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MMPF-4

Security Analysis and Portfolio Management

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I.G.N.O.U.
& Various Central, State & Other Open Universities

By: Kshyama Sagar Meher



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QUESTION PAPER

June – 2024

(Solved)

SECURITY ANALYSIS AND PORTFOLIO MANAGEMENT

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Time: 3 Hours]

[Maximum Marks : 100

Note: Answer any five questions. All questions carry equal marks.

Q. 1. What is an investment process? Describe the various steps involved in the investment process.

Ans. Ref.: See Chapter-1, Page No. 7, Q. No. 1 and Q. No. 2 (Self-Assessment Questions).

Q. 2. Elaborate upon the concept of Initial Public Offerings (IPOs). Discuss the evolution of the process of IPOs over a period of time.

Ans. Ref.: See Chapter-2, Page No. 20, Q. No. 2 (Other Important Questions).

Q. 3. Define 'Systematic Risk'. Explain different types of systematic risk.

Ans. Ref.: See Chapter-3, Page No. 32, Q. No. 1 (Other Important Questions).

Q. 4. Describe different forms of market efficiency giving examples.

Ans. Ref.: See Chapter-4, Page No. 43, Q. No. 3 (Other Important Questions).

Q. 5. Differentiate between Structural Analysis and Industry Analysis.

Ans. Ref.: See Chapter-6, Page No. 65, Q. No. 3 (Other Important Questions).

Q. 6. Write short notes on the following:

(a) Market Indicators.

Ans. Ref.: See Chapter-8, Page No. 84, Q. No. 5(d) (Self-Assessment Questions).

(b) Elliot's Wave Theory.

Ans. Ref.: See Chapter-8, Page No. 84, Q. No. 1 (Other Important Questions).

Q. 7. How is the valuation of Equity Shares done? Explain with the help of different types of valuation models.

Ans. Ref.: See Chapter-9, Page No. 93, Q. No. 2 (Self-Assessment Questions).

■ ■

QUESTION PAPER

June – 2023

(Solved)

SECURITY ANALYSIS AND PORTFOLIO MANAGEMENT

MMPF-4

Time: 3 Hours]

[Maximum Marks : 100

Note: Answer any five questions. All questions carry equal marks.

Q. 1. Distinguish between investment, speculation and gambling giving examples.

Ans. Ref.: See Chapter-1, Page No. 10, Q. No. 3, (Other Important Questions).

Q. 2. Differentiate between primary markets and secondary markets. Explain with the help of examples.

Ans. Ref.: See Chapter-2, Page No. 21, Q. No. 3, (Other Important Questions).

Q. 3. What is Systematic Risk? Explain different types of systematic risk.

Ans. Ref.: See Chapter-3, Page No. 32, Q. No. 1 (Other Important Questions).

Q. 4. Explain the concept of economic forecasting. Illustrate with the help of an example.

Ans. Ref.: See Chapter-5, Page No. 55, Q. No. 3 (Other Important Questions).

Q. 5. Write short notes on the following:

(a) Valuation of stocks.

Ans. Ref.: See Chapter-7, Page No. 74, Q. No. 4 (Other Important Questions).

(b) Dow theory.

Ans. Ref.: See Chapter-8, Page No. 84, Q. No. 5 (b) (Self-Assessment Questions).

Q. 6. Differentiate between fundamental and technical analysis.

Ans. Ref.: See Chapter-8, Page No. 83, Q. No. 3 (Self-Assessment Questions).

Q. 7. What is the need for maintaining portfolios? How does the portfolio management help in mitigating risk?

Ans. Ref.: See Chapter-10, Page No. 104, Q. No. 1 (Other Important Questions).

Q. 8. What is the need for performance evaluation? Explain the concept of benchmark portfolios.

Ans. Ref.: See Chapter-15, Page No. 151, Other Important Question.

■ ■

Sample Preview of The Chapter

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SECURITY ANALYSIS AND PORTFOLIO MANAGEMENT

Introduction to Investment

1

INTRODUCTION

People invest money for various reasons, such as funding future needs like education, managing surplus income and saving occasional windfalls. Investment means committing funds to acquire assets like property or financial instruments with the expectation of future returns through income or value appreciation. Organisations also invest in growing revenues. Financial assets represent claims over issuers and are often held temporarily by investors. These assets can be sold when money is needed. Investments that are easily traded in organised markets at optimal prices are termed marketable securities.

CHAPTER AT A GLANCE

CONCEPT OF INVESTMENT

Investment means postponing current consumption to gain benefits in the future. This involves saving and converting part of your income into financial assets like fixed deposits, bonds, mutual funds or shares. A central idea here is the trade-off between present and future consumption – choosing how much to spend now and how much to invest for later. For example, if someone has ₹ 50,000, they can spend it all today or invest it at 11% interest to receive ₹ 55,500 after a year. Most people find a balance – spending ₹ 30,000 now and investing ₹ 20,000 for future needs.

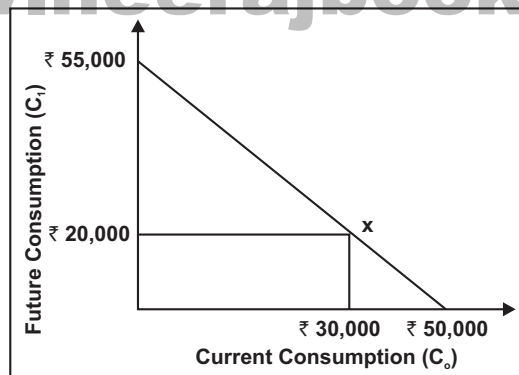


Fig.: Trade-off between present and future consumption

This decision is based on the time value of money, which states that money today is worth more than in the future. To make an investment worthwhile, returns must exceed inflation and compensate for risk. Riskier assets like shares demand a risk premium, while safer investments like government bonds offer lower, but guaranteed returns.

SPECULATION AND GAMBLING

Speculation and gambling both involve risk, but differ in intent and outcome. Gambling relies on luck with negative expected returns, while speculation involves calculated risks with a potential for positive returns, despite the possibility of loss.

Speculation: Speculators take calculated risks after research, aiming for higher profits while accepting potential losses. They understand that greater risk can lead to greater gain. For example, buying futures based on market predictions can yield profit or significant loss.

Speculator vs. Investor: Speculators differ from investors in keywords: They operate with a short-term horizon, seek quick, high returns, shift investments rapidly, and take greater risks—often using borrowed funds. Investors, in contrast, are long-term, risk-averse, and prefer steady returns. Though risky, speculation adds liquidity to markets by balancing demand and supply. For example, speculators may buy or sell stocks during sudden price movements.

Gambling: Gambling is a high-risk game of chance with odds often against the player, unlike speculation which involves calculated risk. For example, in American roulette, a gambler betting \$2 on a single number can win \$160, but the odds of winning are just 1 in 37, making loss more likely than gain.

Key Differences: Speculation involves high-risk financial transactions, but potential for significant gain, often based on research and strategy. In contrast, gambling is betting on outcomes driven by chance, with negative expected returns.

INVESTMENT OBJECTIVES

Asset managers use investment objectives to create a suitable portfolio mix for clients, based on factors like time horizon, risk tolerance and financial situation. Investment objectives guide investment selection and strategy, helping financial advisors meet client goals effectively.

Understanding an Investment Goal: An individual's investment objective, based on strategies like income, growth or trading, helps achieve financial goals. Information such as income, expenses and risk tolerance shapes a tailored portfolio and investment strategy.

Tolerance for Risk: Risk tolerance means an investor's willingness to accept risk. High-risk tolerance may lead to aggressive portfolios with stocks, while moderate and low-risk investors may prefer balanced or income-focused portfolios with bonds and dividends.

Factors Influencing a Person's Investment Goal: Investment decisions are influenced by income, taxes, commissions, fees, total wealth, and assets like Social Security and pensions.

Questionnaire on Investment Objectives: Investors can find free questionnaires on brokerage websites, but should review assumptions and terms carefully. Reassessing the investment objective may be necessary when financial circumstances or goals change.

Types of investment objectives: There are two types of investment objectives – primary and secondary.

Primary Investment Objectives:

Safety: Conservative investors prioritise safety, seeking low-risk investments like government bonds and money market instruments. While these options are secure, their returns may not outpace inflation. No investment is entirely risk-free.

Capital Gain: Capital appreciation is key for wealth growth. It can be achieved through conservative growth, aggressive growth, or speculation. While risky, it offers potential capital gains, but also requires careful forecasting and attracts taxes.

Income: Income investment objectives focus on generating income through dividends, interest, and yields. They offer high returns but also higher risks. They are popular among conservative investors.

Secondary Investment Objectives

Liquidity: Liquidity in investments refers to the ease of converting assets into cash with minimal loss. Investors prefer liquid securities for emergencies and balance their portfolios accordingly.

Tax Savings: Capital gains income is taxed at a lower rate than ordinary income. Tax-saving investments like pension schemes, life insurance, and mutual funds help reduce tax burdens while earning returns.

Investment Environment: Understanding investment principles, framing objectives, and selecting securities is essential. To buy/sell, investors must navigate markets regulated by rules, involving financial instruments and intermediaries. Awareness of the investment environment helps make optimal decisions.

The three elements of the investment environment are:

FINANCIAL INSTRUMENTS

Financial assets can be classified into creditorship and ownership securities based on the buyer's commitment, with further distinction between public and private issues.

Creditorship Securities: Debt instruments represent an issuer's debt obligation. They offer periodic payments and repayment at maturity. For

INTRODUCTION TO INVESTMENT / 3

example, a bond may be bought for ₹ 94.30 and redeemed for ₹ 100 at maturity, earning 6% interest. Both public and private entities can issue these instruments.

Public Debt Instruments: Government debt instruments, including short-term treasury bills and long-term bonds, are high-quality, risk-free securities.

Private Debt Instruments: Private debt instruments are issued by private businesses and typically secured by a mortgage on assets. Examples include convertible debentures, PSU bonds with tax incentives, and Certificates of Deposit (CDs).

Ownership Securities: Ownership securities, or equities, grant investors rights to residual profits. Equity investments can be made directly, indirectly, or through hybrid instruments like preference shares.

Indirect Equities: Indirect equities are instruments offered by institutions like Mutual Funds or Unit Trusts, which invest on behalf of individuals. Investors earn dividends and can trade units through institutions or stock exchanges.

Direct Equities: Direct equities let investors buy shares directly from companies, including new issues or additional shares via rights issues.

Financial Intermediaries: Financial intermediaries link fund users and suppliers, often issuing claims to purchase others' assets. Institutions like UTI, LIC, GIC, IDBI, ICICI and IFCI perform these roles and underwrite or directly invest in capital issues. CRISIL, India's first credit rating agency, was established by key financial bodies and began operations in 1988. It assesses debt and preference shares based on various organisational and market factors. SHCIL, founded by major financial institutions, introduced a book entry system in 1988 to simplify and digitise share transfers, reducing paperwork and streamlining securities transactions. These intermediaries play a vital role in India's financial system.

Financial Markets: Investment market can be divided into two parts. Primary and secondary market. Primary market is open for everyone that can be Banks, Financial institutions, etc. Any individual who want to invest can be the part of this market. Some guidelines given by Securities Exchange Board of India (SEBI) should be followed. A prospectus is provided to investors which has all the informations about the working of the company then the investor can decide whether to invest or not in that particular company. Secondary market is that which works under framework given by Security Contract Act, 1956. Today

all the transactions can be done through computers so it becomes very easy for the investors to get any knowledge about any of their queries.

TYPE OF INVESTMENTS

Investors have many choices for long-term growth, including stocks, bonds, mutual funds, index funds, ETFs, and options – each offering different risk and return potential.

Stocks: Stocks represent ownership in a company, offering potential for high returns and dividends. However, they come with higher risks as companies' values can fluctuate or decline.

Bonds: Bonds are loans to organizations or governments, offering regular interest payments and lower risk than stocks. Government bonds are least risky, while corporate bonds provide higher returns but carry more risk.

Mutual funds: Mutual funds pool money from investors and hire a professional manager to invest in stocks, bonds, or other assets.

ETFs are short for exchange-traded funds: ETFs are index funds that track a benchmark index, trading like stocks with fluctuating daily prices.

Options: An option is a contract allowing the purchase or sale of a stock at a predetermined price and date. Investors can buy, sell, or let the contract expire.

INVESTMENT PROCESS

Investing in securities requires careful planning, as impulsive decisions often lead to losses. A five-step investment process – setting objectives, analyzing securities, constructing, reviewing, and evaluating a portfolio – guides individuals and institutions in making informed investment decisions, helping avoid pitfalls driven by greed or market hype. This structured approach is essential for achieving sound returns over time.

1. Investment objectives and Policy: Investors must define clear, specific investment objectives – either expected return or acceptable risk – based on available wealth. These guide asset selection and policy formation. Ignoring this step leads to poor, risky investment decisions.

2. Security Analysis: After setting investment goals and asset allocation, investors must analyse and select individual securities. This involves economic, industry, and company-level analysis to match investments with risk-return objectives and identify undervalued stocks.

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3. Portfolio Construction: Portfolio construction involves allocating wealth across selected securities while ensuring diversification to reduce risk. Over-diversification can hinder monitoring. It's a continuous process influenced by timing, savings flow, and investment objectives.

4. Portfolio Revision: Portfolio revision involves replacing existing securities when their risk-return profile changes or when the investor's objectives shift due to age, responsibilities, or changing macroeconomic conditions, ensuring alignment with current goals.

5. Portfolio Performance Evaluation: Portfolio performance evaluation assesses changes in investment value over time, comparing portfolio returns and risk to original objectives and benchmarks, helping gauge the effectiveness of portfolio construction and management.

ACTIVITIES

Q. 1. A young couple buys a flat for Rs. 30 lakh with a 25 per cent down payment and the balance in 100 equal monthly instalments. Would you consider the investment a case of postponed consumption? Justify.

Ans. This investment can be considered a case of postponed consumption when an individual chooses to defer their current consumption for future needs. This involves saving or investing money today for benefits or consumption in the future.

In this case, the couple is buying a flat for Rs. 30 lakh. They make a 25% down payment (Rs. 7.5 lakh) and defer the remaining Rs. 22.5 lakh through 100 equal monthly instalments. This arrangement shows postponed consumption for several reasons:

By opting for monthly instalments, the couple is essentially postponing their complete ownership and use of the property until the instalments are fully paid. The property will only be fully paid for after 100 months (about 8.5 years), during which they will continue to use the flat but not pay its full price upfront.

They are sacrificing their immediate disposable income by committing to monthly payments for a long period. They could have used the money they are spending on the flat for other immediate needs or investments, but instead, they have chosen to allocate part of their income to fulfil the goal of owning a home in the future.

The couple will also likely pay interest on the outstanding amount over time. This interest

represents the "cost" of postponing full ownership and consumption of the property, as they choose to spread the expense over a long period. This is another feature of postponed consumption, where the immediate financial burden is delayed, but at the cost of additional interest or financial loss.

By making a down payment and opting for instalments, the couple effectively ensures that they can live in the flat now while paying for it over time. This allows them to use the property for their present living needs even though they have not fully paid for it yet. In the future, once the flat is fully paid off, the couple will fully own it without further financial obligations related to the purchase.

Q. 2. Distinguish between a speculator and an investor.

Ans. The terms speculator and investor are often used interchangeably in casual conversation, but they refer to distinct types of individuals involved in financial markets. While both aim to increase their wealth, their approach, goals, time horizon and risk tolerance fundamentally differ. This distinction is critical for understanding their respective roles in financial markets.

Time Horizon: One of the primary differences between a speculator and an investor is the time horizon. Investors typically have a long-term perspective. They invest their money expecting to benefit from consistent returns over time. This could involve holding assets like stocks, bonds, or real estate for years, often focusing on dividends, interest, or capital appreciation over the long run. Investors are generally not concerned with short-term market fluctuations. Speculators, on the other hand, have a short-term focus. Their goal is to make quick profits by betting on short-term market movements. Speculators may buy and sell financial instruments rapidly, often within days, weeks, or months, aiming to capitalize on volatility and price movements. This approach involves a more immediate need for market timing and forecasting.

Risk Tolerance: Another key distinction lies in their risk tolerance. Investors are generally risk-averse. They prefer investments that offer stability, such as bonds or blue-chip stocks, which are less prone to large swings in value. Their primary goal is to preserve their capital while earning a steady return. Investors are often willing to weather market volatility as long as their long-term investment objectives are met. Speculators, in contrast, are risk-seeking. They