Equity Basics

Q. What is Share / Stock / Equity?
Ans. A share is one of a finite number of equal portions in the capital of a company, mutual fund or limited partnership, entitling the owner to a proportion of distributed, non-reinvested profits known as dividends and to a portion of the value of the company in case of liquidation. Dividends are not guaranteed. They may be increased if the company performs well, but they may also be reduced or eliminated if the company performs poorly.

So when you purchase shares, you become part owner of a company. As an owner, you are usually entitled to voting rights on the board of directors and corporate policy.

Q. Why Invest in Stocks?
Ans. Although past performance cannot guarantee future market results, Stocks, historically have outperformed all other long-term financial assets. They are the only financial asset that has significantly outpaced inflation over time.

Investors buy stock to potentially increase their return on investment in one or both of two ways:

1. **Dividend Payments** - Many companies pay portions of their annual profits to stockholders in the form of dividends. Stocks with consistent track record of paying attractive dividends are known as income stocks because investors often buy these stocks to receive the income by way of dividends in addition to being invested in the company's future growth prospects.

2. **By Selling the stock for more than they originally paid** - Some companies reinvest most of their profits back into the business in order to expand. Stocks of companies with sales and earnings that are expanding faster than the general economy and faster than the average company are called growth stocks because investors expect the company to grow and expect the stock price to grow with it. When such increase in the stock price is witnessed, investors can sell their shares for an amount greater than their purchase price, thus pocketing the difference as profit.

Modes of Stock Purchase

Stocks can be purchased **individually** (meaning you purchase shares of stock in one particular company) or as part of a pool investments, such as **mutual funds.**

Mutual funds are baskets of stocks that are available for the fraction of the price you would need to buy the same stocks individually. That's because a large number of investors pool their money together and invest in the entire portfolio of stocks.

Professional money managers direct the investments within mutual funds, choosing each of the individual investments based on the mutual fund's investment goals. For example, some equity mutual funds invest in well-established companies that pay regular dividends. Others invest in younger, more growth-oriented firms or companies that have been operating below expectations for several years.

Note: As with the purchase of individual stocks, your investment return and principal value of an investment in mutual funds will fluctuate. Your shares may be worth more or less than your original investment when redeemed.

Q. What are the different kinds of risks one should consider while investing?

Ans. Risk in investments can be of the following types:

- **Market Risk or Volatility:** This refers to the fluctuation in the value of investments due to changes in the price of the stocks included in an investor's portfolio which could be caused by a variety of factors such as performance of the company, policy announcements, political factors etc. Even a portfolio of well-diversified assets cannot escape all risk.
- **Inflationary risk**: Also known as purchasing power risk, this is the decline in the purchasing power of money over time, so that even the "safest" investments can leave investors with substantially less purchasing power. For example, assuming an inflation rate of 4% for the next 10 years, if you have Rs.100 today, 10 years from now inflation will have eroded that Rs.100 so that it is worth only Rs.68.
- **Investment or credit risk**: This is the possibility that a company in which an investor is invested in may not be sufficiently profitable to remain in business.

Another manner of classifying risk in securities is as follows:

- **Unsystematic Risk:** Unsystematic risk affects a very specific group of securities or an individual security. Internal risks such as strikes, management policies, etc. are to a large extent controllable and are examples of non-systematic risks. An investor can easily manage such non-systematic risks by having a well-diversified portfolio spread across the companies, industries and groups so that a loss in one may easily be compensated with a gain in other.
- **Systematic Risk:** The risk inherent to the entire market or entire market segment is called Systematic Risk. It is also known as "un-diversifiable risk". Such risks are external and beyond the control of the company. Examples of such risks are economic, political and sociological changes. Their impact is on prices of all individual stocks and they move together in the same manner. Therefore quite often the stock prices may be falling despite good company performance and vice versa.

Since higher returns are associated with higher risks, you, as an investor, need to understand your risk tolerance level and certain principles of investing which can help you diversify and mitigate this risk. Before venturing into the world of stock investments, consider:

- Are you conservative, aggressive or speculative in your approach to investing?
- Are you comfortable owning aggressive stocks?
- Are you looking for a steady stream of income, long-term returns from growth or very high returns from risky short-term trading?

Factors affecting Investment Decisions

Before you begin investing, it's helpful to understand some of the factors that will affect your investment decisions, such as:

- Risk
- Liquidity
- Time Horizon
- Total Return
- Diversification
- Tax Consequences
- Rupee Cost Averaging

- **Risk:** Risk in investments can take various forms.

- **Liquidity:** A "liquid" investment is one that can be readily turned into cash if you need the funds on short notice. Investments can vary greatly in their degree of liquidity. Shares can be traded on any business day at their current market value, which may be more than, equal to or less than the amount initially invested.

- **Time Horizon:** Different investors have different time frames in which to achieve their investment objectives. Generally, young investors with long time horizons should be able to assume greater risks because they have more time to offset any losses with the higher return potential of investments with greater risk. Older investors, however, often choose to reduce risk because they have less time to recoup losses.

- **Total Return:** All investments provide one or a combination of two different types of returns to investors - income or growth. Income is the dividend earned from stocks. Growth is the price appreciation of the security. The total return of an investment is the combination of income and growth realized over a given time period. In selecting investments based upon their expected total return, you should understand which portion is generated from income and which from growth. Usually, the greater the reliance on income, the lower the market risk but the greater the long-term purchasing power (or inflationary) risk.

- **Diversification:** Building a diversified portfolio with securities spread across different investment classes can help you avoid the risk of having all of your eggs in one basket. By mixing industries and types of assets, you spread your risk. A particular market condition may have less impact if your portfolio consists of a wide assortment of securities than if you purchase only one type of security.

  Most beginning investors don't have sufficient capital to properly diversify their portfolio by purchasing individual securities. Investing in mutual funds allows you to buy a professionally managed, diversified portfolio with relatively small rupee amounts. In addition, many mutual funds allow you to take advantage of rupee cost averaging by investing at regular intervals.

Note: Mutual fund investing involves risk. Your principal and investment return in a mutual fund will fluctuate in value. Your investment, when redeemed, may be worth more or less than the original cost.

- **Tax Consequences:** Not all investment returns are subject to the same taxation. Short term and long term returns are taxed at different capital gains rates or even taxed as business income. The taxation policy should be kept in mind while deciding which investments to make.

- **Rupee Cost Averaging**: Rupee cost averaging, the practice of committing a fixed amount of money to an investment program on a regular basis, is a popular practice with many long-term investors. By investing a set amount regularly (usually monthly or quarterly), investors are able to avoid the pitfalls of trying to time market peaks and valleys. Also, because the amount of the investments is set, investors who practice rupee cost averaging buy more shares of a stock or mutual fund when they are less costly and fewer shares when they are more expensive.

  Like any investment strategy, rupee cost averaging doesn't guarantee a profit or protect against loss in a declining market. Because rupee cost averaging requires continuous investment regardless of fluctuating prices, you should consider your financial and emotional ability to continue the program through both rising and declining markets.