares and debentures.

Types of debentures

Following are the type of debentures in India:

Registered and bearer debentures: A registered debenture is registered in the company and can be transferred by the issuance of a transfer deed. Bearer debentures, on the other hand, have no record of them in the company registers and can be transferred by mere delivery.

Secured and unsecured debentures: Secured debentures have a charge on the company's assets. So secured debenture holders can recover their principal amount or any unpaid interest out of the company's mortgaged assets. Unsecured debentures have no such charge or rights.

Redeemable and non-redeemable debentures: Redeemable debentures' principal amount is paid back in a fixed amount of time whereas non-redeemable debentures cannot be paid back in the lifetime of the company and only on liquidation.

First and second debentures: First debentures are those that are repaid before other debentures whereas second debentures are those that are repaid thereafter.

Convertible and non-convertible debentures: Convertible debentures are those that can be converted into shares according to pre-decided terms and conditions. Non-convertible debentures cannot be converted into shares.

Comparison with other forms of investment

Mutual Funds Vs Traditional Investment options

1.Mutual Fund Vs Fixed Deposits

When it comes to saving or investing money, most Indians prefer traditional options such as fixed deposits (FDs), Public Provident Fund (PPF) or gold.

Capital preservation and regular returns: two of the biggest reasons why people put their money in FDs. Debt mutual funds offer similar benefits to the investor.

2.Mutual Fund Vs Public Provident Fund

As the year draws to a close, many investors start looking for tax-saving investment options like PPF. Equity Linked Saving schemes (ELSS) offer the same benefit to investors. Under Section 80C of the Income Tax act, you can claim a maximum deduction of up to Rs 1.5 lakh.

3.Mutual Fund Vs Gold

The allure of gold has captivated Indians for centuries. Every family buys and invests in the yellow metal in the form of jewellery and gold coins. However, gold Exchange Traded Funds (ETFs) are a good alternative to physical gold.

4. Mutual Fund Vs Real Estate

Mutual funds vs real estate has been one of the most widely debated subjects in the realm of personal finance. While mutual funds have gained traction of late, real estate for long has been viewed as a safe and prudent investment option.

5. Mutual Fund Vs Direct Equity

As an asset class, equity has the potential to deliver inflation-indexed returns in the long term. There are two ways to do so, investing directly through stocks or opting for mutual funds. We have compared mutual funds vs direct equity investment on parameters involved among others.

6. Mutual Fund Vs Bank Deposits

Bank deposits for long have been seen as a safe investment avenue by majority of investors. We have compared mutual funds and bank deposits on parameters such as returns, risks and liquidity, among others that will help to make an informed choice**.**

7. Mutual Fund Vs Corporate Bonds

In the past few years, there has been an affinity for corporate bonds. These are issued by companies looking forward to raising capital and primarily invest in debt instruments. Comparisons have been drawn basis risks and returns.

Types of Investments

Investing intimidates a lot of people. There are a lot of options, and it can be hard to figure out which investments are right for the portfolio.

1.Stocks

Stocks may be the most well-known and simple type of investment. When buying stock, buying an ownership share in a publicly traded company takes place. Many of the biggest companies in the country like General Motors, Apple and Facebook — are publicly traded.

2.Bonds

When buying a bond, it is lending money to an entity. Generally, this is a business or a government entity. Companies issue corporate bonds, whereas local governments issue municipal bonds.

After the bond matures the principal, plus a determined rate of interest is earned.

The rate of return for bonds is typically much lower than it is for stocks, but bonds also tend to be lower risk.

3.Mutual Funds

A mutual fund is a pool of many investors' money that is invested broadly in a number of companies. Mutual funds can be actively managed or passively managed. An actively managed fund has a fund manager who picks companies and other instruments in which to put investors' money. Fund managers try to beat the market by choosing investments that will increase in value.

Mutual funds carry many of the same risks as stocks and bonds, depending on what they are invested in. The risk is lesser, though, because the investments are inherently diversified.

4.Exchange-Traded Funds

Exchange-traded funds (ETFs) are similar to mutual funds in that they are a collection of investments that tracks a market index. Unlike mutual funds, which are purchased through a fund company, ETFs are bought and sold on the stock markets. Their price fluctuates throughout the trading day, whereas mutual funds' value is simply the net value of investments.

5.Certificate of Deposit

A certificate of deposit (CD) is a very low-risk investment. A bank is given a certain amount of money for a predetermined amount of time. When that time period is over, principal is got back, plus a predetermined amount of interest. The longer the loan period, the higher the interest rate.There are no major risks to CDs..

6.Retirement Plans

There are a number of types of retirement plans. Workplace retirement plans, sponsored by your employer, include 401(k) plans and 403(b) plans

7.Options

An option is a somewhat more complicated way to buy a stock. When buying an option, purchasing the ability to buy or sell an asset at a certain price at a given time. There are two types of options: call options, for buying assets, and put options, for selling options.The risk of an option is that the stock will decrease in value. If the stock decreases from its initial price, lose the money. Options are a highly advanced investing technique.

8.Annuities

Many people use annuities as part of their retirement savings plan. When you buy an annuity, they purchase a contract with an insurance company and, in return, you get periodic payments. The payments may begin right away or at a specified future date. They may last until death or only for a predetermined period of time.

While annuities are fairly low risk, they aren't high-growth. They make a good supplement to retirement savings, rather than an integral source of funding.

For instance, they are considered relatively safe investments. And while the returns can vary, they can help beat inflation. In addition, mutual funds are more liquid compared to FDs.

Primary Market: Role of NIM

A Primary market is where newly issued securities are being sold to the public. It is also known as new issue market (NIM). Initial public offering (IPO) is the same, where a private company issues securities to the public for the first time.

Primary Market is a form of the capital market wherein new securities are sold by the companies for the very first time to the investors, to raise funds and that is why it is also acknowledged as New Issues Market (NIM).

The process of selling the new securities, in the primary market is called underwriting, which is performed by a group called as underwriters or security dealers.

The underwriting service is offered by financial institutions such as investment banks, insurance companies, etc. The underwriting companies guarantee payment if there is any loss and accepts the risk which occurs as a consequence of such guarantee.

The main function of the primary market is to mobilize the investible money from the savers to the companies or young entrepreneurs who seek funds to set up new businesses or expand the existing venture, by issuing securities.

Types of Issue of Securities in Primary Market

There are several types of issue of securities in the primary market which are discussed as under:

Public Issue: Public issue is when a company enters the market, to raise money from all kinds of investors. The securities offered for sale to the new investors, so as to become a shareholder in the issuer company, is called Public Issue.

Initial Public Offer: Initial Public Offer or IPO, as the name suggests, is the fresh issue of equity shares or convertible securities, or exiting shares or convertible securities by an unlisted company for the very first time i.e. the shares are not previously traded or offered for sale to the general public. This is often followed by listing and trading of the company's securities on the stock exchange.

Further Public Offer: Otherwise called as Follow on offer or FPO, refers to the fresh issue of securities to the general public made by a company already listed on the stock exchange, so as to raise additional funds.

Right Issue: Right Issue is an offer to the company's existing shareholders to buy further new shares of the company at a discount, as a part of the dividend of pre-emption rights. It helps the firms to raise additional funds, without going to the public. It invites its existing shareholders to subscribe for its fresh issue in the proportion of their shareholdings on the record date in the concern.

Bonus Issue: When a company issues fully paid additional shares to the company's existing shareholders for free. The issue is made from the company's free reserves or securities premium account, in a specific proportion to the shareholding on a specific record date.

Private Placement: When a company's stocks or bonds are sold directly to a selected group of people, say 50 to 200 people, called as private investors or institutions, instead of offering the same to the general public is called private placement. Hence, in case of a private placement there are only a handful of subscribers to the company's shares. However, it is capable of raising money, more quickly as compared to offering shares for sale in the open market.

Preferential Allotment: Preferential Issue is one in which the specified securities are allotted by a listed company to a selected group on a preferential basis. The issuing company needs to adhere to the provisions relating to pricing, lock-in period, disclosures, and so on.

Qualified Institutional Placement: When a company, which is already listed in a stock exchange issues shares or debentures (fully or partly convertible) or any other kind of security not including warrants, which are convertible in nature, to Qualified Institutional Buyer (QIB), is called as Qualified Institutional Placement (QIP).

Institutional Placement Programme: Institution Placement Programme or IPP implies a further public issue of equity shares by a listed firm or group of promoters of a listed company, wherein the offer and allocation are made to Qualified Institutional Buyers only.

Role of NIM

1. Origination:

Origination is the work which begins before an issue is actually floated in the market. It is the stage where initial 'spade work' is conducted to find out the investment climate and to be sure that if the issue is floated it will be subscribed to by the public.

The factors which have to be carefully analysed are regarding the soundness of the project. Soundness of the project refers to its technical feasibility backed by its economic and financial viability. It is also concerned with background factors which facilitate the success of an issue.

2. Underwriting:

Underwriting is a kind of guarantee undertaken by an institution of firm of brokers ensuring the marketability of an issue. It is a method whereby the guarantor makes a promise to see the stock issuing company that he would purchase a certain specified number of shares in the event of their not being invested by the public.

Subscription is thus guaranteed even if the public does not purchase the shares for a commission from the issuing company.

The LIC and UTI had emerged as the most important institutional underwriters in the capital market in India. Their underwriting pattern is marked by the policy of underwriting firm, i.e., purchasing industrial securities from the new issue market with the view of holding the securities on their own portfolio.

3. Distribution:

The New Issue Market has a third function besides the function of origination and underwriting. The third function is that of distribution of shares. Distribution means the function of floatation of new issues and their pre and post allotment procedures to the investors. This is performed by brokers and agents. They maintain regular lists of clients and directly contact them for purchase and sale of securities.

The objective of the New Issue Market is to centre its activities towards floatation of New Issues. The methods by which the new issues are placed in the market are: Public Issues, Offer for Sale, Placement, and Right Issues.

Mechanics of floating new issue

1.Public Issue:

A public issue is an issue where anybody and everybody can subscribe for the securities. When an issue or offer of securities is made to new investors for becoming part of shareholders' family of the issuer it is called a public issue.

(a)Initial Public Offer (IPO) and

(b) Further Public Offer (FPO).

Both IPO and FPO can be either a fresh issue or an offer for sale. In terms of companies Act 1956, an issue becomes public if it results in allotment to more than 50 persons.

Initial Public Offer (IPO):

IPO means an offer of specified securities (i.e. equity shares and convertible securities) by an unlisted issuer to the public for subscription (including an offer for sale of its existing securities) for the first time. It is the first sale of stock by a company to the public. The Initial Public Offering can be made through the fixed price method, book building method or a combination of both. IPO enables listing and trading of the issuers securities in the securities market.

(i)Offer through Prospectus:

Public issue through prospectus is the most popular method of distribution of shares of a company. Prospectus is an offer document containing the details of the company. The name of the company, address, location of the industry, authorized, paid up and subscribed capital, date of opening and closing of subscription list, names of lead merchant banker, brokers and underwriters, name of the board of directors, activities of the company and other important data must be included in the prospectus. After going through these details, the public can decide either to subscribe or not to subscribe the shares. The draft of the prospectus must be approved by the board of directors, financial institutions, designated stock exchange etc. An abridged prospectus is being annexed to every share application form.

(ii) Offer of Sale:

This is outright sale of shares through intermediaries like issue houses, brokers etc. Shares are not offered to the public directly. The intermediaries, after buying the entire shares, resell them to the investing public. Then it can be called offer for sale. In this case the issue houses act as agents of the company. The advantage of this method is that the company need not be bothered about the printing and advertisement of prospectus, allotment of shares etc. Foreign companies who want to participate in the share market and Indian investors and promoters who want to sell their shares usually adopt this method.

2. Private Placement:

Shares can be distributed through outright sale by companies to select group of persons (u/s 80 of the Companies Act 1956). This is known as placement or private placement. In other words, when an issuer makes an issue of securities to a select group of persons not exceeding 49, and which is neither a rights issue nor a public issue, it is called a private placement.

In this case, the issue houses or brokers can buy the securities from the company and sell them to his own clients. The brokers here act as wholesalers. They may resell them at a margin. In private placement the promoters may sell a portion of issue to the friends and well-wishers. The promoters have to make a minimum contribution before the issue goes to the public. Financial institutions, mutual funds, investment bank etc. subscribe to placement orders.

3. Rights Issue:

Shares offered to the existing shareholders of a company are called rights issues. The shares are offered in a particular proportion to the existing share ownership. The proportion may be decided on the basis of capital requirement of the company. Such shares are marketable in the market by the owners. Successful companies adopt this method for fund raising.

4. Bonus Issue:

Bonus issue is the issue of shares to the existing shareholders out of the free reserves of the company. The existing shareholders get this as a bonus without payment of any money. Companies usually adopt this method to bring up the value of shares with market value. As the free reserves are capitalized there is an increase of equity capital.

Secondary market- Functions

A secondary market is a platform wherein the shares of companies are traded among investors. It means that investors can freely buy and sell shares without the intervention of the issuing company. In these transactions among investors, the issuing company does not participate in income generation, and share valuation is rather based on its performance in the market. Income in this market is thus generated via the sale of the shares from one investor to another.

Some of the entities that are functional in a secondary market include –

1.Retail investors.

2.Advisory service providers and brokers comprising commission brokers and security dealers, among others.

3.Financial intermediaries including non-banking financial companies, insurance companies, banks and mutual funds.

Functions of Secondary Market

- A stock exchange provides a platform to investors to enter into a trading transaction of bonds, shares, debentures and such other financial instruments.
- Transactions can be entered into at any time, and the market allows for active trading so that there can be immediate purchase or selling with little variation in price among different transactions. Also, there is continuity in trading, which increases the liquidity of assets that are traded in this market.
- Investors find a proper platform, such as an organised exchange to liquidate the holdings. The securities that they hold can be sold in various stock exchanges.
- A secondary market acts as a medium of determining the pricing of assets in a transaction consistent with the demand and supply. The information about transactions price is within the public domain that enables investors to decide accordingly.
- It is indicative of a nation’s economy as well, and also serves as a link between savings and investment. As in, savings are mobilised via investments by way of securities.

Types of Secondary Market

Secondary markets are primarily of two types – Stock exchanges and over-the-counter markets.

Stock exchange

Stock exchanges are centralised platforms where securities trading take place, sans any contact between the buyer and the seller. National Stock Exchange (NSE) and Bombay Stock Exchange (BSE) are examples of such platforms.

Transactions in stock exchanges are subjected to stringent regulations in securities trading. A stock exchange itself acts as a guarantor, and the counterparty risk is almost non-existent. Such a safety net is obtained via a higher transaction cost being levied on investments in the form of commission and exchange fees.

Over-the-counter (OTC) market

Over-the-counter markets are decentralised, comprising participants engaging in trading among themselves. OTC markets retain higher counterparty risks in the absence of regulatory oversight, with the parties directly dealing with each other. Foreign exchange market (FOREX) is an example of an over-the-counter market.

In an OTC market, there exists tremendous competition in acquiring higher volume. Due to this factor, the securities' price differs from one seller to another.

Mechanics of Security Trading.

An investor must have some knowledge of how the securities markets operate. The marketing of old or new securities of the stock markets can be done only through members of the Stock Exchange. These members are either individuals or partnership firms. An individual must use the facilities of these members for trading in securities. The member is a registered dealer of an organized stock exchange. Trading among the members of a recognized stock exchange is to be done under the statutory regulations of the stock exchange. The members carrying on business are known as 'brokers' and can trade only on listed securities.

These members execute customer's orders to buy and sell on the exchange and their firms receive negotiated commissions on those transactions. About one-fourth of all members of the exchange are 'specialists', so called because they specialize in 'making a market' for one or more particular kind of stock.

In the process of trading in stock exchanges, there is the basic need for a 'transaction' between an individual and broker. A transaction to buy and sell securities is also called 'trades'. This is to be done through selection of a broker.

Specified and Non-specified Securities:

It is useful to know that three kinds of securities can be traded upon in the Mumbai Stock Exchange — specified, non-specified and odd lot. In the specified category of equity shares, the criteria are that the share should be listed on the stock exchange for at least 3 years and the issued capital should not be less than Rs. 75 crores.

It should have a market capitalization of two or three times. At least 20,000 shareholders should be on the dividend receiving list. It should be a growth company with shares of Rs. 4.5 crores face value and its shares should be actively traded on the Mumbai Stock Exchange. The companies which do not have specified securities are in the non-specified securities list.

The odd lot includes odd lots of shares and debentures. In India, specified securities are fewer in number compared to other securities but they influence the stock market. To stabilize the market, limits have been imposed.

When the stock market is on the rise being bullish or when it is bearish, limits on brokers and jobbers help in keeping the market firm and stabilized. In normal periods of time, the total outstanding purchases and sales which can be made at one point of time is Rs. 5 crores.

SEBI has brought about uniformity in the different stock exchanges. Nine stock exchanges were given permanent recognition. Every stock exchange is to be managed by a committee called a governing board consisting of brokers, directors, government, SEBI and public representatives.

The Contents in this E-Material is taken from the text and reference book as given in the syllabus.