

Stock Market - Study Material

(III B. Com – General)

UNIT – II

1. Equity Shares and Preference Shares

Equity Shares

Equity shares, also known as ordinary shares, represent ownership in a company. Holders of equity shares are considered part-owners of the company and have a claim on its profits and assets after all other obligations are met. These shares carry voting rights, allowing shareholders to participate in major company decisions, such as electing the board of directors or approving mergers. The value of equity shares is tied to the company's performance, market conditions, and investor sentiment, making them subject to significant price fluctuations.

Key Features of Equity Shares:

- **Voting Rights:** Equity shareholders can vote in the company's annual general meetings (AGMs) or extraordinary general meetings (EGMs), with voting power proportional to their shareholding.
- **Dividend Payments:** Dividends are paid at the discretion of the company's board, depending on profitability. Unlike preference shares, dividends are not fixed and may vary or be skipped in loss-making years.
- **Capital Appreciation:** Equity shares offer the potential for high returns through capital gains if the company performs well and its share price increases.
- **Risk:** These shares carry higher risk due to market volatility and the absence of guaranteed returns. In case of liquidation, equity shareholders are paid last after creditors and preference shareholders.
- **Types:** Equity shares can be classified into authorized, issued, subscribed, and paid-up shares based on the company's capital structure. They may also include rights shares or bonus shares issued to existing shareholders.

Advantages:

- Potential for high returns through dividends and capital appreciation.
- Voting rights provide influence over company policies.
- Liquidity, as equity shares are easily tradable on stock exchanges.

Disadvantages:

- High risk due to market fluctuations and no guaranteed returns.
- Dividends are not mandatory and depend on company profits.
- Last priority in case of company liquidation.

Preference Shares

Preference shares are a hybrid form of capital that combines features of equity and debt. Preference shareholders receive priority over equity shareholders in terms of dividend payments and asset distribution during liquidation. These shares typically do not carry voting rights, except in specific circumstances, such as when dividends are in arrears.

Key Features of Preference Shares:

- **Fixed Dividends:** Preference shareholders are entitled to a fixed dividend rate, paid before equity dividends, making them less risky than equity shares.
- **Priority in Liquidation:** In case of company insolvency, preference shareholders are paid before equity shareholders but after creditors.
- **Types of Preference Shares:**
 - **Cumulative:** Unpaid dividends accumulate and must be paid before equity dividends.
 - **Non-Cumulative:** Unpaid dividends do not accumulate.
 - **Redeemable:** Can be repurchased by the company at a predetermined date or event.
 - **Irredeemable:** Cannot be repurchased during the company's lifetime.
 - **Convertible:** Can be converted into equity shares after a specified period.
 - **Non-Convertible:** Cannot be converted into equity shares.
- **No Voting Rights:** Generally, preference shareholders do not have voting rights unless specified, such as in cases of unpaid dividends.
- **Lower Risk:** Preference shares are less volatile than equity shares due to fixed dividends and priority in repayment.

Advantages:

- Fixed and regular dividends provide income stability.
- Priority in dividend payments and liquidation reduces risk.
- Convertible preference shares offer potential for capital appreciation.

Disadvantages:

- Limited or no voting rights, reducing influence over company decisions.
- Returns are capped at the fixed dividend rate, limiting upside potential.
- Interest rate changes can affect the value of preference shares.

2. Types of Mutual Funds

Mutual funds are investment vehicles that pool money from multiple investors to invest in a diversified portfolio of securities, such as stocks, bonds, or other assets, managed by professional fund managers.

They are categorized based on asset class, investment objective, risk profile, and structure. Below are the major types of mutual funds:

1. Equity Mutual Funds:

- **Description:** These funds invest primarily in stocks, aiming for capital appreciation over the long term. They are suitable for investors with a high-risk appetite.
- **Sub-Types:**
 - **Large-Cap Funds:** Invest in companies with large market capitalization (e.g., top 100 companies in India). They are relatively stable and less volatile.
 - **Mid-Cap Funds:** Focus on medium-sized companies with higher growth potential but increased risk.
 - **Small-Cap Funds:** Invest in smaller companies with high growth potential but significant volatility.
 - **Sectoral/Thematic Funds:** Concentrate on specific sectors (e.g., technology, banking) or themes (e.g., ESG investing).
 - **Equity-Linked Savings Scheme (ELSS):** Equity funds with a 3-year lock-in period, offering tax benefits under Section 80C of the Income Tax Act.
- **Risk and Return:** High risk, high return potential, suitable for long-term investors.

2. Debt Mutual Funds:

- **Description:** These funds invest in fixed-income securities like government bonds, corporate bonds, and money market instruments, aiming for stable returns with lower risk.
- **Sub-Types:**
 - **Liquid Funds:** Invest in short-term instruments (up to 91 days) for high liquidity and low risk.
 - **Dynamic Bond Funds:** Adjust portfolio duration based on interest rate expectations.
 - **Gilt Funds:** Invest in government securities, offering low credit risk but sensitivity to interest rate changes.
 - **Corporate Bond Funds:** Focus on high-rated corporate bonds for moderate returns.
- **Risk and Return:** Lower risk and moderate returns, ideal for conservative investors.

3. Hybrid Mutual Funds:

- **Description:** These funds invest in a mix of equity and debt instruments to balance risk and return.
- **Sub-Types:**
 - **Balanced Funds:** Maintain a fixed ratio of equity and debt (e.g., 60:40).
 - **Dynamic Asset Allocation Funds:** Adjust equity-debt allocation based on market conditions.

- **Arbitrage Funds:** Exploit price differences in equity and derivative markets, offering low risk.
- **Risk and Return:** Moderate risk and returns, suitable for investors seeking balanced exposure.

4. Other Types of Mutual Funds:

- **Index Funds:** Track a specific market index (e.g., Nifty 50) with low costs and passive management.
- **Fund of Funds (FoFs):** Invest in other mutual funds for diversification.
- **International Funds:** Invest in global markets or foreign securities.
- **Solution-Oriented Funds:** Designed for specific goals, such as retirement or children's education, often with lock-in periods.

Advantages of Mutual Funds:

- Diversification reduces risk by spreading investments across assets.
- Professional management by experienced fund managers.
- Flexibility to choose funds based on risk appetite and goals.
- Liquidity, as most funds allow easy redemption (except ELSS).

Disadvantages:

- Management fees and expense ratios can reduce returns.
- Market risks affect equity and hybrid funds.
- Lock-in periods in some funds limit liquidity.

3. National Stock Exchange of India (NSE)

The National Stock Exchange of India (NSE), established in 1992, is the largest stock exchange in India by trading volume and market capitalization. Headquartered in Mumbai, it was the first exchange in India to introduce a fully automated, screen-based trading system, revolutionizing the Indian capital market. The NSE operates under the regulation of the Securities and Exchange Board of India (SEBI) and facilitates trading in equities, derivatives, debt instruments, and mutual funds.

Key Features of the NSE:

- **Trading Platform:** The NSE uses the National Exchange for Automated Trading (NEAT) system, enabling fast, transparent, and efficient trading across the country.
- **Market Segments:**
 - **Equity Market:** Facilitates trading of equity shares of listed companies.
 - **Derivatives Market:** Includes futures and options on indices (e.g., Nifty 50), stocks, and other assets.

- **Debt Market:** Offers trading in government securities, corporate bonds, and other fixed-income instruments.
- **Currency and Interest Rate Derivatives:** Allows trading in currency futures and options.
- **Indices:** The NSE's flagship index, the Nifty 50, tracks the performance of the top 50 companies by market capitalization. Other indices include Nifty Bank, Nifty IT, and Nifty Midcap.
- **Clearing and Settlement:** NSE Clearing Limited (formerly NSCCL) ensures smooth clearing and settlement of trades, reducing counterparty risk.
- **Investor Services:** The NSE provides investor education, grievance redressal, and market data services to promote financial literacy and transparency.

Role and Significance:

- **Liquidity and Accessibility:** The NSE's electronic trading platform ensures high liquidity and accessibility for retail and institutional investors.
- **Market Development:** It has introduced innovative products like exchange-traded funds (ETFs) and derivatives, enhancing market depth.
- **Global Recognition:** The NSE ranks among the world's leading exchanges in terms of trading volume, particularly in equity derivatives.
- **Technology:** Its robust technology infrastructure supports high-speed trading and handles millions of transactions daily.

Key Milestones:

- 1994: Commenced operations with the launch of the wholesale debt market.
- 1995: Introduced equity trading.
- 2000: Launched futures and options trading.
- 2016: Introduced Nifty 50 futures on international exchanges.

Advantages:

- High liquidity and transparency in trading.
- Wide range of financial products for diverse investor needs.
- Strong regulatory oversight ensures investor protection.

Disadvantages:

- Market volatility can pose risks for retail investors.
- Dependence on technology makes it vulnerable to technical glitches.
- High trading volumes may lead to speculative trading.

The NSE plays a pivotal role in India's financial ecosystem, driving economic growth by facilitating capital formation and wealth creation.

1. Mutual Funds

A mutual fund is a pooled investment vehicle that collects money from multiple investors to invest in a diversified portfolio of securities, such as stocks, bonds, or other assets, managed by professional fund managers. It offers individual investors access to professionally managed, diversified portfolios that might otherwise be difficult to create due to high costs or lack of expertise. Mutual funds are regulated by financial authorities (e.g., SEBI in India, SEC in the U.S.) to ensure transparency and investor protection.

Key Features

- **Diversification:** Mutual funds invest in a variety of securities, reducing the risk associated with individual investments.
- **Professional Management:** Fund managers, backed by research teams, make investment decisions to maximize returns and minimize risks.
- **Liquidity:** Investors can buy or sell mutual fund units at the Net Asset Value (NAV), calculated daily.
- **Affordability:** Investors can start with small amounts through Systematic Investment Plans (SIPs), making it accessible to retail investors.
- **Types of Mutual Funds:**
 - **Equity Funds:** Invest primarily in stocks, aiming for capital appreciation (high risk, high return).
 - **Debt Funds:** Focus on fixed-income securities like bonds, offering stable returns (lower risk).
 - **Hybrid Funds:** Combine equity and debt for balanced risk and return.
 - **Sectoral/Thematic Funds:** Focus on specific sectors (e.g., technology, healthcare).
 - **Index Funds:** Track market indices like NIFTY 50 or S&P 500.
 - **ELSS (Equity-Linked Savings Scheme):** Equity funds with tax benefits and a lock-in period.

How Mutual Funds Work

Investors purchase units of a mutual fund, and their money is pooled to invest in a portfolio aligned with the fund's objectives. The fund's performance is reflected in its NAV, which is the total value of assets minus liabilities, divided by the number of units. Investors earn returns through capital gains (increase in NAV), dividends, or interest income. Expenses, such as management fees and operational costs, are deducted as the Expense Ratio.

Advantages

- Diversification reduces risk.
- Professional management saves time and effort.
- Flexibility to invest small amounts via SIPs.

- High liquidity (except for closed-end funds or ELSS with lock-in periods).

Risks

- Market risk: Returns depend on market performance.
- Management risk: Poor decisions by fund managers can affect returns.
- Costs: High expense ratios can erode returns.
- No guaranteed returns, unlike fixed deposits.

Taxation

- **Equity Funds:** Long-term capital gains (LTCG) above ₹1 lakh are taxed at 10% (India); short-term capital gains (STCG) at 15%.
- **Debt Funds:** LTCG (held over 3 years) taxed at 20% with indexation; STCG taxed as per income slab.
- **ELSS:** Qualifies for tax deduction under Section 80C (India) up to ₹1.5 lakh.

2. Underwriters

Underwriters are financial intermediaries, typically investment banks or financial institutions, that play a critical role in the issuance of securities in the primary market. They facilitate the process of raising capital for companies or governments by purchasing securities from the issuer and selling them to investors. Underwriters assume the risk of distributing these securities, ensuring the issuer raises the required funds.

Role of Underwriters

- **Risk Assessment:** Underwriters evaluate the issuer's financial health, market conditions, and demand to determine the feasibility of the issuance.
- **Pricing Securities:** They set the offer price for securities (stocks or bonds) to balance issuer profitability and investor appeal.
- **Guaranteeing Funds:** In a firm commitment underwriting, they purchase the entire issue from the issuer and assume the risk of selling it to the public.
- **Marketing and Distribution:** Underwriters promote the securities to institutional and retail investors, often forming a syndicate to share the risk.
- **Regulatory Compliance:** They ensure the issuance complies with regulations (e.g., SEBI in India, SEC in the U.S.), including preparing prospectuses.

Types of Underwriting

- **Firm Commitment:** Underwriters buy the entire issue and resell it, bearing the risk of unsold securities.
- **Best Efforts:** Underwriters sell as many securities as possible without guaranteeing the full amount.

- **All-or-None:** The issue is canceled if not all securities are sold.
- **Standby Underwriting:** Used in rights issues, where underwriters purchase unsubscribed shares.

Process

1. **Due Diligence:** Underwriters conduct thorough research on the issuer's financials, business model, and market conditions.
2. **Agreement:** A contract is signed, specifying terms like the issue size, price, and underwriter's commission.
3. **Pricing and Allocation:** The underwriter determines the offer price and allocates securities to investors.
4. **Distribution:** Securities are marketed and sold to investors through roadshows and prospectuses.
5. **Stabilization:** Post-issuance, underwriters may stabilize the security's price to prevent volatility.

Importance

- **Capital Access:** Enable issuers to raise funds for expansion, debt repayment, or other needs.
- **Risk Mitigation:** Absorb unsold securities, ensuring issuers receive funds.
- **Market Confidence:** Their due diligence enhances investor trust in the issuance.
- **Efficient Pricing:** Balance issuer and investor interests through accurate pricing.

Risks and Challenges

- **Market Risk:** Poor market conditions can lead to unsold securities.
- **Reputation Risk:** Failed issuances can harm the underwriter's credibility.
- **Regulatory Risk:** Non-compliance can lead to penalties or legal issues.

Compensation

Underwriters earn a fee (underwriting spread), which is the difference between the price paid to the issuer and the price at which securities are sold to investors. The spread compensates for risk and effort.

Conclusion

Underwriters are pivotal in bridging issuers and investors, ensuring smooth capital market operations. Their expertise in pricing, distribution, and risk management makes them indispensable in public offerings and private placements.

3. Secondary Market

The secondary market is where previously issued securities, such as stocks, bonds, and derivatives, are traded among investors. Unlike the primary market, where securities are issued directly by companies

or governments, the secondary market facilitates trading after the initial issuance. Stock exchanges like the NYSE, BSE, or NASDAQ are key platforms for secondary market transactions.

Key Features

- **Liquidity:** Investors can buy or sell securities quickly, converting investments into cash.
- **Price Discovery:** Market forces of supply and demand determine security prices.
- **Accessibility:** Open to retail and institutional investors through brokers or trading platforms.
- **Regulation:** Governed by financial authorities (e.g., SEBI, SEC) to ensure fair trading practices.

Types of Secondary Markets

- **Stock Exchanges:** Organized platforms (e.g., BSE, NSE) where standardized securities are traded with strict regulations.
- **Over-the-Counter (OTC) Markets:** Decentralized markets where securities not listed on exchanges are traded (e.g., corporate bonds, unlisted stocks).
- **Electronic Trading Platforms:** Modern platforms enabling high-speed, automated trading.

Participants

- **Investors:** Retail investors, institutional investors (mutual funds, pension funds), and hedge funds.
- **Brokers/Dealers:** Facilitate trades by connecting buyers and sellers, earning commissions or spreads.
- **Market Makers:** Provide liquidity by continuously quoting buy and sell prices.
- **Regulators:** Ensure transparency, prevent fraud, and protect investors.

How It Works

Investors place buy or sell orders through brokers, executed via stock exchanges or OTC platforms. Trades are settled (typically T+2, i.e., two days after the trade) through clearinghouses, ensuring funds and securities are transferred. Prices fluctuate based on market conditions, company performance, and macroeconomic factors.

Importance

- **Liquidity:** Enables investors to exit investments or adjust portfolios easily.
- **Price Determination:** Reflects the true market value of securities through supply and demand.
- **Wealth Creation:** Allows investors to benefit from capital gains or dividends.
- **Economic Indicator:** Secondary market performance reflects economic health and investor confidence.

Risks

- **Market Risk:** Price volatility due to economic, political, or company-specific events.
- **Liquidity Risk:** Some securities may have low trading volumes, making them hard to sell.

- **Systemic Risk:** Market-wide disruptions can lead to significant losses.

Trading Mechanisms

- **Order Types:** Market orders (executed at current prices), limit orders (executed at a specified price), stop-loss orders.
- **Short Selling:** Borrowing and selling securities to buy back later at a lower price.
- **Margin Trading:** Borrowing funds to trade, amplifying returns and risks.

Regulation

Regulators enforce rules to prevent insider trading, market manipulation, and fraud. They mandate disclosures and ensure fair practices. In India, SEBI oversees the secondary market, while in the U.S., it's the SEC.