CHAPTER III
AN OVERVIEW OF INVESTMENT AVENUES AND MUTUAL FUNDS

3.0 INTRODUCTION

Art of investing is actually easy and simple if an investor spares his valuable time in systematic planning and execution. To be a successful investor, learning is essential. Savings denote that part of earnings that are set apart to be used for meeting future commitments, needs and contingencies. Idle savings when put to work become investment. The difference between ‘saving’ and ‘investing’ is really about one thing: how hard is investor’s money working\(^1\). The first mistake investors often make is waiting too long to start investing. It is better to start early investments. The earlier an investor begins, the more secure his future will be. One does not need a lot of money even starting small will pay off in the long run. Investing small amounts when he is young, is not only smart but will help him learn how to invest properly without risking too much of his money.

3.1 ESSENTIALS OF GOOD INVESTMENT

Safety, liquidity and return are must for financial instrument to qualify as an investment option or avenue. Degree of safety, liquidity or return may vary but none of these can be zero. An investment without any one of the three essentials is not worth considering.

---

3.1.1 SAFETY

The investor’s money is precious. He should keep it in safe hands. Schemes offering unexpectedly higher returns must be viewed with caution. Blindly believing misleading advertisements and publicity by fly-by-night operators is risky\(^2\). He should ensure credibility and financial strength of the institutions before he invests. Speculative bubbles often end up in crash. An investor should avoid herd mentality and take conscious decisions to buy or sell. When markets are crashing and anybody is selling, he should hold back for more appropriate time for coming out of market. He has to look for buying opportunities created by sudden crash. Staying invested longer while ignoring trading fluctuations in stock markets has often rewarded well-informed investors. At the same time weak investments die over a time.

3.1.2 LIQUIDITY

Availability of money when the investor needs is the second most important principle while choosing an investment. Unless investment is convertible into cash with speed and ease, it may not serve the purpose for which it was invested. Deposits in banks, post office, gold, silver and actively traded shares are more liquid as compared to immovable property. Exit route at affordable cost is a must. Forced selling of investments to meet short-term needs is bad planning. An investor should keep a mix of short term, medium term and long term investment for meeting varying needs arising over a period.

3.1.3 RETURNS

Money does not grow in earthen pots. An investor should invest in profit yielding propositions to ensure addition to net worth at the same time hedging against inflation. Whether derived by way of periodic returns or accumulation or both, the investments must grow to meet his growing demands.

3.2 INVESTMENT AVENUES

Composition of investment portfolio must balance needs and aspirations on one hand and risk appetite on the other. Whatever be the choice of investment, an investor should remember that safety of investment is of utmost importance and could not be compromised on any account. Government securities are exposed to minimum risk and thus these are called zero-risk securities, while securities of companies have relatively higher risk, investor has to be vigilant and sensitive enough to foresee the risks involved in the investment and take right decisions at the right time. The following are the investment avenues available for investors in India.

3.2.1 LIFE INSURANCE

Insurance is a function of human psychology and probability. Large number of persons contributes a small sum to create a protection fund against an unknown fear but only a small fraction may meet fate. Contingency fund created out of premium contribution is kept in Government securities and other financial products thereby earning sufficient enough to pay for contingencies.

Life insurance is a contract between the insurance company and applicant / policyholder for payment of a sum of money to the applicant / policyholder or his nominee on happening of certain event. The contract falls under the ambit of Indian Contract Act, 1972. Remedy lies under the Act, for both insurance company and the insured\(^3\).

Once a decision has been taken to take a life-insurance plan, the next big task is to select suitable plan. Life Insurance Corporation of India (LIC) has been the front-runner in number game and has a variety of plans to choose from. The plans cater to diverse needs of all categories of people and are unmatched in reliability,

\(^3\) Ramanathan, K. V. (2012). A study on policyholder’s satisfaction with reference to Life Insurance Corporation of India, Thanjavur division.
benefits and range. New plans are being added and the old ones are amended to cater wider range of needs.

**Types of Life Insurance Policies**

Broadly life insurance policies can be divided into four categories:

1. Cash-value life insurance
2. Term insurance
3. Whole life insurance
4. Annuity plans

**Cash-Value Life Insurance**

Cash-value life insurance and its variants, such as whole life or variable life combine insurance coverage with investing. A portion of the premium goes towards the coverage, and another portion goes towards accumulation of a cash value or into an investment account. Cash value insurance is an excellent investment too, besides providing a cover for contingencies. They are offered by LIC and other private insurance coupled with the risk coverage and tax exemptions to make investment in insurance a wise decision.

**Term Insurance**

Term insurance is just plain insurance – no investment component. This makes the policies cheaper, less complicated, and easier to compare. Term could be for defined period or undefined for whole life. Also called temporary insurance, insurance term life insurance, covers a person against death for a limited time or the ‘term’. For example, the ‘term’ might be one year, ten years or even more or it may be linked to an event for example – until children are grown, or until they finish college, or until they get married or until the policyholder retires, etc.
Whole Life Insurance

Also called permanent insurance, the whole life insurance is permanent in nature and does not expire till the time insured is alive and continues to pay the premium as per the policy. It provides coverage similar to term insurance in addition to maturity amount. A part of the premium goes towards the insurance portion of the policy, a small part of the premium goes towards administration expenses, and the balance of premium goes towards the investment or cash portion of the policy.

Annuity Plans

Life insurance also lets the investor plan for the future by protecting his financial resources against uncertainties of life. Annuity or commonly called pension can help manage money to last a life time. Annuities are the only financial planning tool that can help an investor save and then provide him a payout plan on retirement. It is a secure and steady stream of income he cannot outlive.

3.2.2 POST OFFICE SAVINGS

India Post was established by imperialistic forces 150 years ago in 1854. Post Office offers a lot more than merely delivering the letters. It acts as a bank and at the same time also offers a wide choice of investment options to choose from. An investor can open a savings account, a monthly income deposit, a term deposit, public provident fund, and recurring deposit in next-door post office.

Though there has been a steady decline in the interest rates over last few years and small saving instruments are losing shine, yet these instruments offered by post offices remain popular among salary earners as they offer comparatively higher interest income that one could find elsewhere coupled with 100% safety.

Huge network established by post offices especially in rural areas gives convenience, affordability and availability to all and enjoys a reach unparalleled by
any other institution or bank. Over the years the Post Office has also added to its distribution network and today apart from its physical locations spread over the length and breadth of the country, it also boasts of a dedicated VSAT network connecting over 1200 post offices via satellite.

Absolute safety assured by the Government makes the instruments unique and most sought after by all. Most of the investments are eligible for deduction of income tax. Interest income in case of public provident fund is fully exempt from income tax. Sale / redemption through vast network of Post Offices across India facilitate easy liquidity. Schemes with lock in period also allow premature redemption at an affordable price. Resident Indians, Non-Resident Indians, Minor, Senior Citizens and Hindu Undivided Family are eligible to invest in Post Office Savings Schemes.

**Dematerialisation Of Schemes Certificates**

India Post in association with National Securities Depository Limited (NSDL) has taken an initiative to demat the savings certificates (NSC/KVP) as a step towards investors’ convenience, enhanced security and possibility of future tradability of these instruments. Dematerialization of Savings Certificates entails the process of converting the paper certificates into an equivalent number of securities / units in electronic form and crediting them nto the investors DP Account with Depository Participant (DP):

The investor has the following benefits as a result of dematerialization:

1. Convenience arising from making a single / no visits to the Post office for the entire life cycle of investing in the instrument including purchase and redemption.
2. Consolidation of multiple holdings in a single account.
3. Dispensation of the need to hold physical paper which is perishable as well as unsafe.
4. Automatic redemption on due date.
5. Future possibility of enhanced liquidity (NSC/KVP becoming tradable).
6. Continuation of all the existing facilities to transfer and pledge, make nominations, etc.
7. Full portability. No need for transfer of the instrument from one Post Office to another.

3.2.3 BANK DEPOSITS

Banks are in a business of money lending. They collect funds from depositors and lend to borrowers. Spread between the lending and borrowing rates is the earning of the banks. Besides lending, banks are channels for transfer of money from one to another. Individuals, HUF, firms, business houses, corporations, governments, everybody and anybody can have the facility of transferring funds to another by opening an account and using a cheque facility. Banks have been acting as custodian for millions of account holders. They offer variety of options to account holders to invest their money depending upon the time horizon and return expectations wherein they can earn interest income.

Bank Deposit Schemes

Banks offer various deposit schemes to the customers. They are classified into various heads, according to the safety, liquidity and maturity. They are as follows:

1. Savings Account Schemes

These accounts are used more a money transfer device rather than an investment option. Convenience of operating the account, cheque writing facility, availability of bank branches at every nook and corner of India, transparency in

---

working and error free accounting systems adopted by the banks are some of the reasons for growth of savings accounts. Savings accounts are used for the transfer of salaries, taxes, payment of telephone bills, electricity bills, water bills, mobile phone bills and credit card payments. Cheque writing facility for withdrawal and transfer of funds across the globe is most unique feature, which distinguishes it from other investment options.

2. **Term Deposit Account**

Savings account though earn a moderate interest it would be inappropriate to call it as an investment option. Term deposits on the other hand are the accounts with the bank with a higher time horizon primarily to earn interest besides keeping surplus money in safe hands. Interest rates keep changing and interest is paid either periodically or is reinvested automatically together with the principal.

3. **Recurring Deposits**

Recurring deposits give the element of compulsion to save and provide full liquidity to access savings at any time. Salary earners, small businessmen, petty shopkeepers may carve out of small portion of their monthly receipts and lock it into investment vehicle generating decent returns. The unique feature of this deposit is that no tax shall be deducted from interest irrespective of the amount of deposit or interest earned on it. Since depositing, every month could be cumbersome and hence bank can be instructed to transfer the required amount from savings account to the recurring deposit account. There is flexibility in the period of deposit with maturity ranging from 6 months to 10 years.
3.2.4 BONDS

Bonds are debt paper issued by Corporate, Government, Institutions, etc., to finance large projects. These instruments offer interest income to the investor. These are issued in various forms and sizes to cater to large investors like banks, mutual funds, financial institutions and also to small investors who can buy a bond just for Rs.5000. These bonds are not secured and carry default risk and hence creditworthiness of the issuer is very crucial to understand before investing. Bonds carry maturity period and they are payable on the maturity.

Before maturity sale or purchase transactions take place on WDM – Whole sale Debt segment on NSE and other exchanges. Retail Debt Market (RDM) provides opportunity to small investors to trade in corporate debt paper. It would be screen based transparent system wherein one can buy as low as 10 units. At the moment whole sale debt segment caters to large investors. This would also provide opportunity to corporate to raise large amount of funds for financing its projects.

Most fixed income instruments pay to the holder a periodic interest payment, commonly known as the coupon, and an amount due at maturity, the redemption value. Zero coupon bonds on the other hand do not make periodic interest payments. On maturity the principal amount together with the entire outstanding amount of interest on the instrument is paid as a lump sum, e.g., Treasury bills. These instruments are sold at a discount to the redemption value which is determined by the interest rate payable (yield) on the instrument.

---

3.2.5 SHARES

Unlike most of the investments that give periodic returns with some regularity such as investments in post offices, banks and deposit schemes of companies, investment in shares do not guarantee any returns by way of dividend or appreciation. What to talk about return, even return of principal is at stake making them quite risk propositions. It is also true that number of investors who have lost their capital is much larger as compared to few who have won jackpot.

One can desire to have unlimited returns from stock market and it may comply. This product is the only one where there are no boundaries – neither on upside nor on downside. Ordinarily an investor of shares is owner of the ‘Company’ in proportion to shares held. Each shareholder is entitled to assets of the company in liquidation, as the owner would normally expect. Ownership is easily transferable at a prevailing price enabling a shareholder to make profit or loss. Besides ownership, investing entitles a shareholder to get dividend, if declared; bonus shares in proportion to shares held and right shares in case of new issue.

Small investors often feel that there is no level-playing field and more sophisticated and larger players control the game. They are often put off by the suspicion that large investors actually control the market. But this is not true. In fact, it is almost impossible for an individual or institution to control the entire market. The market behaviour is sum total of diverse economic situations which are not under the command of one or more large players. Only complicity of investors, brokers and financiers using dubious means may culminate into financial scam endangering the whole market for some time, but that is true with every financial instrument in varying degree.

Dividend represents that part of the profits of the company, which is distributed to the shareholders. The other part is retained back for growth and
expansion of the business. Sale / purchase of investment in shares results in capital

gains. Shares are capital assets and their period of holding determines whether they
are short-term or long-term. Shares held for a period of more than one year are

treated as long-term capital assets.

Bonus shares represent increase in capital base and reward to shareholders for
their continued association with the company. Free shares are issued to them on the
basis of their holding on book closure date. Fully paid free shares issued to its
shareholders are known as bonus shares. Whenever companies bring out additional
public issue in the market, it is mandatory for them to offer right of subscription to
existing shareholders known as right issue. The shareholders are also given a right to
renounce this offer in favour of others.

3.2.6 DERIVATIVES

The term ‘derivative’ has its origin in mathematics wherein it refers to a
variable, which has been derived from another variable. A ‘Derivative’ is a financial
product which has been derived from another financial product or commodity. In
other words, financial derivative is financial instrument:

a. Whose value changes in response to the change of price of the underlying
   financial instrument like interest rate, exchange rate, security price,
   commodity price, etc.

b. Which require no initial investment or very little initial investment, and

c. That is settled at a future date.

Thus, derivative indicates that it has neither an existence of its own nor an
independent value. Its value is derived from the underlying cash asset, which is sold
and bought in the market on normal delivery terms. It is a promise to convey

---

University Press.
ownership of some future date. The main role of the derivatives is to act as a hedge against future price risks.

The underlying asset could be stock or an index (group of stocks) or a commodity such as grain, cotton, or currency such as dollars or pounds. The sale of underlying stock of some future date is done by making a promise or entering a contract, which is known as derivative.

Derivatives are not direct sale or purchase or borrow or lending of funds, but it is involved with transferring price list, associated with timely fluctuations on the values of asset. Three categories of participants involved in derivatives known as players are:

a. Speculators – Bet on future movements in the price of an asset.

b. Hedgers – Manage the risk associated with price of asset.

c. Arbitrageurs – Purchase and sale in different markets at the same time to be profited by the difference in prevailing prices of two centres.

**Most Commonly Used Derivative Contracts**

The following are the most commonly used derivative contracts:

- Options
- Future
- Forwards
- Swap

**Options**

Options are contracts giving the holder the right (but not the obligation) to buy or sell securities at a predetermined price also called the strike price or exercise price within or at the end of the specified period also known as expiration period.
The holders of option have limited liability. The companies giving the right of option issue no certificates. The holders pay a premium to the Company giving the right. The options can be of two types:

**a. Call Option**

The holder has the right to purchase and the writer has the obligation to sell the securities at agreed price prior to options expiry date.

**b. Put Option**

The holder has the right to sell and the writer has the obligation to purchase the securities at agreed price prior to the options expiry date.

Based on the time period within which the option is to be exercised the options are divided into two types:

1. American Options are exercisable at any time prior to expiration.
2. European Options are exercisable only at expiration date.

In India, two types of options are permitted to be traded on the stock exchanges:

1. Index options exercisable only at the expiration date.
2. Specific Scrip Options exercisable at any time prior to the expiration date.

Mutual funds, foreign institutional investors, brokers, retail investors generally deal in option market.

**Futures**

A future contract is a standardized contract wherein there is an agreement between two parties to buy and sell an asset at a certain time in future for a certain price. For every buyer of a contract there is a seller. Future contracts are traded on
future exchanges / commodity exchanges/ stock exchanges. Unlike option, no premium is paid by either party.

The parties of contract must perform at settlement date. At that time either actual delivery is made or the contract is settled by making payment of price difference at the time of settlement.

Margins are paid by both buying and selling parties to the exchange to ensure performance of the contract. The futures contract is fully standardized in terms of quantity of underlying asset, date and month of delivery, units of price quotation and minimum price change.

Hedgers, corporate, speculators generally deal in futures.

**Forwards**

Forward contracts are similar to future contracts except that these can be traded in other than stock exchanges also. Also, unlike futures they are not regulated by any regulatory authority like SEBI, RBI, etc.

**Swaps**

It is an agreement between two or more parties to exchange a set of cash flows over a period in future. They can either be currency swaps or interest rate swaps. Currency swaps are those where currencies are exchanged at specified exchange rates and specified intervals. Interest rate swaps are those where one party exchange fixed interest rate payment for another rate over a period.
3.2.7 DEPOSITS WITH COMPANIES

Interest on fixed deposit of the companies was a major source of earnings in the late eighties and early nineties for small and retail investors. Companies are allowed to collect deposits from public to meet their working capital requirements. Usually the deposits are unsecured. Convenience in collecting deposits as compared to getting loans from the banks and financial institutions prompted the companies to offer higher interest than paid by the banks on term deposits. In the beginning defaults were few in spite of weak regulatory framework. Harshad Mehta scam and subsequent fallout in the financial market catering to Indian Industry shattered all beliefs and faiths the public had, in the managements of borrowing companies. Even best of the companies defaulted on commitments. Some became bankrupt and others willful defaulters. Small depositors, majority of them retirees, lost their hard earned money and regulatory framework was too weak to help. The rates of interest plummeted and leaders vanished. Still as the saying goes that higher the risk, higher the profits, there are people who are ready to take calculated risk in order to earn more.

3.2.8 GOLD AND SILVER

Spurt in gold and bullion prices has been quite good in the recent past and if one were to believe goldsmiths, 10 gram gold is poised to touch greater heights in next one year. Gold is priced for its rarity, beauty and unique characteristics. Majestic shining yellow metal tops the list of natural resources. Highly malleable and ductile properties enable goldsmiths to produce unlimited design range. It is one of the purest metals, being non-corrosive and indestructible; jewellery made out of it can be possessed almost forever. Being an excellent conductor of electricity it also finds use in industrial applications, especially electronic.

Nations may rise and fall, currencies come and go, but gold endures. In today’s uncertain climate, many investors turn to gold because it is a ‘currency without borders’, liquid under virtually any circumstances across the world. It has stabilizing influence in any investment portfolio. Financial professionals and sophisticated investors worldwide are increasingly using gold stabilizer.

Unfortunately in India, though gold is possessed by all and sundry it is not used as an investment vehicle. Primarily it is consumed as jewellery.

Silver has never been far behind of gold. Both gold and silver have been used as currency in barter system. High liquidity, ease to carry and hide small quantities possessing large values are other points, which make these, metals an attractive investment. Used extensively for religious ceremonies, customs and traditions, these metals have been possessed for pride, security, investment and hedge against inflation.

3.2.9 REAL ESTATE

Thanks to ever growing mankind population world over, the real estate market continues to be under pressure. Landmass is constant – no more land can be created. Reclamation, sky-scrappers, deforestation have their own limitations. Demand for land will keep rising and so be the prices. Investment in real estate is the real investment.

To possess land is natural inborn desire of all human beings. It has always been a matter of pride to own land. Minerals, oil, gas, coal, precious metals and other underlying resources, proximity to rivers, lakes and sea, land fertility, vegetation are

---

9 Michael S. Giliberto (2009), Equity Real Estate Investment Trusts and Real Estate Returns, Journal of Real Estate Research, Volume 5, Number 2, pp. 259-263
the obvious reasons for human settlements through ages. Many wars have been fought for control of these natural resources.

3.2.10 MUTUAL FUNDS

The Mutual Funds originated in UK and thereafter they crossed the border to reach other destinations\textsuperscript{10}. The concept of MF was indianite only in the later part of the twentieth century in the year 1964 with its roots embedded into Unit Trust of India (UTI). Now, booming stock markets & innovative marketing strategies of mutual fund companies in India are influencing the retail investors to invest their surplus funds with different schemes of mutual fund companies with or without complete understanding of Mutual Funds (MF).

Mutual funds also invest in more exotic financial instruments such as futures, options, forwards, and swaps. In addition, some mutual funds invest mainly in shares in some market sector or industry such as financial services, utilities, or technologies. These are referred to as sector or specialty funds. Bond funds come in different types and vary according to risk (for example, investment-grade corporate bonds and high-yield junk bonds), by maturity, as bonds are short- and long-term, and by type of issuing institution, which may be a corporation, a government agency, or a municipality.

Bond and stock funds invest mainly in domestic funds, such as US securities, global funds have both, domestic and foreign securities and international funds focus on foreign securities. Investment is the allocation of funds to assets and securities after considering their return and risk factors. Investor plans for long horizon after considering the fundamental factors and assumes moderate risk.

A mutual Fund is a trust that pools the savings of a number of investors who share a common financial goal. Anybody with an investible surplus of as little as a few hundred rupees can invest in Mutual Funds. These investors buy units of a particular Mutual Fund scheme that has a defined investment objective and strategy. The money thus collected is then invested by the fund manager in different types of securities.

### 3.3 TYPES OF MUTUAL FUNDS

Most funds have a particular strategy they focus on when investing. For instance, some invest only in Blue Chip companies that are more established and are relatively low risk. On the other hand, some focus on high-risk startup companies that have the potential for double and triple digit growth. Finding a mutual fund that fits your investment criteria and style is important. Types of mutual funds are:

**Value stocks**

Stocks from firms with relative low Price to Earning (P/E) Ratio usually pay good dividends. The investor is looking for income rather than capital gains.

**Growth stock**

Stocks from firms with higher low Price to Earning (P/E) Ratio usually pay small dividends. The investor is looking for capital gains rather than income.

**Income stock**

The investor is looking for income which usually comes from dividends or interest. These stocks are from firms which pay relative high dividends. This fund may include bonds which pay high dividends. This fund is much like the value stock fund, but accepts a little more risk and is not limited to stocks.
Index funds

The securities in this fund are the same as in an Index fund such as the Dow Jones Average or Standard and Poor's. The number and ratios or securities are maintained by the fund manager to mimic the Index fund it is following.

Enhanced index

This is an index fund which has been modified by either adding value or reducing volatility through selective stock-picking.

Stock market sector

The securities in this fund are chosen from a particular marked sector such as Aerospace, retail, utilities, etc.

Defensive stock

The securities in this fund are chosen from a stock which usually is not impacted by economic down turns.

Socially responsible

This fund would invest according to non-economic guidelines. Funds may make investments based on such issues as environmental responsibility, human rights, or religious views. For example, socially responsible funds may take a proactive stance by selectively investing in environmentally-friendly companies or firms with good employee relations. Therefore the fund would avoid securities from firms who profit from alcohol, tobacco, gambling, pornography etc.

Balanced funds

The investor may wish to balance his risk between various sectors such as asset size, income or growth. Therefore the fund is a balance between various attributes desired.
**Tax efficient**

Aims to minimize tax bills, such as keeping turnover levels low or shying away from companies that provide dividends, which are regular payouts in cash or stock that, are taxable in the year that they are received. These funds still shoot for solid returns; they just want less of them showing up on the tax returns.

**Closed end**

This fund has a fixed number of shares. The value of the shares fluctuates with the market, but fund manager has less influence because the price of the underlining owned securities has greater influence.

**Exchange traded funds (ETFs)**

Baskets of securities (stocks or bonds) that track highly recognized indexes. Similar to mutual funds, except that they trade the same way that a stock trades, on a stock exchange.

**3.4 CONCLUSION**

In this chapter, various investment avenues available for retail investors in India have been discussed. These avenues are just illustrative and not exhaustive. Apart from these avenues, other investment avenues like debentures, commodity trading, financial house keeping are also available at the disposal of retail investors. However, the investment avenues briefed in this chapter have been found to be the major avenues preferred by the retail investors.