# Khandelwal Vaish Girls Institute of Technology

## Internal Examination 2017 - 18

## Security Analysis and Portfolio Management

## MBA Semester III

## Question Paper & Answer Key

MM: 30 Time : 02:30 hours

1. **What are Securities market? Explain the primary market and secondary market?** (4)

Ans. **Securities market** is a component of the wider financial market where securities can be bought and sold between subjects of the economy, on the basis of demand and supply. Securities markets encompasses equity markets, bond markets and derivatives markets where prices can be determined and participants both professional and non-professionals can meet.

Securities markets can be split into below two levels. Primary markets, where new securities are issued and secondary markets where existing securities can be bought and sold. Secondary markets can further be split into organized exchanges, such stock exchanges and over-the-counter where individual parties come together and buy or sell securities directly. For securities holders knowing that a secondary market exists in which their securities may be sold and converted into cash increases the willingness of people to hold stocks and bonds and thus increases the ability of firms to issue securities.

**The primary market** is that part of the capital markets that deals with the issue of new securities. Companies, governments or public sector institutions can obtain funding through the sale of a new stock or bond issue. This is typically done through a syndicate of securities dealers. The process of selling new issues to investors is called underwriting. In the case of a new stock issue, this sale is a public offering. Dealers earn a commission that is built into the price of the security offering, though it can be found in the prospectus. Primary markets create long term instruments through which corporate entities borrow from capital market.

**Features of primary markets are:**

- This is the market for new long term equity capital. The primary market is the market where the securities are sold for the first time. Therefore, it is also called the new issue market (NIM).
- In a primary issue, the securities are issued by the company directly to investors.
- The company receives the money and issues new security certificates to the investors.
- Primary issues are used by companies for the purpose of setting up new business or for expanding or modernizing the existing business.
- The primary market performs the crucial function of facilitating capital formation in the economy.
- The new issue market does not include certain other sources of new long term external finance, such as loans from financial institutions. Borrowers in the new issue market may be raising capital for converting private capital into public capital; this is known as "going public."

**Secondary market: The secondary market**, also known as the aftermarket, is the financial market where previously issued securities and financial instruments such as stock, bonds, options, and futures are bought and sold. The term "secondary market" is also used to refer to the market for any used goods or assets, or an alternative use for an existing product or asset where the customer base is the second market (for example, corn has been traditionally used primarily for food production and feedstock, but a "second" or "third" market has developed for use in ethanol production). Stock exchange and over the counter markets.

- With primary issuances of securities or financial instruments, or the primary market, investors purchase these securities directly from issuers such as corporations issuing shares in an IPO or private placement, or directly from the federal government in the case of treasuries. After the initial issuance, investors can purchase from other investors in the secondary market.

- The secondary market for a variety of assets can vary from loans to stocks, from fragmented to centralized, and from illiquid to very liquid. The major stock exchanges are the most visible example of liquid secondary markets - in this case, for stocks of publicly traded companies. Exchanges such as the New York Stock Exchange, Nasdaq and the American Stock Exchange provide a centralized, liquid secondary market for the investors who own stocks that trade on those exchanges. Most bonds and structured products trade “over the counter,” or by phoning the bond desk of one’s broker-dealer. Loans sometimes trade online using a Loan Exchange.

2. **Write objectives and functions of SEBI?** (4)

Ans. Securities Exchange Board of India (SEBI) was set up in 1988 to regulate the functions of securities market. SEBI promotes orderly and healthy development in the stock market but initially SEBI was not able to exercise complete control over the stock market transactions.

It was left as a watch dog to observe the activities but was found ineffective in regulating and controlling them. As a result in May 1992, SEBI was granted legal status. SEBI is a body corporate having a separate legal existence and perpetual succession.

**Objectives of SEBI:** The overall objectives of SEBI are to protect the interest of investors and to promote the development of stock exchange and to regulate the activities of stock market. The objectives of SEBI are:

- To regulate the activities of stock exchange.
- To protect the rights of investors and ensuring safety to their investment.
- To prevent fraudulent and malpractices by having balance between self regulation of business and its statutory regulations.
- To regulate and develop a code of conduct for intermediaries such as brokers, underwriters, etc.

**Functions of SEBI:** We can classify the functions of SEBI into three categories:-

- Protective functions
- Developmental functions
- Regulatory functions

**Protective Functions:** As protective functions SEBI performs following functions:

- **SEBI checks Price Rigging:** Price Rigging means some people manipulate the prices of securities for inflation or depressing the market price of securities. SEBI prohibits such practice to avoid fraud and cheating which can happen to any investor.

- **SEBI prohibits Insider trading:** Any person which is connected with a company such as directors, promoters, workers etc is called Insiders. Due to working in the company they have sensitive information which affects the prices of the securities. Such information is not available to people at large but Insider gets this key full knowledge by working in such company. Insider can use this information for their personal benefits or make a profit from it, such process is known as Insider Trading. **For Example -** Managers or Directors of a company may know that company will issue Bonus shares to its shareholders at a particular time and they purchase shares from market to make a profit with bonus issue.
  SEBI always restricts these types of practices when Insiders are buying securities of the company and take strict action to avoid this in future.

- **SEBI prohibits fraudulent and Unfair Trade Practices:** SEBI always restricts the companies which make misleading statements which are likely to induce the sale or purchase of securities by any other person.

- SEBI sometimes educate the investors so that become able to evaluate the securities and always invest in profitable securities.

- SEBI issues guidelines to protect the interest of debenture holders.

- SEBI is empowered to investigate cases of insider trading and has provision for stiff fine and imprisonment.

- SEBI has stopped the practice of allotment of preferential shares unrelated to market prices.

- SEBI has stopped the practice of making a preferential allotment of shares unrelated to market prices.

**Developmental Functions:** Under developmental categories following functions are performed by SEBI:

- SEBI promotes training of intermediaries of the securities market.
- SEBI tries to promote activities of stock exchange by adopting a flexible and adaptable approach in following way:
  - SEBI has permitted **internet trading** through **registered stock brokers**.
  - SEBI has made underwriting optional to reduce the cost of issue.

- An Even initial public offer of primary market is permitted through the stock exchange.

**Regulatory Functions:** These functions are performed by SEBI to regulate the business in stock exchange. To regulate the activities of stock exchange following functions are performed:

- SEBI has framed rules and regulations and a code of conduct to regulate the intermediaries such as merchant bankers, brokers, underwriters, etc.
- These intermediaries have been brought under the regulatory purview and private placement has been made more restrictive.
- SEBI registers and regulates the working of stock brokers, sub-brokers, share transfer agents, trustees, merchant bankers and all those who are associated with stock exchange in any manner.
- SEBI registers and regulates the working of mutual funds etc.
- SEBI regulates takeover of the companies.
- SEBI conducts inquiries and audit of stock exchanges.

3. **What are the Methods of Construction of Index Number?** (3)

Ans. **Index Numbers: Methods of Construction of Index Number:** An index number is a statistical derives to measure changes in the value of money. It is a number which represents the average price of a group of commodities at a particular time in relation to the average price of the same group of commodities at another time.

**Methods of Construction of Index Number:** In constructing an index number, the following steps should be noted:

- **Purpose of the Index Number:** Before constructing an index number, it should be decided the purpose for which it is needed. An index number constructed for one category or purpose cannot be used for others. A cost of living index of working classes cannot be used for farmers because the items entering into their consumption will be different.
- **Selection of Commodities:** Commodities to be selected depend upon the purpose or objective of the index number to be constructed. But the number of commodities should neither be too large nor too small.

  Moreover, commodities to be selected must be broadly representative of the group of commodities. They should also be comparable in the sense that standard or graded items should be taken.
- **Selection of Prices:** The next step is to select the prices of these commodities. For this purpose, care should be taken to select prices from representative persons, places or journals or other sources. But they must be reliable. Prices may be quoted in money terms i.e. Rs. 100 per quintal or in quantity terms, i.e. 2 kg. per rupee. Care should be taken not to mix these prices. Then the problem is to select wholesale or retail prices. This depends on the type of index number. For a consumer price index, wholesale prices

are required, while for a cost of living index, retail prices are needed. But different prices should not be mixed up.

- **Selection of an Average:** Since index numbers are averages, the problem is how to select an appropriate average. The two important averages are the arithmetic mean and geometric mean. The arithmetic mean is the simpler of the two. But geometric mean is more accurate. However, the average prices should be reduced to price relatives (percentages) either on the basis of the fixed base method or the chain base method.
- **Selection of Weights:** While constructing an index number due weightage or importance should be given to the various commodities. Commodities which are more important in the consumption of consumers should be given higher weightage than other commodities. The weights are determined with reference to the relative amounts of income spent on commodities by consumers. Weights may be given in terms of value or quantity.
- **Selection of the Base Period:** The selection of the base period is the most important step in the construction of an index number. It is a period against which comparisons are made. The base period should be normal and free from any unusual events such as war, famine, earthquake, drought, boom, etc. It should not be either very recent or remote.
- **Selection of Formula:** A number of formulas have been devised to construct an index number. But the selection of an appropriate formula depends upon the availability of data and purpose of the index number. No single formula may be used for all types of index numbers.

4. **What is Risk? Explain types of Risk.** (4)

Ans. Risk implies future uncertainty about deviation from expected earnings or expected outcome. Risk measures the uncertainty that an investor is willing to take to realize a gain from an investment.

Risks are of different types and originate from different situations. We have liquidity risk, sovereign risk, insurance risk, business risk, default risk, etc. Various risks originate due to the uncertainty arising out of various factors that influence an investment or a situation.

**Systematic Risk Vs Unsystematic Risk :**

- **Systematic Risk** is always a risk incorporated in every investment like shares or debentures. The two major components of risk systematic risk and unsystematic risk, which when combined results in total risk.

  Systematic risk is a result of external and uncontrollable variables, which are not industry or security specific and affects the entire market leading to the fluctuation in prices of all the securities.

- **Unsystematic Risk:** Other hand, unsystematic risk refers to the risk which emerges out of controlled and known variables, that are industry or security specific.

  Systematic risk cannot be eliminated by diversification of portfolio, whereas the diversification proves helpful in avoiding unsystematic risk. Take a full read of this article to know about the differences between systematic and unsystematic risk.

5. **Explain the meaning of business environment and identify the features and importance of business environment?** (4)

Ans. The term ‘business environment’ connotes external forces, factors and institutions that are beyond the control of the business and they affect the functioning of a business enterprise. These include customers, competitors, suppliers, government, and the social, political, legal and technological factors etc. While some of these factors or forces may have direct influence over the business firm, others may operate indirectly. Thus, business environment may be defined as the total surroundings, which have a direct or indirect bearing on the functioning of business. It may also be defined as the set of external factors, such as economic factors, social factors, political and legal factors, demographic factors, technical factors etc., which are uncontrollable in nature and affects the business decisions of a firm.

**Importance of Business Environment:** There is a close and continuous interaction between the business and its environment. This interaction helps in strengthening the business firm and using its resources more effectively. As stated above, the business environment is multifaceted, complex, and dynamic in nature and has a far-reaching impact on the survival and growth of the business. To be more specific, proper understanding of the social, political, legal and economic environment helps the business in the following ways:

a) **Determining Opportunities and Threats:** The interaction between the business and its environment would identify opportunities for and threats to the business. It helps the business enterprises for meeting the challenges successfully.

b) **Giving Direction for Growth:** The interaction with the environment leads to opening up new frontiers of growth for the business firms. It enables the business to identify the areas for growth and expansion of their activities.

c) **Continuous Learning:** Environmental analysis makes the task of managers easier in dealing with business challenges. The managers are motivated to continuously update their knowledge, understanding and skills to meet the predicted changes in realm of business.

d) **Image Building:** Environmental understanding helps the business organisations in improving their image by showing their sensitivity to the environment within which they are working. For example, in view of the shortage of power, many companies have set up Captive Power Plants (CPP) in their factories to meet their own requirement of power.

e) **Meeting Competition:** It helps the firms to analyze the competitors' strategies and formulate their own strategies accordingly.

f) **Identifying Firm's Strength and Weakness:** Business environment helps to identify the individual strengths and weaknesses in view of the technological and global developments.

**Features of Business Environment**: On the basis of the above discussion the features of business environment can be summarized as follows.

- Business environment is the sum total of all factors external to the business firm and that greatly influence their functioning.
- It covers factors and forces like customers, competitors, suppliers, government, and the social, cultural, political, technological and legal conditions.
- The business environment is dynamic in nature, that means, it keeps on changing.
- The changes in business environment are unpredictable. It is very difficult to predict the exact nature of future happenings and the changes in economic and social environment.
- Business Environment differs from place to place, region to region and country to country. Political conditions in India differ from those in Pakistan. Taste and values cherished by people in India and China vary considerably.

6. **Define Portfolio Analysis.** (3)

Ans. **Definition:** Portfolio Analysis is the process of reviewing or assessing the elements of the entire portfolio of securities or products in a business. The review is done for careful analysis of risk and return. Portfolio Analysis conducted at regular intervals helps the investor to make changes in the portfolio allocation and change them according to the changing market and different circumstances. The analysis also helps in proper resource/asset allocation to different elements in the portfolio.

7. **What is the meaning of Portfolio management? Explain its objectives of Portfolio management?** (4)

Ans. The portfolio is a collection of investment instruments like shares, mutual funds, fixed deposits and other cash equivalents etc. Portfolio management is the art of selecting the right investment tools in the right proportion to generate optimum returns from the investment made. Best portfolio management practice runs on the principle of minimum risk and maximum return within a given time frame. A portfolio is built based on investor's income, investment budget and risk appetite keeping the expected rate of return in mind.

**Objectives of Portfolio Management:** When a portfolio is built, following objectives are to be kept in mind by the portfolio manager based on an individual's expectation. The choice of one or more of these depends on the investor's personal preference.

- Capital growth
- Security of principal amount invested

- Liquidity
- Marketability of securities invested in
- Diversification of Risk
- Consistent Returns
- Tax Planning

Investors hire portfolio managers and avail professional services for the management of portfolio by as paying a pre-decided fee for these services. Let us understanding who is a portfolio manager and tasks involved in the management of portfolio.

8. **What is mutual fund and explain equity fund and debt fund.** (4)

Ans. A **mutual fund** is an investment vehicle made up of a pool of moneys collected from many investors for the purpose of investing in securities such as stocks, bonds, money market instruments and other assets.

**Debt funds:** A debt fund is a type of mutual fund that invests shareholder's money in fixed income securities such as bonds and treasury bills. A debt fund may invest in short-term or long-term bonds, securitized products, money market instruments or floating rate debt.

**Equity funds:** An equity fund, also known as stock fund, is a type of mutual fund that invests shareholder's money principally in stocks. The equity mutual funds are principally categorized according to company size, the investment style of the holdings in the portfolio and geography.