Women University Press
Jayoti Publication Desk
ISBN No. : 978-93-94024-80-9

Security Analysis & Capital Market

JV'n Prof. (Dr.) Sanjay Chhabra

JAYOTI VIDYAPEETH WOMEN'S UNIVERSITY, JAIPUR

UGC Approved Under 2(f) & 12(b) | NAAC Accredited | Recognized by Statutory Councils

Printed by :
JAYOTI PUBLICATION DESK

Published by :
Women University Press
Jayoti Vidyapeeth Women's University, Jaipur

Faculty of Law & Governance

Title: SECURITY ANALYSIS AND CAPITAL MARKET

Author Name: DR. SANJAY CHHABRA

Published By: Jayoti Publication Desk Women University Press Jayoti Vidyapeeth Womens University Jaipur

Publisher's Address: Jayoti Publication Desk Women University Press Jayoti Vidyapeeth Womens University Jaipur
Vedaant Gyan Valley,
Village-Jharna, Mahala Jobner Link Road, NH-8
Jaipur Ajmer Express Way,
Jaipur-303122, Rajasthan (INDIA)

Printer's Detail: Jayoti Publication Desk Women University Press Jayoti Vidyapeeth Womens University Jaipur
Edition Detail: I

ISBN: 978-93-94024-80-9

SECURITY ANALYSIS AND CAPITAL MARKET

(FOR BBA/LLB VI th SEMESTER)

''बेटी बचाओ, बेटी पढ़ाओ''

DR. SANJAY CHHABRA

PROFESSOR

FACULTY OF LAW & GOVERNANCE

JAYOTI VIDYAPEETH WOMEN'S UNIVERSITY

JAIPUR ; RAJASTHAN

CONTENTS

SECURITY ANALYSIS AND CAPITAL MARKET

UNIT I

Concept of Security: Concept of security analysis, portfolio management. Investment – Concept, features, importance, types. Types of security-Equity shares, Preference shares, investment objectives and constraints-security and non-security forms of investment, Bonds or fixed income securities.

Concept of security analysis

Introduction

Security analysis is a pre-requisite for making investments. In the present day financial markets, investment has become complicated. One makes investments for a return higher than what he can get by keeping the money in a commercial or cooperative bank or even in an investment bank. In the finance field, it is a common knowledge that money or finance is scarce and that investors try to maximize their return. But the finance theory states that the return is higher, if the risk is also higher. Return and risk go together and they have a tradeoff. Most of the investments are risky to some degree. The art of investment is to see that the return is maximized with the minimum of risk, which is inherent in investments. If the investor keeps his money in a bank in savings account, he takes the least risk, as the money is safe and he will get back when he wants it. But he runs the risk that the return in real terms, adjusted for inflation is negative or small and even if positive, it may not come up to his expectations or needs. In the above discussion, we concentrated on the word 'Investment'. But for making investment, we need to make security analysis. It then becomes necessary to define properly investment and security analysis at the outset.

Meaning of security analysis

Investment is commitment of funds in the expectation of some positive rate of return. These funds are to be used by another party, user of fund, for productive activity. It can be giving an advance or loan or contributing to the equity (ownership capital) or debt capital of a corporate or non-corporate business unit. In other words, investment means conversion of cash or money into a monetary asset or a claim on future money for a return. This return is for saving, parting with saving or liquidity and lastly for taking a risk involving the uncertainty about the actual return, time of waiting and cost of getting back funds, safety of funds, and risk of the variability of the return. Investment in capital market is made in various financial instruments, which are all claims on money. These instruments may be of various categories with different characteristics. These are all called securities in the market parlance. In a legal sense also, the Securities Contracts Regulation Act, (1956) has defined the security as inclusive of shares, scrips, stocks, bonds, debentures or any other marketable securities of a like nature or of any debentures of a company or body corporate, the Government and semi-Government body etc. It includes all rights and interests in them including warrants, and loyalty coupons etc., issued by any of the bodies, organizations or the Government. The derivatives of securities and Security Index are also included as securities in the above definition in 1998. In the strict sense of the word, a security is an instrument of promissory note or a method of borrowing or lending or a source of contributing to the funds needed by a corporate body or non-corporate body. Private security for example is also a security as it is a promissory note of an individual or firm and gives rise to a claim on money. But such private securities or even securities of private companies or promissory notes of individuals, partnerships or firms to the extent that their marketability is poor or nil, are not part of the capital market and do not constitute part of the security analysis. In nutshell, securities are financial instruments that have been created to represent a legal obligation to pay a sum in future in return for the current receipt of value. Securities thus represent the cash equivalent received from another person.

Definition of security analysis: For making proper investment involving both risk and return, the investor has to make a study of the alternative avenues of investment– their risk and return characteristics and make proper projection or expectation of the risk and return of the alternative investments under consideration. He has to tune the expectations to his preferences of the risk and return for making a proper investment choice.

The process of analyzing the individual securities and the market as a whole and estimating the risk and return expected from each of the investments with a view to identifying undervalued securities for buying and overvalued securities for selling is both an art and a science and this is what is called security analysis.

Security Analysis in both traditional sense and modern sense involves the projection of future dividend, or earnings flows, forecast of the share price in the future and estimating the intrinsic value of a security based on the forecast of earnings or dividends. Thus, security analysis in traditional sense is essentially an analysis of the fundamental value of a share and its forecast for the future through the calculation of its intrinsic worth of the share. Modern security analysis relies on the fundamental analysis of the security, leading to its intrinsic worth and also risk-return analysis depending on the variability of the returns, covariance, safety of funds and the projections of the future returns. If the security analysis is art of the total security analysis that the investor should aim at.

1.8. Meaning of portfolio management

A combination of such securities with different risk-return characteristics will constitute the portfolio of the investor. Thus, a portfolio is a combination of various assets and/or instruments of investments. The combination may have different features of risk and return, separate from those of the components. The portfolio is also built up out of the wealth or income of the investor over a period of time, with a view to suit his risk or return preferences to that of the portfolio that he holds. The portfolio analysis is thus an analysis of the risk-return characteristics of individual securities in the portfolio and changes that may take place in combination with other securities due to interaction among themselves and impact of each one of them on others. As referred earlier, portfolios are combinations of assets held by the investors. These combinations may be of various asset classes like equity and debt and of different issuers like Government bonds and corporate debt or of various instruments like discount bonds, warrants, debentures and Blue chip equity or scrip of emerging blue chip companies. The traditional Portfolio Theory aims at the selection of such securities that would fit in well with the asset preferences, needs and choices of the investor. Thus, a retired executive invests in fixed income based on fundamental factors of the company, then the forecast of securities for a regular and fixed return. A business executive or a young aggressive investor on the other hand invests in new and growing companies and in risky ventures. Modern Portfolio Theory postulates that maximisation of return and or minimisation of risk will yield optimal returns and the choice and attitudes of investors are only a starting point for investment decision and that rigorous risk return analysis is necessary for optimisation of returns. In risk return analysis, the attitudes and preferences of investors are taken into account as also their risk-return trade off stemming from the analysis of individual securities. The return on portfolio is a weighted average of returns of the individual stocks; and the weights are proportional to each stock's percentage in the total portfolio. Besides the stocks when put together in a basket may not give a total risk which is the mathematical equivalent of total of risks of all the individual stocks, due to the simple reason that the risks of some stocks may be compensated by the risks of other stocks or vice versa. The risks of some stocks can also be accentuated by those of others in the portfolio. The modern portfolio theory states that the combined risk of a portfolio may be greater or lesser than the sum of the risks of the components of individual securities. Portfolio analysis includes selection of securities, portfolio construction, revision of portfolio, evaluation and monitoring of the performance of the portfolio.

Investments: meaning, types and characteristics

Financial markets have the basic function of mobilising the investments needed by corporate entities. They also act as marketplaces for investors who are attracted by the returns offered by the investment opportunities in the market. In this context there is a need to understand the meaning of investment and the motives of investment. (Investment may be defined as an activity that commits funds in any financial/physical form in the present with an expectation of receiving additional return in the future. The expectation brings with it a probability that the quantum of return may vary from a minimum to a maximum. This possibility of variation in the actual return is known as investment risk. Thus every investment involves a return and risk. Investment is an activity that is undertaken by those who have savings. Savings can be defined as the excess of income over expenditure. However, all savers need not be investors. For example, an individual who sets aside some money in a box for a birthday present is a saver, but cannot be considered an investor. On the other hand, an individual who opens a savings bank account and deposits some money regularly for a birthday present would be called an investor. The motive of savings does not make a saver an investor. However, expectations distinguish the investor from a saver. The saver who puts aside money in a box does not expect excess returns from the savings. However, the saver who opens a savings bank account expects a return from the bank and hence is differentiated as an investor. The expectation of return is hence an essential characteristic of investment.

An investor earns/expects to earn additional monetary value from the mode of investment that could be in the form of physical/financial assets. A bank deposit is a financial asset. The purchase of gold would be a physical asset. Investment activity is recognised when an asset is purchased with an intention to earn an expected fund flow or an appreciation in value. An individual may have purchased a house with an expectation of price appreciation and may consider it as an investment. However, investment need not necessarily represent purchase of a physical asset. If a bank has advanced some money to a customer, the loan can be considered as an investment for the bank. The loan instrument is expected to give back the money along with interest at a future date. The purchase of an insurance plan for its benefits such as protection against risk, tax benefits, and so on, indicates an expectation in the future and hence may be considered as an investment.

From the above examples it can be seen that investment involves employment of funds with the aim of achieving additional income or growth in value. The essential quality of an investment is that it involves the expectation of a reward. Investment, hence, involves the commitment of resources at present that have been saved in the hope that some benefits will accrue from them in the future.

1.2.1. Types of investments

Investments may be classified as financial investments or economic investments. In the financial sense, investment is the commitment of funds to derive future income in the form of interest, dividend, premium, pension benefits, or appreciation in the value of the initial investment. Hence, the purchase of shares, debentures, post office savings certificates, and insurance policies are all financial investments. Such investments generate financial assets. These activities are undertaken by anyone who desires a return and is willing to accept the risk from the financial instrument. Economic investments are undertaken with an expectation of increasing the current economy's capital stock that consists of goods and services. Capital stock is used in the production of other goods and services desired by the society. Investment in this sense implies the expectation of formation of new and productive capital in the form of new constructions, plant and machinery, inventories, and so on. Such investments generate physical assets and also industrial activity. These activities are undertaken by corporate entities that participate in the capital market. Financial investments and economic investments are, however, related and dependent. The money invested in financial investments is ultimately converted into physical assets. Thus, all investments result in the acquisition of some asset, either financial or physical. In this sense, markets are also closely related to each other. Hence, the perfect financial market should reflect the progress pattern of the real market since, in reality, financial markets exist only as a support to the real market.

1.2.2. Characteristics of investment

The features of economic and financial investments can be summarised as return, risk, safety, and liquidity. Return: All investments are characterised by the expectation of a return. In fact, investments are made with the primary objective of deriving a return. The expectation of a return may be from income (yield) as well as through capital appreciation. Capital appreciation is the difference between the sale price and the purchase price of the investment. The dividend or interest from the investment is the yield. Different types of investments promise different rates of return. The expectation of return from an investment depends upon the nature of investment, maturity period, market demand, and so on. The purpose for which the investment is put to use influences, to a large extent, the expectation of return of the investors. Investment in high growth potential sectors would certainly increase such expectations. The longer the maturity period, the longer is the duration for which the investor parts with the value of the investment. Hence, the investor would expect a higher return from such investments.

Risk: Risk is inherent in any investment. Risk may relate to loss of capital, delay in repayment of capital, non-payment of interest, or variability of returns. While some investments such as government securities and bank deposits are almost without risk, others are more risky. The risk of an investment is determined by the investment's maturity period repayment capacity, nature of return commitment, and so on. The longer the maturity period, greater is the risk. When the expected time in which the investment has to be returned is a long duration, say 10 years, instead of five years, the uncertainty surrounding the return flow from the investment increases. This uncertainty leads to a higher risk level for the investment with longer maturity rather than on an investment with shorter maturity.

Safety: The safety of investment is identified with the certainty of return of capital without loss of money or time. Safety is another feature that an investor desires from investments. Every investor expects to get back the initial capital on maturity without loss and without delay. Investment safety is gauged through the reputation established by the borrower of funds. A highly reputed and successful corporate entity assures the investors of their initial capital. For example, investment is considered safe especially when it is made in securities issued by the government of a developed nation.

Liquidity: An investment that is easily saleable or marketable without loss of money and without loss of time is said to possess the characteristic of liquidity. Some investments such as deposits in unknown corporate entities, bank deposits, post office deposits, national savings certificate, and so on are not marketable. There is no well-established trading mechanism that helps the investors of these instruments to subsequently buy/sell them frequently from a market. Investment instruments such as preference shares and debentures (listed on a stock exchange) are marketable. The extent of trading, however, depends on the demand and supply of such instruments in the market for the investors. Equity shares of companies listed on recognised stock exchanges are easily marketable. A well-developed secondary market for securities increases the liquidity of the instruments traded therein. An investor tends to prefer maximisation of expected return, minimisation of risk, safety of funds, and liquidity of investments.

1.3. Objectives of investment

A prudent and consistent saving habit lets income earners to set aside a certain amount of current income for future consumption. Savings kept as cash do not result in an incremental return. Hence, savings are invested in assets with the desired risk-return characteristics. The main objective of an investment process is to minimise risk while simultaneously maximising the expected returns from the investment and assuring safety and liquidity of the invested assets.
Investors look for growth/increase in current wealth through investment opportunities. Given an investment environment, an investor's preference will be for investment opportunities that give the highest return. Investors desire to earn as large returns as possible but with the minimum of risk. Risk can also be stated as the probability that the actual return realised from an investment may be different from the expected return. Financial assets can be grouped into different classes of risk based on the return. Government securities constitute the low risk category as there is very little deviation from expectations and hence are riskless. Shares of corporate entities would form the high-risk category of financial assets as their returns depend on many uncontrollable

factors. An investor would be prepared to assume a higher risk only if the expected return is proportionately higher. Hence, there is a trade-off between risk and return.
The objective of safety and liquidity helps an investor to design a retirement plan. This is done to substantiate an investor's earnings beyond the employment tenure. With this in mind, the investor sets aside a part of the current income in growth/income-yielding assets that would give an assured return after a period of time. Savings kept as idle cash do not become investments since it loses its value over time due to rise in prices. This rise in prices, or inflation, invariably erodes the value of money. Investments are, hence, made with the objective to provide a hedge or protection against inflation over the investment duration. This time value concept necessitates investors to choose asset types that will enable them to retain at least the cash value held at present over a future period. In effect, the real rate of return would be negative if the investment cannot earn a higher return than the inflation rate. For example, if inflation is at an average annual rate of 4 per cent, then the expected return from an investment should be above 4 per cent to help savings funds to flow into investment avenues. The objective of investment hence can be stated as giving an expected return from the asset that is higher than the prevalent inflation rate in the economy. The third objective of investment is the utilisation of tax incentive schemes offered by the government. In order to foster investment habits, many economies offer incentives in the form of tax-saving schemes. Tax rates are applicable for a fiscal year; therefore, to cut down on immediate tax expenditures as investor would invest in taxsaving investment schemes offered by the government. This objective of the investor to reduce present tax payments and hence invest in tax-saving schemes can be considered as a short-term investment objective. Tax-saving schemes also offer a marginal return to the investors. Based on the tax policies of the country, investment criteria could solely depend on this factor also.

TYPES OF SECURITIES

Equity shares

Equity shares represent ownership capital and its owners (equity shareholders) share the rewards and risks associated with the ownership of corporate enterprises. These are also called, ordinary shares, in contrast with preference shares, which carry certain preferences/prior rights in regard to income and redemption. Equity investors have residual claim on income and assets besides enjoying rights to control and pre-emptive right. The return on common stocks comes from either of two sources - the periodic receipt of dividends, which are payments made by the firm to its shareholders, and increases in value, or capital gains, which result from selling the stock at a price above that originally paid. Further, common stock can be bought in round (a 100 unit share of stock, or multiples thereof) or odd (fewer than 100 shares of stock) lots. Basically an investor incurs two types of transaction costs when buying or selling shares viz. STT (Security Transaction Tax) and brokerage. The major component is, of course, the brokerage paid at the time of transaction. As a rule, brokerage fees varies between 0.25 to 1 per cent of most transactions. Earlier the cost was dramatically high since the introduction of negotiated commissions on May 1, 1975 but the cost has declined substantially with the introduction of Demat services.
Shares have a better track record of appreciating and beating inflation than any other type of investment over time. However, stock markets are volatile by nature and are very risky. The stock market has lured many investors who have developed different kinds of tools to identify the past pattern of price movements and predict, to some extent, the future position of the

securities. Investors can opt for corporate securities as investment in the stock market since there is a possibility to get dividends and capital gain returns.
Investors can invest in shares either through market offerings or in the secondary market. The primary market has shown abnormal returns to investors subscribed for the public issue and were allotted shares. The average initial returns (the difference between the first listed price and the issue price) for an investor in the public issues could be nearly 35 percent in the Indian market. The investor, however, has to bear in mind that the shares of a blue chip company, though issued at a premium, could have a far greater demand in the market for various reasons. When there is an over subscription on the issue, many small investors might not get an allotment of the shares. Hence, demand for the shares goes up immediately when the shares are traded in the secondary market. In India, the investments into shares and debentures including mutual funds units (except UTI units) as a percentage of household financial savings has dropped significantly from 23.3 per cent in 1991-92 to 1.4 per cent in 2003-04

8.3. Fixed income securities

Preference shares : Preference shares refer to a form that partakes some characteristics of equity shares (ownership) and some attributes of debentures (fixed income). Generally, the dividend is cumulative and shares are redeemable. Redemption period is usually 7-12 years. But, preference dividend is payable only out of distributable profits. It does not carry voting rights. Investors, though enjoy the assurance of a stable dividend but generally receive modest returns and vulnerable to arbitrary managerial actions. It is, however, not a popular capital market instrument in India. Preference shares also get traded in the market and give liquidity to investors. Though trading in preference shares is not quite frequent, investors can opt for this type of investment when their risk preference is very low.

Debentures and bonds : These are essentially long-term debt instruments. Many types of debentures and bonds have been structured to suit investors with different time needs. Though having a higher risk as compared to bank fixed deposits, bonds and debentures do offer higher returns.
Debenture investment requires scanning the market and choosing specific securities that will cater to the investment objectives of the investors. Investors also need to look into the following.
The credit rating of the issuing companies- rating by independent agencies such as ICRA, CRISIL, and CARE indicate the levels of safety of debt instruments. The method of compounding by the companies- securities that offer more frequent compounding such as daily, monthly, quarterly, would result in higher returns. When all other parameters of risk, safety, liquidity, and so on are the same, the choice of a security should depend on frequent compounding of interest.
Convertible debentures: A convertible bond is a bond that may be compulsorily or optionally converted into equity shares in future. The general features of a convertible bond include the conversion ratio, conversion price, conversion timing, and conversion (or stock) value. Holders are entitled to a fixed income till the conversion option is exercised and would share the benefits associated with equity shares after the conversion. All details about conversion terms are specified in offer document or prospectus. The convertible debentures presently in India can be compulsorily convertible within 18 months or optionally convertible within 36 months or convertible after 36 months with call and put features.

Government securities: They refer to the marketable debt instruments issued by the government or semi-government bodies. A government security is a claim on the government and totally secure financial instrument ensuring safety of both capital and income. That's why it is called gilt-edged security or stock. Central government securities are the safest among all securities. Government securities have maturities ranging from 2 to 30 years and presently these carry interest rates varying between 6 and 10 per cent. Interest is calculated on the basis of a 360-day year. Government securities are issued with a minimum denomination of Rs. 10,000, and in multiples of Rs. 10,000 thereafter. There are various types of government securities : fixed rate coupon, which is the most common, floating rate zero coupon (which are issued at a discount to face value) and partly paid bonds. Floating rate bonds are indexed to the prevalent 364-day T-bill rate. Sometimes the Government decides to sell convertible 91/364-day T-Bills. These T-bills convert into government securities on maturity date. The holder has the option to convert into government securities.

The interest earned on investment under government securities ischarged under the head "Income from other sources" while the profit/loss on investment is charged under the head "income from business and profession."

Withholding tax on government securities was abolished from June 1, 1997 by virtue of provision (iv) to Section 193 of Income Tax Act, tax payable on any security of Central or State government. There is no stamp duty payable either on registration of ownership. These securities carry some tax advantages also.

Public sector undertakings bonds: Public Sector Undertakings (PSUs) issue debentures that are referred to as PSU bonds. Minimum maturity of PSU bonds is generally 5 years for taxable bonds and 7 years for tax-free bonds. The maturity of some bonds is also 10 years. The typical maturity of a corporate debenture is between 3-12 years. Debentures with lower maturity are normally issued as debenture convertible partly or fully into equity. The interest income from bonds and debentures is classified under the heading "income from business or profession". The difference between face value and issue price in the case of Deep Discount Bonds can be classified as interest to be accrued on field basis every year. The incidence of TDS on bonds and debentures depend on the terms and structure thereof. The interest on taxable bonds is exempt only upto a certain limit as per section 80L of the Income-Tax Act, whereas the interest on tax-free bonds is fully exempt. While PSUs are free to set the interest rates on taxable bonds, they cannot offer more than a certain interest rate on tax-free bonds, which is fixed by the Ministry of Finance. More important, a PSU can issue tax-free bonds only with the prior approval of Ministry of Finance.

In general, PSU bonds have the following investor-friendly features-

a) there is no deduction of tax at source on the interest paid on these bonds;

b) they are transferable by mere endorsement and delivery;

c) there is no stamp duty applicable on transfer; and

d) they are traded on the stock exchanges.

In addition, some institutions are ready to buy and sell these bonds with a small price difference.

Kisan Vikas Patra (KVP): Kisan Vikas Patra (KVP) comes in the denominations (face value) of Rs. 1,000, Rs. 5,000 and Rs. 10,000. There is no maximum limit on the purchase of certificate. KVP double the money in 8.7 years that works out to a yield of a little over 8 percent. As tax concessions are not available on interest amount, for investors in higher tax brackets, the yields are somewhat lower. Investors can also use money in emergencies by breaking it after 2.5 years. However, early withdrawal lowers returns. Certificate can be encashed at the post-office of its issue.

8.4. Money market instruments

Money market securities have very short-term maturity i.e. less than a year. Common money market securities include treasury bills, commercial paper and certificate of deposit.

Treasury bills: A treasury bill is a short-term money market instrument issued by RBI for the government for financing the temporary funding requirements. T-bills have tenor like 14 days, 91 days, 182 days and 364 days. In the monetary and credit policy of 2001-2002, 14days and 182 days T-bills have been introduced. It is issued in the form of a zero coupon instrument at discount to face value redeemable at par on maturity. The discount earned on T-bills, as well as the profit/loss on investment is charged under the head "Income from Business and Profession". By virtue of provision (iv) to section 193 of Income Tax Act, no tax is required to be deducted at source on interest payable on any security of Central or State Government (Only for coupon payments). No TDS (Tax deducted at source) is attracted on discount i.e. differential between issue price and face value in case of treasury bills. Due to a large denomination and low rate of return, it has virtually no appeal for individual investors.

Commercial paper: It represents short-term unsecured promissory notes issued by firms that enjoy a fairly high credit-rating. Generally large firms with considerable financial strength are able to issue commercial paper. All commercial paper (CP) issues have to be mandatorily rated by one of the rating agencies in India. The minimum rating required is P2 (as per RBI guidelines dated October 10, 2001) or equivalent. CPs are issued at discount to face value and is redeemable at par on maturity. Typically CPs are issued for a period of 30/45/60/90/120/270/360 days. There are no brokers in the CP market. Trading is done over the counter with the counter parties involved. CP can be issued in denominations of Rs. 5 lakh or multiples thereof. Amount invested by single investor should not be less than Rs. 5 lakh (face value). Issue of CP is subject to payment for stamp duty. The stamp duty on a primary issue of CP is 0.25 per cent for all other investors, with a concessional rate of 0.05 for banks. CPs are transferable by endorsement and physical delivery. CPs are subject to liquidity risk, credit risk and operational risk. The provisions of the Income Tax Act relating to deduction of tax at source are not applicable in the case of CPs. Typically it is of high denomination and hence bought mainly by institutional investors and companies.

Certificate of deposits: A certificate of deposit (CD) represents a title to a negotiable deposit with a commercial bank. It carries a reasonably attractive interest rate. CDs are freely transferable by endorsement and delivery after 15 days of the date of issue. They are issued at a discount to face value and are redeemable at par on maturity. CDs are not required to be rated and are traded over the counter directly with the counterparty. The minimum size of a CD issue is Rs. 5 lakhs. It involves price risk- as exposed to interest rate risk, liquidity risk, credit risk (counterparty risk is minimal since CD is a secure instrument) and settlement risk. The RBI allows CD to be issued upto one year maturity. However the maturity most quoted in the market is 90 days. Being of high denomination, it is of interest mainly to institutional investors and companies.

Mutual funds

While some of the investors prefer to build their own portfolio of stock market instruments, according to their own ability, knowledge and experience, many people do not have the inclination, time or knowledge to handle their own investments. Mutual funds provide this service to the latter. In fact, small investors face many handicaps in the share market. They cannot afford professional advice and also can’t invest in a balanced and diversified portfolio with limited resources and incur huge expenses on buying and selling of shares. Mutual funds have come as a boon to the small and medium investors. Mutual fund is a special type of investment institution, which pools the savings of the community and invests large funds in a fairly large and well-diversified portfolio of sound investments for the mutual benefit of the members. So, it’s a media through which investors can reap all benefits of good investing. In brief, there is no other way out for small investors to enter the capital market, except the mutual funds.

Open-ended mutual fund accepts funds from investors by offering its units or shares on a continuing basis. It permits investors to withdraw funds on a continuing basis under a re-purchase agreement. Such schemes have no maturity period and are ordinarily not listed. Contrarily, the subscription to a close-ended scheme is kept open only for a limited period (usually one month to three months). It does not allow investors to withdraw funds as and when they like. It has a fixed maturity period (usually five to fifteen years). Such schemes are listed on the secondary market.

Mutual funds in India invest in three broad kinds of instruments as follows-

- Equity shares and equity related instruments (convertible debentures and warrants)
- Debt instruments (non-convertible debentures, public sector bonds, and government securities)
- Money Market Instruments (certificate of deposits, commercial paper, and call money).

UNIT II

- Securities markets: Primary market – Concept of capital issue, features, functions and investors and investors protection.
- Secondary market – structure, functions, products and features. Development of stock market in India. Concept of listing, membership, trading and settlement procedure and Demat.

Primary market

The primary market is the doorway for corporate enterprises to enter the capital market. The issues of new securities are offered to the public through the primary market. The issue is thus an open public offer to sell the securities. The sale is made at a value predetermined by the firm issuing the security. Sometimes a road show is conducted to feel the pulse of the public in fixing the value for a security. The securities have a face value, which is the denomination in which it is divided. For instance, an instrument could have a face value of Re 1, Rs. 5, Rs. 10, or Rs. 100 in India. This denomination determines the number of units of the security that are offered to the public. The price at which the security is offered to the public is the offer price of the instrument. This price could be equal to or greater or lesser than the face value. When the offer price is greater than the face value, the offer is said to be at a premium. When the offer price is less than the face value, the offer is at a discount. When the two prices are equal, the offer is at par.
Several intermediaries have sprung up to help corporate entities to offer their debt and equity instruments to the public. Merchant bankers and underwriters are the major intermediaries who help to match the fund requirement of corporate entities with the surplus fund position of public. The public is represented by both individual investors and institutional investors. Sometimes, when the market is dominated by institutions, the market is said to be institutionalised. Once the offer process of the securities to the public is complete, the securities are listed in the markets. The corporate then has to comply with the specific regulations of each local market in which its securities are listed.

Secondary market

The secondary market refers to the exchange of securities that have been listed through the primary market. The price at which it is traded in the capital market is the market price of the instrument. It is the secondary market that offers tradability to the financial instruments. The number of financial instruments participating in the secondary market hence, cannot exceed the number of financial instruments recorded through the primary market. The secondary market also comes under the regulatory authorities of the market and the main role of the regulator in the secondary market is to safeguard the interest of players in the market. Both individuals and institutions can take part in the secondary market. Brokers and depositories are the main intermediaries in this market, who transact business on behalf of the investors. The brokers can appoint a network of subbrokers to mobilise investors participation in the market. Depositories help in scripless trading by holding investor accounts in electronic media.
Over a period of time, the secondary market has grown in size and in terms of efficiency. The secondary market may be further sub-divided into the spot market and derivative market.

Relationship between the primary and secondary market

1. The primary/new issue market cannot function without the secondary market. The secondary market or the stock market provides liquidity for the issued securities. The issued securities are traded in the secondary market offering liquidity to the stocks at a fair price.
2. The new issue market provides a direct link between the prospective investors and the company. By providing liquidity and safety, the stock markets encourage the public to subscribe to the new issues. The marketability and the capital appreciation provided in the stock market are the major factors that attract the investing public towards the stock market. Thus, it provides an indirect link between the savers and the company.
3. The stock exchanges through their listing requirements, exercise control over the primary market. The company seeking for listing on the respective stock exchange has to comply with all the rules and regulations given by the stock exchange.
4. Though the primary and secondary markets are complementary to each other, their functions and the organisational set up are different from each other. The health of the primary market depends on the secondary market and vice versa.

Differences between primary and secondary market

Following are the major points of difference between Primary and Secondary Markets:

Primary Market
1. Market for new securities.
2. No fixed geographical location.
3. Results in raising fresh resources for the corporate sector.
4. All companies participate into primary market.
5. No tangible form or administrative set-up. Recognised only by the services it renders.
6. Controlled by SEBI, Stock Exchanges and the Companies Act.

Secondary Market

1. Market for existing securities.
2. Located at a fixed place.
3. Facilitates transfer of securities from one corporate investor to another.
4. Securities of only listed companies can be traded at Stock exchanges.
5. Has a definite administrative set-up and a tangible form.
6. Subjected to control both from within and outside.

Pricing of new issues

Issue of capital prior to May 27, 1992 was governed by the Controller of Capital Issues Act, 1947. Under the Act, the premium was fixed as per the valuation guidelines issued. The guidelines provided for fixation of a fair price on the basis of the net asset value per share on the expanded equity base taking into account, the fresh capital and the profit earning capacity. The repealing of the Capital Issue Control Act resulted in an era of free pricing of securities. Issuers and merchant bankers fixed the offer prices. Pricing of the public issue has to be carried out according to the guidelines issued by SEBI.

At premium: Companies are permitted to price their issues at premium in the case of the following
a) First issue of new companies set up by existing companies with the track record.
b) First issue of existing private/closely held or other existing unlisted companies with three-year track record of consistent profitability.
c) First public issue by existing private/closely held or other existing unlisted companies without three year track record but promoted by existing companies with a five-year track record of consistent profitability.
d) Existing private/closely held or other existing unlisted company with three-year track record of consistent profitability, seeking disinvestments by offers to public without issuing fresh capital (disinvestments).
e) Public issue by existing listed companies with the last three years of dividend paying track record.

At par value: The price of the share should be at par in case of:
a) First public issue by existing private, closely held or other existing unlisted companies without three year track record of consistent profitability and
b) Existing private/closely held and other unlisted companies without three-year track record of consistent profitability seeking disinvestments offer to public without issuing fresh capital (disinvestments).

Allotment of shares

As per SEBI regulation, the allocation of shares is done under proportionate allotment method. The allotment for each category is inversely proportional to the over subscription ratio. The applications will be categorised according to the number of shares applied for. Then allocation is done by proportionate basis. If the allocation to a applicant works out to be more than hundred but is not a multiple of hundred, the number excess of hundred and fifty would be rounded off to the higher multiple of 100 i.e. 200. If the number is lower than 50 it would be rounded off to the lower multiple of hundred. For example, if the allocation is 155 under the proportionate allotment method then, it would be rounded off to 200. If it is 148, then it would be rounded off to 100. If the shares allocated on a proportionate basis to any category are more than the shares allotted to applicants in that category, the balance shares allotment shall be first adjusted against any other category where the allotment of shares are not sufficient for proportionate allotment in that category. The balance shares, if any remaining after such adjustment will be added to the category comprising of applicants applying for minimum number of shares.

Factors to be considered by the investors in selecting a public issue

The number of stocks which has remained inactive, increased steadily over the past few years, irrespective of the overall market levels. Price rigging, indifferent usage of funds, vanishing companies, lack of transparency, the notion that equity is a cheap source of fund and the permitted free pricing of the issuers are leading to the prevailing primary market conditions. In this context, the investor has to be alert and careful in his investment. He has to analyse several factors. They are given below :

1) Promoters' past performance with reference to the companies promoted by them earlier.

2) The integrity of the promoters should be found out with enquiries and from financial magazines and newspapers.

3) The managing directors' background and experience in the field.

4) The composition of the Board of Directors is to be studied to find out whether it is broad based and professionals are included.

5) The credibility of the project appraising institution or agency.

6) The stake of the appraising agency in the forthcoming issue.

7) Availability of raw materials, government norms regarding it and the tax concessions, if any.

8) Reliability of the demand and supply projections of the product.

9) Competition faced in the market and the marketing strategy.

10) If the product is export oriented, the tie-up with the foreign collaborator or agency for the purchase of products.

11) Accounting policy and Revaluation of the assets, if any.

12) Analysis of the data related to capital, reserves, turnover, profit, dividend record and profitability ratio.

13) Possibilities for achieving the financial projections as indicated by the appraising institution.

14) Pending litigations and their effect on the profitability of the company. Default in the payment of dues to the banks and financial institutions.

15) A careful study of the general and specific risk factors should be carried out.

16) A thorough reading of the auditors' report is needed especially with reference to significant notes to accounts, qualifying
remarks and changes in the accounting policy. In the case of letter of offer the investors have to look for the recent un-audited working results at the end of letter of offer.

17) Investor should find out whether all the required statutory clearance has been obtained if not what is the current status. The clearances used to have a bearing on the completion of the project.

18) Promptness in replying to the enquiries of allocation of shares, refund of money, annual reports, dividends and share transfer should be assessed with the help of past record.

Investors protection in the primary market

The investing public should be protected to ensure healthy growth of primary market. The term investors protection has a wider meaning in the primary market. The principal ingredients of investor protection are- (a) Provision of all the relevant information; (b) Provision of accurate information; and (c) Transparent allotment procedures without any bias. To provide the above mentioned factors several steps have been taken. They are project appraisal, under-writing, clearance of the issue document by the stock exchange and SEBI's scrutiny of the issue document.

1. Project appraisal is the first step in the entire process of the project. Technical and economic feasibility of the project is evaluated. If the project itself is not technically feasible and economically viable, whatever may be the other steps taken to protect the investors are defeated. Appraisal shows whether the project is meaningful and can be financed. The investors' protection starts right from the protection of the principal amount of investment. Based on the appraisal, the project cost is finalised. The cost should be neither understated nor overstated. The profitability of the project should be estimated and given. To ensure fair project appraisal, SEBI has made it mandatory for the project appraisal body to participate a certain amount in the forthcoming issue.

2. Once the issue is finalised the underwriting procedure starts. Reputed institutions and agencies, providing credibility to the issue normally underwrite the issue. If the lead managers participate more than five per cent of the minimum stipulated amount offered to the public, it would increase the confidence of the public regarding the pricing and saleability of the issue.

3. SEBI has issued stringent norms for the disclosure of information in the prospectus. It is the duty of the lead manager to verify the accuracy of the data provided in the prospectus. The pending litigation should be given clearly. The promoters' credibility in fulfilling the promises of the previous issues (if any) should be stated. A clear version of the risk factors should be given. Any adverse development that affects the normal functioning and the profit of the company should be highlighted in the risk factor.

4. The issue document has to be cleared by the stock exchange on which the proposed listing is offered. The stock exchanges verify the factors related with the smooth trading of the shares. Any bottleneck in this area will be eliminated since the transferability is the basic right of the shareholders. Trading of the shares helps the investor to liquidate his share at any time. If the issues are not traded in the secondary market at a good price, they would dampen the spirit of the investor.

5. The Board of Directors should sign the prospectus. A copy is also filed with the office to the Registrar of the Companies. This along with the other material documents referred to in the prospectus are available for inspection by the members of the public. The minimum amount to be subscribed by the promoters and maintained for a minimum number of years also safeguard the interest of the investors.

6. SEBI scrutinises the various offer documents from the view point of investors' protection and full disclosure. It has the power to delete the unsubstantiated claims and ask for additional information wherever needed. This makes the lead managers to prepare the offer document with due care and diligence. When the disclosure of the information is complete, wide publicity has to be given in the newspapers. In the allotment procedure to make sure of transparency, SEBI's nominee is appointed apart from the stock exchange nominee in the allotment committee. Inclusion of valid applications and rejection of invalid applications are checked. The representative of the SEBI's see to it that undue preference is not given to certain group of investors.

7. For *redressal of investors grievances*, the Department of Company Affairs has introduced computerised system of processing the complaints to handle it effectively. The companies are requested to give feedback regarding the action taken on each complaint within a stipulated time period. If the companies do not respond and are slow in the process of settlement of complaints, penal action can be taken against the companies under the provisions of the Companies Act. If the performance of the Registrar to the issue is not satisfactory in settling the complaints, SEBI can take appropriate action against such Registrar. Several Investors Associations are also functioning to help the investors complaints redressed promptly.

SECONDARY MARKET

Introduction

Stock exchanges provide an organised market for transactions in shares and other securities. The emergence of capital market can be traced back to the second half of the eighteenth century when the transactions were limited to loan stock transactions of the East India Company. By 1830 some corporate stocks had emerged due to economic boom and establishment of textile mills. Stock exchanges at Bombay, Ahmedabad and Calcutta started functioning, though without formal organisation. Bombay Stock Exchange was formalized in 1875 with the establishment of 'Native Share and Share Brokers Association'. Stock exchange trading got a big boost during the First World War and the Second World War with the incorporation of large number of joint stock companies and coming up of new stock exchanges at Madras, Delhi, Nagpur, Kanpur, Hyderabad, and Bangalore. As of 2005, there are 23 recognised stock exchanges in India with about 6000 stock brokers. The secondary market for securities has undergone tremendous transformation and growth in terms of number of listed companies, net worth of listed companies, number of shareholders, number of intermediaries, and annual market capitalisaion.

Regulation and Management of Stock Exchanges

All stock exchanges were subject to self-regulation and the activities in stock exchanges were of speculative character till 1956. The securities contracts (Regulation) Act (SCRA) was promulgated in 1956. The Ministry of Finance was vested through Stock Exchange division, powers to administer SCRA including recognition of stock exchanges and their operations. The Securities and Exchange Board of India (SEBI) which is presently working as a regulator of stock market also tries to ensure a qualitative improvement in the stock market by rendering it fair, transparent and efficient. Various functions of SEBI would be discussed in one of the forthcoming chapters. In addition, all stock exchanges have their own separate 'Governing Boards'. These governing boards consist of elected member-directors (i.e. stock broker directors), public representatives, and government/SEBI nominees. Each stock exchange has its rules, bye-laws and regulations which vest in the government/SEBI powers to nominate Presidents and Vice-Presidents of stock exchanges and to approve appointment of Chief-executive and public representatives to the governing board. The chief executive exercises control on members including their admission, expulsion, adjudication of disputes, imposition of penalties, regulation of market and investor protection. The pie chart in Figure 4.1 shows the distribution of trading activity in terms of volume in the exchanges. The Bombay Stock Exchange (BSE) and National Stock Exchange (NSE) together account for more than 70% of all capital market activity in India. The other major exchanges are the Calcutta, Delhi and Ahmedabad stock exchanges. The remaining exchanges account for only 4 per cent of the Indian capital market activity.

An Introduction to select stock exchanges

Besides the regional stock exchanges three national stock exchanges have been set up in India. They are the National Stock Exchange, Over the Counter Exchange of India Limited (OTCEI), Interconnected Stock Exchange of India Limited (ISE). All these exchanges have their head office at Mumbai.

The Bombay Stock Exchange

The Indian stock market is one of the oldest market in Asian markets. Its history dates back to nearly two centuries when the records of security dealings in India were meagre and obscure. The East India Company was the dominant institution in those days and business in its loan securities was transacted towards the close of the eighteenth century.
By the 1830s, business in corporate stocks and shares in bank and cotton presses took place in Bombay. Though the trading list was broader in 1839, there were only half a dozen brokers recognised by banks and merchants. In 1860-61, the American Civil War broke out and cotton supply from the United States of America and Europe was stopped. This resulted in the "Share Mania" for cotton trading in India. The number of brokers increased to between 200 and 250. However, at the end of the American Civil War, in 1865, a disastrous slump began— for example, a Bank of Bombay's share that had touched Rs. 2,850 could only be sold at Rs. 87. At the same time, brokers found a place in Dalal Street, Bombay, where they could conveniently assemble and transact business. In 1875, they formally established the "Native Share and Stock Brokers' association". In 1895, the association acquired premises in the same street; it was inaugurated in 1899 as the Bombay Stock Exchange. The Bombay Stock Exchange has been converted into company for very recently. Now it is known as Mumbai Stock Exchange Ltd. The executive director is in charge of the administration of the exchange and is supported by elected directors, Securities Exchange Board of India (SEBI) nominees, and public representatives.

The National Stock Exchange

The National Stock Exchange of India Limited was set up to provide access to investors from across the country on an equal footing. NSE was promoted by leading financial institutions at the behest of the Government of India and was incorporated in November 1992 as a tax-paying company, unlike other stock exchanges in the country. On its recognition as a stock exchange under the Securities Contracts (Regulation) Act, 1956 in April 1993, NSE commenced operations in the wholesale debt market (WDM) segment in June 1994. The capital market (equities) segment commenced operations in November 1994, and operations in the derivatives segment commenced in June 2000. The organisational structure of NSE (Figure 4.2.) is through the link between National Securities Clearing Corporation Ltd. (NSCCL), India Index Services and Products Ltd. (IISL), National Securities Depository Ltd. (NSDL), DotEx International Limited (DotEx) and NSE.IT Ltd. The National Securities Clearing Corporation Ltd., a wholly owned subsidiary of NSE, was incorporated in August 1995. It was set up to bring and sustain confidence in the clearing and settlement of securities, to promote and maintain short and consistent settlement cycles, and to provide counterparty risk guarantee. India Index Services and Products Limited, a joint venture between NSE and the Credit Rating Information Services of India Limited(CRISIL), was set up in May 1998 to provide a variety of indices and index-related services and products for the Indian capital market. It has a consulting and licensing agreement with Standard and Poor's (S & *P*) for co-branding equity indices. In order to counteract the problems associated with trading in physical securities, NSE joined hands with the Industrial Development Bank of India (IDBI) and Unit Trust of India (UTI) to promote dematerialisation of securities. Together they set up the National Securities Depository Limited the first depository in India. NSDL commenced operations in November 1996. It has since established a national infrastructure of international standard to handle trading and settlement in dematerialised form and thus has completely eliminated the risks associated with fake/bad/stolen paper documents. NSE.IT, a 100 per cent subsidiary of NSE, provides technical services and solutions in the area of trading, broker front-end and back-office, clearing and settlement, web-based trading, risk management, treasury management, asset liability management, banking, insurance, and so on. The company also plans to provide consultancy and implementation services in the areas of data warehousing, business continuity plans, mainframe facility management, site maintenance and backups, real time market analysis and financial news, and so on. NSE.IT is an export-oriented unit with Straight Through Processing (STP). NSE.IT and i-flex Solutions Limited, a leader in e-enabling the global financial services industry, promoted DotEx International Limited. DotEx provides customer fulfilment infrastructure for the securities industry. The initial offering of DotEx is the DotEx Plaza where multiple market participants such as brokers, depository participants, and banks can offer web-based services to their customers. As a neutral aggregator and infrastructure provider, Dot Ex offers choice and convenience to investors.

Over the Counter Exchange of India

The Over the Counter Exchange of India was incorporated in 1990 and was recognised as a Stock Exchange under the Securities Contracts (Regulation) Act, 1956. The exchange was set up to aid enterprising promoters in raising finance for new projects in a cost effective manner and to provide investors with a transparent and efficient mode of trading. OTCEI has been co-promoted by the leading financial institutions of the country, namely, Unit Trust of India, ICICI, Industrial Development Bank of India, SBI Capital Markets Limited, Industrial Finance Corporation of India, Life Insurance Corporation of India, Canbank Financial Services Limited, and General Insurance Corporation of India and its subsidiaries. NSCCL and NSDL provide clearing house facility to OTCEI. Modelled along the lines of the NASDAQ market of USA, OTCEI introduced many novel concepts to the Indian capital markets such as screen-based nationwide trading, sponsorship of companies, market making, and scripless trading. The exchange had 115 listing in 2002. Securities are traded on OTCEI through the “OTCEI Automated Securities Integrated System” (OASIS), a state-of the art screen-based trading system (SBTS). OASIS combines the principles of order-driven and quote driven markets and enables trading members to access a transparent and efficient market directly through a nationwide telecommunication network.

Inter-connected Stock Exchange Ltd. (ICSE)

With coming into existence of a large number of regional stock exchanges in the recent years, a need to integrate their functioning had also been felt for growth of capital market as also for providing opportunity to the investors to transact business at nationwide platform. Such integration also avoids erratic price movements in individual exchanges unaligned to the overall trends. In October 1997, SEBI granted an in-principle approval to the proposal of the inter-connected Stock Exchange Ltd. (ICSE) to set up a national level stock exchange under Section 4 of the Securities Contract Regulation Act (SCRA). ICSE has been promoted by 14 regional stock exchanges and may be incorporated as a company under the provisions of the Companies Act, 1956. ICSE provides trading, clearing, settlement, risk management, and surveillance support to the inter-connected market system. The stock exchange has set up ISE securities and Services Limited (ISS) to take membership of NSC and BSE, so that traders and dealers through ISS can access other markets in addition to the local market. It is a landmark development in integrating securities market. The cost of acquiring membership rights on ICSE, is Rs. 5000 for traders and Rs. 5 lakh for dealers. These are nominal as compared the other exchanges. The trading members of ICSE will have to satisfy the capital adequacy requirements separately in addition to the capital adequacy requirement of the regional stock exchanges. The ICSE segment uses the Online Regional Bourse Interconnected Trading (ORBIT) software for trading. The NSE segment of ICSE uses the Open Dealer Integrated Network (ODIN) software for trading and Member Accounting and Trade Confirmation House (MATCH) software for clearing and settlement. ICSE has to set up a clearing corporation and clearing house for settlement of trades at the national market system. ICSE has already set up a settlement guarantee fund. It also proposes to set up a specialised team at each regional clearing house.

LISTING OF SECURITIES

Admitting a security for its purchase and sale on a recognised stock exchange is called listing of a security. Central Listing Authority (CLA) is being set up with representatives of regional exchanges. The CLA has two primary roles- laying down standard listing processes and carrying out the due-diligence of a company to be listed. The CLA has also the responsibility to update the listing norms depending upon the internal and external environmental developments.

In order to restore confidence of the investors in the stock markets, the SEBI has also been working out new listing modalities, making the listing of unscrupulous companies difficult. Uniform criteria for listing for companies in any of the stock exchanges, would prevent unscrupulous promoters from entering the capital market through smaller exchanges. According to Section 73 of the Companies Act, 1956, every company intending to offer shares or debentures to the public for subscription by issue of a prospectus has to first make an application to one or more recognised stock exchanges for their listing. However, listing is not obligatory for companies not making public issue of shares and debentures. However, unlisted companies are subjected to promoters' quota with a lock-in stipulation. As per the Disclosure and Investor Protection (DIP) guidelines published in July 1997, the SEBI has reduced the promoters' contribution subject to lock-in in case of offers for sale of securities of unlisted companies to 20 per cent from the prevailing 25 per cent. In March 2001, the SEBI allowed all companies to issue debt securities to the public without listing equity. However, this has been allowed only for investment grade securities. Before this provision this facility was available only to infrastructure companies and municipal corporations.

Merits of listing

Regular information: The transactions of the listed shares regularly appear in the news paper, providing adequate information regarding the current worth of the securities. Buying and selling activities can be decided on the basis of the price quotations.

Insure best prices: The price quotations and the volume traded regarding the listed shares appear in the news papers. According to the demand and supply of the shares, prices are determined. This results in best price.

More liquidity: Listed shares can be sold at any recognised stock exchange and converted into cash quickly. Finding out buyers would be easy in the security market through brokers and screen based trading.
Periodic reports: Listed companies have to provide periodic report to the public. Half yearly financial reports should be published in the financial newspapers or in any other news papers. In 1985, it has been made obligatory for all listed companies to submit unaudited financial results on a half yearly basis within 2 months of the expiry of that half year. At present quarterly reports have to be published.
Transferability: Listing provides free transferability of securities. After the incorporation of Section 22-A in the securities Contract (Regulation) Act, free transfer of shares has been ensured.
Income tax benefit: Income-tax Act treats the listed companies as widely held companies. The advantages available to a widely held company are applicable to the listed company.
Wide publicity: Since the prices are quoted in the newspaper, the listed companies get wide publicity. This not only does good to the investor but also to the corporate to attract the public for further issues.

Consequences of non-listing

In case the company has not applied for listing or the one or more recognised stock exchanges have not granted permission before the expiry of ten weeks from the date of closure of subscription list, then the following consequences follow:
(i) subject themselves to various regulatory measures of SEBI and stock exchanges;
(ii) submit required books, documents and papers and disclose any other information which the stock exchange ask for;
(iii) send to all shareholders the notices of Annual General Meetings, Annual Reports, etc.; and
(iv) place its securities with the public.

Qualification for listing

Following are the minimum essential requirements, which a company has to comply with before its securities can qualify for listing on a recognised stock exchange:
(a) Minimum Issued Capital and Minimum Public Offer: The minimum issued capital of the company must be Rs. 3 crore of which at least Rs. 1.80 crore in face value must be offered to the general public.
(b) Minimum number of shareholders: There must be at least five public shareholders for every Rs. 1 lakh of fresh public issue of capital and ten public shareholders for every Rs. 1 lakh of offer for sale of the existing capital. The rules are different in case of investment companies.
(c) Payment of interest on excess application money: The companies are obliged to pay interest on excess application money at the rates ranging from 4 per cent to 15 per cent depending on the delay beyond 10 weeks from the date of closure of the subscription list.
(d) Listing on more than one exchange and on regional exchanges:
Every company with paid-up capital of more than Rs. 5 crore has to get itself listed on more than one stock exchange, including compulsory listing on regional stock exchange.

(e) Compulsory provisions in the articles of association: A company applying for listing on a recognised stock exchange must satisfy the stock exchange that in addition to other matters, its articles of association provide for the following:
(i) that the company shall use a common form of transfer,
(ii) that the fully paid shares will be free from all lien,
(iii) in the case of partly paid shares, the company's lien, if any, will be restricted to money called or payable at a fixed time in respect of such shares,
(iv) that any amount paid-up in advance of calls on any share may carry interest but shall not entitle the holder of the share to participate in respect thereof, in a dividend subsequently declared,
(v) that there will be no forfeiture of unclaimed dividends before the claim becomes barred by law, and
(vi) that option or right to call of shares shall not be given to any person except with the sanction of the company in general meeting.
(f) Minimum public offer for subscription: At least twenty-five per cent of each class or kind of securities issued by the company is to be offered to the public for subscription through advertisement in newspapers for a period of not less than two days and that applications received in pursuance of such offer are to be allotted fairly and unconditionally.
(g) Cost of public issue of capital: The new companies will be considered for listing and the listing of old companies will continue only if they adhere to the ceiling in expenditure of public issues.
(h) Undertaking regarding restriction on transfer of shares from promoters quota: The auditors/practising company secretary of the company applying for listing (other than specified institutions) have to certify that the share certificates have been stamped so that shares from promoter's quota cannot be sold/hypothecated/transferred for a period of three years.
(i) Corporate governance must for listing: New companies applying for listing have to enter into an agreement with the stock exchange undertaking to comply with corporate governance rules. All companies already listed on the stock exchanges will have to adhere to the new code if they want to remain listed on exchanges.

Other conditions and undertakings for listing

A company applying for listing has to satisfy following more conditions prior to listing—
(a) (i) that letters of allotment and letters of regret will be issued simultaneously at the same time,
(ii) that letters of rights will be issued simultaneously.
(iii) that letters of allotment, acceptance or rights will be serially numbered, printed on good quality paper and examined and signed by a responsible officer of the company and that whenever possible, they will contain the distinctive numbers of the securities to which they relate,
(iv) that letters of allotment will contain a provison; and
(v) that letters of allotment and letters of rights will state how the next payment of interest or dividend on the securities will be calculated;
(b) to issue, when so required, receipts for all securities deposited with it whether for registration, sub-division, exchange or for other purposes; and not to charge any fee for these services;
(c) to issue, when so required, consolidation and renewal certificates in denominations of the market unit of trading to split certificates, letters of allotment, letters of rights and transfer,

renewal, consolidation and split receipts into smaller units, to split call notices, issue duplicates thereof and not require any discharge on call receipts and to accept the discharge of members of stock exchange on split, consolidation and renewal receipts as good and sufficient without insisting on the discharge of the registered holders;
(d) when documents are lodged for sub-division or consolidation for renewal through the clearing house of the exchange—
(i) to accept the discharge of an official of the stock exchange clearing house on the company's split receipts and consolidation receipts and renewal receipts, as good and sufficient discharge without insisting on the discharge of the registered holders, and
(ii) to verify when the company is unable to issue certificates or split receipt or consolidation receipts or renewal receipts immediately on lodgement whether the discharge of the registered holders, on the documents lodged for sub-division or consolidation or renewal and their signatures on the relative transfers are in order;
(e) on production of the necessary documents by shareholders or by members of the exchange, to make on transfers an endorsement to the effect that the power of attorney or letters of administration or death certificate or certificate of the controller of Estate Duty or similar other documents has been duly exhibited to and registered by the company;
(f) to issue certificates in respect of shares or debentures lodged for transfer within a period of one month of the date of lodgement of transfer and to issue balance certificates within the same period where the transfer is accompanied by a larger certificate;
(g) to advise the stock exchange of the date of the board meeting at which the declaration or recommendation of a dividend or the issue of right or bonus share will be considered;
(h) to recommend or declare all dividends and/or cash bonuses, at least five days before the commencement of the closure of its transfer books or the record date fixed for the purpose and to advise the stock exchange in writing of all dividends and/or cash bonuses recommended or declared immediately after a meeting of the board of the company has been held to finalise the same;
(i) to notify the stock exchange of any material change in the general character of nature of the company's business;
(j) to notify the stock exchange of any change- (i) in the company's directorate by death, resignation, removal or otherwise; (ii) of managing director, managing agent or secretaries and treasurers; and (iii) of auditors appointed to audit the books and accounts of the company;
(k) to forward to the stock exchange copies of statutory and annual reports and audited accounts as soon as issued, including director's report,
(l) to forward to the stock exchange, as soon as they are issued, copies of all other notices and circulars sent to the shareholders including proceedings of ordinary and extraordinary general meetings of the company and to file with the stock exchange certified copies of resolutions of the company as soon as such resolutions become effective;
(m) to notify the stock exchange prior to intimating the shareholders of any new issue of securities whether by way of right, privilege, bonus or otherwise and the manner in which it is proposed to offer or allot the same;
(n) to notify the stock exchange in the event of re-issue of any forfeited securities or the issue of securities held in reserve for future issue;
(o) to notify the stock exchange of any other alteration of capital including calls;

(p) to close the transfer books only for the purpose of declaration of dividend or issue or right or bonus shares or for such other purposes as the stock exchange may agree and after due notice and sanction;

(q) to intimate the stock exchange any other information necessary to enable the shareholders to appraise the position of the company and to avoid the establishment of a false market in the shares of the company;

(r) that in the event of the application for listing being granted, such listing shall be subject to the rules and bye-laws of the exchange in force from time to time and that the company will comply within a reasonable time, with such further listing requirements as may be promulgated by the exchange as a general condition for new listings. A fresh application for listing is necessary in respect of all new issues desired to be dealt in, provided that where such new securities are identical in all respects with those already listed, admission to dealings is granted on the company intimating to the stock exchange particulars of such new issues.

Listing application

A public company desirous of listing its securities on a recognized stock exchange has to apply for the purpose to the stock exchange and forward along with its application the following documents and particulars:

(a) Three certified copies of memorandum and articles of association and, in the case of a debenture issue, a copy of the trust deed.

(b) Copies of all prospectuses or statements in lieu of prospectuses issued by the company at any time.

(c) Copies of offers for sale and circulars or advertisements offering any securities for subscription or sale during the last five years.

(d) Copies of balance sheets and audited accounts for the last five years, or in the case of new companies, for such shorter period for which accounts have been made up.

(e) A statement showing- (i) dividends and cash bonuses, if any, paid during the last ten years (or such shorter period as the company has been in existence, whether as a private or public company), and (ii) dividends or interest in arrears, if any.

(f) Certified copies of agreements or other documents relating to arrangements with or between- (i) vendors and/or promoters; (ii) underwriters and subunderwriters; and (iii) brokers and sub-brokers.

(g) Certified copies of agreements with - (i) managing agents and secretaries and treasurers; (ii) selling agents; (iii) managing directors and technical directors; and (iv) general manager, sales manager, manager or secretary.

(h) Certified copy of every letter, report, balance sheet, valuation contract, court order or other document, part of which is reproduced or referred to in any prospectus, offer for sale, circular or advertisement offering securities for subscription or sale, during the last five years.

(i) A statement containing particulars of the dates of, and parties to all material contracts, agreements (including agreements for technical advice and collaboration), concessions and similar other documents (except those entered into in the ordinary course of business carried on or intended to be carried on by the company) together with a brief description of the terms, subject-matter and general nature of the documents.

(j) A brief history of the company since its incorporation, giving details of its activities including any reorganisation, reconstruction or amalgamation, changes in its capital structure (authorised, issued and subscribed), and debenture borrowings, if any.
(k) Particulars of shares and debentures issued- (i) for consideration other than cash, whether in whole or part, (ii) at a premium or discount, or (iii) in pursuance of an option.
(l) A statement containing particulars of any commission, brokerage, discount or other special terms including an option for the issue of any kind of the securities granted to any person.
(m) A list of highest ten holders of each class or kind of securities of the company as on the date of application along with particulars as to the number of shares or debentures held by and the address of each such holder.
(n) Particulars of shares or debentures for which permission to deal is applied for: Provided that a recognised stock exchange may, either generally by its bye-laws or in any particular case, call for such further particulars or documents as it deems proper.

Stock Exchange Members

Transactions in any stock exchange are executed by member brokers who deal with investors. A member of a stock exchange is an individual or a corporate body who holds the right to trade in the stocks listed on the exchange. A corporate body could have a partnership, corporate, or a composite corporate membership. All members are permitted to trade in the trading ring. They can trade in the ring on their own behalf or on behalf of non-members. An investor can buy or sell securities only through one of the members who is also registration banking of the exchange. The Bombay Stock Exchange has, at present (2004), 678 members, of whom 192 are individual members and 486 are corporate members. The brokers in a stock exchange act as a link between those who want to buy shares and those who want to sell the shares. A broker for this intermediary function is paid a commission called the brokerage. Brokers can appoint sub-brokers, who are not members of the exchange, to act on their behalf in various localities. Besides brokers, there are also jobbers in the secondary market. They are also called market makers in the exchange. They place both buy and sell orders for selected shares. Thus they give two quotations, the purchase price and the sale price, for the same share. Brokers are paid commission for this intermediary function. Bookers are paid commission for this intermediary funcion. Stock exchange brokers are categorised into foreign broker, industrial group, local bodies, subsidiary of financial institutions and banks, and subsidiary of stock exchange. A sample list of member categories from the Bombay Stock exchange is given below. *Foreign brokers:* ABN Amro Asia Equities (India) Ltd., Birla Sun Life Securities Ltd., Credit Suisse First Boston (India) Securities Pvt. Ltd. *Industrial groups:* Apollo Sindhoori Capital Investments Ltd., Cholamandalam Securities Ltd., Reliance Sharea and Stock Brokers Ltd.
Local bodies: A A Doshi Share and Stock Brokers Ltd., Abhipra Capital Ltd., Acme Shares and Stock Pvt. Ltd. *Subsidiaries of Indian Financial Institutions and Banks:* ICICI Brokerage Services Ltd., IDBI Capital Markets Services Ltd., SBI Capital Markets Ltd., UTI Securities Exchange Ltd. *Subsidiaries of stock exchanges:* Cochin Stockbrokers Ltd., LSE Securities Ltd., MSE Financial Services Ltd.

Advantages of Stock Exchanges

The existence of secondary markets for shares is of advantage to both the company and the investors. As for the companies, a good performance of the company's shares in the capital market creates a good image or goodwill for the company so that it can use this market information successfully for its future finance requirements. A successful company in this sense will get an over-subscription of applications in subsequent new issues and it will also be able to price its subsequent issues at a desired premium. Investors also benefit from secondary markets. If not for the secondary markets, investors may not sell or buy shares from other market players. They would never be able to get capital appreciation benefits when they require funds for their immediate needs. Those who trade in the secondary market are given the option to sell or buy a share on any trading day, provided there is the requisite demand/supply. This assures investors that they can take back the investment when needed. Thus, the secondary market performs the economic function of transfer of funds between the public at large and the industry. A secondary market could provide quality service if it could assure its investors of fast, fair, orderly, and open system of purchase and sale of shares at known prices. Due to improved trading mechanisms and transparency in stock exchange operations, and monitoring by the regulatory body, the stock exchanges can perform their role efficiently to both the investors and the corporate entities. Trading in stock exchanges has been made transparent and smooth through computerised screan-barnd trading. This has enabled online trading of shares in the secondary market. The online system is orderquote-driven and facilitates efficient processing, automatic order matching, and faster execution of orders in a transparent manner. This facility enables members to enter orders on the trader workstations (TWSs) from their offices instead of assembling in the trading ring. This facility has enabled many regional stock exchanges to widen their market nationally and internationally.

4.7. Scrips traded on stock exchanges

At the Bombay Stock Exchange, trading takes place in groups. The scrips traded on the exchange have been classified into A, B1, B2, F, G, T, and Z groups. The number of scrips listed on the exchange under A, B1, B2, and Z groups, which represent the equity segments, as at the end of June 30, 2004, was 198, 790, 1830 and 2776 respectively. The number of securities listed in the G and F segment was 85 and 730 on the same date. The categories of securities traded under these groups are given below:

(i) Group A- Specified shares
(ii) Group B- Non-specified shares (further classified into B1 and B2 groups)
(iii) Group C- Odd lots and permitted shares
(iv) Group F- Debt market (Fixed income securities)
(v) Group G- Government Securities
(vi) Group Z- List of companies which have failed to comply with listing requirements and/or failed to resolve investor complaints.

Besides the exchanges also has another segment called the 'tradeto-trade' category that has been shifted to 'T' group. Trade-to-trade category was created as a preventive surveillance measure to ensure market safety and integrity. Group A, includes only actively traded shares. The governing body of BSE includes only those shares in this group that satisfy certain conditions stated by the exchange. Given the stringent conditions laid down for being listed in this group, the shares of only a few companies get listed in this group. The rest of the shares are listed under Group B. Group C has odd lots and permitted shares. Odd lots trading is allowed to enable trading in small quantities (less than market lots) to provide liquidity to such trading. Permitted shares are those that are not listed on the exchange, but are permitted to be traded since they are listed on other stock exchanges in India. National Stock Exchanges does not differentiate between Group A and B shares.

Trading at Stock Exchanges

Trading in any of various categories of the shares is done during trading hours fixed by the specific stock exchange. If trading is done before or after these fixed hours, it is called as kerb trading. During trading hours, members approach other brokers or jobbers who have an offer or sale quotations. Once the offer for sale and purchase is matched, a transaction takes place and is recorded by the concerned parties. At the end of each trading day, the brokers make a note of the transactions that actually took place, on whose behalf and for what value. Though trading in shares takes place on all stock exchange working days, the settlements need not take place automatically. The Settlement Committee of the exchanges fix the schedules of trading and settlement. In these schedules, the settlement for purchase or sale transactions may also take place once in a fortnight, that is, 10 or 15 trading days (excluding Saturdays, Sundays, and public holidays). After the fortnight, three days are offered as grace days. There might also be one or two additional days for correcting errors and omissions, and then securing a final settlement for each member's position in respect of the shares dealt in. After consolidating both the purchase and sale transactions, the members arrive at the net settlement to be made for each company's share. On the specified settlement day, say alternate Fridays, two types of settlements may take place. One is on a cash basis and the other is a forward contract. Cash settlements imply that the sale and purchase of shares noted down by the brokers will be finalised through the act of receiving cash by the seller and the receipt of share documents by the buyer. Thus, the delivery of assets takes place on the settlement day. In forward contracts of settlement, the transactions recorded are renewed by a carry forward contract. Here, the payment for sale and delivery of share certificate do not take place. However, on the cash settlement date, the speculatory might ask for a postponement of the deal, that is, either to buy or sell a share on the next settlement date by fixing a charge as a penalty for not executing the deal. The original contract (buy/sell) price will be updated with this charge. All deliveries for shares and payments due from forward contract adjustments have to be settled with respective deliveries and payments before the next settlement date. These forward contracts are entered in the settlement register and on the next settlement date, the transactions are executed and balance amounts transferred to the accounts of the respective investors. With technology playing a major role in settlements, several stock exchanges have shifted to the Compulsory Rolling Settlement (CRS) system. Under this system, there is no physical delivery of securities. The CRS could be a T+5, T+3, T+2, T+1, or T+0 settlement. T+3 implies that the securities come for settlement three days after the trade has taken place, irrespective of the day of the week. A stock exchange that offers CRS, trades securities in a dematerialised form. The delivery of share market dealings can be effected in any of the following ways: hand delivery, spot delivery, special delivery, or delivery for clearing. In case of hand delivery, the certificate to be delivered and the payment of cash should be completed on the date specified by the parties when drawing up the agreement. In spot deliveries, settlement takes place on the very next day or on the day of the contract. In case the parties are in different localities, the actual period of dispatch of securities or remittance of cash through post is excluded in the computation. Special delivery takes place when the settlement is made any time after the specified settlement date but before two months after the expiry of the contract date or as stipulated by the governing board of the stock exchange. In delivery for clearing, the settlement takes place through a clearing house. For this purpose stock exchanges have an in-house clearing house or an external clearing agency working for the exchange, which acts as a dispatcher. The shares for delivery are handed over to the buyer in the stipulated time and the seller receives the dues the same time from the clearing house on the respective pay-in and pay out days. The function of the clearing houses is restricted to the delivery of assets. It does not act as a collecting agent. Therefore, if a party defaults, then the other party must fulfil the obligations to the clearing house. Dealers in shares have to be sure of the integrity of the member with whom transactions are entered into. Otherwise, the loss would fall on the dealer.

Trading Limits

Stock exchanges specify trading limits to scrutinise and monitor the trading activities of the market. In India, SEBI has prescribed the intra-day Trading Limits IDTL), gross exposure requirements, and margin requirements in the secondary market. The intra-day trading limit (gross purchases + gross sales) prescribed is 33.33 times of the base minimum capital and additional capital deposited by the members with the exchange. Institutional business, that is, transactions done on behalf of the scheduled commercial banks, Indian financial institutions, foreign institutional investors, and mutual funds registered with SEBI are not included while watching the compliance of the members with the intra-day trading limit.

The exchange provides online warning to the members when they reach 70 per cent, 80 per cent, and 90 per cent of their respective intra-day trading limit. However, when a member crosses 100 per cent of the intra-day trading limit, a message is flashed on the trading workstation that says "CAPITAL ADEQUACY LIMIT VIOLATED". Immediately, all TWSs of the member get deactivated. The TWSs of the members, in such cases, are reactivated only after they deposit additional capital to cover their turnover in excess of the intra-day trading limit. A fine (Rs. 5,000 in BSE) is levied if a member does not deposit the additional capital to cover the required turnover in excess of the intra-day trading limit on the day of the violation. *Gross exposure requirement-* SEBI has prescribed a ceiling on the gross exposure (scripwise cumulative net outstanding purchases + cumulative net outstanding sales) of members which is 15 times of the base minimum capital + the additional capital deposited by them with the exchange. Thus, the gross exposure is computed as the receivable obligations or purchase position of the previous settlement for which members have yet to make a pay-in the weekly settlement category and outstanding unsettled (purchase + sale) positions in rolling settlements. Institutional business, however, are excluded from the computation of gross exposure of the members. Sale transactions marked for physical delivery at the time of trade and subsequently delivered in demat (dematerialised) mode to the clearing house are not included in the gross exposure limits of the members. Warnings are flashed on the TWSs of the members as soon as they reach 50 per cent, 70 per cent, and 90 per cent of their gross exposure limits. When a member crosses 100 per cent of the gross exposure limit, a message is flashed on the TWSs stating "GROSS EXPOSURE LIMIT EXCEEDED". Subsequently, the TWSs are automatically deactivated. The TWSs of the members, in such cases, are reactivated only after they deposit additional capital to cover their exposure in excess of the gross exposure limit.

Margin requirements- Margins are required to cover trade exposures. Margins play an important role, controlling for liquidity and safety of trades in a stock market. The higher the margin requirement of an exchange, the better the safety of the transacted deal. However, this cautions investors to limit speculative transactions and also reduces liquidity in the market. The lower the margin requirements imposed by the exchange, the higher will be the liquidity, since this will encourage speculative trading in the market; and conversely lower will be the safety of the trades. In India, compulsory collection of margins from clients including institutions is prevalent. Collection of margins on a portfolio basis is not allowed. Securities that are bought from the stock market can be paid for by the investor with his own funds or a mix of personal and borrowed funds. Buying with borrowed funds permits the investor to enlarge the scope of his investment activities since it enables him to buy a security whenever it touches a good price. This is called as trading on borrowed funds or “margin trading”. Margin trading lets the investor borrow money from a bank or a broker to buy shares. In India only brokers are allowed to provide the margins. Brokers borrow funds from a banker with the shares as collateral for the loan. The safety of this mechanism relies on the risk management capabilities of both the stockbroker and the banker.

Compulsory Rolling Settlements

Compulsory rolling settlements may require a Value at Risk (VaR) margin, additional volatility margin, mark to mark margin, special ad hoc margin, and special margin. These are discussed below.

Value at risk margin

The VaR margin calculation is based on the volatility of either the BSE Sensex or S&*P* CNX Nifty. The margin is calculated as the higher of scrip VaR and index VaR multiplied with a suitable multiplier. Scrip-wise VaR: The scrip-wise daily volatility is calculated using the exponential moving weighted average method for the preceding six months. This method is also applied by other stock exchanges such as NSE.

Additional Volatility Margin

The members/custodians are required by SEBI to pay the additional volatility margin (AVM) on the net outstanding sale position of their institutional clients. In view of the introduction of the VaR margin system in CRS, SEBI has directed that the members/custodians would be required to pay AVM which is equal to the positive differential between the scrip VaR calculated and the minimum VaR (1.75 times of index VaR). The AVM payable can be adjusted against unutilised additional capital deposited with the exchange. The AVM paid by the members in cash on the sale position of institutions is refunded to them in the pay-in of the concerned settlement.

Mark to market margin

For the mark to market (MTM) margin in the rolling settlement, the notional plus actual losses and profits in each scrip are calculated for the trade day. Then the profits and losses are needed to arrive at the scrip level profit or loss. Then the profits made in certain scrips are netted with losses in other scrips. If there is a net loss, the same is collected as the MTM margin over and above the daily VaR margin. However, if there is a net profit at the aggregate level, the same is ignored for the purpose of computing the MTM margin.

Special Adhoc Margin

As a risk management measurl, the exchange may prescribe exposure limits in the scrips traded in CRS. At BSE, a 25 per cent special ad hoc margin (SAM) is collected if the exposure on a single scrip is equal or above Rs. 100 lakhs and up to Rs. 200 lakhs.

Special margin

From time to time, the special margin is imposed as a surveillance measure on various scrips in CRS. The special margin is charged on the net purchase and/or sale position of members to the extent of the traded position per settlement. Further, a special margin is required to be paid in cash only on T + 1 day and the margin, once collected, is released only on the pay-in day of the respective settlement. Further, it is not adjusted against the unutilised additional capital of the members as in the case of other margins. The rates of special margins on individual scrips (either on the sale and/or purchase) are notified by the exchange from time to time.

Settlement procedure for traded securities

Settlement procedure varies for securities of different groups, i.e., specified, non-specified and odd-lot securities.
(a) Specified securities: These consist of equity shares of established companies. Following is the criteria for including shares in the specified list:
(i) the shares should have been listed on a recognised stock exchange for a minimum period of three years.
(ii) the issued capital of the company should be at least Rs. 75 crore and the market capitalisation of the company should be two-three times;
(iii) the number of shares held by the public should be of a minimum face value of Rs. 4.50 crore;
(iv) the company should have at least 20,000 shareholders on dividend paying list;
(v) the company should preferably be growth oriented; and
(vi) the shares of the company must have been actively traded during the previous months. In brief it can be said that specified list includes actively traded shares of large growth oriented companies. Only small number of shares are in specified group but they account for major portion of capitalisation in Indian stock market.
(b) Non-specified securities: These are the shares and debentures of all companies other than those in the specified list.
(c) Odd-lot securities: These include preference shares and odd lots of shares and debentures, i.e., where a single share certificate is of smaller denomination than the minimum denomination required for regular trading.

Settlement procedure for specified group

The settlement is done at the end of each settlement period. An accounting year of a stock exchange is divided into settlement periods. Each settlement period is generally two weeks long starting from a Friday and ending on Thursday of the second following week. Steps in settlement are as follows:
First of all, at the end of each working day the details of all purchases and sales as recorded in sauda sheets are submitted to the computer centre. The details are verified in the computer centre where the matched transactions are logged. Unmatched transactions are reverted back to the members for verification. In the badla session on Friday, i.e., the next day after the settlement period is over, the members decide whether the transaction is settled or a particular transaction is to be further carried forward. The carry forward of transactions is called badla and has been banned. The computer centre is informed about all the settlements. After verifying all the details provided by the members, the computer centre issues to each member (a) money settlement slips showing the difference between payables and receivables, and the payslips and receive slips, (b) delivery order and receive orders of shares, and (c) carry over margin statement in case of badla transactions, now banned. Based on the above advice of the computer centre, the members file with the clearing house the balance sheet giving full details of pay and receive slips. These details are accompanied with the cheques/drafts and securities certificates as per the delivery order. This process is completed on the *pay-in day* specified by the stock exchange. After having examined and processed the drafts, cheques and securities certificates, the clearing house makes the payment (which is through settlement of difference on purchases and sales by members) and delivers the securities certificates to the members on the *pay-out day*, which is the next Wednesday.

Settlement procedure for Non-specified group

Settlement procedure for non-specified group differs from specified group in two ways:
1. Badla transactions were not permitted in non-specified group. Of course now badla has been banned for both these groups of securities and therefore there is no difference in this respect. Only modified forward trading is permitted now.
2. Whereas in case of specified group, the clearing house handles both the money part and the physical delivery of securities, In case of non-specified group of securities, the clearing house handles only the money part. On the pay-in day members submit only the balance sheet and the cheques/drafts and on the pay-out day they receive only monetary payments from the clearing house. The actual physical delivery of securities is handled by members themselves.

Settlement of Odd-Lot Transactions

The role of stock exchange is limited in case of odd-lot securities. The stock exchange neither physically receives/gives securities nor the money involved. The members themselves handle both these aspects. The stock exchange does the job of verification and matching of transactions. It also issues to the members a statement of all unmatched transactions entered into the previous settlement period. The actual settlement of transactions is done by members between themselves.

Rolling Settlement

On December 17, 1997, the SEBI announced that transactions on dematerialised shares should be settled on rolling basis on the fifth day after the respective transaction. Accordingly, trading in demat shares commenced on the basis of T+5 rolling settlement cycle w.e.f. January 15, 1998 on optional basis. Rolling settlement on T + 5 basis was kicked off initially with 10 scrips on January 10, 2000. the system allows settlement of each day's trade at the end of five days. The system was introduced in those exchanges which were connected to a depository. Rolling system was first introduction at Bombay Stock Exchange while the National Stock Exchange was next to follow. Initial ten selected scrips for rolling settlement were: BFL Software, Citicorp Securities, Cybertech Systems and Software, Hitech Drilling Services, Lupin Laboratories, Maars Software International, Morepen Lab, Sri Adhikari Brothers, Tata Infotech, and Visual Soft (India). This select list was chosen on the basis of the criteria that they appeared on the demat list and that each selected share had a daily turnover of Rs. One crore and above. The risk containment measures like margin requirements, exposure limits, etc., for rolling settlement would be the same as those for other settlements. After gaining experience, the list for rolling settlement was expanded. The list of ten select scrips did not include badla or carry forward scrips. The feedback from market participants as well as the results of the study undertaken by SEBI indicate the need for facilities like Continuous Net Settlement (CNS), Carry Forward in Rolling Settlement (CFRS), and the Automated Lending and Borrowing Mechanism (ALBM) in rolling settlement for increasing the popularity of rolling settlement. As an experiment, fifteen scrips in the present compulsory rolling settlement were allowed with the facilities of CNS, CFRS and ALBRS. Some stock exchanges commenced these facilities. More than top 200 scrips were brought under compulsory rolling settlement from July 1, 2001 from the Carry Forward, Automated Lending and Borrowing System (ALBM) and the Borrowing and Lending of Securities System (BLESS). All scrips which did not form part of the above were brought within the ambit of rolling settlement from January 2, 2002. In the interim period these stocks were treated on the uniform settlement cycle, Monday to Friday. On 20th December 2001, 414 scrips were under compulsory rolling settlement on a T + 5 basis, but from 31st December 2001 all the remaining scrips traded on the stock exchanges were brought under the rolling settlement. W.e.f. from April 1, 2002, the SEBI reduced the period for compulsory rolling settlements of all listed scrips by two days, i.e., instead of the prevailing six-day period (Trading day + 5 working days) to T + 3. SEBI further reduced the rolling settlement cycle to T + 2 on stock exchanges w.e.f. April 1, 2003, to reduce risks in capital market and protect investors' interest. The regulator issued separate instructions to intermediaries and exchanges and took steps to ensure smooth transition from T + 3 cycle to T + 2 settlement mechanism by widening use of electronic fund transfer and straight through processing under the T + 2 cycle, the confirmation for institutional trades by custodians is to be done by 11.00 a.m. on T + 1 basis. In rolling settlement, a fresh short trade has to be squared up on the same day as the settlement period becomes of one day only. However, with the stock-lending allowed, the client can indulge in short selling by giving delivery after borrowing from agencies like Stock Holding Corporation of India Ltd. It was also decided to do away with price bands on stocks which are in rolling mode. There would be a daily settlement cycle across all exchanges which would automatically bring in uniformity and eliminate arbitrage operations. In rolling settlement the sellers and buyers get the monies and securities for their sale and purchase transactions relatively quickly. Thus, investors benefit from increased liquidity and safety.

UNIT III

- SEBI and its Regulation; Constitution of SEBI, Power and functions of SEBI. Regulation of Securities market. SEBI's role in the Primary and secondary market. Mutual Funds; Management types and role in capital market.
- Security Analysis; Introduction, Technical, Economic, Industrial and Company analysis. Security trading, dealing and organization. Security credit ratings.

Introduction

SEBI is also known as the Security and Exchange Board of India was established on 12 April 1992 through the SEBI Act, 1992. It was a non-statutory body established to regulate the securities market. The headquarters of the board is situated in Bandra Kurla Complex, Mumbai. SEBI helps in regulating the Indian Capital Market by protecting the interest of investors and establishing the rules and regulations for the development of the capital market.

SEBI

SEBI or the Security and Exchange Board of India is a regulatory body controlled by the Government of India to regulate the capital and security market. Before the Security and Exchange Board of India, the Controller of Capital Issues was the regulating body to regulate the market which was controlled by the Capital Issues (Control) Act, 1947.

Majorly, SEBI controls the issuers of securities, the investors and the market intermediaries. The Board draft regulations and statutes under its legislative authority, also pass rulings and orders under its judicial capacity and operate investigations in its executive limits. SEBI works as a barrier to avoid malpractices related to the stock market by establishing a code of conduct and promoting the healthy functioning of the stock exchange. Initially, SEBI didn’t have the authority to regulate the stock exchange, but in 1992 the Union Government gave statutory powers to SEBI through the SEBI Act, 1992.

Reasons for the Establishment of SEBI

During the fall of the 1970s and the rise of the 1980s, the people of India were preferring to work in the Capital Market as the market was trending. Without any authority, problems like unofficial private placements, the rigging of prices, unofficial self-styled merchant bankers started violating the rules and regulations of the stock exchange which caused delays in the delivery of shares.

The Government felt an immediate need to establish a regulatory body to regulate its working and to find solutions for all the problems the market was going through, as the people were losing interest in the market. This led to the establishment of the Security and Exchange Board of India.

Purpose and Role of SEBI

SEBI helps in creating a healthy environment to facilitate an effective mobilization between the market participants and investors. It helps in locating the resources with the help of the securities market. SEBI establish rules and regulations, policy framework and infrastructure to meet the needs of the market.
The financial market majorly comprises of three groups:

The Issuer of Securities

Issuers are the group that works in the corporate department to easily raise funds from the various sources of the market. So, SEBI helps the issuers by providing them a healthy and open environment to work efficiently.

Investors

The investors are the soul of the market as they keep the market alive by providing accurate supplies, correct information, and protection to the people on a daily basis. SEBI helps investors by creating a malpractice free environment to attract and protect the money of the people who invested in the market.

Financial Intermediaries

The intermediaries are the people who act as middlemen between the issuers and the investors. SEBI helps in creating a competitive professional market which gives a better service to the issuers and the investors. They also provide efficient infrastructure and secured financial transactions.

Organizational Structure of SEBI

The members of the Security and Exchange Board of India are:

- The Chairman who is appointed by the Union Government of India.
- Two members who are selected from the officers of the Union Finance Ministry.
- One member who is appointed from the Reserve Bank of India.
- The other five members are appointed by the Union Government of India, out of five three must be whole-time members.

Dr. S.A. Dave was the first Chairman of SEBI who was appointed on 10th April 1988. Ajay Tyagi is the present Chairman appointed on 10th February 2017 replacing U K Sinha.

Functions of SEBI

SEBI basically protects the interest of the investors in the security market, promotes the development of the security market and regulates the business. The functions of the Security and Exchange Board of India can primarily be categorized into three parts:

Protective Function

Protective functions are used to protect the interest of investors and other financial participants. These functions are:

- Prevent Insider Trading: When the people working in the market like director, promoters or employees working in the company starts to buy or sell the securities because they have access to the confidential price which results in affecting the price of the security is known as insider trading. SEBI restricted companies to buy their own shares from the secondary market and SEBI also regulates regular check-ups to prevent insider trading and avoid malpractices.
- Checks price rigging: The malpractices which create unreasonable fluctuations in the price of the securities with the help of increasing or decreasing the market price of stocks which results in an immense loss for the investors or traders are known as price rigging. To prevent price rigging, SEBI keeps active surveillance on the factors which can promote price rigging.
- Promotes fair trade practices: SEBI established rules and regulations and a certain code of conduct in the securities market to restrict fraudulent and unfair trade practices.
- Providing awareness/financial education for investors: SEBI conducts seminars both online and offline to educate the investors about insights into the financial market and money management.

Regulatory Function

Regulatory functions are generally used to check the functioning of the financial business in the market. They establish rules to regulate the financial intermediaries and corporates for the efficiency of the market. These functions are:

- SEBI designed guidelines and code of conduct for efficient working of financial intermediaries and corporate.
- Established rules for taking over a company.
- Conducts regular inquiries and audits of stock exchanges.
- Regulates the process of mutual funds.
- Registration of brokers, sub-brokers, and merchant bankers is controlled by SEBI.
- Levying of fees is regulated by SEBI.
- Restrictions on private placement.

Development Function

The development functions are the steps taken by SEBI to improve the security of the market through technology. The functions are:

- By providing training sessions to the intermediaries of the market.
- By promoting fair trading and restrictions on malpractices of any kind.
- By introducing the DEMAT format.
- By promoting self-regulating organizations.
- By introducing online trading through registered stock brokers.
- By providing discount brokerage.

Objectives of SEBI

The objectives of SEBI are:

- Protection of investors: The primary objective of SEBI is to protect the rights and interests of the people in the stock market by guiding them to a healthy environment and protecting the money involved in the market.
- Prevention of malpractices: The main objective for the formation of SEBI was to prevent fraud and malpractices related to trading and to regulate the activities of the stock exchange.
- Promoting fair and proper functioning: SEBI was established to maintain the functioning of the capital market and to promote functioning of the stock exchange. They are ordered to keep eyes on the activities of the financial intermediaries and regulate the securities industry efficiently.
- Establishing Balance: SEBI has to maintain a balance between the statutory regulation and self-regulation of the securities industry.
- Establishing a code of conduct: SEBI is required to develop and regulate a code of conduct to avoid frauds and malpractices caused by intermediaries such as brokers, underwriters and other people.

Features of SEBI

Sebi is an organization that is responsible for maintaining an environment that is free from malpractices to restore the confidence of the general public who invest their hard-earned money in the market. SEBI controls the bylaws of every stock exchange in the country. SEBI keeps an eye on all the books of accounts related to the stock exchange and financial intermediaries to check their irregularities. The features of the Security and Exchange Board of India are given below:

- Quasi-Judicial

SEBI is allowed to conduct hearings and can pass judgments on unethical cases and fraudulent trade practices. This feature of SEBI helps to protect transparency, accountability, reliability, and fairness in the capital market.

- Quasi-Legislative

SEBI is allowed to draft legislatures with respect to the capital market. SEBI drafts rules and regulations to protect the interests of the investors. For eg: SEBI LODR or Listing Obligation and Disclosure Requirements. This helps in consolidating and streamlining the provisions of existing listing agreements for several segments of the financial market like equity shares. This helps in protecting the market from malpractices and fraudulent trading activities happening at the bay.

- Quasi-Executive

SEBI covers the implementation of the legislation. They are allowed to file a complaint against any person who violates their rules and regulations. They also have the power to inspect all the books and records to check for wrongdoings.

Establishment of SEBI Act

The Parliament established the Securities and Exchange Board of India Act,1992 or SEBI Act, 1992 to regulate and develop the securities market in India. It was further amended to meet the changes in the developing requirements of the securities market.

Features and Regulations of the Act

Sebi is an organization that is responsible for maintaining an environment that is free from malpractices to restore the confidence of the general public who invest their hard-earned money in the market. SEBI controls the bylaws of every stock exchange in the country. SEBI keeps an eye on all the books of accounts related to the stock exchange and financial intermediaries to check their irregularities. SEBI Act defines and gives powers to the body. The SEBI Act is divided into seven chapters that provide the rules and regulations associated with the capital market.

- The First Chapter is an introductory or preliminary chapter of the Act which provides the title, extent, and definitions of the terms used in the Act.
- The Second Chapter is the establishment of the Securities and Exchange Board of India. This chapter deals with management, employees, meetings, and the office of the board. This provides the necessary details of the board established by this Act.
- The Third Chapter is the transfer of assets, liabilities, etc. of the existing Security and Exchange Board to the Board, which means it declares the provisions to be used to transfer the assets in the case of the formation of a new board.
- The Fourth Chapter is the powers and functions of the Board. This chapter helps in mentioning the powers and functions of the board which are given by the Act. The Board is bound to follow the instructions given by the act and is not allowed to exploit their powers.
- The Fifth Chapter is the Registration Certificate. It deals with the documentation involved in the registration of the stockbrokers, sub-brokers, and share transfer agents, etc.

- The Sixth Chapter is finance, accounts, and audits. This chapter controls all the grants given by the Central Government, funds and accounts, to ensure the productivity of the board as well as the capital market.
- The Seventh Chapter miscellaneous, which discusses other topics that are relevant to the board and the market. To help the board from avoiding mistakes.

The laws and regulations of the Security and Exchange Board of India are very important and must be followed seriously by the people who are entitled or registered with the stock exchange and capital market of India. The SEBI Act, 1992 is the supreme power of the securities market of India and has the authority to make laws and regulations. And these rules and regulations are applied to all the listed companies, their board of directors, key managerial personnel of such companies, investors, and all the other companies who are associated with the security market sector.

The most valuable regulations promoted by SEBI are:

- Regulations on the Issue of Capital and Disclosure Requirements, 2009

These regulations helped with the issues related to capital and disclosure by improving the trading in securities of the listed companies and investors in India.

- Regulations on Substantial Acquisition of Shares and Takeovers, 2011

These regulations of SEBI were established to solve difficulties related to the legal and fair acquisition of shares and takeovers.

- Regulations on Prohibition of Insider Training, 2015

These regulations introduced new provisions for prohibiting the insider training of securities and tries to protect the laws for lawful and fair trading in India.

- The Equity Listing Agreement

These provisions were a reminder of the clauses which mainly dealt with the mandatory compliances to be made between the stock exchange of India and the listed companies.

Scope of Act

The Preamble of the SEBI Act, 1992 provides that SEBI came into force to cover two objectives:

- To protect the interests of investors in Securities.
- To promote the development and regulations of the securities market.

All the provisions and regulations are made to achieve their goal of improving the market and to reach their goal. SEBI acts like a mini-state as it works includes executive, judiciary and legislature. Section 11 of the SEBI Act allows the board to work on its objective.

SEBI controls:

- The regulations of the stock exchange and capital market.
- Prohibition of fraudulent and unfair trade.
- Improving education and training of intermediaries of the securities market.

- Promoting investors and registering intermediaries.
- Regulating substantial acquisition of shares and takeovers of companies.
- Calling for information and records.
- Conducting inquiries of audits and stock exchanges.

SEBI is India's capital market regulator and is trying to benefit the investors by:

- Increasing the trading volumes
- Syncing with the Global Markets
- Hedging

SEBI helped the market participants by consolidating their settlement functions at a single clearing meeting and by reducing the effective trading cost for investors. The board improved the market by allowing the contributions of the foreign participants through certain background checks before entering the Indian Market.

Recognition of Stock Exchanges

'Stock exchange' means any body of individuals, whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities. Such body to be recognised under SCRA and SEBI has to meet certain requirements regarding procedure for application, having a governing board, constitution, bye-laws, rules and regulations, filing of periodical returns, etc. These have been mentioned below:

Application for recognition of stock exchanges: Any stock exchange, which is desirous of being recognised under SEBI Act, has to make an application in the prescribed manner to the Central Government. Such application is to be accompanied by a copy of the bye-laws of the stock exchange for the regulation and control of contracts and also a copy of the rules relating to the constitution of the stock exchange and in particular to-
(a) the governing body of such stock exchange, its constitution and powers of management and the manner in which its business is to be transacted;
(b) the powers and duties of the office bearers of stock exchange;
(c) the admission into the stock exchange of various classes of members, the qualifications for membership, and the exclusion, suspension, expulsion and re-admission of members;
(d) the procedure for the registration of partnership as members of the stock exchange in cases where the rules provide for such membership; and the nomination and appointment of authorised representatives and clerks; and
(e) such other particulars as specifically prescribed.

Grant of recognition to stock exchange: The Central Government may grant recognition if it is satisfied:
(a) that the rules and bye-laws of the stock exchange applying for registration ensure fair dealing and protect investors;
(b) that the stock exchange is willing to comply with any other conditions it may impose for the purpose of carrying out the object of this Act; and

(c) that it would be in the interest of the trade and also in the public interest to grant recognition to the stock exchange. For the grant of recognition to stock exchanges the Central Government may prescribe conditions relating to-
(i) the qualifications for membership of stock exchanges;
(ii) the manner in which contracts shall be entered into and enforced as between members;
(iii) the representation of the Central Government on each of the stock exchanges by such number of persons not exceeding three as the Central Government may nominate in this behalf; and
(iv) the maintenance of accounts of members and their audit by chartered accountants whenever such audit is required by the Central Government.

Renewal of Recognition

Three months before the expiry of the period of recognition, a recognised stock exchange desirous of renewal of such recognition may make an application to the Central Government following the aforesaid provisions.

Withdrawal of Recognition

If the Central Government is of the opinion that the recognition granted to a stock exchange is against the interest of the trade or in the public interest, it may withdraw the recognition granted to the stock exchange after giving due opportunity to the governing body of the stock exchange to explain its position. Such withdrawal has no effect on the validity of any contract entered into or made before the date of withdrawal.

Power of Central Government and SEBI to Call for Periodical

Returns or Direct Inquiries to be Made

1. Every recognised stock exchange has to furnish to SEBI annual report and other periodical returns relating to its affairs as required.
2. Every recognised stock exchange and every member thereof has to maintain and preserve for upto five years, such books of account, and other documents as the Central Government, after consultation with the stock exchange concerned, may prescribe in the interest of the trade or in the public interest. SEBI can inspect these books.

Power of SEBI to Direct an Enquiry

(i) SEBI can direct a recognised stock exchange or any member thereof to furnish in writing such information or explanation relating to the affairs of the stock exchange or of the member in relation to the stock exchange as it may require, or
(ii) Appoint one or more persons to make an inquiry in the prescribed manner in relation to the affairs of the governing body of a stock exchange or the affairs of any of the members of the stock exchange in relation to the stock exchange and submit a report.

Power of recognised stock exchange to make rules restricting voting rights, etc.

A recognised stock exchange may make rules or amend any rules or amend any rules made by it to provide for all or any of the following matters:

(a) the restriction of voting rights to members only in respect of any matter placed before the stock exchange at any meeting;
(b) the regulation of voting rights in respect of any matter placed before the stock exchange at any meeting so that each member may be entitled to have one vote only, irrespective of his share of the paid-up equity capital of the stock exchange;
(c) the restriction on the right of a member to appoint another person as his proxy to attend and vote at a meeting of the stock exchange;
(d) such incidental, consequential and supplementary matters as may be necessary to give effect to any of the matters specified in clauses (a), (b) and (c).

Power of recognised stock exchanges to make bye-laws

Subject to the prior approval of the SEBI, any recognised stock exchange can make bye-laws for the regulation and control of contracts. These bye-laws may provide for-
(a) the opening and closing of markets and the regulation of the hours of trade;
(b) a clearing house for periodical settlement of contracts and differences thereunder, the delivery of and payment for securities, the passing on of delivery order and the regulation and maintenance of such clearing house;
(c) the submission to the Securities and Exchange Board of India by the clearing house as soon as may be after each periodical settlement of all or any of the following particulars as the Securities and Exchange Board of India may, from time to time, require namely:-
(i) the total number of each category of security carried over from one settlement period to another,
(ii) the total number of each category of security, contracts in respect of which have been squared up during the course of each settlement period;
(iii) the total number of each category of security actually delivered at each clearing;
(d) the publication by the clearing house of all or any of the particulars submitted to the Securities and Exchange Board of India under clause (c) subject to the directions, if any, issued by the Securities and Exchange Board of India in this behalf;
(e) the regulation or prohibition of blank transfers;
(f) the number and classes of contracts in respect of which settlements shall be made or differences paid through the clearing house;
(g) the regulation or prohibition of badlas or carry-over facilities;
(h) the fixing, altering or postponing of days for settlements;
(i) the determination and declaration of market rates, including the opening, closing, highest and lowest rates for securities;
(j) the terms, conditions and incidents of contracts, including the prescription of margin requirements, if any, and conditions relating thereto, and the forms of contracts in writing;
(k) the regulation of the entering into, making, performance, rescission and termination, of contracts, including contracts between members or between a member and his constituent or between a member and a person who is not a member, and the consequences of default or insolvency on the part of a seller or buyer or intermediary, the consequences of a breach or omission by a seller or buyer, and the responsibility of members who are not parties to such contracts;
(l) the regulation of taravani business including the placing of limitations thereon;

(m) the listing of securities on the stock exchange, the inclusion of any security for the purpose of dealings and the suspension or withdrawal of any such securities, and the suspension or prohibition of trading in any specified securities;
(n) the method and procedure for the settlement of claims or disputes, including settlement by arbitration;
(o) the levy and recovery of fees, fines and penalties;
(p) the regulation of the course of business between parties to contract in any capacity;
(q) the fixing of a scale of brokerage and other charges;
(r) the making, comparing, settling and closing of bargains;
(s) the emergencies in trade which may arise, whether as a result of pool or syndicated operations or cornering or otherwise, and the exercise of powers in such emergencies, including the power to fix maximum and minimum prices for securities;
(t) the regulation of dealing by members for their own account; and
(u) the separation of the functions of jobbers and brokers;

Submission of annual report

Every recognised stock exchange has to before the 31st day of January in each year of within such extended time as allowed, furnish the Central Government annually with a report about its activities during the preceding calendar year. The report must contain detailed
information about the following:
(i) Changes in rules and bye-laws, if any;
(ii) Changes in the composition of the governing body;
(iii) Any new sub-committees set up and changes in the composition of existing ones;
(iv) Admissions, re-admissions, deaths or resignations of members;
(v) Disciplinary action against members;
(vi) Arbitration of disputes (nature and number) between members and non-members;
(vii) Defaults;
(viii) Action taken to combat any emergency in trade;
(ix) Securities listed and delisted; and
(x) Securities brought on or removed from the forward list. Every recognised stock exchange has also to furnish the Central Government a copy of its audited balance sheet and profit and loss account for its preceding financial year within one month of the date of holding of its annual general meeting.

Submission of periodical returns

Every recognised stock exchange has to furnish the Central Government periodical returns relating to-
(i) The official rates for the securities enlisted thereon;
(ii) The number of shares delivered through the clearing house;
(iii) The making-up prices;
(iv) The clearing house programmes;
(v) The number of securities listed and delisted during the previous three months;
(vi) The number of securities brought on or removed from the forward list during the previous three months; and

(vii) Any other matter as may be specified by the Central Government.

Mutual Fund Liquidity

According to the theory of contrary opinion, it makes sense to go against the crowd because the crowd is generally wrong. Based on this theory, several indicators have been developed. One of them reflects mutual fund liquidity. If mutual fund liquidity is low, it means that the mutual funds are bullish. So contrarians argue that the market is at or near a peak and hence is likely to decline. Thus low mutual fund liquidity is considered as a bearish indicator. Conversely, when the mutual fund liquidity is high, it means that the mutual funds are bearish. So, contrarians believe that the market is at or near a bottom and hence is poised to rise because it is an indication of potential purchasing power that can be injected into the market to lift it upward. . Thus, high mutual fund liquidity is considered as a bullish indication.

Security analysis

INTRODUCTION

Security analysis is the basis for rational investment decisions. If a security's estimated value is above its market price, the security analyst will recommend buying the stock. If the estimated value is below the market price, the security should be sold before its price drops. However, the values of the securities are continuously changing as news about the securities becomes known. The search for the security pricing involves the use of fundamental analysis.

FUNDAMENTAL ANALYSIS: I

fundamental analysis, the security analysts studies the fundamental facts affecting a stock's values, such as company's earnings, their management, the economic outlook, the firm's competition, market conditions etc. Fundamental analysis is primarily concerned with determining the intrinsic value or the true value of a security. For determining the security's intrinsic value the details of all major factors (GNP, industry sales, firm sales and expense etc) is collected or an estimates of earnings per share may be multiplied by a justified or normal prices earnings ratio. After making this determination, the intrinsic value is compared with the security's current market price. If the market price is substantially greater than the intrinsic value the security is said to be overpriced. If the market price is substantially less than the intrinsic value, the security is said to be underpriced. However, fundamental analysis comprises:

1. Economic Analysis
2. Industry Analysis
3. Company Analysis

Here, in this lesson Economic and Industry analysis are explained in detail and the company analysis is discussed the next lesson.

ECONOMIC ANALYSIS

For the security analyst or investor, the anticipated economic environment, and therefore the economic forecast, is important for making decisions concerning both the timings of an investment and the relative investment desirability among the various industries in the economy. The key for the analyst is that overall economic activities manifest itself in the behaviour of the stocks in general. That is, the success of the economy will ultimately include the success of the overall market. For studying the Economic Analysis, the Macro Economic Factors and the Forecasting Techniques are studied in following paragraphs.

MACRO ECONOMIC FACTORS

The macro economy is the study of all the firms operates in economic environment. The key variables to describe the state of economy are explained as below:

1. Growth rate of Gross Domestic Product (GDP): GDP is a measure of the total production of final goods and services in the economy during a year. It is indicator of economic growth. It consists of personal consumption expenditure, gross private domestic investment, government expenditure on goods and services and net export of goods and services. The firm estimates of GDP growth rate are available with a time lag of one or two years. The expected rate of growth of GDP will be 7.5 percent in year 2005-06. Generally, GDP growth rate ranges from 6-8 percent. The growth rate of economy points out the prospects for the industrial sector and the returns investors can expect from investment in shares. The higher the growth rate of GDP, other things being equal, the more favorable it is for stock market.

2. Savings and investment: Growth of an economy requires proper amount of investments which in turn is dependent upon amount of domestic savings. The amount of savings is favorably related to investment in a country. The level of investment in the economy and the proportion of investment in capital market is major area of concern for investment analysts. The level of investment in the economy is equal to: Domestic savings + inflow of foreign capital - investment made abroad. Stock market is an important channel to mobilize savings, from the individuals who have excess of it, to the individual or corporate, who have deficit of it. Savings are distributed over various assets like equity shares, bonds, small savings schemes, bank deposits, mutual fund units, real estates, bullion etc. The demand for corporate securities has an important bearing on stock prices movements. Greater the allocation of equity in investment, favorable impact it have on stock prices.

3. Industry Growth rate: The GDP growth rate represents the average of the growth rate of agricultural sector, industrial sector and the service sector. The current contribution of industry sector in GDP in the year 2004-05 is 6.75 percent approximately. Publicly listed company play a major role in the industrial sector. The stock market analysts focus on the overall growth of different industries contributing in economic development. The higher the growth rate of the industrial sector, other things being equal, the more favourable it is for the stock market.

4. Price level and Inflation: If the inflation rate increases, then the growth rate would be very little. The increasingly inflation rate significantly affect the demand of consumer product industry. The inflation rate in the Indian economy has been around 7 percent till 1990s. In recent years, the inflation rate has fallen significantly. At present it ranges from 4-5 percent (2005). The industry which have a weak market and come under the purview of price control policy of the government may lose the market, like sugar industry. On the other hand the industry which enjoy a strong market for their product and which do not come under purview of price control may benefit from inflation. If there is a mild level of inflation, it is good to the stock market but high rate of inflation is harmful to the stock market.

5. Agriculture and monsoons: Agriculture is directly and indirectly linked with the industries. Hence increase or decrease in agricultural production has a significant impact on the industrial production and corporate performance. Companies using agricultural raw materials as inputs or supplying inputs to agriculture are directly affected by change in agriculture production. For example- Sugar, Cotton, Textile and Food processing industries depend upon agriculture for raw material. Fertilizer and insecticides industries are supplying inputs to agriculture. A good monsoon leads to higher demand for inputs and results in bumper crops. This would lead to buoyancy in stock market. If the monsoon is bad, agriculture production suffers and cast a shadow on the share market.

6. Interest Rate: Interest rates vary with maturity, default risk, inflation rate, productivity of capital etc. The interest rate on money market instruments like Treasury Bills are low, long dated government securities carry slightly higher interest rate and interest rate on corporate debenture is still higher. With the deregulation interest rates are softened, which were quite high in regulated environment. Interest rate affects the cost of financing to the firms. A decrease in interest rate implies lower cost of finance for firms and more profitability and it finally leads to decline in discount rate applied by the equity investors, both of which have a favourable impact on stock prices. At lower interest rates, more money at cheap cost is available to the persons who do business with borrowed money, this leads to speculation and rise in price of share.

7. Government budget and deficit: Government plays an important role in the growth of any economy. The government prepares a central budget which provides complete information on revenue, expenditure and deficit of the government for a given period. Government revenue come from various direct and indirect taxes and government made expenditure on various developmental activities. The excess of expenditure over revenue leads to budget deficit. For financing the deficit the government goes for external and internal borrowings. Thus, the deficit budget may lead to high rate of inflation and adversely affects the cost of production and surplus budget may results in deflation. Hence, balanced budget is highly favourable to the stock market.

8. The tax structure: The business community eagerly awaits the government announcements regarding the tax policy in March every year. The type of tax exemption has impact on the profitability of the industries. Concession and incentives given to certain industry encourages investment in that industry and have favourable impact on stock market.

9. Balance of payment, forex reserves and exchange rate: Balance of payment is the record of all the receipts and payment of a country with the rest of the world. This difference in receipt and payment may be surplus or deficit. Balance of payment is a measure of strength of rupee on external account. The surplus balance of payment augments forex reserves of the country and has a favourable impact on the exchange rates; on the other hand if deficit increases, the forex reserve depletes and has an adverse impact on the exchange rates. The industries involved in export and import are considerably affected by changes in foreign exchange rates. The volatility in foreign exchange rates affects the investment of foreign institutional investors in Indian Stock Market. Thus, favourable balance of payment renders favourable impact on stock market.

10. Infrastructural facilities and arrangements: Infrastructure facilities and arrangements play an important role in growth of industry and agriculture sector. A wide network of communication system, regular supply or power, a well-developed transportation system (railways, transportation, road network, inland waterways, port facilities, air links and telecommunication system) boost the industrial production and improves the growth of the economy. Banking and

financial sector should be sound enough to provide adequate support to industry and agriculture. The government has liberalized its policy regarding the communication, transport and power sector
for foreign investment. Thus, good infrastructure facilities affect the stock market favourable.
11. Demographic factors: The demographic data details about the population by age, occupation, literacy and geographic location. These factors are studied to forecast the demand for the consumer goods. The data related to population indicates the availability of work force. The cheap labour force in India has encouraged many multinationals to start their ventures. Population, by providing labour and demand for products, affects the industry and stock market.
12. Sentiments: The sentiments of consumers and business can have an important bearing on economic performance. Higher consumer confidence leads to higher expenditure and higher business confidence leads to greater business investments. All this ultimately leads to economic growth. Thus, sentiments influence consumption and investment decisions and have a bearing on the aggregate demand for goods and services.

ECONOMIC FORECASTING TECHNIQUES

To estimate the stock price changes, an analyst has to analyze the macro economic environment. All the economic activities affect the corporate profits, investor's attitudes and share price. For the purpose of economic analysis and in order to decide the right time to invest in securities some techniques are used. These are explained as below:
1. Anticipatory Surveys: Under this prominent people in government and industry are asked about their plans with respect to construction, plant and equipment expenditure, inventory adjustments and the consumers about their future spending plans. To the extent that these people plan and budget for expenditure in advance and adhere to their intentions, surveys of intentions constitute a valuable input in forecasting process. It is necessary that surveys of intentions be based on elaborate statistical sampling procedures, the greatest short coming of intentions, surveys is that the forecaster has no guarantee that the intention will be carried out. External shocks, such as strikes, political turmoil or government action can cause changes in intentions.
2. *Barometric or Indicator approach:* Barometric technique is based on the presumption that relationship can exist among various economic time series. For example, industrial production overtime and industrial loans by commercial banks over time may move in same direction. Historical data are examined in order to ascertain which economic variables have led, lagged after of moved together with the economy. A leading indicator may be leading because it measures something that overshadows a change in production activity. Examples of these indicators are highlighted in Figure-1. There are three kind of relationships among economic time series:
a) Leading series: Leading series consists of the data that move ahead of the series being compared. For example, applications for the amount of housing loan over time is a leading series for the demand of construction material, birth rate of children is the leading series for demand of seats in schools etc. In other words, leading indicators are those time series data that historically reach their high points (peaks) or their low points (troughs) in advance of total economic activity.
b) Coincident series: When data in series moves up and down along with some other series, it is known as coincident series. A series of data on national income is often coincident with the series of employment in an economy (over a short-period). In other words, coincident indicators reach their peaks or trough at approximately the same time as the economy.

c) Lagging series: Where data moves up and down behind the series being compared, example, data on industrial wages over time is a lagging series when compared with series of price index for industrial workers. They reach their turning points after the economy has already reached its own.

3. Diffusion Indexes: Some of the indicators appear in more than one class, and then the problem of choice may arise. Furthermore, it is not advisable to rely on just one of the indicators. This leads to the usage of what is referred to as the diffusion index. A diffusion index copes with the problem of differing signals given by the indicators. It is percentage of rising indicators. In this method a group of leading indicators is initially chosen. Then the percentage of the group of chosen indicators which have fallen (or, risen) over the last period is plotted against time to get the diffusion index. For example, if there are say 9 leading indicators for forecasting the construction activity of dwelling units and if by plotting we find that say, 6 indices show a rise, then we can calculate that diffusion index is (6/9*100) = 66.7 percent. When the index exceeds 50 percent, we can predict a rise in forecast variable.

4. Money and Stock Prices: Monetary theory in its simplest form states that fluctuations in the rate of growth of money supply are of utmost importance in determining GNP, corporate profits, interest rates, stock prices etc. Monetarists contend that changes in growth rate of money supply set off a complicated series of events that ultimately affects share prices. In addition, these monetary changes lead stock price changes. Thus, while making forecasts, changes in growth rate of money supply should be given due importance. Some thinkers states that stock market leads changes in money supply. However, sound monetary policy is a necessary ingredient for steady growth and stable prices.

5. Econometric Model Building: The econometric methods combine statistical tools with economic theories to estimate economic variables and to forecast the intended economic variables. The forecast made through econometric method are much more reliable than those made through any other method. For applying econometric technique, the user is to specify in a formal mathematical manner the precise relation between the dependent and independent variable. In using econometrics, the forecaster must quantify precisely the relationships and assumptions he is making. This not only gives him direction but also the magnitudes. An econometric model may be a single-equation regression model or it may consist of a system of simultaneous equations. Single equation regression serves the purpose of forecasting in many cases. But where the relationship between economic variables are complex and variable are so interrelated that unless one is determined, the other cannot be determined, a single-equation regression model does not serve the purpose. In that case, a system of simultaneous equations is used to estimate and forecast the target variable.

6. Opportunistic Model Building: Opportunistic model building or GNP model building or sectoral analysis is widely used forecasting method. Initially, the forecaster must hypothesize total demand and thus total income during the forecast period. Obviously, this will necessitate assuming certain environmental decisions, such as war or peace, political relationships among the level of interest rates. After, this work has been done, the forecaster begins building a forecast of the GNP figure by estimating the levels of the various component of GNP like the number of consumption expenditures, gross private domestic investment, government purchases of goods and services and net exports. After adding the four major categories the forecaster comes up with a GNP forecast. Now he tests this total for consistency with an independently arrived at a priori forecast of GNP.

INDUSTRY ANALYSIS

The mediocre firm in the growth industry usually out performs the best stocks in a stagnant industry. Therefore, it is worthwhile for a security analyst to pinpoint growth industry, which has good investment prospects. The past performance of an industry is not a good predictor of the future- if one look very far into the future. Therefore, it is important to study industry analysis. For an industry analyst- industry life cycle analysis, characteristics and classification of industry is important. All these aspects are enlightened in following sections:

INDUSTRY LIFE CYCLE ANALYSIS

Many industrial economists believe that the development of almost every industry may be analyzed in terms of following stages (Figure-2):

1. Pioneering stage: During this stage, the technology and product is relatively new. The prospective demand for the product is promising in this industry. The demand for the product attracts many producers to produce the particular product. This lead to severe competition and only fittest companies survive in this stage. The producers try to develop brand name, differentiate the product and create a product image. This would lead to non-price competition too. The severe competition often leads to change of position of the firms in terms of market share and profit.

2. Rapid growth stage: This stage starts with the appearance of surviving firms from the pioneering stage. The companies that beat the competition grow strongly in sales, market share and financial performance. The improved technology of production leads to low cost and good quality of products. Companies with rapid growth in this stage, declare dividends during this stage. It is always advisable to invest in these companies.

3. Maturity and stabilization stage: After enjoying above-average growth, the industry now enters in maturity and stabilization stage. The symptoms of technology obsolescence may appear. To keep going, technological innovation in the production process should be introduced. A close monitoring at industries events are necessary at this stage.

4. Decline stage: The industry enters the growth stage with satiation of demand, encroachment of new products, and change in consumer preferences. At this stage the earnings of the industry are started declining. In this stage the growth of industry is low even in boom period and decline at a higher rate during recession. It is always advisable not to invest in the share of low growth industry.

CHARACTERISTICS OF AN INDUSTRY ANALYSIS

In an industry analysis, the following key characteristics should be considered by the analyst. These are explained as below:

1. Post sales and Earnings performance: The two important factors which play an important role in the success of the security investment are sales and earnings. The historical performance of sales and earnings should be given due consideration, to know how the industry have reacted in the past. With the knowledge and understanding of the reasons of the past behaviour, the investor can assess the relative magnitude of performance in future. The cost structure of an industry is also an important factor to look into. The higher the cost component, the higher the sales volume necessary to achieve the firm’s break-even point, and vice-versa.

2. Nature of Competition: The numbers of the firms in the industry and the market share of the top firms in the industry should be analyzed. One way to determine competitive conditions is to observe whether any barriers to entry exist. The demand of particular product, its profitability and price of concerned company scrip's also determine the nature of competition. The investor before investing in the scrip of a company should analyze the market share of the particular company's product and should compare it with other companies. If too many firms are present in the organized sector, the competition would be severe. This will lead to a decline in price of the product.

3. Raw Material and Inputs: Here, we have to look into the industries, which are dependent upon imports of scarce raw material, competition from other companies and industries, barriers to entry of a new company, protection from foreign competition, import and export restriction etc. An industry which has a limited supply of materials domestically and where imports are restricted will have dim growth prospects. Labour is also an input and industries with labour problems may have difficulties of growth.

4. Attitude of Government towards Industry: It is important for the analyst or prospective investor to consider the probable role government will play in industry. Will it provide financial support or otherwise? Or it will restrain the industry's development through restrictive legislation and legal enforcement? The government policy with regard to granting of clearance, installed capacity and reservation of the products for small industry etc. are also factors to be considered for industry analysis.

5. Management: An industry with many problems may be well managed, if the promoters and the management are efficient. The management likes Tatas, Birla's, Ambani's etc. who have a reputation, built up their companies on strong foundations. The management has to be assessed in terms of their capabilities, popularity, honesty and integrity. In case of new industries no track record is available and thus, investors have to carefully assess the project reports and the assessment of financial institutions in this regard. A good management also ensures that the future expansion plans are put on sound basis.

6. Labour Conditions and Other Industrial Problems: The labour scenario in a particular industry is of great importance. If we are dealing with a labour intensive production process or a very mechanized capital intensive process where labour performs crucial operations, the possibility of strike looms as an important factor to be reckoned with. Certain industries with problems of marketing like high storage costs, high transport costs etc leads to poor growth potential and investors have to careful in investing in such companies.

7. Nature of Product Line: The position of the industry in the life cycle of its growth- initial stage, high growth stage and maturing stage are to be noted. It is also necessary to know the industries with a high growth potential like computers, electronics, chemicals, diamonds etc., and whether the industry is in the priority sector of the key industry group or capital goods or consumer goods groups. The importance attached by the government in their policy and of the Planning Commission in their assessment of these industries is to be studied.

8. Capacity Installed and Utilized: The demand for industrial products in the economy is estimated by the Planning Commission and the Government and the units are given licensed capacity on the basis of these estimates. If the demand is rising as expected and market is good for the products, the utilization of capacity will be higher, leading to bright prospects and higher profitability. If the quality of the product is poor, competition is high and there are other constraints to the availability of inputs and there are labour problems, then the capacity utilization will be low and profitability will be poor.

9. Industry Share Price Relative to Industry Earnings: While making investment the current price of securities in the industry, their risk and returns they promise is considered. If the price is very high relative to future earnings growth, the investment in these securities is not wise. Conversely, if future prospects are dim but prices are low relative to fairly level future patterns of earnings, the stocks in this industry might be an attractive investment.
10. Research and Development: For any industry to survive in the national and international markets, product and production process have to be technically competitive. This depends upon the research and development in the particular industry. Proper research and development activities help in obtaining economic of scale and new market for product. While making investment in any industry the percentage of expenditure made on research and development should also be considered.
11. Pollution Standards: These are very high and restricted in the industrial sector. These differ from industry to industry, for example, in leather, chemical and pharmaceutical industries the industrial effluents are more.

TECHNIQUES FOR EVALUATING RELEVANT INDUSTRY FACTORS

The techniques (long term and short term) for evaluating industry factors are explained in the following sections. These are:
1. End-Use and Regression Analysis: End-use analysis for product demand analysis refers to a process whereby the analyst attempts to diagnose the factors that determine the demand for output of the industry. In a single product firm, units demanded multiplied by price will equal sales revenue. The analyst frequently forecast the factors like disposable income, per capita consumption, price elasticity of demand etc. that influence the demand of the product. For studying the relationship between various variables simple linear regression analysis and correlation analysis is used. Industry sales against time, industry sales against macro-economic variables like gross national product, personal income disposable income and industry earnings over time may be regressed. When two or more independent variables are better able to explain variability in the dependent variables, the multiple regression analysis is used.
2. Input-Output Analysis: It is a way of getting inside demand analysis or end use analysis. It reflects the flow of goods and services through the economy including intermediate steps in the production process as goods proceed from raw material stage to final consumption stage. Thus input-output analysis observes patterns of consumption at all stages in order to direct any changing patterns or trends that might indicate the growth or decline on industries. This technique is more appropriate for an intermediate or long term forecast than for short term forecast.
3. Growth Rate: The growth rate of different industry should be forecasted by considering historical data. Once the growth rate is estimated, future values of earnings or sales may be forecast. Since the growth rate is such an important factor in determining the stock prices, not only its size but its duration must be estimated. Sometimes, patents expire, competition with in an industry becomes more aggressive because foreign firms begin to compete, economically depressed periods occur or other factors cause growth rate to drop. we have discussed about Economic Analysis and Industry Analysis and now in this lesson light is thrown on company analysis. In the company analysis the investment analyst collect all the information related to the company and evaluates the present and future value of the stock. In this analysis, all the factors affecting the earnings of a particular company are considered. The risk and return associated

with the purchase of a stock is analyzed to take a better investment decisions. The valuation process depends upon the investor ability to elicit information from the relationship.

FUNDAMENTAL ANALYSIS: II

and inter-relationship among the company related variables. Up-to date information is required on the status and trends in the economy, particular industries and firms. Success in investing will be largely dependent on:

- Discovering new and credible information rapidly and in more details then others do. This depends upon the analyst ability to develop a system that couples original thoughts and unique ways of forming expectations about the prospects for individual company. For this purpose various public and private sources of information are analyzed.
- Applying superior judgement so as to ascertain the relevance of information to the decision at hand. Judgement depends upon one's knowledge and experiences. By applying various tools of analysis to the data, the investor formulates expectations and judgement about the alternatives available to him. For company analysis, the internal and external information need to be studied. *Internal information* consists of data and events made public by firms concerning their operations. The principle information sources generated internally by a firm are its financial statements. *External sources* of information are those generated independently outside the company. They provide supplement to internal sources. A good analyst must train himself to understand the kind of flexibility permitted in accounting and the effect of this flexibility on his interpretation of what he sees. For company analysis, the factors that need to be considered and the methods of analyzing financial statement of the company are highlighted in following lines.

COMPANY ANALYSIS

Fundamental analysis is the method of analyzing companies based on factors that affect their intrinsic value. There are two sides to this method: the quantitative and the qualitative. The *quantitative side* involves looking at factors that can be measured numerically, such as the company's assets, liabilities, cash flow, revenue and price to earnings ratio. The limitation of quantitative analysis, however, is that it does not capture the company's aspects or risks unmeasurable by a number - things like the value of an executive or the risks a company faces with legal issues. The analysis of these things is the other side of fundamental analysis: the *qualitative side or nonnumber side*. Although relatively more difficult to analyze, the qualitative factors are an important part of a company. Since they are not measured by a number, they more represent an either negative or positive force affecting the company. But some of these qualitative factors will have more of an effect, and determining the extent of these effects is what is so challenging. To start, identify a set of qualitative factors and then decide which of these factors add value to the company, and which of these factors decrease value. Then determine their relative importance. The qualities one analyzes can be categorized as having a positive effect, negative effect or minimal effect. The best way to incorporate qualitative analysis into evaluation of a company is to do it once you have done the quantitative analysis. The conclusion come to on the qualitative side can put quantitative analysis into better perspective. If when looking at the company numbers one saw good reason to buy/invest in the company, but then

found many negative qualities, he may want to think twice about buying/investing. Negative qualities might include potential litigations, poor R and D prospects or a board full of insiders.
The conclusions of qualitative analysis either reconfirm or raise questions about the conclusions of quantitative analysis. Fundamental analysis is not as simple as looking at numbers and computing ratios; it is also important to look at influences and qualities that do not have a number value. The present and future values are affected by the following factors (*Figure-1*):

1) Competitive Edge: Many industries in India are composed of hundreds of individuals companies. The large companies are successful in meeting the competition and some companies rise to the position of eminence and dominance. The companies who have obtain the leadership position; have proven his ability to withstand competition and to have a sizable share in the market.
The competitiveness of the company can be studied with the help of:
a) Market share: The market share of the company helps to determine a company's relative position within the industry. If the market share is high, the company would be able to meet the competition successfully. The size of the company should also be considered while analyzing the market share, because the smaller companies may find it difficult to survive in the future.
b) Growth of annual sales: Investor generally prefers to study the growth in sales because the larger size companies may be able to withstand the business cycle rather than the company of smaller size. The rapid growth keeps the investor in better position as growth in sales is followed by growth in profit. The growth in sales of the company is analyzed both in rupee terms and in physical terms.
c) Stability of annual sales: If a firm has stable sales revenue, other things being remaining constant, will have more stable earnings. Wide variation in sales leads to variation in capacity utilization, financial planning and dividends. This affects the company's position and investor's decision to invest.

2) Earnings: The earning of the company should also be analyzed along with the sales level. The income of the company is generated through the operating (in service industry like banks-interest on loans and investment) and non-operating income (ant company, rentals from lease, dividends from securities). The investor should analyze the sources of income properly. The investor should be well aware with the fact that the earnings of the company may vary due to following reasons:

- Change in sales.
- Change in costs.
- Depreciation method adopted.
- Inventory accounting method.
- Wages, salaries and fringe benefits.
- Income tax and other taxes.

3) Capital Structure: Capital structure is combination of owned capital and debt capital which enables to maximize the value of the firm. Under this, we determine the proportion in which the capital should be raised from the different securities. The capital structure decisions are related with the mutual proportion of the long term sources of capital. The owned capital includes share capital
a) Preference shares: Preference shares are those shares which have preferential rights regarding the payment of dividend and repayment of capital over the equity shareholders. At present many

companies resort to preference shares. The preference shares induct some degree of leverage in finance. The leverage effect of the preference shares is comparatively lesser than that the debt because the preference shares dividend are not tax deductible. If the portion of preference share in the capital is large, it tends to create instability in the earnings of equity shares when the earnings of the company fluctuate.
b) Debt: It is an important source of finance as it has the specific benefit of low cost of capital because interest is tax deductible. The leverage effect of debt is highly advantageous to the equity shareholders. The limits of debt depend upon the firm's earning capacity and its fixed assets.

4) Management: The basic objective of the company is to attain the stated objectives of the company for the good of the equity holders, the public and employees. If the objectives of the company are achieved, investor will have a profit. Good management results in high profit to investors. Management is responsible for planning, organizing, actuating and controlling the activities of the company. The good management depends upon the qualities of the manager.

5) Operating Efficiency: The operating efficiency of the company directly affects the earnings capacity of a company. An expanding company that maintains high operating efficiency with a low break even point earns more than the company with high break even point. If a firm has stable operating ratio, the revenues also would be stable. Efficient use of fixed assets with raw materials, labour and management would lead to more income from sales. This leads to internal fund generation for the expansion of the firm.

6) Financial Performance:

a) Balance Sheet: The level, trends, and stability of earnings are powerful forces in the determination of security prices. Balance sheet shows the assets, liabilities and owner's equity in a company. It is the analyst's primary source of information on the financial strength of a company. Accounting principles dictate the basis for assigning values to assets. Liability values are set by contracts. When assets are reduced by liabilities, the book value of share holder's equity can be ascertained. The book value differs from current value in the market place, since market value is dependent upon the earnings power of assets and not their cost of values in the accounts.

b) Profit and Loss account: It is also called as income statement. It expresses the results of financial operations during an accounting year i.e. with the help of this statement we can find out how much profit or loss has taken place from the operation of the business during a period of time. It also helps to ascertain how the changes in the owner's interest in a given period has taken place due to business operations. Last of all, for analyzing the financial position of any company following factors need to be considered for evaluating present situation and prospects of company.

COMPANY ANALYSIS: THE STUDY OF FINANCIALS STATEMENTS

Financial statement means a statement or document which explains necessary financial information. Financial statements express the financial position of a business at the end of accounting period (Balance Sheet) and result of its operations performed during the year (Profit and Loss Account). In order to determine whether the financial or operational performance of company is satisfactory or not, the financial data are analyzed. Different methods are used for this purpose. The main techniques of financial analysis are:

1. Comparative Financial Statements
2. Trend Analysis
3. Common Size Statement
4. Fund Flow Statement
5. Cash Flow Statement
6. Ratio Analysis

1) Comparative Financial Statements: In comparative financial statement, the financial statements of two periods are kept by side so that they can be compared. By preparing comparative statement the nature and quantum of change in different items can be calculated and it also helps in future estimates. By comparing with the data of the previous years it can be ascertained what type of changes in the different items of current year have taken place and future trends of business can be estimated.

2) Trend Analysis: In order to compare the financial statements of various years trend percentages are significant. Trend analysis helps in future forecast of various items on the basis of the data of previous years. Under this method one year is taken as base year and on its basis the ratios in percentage for other years are calculated. From the study of these ratios the changes in that item are examined and trend is estimated. Sometimes sales may be increasing continuously and the inventories may also be rising. This would indicate the loss of market share of a particular company’s product. Likewise sales may have an increasing trend but profit may remain the same. Here the investor has to look into the cost and management efficiency of the company.

3) Common Size Statement: Common size financial statements are such statements in which items of the financial statements are converted in percentage on the basis of common base. In common size Income Statement, net sales may be considered as 100 percent. Other items are converted as its proportion. Similarly, for the Balance sheet items total assets or total liabilities may be taken as 100 percent and proportion of other items to this total can be calculated in percentage.

4) Fund Flow Statement: Income Statement or Profit or Loss Account helps in ascertainment of profit or loss for a fixed period. Balance Sheet shows the financial position of business on a particular date at the close of year. Income statement does not fully explain funds from operations of business because various non-fund items are shown in Profit or Loss Account. Balance Sheet shows only static financial position of business and financial changes occurred during a year can’t be known from the financial statement of a particular date. Thus, Fund Flow Statement is prepared to find out financial changes between two dates. It is a technique of analyzing financial statements. With the help of this statement, the amount of change in the funds of a business between two dates and reasons thereof can be ascertained. The investor could see clearly the amount of funds generated or lost in operations. These reveal the real picture of the financial position of the company.

5) Cash Flow Statement: The investor is interested in knowing the cash inflow and outflow of the enterprise. The cash flow statement expresses the reasons of change in cash balances of company between two dates. It provides a summary of stocks of cash and uses of cash in the organization. It shows the cash inflows and outflows. Inflows (sources) of cash result from cash profit earned by the organization, issue of shares and debentures for cash, borrowings, sale of assets or investments, etc. The outflows (uses) of cash results from purchase of assets, investment redemption of debentures or preferences shares, repayment of loans, payment of tax, dividend, interest etc. With the help of cash flow statement the investor can review the cash movement over an operating cycle. The factors responsible for the reduction of cash balances in spite of increase in profits or vice versa can be found out.

6) Ratio Analysis: Ratio is a relationship between two figures expressed mathematically. It is quantitative relationship between two items for the purpose of comparison. Ratio analysis is a technique of analyzing financial statements. It helps in estimating financial soundness or weakness. Ratios present the relationships between items presented in profit and loss account and balance sheet. It summaries the data for easy understanding, comparison and interpretation. The ratios are divided in the following group:

a) Liquidity Ratios: Liquidity rations means ability of the company to pay the short term debts in time. These ratios are calculated to analyze the short term financial position and short term financial solvency of firm. Commercial banks and short term creditors are interested in such analysis. These ratios are:
i) Current Ratio = Current Assets/Current Liabilities
ii) Acid Test Ratio = (Current assets – Inventories)/Current Liabilities

b) Turnover Ratios: These ratios show how well the assets are used and the extent of excess inventory. The different type of turnover ratios are as follows:
i) Inventory turnover ratio = Net Sales/Inventory
ii) Receivables turnover ratio = Net Sales/Receivables
iii) Fixed assets turnover ratio = Net Sales/Fixed Assets
iv) Total assets turnover ratio = Net Sales/Total Assets

c) Profit Margin Ratios: Earning of more and more profit with the optimum use of available resources of business is called profitability. The investor is very particular in knowing net profit to sales, net profit to total assets and net profit to equity.
The profitability ratio measures the overall efficiency and control of firm.

Net Profit Margin = Profit after Tax/Sales

The technical approach is the oldest approach to equity investment dating back to the late 19th century. It continues to flourish in modern times as well. As an investor, we often encounter technical analysis because newspapers cover it; television programmers routinely call technical experts for their comments and investment advisory services circulate technical reports. As an approach to investment analysis, technical analysis is radically different from fundamental analysis.

The basic differences are –

1. While the fundamental analysis believes that the market is 90 percent logical and 10percent psychological, the technical analysis assumes that the market is 90 percent psychological and 10 percent logical.
2. Like fundamental analysis, technical analysis does not evaluate the large number of fundamental factors relating to the company, the industry and the economy but in it, the internal market data is analyzed with the help of charts and graphs.
3. Technical analysis mainly seeks to predict short-term price movement appealing the short-term traders where fundamental analysis tries to establish long-term values. Hence, it appeals to long tern investors.
4. The technical analysis is based on the premise that the history repeats itself. Therefore, the technical analysis answers the question "What had happened in the market" while on the basis of potentialities of market fundamental analysis answers the question, "What will happen in the market".

Meaning of Technical Analysis

Technical analysis involves a study of market-generated data like prices and volumes to determine the future direction of price movement. It is a process of identifying trend reversal at an earlier stage to formulate the buying and selling strategy. With the help of several indicators, the relationship between price –volume and supply-demand is analyzed for the overall market and individual stocks.

Assumptions

The basic premises, on which technical analysis is formulated, are as follows:

1. The market value of the scrip is determined by the interaction of demand and supply.
2. Supply and demand is governed by numerous factors, both rational and irrational. These factors include economic variables relied by the fundamental analysis as well as opinions, moods and guesses.
3. The market discounts everything. The price of the security quoted represents the hope, fears and inside information received by the market players. Insider information regarding the issuance of bonus shares and right issues may support the prices. The loss of earnings and information regarding the forthcoming labor problem may result in fall in price. These factors may cause a shift in demand and supply, changing the direction of trends.
4. The market always moves in the trends except for minor deviations.
5. It is known fact that history repeats itself. It is true to stock market also. In the rising market, investors' psychology has upbeats and they purchase the shares in great volumes driving the prices higher. At the same time in the down trend, they may be very eager to get out of the market by selling them and thus plunging the share price further. The market technicians assume that past prices predict the future.
6. As the market always moves in trends, analysis of past market data can be used to predict future price behavior.

Evaluation of Technical Analysis

Technical analysis appears to be a high controversial approach to security analysis. The analysts offer arguments as well as disarguments for this alternative of security analysis. Among them, few are as follows:

Arguments

1. Under the influence of crowd psychology, trends persist for quite some time. Tools of technical analysis that help in identifying these trends early are helpful in investment decision-making.
2. Shifts in demand and supply are gradual rather than instantaneous. Technical analysis helps in detecting these shifts rather early and hence provides clues to future price movements,
3. Fundamental information about a company is absorbed and assimilated by the market over the period of time. Hence, the price movement tends to continue in more or less in the same direction till the information is fully assimilated in the market.
4. Charts provide a picture of what has happened in the past and hence give a sense of volatility that can be expected from the stock. Further, the information on trading volume, which is ordinarily provided at the bottom of a bar chart, gives a fair idea of the extent of public interest in the stock.

Disagreements

1. Most technical analysts are not able to offer convincing explanations for the tools employed by them.
2. Empirical evidence in support of the random walk hypothesis casts its shadow over the usefulness of technical analysis.
3. By the time an uptrend or downtrend may have been signaled by the technical analysis, may already have taken place.
4. Ultimately, technical analysis must be a self-defeating proposition. As more and more people employ it, the value of such analysis tends to decline.
5. There is a great deal of ambiguity in the identification of configurations as well as trend lines and channels on the charts. The same chart can be interpreted differently. Despite these limitations, technical analysis is very popular. It is only in the rational, efficient and well-ordered market where technical analysis has no use. But given the imperfections, inefficiencies and irrationalities that characterize real markets, technical analysis can be helpful. Hence, it can be concluded that technical analysis may be used, albeit to a limited extent, in conjunction with fundamental analysis to guide investment decision-making, as it is supplementary to fundamental analysis rather than substitute for it.

Credit rating agencies

Credit rating is a fee-based financial advisory service for the evaluation of a specific instrument (especially debt, share, and so on), and is intended to grade different instruments in terms of the credit risk associated with the particular instrument. Rating is only an opinion expressed by an independent professional organisation following a detailed study of all the relevant factors. It does not amount to a recommendation to buy, hold, or sell an instrument as it does not take into consideration factors such as market prices, personal risk preferences of an investor, and other factors that influence an investment decision. Credit rating is beneficial to investors, companies, banks, and financial institutions. SEBI will grant registration to a credit rating agency if a public financial institution, a bank, or a foreign credit rating agency having at least five years' experience in rating securities promotes the applicant. A company or a body corporate having continuous networth of minimum Rs. 100 crores as per its audited annual accounts for the preceding five years may also promote the credit rating agency. Every credit rating agency must enter into a written agreement with each client whose securities it proposes to rate. The agreement deals with the rights and liabilities of each party in respect of the rating of securities, the fee to be charged by the credit rating agency, and a periodic review of the rating. The client has to agree to cooperate with the credit rating agency, and a periodic review of the rating. The client has to agree to cooperate with the credit rating agency in order to enable the latter to arrive at, and maintain, a true and accurate rating of the client's securities and in particular provide true, adequate, and timely information for the purpose. The credit rating agency must disclose to the client the rating assigned to its securities through regular methods of dissemination, irrespective of whether the rating is or is not accepted by the client. A credit rating agency cannot withdraw a rating so long as the obligations under the security rated by it are outstanding, except where the company whose security is rated is wound up or merged or amalgamated with another company. Every credit rating agency has to make public the definitions of the concerned rating, along with the symbol, and also state that the ratings do not constitute a recommendation to buy, hold, or sell any security. The credit rating agency has to give the public information relating to the rationale of the ratings, which covers an analysis of the various factors justifying a favourable assessment, as well as factors constituting a risk.

The rating agency also has to comply with the requirement of maintaining books of accounts and other relevant information as per SEBI regulations. The credit rating agency has to treat as confidential, information supplied to it by the client and it cannot disclose the same to any other person, except where such disclosure is required or permitted by law. No credit rating agency can rate a security issued by its promoter. In case the promoter is a lending institution, its chairman, director, or employees cannot be a chairman, director, or employees of the credit rating agency or its rating committee. No credit rating agency can rate a security issued by a borrower or a subsidiary or an associate of its promoter, if the chairman, directors, or employees are common. The credit rating agency cannot rate a security issued by its associate or subsidiary, if the credit rating agency or its rating committee has a chairman, director or employee who is also a chairman, director or employee of any such entity.