**Investment Management**
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**Lecture - 03**
**Types of Investments**

Hello there. Welcome back to the course Investment Management. And, we are discussing about the Financial Institutions and Market. Subsequently, we would like to understand what are the types of investment that are available for in investors in the markets and that are channelized through institutions.

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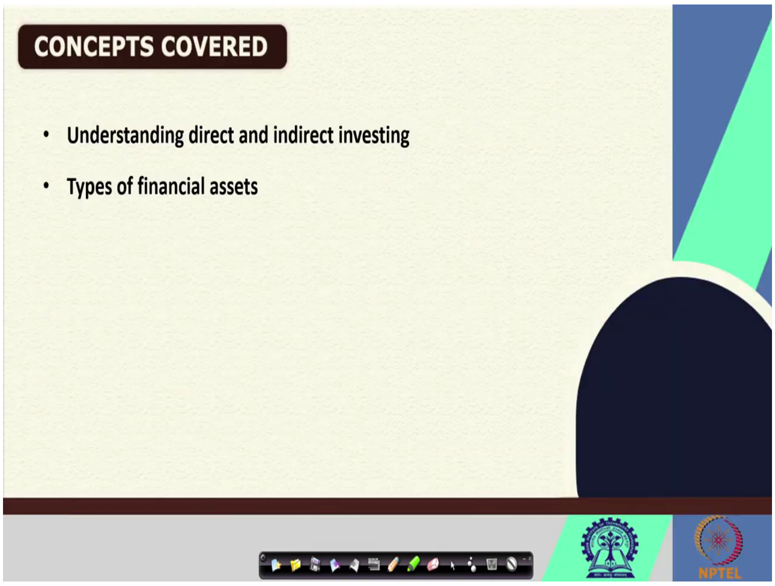

So, this session is about Types of Investment. Essentially, we will discuss in the session about the direct and indirect investing that investors can adopt and different types of financial assets that we can use for generalizing our savings towards investment.

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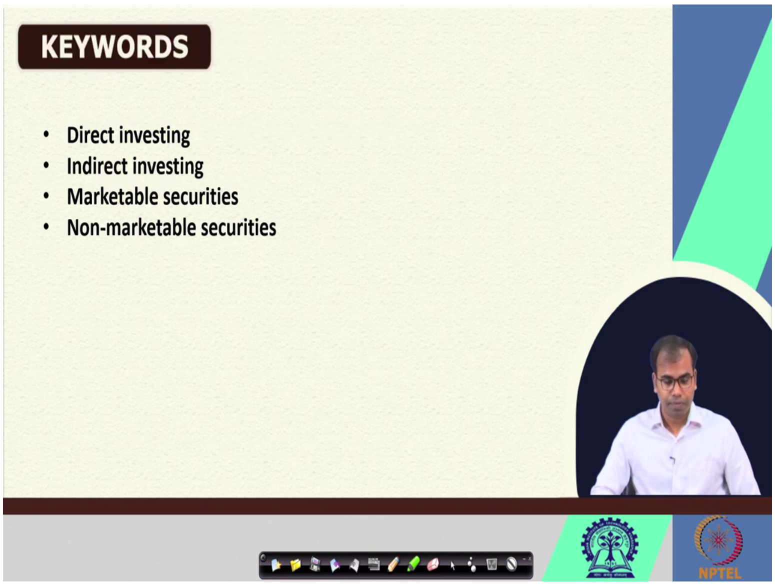


Essentially, we are going to start with the mode through which direct and indirect investing operates. And then what are the marketable and non-marketable securities, that are available for investors in the market through those institutions.

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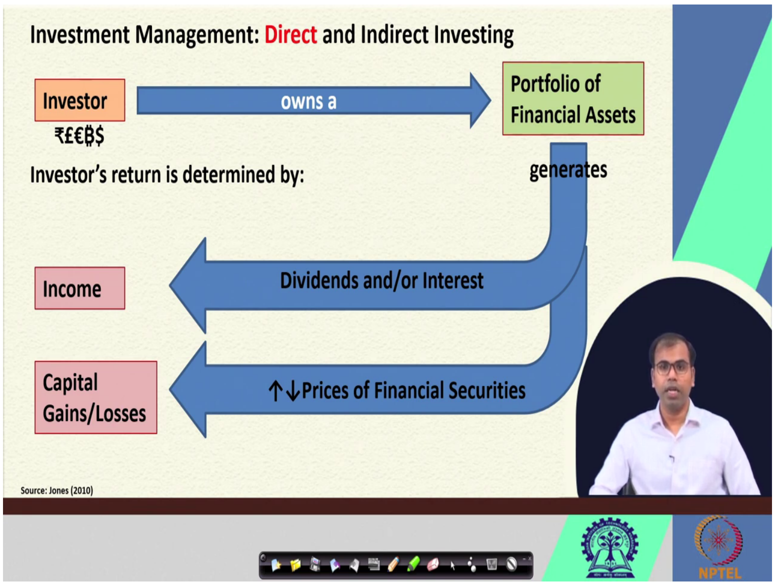


So, to start with, if we look at direct approach of investment or the mode the approach through which an investor can invest her savings directly in different different instruments or different financial securities. Typically, it begins with an investor having some amount of money for investment in the form of savings or investable fund and that fund can be used to own a financial asset. This asset could be individual asset or a portfolio of financial asset as well.

For example, if I hold one share of a company, then I hold an individual financial asset. But if I have shares of company A and company B as well as I own a bond issued by a particular government or a company, then I typically hold a portfolio of financial assets. So, an individual with some amount of investable fund can use that money to own individual security or a portfolio of financial asset.

Now, that portfolio of financial asset usually is used to generate returns for the investor which means investors return is determined by income that is generated by a portfolio of financial assets in the form of dividend and interest, depending on what type of investment we have made.

So, if we hold a portfolio of financial assets which comprises bonds, then I will be earning bond interest on bonds. And if I have portfolio of financial assets comprising of stocks, then I will be earning income in the form of dividends. And if my portfolio consists of both bonds and stocks then I will be earning both interest and dividend to be determined as my income. That is one source of income for the investor.

Another source of income for the investor could be the appreciation or depreciation in the prices of financial securities. Suppose, I own share of a company that I have purchased for 100 rupees a share and that I did on 1st January 2022. On 31st December 2022, I observed that the price of that share has gone up from 100 rupees to 120 rupees, which means I have 20 rupees of appreciation in the price of that financial security.

And already the company has declared a dividend of 10 rupees on that share, which means in the period of 1 year, I have earned 10 rupees of dividend and I have also gained a notional capital gain of 20 rupees. So, my total return on that investment will be 100, 10 rupees of dividend income and 20 rupees of capital appreciation or capital gain.

So, if I sell my share on 31st December 2022, then I will be earning 10 rupees of dividend income plus 20 rupees of capital appreciation. So, total income of 30 rupees on an investment of 100 rupees in the beginning. So, on 1st January 2022, I had invested 100 rupees. And when I sell that investment on 31st December 2022, so total return that I have generated is 30 rupees on an investment of 100 rupees. So, my total return is 30 percent.

This may be different if the price of financial security is go down. So, for example, if that share on 31st December 2022 is worth 85 only, then I have lost the value of that share by 15 rupees. So, my total return will be 10 rupees of dividend income and negative capital appreciation, in a capital loss essentially.

So, 15 rupees of capital loss. So, total return is 10 rupees minus 15 rupees, so minus 5 rupee. So, my invest, as an investor my return would be minus 5 rupee on an investment of 100 rupees. So, I have lost 5 percent of my investment value. So, that is how direct investing works.

Now, calculation of return on investment would be very similar across all approaches of investment, but the holding that I have explained in the form of owning direct share in a company or a bond that is issued by a company or a government is typically the form of direct investing.

Which means, if investor holds the share or bond or any other financial asset directly, then it is a direct investment. On the other hand, if the investor does not own the share of a issued by a company or a bond issued by a company directly, then it is called indirect investing.

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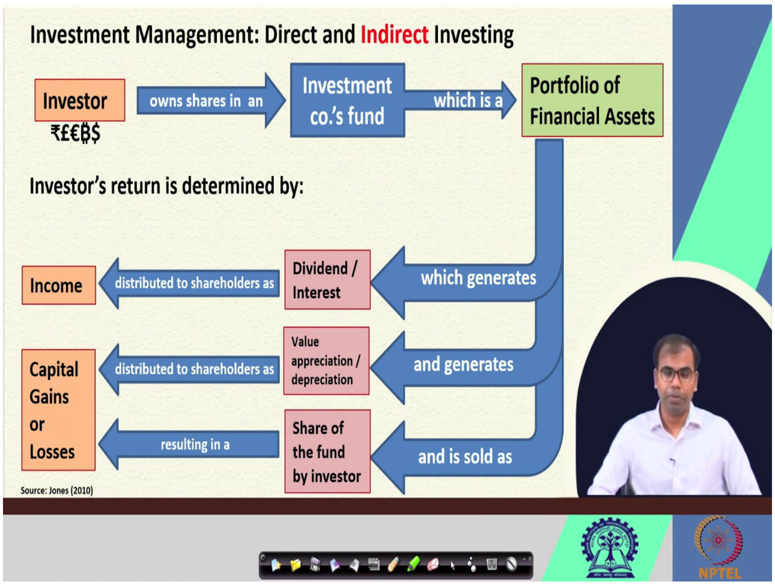


Now, in that case also investor might have some spare funds, some money that she has saved from her earnings and she wants to invest that money in some financial assets. As highlighted earlier we have a choice to invest in real assets and financial assets, but most of the time real assets might require huge amount of fund which not all of us can have. So, we prefer to invest in financial assets.

Remember, the example of willing to wish wishing to own or an automobile factory, but since we cannot afford, so we would go and buy the share of an automobile manufacturer. So, that is how investor can hold a financial asset. Now, that financial asset can be in the form of shares in an investment company, right.

For example, earlier we discussed about types of financial institutions, and we know that mutual fund can be one of the investment companies or one of the financial institutions that are operating in financial markets. So, investor can own shares in an investment company's fund.

So, as an investor, if I have some spare money, I can use that money to buy a mutual fund share or mutual fund unit and that will be indirect investing. Rest of the things are more or less similar to direct investing. But here investment company acts as the investor or on behalf of the investor who have given their money to investment fund investment company.

So, what the investment company does? It is typically holding a portfolio of financial assets and these financial assets determine the investor return. So, if the financial asset generates dividend or interest depending on what type of assets you are holding, then that dividend will be distributed to the shareholders as income.

Remember, investor has very little amount of money to invest. So, there will be 1000s of people like her who would be giving their money to investment company. So, investment company will pool all the funds together and invest in a portfolio of financial assets which will generate dividend or interest, and then dividend or interest can be distributed to the shareholders in the form of income.

Similarly, the portfolio of financial asset can generate capital gain or value appreciation or value depreciation which is capital gain or capital loss that can again be distributed among the shareholders. And in the process, it may also happen that investor can also buy and sell shares of that mutual fund or investment company's fund. So, that portfolio of financial asset can also be sold as shares of the fund by investor herself and that can also be result in a capital gain or capital loss.

So, here in indirect form of investing, investor can expect to earn a return in the form of the income which is received as dividend or interest or part of dividend or interest distributed to the shareholders plus capital gains or losses. Examples could be very similar. So, if I have 100 rupees, but my 100 rupee cannot buy a portfolio of financial asset or maybe I am not very much willing to take direct exposure to financial assets.

So, I would give that 100 rupees to a mutual fund that will pool similar 100 rupees from 1000s of people and use that money, use that pooled money to invest in portfolio of financial asset that can subsequently generate dividend or interest and value appreciation. And then in this investment company will keep part of it.

And subsequently, it will distribute remaining income in the form of dividend or interest to the shareholders or capital in the form of capital gains or losses among the shareholders. That is how typically indirect investing works.

Now, having understood the mechanism of direct and indirect investing, and connecting it with the nature of investment, nature of investment in assets or the liability that people hold as discussed earlier. We would want to know who holds what, who are the people or on an average Indian people for example, hold their assets or their investment in what form.

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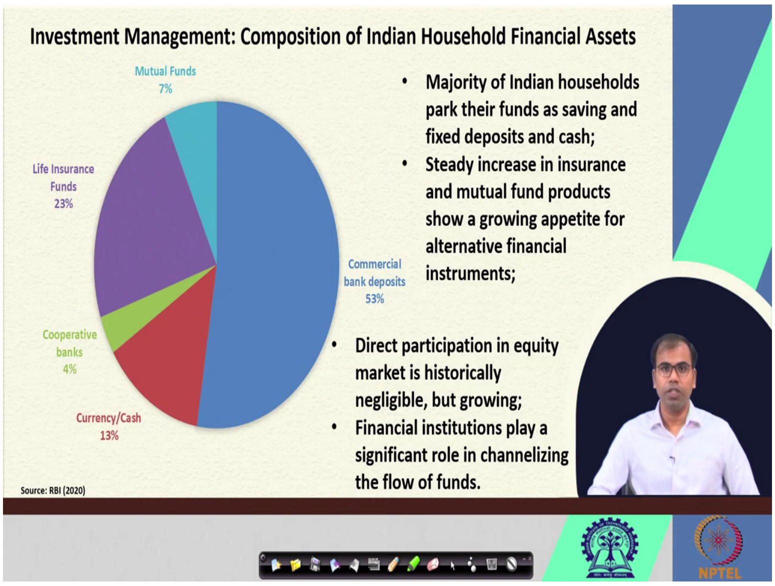


To answer to this question, let us look at this data. Now, this data is from 2022 RBI report, which shows that most of the people in India hold their financial assets in the form of commercial bank deposits. Which means, majority of Indian households park their funds in the form of savings and fixed deposit and cash as well. So, if you look at the combined weight of commercial bank deposits and currency or cash, you would see that 66 percent of financial wealth is stored in the form of bank deposits and cash.

And, affiliate, the Indian household participation in insurance and mutual fund products have steadily growing, which shows that there is a growing appetite for alternative financial instrument among the Indian households. And direct participation in equity market is historically negligible, but recently it is growing. So, there are a majority of Indian households have exposure to financial market or stock market indirectly in the form of mutual funds.

Here, financial institutions play a significant role in channelizing the flow of fund, because they will be the agencies that will be educating the people about the benefit of channelizing their funds from a traditional investment or traditional venue of investment such as commercial bank deposits to more return generating investments, such as mutual fund or any other investment like direct participation in equity market.

So, you can see, looking by looking at the graph, you can understand that most of the people hold their investment or hold their money, hold their financial assets in the form of bank deposits including savings and fixed deposits and currency. Just 7 percent people hold, 7 percent of Indian household have investment of financial assets in mutual funds and Indian household 23 percent have their financial assets in the form of Life Insurance Funds and 4 percent in the form of Cooperative Banks.

So, if you compare this data for countries like USA or UK or Germany, you will observe that majority of the household in those developed countries have their financial assets in ah assets like Insurance Funds, Retirement Funds, Mutual Funds, Stock Market and so on. So, what are the avenues that investors typically have? Let us take a look at that.

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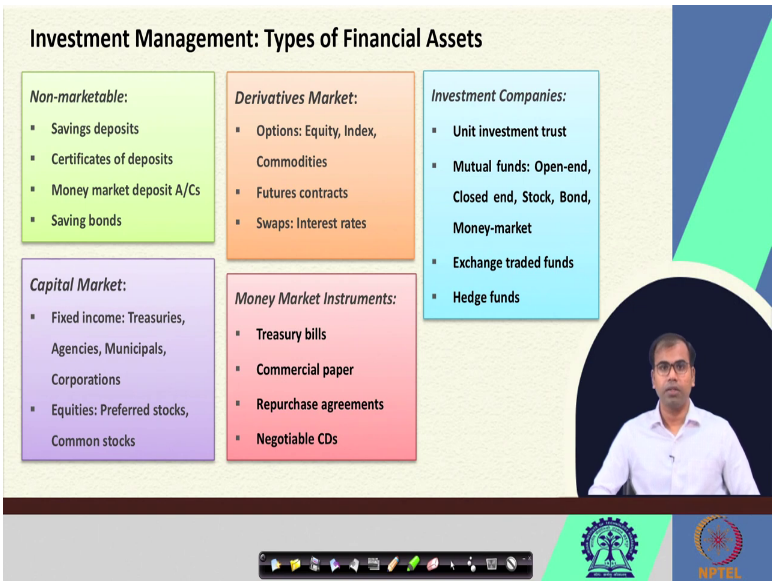


If you look at the types of investment or type of financial assets that are available for investors, we start with non-marketable assets. So, there are some non-marketable financial assets such as savings deposits, certificate of deposits, money market deposit accounts, savings bonds and then there are marketable deposits.

Including, in marketable financial assets, we have instruments in as money market instruments that include treasury bill, commercial paper, repo agreements, negotiable certificate of deposits. And then, we have capital market instruments such as fixed income securities, like treasuries, issues, issues by agencies, municipal corporations, companies. And then, we have equities which include preferred stock, common stock and so on.

Then, we have derivative market instruments or financial assets in derivative market such as options and future. Both options and future can be on equity or index or commodities. Then, we have swaps and also, we have indirect exposure towards these financial assets through investment companies. These include Unit Investment

Trust, Mutual Funds which include both open-ended, close-ended that can be on stocks and bonds and money market instruments, exchange traded funds and hedge funds. Now, a closer look at each of these types of financial assets will tell us their unique characteristics.

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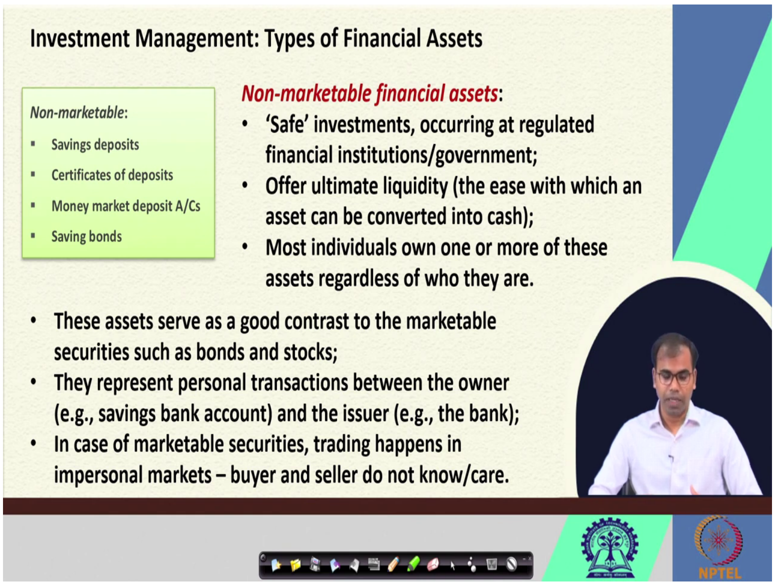


So, if you look at the non-marketable financial assets, we know that it is considered as safe investment. Typically, occur at regulated financial institutions or government such as banks. Of course, it goes without saying that such investments such financial assets offer ultimate liquidity. Here liquidity means the ease with which you can convert an asset into cash.

So, non-marketable financial assets such as savings deposit, you know the savings account that you have in your commercial bank next door. So, you can anytime go and demand for your money. So, it is the most liquid or at least one of the most liquid assets that you can hold. And apparently, most individuals, most of us own one or more of these non-marketable financial assets regardless of our profession or age or education and so on.

These assets of course, serve as a good contrast to the marketable securities such as bonds and stocks. In some cases, there will be less liquidity here. It is very high liquidity in most cases. They also represent a personal level of personal transaction between the owner which is essentially savings bank account, and the issuer, that is the bank that has issued the savings bank account.

So, typically, most of these non-marketable financial assets are traded or exchanged on a personal level which means if I have a savings bank account, I have to personally deal with that savings bank account. It is non-transferable. But in case of marketable securities, trading typically happens anonymously which means it is an impersonal market.

Buyers and sellers do not know or maybe they do not care who the buyer who the buyer is or seller does not care about who the buyer is. And similarly, a buyer does not know or does not care about who the seller is. So, most of the transaction in marketable securities happen in impersonal way. So, in case of non-marketable financial assets, typically, it is a very personal level of transaction between the owner and the issuer.

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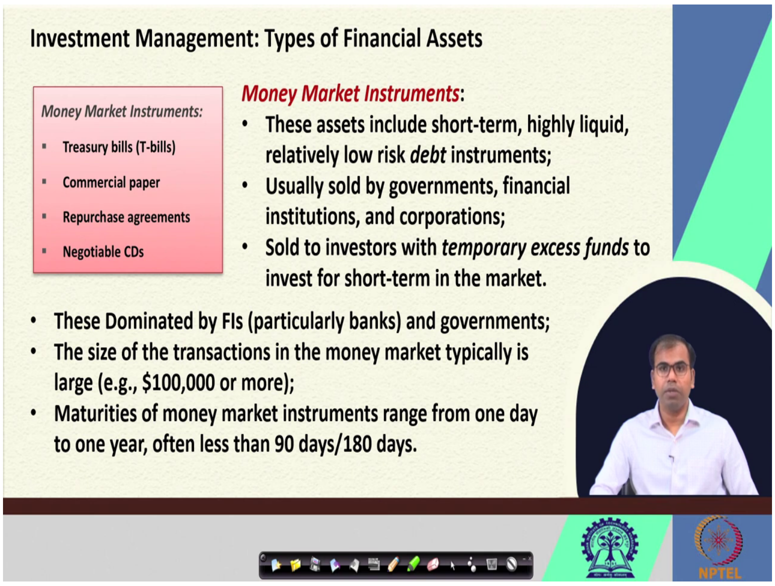


If you go towards marketable instruments, marketable securities to start with if you look at money market instruments which include treasury bills, also known as T-bills, commercial papers, repurchase agreement or repo agreements and negotiable certificate of deposits.

These assets or these financial instruments are basically short term, highly liquid, relatively low risk debt instrument which means you have someone has expressed the desire to borrow money for a short time and it is typically considered as a low risk investment.

Usually, money market instruments are sold by governments, financial institutions and corporations and they sell it to investors who have temporary excess funds to invest for short term in the market. So, if an institution or an entity wants to borrow money in money market fund, money market, it does not have to borrow for very long time.

Similarly, if someone has to invest in money market instrument, that entity or that organization does not have to invest for long term. It is a very temporary investment, temporary form of investment where investor and borrower both are in the need in the need of investing and borrowing money for short term.

And these are typically dominated by financial institutions, mostly individuals do not participate in money market instrument buying or selling of money market instruments. Typically, banks and governments are at play in money markets because of the size as well as the maturity. So, size of these transactions in the money market typically is as large as 100,000 dollars or even more. And similarly, maturities of instruments being traded in money market can range from 1 day to 1 year.

So, there are instruments which have maturity of overnight or it could go as long as 90 days, 182 days and so on and so forth. So, these are the characteristics of money market instruments.

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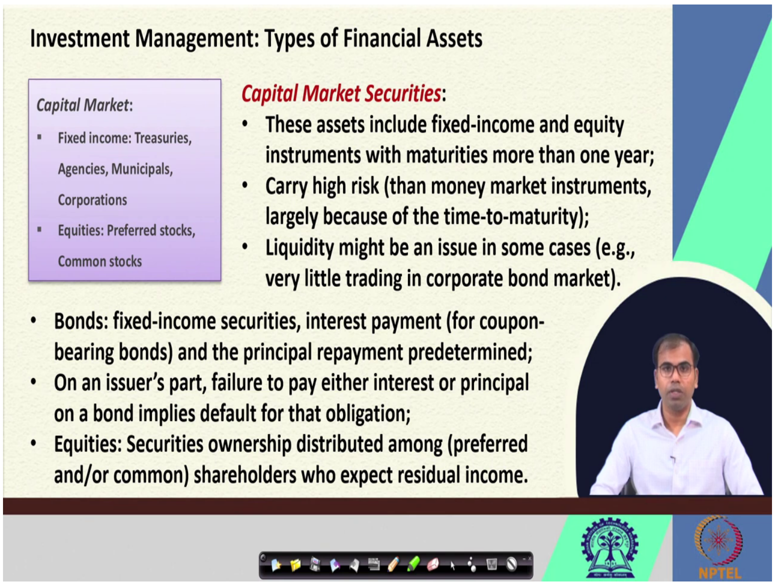


Talking about capital market instruments, we know that there are two measures types of instruments that are available in capital market, fixed income securities or equities or equity investment. Fixed income securities such as bonds or debentures are typically issued by treasuries or agencies or municipal offices or business corporations. Whereas, equity shares or equity investment are issued in the form of preferred stocks or common stocks by any company.

And we know that these assets are having maturities for more than 1 year. It goes without saying that these carry high risk, particularly higher than the money market instruments because mainly because of the time to maturity, we know that the longer we have to wait for a return, the more risky it becomes. Because future is uncertain, so we perceive it as more risky.

In some cases, liquidity might be an issue in case of capital market instruments, some instruments such as some bonds or some stocks can be considered as less liquid. For example, if you look at the data, in India corporate bond market is not picking up. We see very little trading, very thin trading in corporate bond market in India.

Similarly, if you look at the stock market where equity shares are being traded like National Stock Exchange or Bombay Stock Exchange, you will find that there will be some companies whose shares are very thinly traded. Particularly, companies which have very small businesses or you know the penny stocks or small cap stocks where not much trading happen because they are not much in demand. So, these liquidity can be an issue in some cases.

Talking about specific instruments such as bonds, we know that these are fixed income securities where if it is a coupon bearing bond, interest or coupon payment happens and the principal repayment is predetermined. Particularly on an issuer's part, failure to pay either interest or principal on a bond, shows or indicate that there is a default for that obligation and it is typically secured with some asset or some other obligation.

So, institutions or companies or entities that issue bonds have to meet the obligation of making regular payment if it is a coupon bearing bond. There are different varieties of bonds, such as zero-coupon bearing bond which is zero-coupon bond in which case there is no coupon or no interest payment. But in case of coupon bearing bond, holder of the bond will receive periodical interest payment.

There are convertible bonds where which could be converted after some time into some other type of instrument such as equity or shares. Talking of equities, equities are typically considered as securitized ownership in a company or in a business distributed among shareholders who expect residual income.

So, essentially, when I hold equity share of a company, I am holding a part of the company in the form of preferred stock or common stock. And I expect that after meeting all the obligation, the company will have some residual income as remaining portion of the net profit that would be available for distribution in the form of dividend to the shareholders.

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Then, comes the derivative market. In derivative market, we can have options, futures, swaps, and these are the securities that derive their value in whole or in part by having a claim on some underlying assets or obligations. So, if I have options on an equity or equity share, the value of that option is driven by the value of the underlying asset that is equity share.

Similarly, if I have a derivative on commodity, let us say iron ore or gold or crude oil, so the value of that derivative contract, be it options or future will depend on the price of the underlying commodity such as gold or iron or crude oil. Most commonly options and future contracts are the highly traded derivative instruments in the market.

They are traded quickly and cheaply on organized exchanges in a very anonymous way, where options are basically the securitized instruments that provide the right to buy or sell a stated number of share or any financial instrument or in the quantity of that instrument within a specified period at a specified price.

So, when you buy an option, you have the right to buy or sell. If it is an option to buy, you have the right to buy, and if it is an option to sell, you have a right to sell. A stated number of a particular financial instrument or financial security within a specified period that is called maturity period or expiry period, and specified price, that have to be agreed in the beginning.

So, these could be two types, put options and call options. Put options are basically an option to sell and call options is an option to buy. These two instruments, these two types of options are extensively used for risk management as well, particularly by banks and financial institutions.

And then we have futures, futures contract which are basically agreement to provide for the future exchange of a particular asset at a currently determined market price. So, in case of futures agreement, we have the agreement to decide a price right now and the delivery of that commodity or that asset has to be done in a future date. So, these are some derivative instruments that are widely traded in financial markets. We will discuss more about these instruments in later time.

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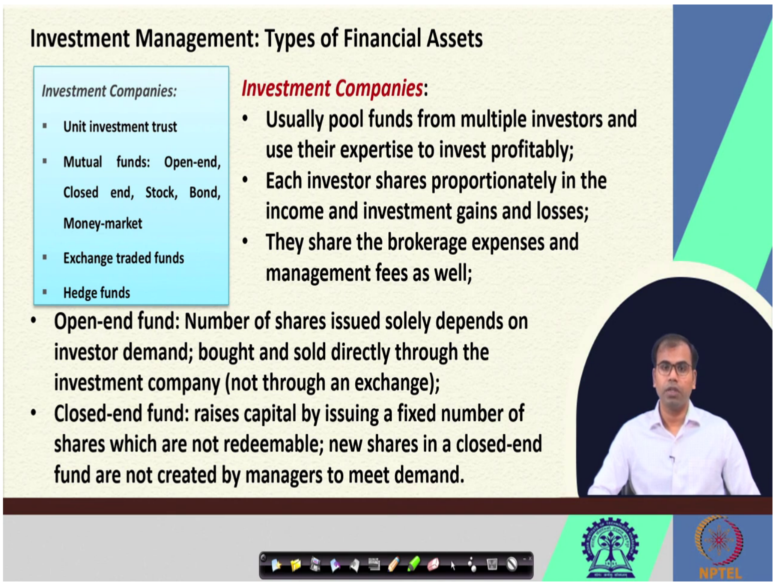


Finally, we have the investment companies which will have investors who want to have indirect investing exposure to the same assets that we have discussed so far. So, investment companies include unit investment trust, mutual funds, hedge funds, exchange traded funds and so on. So, typically, they are in the job of pooling money, pooling funds from multiple investors and use that money with their expertise to invest profitably.

So, what they do is they pool money from people different people. If it is mutual fund, those people will be small investors. If it is a hedge fund, there will be high net worth individuals. And in that case, each investor will share proportionately in the income and capital gains and losses.

As I highlighted earlier when we talked about indirect investing, investor will share proportionately in the income and investment. Of course, they have to share the brokerage expenses and management fees as well because if mutual fund or hedge fund or exchange traded fund, they are managing the money on behalf of several investors, they have to be compensated for their effort, their skills.

There could be open-ended fund where number of shares issued solely depends on the investor demand, which means it can be bought and sold directly through the investment company and it cannot be done through exchanges. And then, there is closed-ended fund which raises capital by issuing a fixed number of shares which are not redeemable.

Typically, new shares in a closed ended funds are not created by managers to meet the demand like happens in open-ended funds. So, these are the types of financial assets that are available for investors to invest. And we will discuss more details about these assets with their perspective for investor in subsequent sessions.

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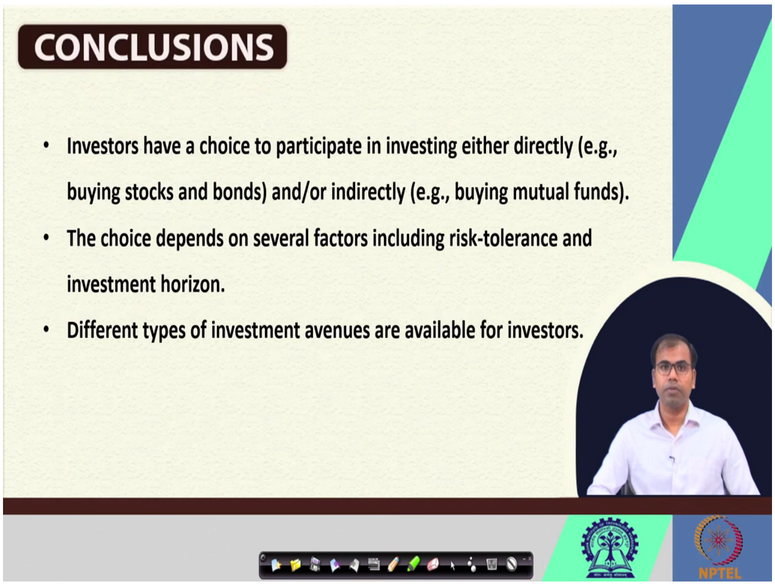

To conclude, we have discussed that investors typically have a choice to participate in investment activity either directly by way of buying or buying stocks and bonds and other assets or indirectly by buying shares in a mutual fund or any other investment companies. The choice depends on several factors. It includes risk tolerance, if a person is risk seeker, then he or she can directly participate in stock market or financial asset trading.

And if the person is risk-averse, then probably he, she would like to participate in financial asset market indirectly by way of Mutual Fund or Investment Companies. It also depends on investment horizon. If they want to invest for long term, probably they can be more risk seeker. And if they want to invest for short term, they cannot be as much risk seeker as people who are investing for long term.

To end, we know that there are several types of investment avenues that are available for investors including non-marketable instruments and marketable instruments. Such as, capital market instrument including bonds and equities, and derivative instruments and money market instrument as well as the products that are offered by investment management companies.

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With this, I end this session.

Thank you very much.