Beginner's Guide to the Capital Markets

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INTRODUCTION

Financial Education

1. **Basics**
   a. **Importance of financial education**: As much as skills are required to earn money, it is required in equal measure in spending it wisely. Accordingly, **financial education** provides you the basic life skill to build a secure financial future. Proper financial knowledge can improve your ability to save for your long term goals and prevent you and your family from financial exigencies. It is important to know the following concepts:

   b. **Savings and Investing**
   Saving is the excess of your income over your expenditure. Generally, savings is in the form of savings bank account and cash. Your money is very safe in a savings account, earning a **small rate** of interest and you can get back your money as and when you need it (high **liquidity)**.

   Whereas when you are investing, you are setting your money aside for long term goals. It is normal for investments to rise and fall in value over time. However, in the end, prudent investments can earn a lot more than in your savings account.

   c. **Budgeting**
   The first step in your financial planning is budgeting - a process for tracking, planning and controlling the inflow and outflow of your income. It entails identifying all the sources of income and taking into account all current and future expenses, with an aim to meet your financial goals. The primary aim of a budgeting is to ensure reasonable savings after providing for all expenses.

   Benefits of budgeting
   - it puts checks and balances in place in order to prevent overspending at various levels;
   - it takes into account the unexpected need for funds;
   - it disciplines you in matters of earning and spending; and
   - it helps you to maintain same standard of living even after post retirement

   d. **Inflation effects on Investments**
   While planning your investment, it is important to take into account the effects of inflation on your investments. Inflation is the rise in prices of goods and services. As the prices of goods and services increase, the value of rupee goes down and you will not be able to purchase as much with those rupees as you could have in the last month or last year.

The effect of inflation on investment can be better understood with the following illustration:

Say that your monthly consumption of petrol is 10 litres, costing you ₹ 500 @ ₹ 50 / litre. Further, you meet this expense out of the monthly interest income of ₹ 500, earned from your fixed deposit. If the inflation rate during the year is 10%, then price of petrol per litre would increase from ₹ 50 to ₹ 55 / litre. Accordingly, the next year you will not be able to purchase 10 litres of petrol, now costing ₹ 55 / litre, out your interest income of ₹ 500 from your fixed deposit. Hence your financial plan should aim to earn returns above the rate of inflation.

e. **Risk and Return**

Risk and return go hand in hand. Risk is loosely defined as the chance of loosing all or part of your money invested. The good news is that investment risk comes with the potential for return – which makes the activity worthwhile.

The basic thing to remember about risk is that it increases as the potential return increases. Essentially, higher the risk, the higher is the potential return. (Do not forget the two words - "potential return". There is no guarantee).

f. **Power of Compounding**

As you pursue your financial planning, the most powerful tool for creating wealth safely and surely is the magical 'power of compounding'. If you park your money in an investment with a given return, and then reinvest those earnings as you receive them, your investment grows exponentially over time.

Illustratively, if you set aside a sum of say ₹ 5,000 every month from the age of 25, earning interest at the rate of 10% p.a., in 60 years you will have with you funds worth more than ₹ 1 crore. However, if you start at 40 with the same amount and rate of interest, the fund accumulated will amount to only around ₹ 33 lakh.

Hence, it is always advisable to start savings early to enjoy the benefits of power of compounding

g. **Time Value of Money**

Money has time value. As the time passes, the value of money decreases. This means that the value of a thousand rupee note you have today is higher than its value five years hence, even if there is no inflation. This is because we prefer consumption today to consumption in future which is uncertain. That is why, if you invest ₹ 1,000 today at 5% per annum, you

would receive ₹ 1,050 after a year. Thus, ₹ 1,000 today is equivalent to ₹ 1,050 received after a year or its value one year hence.

2. **Products Available:** There are a large variety of financial products available for investment. You need to choose the best product or the best combination of products to meet your preference and objectives. Your choice generally takes a balance view of three factors, namely, Liquidity, Safety and Return depending on the stage of life.

   a. **Savings Related products**
      Bank deposits are generally safe because they are partly covered by deposit insurance and banks have high capital requirements. The banks are regulated by the Reserve Bank of India. They offer various types of deposits, depending on the needs of the customer. Bank deposits are preferred more for their liquidity and safety than for their returns.

   b. **Investment Related Products**
      Company fixed deposits are fixed deposit scheme offered by (manufacturing) companies. They are similar to bank fixed deposits but entail lesser liquidity and usually carry higher risk and return.

      Capital market offers products like equity, debt, hybrid instruments and various mutual fund schemes. Each of this investment class carries different risk-return profile and is covered separately under 'products available in capital markets'.

   c. **Protection Related Products**
      - **Life Insurance** is a contract providing for payment of a sum of money to the person assured or, following him to the person entitled to receive the same, on the happening of a certain event.
      - **Term Life Insurance** Lump sum is paid to the designated beneficiary in case of the death of the insured.
      - **Endowment Policies** Provide for periodic payment of premia and a lump sum amount either in the event of death of the insured or on the date of expiry of the policy, whichever occurs earlier.
      - **Units Linked Insurance Policy (ULIP)** provides a combination of risk cover and investment.

      For more details on insurance products, please refer to the website of the Insurance Regulatory and Development Authority (IRDA), www.irda.org.in

   d. **Pension Products**
      - **New Pension System (NPS):** You can build your retirement corpus during your working days by regularly contributing (the minimum amount being ₹ 6,000 p.a.) to the **NPS** till the age of 60. Your

contribution will be invested by the Pension Fund Manager (**PFM**) you choose, in the investment option of your choice:

1. Active Choice
   - Asset Class E (Equity): Invests in index funds (the maximum allowed is 50%, the balance has to be in Asset Class G & C)
   - Asset Class G (Government securities): Invests in central and state government bonds
   - Asset Class C (non government debt): Invests in liquid funds of Asset Management Companies, bank fixed deposits, rated bonds issued by corporates, banks, financial institutions, PSUs, Municipality and Infrastructure entities.

2. Auto Choice (Life cycle fund): Under this option, your contributions will be automatically allocated to the three asset classes in a predefined manner depending on you age, as illustrated in table below.

Age	**Asset Class E**	**Asset Class C**	**Asset Class G**
Up to 35 years	50%	30%	20%
45 years	30%	20%	50%
55 years	10%	10%	80%

Upon subscribing, you will be allotted a Permanent pension account number (**PPAN**) and your account will reflect your contributions etc. PPAN will remain constant even if you change the PFM, your location or employer. The returns earned by your contributions would depend on your investment option. Charges are applicable to the NPS account as prescribed by the regulator.

At the age of 60, a minimum of 40% of the accumulated amount in the account has to be used to buy a pension (annuity) scheme from an insurance company of your choice from whom you will receive monthly pension. The balance of 60% in your account can be withdrawn or be used to buy annuity.

NPS is regulated by Pension Fund Regulatory and Development Authority (PFRDA) and for further details on NPS, please visit PFRDA's website (www.pfrda.org.in)

- **Annuity / Pension Policies / Funds** are offered by insurance companies and offer guaranteed income either for life or for a certain period without any insurance cover.

e. **Borrowing Related Products**

- **Personal Loans** are usually expensive and are generally taken when you have to meet unexpected needs that are beyond your immediate financial means.
- **Housing Loan** is just another loan with your house as the collateral.
- **Reverse Mortgage** Senior citizens having house property but no regular income, can mortgage their house to a bank / housing finance company. In return, they receive regular periodical payments up to a maximum of 15 years. The bank will recover this loan by selling off the property upon the demise or leaves the place. Excess amount, if any is paid to the legal heir.
- **Loan against Securities** preserves investment, apart from taking care of personal needs.
- **Credit Card Debt** is very expensive and is usually resorted to when all other options including personal loans are exhausted.

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An overview of capital market

Generally, the personal savings of an entrepreneur along with contributions from friends and relatives are the source of fund to start new or to expand existing business. This may not be feasible in case of large projects as the required contribution from the entrepreneur (promoter) would be very large even after availing term loan; the promoter may not be able to bring his / her share (equity capital).Thus availability of capital can be a major constraint in setting up or expanding business on a large scale

However, instead of depending upon a limited pool of savings of a small circle of friends and relatives, the promoter has the option of raising money from the public across the country by selling (issuing) shares of the company. For this purpose, the promoter can invite investment to his or her venture by issuing offer document which gives full details about track record, the company, the nature of the project, the business model, the expected profitability etc.

If you are comfortable with this proposed venture, you may invest and thus become a shareholder of the company. Through aggregation, even small amounts available with a very large number of individuals translate into usable capital for corporates. Your small savings of, say, even ₹ 5,000 can contribute in setting up, say, a ₹ 5,000 crore Cement or Steel plant. This mechanism by which corporates raise money from public is called the primary markets.

Importantly, when you, as a shareholder, need your money back, you can sell these shares to other or new investors. Such trades do not reduce or alter the company's capital. Stock exchanges bring such sellers and buyers together and facilitate trading. Therefore, companies raising money from public are required to list their shares on the stock exchange. This mechanism of buying and selling shares through stock exchange is known as the secondary markets.

As a shareholder, you are part owner of the company and entitled to all the benefits of ownership, including dividend (company's profit distributed to owners). Over the years if the company performs well, other investors would like to become owners of this performing company by buying its shares. This increase in demand for shares leads to increase in its price. You then have the option of selling your shares at a higher price than at which you purchased it. You can thus increase your wealth, provided you make the right choice. The reverse is also true!

Apart from shares, there are many other financial instruments (**securities**) used for raising capital. Debentures or bonds are debt instruments which pay interest over their life time and are used by corporates to raise medium or long term debt capital. If you prefer fixed income, you may invest in these instruments which may give you higher rate of interest than bank fixed deposit, because of the

higher risk. Besides, equity and debt, a combination of these instruments, like convertible debentures, preference shares are also issued to raise capital.

If you have constraints like time, wherewithal, small amount etc. to invest in the market directly, Mutual Funds (MFs), which are regulated entities, provide an alternative avenue. They collect money from many investors and invest the aggregate amount in the markets in a professional and transparent manner. The returns from these investments net of management fees are available to you as a MF unit holder.

MFs offer various schemes, like those investing only in equity or debt, index funds, gold funds, etc. to cater to risk appetite of various investors. Even with very small amounts, you can invest in MF schemes through monthly systematic investment plans (SIP).

The institutions, players and mechanism that bring suppliers and users of capital together, is known as capital market. It allows people to do more with their savings by providing variety of assets thereby enhancing the wealth of investors who make the right choice. Simultaneously, it enables entrepreneurs to do more with their ideas and talent, facilitating capital formation.

Thus capital market mobilizes savings and channelizes it, through **securities**, into preferred entrepreneurs.

It is not that the providers of funds meet the user of and exchange funds for securities. It is because the securities offered by the users may not match the preference of the providers of funds. There are a large variety of intermediaries who bring the providers and user of funds together to facilitate the transactions.

The market is supervised by SEBI. It ensures supply of quality securities and non-manipulated demand for them. It develops best market practices and takes enforcement actions against the miscreants. It essentially maintains discipline in the market so that the participants can undertake transaction safely.

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Products available in capital market

1. **Equity** (instrument of ownership)
   Equity shares are instruments issued by companies to raise capital and it represents the title to the ownership of a company. You become an owner of a company by subscribing to its equity capital (whereby you will be allotted shares) or by buying its shares from its existing owner(s).

   As a shareholder, you bear the entrepreneurial risk of the business venture and are entitled to benefits of ownership like share in the distributed profit (dividend) etc. The returns earned in equity depend upon the profits made by the company. company's future growth etc.

2. **Debt** (loan instruments)
   a. Corporate debt
   - **Debentures** are instrument issued by companies to raise debt capital. As an investor, you lend you money to the company, in return for its promise to pay you interest at a fixed rate (usually payable half yearly on specific dates) and to repay the loan amount on a specified maturity date say after 5/7/10 years (**redemption**).

     Normally specific asset(s) of the company are held (**secured**) in favour of debenture holders. This can be liquidated, if the company is unable to pay the interest or principal amount. Unlike loans, you can buy or sell these instruments in the market.

     Types of debentures that are offered are as follows:
     - Non convertible debentures (NCD) – Total amount is redeemed by the issuer
     - Partially convertible debentures (PCD) – Part of it is redeemed and the remaining is converted to equity shares as per the specified terms
     - Fully convertible debentures (FCD) – Whole value is converted into equity at a specified price

   - **Bonds** are broadly similar to debentures. They are issued by companies, financial institutions, municipalities or government companies and are normally not secured by any assets of the company (**unsecured**).

     Types of bonds
     Regular Income Bonds provide a stable source of income at regular, pre-determined intervals

     Tax-Saving Bonds offer tax exemption up to a specified amount of investment, depending on the scheme and the Government notification. Examples are:
     - Infrastructure Bonds under Section 88 of the Income Tax Act, 1961

- NABARD/ NHAI/REC Bonds under Section 54EC of the Income Tax Act, 1961
- RBI Tax Relief Bonds

b. Government debt:

- **Government securities (G-Secs)** are instruments issued by Government of India to raise money. G Secs pays interest at fixed rate on specific dates on half-yearly basis. It is available in wide range of maturity, from short dated (one year) to long dated (up to thirty years). Since it is sovereign borrowing, it is free from risk of default (**credit** risk). You can subscribe to these bonds through RBI or buy it in stock exchange.

c. Money Market instruments (loan instruments up to one year tenure)

- **Treasury Bills** (T-bills) are short term instruments issued by the Government for its cash management. It is issued at discount to face value and has maturity ranging from 14 to 365 days. Illustratively, a T-bill issued at Rs. 98.50 matures to Rs. 100 in 91 days, offering an yield of 6.25% p.a.

- **Commercial Papers** (CPs) are short term unsecured instruments issued by the companies for their cash management. It is issued at discount to face value and has maturity ranging from 90 to 365 days.

- **Certificate of Deposits** (CDs) are short term unsecured instruments issued by the banks for their cash management. It is issued at discount to face value and has maturity ranging from 90 to 365 days.

3. Hybrid instruments (combination of ownership and loan instruments)

- **Preferred Stock / Preference shares** entitle you to receive dividend at a fixed rate. Importantly, this dividend had to be paid to you before dividend can be paid to equity shareholders. In the event of liquidation of the company, your claim to the company's surplus will be higher than that of the equity holders, but however, below the claims of the company's creditors, bondholders / debenture holders.

- **Cumulative Preference Shares**: A type of preference shares on which dividend accumulates if remains unpaid. All arrears of preference dividend have to be paid out before paying dividend on equity shares.

- **Cumulative Convertible Preference Shares:** A type of preference shares where the dividend payable on the same accumulates, if not paid. After a specified date, these shares will be converted into equity capital of the company.

- **Participating Preference Shares** gives you the right to participate in profits of the company after the specified fixed dividend is paid. Participation right is linked with the quantum of dividend paid on the equity shares over and above a particular specified level.

4. **Mutual Funds**

Mutual funds collect money from many investors and invest this corpus in equity, debt or a combination of both, in a professional and transparent manner. In return for your investment, you receive units of mutual funds which entitle you to the benefit of the collective return earned by the fund, after reduction of management fees.

Mutual funds offer different schemes to cater to the needs of the investor are regulated by securities and Exchange board of India (SEBI)

Types of Mutual Funds

At the fundamental level, there are three types of mutual funds:

- Equity funds (stocks)
- Fixed-income funds (bonds)
- Money market funds

Classification of mutual funds

a. **By structure**
    - **Open-ended Funds**
      An open-ended fund does not have a maturity date.
    - **Closed-end Funds**
      Closed-end funds run for a specific period.

b. **By investment objective**
    - **Growth Funds**
      A mutual fund scheme investing in equity
    - **Bond / Income Funds**
      A mutual fund scheme investing primarily in government and corporate debt to provide income on a steady basis.
    - **Balanced Funds**
      A mutual fund scheme investing in a mix of equity and debt.
    - **Money Market Funds**
      A mutual fund scheme investing in money market instruments.

c. **Others**
    - **Tax savings schemes (Equity Linked Saving Scheme-ELSS)**
      Equity funds along with tax benefits to the investors and has a lock in period of three years.
    - **Sector funds**

They target at the specific sectors of the economy such as financial, technology, health, etc.

- **Index Funds**
  This type of mutual fund replicates the performance of a broad market index such as the SENSEX or NIFTY.

The above mentioned categories of mutual fund schemes are basic in nature and for full details please refer to SEBI's"Beginner's guide on mutual funds".

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Securities and Exchange Board of India – An Introduction

The securities market enables capital formation in the economy and enhances wealth of investors who make the right choices. The investor confidence is the key prerequisite for the emergence of a vibrant and deep capital market. The role of regulator in creating and enhancing investor confidence is, therefore, paramount.

Accordingly, Securities and Exchange Board of India (SEBI) was set up by an Act of Parliament of India in April, 1992 with a mandate to

- Protect the interest of investors
- Promote the development of and
- Regulate the securities market

Market regulation

SEBI prescribes the conditions for issuer companies to raise capital from the pubic so as to protect the interest of the suppliers of capital (investors). The extensive disclosures prescribed for issuers facilitate informed investment decision making by investors while simultaneously ensuring quality of the issuer. Further, it has prescribed norms for such corporates on 'on going' basis and also during their restructuring (like substantial acquisition, buy back and delisting of shares) to safeguard the interest of investors.

To ensure fair and high standards of service to investors, SEBI allows only fit and proper entities to operate in the capital markets as intermediaries. In this regard, it has prescribed detailed and uniform norms of their registration. Further, to ensure market integrity, it has prescribed norms for fair market practices including prohibiting fraudulent and unfair trade practices and insider trading. Detailed norms for safeguarding the interest of investors in secondary markets have also been prescribed. SEBI also prescribes conditions for operation of collective investor schemes, including Mutual Funds.

Market development:

On an on going basis, SEBI initiates measures to widen and deepen the securities markets by bringing changes in market micro and macrostructure. The major market development measures undertaken by SEBI include shift from the non transparent open out cry system to the transparent screen based on line trading system, elimination of problems of physical certificates by shifting to electronic mode (demat), implementing robust risk management framework in stock market trading etc. In the recent past SEBI has initiated ASBA (application supported by blocked amount) to eliminate problems pertaining to refunds in public issues.

SEBI's major policy decisions are formulated through a consultative process involving expert committees with representation from industry, academia,

investors' associations. Further, public comments are invited before implementation of major changes, rendering the whole process participative.

Investor protection:
The above mentioned regulatory framework and the market development measures of SEBI are invariably geared towards protecting the interest of investors. Besides, SEBI also has a comprehensive mechanism to facilitate redressal of investor's grievances. Further, in keeping with its belief that an informed investor is a protected investor, SEBI promotes education and awareness of investors. Moreover, mechanisms for dispute redressal (arbitration at stock exchanges) and to compensate investors have also been provided.

Enforcement:
SEBI ascertains compliance to its norms by carrying out inspections of registered intermediaries, investigations and while processing of documents filed with it, including investors complaints. SEBI is vested with the power of civil court to call for information and records, to issue summons, to inspect and to investigate entities associated with securities markets. If breach of norms is established, SEBI suspends or cancels the license granted to intermediaries. Besides, SEBI issues prohibitive and cease and desist orders against intermediaries and non intermediaries and also imposes monetary penalties through adjudication proceedings.

Apart from these civil proceedings, SEBI also launches criminal proceedings against entities for breach of norms. All such orders of SEBI are available in the website (www.sebi.gov.in), serving as a warning to potential defaulter.

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Securities and Exchange Board of India and investor protection

Securities and Exchange Board of India (SEBI) has been established with the prime mandate to protect the interest of investors in securities. It is also mandated to promote the development of, and to regulate the securities market.

An investor enjoys investing, if (i) he knows how to invest; (ii) he has full knowledge of the market; (iii) the market is safe and there are no miscreants; and (iv) there are arrangements for redressal in case of grievances. Accordingly, SEBI's investor protection strategy has four elements.

First, build the capacity of investors through education and awareness to enable an investor to take informed investment decisions. SEBI endeavours to ensure that the investor learns investing, that is, he obtains and uses information required for investing, evaluates various investment options to suit his specific goals, ascertains his rights and obligations in a particular investment, deals through registered intermediaries, takes necessary precautions, seeks help in case of any grievance, etc. SEBI has been organizing investor education and awareness workshops directly, and through investor associations and market participants, and been encouraging market participants to organize similar programmes. It maintains an updated, comprehensive web site for education of investors. It publishes various kinds of cautions through media. It responds to the queries of investors through telephone, e-mails, letters, and in person for those who visit SEBI office.

Second, make available every detail relevant for investment in public domain. SEBI has adopted disclosure based regulatory regime. Under this framework, issuers and intermediaries disclose relevant details about themselves, the products, the market and the regulations so that the investor can take informed investment decisions based on such disclosures. SEBI has prescribed and monitors various initial and continuous disclosures.

Third, ensure that the market has systems and practices which make transactions safe. SEBI has taken various measures such as screen based trading system, dematerialization of securities, T+2 rolling settlement, and framed various regulations to regulate intermediaries, issue and trading of securities, corporate restructuring, etc. to protect the interests of investors in securities. It also ensures that only the fit and proper persons are allowed to operate in the market, every participant has incentive to comply with the prescribed standards, and the miscreant are awarded exemplary punishment.

Fourth, facilitate redressal of investor grievances. SEBI has a comprehensive mechanism to facilitate redressal of investor grievances against intermediaries and listed companies. It follows up with the companies and intermediaries who do not redress investors' grievances, by sending reminders to them and having meetings with them. It takes appropriate enforcement actions as provided under

the law (including launch of adjudication, prosecution proceedings, directions) where progress in redressal of investor grievances is not satisfactory. It has set up a comprehensive arbitration mechanism in stock exchanges and depositories for resolution disputes of the investors. The stock exchanges have investor protection funds to compensate investors when a broker is declared a defaulter. Depository indemnifies investors for loss due to negligence of depository or depository participant.

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