CHAPTER – 2
THEORETICAL BACKGROUND
2.1. Investment:

Investment is something worth buying because it may be profitable or useful in future. It is the act of investing money in profitable ventures. A person who performs this action of investment is said to be an investor. If someone has more money than one needs for current consumption, then one is said to be a potential investor. One may deposit his surplus in a bank account to earn a fixed rate of interest, purchase a speculative share on the stock market, buy gold, contribute to a provident fund account, buy a piece of art and/or invest in some other form. Whatever may be the decision, one is making a sacrifice in the present in hope of deriving benefits in future. Whatever may be the investment decision, it always has two aspects: time and risk. While sacrifice occurs in the present and is certain, the benefits come in future and may be uncertain. A person’s economic well-being in the long run depends significantly on how wisely or foolishly he/she invests.

In financial terms, investing is said to be commitment of money or capital in a business, project or enterprise to gain a profit after thoroughly analysing the past performance and future prospects of business, project, or enterprise¹. 

a. Stocks, bonds, cash equivalents and mutual funds are the most common forms of investments.

b. Stocks, bonds, mutual funds and certificates of deposits are commonly termed as securities.

c. Investments in each of the securities is possible either through the primary or the secondary market route through financial intermediaries and distributors such as investment banks, brokerage houses, and now other banks as well.

Benjamin Graham ² an economist, professional investor and father of speculative analysis defined an investment operation as one that, upon thorough analysis, promises safety of principal and an adequate return. Operations not meeting these requirements are said to be speculative.


² Benjamin Graham was a British born American professional investor. He is considered as the “Father of Value Investing” and as the “Dean of Wall Street”. Ben Graham excelled at making money in the stock market for himself and his clients without taking big risks. While best known as Warren Buffet’s mentor, Graham was also a famous author.
Warren Buffet, the legendary investor, defines investing as an act of seeking value at least sufficient to justify the amount paid. Consciously paying more in the hope that the investment can soon be sold for a still higher price is labelled as speculation.

Routinely investment is not speculation. Speculation implies the act whereby, people make an investment in a risky asset, hoping to obtain profits from future changes in the prices of assets. This hope could be based on the reports that people may have heard, but they may not have checked the credentials of the asset. Investors are said to speculate when they commit money to something that they do not understand. Making an investment involves understanding the financial strength, future prospects, expected return and the corresponding risk. The detailed analysis helps in taking a considered view. It is believed that in the long run the market prices start reflecting the fundamental valuations. Speculations on the other hand, involve taking a short term view based on the volatilities of the market in order to benefit from the price movements. A speculator works on the assumption of favourable price movements which may or may not happen. A speculator may use technical charts and analysis to predict price movements but the same will lack significant rigour. Investors should remember that if every rupee used for speculation is lost, it does not help them over long-term to create wealth.

Speculation promises to give profits immediately but, rarely delivers. On the other hand, patient investing gives reasonable assurance about delivering positive returns over the longer time horizon, simply through the power of compounding. Compounding in simple terms is generating earnings. For eg. Interest earned in one period earns additional interest during each subsequent time period. Investment is neither trading. An investor who keeps on buying and selling of shares like a retailer is known as a trader. The holding periods are generally short for a trader and he or she deals in large volumes on low margins. A similar concept is that of the day trader who does buying and selling during the day and keeps no open positions overnight. A day trader squares off the position everyday and has to calculate profit and loss on the basis of the trading and profit and loss account, similar
to a retail trader in goods. No tax benefits like long term or short term capital gains are available to a trader as may be applicable to the normal investor.

Investment is not hedging. Every investment has an inherent risk and an investor takes steps to reduce the risks. This technique is called hedging which may involve cover operations such as buying a call or selling a put or taking a forward cover against foreign exchange exposure, etc. Another variation could be immunisation, especially in case of debt securities where the investments may be balanced against liabilities such as loans by holding contra positions. This ensures that any movement in interest rates is automatically offset.

Investment is diversification. A diversified portfolio is the weighted average return but the risk of portfolio is lower as compared to the individual securities. Individual investment should be chosen in such a way, that there is not much correlations amongst investments. It should be remembered that the diversification also reduces the probability of making higher than the expected returns. The key to diversification lies in investing in different assets which are not correlated in terms of their market risk. There are mainly two kinds of assets – financial and physical assets. Financial assets are cash, fixed income securities, shares, etc. whereas, the physical assets could be gold, other commodities, residential and commercial properties, diamonds and precious stones, coins, art etc.

Each asset has distinct risk and return characteristics. Some are riskier than the others. Some are correlated in terms with their market risk whereas others have little or low co-variance. Each security should be viewed in terms of the type of risks it carries. Inflation, interest rates, reinvestment, default, liquidity risks, are the kind of risks a security may carry in varying degrees. An example could be investment in gold, which is quite distinct from the investment in equity market. Both do not have high correlation.
Idle cash is not an investment, since its value is likely to be eroded by inflation. Investment can be differentiated on the basis of a number of factors, such as whether the investment is a security or property; direct or indirect debt, equity, or options; low or high risk; and short or long term.

a. Securities and property:

Investments that represent evidence of debt, ownership of business, or the legal right to acquire or sell an ownership interest in a business are called securities. The most common types of securities are bonds, stocks, and options. Property, on the other hand, is investment in real property or tangible personal property. Real property is land, building, and that which is permanently affixed to the land. Tangible personal property includes items such as gold, antiques, art, and other collectibles. Although security investments are quite popular, many people prefer property investments because they feel more comfortable owning something they can see and touch. But because of the existence of organized mechanisms for buying and selling securities and their widespread popularity, the researcher intends to focus primarily on securities rather than on property investments.

b. Direct and Indirect:

A direct investment is one in which an investor directly acquires a claim on a security or property. For example, when a person buys a stock, a bond, a rare coin, or a parcel of real estate in order to preserve value or earn income, that individual has made a direct investment. An indirect investment is an investment made in a portfolio or group of securities or properties. For example, an investor may purchase a share of a mutual fund, which is a diversified portfolio of securities issued by a variety of firms. By doing so, he/she will own a claim on a fraction of the entire portfolio rather than on the security of a single firm. It is also possible to invest directly in property – for example, by buying an interest in a limited partnership that deals in real estate, oil wells, and the like. Although direct investments are preferred by many investors, indirect investments have certain attributes that make them attractive as well.

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c. **Debt, Equity, and Options:**

Usually, an investment represents a debt or an equity interest. Debt is an intangible investment. It represents funds loaned in exchange for the receipt of interest and the promised repayment of the loan at a given future date. When an investor buys a debt instrument like a bond, he in effect lends money to the issuer, who agrees to pay a stated rate of interest over a specified period of time, at the end of which the original sum will be returned.

Equity represents an on-going ownership interest in a specific business or property. An equity in investment may be held as a security or by title to a specific property. An investor typically obtains an equity interest in a business by purchasing securities known collectively as stock. Options are neither debt nor equity; rather, they are securities that provide the investor with an opportunity to purchase another security or asset at a specified price over a stated period of time. An investor, for example, pays ₹500 for an option to purchase a 2% in the A Company for 600 units, total amounting to ₹30,000. If a 2% interest is currently valued at only ₹24,000, the person would not now exercise this option. Option investments, although not as common as various types of debt and equity investments, are growing rapidly in popularity.

d. **Low and High Risk:**

Investments are sometimes differentiated on the basis of risk. As used in finance, risk refers to the change that the value or return on an investment differs unfavourably from its expected value. In other words, it is the change of something undesirable occurring. The broader the range of possible values or returns associated with an investment, the greater its risk, and vice versa. The individual investor has before him investments ranging from low – risk government securities to high – risk characteristic, the actual level of risk depending on the specific vehicle. For example, even though stocks are generally believed to be more risky than bonds, there are also high – risk bonds that are in fact more risky than the stock of a financially sound firm.

Low risk investments are those considered safe with regard to the receipt of a positive and consistent returns. High risk investments are considered speculative. The
term investment and speculation are used to refer to different approaches to the investment process. As already stated, investment is viewed as the process of purchasing securities or property for which stability of value and levels of expected return are not only positive but somewhat predictable. Speculation is the process of buying similar securities in which the future value and level of expected earnings are highly uncertain. Simply stated, speculation is on the high-risk end of the investment process. Of course, due to the greater risk, the returns associated with speculation are expected to be greater.

e. Short and Long Term

The life of an investment can be described as either short or long term. Short-term investments typically mature within one year. Long-term investments are those with longer maturities or perhaps, like common stock, with no maturity at all. For example, a six-month certificate of deposit (CD) would be a short-term investment, whereas a 20-years bond would be a long-term investment and selling it after a short period of time, say six months, an investor can use a long-term vehicle to meet a short-term goal. It is not unusual to find the investors matching the maturity of an investment to the period of time over which they wish to invest their funds. For instance, an investor with money that will not be needed for six months could purchase a six-month certificate of deposit, whereas a 40-years – old investor wishing to build a retirement fund may purchase a 20-years corporate bond. The breakdown of short term and long term may also be useful for tax purpose.

2.1.1. Motive of Investment:

If everyone works for money, it is equally important to ensure that money works for us. In order to improve one’s future welfare one invests. Funds to be invested come from assets already owned, borrowed money, and savings or foregone consumption. By foregoing consumption today and investing the savings, the investors expect to enhance their future consumption possibilities. Anticipated future consumption for other family members may be, such as education funds for children or by themselves, possibly in retirement when the individuals are less able to work and produce for their daily needs. Regardless of the varied reasons to invest, one
should seek to manage their wealth effectively, obtaining the most from it. This includes protecting the assets from inflation, taxes and such other factors.

Lord Keynes, the famous economist has stated the following eight investment motives:

a. The proprietary motive: To build a reserve against unforeseen contingencies.
b. The life cycle motive: To provide for anticipated future relationship between income and needs.
c. The inter-temporal substitution motive: To meet future consumption demand and cost of abstinence from the present consumption.
d. The improvement motive: To raise one’s living standards in future.
e. The independence motive: To enjoy a sense of economic independence or financial freedom and to command financial security.
f. The enterprise motive: To accumulate capital in order to exhibit managerial skills by undertaking future business ventures.
g. The bequest motive: To leave behind a fortune so that the future generations could enjoy some sort of security or to carry out activities in tune with one’s wishes even after his/her demise.
h. The avarice motive: To satisfy one’s speculative tendencies or gambling instincts.

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2.1.2. Investment Avenues:

As an investor, one may have a wide array of investment avenues available to them.

![Figure 2.1 Investment Avenues](image)

i. Equity Shares:

Equity shares represent ownership capital. As an equity shareholder, one has an ownership stake in the company. This essentially means that one has a residual interest in income and wealth. Each share of common stock represents a fractional ownership interest in the firm. For example, one share of common stock in a corporation that has 10,000 shares outstanding would represent 1/10,000 ownership interest. The return on common stock investment comes from either of the two sources, first – the periodic receipt of dividends, which are payments made by the firm to its shareholders, and second - increase in value, or capital gains, which result from selling the stock at a price above that originally paid. For example, if one purchases a single share of M and N Industries’ common stock for ₹40 per share.
During the first year, the investor owning it would receive ₹2.50 per share in cash dividends, and at the end of the year if the stock is sold for ₹44 per share, ignoring the costs associated with buying and selling the stock, the investor would earn ₹2.50 in dividends and ₹4 in capital gain. Thus, as equity offers a broad range of return–risk combinations it is the most popular form of investment vehicle.

Equity shares are classified into the following broad categories by stock market analysts:

a. Blue chip shares
b. Growth shares
c. Income shares
d. Cyclical shares
e. Speculative shares

ii. Fixed Income Securities:

Fixed income securities, in contrast to equity shares, provide a fixed stream of returns. Fixed income securities are a group of investment vehicles that offer a fixed period return. Some forms offer contractually guaranteed returns; others have specified, but not guaranteed, returns. Due to their fixed returns, fixed–income securities tend to experience their greatest popularity during periods of high interest rates, such as those during the late 1970s and early 1980s. The key forms of fixed income securities are bonds, preferred stock, and convertible securities.

The most important fixed income securities in India are:

a. Preference shares
b. Corporate debentures
c. Government securities
d. Money market instruments
e. Indira Vikas Patras
iii. Mutual Fund Schemes:

Instead of directly buying equity shares and/or fixed income securities, one can participate in various schemes floated by mutual funds which, in turn invest in equity shares and fixed income securities. There are three broad types of mutual fund schemes:

a. Growth Schemes
b. Income Schemes
c. Balanced Schemes

iv. Deposits:

Deposits, like fixed income securities earn a fixed return. However, unlike fixed income securities, deposits are not negotiable or transferable. The important types of deposits in India are:

a. Bank Deposits
b. Company Deposits
c. Postal Deposits

v. Tax-sheltered saving schemes:

Tax sheltered saving schemes provide tax benefits to those who participate in them. The most tax-sheltered saving schemes in India are:

a. Employee Provident Fund Scheme
b. Public Provident Fund Scheme
c. National Saving Certificates
d. Infrastructure Bonds

vi. Life Insurance:

In a broad sense, life insurance may be viewed as an investment. Insurance premiums represent the sacrifice and the assured sum of the benefit. The important types of insurance policies in India are:

a. Endowment assurance policy
b. Money back policy
c. Whole life policy
d. Premium back term assurance policy
vii. Real Estate:

For the bulk of the investors the most important asset in their portfolio is a residential house. In addition to a residential house, the more affluent investors are likely to be interested in the following types of real estate:

a. Agricultural land
b. Semi-urban land
c. Time share in a holiday resort
d. Commercial Spaces

viii. Commodities:

The others types of speculative investment are commodities and financial future, and tangibles. Commodities and financial futures contracts are legally binding obligations that the sellers of such contracts will make delivery and the buyers of the contracts will take delivery of a specified commodity (for example, soyabean, pork bellies, cocoa), foreign currency, of financial instrument (a specific security or its cash equivalent) at some specific date in the future. Trading in commodities and financial futures is generally a highly specialized, a high-risk proposition since the opportunity to make a profit depends on a verity of uncontrollable factors tied to world events and economic activity. Tangibles, in contrast, are investment assets, other than real estate, that can be seen or touched. They include gold and other precious metals, diamonds, and collectibles such as stamps, coins, art, and antiques. These speculative vehicles are purchased as investments in anticipation of price increases. During the ownership period these may also provide the investor with psychological or aesthetic enjoyment.

ix. Financial Derivatives:

Derivatives, as an innovation in markets are instruments of risk reduction. They are also termed as opportunity as an alternative investment, speculative investment etc. The derivatives are normally contracts agreeing to perform an action at a future date. The “time lag” between the dates of contract and the execution of contract ushers in the concept of interest on the value of asset. Carefully observed, this provides an opportunity to take advantage of the changes in value (price) on account of demand and supply apart from the interest factor.
Engineered financial products, can be termed as Derivatives. For example, an individual enters into a contract for providing space on rent with another entity. The contracts give rise to future cash flows. The future cash flows are discounted and the asset to rent out is created out of the money borrowed against the discounted value of future cash flows. In this transaction, it is observed that the opportunity of future cash flow is converted into present cash flow to acquire an asset, which provides the future cash flow. This is only an example of financial engineering opportunity the derivatives can provide.

The most common derivatives are:

a. Futures
b. Option
c. Swaps

a. Futures: The standardised contracts, agreeing to perform an action (buy or sell) on a future date at a predetermined price is known as Futures. There can be commodity futures, equity futures and currency futures.

b. Options: Options are another form of derivatives, providing choice to the buyer of the contract, to enforce the contract or otherwise on the day of the expiry. It is to be understood clearly that a buyer of an option contract has choices but not the seller (writer) of an option contract. The seller of an option contract has commitment to be fulfilled. He has obligations to perform.

c. Swap: Swap is contract between two parties to exchange payments at predetermined time intervals for a definite period of time, but calculated at different rates with reference to a pre-agreed index. Interest rate swap, on a fixed rate and floating rate, is an example of such plain contract of swap.
2.1.3. Investment fundamentals:

Once the nature and the motive of investment is understood it is necessary to know the investment fundamentals. Some of the fundamental rules of investments are:

a. Start early – Start early and retire rich. One must invest whatever he/she can immediately and move steadily towards a secured tomorrow.

b. Invest regularly – Invest regularly and methodically.

c. Ensure higher returns on investments – Regular investment in investment avenues that provide the magic of compounding.

d. Never time the market – One should be a smart investor. One must always invest in time, but, never try to time the market. Timing the market is mastered by none and is beyond one’s control.

e. Be patient – Investments have to be dealt with patience. For long term wealth creation, one needs to be patient. The longer the investment horizon, the lesser the risk and greater are the returns.

Indian investors have always preferred fixed income securities where the returns are assured and have compromised on the returns. In general investors are risk averse and more so Indian investors. The investment fundamentals can be explained by an example:

Mr. A, a very conservative investor, has been religiously investing ₹5,000/- p.m. in a provident fund account which gives him interest at the rate of 8% p.a. compounded annually. Mr. B, on the advise of his planner, has been investing ₹5,000/- p.m. in equity linked investments which have given him around 15% p.a. return. Both start at the same age of 25 years and keep investing for 30 years. Mr. A would then have an amount of ₹74.50 lacs in his provident fund account while Mr. B would have accumulated ₹3.46 crores which is about 5 times the retirement capital of Mr. A.

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These dramatic results have been possible because of the focus on the rate of return. Mr. A has done well by starting early and investing regularly but he has not focused on the rate of returns on his investments. While assured returns are important it is also important to focus on expected returns on investment, even at a risk.

2.2 Risk And Return:

2.2.1. Understanding Risk:

“Risk” with reference to investment is the chance that a person may lose his capital but more importantly the chance that the investor may not get the desired return on an investment vehicle. Investors invest in various investment products that are generally fixed income instruments and market oriented investments. In the case of fixed income instruments there being a definite interest rate, there is virtually no “risk” of not being able to get the desired returns but in the case of other instruments an investor goes with an expectation of a certain amount of return and the term “risk” in this context refers to the probability of the investor not getting the desired/expected returns.

2.2.2. The Risk Averse Investor:

It is a standard assumption that investors are rational. Rational investors prefer certainty to uncertainty. It is easy to say that investors dislike risk, but more precisely, investors are said to be risk averse. A risk – averse investor is one who does not assume risk simply for its own sake and does not incur any given level of risk unless there is an expectation of adequate compensation for having done so. It is not irrational to assume very large risk, as long as it is compensated for higher returns. In fact, investors cannot reasonably expect to earn larger returns without assuming larger risks.

Investors deal with risk by choosing the amount of risk they are willing to incur. Some investors choose to incur high levels of risk with the expectation of high levels of return. Other investors are unwilling to assume high risk, and nor do they expect to earn large returns. Lower the risk, lower the return. Taken to its logical conclusion, the minimization of risk would result in everyone holding risk – free assets such as savings accounts and treasury bills. Thus, it is necessary to think in terms of the expected return/risk trade-off that results from the direct relationship between the risk and the expected return of an investment.
2.2.3. Influence of Time on Risk:

Investors need to think about the time period involved in their investment plans. Whatever could be the objective of financial planning, it would require a policy statement that refers to specific planning horizons. In the case of an individual investor, it could be a year or two in anticipation of a down payment on a home purchase or it could be a lifetime, if planning for retirement. Longer the time horizon, the more risk is incorporated into the financial planning. Also, younger a person, longer would be his time horizon with more exposure to equities.

Time has a different effect when analyzing the risk of owning fixed income securities, such as bonds. There is more risk associated with holding a long term bond than a short term one because of the uncertainty of future inflation and interest rate levels.

2.2.4. Types of Investment Risk:

There are various types of risks in investment that an investor should be aware of. The investor will be able to have a better risk-return trade off if he/she knows the type of risks associated with the investment avenue

a. Systematic Risk:

The risk that affects the entire market or entire market segment is a systematic risk. It cannot be avoided through diversification. Systematic risk can be mitigated only by being hedged. It covers two types of risks; market risk and interest rate risk.

i. Market Risk:

The variability in a security's returns resulting from fluctuations in the aggregate market is known as market risk. All securities are exposed to market risk involving recessions, wars, structural changes in the economy, tax law changes, even changes in consumer preferences. Market risk is sometimes used synonymously with systematic risk. It is also important to know that this risk cannot be removed through diversifying across different securities and hence market risk is a non-diversifiable risk.
ii. Interest Rate Risk

The variability in a security's return resulting from changes in the level of interest rates is referred to as interest rate risk. Such changes generally affect securities inversely; that is, other things being equal, security prices move inversely to interest rates. The reason for this movement is tied up with the valuation of securities. Interest rate risk affects bonds more directly than common stocks and is a major risk faced by all bondholders, as interest rates change in the opposite direction.

If the current scenario is such that the interest rates may rise in the near future and may keep rising for some time, then more of short term debt instruments would find place in the portfolio. In a scenario where the interest rates have reached historic peaks and if fall in the future, then it would make sense to commit funds for long term and hence investors need to be advised to get into long term bonds/annuities of insurance companies, etc. to protect from these risks.

b. Non-Systematic Risk:

The variability in a security's total returns not related to overall market variability is called the non-systematic (non market) risk. This risk is unique to a particular security and is associated with factors like business and financial risk as well as liquidity risk. Although all securities tend to have some non-systematic risk, it is generally connected with common stocks.

i. Business Risk

The risk of doing business in a particular industry or environment is called business risk. For example, some commodities like fertilizers and oil are highly price sensitive in the Indian context and the Government policies of subsidies substantially affect the profitability of the companies engaged in manufacturing/marketing these products.

ii. Financial Risk:

Financial risk is the additional risk a shareholder bears when a company uses debt in addition to equity financing. Companies that issue more debt instruments would have higher financial risk than companies financed mostly or entirely by equity.
iii. Liquidity Risk:

Liquidity in the context of investment in securities is related to being able to sell and realize cash with the least possible loss in terms of time and money. Liquidity risk is the risk associated with the particular secondary market in which a security trades. An investment that can be bought or sold quickly and without significant price concession is considered liquid. The more uncertainty about the time element and the price concession, greater is the liquidity risk. A treasury bill has little or no liquidity risk, whereas a small-cap stock listed in a regional stock exchange may have substantial liquidity risk.

c. Reinvestment Risk:

In the context of bonds, investors look at the current yield as well as Yield To Maturity (YTM) i.e. the return one would get if the securities were held till the maturity and redeemed with the issuing institution. YTM is a promised yield, because investors earn the indicated yield only if the bond is held to maturity and the periodic interest payments are reinvested at the calculated YTM. It is important to reinvest the periodic payments, at the same rate as the YTM, to obtain the YTM yield on the security. In the context of long term bonds during the tenure of which the interest rates may fluctuate in any economy it is virtually difficult for the investors to invest periodic coupon payments at YTM and hence the risk of not being able to get the desired return (YTM) and this risk is referred to as reinvestment risk. This calculation assumes that the investment rate is the yield to maturity.

d. Purchasing Power Risk or Inflation Risk:

A factor affecting all securities is the purchasing power risk. It is also known as inflation risk. This is the possibility that the purchasing power of invested money may decline. With uncertain inflation, the real (inflation-adjusted) return involves risk even if the nominal return is safe, e.g., a treasury bond. This risk is related to interest rate risk, since interest rates generally rise as inflation increases, because lenders demand additional inflation premiums to compensate for the loss of purchasing power.
e. Regulation Risk:

Some investments can be relatively attractive than other investments because of certain regulations or tax laws that give them an advantage of some kind. The interest earned on Public Provident Fund accounts are totally tax free (exclusion from income u/s 10 of the Indian Income Tax Act). As a result of that special tax exemption on the interest as well as the invested amount qualify for deduction from income u/s 80C. The yield on PPF account is much higher than its current interest rate of 8.8%. The risk of a regulatory change that could adversely affect the stature of an investment is a real danger. That is one risk associated with investments which cannot be avoided. The best solution lies in periodic review of investment plans.

f. International Risk

International Risk includes both country risk and exchange Rate risk.

i. Country Risk:

Country risk, also referred to as political risk, is an important risk for investors today. With more investors investing internationally, both directly and indirectly, the political and therefore economic stability and viability of a country's economy need to be considered. There is no “right or wrong” amount of risk. It is a very personal decision for each investor. However, young investors can afford higher risk than older investors can, because young investors have more time to recover if disaster strikes.

ii. Exchange Rate Risk:

All investors who invest internationally in today's increasingly global investment arena face the prospect of uncertainty in the returns after they convert the foreign gains back to their own currency. Unlike the past when most Indian investors ignored international investing alternatives, investors today must recognize and understand exchange rate risk, which can be defined as the variability in returns on securities caused by currency fluctuations. Exchange rate risk is sometimes called currency risk. For example, a U.S. investor who buys an Indian stock denominated in Indian rupees must ultimately convert the returns from this stock back to dollars. If the exchange rate has moved against the investor, it can partially or totally negate the original return earned. A stable rather than a depreciating foreign currency is what the investor would be looking for while deciding to invest in that country. The returns to
an international investor is always the market returns + or – the foreign currency appreciation or depreciation in the intervening period.

Obviously, the investors who invest only in domestic markets do not race this risk, but in today's global environment where investors increasingly consider alternatives from other countries, this factor has become important. Currency risk affects international mutual funds, global mutual funds, closed-end single country funds, American Depository Receipts (ADRs), foreign stocks, and foreign bonds.

2.2.5. Handling Risk:

Investment planning is almost impossible without a thorough understanding of risk. There is often a risk/return trade off. That is, greater the risk accepted, greater must be the potential return that converts one's funds to a favourable outcome. Generally, as the level of risk rises, the rate of return should also rise, and vice versa. Risk is an integral part of investments. Risk in the context of investments not only refers to the chance of losing one’s capital, but mainly to the probability of getting less than expected returns from an investment vehicle. Thus, risk in investments cannot be avoided but it can be managed to suit one's risk profile and investment objectives.

The various ways to handle risk are as follows;

a. Avoiding Risk:

One way to handle risk is to avoid it. Risk avoidance occurs when one chooses to completely avoid the associated risk. Eg. An individual may have the risk of being infected by swine flu. By choosing to get vaccinated, the individual could avoid that risk altogether. Similarly, in the investment world, avoidance of some risk is deemed to be possible through the act of investing in “risk – free” investments. Short – term maturity Government bonds are usually equated with a “risk – free” rate of return. In the Indian market “risk – free” returns are the returns available on treasury bills of a certain tenure; necessarily less than one year and about 90 days or 180 days. Stock market risk, for example, can be completely avoided by choosing not to invest in equities and equity related instruments.
b. **Risk Transfer:**

Another way to handle risk is to transfer the risk. A perfect example of risk transfer could be the insurance. An insurance company allows one to transfer the risk of large medical bills to them in exchange for a fee called an insurance premium. The company knows that statistically, if they collect enough premiums and have a large enough pool of insured persons, they can pay the costs of the minority who will require extensive medical treatment and have enough funds left to record a profit.

Risk transfer can happen in investing. One may purchase a put option on a stock or on the market index which allows that person to “put to” or sell to someone their stock or the index at a set price, regardless of how much lower the stock or the index may drop.

c. **Diversification:**

Obtaining the required returns and simultaneously reducing the risk can be achieved through diversification. Diversification of investments can happen in any of the following ways;

i. Across different asset classes – equity; debt; commodities; precious metals; real estate etc.
ii. Across different countries (geographies) - India; USA; UK; Japan; Singapore; Australia; Middle East etc.
iii. Across different securities – Different stocks; bonds, etc.
iv. Across maturities-short term; long term & medium term.

i. **Diversification across different asset classes**

Investments need to be diversified across different asset classes. Proper allocation among different assets needs to be made. This is known as the Asset Allocation Plan.

Here, it is important to decide the quantum of investments in risky asset classes like equity, real estate, etc. based on the age, risk appetite, etc. of the investor. Over dependence on a particular asset class can also be quite risky. If an investor is
highly risk averse and has little or no exposure to equities, then he/she will find the going tough if the interest rates in the economy were to fall. He/she will continue to earn less over a period of time and may even suffer loss on existing investing because of fall in bond prices. Hence, exposure to equity should be considered in such cases.

Similarly, a very high exposure to equity can prove very tricky because the stock market over a long period of time may turn bearish and the investor may get very little return and capital appreciation in this period. The chances of capital loss are also quite high in such cases. Equity is a long term asset class and should be accordingly planned while deciding the Asset Allocation Plan.

While investing in stocks it is essential to invest in a number of stocks and not just a few to reduce the risk. But the purpose of diversification can be achieved only if the stocks belong to different sectors and that some of the sectors are not related to each other.

The following features need to be considered regarding diversification across securities:
1. The number of securities should be limited to say 20 to 30 and not more.
2. The securities should ideally belong to different industrial sectors and if possible even different geographical regions
3. The correlation of market movements may be built in selecting stocks in a portfolio, e.g. oil marketing companies and automobiles; export oriented and import dependant companies; lending companies and borrowing companies, etc.

**ii. Risk Reduction through Product Diversification**

It is important to have a dynamic asset allocation plan diversified among different asset classes. Financial investment products comprise direct equity; indirect equity through the mutual fund route; balanced fund which focuses on both debt and equity; debt - corporate and government; fixed income instruments like small saving schemes; government bonds, fixed deposits - bank and corporate, etc. Risk on the total portfolio is reduced through investments among different products, in a pre-
determined proportion, depending upon the risk profile of the investor and managed through periodic review of the proportion.

iii. Risk Reduction through Time Diversification

When it comes to equity investments, it is a well established fact, especially in respect of retail investors that they cannot time the market, it is the time one stays invested that would determine the returns on equity investments over a period of time and not market timing. Many investors tend to take higher exposure to equity at market highs and tend to reduce their exposure during market lows due to emotional swings. These investors invariably end up losing money. The best and time tested solution lies in systematic investment and sticking to asset allocation plans. The quantum of funds allocated to equities can be invested over a period of time through systematic investment plans. Almost all mutual funds offer SIP's where the people can invest in these funds on a monthly basis at predetermined dates and fixed amounts per month. Auto debit and ECS make it very convenient for investors to invest on a systematic basis. Another very important strategy could be parking the available funds in floating rate debt funds and transferring fixed quantum of funds on a monthly basis through a systematic transfer plan out of floaters through SIP's into equity funds. In this strategy, the funds may earn decent returns in floating rate funds with less interest-rate risk while the equity market timing-risk is reduced through SIP's.

d. Hedging:

Diversification reduces unsystematic risk in a portfolio. Unsystematic risk refers to a specific individual corporate or country financial risk event. Therefore, as there is an increase in the number of securities in the portfolio, the unsystematic risk in the portfolio decreases. The remaining risk is called systematic or market risk. Systematic risk cannot be diversified out of a portfolio; however, systematic risk can be hedged.
2.2.6. Measurement of Risk:

It is important for investors to be able to quantify and measure risk. Risk is associated with the expected returns. It is observed that probabilities represent the likelihood of various outcomes and are typically expressed as a decimal (sometimes fractions are used.) The sum of the probabilities of all possible outcomes must be 1.0, because they must completely describe all the (perceived) likely occurrences. To describe the single most likely outcome from a particular probability distribution, it is necessary to calculate its expected value. The expected value is the average of all possible return outcomes, where each outcome is weighted by its respective probability of occurrence. For investors, this can be described as the expected return.

In case of a fixed income security like a Government of India Bond or a bank fixed deposit normally the expected return is the same as the coupon rate/ or rate of interest. There are no uncertainties about being able to get the expected return.

In case of investments where the returns are market dependant, for example a stock, one will have to estimate the possible returns and the probability of getting the same, as given below:

<table>
<thead>
<tr>
<th>Returns</th>
<th>Probability of getting returns</th>
</tr>
</thead>
<tbody>
<tr>
<td>4%</td>
<td>0.2</td>
</tr>
<tr>
<td>8%</td>
<td>0.2</td>
</tr>
<tr>
<td>12%</td>
<td>0.4</td>
</tr>
<tr>
<td>16%</td>
<td>0.2</td>
</tr>
</tbody>
</table>

In this case, the expected return is calculated as under:

Expected return $= \text{Sum} \ (\text{returns} \times \text{probability})$

$= (0.04 \times 0.2 + 0.08 \times 0.2 + 0.12 \times 0.4 + 0.16 \times 0.2)$

$= 0.008 + 0.016 + 0.048 + 0.032$

$= 0.104$ or 10.4%

2.2.6.a. Standard Deviation:

In order to calculate the total risk associated with the expected return, the variance or standard deviation is used. This is a measure of the spread or dispersion in the probability distribution. It is a measurement of the dispersion of a random variable
around its mean. Larger the dispersion, larger is the variance or standard deviation, and larger the standard deviation, the more uncertain is the outcome.

**Calculating standard deviation:**

The above table can be used for calculating the expected returns and find out the standard deviation of the same:

<table>
<thead>
<tr>
<th>Returns</th>
<th>Probability of getting returns</th>
</tr>
</thead>
<tbody>
<tr>
<td>4%</td>
<td>0.2</td>
</tr>
<tr>
<td>8%</td>
<td>0.2</td>
</tr>
<tr>
<td>12%</td>
<td>0.4</td>
</tr>
<tr>
<td>16%</td>
<td>0.2</td>
</tr>
</tbody>
</table>

Standard deviation is square root of variance

\[
\text{Variance} = \text{Sum of} \{ \text{probabilities} \times (\text{actual return} - \text{expected return})^2 \}
\]

\[
\text{Variance} = \sum \text{probability} \times (\text{actual return} - \text{expected return})^2
\]

So, based on the figure in the table we can work out of variance as under; Expected return as already calculated is 10.4%

<table>
<thead>
<tr>
<th>Actual return</th>
<th>Actual return minus Expected return</th>
<th>Difference squared</th>
<th>Probability</th>
<th>Square of difference × probability</th>
</tr>
</thead>
<tbody>
<tr>
<td>4</td>
<td>– 6.4</td>
<td>40.96</td>
<td>0.2</td>
<td>8.192</td>
</tr>
<tr>
<td>8</td>
<td>– 2.4</td>
<td>5.76</td>
<td>0.2</td>
<td>11.52</td>
</tr>
<tr>
<td>12</td>
<td>1.6</td>
<td>2.56</td>
<td>0.4</td>
<td>1.024</td>
</tr>
<tr>
<td>16</td>
<td>5.6</td>
<td>31.36</td>
<td>0.2</td>
<td>6.272</td>
</tr>
</tbody>
</table>

Variance = sum of last column = (8.192 + 11.52 + 1.024 + 6.272) = 16.64

Standard deviation = Square root of variance = 4.08

Thus, the standard deviation of return measures the total risk of one security or the total risk of a portfolio of securities. The historical standard deviation (ex-post value) can be calculated for individual securities or portfolios of securities using total returns for some specified period of time. This ex-post value is useful in evaluating the total risk for a particular historical period and in estimating the total risk that is expected to prevail over some future period.
The standard deviation, combined with the normal distribution, can provide some useful information about the dispersion or variation in returns. In a normal distribution, the probability that a particular outcome will be above or below a specified value can be determined. With one standard deviation on either side of the arithmetic mean of the distribution, 68.3 percent of the outcomes will be encompassed; i.e. there is a 68.3 percent probability that the actual outcome will be within one plus or minus standard deviation of the arithmetic mean. The probabilities are 95 and 99 percent that the outcome will be within two or three standard deviations, respectively, of the arithmetic mean.

![Figure 2.2. Normal Distribution of Risk](image)

In a bell shaped normal distribution the probabilities for values lying within certain bands are as follows.

- \( \pm 1 \text{ S. D.} \) 68.3%
- \( \pm 2 \text{ S. D.} \) 95.4%
- \( \pm 3 \text{ S. D.} \) 99.7%

Using standard deviation as a measure of risk can have its drawbacks. For starters, it may happen that investors own a fund with a low standard deviation and still lose money. The other flaw with standard deviation is that it is not intuitive. A standard deviation of 7% is higher than a standard deviation of 5%, but these are absolute figures and one cannot reach a conclusion as to whether these are high or low.
figures. Standard deviation not being a relative measure cannot be compared to other funds or to a benchmark, it is not very useful to the investor without some context.

2.2.6.b. Beta

Beta is a measure of the systematic risk of a security that cannot be avoided through diversification. Beta measures non-diversifiable risk. Beta shows the price of an individual stock which performs with changes in the market. In effect, the more responsive the price of a stock to the changes in the market, the higher is its Beta.

Beta is a relative measure of risk. If the security's returns move more (or less) than the market's returns as the latter changes, the security's returns have more (or less) volatility (fluctuations in price) than those of the market. It is important to note that beta measures a security's volatility, or fluctuations in price. It is found by relating the historical returns on a security with the historical returns for the market. Market return is typically measured by the average return of all (or a large sample of) stocks. Betas can be positive or negative, though nearly all betas are positive and most stocks have betas that fall between 0.5 and 1.75. In general, higher the beta, the riskier the security. The positive or negative sign preceding the beta number merely indicates whether the stock's return changes in the same direction as the general market (positive beta) or in the opposite direction (negative beta).

Following are the important features of Beta;

a. Beta measures the non-diversifiable or market risk of a security.
b. The beta for the market is 1.
c. Stocks may have positive or negative betas; nearly all are positive.
d. Stocks with betas of greater than 1 are more responsive to changes in market

2.2.7. Understanding Return:

Return is a key variable in the investment decision because this measure compares the amount of actual or expected gain provided by various investments. Return can be measured in a historical sense, or used to formulate future expectations. By using historical data in combination with other environmental factors expected
returns can be estimated and utilized in making the investment decision. The historical performance is considered while formulating expectations about the future performance of an investment.

The level of return achieved or expected from an investment depends on a variety of factors. The key forces are internal characteristics, external forces, and inflation.

i. Internal characteristics:

Certain characteristics such as the type of an investment vehicle, the quality of management, the way the investment is financed, the customer base of the issuer, and so on, all affect the level of return. The common stock of a large, well–managed, complete equity–financed steel manufacturer whose major customer is General Motors would be expected to provide a level of return different from that of a small, poorly managed, largely debt–financed, clothing manufacturer whose customers are small specialty stores.

ii. External Forces:

External forces such as war, shortage, price controls, Federal Reserve actions, and political events, which are not under the control of the issuer of the investment vehicle, may also affect the level of return. Because different investment vehicles are affected differently by these forces, it is not unusual to find two vehicles with similar internal characteristics offering significantly different returns. Thus as a result of the same external force the expected return from one vehicle may increase, where that of another may be reduced.

iii. Inflation:

Inflation tends to have a favourable impact on certain types of investment vehicles, such as real estate, and a negative one on others, such as stocks and fixed–income securities. Rising interest rates, which normally accompany increasing rates of inflation, significantly affect returns. Accordingly, actions are taken by the federal government to control inflation. Its presence can increase, decrease, or have no effect
on investment returns. Furthermore, the return on each type of investment vehicle exhibits its own unique response to inflation.

2.2.7.a. The Time Value of Money:

Time value of money refers to the fact that as long as an opportunity exists to earn interest, the value of money is affected by the point in time than it is expected to be received. Opportunity to earn interest on funds is readily available. The sooner one receives a return on a given investment the better. The time – value concepts should be considered when making investment decisions.

2.2.7.b. Interest : The basic return to savers:

A saving account at a financial institution is one of the most basic forms of investment. The saver receives interest in exchange for placing idle funds in an account. The interest received is clearly current income; but the saver experiences neither a capital gain nor loss, since the value of the investment (the initial deposit) changes only by the amount of interest earned. For the saver, the interest earned over a given time frame is that period’s current income. In other words, total return comes from the current income provided through interest.

i. Simple Interest

The income paid on vehicles such as Certificates of Deposit, Bonds, and other forms of investment that pay interest is most often calculated using the simple interest method. Interest is paid only on the actual balance for the actual amount of time it is on deposit.

ii. Compound Interest

Compound interest is paid not only on the initial deposit but also any interest accumulated from one period to next. This is the method usually used by savings institutions. When interest is compounded annually, compound and simple interest calculations provide similar result. The simple interest method is used in the compounding process; that is, interest is paid only on the actual balance for the actual amount of time it is on deposit. When compound interest is used, the stated and true interest rates are equal only when interest is compounded annually, In general, the
more frequently interest is compounded at a stated rate, the higher will be the true rate of interest.

2.2.7.c. Measuring Return:

In order to compare returns from different investment vehicles, there has to be a consistent measure that incorporates time value of money and considers differences in the timing of investment income and/or capital gains (or losses). Such an approach allows placing a current value on future benefits. The holding period return is a measure that assesses alternative investment outlets effectively.

i. Holding Period Return:

The holding period is the relevant period of time over which one wishes to measure the return on any investment vehicle. When making return comparisons, the use of holding periods of the same length of time adds further objectivity to the analysis. For example, comparison of the return on a stock over a six-month period with the return on a bond over a one-year holding period can result in a poor investment decision. To avoid this type of situation, the holding period should be defined and consistently applied or annualized to create a standard. Similar periods in time should be used when comparing the returns from alternative investment vehicles.

The holding period return (HPR) is the total return earned from holding an investment for a specified period of time (the holding period). It represents the sum of current income and capital gains (or losses) achieved over the holding period, divided by the beginning investment value; it is customarily used with holding periods of one year or less.

While measuring the returns in the holding period, capital gains need to be considered. Capital gain returns are realized only when the investment vehicle is actually sold at the end of the holding period.
2.3. Behavioral Finance And Wealth Management:

Behavioral finance is commonly defined as the application of psychology to finance. It can be classified as Behavioral Finance Micro and Behavioral Finance Macro\(^6\).

i. Behavioral Finance Micro (BFMI) examines behaviours or biases of individual investors that distinguish them from the rational actors envisioned in classical economic theory.

ii. Behavioral Finance Macro (BFMA) detects and describes anomalies in the efficient market hypothesis that behavioural models may explain.

From the point of view of wealth management of individual investors, the focus is on BFMI, i.e. the study of individual investor behaviour. It focuses on the rationality of the individual investors by considering the cognitive psychology and emotional psychology of the investors in making financial decisions. Behavioral finance attempts to identify and learn the individual investors from the human psychological phenomena. It is governed by basic precepts and assumptions - perfect rationality, perfect self-interest, and perfect information.

i. Perfect Rationality:

When humans are rational, they have the ability to reason and to make beneficial judgments. However, rationality is not the sole driver of human behaviour.


\(^7\) Cognitive psychology is the scientific study of cognition, or the mental process that are believed to drive human behaviour. Research in cognitive psychology investigates a variety of topics, including memory, attention, perception, knowledge representation, reasoning, creativity, and problem solving. Cognitive psychology is a relatively recent development in the history of psychological research, emerging only in the late 1950s and early 1960s. The term “cognitive psychology” was coined by Ulrich Neisser in 1967, when he published a book with that title. The cognitive approach was actually brought to prominence, however, by Donald Broadbent, who published Perception and Communication in 1958. Broadbent promulgated the information-processing archetypic of cognition that, to this day, serves as the dominant cognitive psychological model. Broadbent’s approach treats mental processes like software running on a computer (the brain). Cognitive psychology commonly describes human thought in terms of input, representation, computation or processing, and output. Psychologists Amos Tversky and Daniel Kahneman would eventually create a theory—prospect theory—that is viewed as the intellectual foundation of behavioral finance micro. Tversky and Kahneman examined mental processes as they directly relate to decision making under conditions of uncertainty.
In fact, it may not even be the primary driver, as many psychologists believe that the human intellect is actually compliant to human emotion. Therefore, human behaviour is less the product of logic than of subjective impulses, such as fear, love, hate, pleasure, and pain. Humans use their intellect only to achieve or to avoid these emotional outcomes.

ii. Perfect Self-interest:

People are not perfectly self-interested. If they were, philanthropy would not exist. Religions prizing selflessness, sacrifice, and kindness to strangers would not have prevailed as they have over centuries. Perfect self-interest would prevent people from performing such unselfish deeds as volunteering, helping the needy, or serving in the military. It would also rule out self-destructive behaviour, such as suicide, alcoholism, and substance abuse.

iii. Perfect Information:

Some people may possess perfect or near-perfect information on certain subjects; a doctor or a dentist, one would hope, is impeccably versed in his or her field. It is impossible, however, for every person to enjoy perfect knowledge of every subject. In the world of investing, there are nearly infinite matters to know and learn; and even the most successful investors do not master all disciplines.

Behavioral finance gives a clear understanding of how investor psychology impacts investment outcomes. It helps in the structuring of the portfolio by identifying the financial goals on understanding the psychology and emotions behind the decisions for creating the goals.

It is commonly observed that people have little difficulty in making hundreds of decisions. This is because the best course of action is often obvious and many decisions do not determine outcomes significant enough to merit a great deal of attention. On occasion, however, though many potential decision paths originate, the correct course is unclear. Sometimes, decisions also have significant consequences. These situations demand substantial time and effort to try to devise a systematic approach to analyzing various courses of action.
Even in a perfect world, when a decision maker has to choose one among a number of possible actions, the ultimate consequences of each, if not every, available action depends on uncertainties to be resolved in the future. When deciding under uncertainty, there are generally accepted guidelines that a decision maker should follow:

1. Taking an inventory of all viable options available for obtaining information, for experimentation, and for action.
2. Listing the events that may occur.
3. Arranging pertinent information and choices/assumptions.
4. Ranking the consequences resulting from the various courses of action.
5. Determining the probability of an uncertain event occurring.

Unfortunately, while facing uncertainty, most people cannot and do not systematically describe problems, record all the necessary data, or synthesize information to create rules for making decisions. Instead, most people venture down somewhat more subjective, less ideal paths of reasoning in an attempt to determine the course of action consistent with their basic judgments and preferences.

Behavioural Finance remains underutilized in the wealth management of the individual investors, as it has not been framed appropriately in the user-friendly manner. Though a lot of literature is available on the behavioural biases, practitioners like the financial advisors find it difficult to identify the biases and then, advise their clients to deal with them. Even if the behavioural biases of the individual investors are identified, financial advisors lack pragmatic guidelines for tailoring the asset allocation process to reflect the specific bias.

2.4. Financial Planning and Portfolio Management:

2.4.1. Financial Planning:

Financial Planning is the process of meeting one’s goals, through the proper management of finances. Life goals can include buying a home, savings for the child’s education, planning for the retirement or estate planning. This process consists of six basic steps. One can work out actually where he is now, what he may need in
future and what he must do to reach the goal. The process involves gathering relevant financial information, setting life goals, examining one’s financial status, mapping the gap and coming up with a strategy for a plan on how he can meet with the goals.

2.4.1.a. The Benefits of Financial Planning:

Financial Planning helps in giving direction and meaning to one’s financial decisions. It allows understanding how each financial decision affects other areas of finance, eg. buying a particular investment product may help one to pay off his mortgage faster or may delay his retirement significantly. By viewing each financial decision as a part of a whole, the long term and short term effects on one’s life goals may be considered. It helps one to feel more secure and more adaptable to life changes, once they can measure that they are moving closer to realization of their goals.

Financial planning is a highly personalized service. It is not a product. It is a cyclical service that constantly repeats as needs change over time. Preparation and implementation of the financial plan is a long-term relationship and not a one-off exercise. To build a financial plan, one not only needs to get a good understanding of the goals and needs, but also needs to get a good grip on his own current financial state.

Once the needs/objectives have been identified, two things need to be done:

a. Converting the goals into Financial Goals
b. Prioritizing the Financial Goals

There are two components that go into converting the needs into financial goals. First is to evaluate and find out when one needs to make withdrawals from his investments for each of the needs/objectives. Then the amount of money needed in current value to meet the objectives/need is estimated. Then by using a suitable inflation factor one can project the amount of money needed to meet the objective/need in future. Similarly, one can estimate the amount of money needed to meet all such objectives/needs. Once all the financial goals are listed down the investor needs to prioritize them based on the order of importance. Following are the steps to be followed:
a. **Preparation of Financial Statements:**

The first step in this is to create the financial statement. In the balance sheet all assets and liabilities need to be listed down.

Networth = Value of all assets – Value of all liabilities

This exercise enables to understand the current financial state. The goals and objectives is where the investor has to reach or fulfill. A financial plan helps to move towards achieving the goals in life from the current state, which would be the starting point.

b. **Preparation of Cash Flow Statement:**

The balance sheet or the networth statement gives an idea to the current financial state, but it does not give an idea of how money is coming in and going out in the investor's life. For this a list of all the incomes from all sources and all the expenditures is prepared. For the purpose of income, the overall family income is taken into account. In case, both husband and wife are working then both their incomes should be included.

Savings = Total income from all sources – Total expenses

The savings would help the investor build financial resources which in turn would enable him/her to fulfill the various goals in life. In case there are very less or no savings, then it may be a cause for concern. A detailed study of the cash flows enables to evaluate the long term financial health of the individual.

In case the individual is living the current lifestyle beyond his/her means which is not sustainable in the long run, the investor must become aware of it. A corrective course of action can then be planned.

c. **Analyzing Goals and Needs in relation to the working done on Financial Data:**

The individuals must analyze the information of current resources to meet the needs and goals. Also, personal and economic assumptions must be considered at this step of the process.
These assumptions may include, but are not limited to, the following:

- Personal assumptions, such as retirement age, life expectancies, income needs, risk factors, time horizons and special needs; and
- Economic assumptions, such as: inflation rates, tax rates and investment returns

Such an analysis forms the foundation for determining strengths and weaknesses of the individuals’ financial situation and current course of action. Post this analysis, it becomes easy for the individuals to identify where they are not able to save and invest adequate money to fulfill all the goals listed by them.

d. Elements that go into building the Financial Plan:

The financial plan would touch upon various areas related to the individual investor’s goals and objectives in life. These are;

i. Insurance Planning:

It is critical as the major risks for the investor are covered. Insurance covers only financial loss which is caused by various risks. The individual investor needs to plan for;

a. Life Insurance Cover – To maintain the existing lifestyle after death of the loved one or post retirement.
b. Medical Insurance Cover – To pay medical bills
c. Disability Insurance Cover – To ensure continuity of income in the event of disability
d. General Insurance Cover – To replace or repair tangible assets held

ii. Investment Planning:

Investment planning is critical for reaching the financial goals. The financial goals are met through creating financial resources by investing savings generated over a period of time. Every individual has different levels of risk appetite and thus the investment needs of individuals are different. The core part of investment planning
consists of deciding on an asset allocation strategy which is in line with the overall objectives of the individuals. Asset allocation means diversifying money among different types of investment categories, such as stocks, bonds and cash. Assets allocation is the primary basis which decides the rate at which wealth grows in the long run.

The various asset classes that an investor can invest in are:

i. Debt
ii. Equity
iii. Real Estate
iv. Commodities including gold
v. Other asset classes like currency, art, etc.

Different asset classes like debt, equity, real estate, etc. grow at certain natural growth rates over the long term. The individual has to work out an investment strategy to invest the savings across various asset classes in a suitable ratio. This would enable the money to grow at a rate which would help the individual meet the objectives and goals which have been finalized. If a higher rate is needed then accordingly a higher exposure to higher growth assets like equities is required. Discipline in maintaining the asset allocation is the key to achieving the success in the long term.

Generally for most investors the important asset classes are debt and equity. Debt generally gives return close to inflation. To make higher returns the investor needs to invest some part of their savings into the equity asset class.

*Asset Allocation strategy is primarily based on:*

- Returns that need to be generated on the investments
- Risk profile of the client
- Time horizon of investing
- Personal circumstances of the client

Once the broad asset allocation strategy is finalized as a part of the financial plan, it is necessary for the individual to evaluate the various investment options. For
each of the asset classes, suitable investment options are evaluated. Thorough understandings of how different products work and costs are associated with them are critical for this evaluation. Product selection is done based on the evaluation.

iii. Retirement Planning:

The purpose of retirement planning is to ensure that the individual investor will be able to maintain his/her current standard of living after retirement, even in the absence of regular cash inflows by way of income.

For this the individual investor needs to decide the following points:

- The type of lifestyle they wish to lead after retirement
- Setting realistic retirement goals
- Determine the total amount of money that would be needed for retirement.

This is usually done by going through a retirement need analysis.

In most cases when not planned, individuals generally underestimate the amount of financial capital required for a comfortable retired life. In such cases generally parents need to depend on their children or alternatively have to compromise their lifestyle. To avoid such a scenario, a proper planning is essential. Following table gives a better idea for investors of various profiles to plan for their retirement;

<table>
<thead>
<tr>
<th>Investor in their 20s</th>
<th>Investor in their 30s</th>
<th>Investor in their 40s</th>
</tr>
</thead>
<tbody>
<tr>
<td>There is a lack of urgency</td>
<td>There is stability in terms of career</td>
<td>It is the time the planning should be in place</td>
</tr>
<tr>
<td>Income is low as this is the start of the career curve</td>
<td>Income is substantial as the career is on a growth</td>
<td>Income is at its peak</td>
</tr>
<tr>
<td>Lifestyle determines the expense</td>
<td>Responsibilities curb the expenses</td>
<td>Responsibilities curb expenses</td>
</tr>
<tr>
<td>Money can be saved as expenses on fixed items are less</td>
<td>Payments are on a rise, due to fixed investments</td>
<td>There is a lot of demand for funds</td>
</tr>
<tr>
<td>Indulges in impulsive buying</td>
<td>Lessened impulsive buying</td>
<td>Does not indulge in impulsive buying</td>
</tr>
<tr>
<td>Starting planning at this stage insures a head start</td>
<td>Planning for retirement will compete with other avenues</td>
<td>Most productive years for the retirement planning process</td>
</tr>
<tr>
<td>Right place for the power of compounding to work</td>
<td>Sacrifice and prioritizing now will pay rich dividends later</td>
<td>Financial position is most conducive to allow planning and investment</td>
</tr>
</tbody>
</table>
iv. Income Tax Planning:

A lot of individuals invest only with the objective of saving tax. No consideration is given to where the money is invested and how does it fit into the overall strategy of meeting life goals. **Saving tax is not a financial goal in itself.**

Tax planning is all about using any allowable strategy to reduce and minimise tax liabilities. Tax planning is supposed to be used as part of the overall strategy and not independently. Depending upon the prevalent tax laws, tax savings may be available on the investments made in insurance, stocks etc.

v. Estate Planning:

Estate Planning is the most neglected and ignored part of personal finances. Estate planning is crucial as a means of providing for one’s family over the long term. Failing to plan for the legal and financial aftermath of death usually results in much heartache and pain for the survivors.

**2.4.1.b. Financial Planning Process:**

Different people have different perceptions of risk in investing. Some people are aggressive investors, whereas, other people may be moderate or conservative investors. As the needs evolve or undergo a change through various phases of life, the financial behaviour of people also undergoes corresponding changes. Some of the needs of people at different phases of life as discussed earlier are:

a. Protection against premature death  
b. Retirement planning  
c. Protection from disability and ill health  
d. Education and marriage of children  
e. Wealth creation  
f. Wealth preservation

The process of financial planning involves many steps such as analyzing financial needs and creating a financial and risk profile of the investors. Based on the collected information, financial scenarios can be developed showing upside potential and downside risk of each of the portfolios. There is need to put in place a mechanism for monitoring the portfolios regularly to check growth and returns in tune with the
financial objectives. In addition, the financial plan must be reviewed for performance periodically and at least once a year and on occurrence of major events in the life of the investor and changes in investor needs. There are many ways in which one can construct an over-all financial plan. For example, Financial Planning Standards Board suggests seven steps to construct a financial plan. The financial planning process involves the following steps:

1. Conducting needs analysis
2. Evaluating existing resources
3. Conducting risk assessment
4. Developing the financial plan
5. Implementing the financial plan
6. Monitoring the financial plan

The steps in the financial planning process are not independent of each other nor do they need to be followed one at a time sequentially. At the same time, it is also true to a large extent that one step may logically lead to another.

1. Conducting Need Analysis:

   This step involves:
   a. Identifying needs of protection, retirement, health, wealth creation and preservation
   b. Quantifying these needs
   c. Arriving at the time frame

   Individuals invest in various financial instruments, which in turn reap returns not only from individual investments but also from the overall economic growth. An investor would like to gain more than the inflation rate to have a real return from the investment. Another concern is longevity and after retirement life spans, coupled with small nucleus family norms. Therefore any financial plan has to take care of this concern, which is a crucial need.
2. **Evaluating Existing Resources:**

   The existing resources of the customers need to be evaluated as follows:

   a. Cash Flows: Income, Expenses
   b. Net Worth: Assets, Liabilities

   Further it is necessary to understand and quantify the present and the future financial flows of the investor. This helps in quantifying the surpluses available from time to time. A financial balance sheet of the individual can also be drawn to arrive at their net worth. It helps understand various classes of assets and their correlation with each other.

3. **Conducting Risk Assessment:**

   Assessment of risk is conducted by:

   a. Risk profile
   b. Recommending appropriate asset allocation

   a. Risk profile:

   It is necessary to understand the risk appetite of the investor. This helps to categorise the investor into aggressive, moderate and conservative investors based on their risk profile. There is always a correlation between the risk appetites of the investors and the returns they expect. Higher the risk, higher is the returns expected. This is known as risk-return trade off.

   b. Asset Allocation:

   A portfolio needs to have proper allocation among various asset classes to bring the portfolio risk within acceptable levels with reasonable returns. Asset allocation is a group of assets, which is held together to obtain the desired portfolio characteristics to suit distinct investor profiles. Bonds, stocks, and cash equivalents are most commonly used asset classes in any asset allocation. Asset allocation is the key to the performance of the portfolio.
Assets are viewed by investors as sacred, serious and aggressive assets. Sacred assets are which an investor is usually not willing to dispose off as the first option such as a house, gold or a fixed deposit. These assets generally have low risk and low returns. Serious assets could be debt funds or bonds with higher returns but also higher risk. It is necessary to have proper allocation among various asset classes to have a healthy and performing portfolio. Investors, who are willing to accept considerable volatility in their portfolios, invest in aggressive assets. Understanding the investment style of an investor is an important step in the process of investment.

Asset allocation decisions are a function of the investor’s risk appetite, investment time horizon, and the time the investors are willing to spend on their portfolio. Allocation depends on the investor’s expectations of returns and risks they are willing to take to get the desired returns.

As the asset allocation changes, the returns as well as the risk profile of the portfolio changes considerably. Therefore, asset allocation is an investment portfolio technique. It aims to balance risk and create diversification by dividing assets among major categories such as cash, debt and equity, based on the risk profile and financial needs of the investor.

4. Developing the Financial Plan:

Developing the financial plan for the investor involves:

a. Developing the plan for fulfilling protection, retirement, health and wealth creation and preservation needs of the investors

b. Explaining the plan and rationale to the investor

In this step it is necessary to work out a few investment scenarios with their risk and return, giving both upside potential and downside risk, keeping in mind the profile and risk appetite of the investor, and detailing the financial goals and the holding period of investment.

Understanding tax laws such as capital gains, individual income tax, and estate planning by professional planners would be useful for investors. An understanding of the operating regulatory framework is also essential.
Finally, the suggested plans need to be put up to the investor and explained fully. It is necessary that the investor approves the plan and owns it.

Financial planners should identify the securities in which the customers wish to make investment. To identify their investment options, planners need to;

a. Understand historical trends of investments
b. Perform financial analysis of the companies and compare with the peer group
c. Obtain relevant economic news
d. Forecast future performance
e. Take recommendations of the experts

The investor’s assets can be appropriately allocated on the basis of evaluation of investment options.

5. **Implementing the Financial Plan:**

This step involves executing the plan through optimal investment. It is important to create a proper record of the financial plan and its implementation. Recording of essential details, due dates, and dates of receipts of flows would be useful and necessary.

It should be noted that the average rupee cost of acquisition of a financial asset such as units of mutual funds or equity shares reduces when acquired under a disciplined approach such as regular investment or systematic investment plan.

No one, including experts, has been able to time the market. What is more important is a disciplined approach to investment and then investors should allow the portfolio time to grow. Longer the holding period, larger are the gains from the investment.

The two major factors that impact portfolio performance are proper asset allocation and the duration or the holding period for which the investment is held.
6. Monitoring the Financial Plan:

This plan involves:

a. Setting up tracking mechanism
b. Performing periodic review of portfolio
c. Rebalancing the portfolio in tune with the asset allocation

When the plan is implemented, it needs to be monitored from time to time to see that the portfolio is growing in accordance with the customer’s financial goals. In case there are sharp imbalances observed in the asset classes, such as when the aggressive portion grows at a faster pace than envisaged, it may be prudent to book or shed the extraordinary gains and rebalance the portfolio.

On the other hand, if the aggressive portfolio dwindles in value, it may be necessary to rebalance by infusing funds from other assets, such as fixed deposits. In this way, the original plan retains its risk-return character and does not expose the customer to unnecessary large variances in performance. Therefore, it is essential that there is regular monitoring from time to time.

2.4.1.c. Investing Over the Life Cycle:

Just as investors take different courses of action as they move through different stages of an economic/market cycle, they also tend to follow different investment philosophies. Generally speaking, most investors tend to be more aggressive when they are young and more conservative as they grow older. In general, investors tend to move through the following investment stages.

![Investing Life Cycle Diagram]

Figure 2.4. Investing Life Cycle

Most young investors, those in their twenties and thirties prefer growth oriented investments that stress capital gains rather than current income. Often young investors do not have much in the way of investable funds, so capital gains are viewed
as the quickest if not necessarily the surest, way to build up investment capital. Such investors are inclined to favour speculative and growth – oriented common stocks and mutual funds, convertible securities, and other investment vehicle (like puts and calls, and stock index options that offer substantial price appreciation within relatively short time periods.

As investors approach the middle –age consolidation stage of life i.e. the mid-forties, family demands and responsibilities take a big change and so does the approach to investing. While growth-oriented securities are still employed, investing is far less speculative. Quality – growth vehicles are used, and more attention is given to current income as an important source of return. Thus the whole portfolio goes through a transition to higher – quality securities, and at the same time the foundation is being set for the retirement years. Blue chip growth and income stocks, preferred stocks, convertibles, high – grade bonds, and mutual funds are all widely used at this point in life. And because taxes are becoming a bigger burden with a rising income and standard of living, tax – free bonds and tax – sheltered investment assume a more prominent role.

Finally, the investor moves into his or her retirement years, wherein preservation of capital and current income are the principal concerns. A secure, high level of income is now paramount, and capital gains are viewed as merely a pleasant occasional by – product of investing. The investment portfolio becomes highly conservative, as it now consists of blue chip income stocks, high – yielding government bonds, quality corporate bonds, bank certificates of deposit, and other money market investments. Along with much higher quality securities, the portfolio has probably also become a lot “shorter”, as more money is being placed into various short – term saving accounts and money market funds. The objective at this point is to live as comfortably as you can on your investment, for it is possible to really reap the rewards of a lifetime of saving and investing.
2.4.1.d. Common Mistakes in the planning process:

Following are some of the common mistakes individuals make when approaching investments:

1. Setting non-measurable financial goals.
2. Making a financial decision without understanding its effect on other financial issues.
3. Getting confused between financial planning and investing.
4. Neglecting to re-evaluate their financial plan periodically.
5. Presuming that financial planning is only for the wealthy or when one gets older.
6. Thinking that financial planning is the same as retirement planning.
7. Waiting until a money crisis to begin financial planning.
8. Expecting unrealistic returns on investments.
9. Thinking that using a financial planner means losing control.
10. Believing that financial planning is primarily tax planning.

2.4.2. Portfolio Management:

Portfolio is a collection of investment vehicles assembled to meet a common investment goal. Several terms regarding portfolio objectives should be clarified at this point. A growth-oriented portfolio's primary orientation is long-term price appreciation. An income-oriented portfolio stresses current dividend and interest return.

2.4.2.a. Portfolio Objectives:

The first step for the investor is to establish portfolio objectives. Setting these objectives involves definite tradeoffs between risk and return, between potential price appreciation and current income, and between varying risk levels in the portfolio. The factors involved in the portfolio objective decisions include the investor's ability to bear risk, current income needs, and income tax bracket. The key point is that the portfolio objectives must be established before beginning to invest. Two concepts that are especially important to successful portfolio management are the effects on risk from diversification and the concept of an efficient portfolio.
The ultimate goal of an investor is the creation of an efficient portfolio, i.e. one that provides the highest return for a given level of risk, or has the lowest risk for a given level of return. Although it may be difficult to create such a portfolio, an investor should at least search out reasonable investment alternatives to get the best combinations of risk and return. Thus, when given the choice between two equal risky investments offering different returns, the investor would be expected to choose the alternative with the highest return. Likewise, given two investment vehicles offering the same returns but differing in risk, the risk-averse investor would prefer the vehicle with the lower risk. In pursuing the creation of an efficient portfolio, the investor should be able to create the best portfolio possible given his or her disposition toward risk and the alternative investment vehicles available.

2.4.2.b. Investor Characteristics:

An investor's personal financial and family situations are important inputs in determining portfolio policy. The following are vital determinants:

- Level and stability of income.
- Family factors.
- Net worth.
- Investor experience and age.
- Investor disposition toward risk.

The portfolio strategy of an individual investor obviously must be tailored to meet that person's needs. The types of investments in the portfolio depend upon relative income needs and ability to bear risk. The investor's income, family responsibilities, relative financial, security, experience, and age all enter into the delicate equation that yields a portfolio strategy. A relatively young investor may have an aggressive investment policy, particularly if that person's family obligations are well met. A married investor with young children would not be seeking high-risk investments until some measure of financial security has been provided for the family. On the other hand, if the married investor has ample savings and insurance protection for the family, he/she may be ready to embark on a program with risky elements. Once financial security has been provided for, more risky ventures can be undertaken. A single investor with no family responsibilities could handle risk better than an
individual who has such responsibilities. Simply stated, an investor's risk exposure should not exceed his/her ability to bear risk.

The size and certainty of an investor's employment income also bear on portfolio strategy. An investor with a secure job is more likely to embark on a risk-oriented investment program than one who has a less secure position. Income taxes bear on the investment decision as well. The higher an investor's income, the more important the tax ramifications of an investment program become. Normally investors assume higher levels of investment risk gradually over time. Very often investors who make risky initial investments suffer heavy losses, damaging the long-run potential of their entire investment program. A cautiously developed investment program is likely to provide more favourable long-run results than an impulsive, risky one. Finally, investors should carefully consider risk. High-risk investments have high-return potential and a high risk of loss.

2.4.2.c. Specifying Investor Objectives:

Once an investor has developed a personal financial profile, the next question is, what does he/she want from his/her portfolio? This seems easy to answer as everyone would like to double his/her money every year by making low-risk investments. However, the realities of the highly competitive investment environment make this outcome unlikely. The presence of risk makes the establishment of realistic goals a basic requirement for a successful investment program. There is generally a trade off between earning a high current income from an investment portfolio or obtaining significant capital appreciation from it. An investor must usually choose one or the other, as it is difficult to have both. The price of having high appreciation potential in the portfolio is often low current income potential. One must balance the certainty of high current income and limited price appreciation with the uncertainty of high future price appreciation.

The investor's needs may determine which avenue is chosen. For instance, a retired investor whose income depends on his or her portfolio will probably choose a lower-risk, current-income-oriented approach out of the need for financial survival. In contrast, a high-income, financially secure investor (a doctor, for instance) may be much more willing to take on risky investments in the hope of improving net worth. A
young investor with a secure job is less concerned about current income and is more able to bear risk. This type of investor is more appreciation oriented and may choose speculative investments. As an investor approaches retirement, the desired level of income rises. The aging investor is less willing to bear risk. Such an investor wants to keep what he has, because he is or will soon be utilizing these investments as a source of retirement income. The retired 75-year-old investor typically wants minimal risk in a portfolio because he needs a dependable source of current income. Thus it should be clear that a portfolio must be built around the individual's needs, which depend on income, responsibilities, financial resources, age, retirement plans, and ability to bear risk.

2.4.2.d. Portfolio Objectives And Policies:

Portfolio management is a very logical activity and is best implemented after careful analysis of the investor's needs and of the investment vehicles available for inclusion in the portfolio. The following objectives should be considered when structuring a portfolio:

- Current income needs.
- Capital preservation.
- Capital growth.
- Tax considerations.
- Risk.

Any one or more of these factors will play an influential role in defining the type of portfolio acquired by an investor. For convenience, these factors can be tied together as follows: the first two items, current income and capital preservation, are portfolio objectives synonymous with a low-risk, conservative investment strategy. Normally a portfolio with this orientation contains low-beta (low-risk) securities. A capital growth objective implies increased risk and a reduced level of current income. Higher-risk growth stocks, options, commodities and financial futures, gold, real estate, and other more speculative investments may be suitable for this investor. An investor's tax bracket influences investment strategy. A high-income investor probably wishes to deter taxes and earn investment returns in the form of capital gains. This implies a strategy of higher-risk investments and a longer holding period. Lower-bracket investors are less concerned with how they earn the income, and they
may wish to invest in higher current income investments. The most important item an investor must decide upon is the risk. The risk-return tradeoff should be considered in all investment decisions.

2.5. Investor Behaviour:

Investors take risk based on their risk appetite and choose investment options accordingly. When the money is invested with a mutual fund or placed with the portfolio manager, the investor is affected by the investment style.

Investor may adopt an active investment approach. Under such an approach, the investor or the manager, actively manages the portfolio within the contours of agreed objectives such as asset allocation between debt and equity. There are some variations in the active investment style, e.g. momentum, growth and value investment styles. Momentum investment style shows preference to investing in momentum stocks where the values are expected to rise rapidly. Growth investment style prefers investing in companies that grow faster than the economy, whereas, value investment style shows preference for currently under-valued stocks whose current valuation does not reflect some valuable aspect of the company. “Active investors” are thus defined as those individuals who earn their own wealth in their lifetimes. They are actively involved in the wealth creation, and they risk their own capital in achieving their wealth objectives. Active investors have a higher tolerance for risk than need for security. Related to their high risk tolerance is the fact that active investors prefer to maintain control of their own investments. Their tolerance for risk is high because they believe in themselves. If they become involved in an aggressive investment of which they are not in control, their risk tolerance drops quickly. They get very much involved in their own investments to the point that they gather tremendous amounts of information about the investments and tend to drive their investment managers crazy. By their involvement and control, they feel that they reduce risk to an acceptable level.8

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A passive investor on the other hand sticks to a particular asset allocation. That is why index schemes are known as passive schemes. Exchange traded funds are also a variation of index schemes. “Passive investors” are defined as those investors who become wealthy passively—for example, by inheritance or by risking the capital of others rather than risking their own capital. Passive investors have a greater need for security than they have tolerance for risk. Occupational groups that tend to have passive investors include corporate executives, lawyers with large regional firms, certified public accountants with large CPA firms, medical and dental non-surgeons, and individuals with inherited wealth, small business owners who inherited the business, politicians, bankers, and journalists. The smaller the economic resources an investor has, the more likely the person is to be a passive investor. The lack of resources gives individuals a higher security need and a lower tolerance for risk. Thus, a large percentage of the middle and lower socio-economic classes are passive investors.\(^9\)

Another way of looking at an investor is to measure his attitude to risk and capacity to break risk. As the investment option for each of the investor types is different, it becomes essential to determine the style of the investor before they invest. The various investor types are:

a. **Aggressive Investor:** They are investors who are ready to take higher risk commensurate with higher returns. Such investors may invest in equity and such risky instruments to earn every extra bit of the returns.

b. **Moderate Investor:** Moderate investors are those who take risk within limits depending upon their capacity and appetite and such investors may invest in diversified equity funds and such other instruments. They are content and believe in earning slow and steady gains and are not interested in making quick money. A long-term investor is one who does not mind taking some occasional risks so as to optimise returns and achieve continuous growth.

\(^9\) Simple investor types from one of the oldest and most prevalent psychographic investor models, based on the work of Marilyn MacGruder Barnewall. Pompian Michel M. “Behavioural Finance and Wealth Management: How to build Optimal Portfolios that Account for Investors Biases”, John Wiley & Sons, Inc., 2006
c. Conservative Investor: They are investors who are happy with the average returns without taking undue risk. Such investors generally invest in fixed deposits and debt funds. Conservative investors are risk averse investors whose primary objective is capital preservation. Such investors want a steady growth in income and are not capable of taking shocks, in terms of losses in investments. In other words, they are passive investors.

Apart from this, the high net worth individuals can also be segmented as follows:

a. Wealth Builders: Individuals who are actively adding to their asset base, are fairly risk seeking and expect the best possible returns for every unit invested. They have a high current income and financial acumen. Typically, they would be owners of business, or top level employees in corporate. They invest actively and are competitive, demanding and fickle-minded. On the other hand, they also tend to be receptive to new ideas and schemes.

b. Wealth Preservers: Individuals, whose main focus is to protect whatever wealth they already have. They do not tend to try out new products until they have enough data on their performance. Typically, they are at the retirement stage or already retired with low current income. They tend to be risk averse and relatively passive investors. They could also be inheritors of wealth whose main objective is wealth conservation.

There are two major variables, which help the investors in determining their investment style:

a. Risk tolerance
b. Amount of time they can dedicate to investing and their time horizon

a. Risk tolerance:

It refers to the comfort of the investors in seeing their investments reduced in the near term, while waiting for the investments to increase in the long term. Investors should be aware of the market fluctuations that may happen during the tenure of their
investments. They should be prepared for such market fluctuations if they expect higher returns.

Investors with distinct investment styles invest in different types of products having varying risk return relationships. There are various degrees of risk across the investment spectrum, from government savings bonds, which are the least risky to equities, commodities and options, which are the riskiest. The former, carrying only sovereign risk are considered risk-free because of the government guarantees. However, investors may lose significant amount of their invested money because they take a risk of being an owner/partner/shareholder of the business by investing in equities, commodities and options. Although the Government of India (GOI) saving bonds and bank fixed deposits (FDs) are the safest, the returns offered are not very attractive. Although stocks have historically increased in price over the long term, investments in equities however could be volatile and very risky over a shorter term period.

Investors do not lose until they sell what they have invested. If investors had not panicked and sold post the 800 points fall in a single day on May 17, 2004 at the Bombay Stock Exchange (BSE) sensex level of 4227.50, they would have done quite well because the market rebounded sharply from its bottom to trade at 6,000 level by mid November 2004. Therefore, investors need to think of the long-term needs while investing in the stock market rather than the short-term needs.

b. Time:

It is the time the investors want to spend on investing. It determines how active they can be as investors for managing their money. If an investor wants to spend 15 minutes a month on investing, then the passive strategies can be used. However, if one plans to set out eight hours a week to devote to investing, then one may consider researching companies and pouring over financial statements to pick lucrative individual stocks.

In addition, the time horizon is significant. Whether the invested money is needed in the next week or in 15 years dramatically affects the investment vehicle that the investors should use. Although stocks deliver great long-term returns, the returns over a period of 3 years or less can be scary. Therefore, setting investment goals,
planning the outlay of an investment amount and time horizon, and making appropriate investment choices in line with investor profiles is essential for the success of any investment plan.

Investor personalities can also be classified on the level of confidence and method of action\textsuperscript{10}. The first aspect of personality deals with the confidence with which the investor approaches life, regardless of whether it is his approach to his career, his health, his money. These are important emotional choices, and they are dictated by the confidence the investor has about such things or how much he tends to worry about them. The second element deals with whether the investor is methodical, careful, and analytical in his approach to life or whether he is emotional, intuitive, and impetuous. These two elements can be thought of as two “axes” of individual psychology; one axis is called “confident-anxious” and the other is called the “careful-impetuous” axis.

![Investor Personalities on the level of confidence](image)

Figure 2.5. Investor Personalities on the level of confidence

a) The Adventurer — people who are willing to put it all on one bet and go for it because they have confidence. They are difficult to advise, because they have their own ideas about investing. They are willing to take risks, and they are volatile clients from an investment counsel point of view.

b) The Celebrity — These people like to be where the action is. They are afraid of being left out. They really do not have their own ideas about investments. They may have their own ideas about other things in life, but not investing. As a result they are the best prey for maximum broker turnover.

c) The Individualist — These people tend to go their own way and are typified by the small business person or an independent professional, such as a lawyer, CPA, or engineer. These are people who are trying to make their own decisions in life, carefully going about things, having a certain degree of confidence about them, but also being careful, methodical, and analytical. These are clients whom everyone is looking for—rational investors with whom the portfolio manager can talk sense.

d) The Guardian—Typically as people get older and begin considering retirement, they approach this personality profile. They are careful and a little bit worried about their money. They recognize that they face a limited earning time span and have to preserve their assets. They are definitely not interested in volatility or excitement. Guardians lack confidence in their ability to forecast the future or to understand where to put money, so they look for guidance.

e) The Straight Arrow — These people are well balanced, and so they cannot be placed in any specific quadrant, so they fall near the center. On average this group of clients is the average investor, a relatively balanced composite of each of the other four investor types, and by implication a group willing to be exposed to medium amounts of risk.

Investors are said to let their emotions take control when making choices about their portfolios in the absence of professional advice. It is these emotions based decisions that more than any factor, destroys the investor’s chances of reaching their
ultimate financial goals. These investors need to replace their emotion responses to the market with ones that are rational and disciplined.

Motives of investors both rational and irrational are considered under behavioural finance as defining the long run price formation in the financial markets. It is expected from the rational investors that they update their beliefs correctly on receiving new information and make choices in tune with expected utility. A crucial component of any model of financial markets is a specification of how investors form expectations. Some of these are:

a. Optimism and wishful thinking: Most people display unrealistically rosy views of their abilities and prospects.

b. Representativeness: People try to determine the probability if an item belongs to a set or a model generates a data set.

c. Conservatism: People may be reluctant to search for evidence that contradicts their beliefs; they tend to treat such evidence with excessive skepticism and may misinterpret evidence that goes against their hypothesis.

d. Belief Perseverance: People often cling to their beliefs tightly and for too long.

e. Anchoring: People often start with an initial, possibly some arbitrary value or belief and then adjust away from it.

f. Availability bias: When judging the probability of an event, people often search their own memories for relevant information.

2.6. Concluding Remarks:

Investment is thus, engaging the funds into various investment avenues considering the short-term and long-term goals identified by the investor. The chapter above gives an explanation of investment, its characteristics and various investment avenues wherein, the funds can organized. It further explains how investment can be simplified by managing the portfolio well and effective financial planning. The process of investment can be made easier by considering risk and return which are very important aspects of investment. It can be made effective if an investor is able to identify his profile and make investments accordingly.