

# **Handbook on Basics of Financial Markets**



**NATIONAL STOCK EXCHANGE OF INDIA LIMITED**



❖ **What is Investment?**

The money you earn is partly spent and the rest saved for meeting future expenses. Instead of keeping the savings idle you may like to use savings in order to get return on it in the future. This is called Investment.

❖ **Why should one invest?**

One needs to invest to:

- earn return on your idle resources
- generate a specified sum of money for a specific goal in life
- make a provision for an uncertain future

One of the important reasons why one needs to invest wisely is to meet the cost of Inflation. Inflation is the rate at which the cost of living increases. The cost of living is simply what it costs to buy the goods and services you need to live. Inflation causes money to lose value because it will not buy the same amount of a good or a service in the future as it does now or did in the past. For example, if there was a 6% inflation rate for the next 20 years, a Rs. 100 purchase today would cost Rs. 321 in 20 years. This is why it is important to consider inflation as a factor in any long-term investment strategy. Remember to look at an investment's 'real' rate of return, which is the return after inflation. The aim of investments should be to provide a return above the inflation rate to ensure that the investment does not decrease in value. For example, if the annual inflation rate is 6%, then the investment will need to earn more than 6% to ensure it increases in value. If the after-tax return on your investment is less than the inflation rate, then your assets have actually decreased in value; that is, they won't buy as much today as they did last year.

❖ **When to start Investing?**

The sooner one starts investing the better. By investing early you allow your investments more time to grow, whereby the concept

of compounding (as we shall see later) increases your income, by a cumulating the principal and the interest or dividend earned on it, year after year. The three golden rules for all investors are:

- Invest early
- Invest regularly
- Invest for long term and not short term

❖ **What care should one take while investing?**

Before making any investment, one must ensure to:

1. obtain written documents explaining the investment
2. read and understand such documents
3. verify the legitimacy of the investment
4. find out the costs and benefits associated with the investment
5. assess the risk-return profile of the investment
6. know the liquidity and safety aspects of the investment
7. ascertain if it is appropriate for your specific goals
8. compare these details with other investment opportunities available
9. examine if it fits in with other investments you are considering or you have already made
10. deal only through an authorised intermediary
11. seek all clarifications about the intermediary and the investment
12. explore the options available to you if something were to go wrong, and then, if satisfied, make the investment.

These are called the Twelve Important Steps to Investing.

❖ **What is meant by Interest?**

When we borrow money, we are expected to pay for using it – this

is known as Interest. Interest is an amount charged to the borrower for the privilege of using the lender's money. Interest is usually calculated as a percentage of the principal balance (the amount of money borrowed). The percentage rate may be fixed for the life of the loan, or it may be variable, depending on the terms of the loan.

❖ **What factors determine interest rates?**

When we talk of interest rates, there are different types of interest rates - rates that banks offer to their depositors, rates that they lend to their borrowers, the rate at which the Government borrows in the Bond/Government Securities market, rates offered to investors in small savings schemes like NSC, PPF, rates at which companies issue fixed deposits etc.

The factors which govern these interest rates are mostly economy related and are commonly referred to as macroeconomic factors. Some of these factors are:

- Demand for money
- Level of Government borrowings
- Supply of money
- Inflation rate
- The Reserve Bank of India and the Government policies which determine some of the variables mentioned above

❖ **What are various options available for investment?**

One may invest in:

- ★ Physical assets like real estate, gold/jewellery, commodities etc. and/or
- ★ Financial assets such as fixed deposits with banks, small saving instruments with post offices, insurance/provident/pension fund etc. or securities market related instruments like shares, bonds, debentures etc.

❖ **What are various Short-term financial options available for investment?**

Broadly speaking, savings bank account, money market/liquid funds and fixed deposits with banks may be considered as short-term financial investment options:

**Savings Bank Account** is often the first banking product people use, which offers low interest (4%-5% p.a.), making them only marginally better than fixed deposits.

**Money Market or Liquid Funds** are a specialized form of mutual funds that invest in extremely short-term fixed income instruments and thereby provide easy liquidity. Unlike most mutual funds, money market funds are primarily oriented towards protecting your capital and then, aim to maximise returns. Money market funds usually yield better returns than savings accounts, but lower than bank fixed deposits.

**Fixed Deposits with Banks** are also referred to as term deposits and minimum investment period for bank FDs is 30 days. Fixed Deposits with banks are for investors with low risk appetite, and may be considered for 6-12 months investment period as normally interest on less than 6 months bank FDs is likely to be lower than money market fund returns.

❖ **What are various Long-term financial options available for investment?**

Post Office Savings Schemes, Public Provident Fund, Company Fixed Deposits, Bonds and Debentures, Mutual Funds etc.

**Post Office Savings:** Post Office Monthly Income Scheme is a low risk saving instrument, which can be availed through any post office. It provides an interest rate of 8% per annum, which is paid monthly. Minimum amount, which can be invested, is Rs. 1,000/- and additional investment in multiples of 1,000/-. Maximum amount is Rs. 3,00,000/- (if Single) or Rs. 6,00,000/- (if held Jointly) during

a year. It has a maturity period of 6 years. A bonus of 10% is paid at the time of maturity. Premature withdrawal is permitted if deposit is more than one year old. A deduction of 5% is levied from the principal amount if withdrawn prematurely; the 10% bonus is also denied.

**Public Provident Fund:** A long term savings instrument with a maturity of 15 years and interest payable at 8% per annum compounded annually. A PPF account can be opened through a nationalized bank at anytime during the year and is open all through the year for depositing money. Tax benefits can be availed for the amount invested and interest accrued is tax-free. A withdrawal is permissible every year from the seventh financial year of the date of opening of the account and the amount of withdrawal will be limited to 50% of the balance at credit at the end of the 4th year immediately preceding the year in which the amount is withdrawn or at the end of the preceding year whichever is lower the amount of loan if any.

**Company Fixed Deposits:** These are short-term (six months) to medium-term (three to five years) borrowings by companies at a fixed rate of interest which is payable monthly, quarterly, semi-annually or annually. They can also be cumulative fixed deposits where the entire principal alongwith the interest is paid at the end of the loan period. The rate of interest varies between 6-9% per annum for company FDs. The interest received is after deduction of taxes.

**Bonds:** It is a fixed income (debt) instrument issued for a period of more than one year with the purpose of raising capital. The central or state government, corporations and similar institutions sell bonds. A bond is generally a promise to repay the principal along with a fixed rate of interest on a specified date, called the Maturity Date.

**Mutual Funds:** These are funds operated by an investment company which raises money from the public and invests in a group of assets (shares, debentures etc.), in accordance with a stated set of objectives. It is a substitute for those who are unable to invest directly in equities or debt because of resource, time or knowledge constraints. Benefits

include professional money management, buying in small amounts and diversification. Mutual fund units are issued and redeemed by the Fund Management Company based on the fund's net asset value (NAV), which is determined at the end of each trading session. NAV is calculated as the value of all the shares held by the fund, minus expenses, divided by the number of units issued. Mutual Funds are usually long term investment vehicle though there some categories of mutual funds, such as money market mutual funds which are short term instruments.

❖ **What is meant by a Stock Exchange?**

The Securities Contract (Regulation) Act, 1956 [SCRA] defines 'Stock Exchange' as any body of individuals, whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities. Stock exchange could be a regional stock exchange whose area of operation/jurisdiction is specified at the time of its recognition or national exchanges, which are permitted to have nationwide trading since inception. NSE was incorporated as a national stock exchange.

❖ **What is an 'Equity'/Share?**

Total equity capital of a company is divided into equal units of small denominations, each called a share. For example, in a company the total equity capital of Rs 2,00,00,000 is divided into 20,00,000 units of Rs 10 each. Each such unit of Rs 10 is called a Share. Thus, the company then is said to have 20,00,000 equity shares of Rs 10 each. The holders of such shares are members of the company and have voting rights.

❖ **What is a 'Debt Instrument'?**

Debt instrument represents a contract whereby one party lends money to another on pre-determined terms with regards to rate and periodicity of interest, repayment of principal amount by the borrower



to the lender. In the Indian securities markets, the term ‘bond’ is used for debt instruments issued by the Central and State governments and public sector organizations and the term ‘debenture’ is used for instruments issued by private corporate sector.

❖ **What is a Derivative?**

Derivative is a product whose value is derived from the value of one or more basic variables, called underlying. The underlying asset can be equity, index, foreign exchange (forex), commodity or any other asset. Derivative products initially emerged as hedging devices against fluctuations in commodity prices and commodity-linked derivatives remained the sole form of such products for almost three hundred years. The financial derivatives came into spotlight in post-1970 period due to growing instability in the financial markets. However, since their emergence, these products have become very popular and by 1990s, they accounted for about two-thirds of total transactions in derivative products.

❖ **What is a Mutual Fund?**

A Mutual Fund is a body corporate registered with SEBI (Securities Exchange Board of India) that pools money from individuals/corporate investors and invests the same in a variety of different financial instruments or securities such as equity shares, Government securities, Bonds, debentures etc. Mutual funds can thus be considered as financial intermediaries in the investment business that collect funds from the public and invest on behalf of the investors. Mutual funds issue units to the investors. The appreciation of the portfolio or securities in which the mutual fund has invested the money leads to an appreciation in the value of the units held by investors. The investment objectives outlined by a Mutual Fund in its prospectus are binding on the Mutual Fund scheme. The investment objectives specify the class of securities a Mutual Fund can invest in. Mutual Funds invest in various asset classes like equity, bonds, debentures,

commercial paper and government securities. The schemes offered by mutual funds vary from fund to fund. Some are pure equity schemes; others are a mix of equity and bonds. Investors are also given the option of getting dividends, which are declared periodically by the mutual fund, or to participate only in the capital appreciation of the scheme.

❖ **What is an Index ?**

An Index shows how a specified portfolio of share prices are moving in order to give an indication of market trends. It is a basket of securities and the average price movement of the basket of securities indicates the index movement, whether upwards or downwards.

❖ **What is a Depository?**

A depository is like a bank wherein the deposits are securities (viz. shares, debentures, bonds, government securities, units etc.) in electronic form.

❖ **What is Dematerialization ?**

Dematerialization is the process by which physical certificates of an investor are converted to an equivalent number of securities in electronic form and credited to the investor's account with his Depository Participant (DP).

❖ **What is the function of Securities Market?**

Securities Markets is a place where buyers and sellers of securities can enter into transactions to purchase and sell shares, bonds, debentures etc. Further, it performs an important role of enabling corporates, entrepreneurs to raise resources for their companies and business ventures through public issues. Transfer of resources from those having idle resources (investors) to others who have a need for them (corporates) is most efficiently achieved through the securities

market. Stated formally, securities markets provide channels for reallocation of savings to investments and entrepreneurship. Savings are linked to investments by a variety of intermediaries, through a range of financial products, called ‘Securities’.

❖ **Which are the securities one can invest in?**

- ★ Shares
- ★ Government Securities
- ★ Derivative products
- ★ Units of Mutual Funds etc., are some of the securities investors in the securities market can invest in.

❖ **What is the role of the ‘Primary Market’?**

The primary market provides the channel for sale of new securities. Primary market provides opportunity to issuers of securities; Government as well as corporates, to raise resources to meet their requirements of investment and/or discharge some obligation. They may issue the securities at face value, or at a discount/premium and these securities may take a variety of forms such as equity, debt etc. They may issue the securities in domestic market and/or international market.

❖ **Why do companies need to issue shares to the public?**

Most companies are usually started privately by their promoter(s). However, the promoters’ capital and the borrowings from banks and financial institutions may not be sufficient for setting up or running the business over a long term. So companies invite the public to contribute towards the equity and issue shares to individual investors. The way to invite share capital from the public is through a ‘Public Issue’. Simply stated, a public issue is an offer to the public to subscribe to the share capital of a company. Once this is done, the company allots shares to the applicants as per the prescribed rules and regulations laid down by SEBI.

❖ **What is meant by Market Capitalisation?**

The market value of a quoted company, which is calculated by multiplying its current share price (market price) by the number of shares in issue is called as market capitalization. E.g. Company A has 120 million shares in issue. The current market price is Rs. 100. The market capitalisation of company A is Rs. 12000 million.

❖ **What is an Initial Public Offer (IPO)?**

An Initial Public Offer (IPO) is the selling of securities to the public in the primary market. It is when an unlisted company makes either a fresh issue of securities or an offer for sale of its existing securities or both for the first time to the public. This paves way for listing and trading of the issuer's securities. The sale of securities can be either through book building or through normal public issue.

❖ **What is a Prospectus ?**

A large number of new companies float public issues. While a large number of these companies are genuine, quite a few may want to exploit the investors. Therefore, it is very important that an investor before applying for any issue identifies future potential of a company. A part of the guidelines issued by SEBI (Securities and Exchange Board of India) is the disclosure of 23 information to the public. This disclosure includes information like the reason for raising the money, the way money is proposed to be spent, the return expected on the money etc. This information is in the form of 'Prospectus' which also includes information regarding the size of the issue, the current status of the company, its equity capital, its current and past performance, the promoters, the project, cost of the project, means of financing, product and capacity etc. It also contains lot of mandatory information regarding underwriting and statutory compliances. This helps investors to evaluate short term and long term prospects of the company.

❖ **What is meant by Secondary market?**

Secondary market refers to a market where securities are traded after being initially offered to the public in the primary market and/or listed on the Stock Exchange. Majority of the trading is done in the secondary market. Secondary market comprises of equity markets and the debt markets.

❖ **What is a Contract Note?**

Contract Note is a confirmation of trades done on a particular day on behalf of the client by a trading member. It imposes a legally enforceable relationship between the client and the trading member with respect to purchase/sale and settlement of trades. It also helps to settle disputes/claims between the investor and the trading member. It is a prerequisite for filing a complaint or arbitration proceeding against the trading member in case of a dispute. A valid contract note should be in the prescribed form, contain the details of trades, stamped with requisite value and duly signed by the authorized signatory. Contract notes are kept in duplicate, the trading member and the client should keep one copy each. After verifying the details contained therein, the client keeps one copy and returns the second copy to the trading member duly acknowledged by him.

❖ **What precautions must one take before investing in the stock markets?**

Here are some useful pointers to bear in mind before you invest in the markets:

- Make sure your broker is registered with SEBI and the exchanges and do not deal with unregistered intermediaries.
- Ensure that you receive contract notes for all your transactions from your broker within one working day of execution of the trades.

- All investments carry risk of some kind. Investors should always know the risk that they are taking and invest in a manner that matches their risk tolerance.
- Do not be misled by market rumours, luring advertisement or 'hot tips' of the day.
- Take informed decisions by studying the fundamentals of the company. Find out the business the company is into, its future prospects, quality of management, past track record etc Sources of knowing about a company are through annual reports, economic magazines, databases available with vendors or your financial advisor.
- If your financial advisor or broker advises you to invest in a company you have never heard of, be cautious. Spend some time checking out about the company before investing.
- Do not be attracted by announcements of fantastic results/news reports, about a company. Do your own research before investing in any stock.
- Do not be attracted to stocks based on what an internet website promotes, unless you have done adequate study of the company.
- Investing in very low priced stocks or what are known as penny stocks does not guarantee high returns.
- Be cautious about stocks which show a sudden spurt in price or trading activity.
- Any advise or tip that claims that there are huge returns expected, especially for acting quickly, may be risky and may lead to losing some, most, or all of your money.

❖ **What Do's and Don'ts should an investor bear in mind when investing in the stock markets?**

- Ensure that the intermediary (broker/sub-broker) has a valid SEBI registration certificate.

- Enter into an agreement with your broker/sub-broker setting out terms and conditions clearly.
- Ensure that you give all your details in the 'Know Your Client' form.
- Ensure that you read carefully and understand the contents of the 'Risk Disclosure Document' and then acknowledge it.
- Insist on a contract note issued by your broker only, for trades done each day.
- Ensure that you receive the contract note from your broker within 24 hours of the transaction.
- Ensure that the contract note contains details such as the broker's name, trade time and number, transaction price, brokerage, service tax, securities transaction tax etc. and is signed by the Authorised Signatory of the broker.
- To cross check genuineness of the transactions, log in to the NSE website ([www.nseindia.com](http://www.nseindia.com)) and go to the trade verification facility extended by NSE at [www.nseindia.com/content/equities/eq\\_trdverify.htm](http://www.nseindia.com/content/equities/eq_trdverify.htm).
- Issue account payee cheques/demand drafts in the name of your broker only, as it appears on the contract note/SEBI registration certificate of the broker.
- While delivering shares to your broker to meet your obligations, ensure that the delivery instructions are made only to the designated account of your broker only.
- Insist on periodical statement of accounts of funds and securities from your broker. Cross check and reconcile your accounts promptly and in case of any discrepancies bring it to the attention of your broker immediately.
- Please ensure that you receive payments/deliveries from your broker, for the transactions entered by you, within one working day of the payout date.

- Ensure that you do not undertake deals on behalf of others or trade on your own name and then issue cheques from a family members' / friends' bank accounts.
- Similarly, the Demat delivery instruction slip should be from your own Demat account, not from any other family members' / friends' accounts.
- Do not sign blank delivery instruction slip(s) while meeting security payin obligation.
- No intermediary in the market can accept deposit assuring fixed returns. Hence do not give your money as deposit against assurances of returns.
- 'Portfolio Management Services' could be offered only by intermediaries having specific approval of SEBI for PMS. Hence, do not part your funds to unauthorized persons for Portfolio Management.
- Delivery Instruction Slip is a very valuable document. Do not leave signed blank delivery instruction slip with anyone. While meeting pay in obligation make sure that correct ID of authorised intermediary is filled in the Delivery Instruction Form.
- Be cautious while taking funding form authorised intermediaries as these transactions are not covered under Settlement Guarantee mechanisms of the exchange.
- Insist on execution of all orders under unique client code allotted to you. Do not accept trades executed under some other client code to your account.
- When you are authorising someone through 'Power of Attorney' for operation of your DP account, make sure that:
  - ★ your authorization is in favour of registered intermediary only.



- ★ authorisation is only for limited purpose of debits and credits arising out of valid transactions executed through that intermediary only.
- ★ you verify DP statement periodically say every month/fortnight to ensure that no unauthorised transactions have taken place in your account.
- ★ authorization given by you has been properly used for the purpose for which authorization has been given.
- ★ in case you find wrong entries please report in writing to the authorized intermediary.
- ★ Don't accept unsigned/duplicate contract note.
- ★ Don't accept contract note signed by any unauthorised person.
- ★ Don't delay payment/deliveries of securities to broker.
- ★ In the event of any discrepancies/disputes, please bring them to the notice of the broker immediately in writing (acknowledged by the broker) and ensure their prompt rectification.
- ★ In case of sub-broker disputes, inform the main broker in writing about the dispute at the earliest and in any case not later than 6 months.
- ★ If your broker/sub-broker does not resolve your complaints within a reasonable period (say within 15 days), please bring it to the attention of the 'Investor Grievances Cell' of the NSE.
- ★ While lodging a complaint with the 'Investor Grievances Cell' of the NSE, it is very important that you submit copies of all relevant documents like contract notes, proof of payments delivery of shares etc. alongwith the complaint. Remember, in the absence of sufficient documents, resolution of complaints becomes difficult.

- ★ Familiarise yourself with the rules, regulations and circulars issued by stock exchanges/SEBI before carrying out any transaction.

For more information on Basics of Financial Markets, please refer to the NCFM module :

Financial Markets : A Beginners' Module. Details are available on the website - [www.nseindia.com](http://www.nseindia.com) under the link 'NCFM'.

## **Disclaimer**

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Please refer to relevant regulations and circulars in case of specific cases and problems.



**NATIONAL STOCK EXCHANGE OF INDIA LIMITED**

“Exchange Plaza”, Bandra Kurla Complex,  
Bandra (East), Mumbai 400051, INDIA.

Tel.: +91 22 2659 8100 / 66418100 Fax: +91 22 2659 8120

Website: [www.nseindia.com](http://www.nseindia.com) • email: [cc\\_nse@nse.co.in](mailto:cc_nse@nse.co.in)

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