Understanding Securities markets, types, features and concepts

Learn the Securities Market Basics, including stock markets, types of securities, features, and concepts. This guide is perfect for beginners who want to learn more about the securities market and how to invest.

Introduction to Basics of Securities Market

The securities markets provide a regulated framework for efficient flow of capital (equity and debt) from investors to business in the financial market system. Securities markets are basically a platform for allocation of savings to investments. Like any market, the securities market is also a place where buyers and sellers get together; the only difference being that the securities market also contributes to capital formation, apart from providing liquidity and price discovery. Due to the power of securities markets, the savings of households, business firms and government can be channelized to fund the capital requirements of a business enterprise.

Key Characteristics of Securities Market

Before we understand what are securities markets let us first understand what a Security is? A security could be a share / bond or any other financial instrument that has value or is linked to an underlying instrument that has value. According to the Securities Contracts Regulation Act (SCRA), a security is one that is exchange tradable. Here are some key features of securities; as applicable to financial markets.

- Securities represent the terms of exchange of money between two parties; the buyer and the seller in this case.
- Securities can be issued by borrowers / equity funders to raise money at a reasonable cost and gives security ownership to investors.
- Businesses issue securities to raise money from investor with surplus funds through a regulated contract and a regulated and monitored mechanism.
- While the issuer of the security provides the terms for raising capital, investors have a claim to the rights represented by the securities.
- Securities can be broadly classified into equity (risk participation) or debt (claim on cash flows).
- While debt securities are issued for a specific period, equity securities are perpetual. Debt securities pay interest while equity pays out dividends, but it is not assured.

Security Markets: Structure and Participants

Securities market can be broken up into three broad segments, although both are very closely inter-related.

- Primary market refers to the segment of the market where the securities are issued by companies either as a new issue or as an offer for sale. Both equity and debt securities have a primary market where they are first issued.

- Secondary markets are where the actual trading of these securities takes place. Primary issues of debt and equity eventually get traded in the secondary market for price discovery. The secondary market is the normal trading market.

- Derivatives market deals in futures and options. Unlike equities that signify ownership, derivatives are just contracts and are used to manage the risk underlying in the security. Traders can also trade in derivative contracts.

Let us now turn to the key participants in the securities market

Investors are individuals or institutions with surplus funds which are used to purchase securities. The objective of investors is to convert savings into financial investments. Such investors can be retail or institutional.

Issuers are the businesses or fund raisers looking to raise money by issuing securities. They issue securities for short-term and long-term capital needs of the business. Issuers include companies, governments, financial institutions, PSUs, mutual funds etc.

Other than the issuers and the investors who are the essential participants, there are a number of intermediaries who make the smooth functioning of securities market possible.

Key Intermediaries in the Securities Market

Intermediaries, as the name suggests, are agents coordinating between investors and issuers. SEBI (Intermediaries) Regulations, 2008, classifies intermediaries as follows.

- AMCs / Portfolio Managers manage a portfolio of securities and offer units that represent participation in a pool of money. They help investors diversify risk and build wealth.

- Investment bankers or lead managers manage IPOs, rights issues, debt raising, raising of FDs, and placement with institutions, syndication and give corporate advisory services too.

- Underwriters guarantee the sale of an IPO and give comfort to issuers by undertaking to take up shares that don't get sold. They are paid an underwriting fee for this service.

- Brokers are registered trading members of stock exchanges and they execute transactions in the secondary market. They also market IPOs and also give appropriate advice to clients.

- Sub-brokers / Franchisees are affiliated to brokers and help the brokers to reach out to a larger network of investors in specific geographies.

- Clearing members are members of the stock exchange who are responsible for the clearing and settlement of trades on a daily basis on the stock exchange.

- Bankers to an issue are appointed during IPOs, to collect application forms and monies from investors and coordinate with lead managers and facilitate transfer of funds.

- Registrars & Transfer Agents (RTAs) maintain the record of investors on behalf of the issuer. They manage allotment of IPOs, effect transfer of ownership and execute corporate actions.

- Depository Participants (DPs) are the link between the depository (NSDL/CDSL) and the investors. They hold the shares of investors in custody in electronic form.

- Custodians are to institutional investors what the DP is to retail investors. Custodians manage transactions pertaining to delivery of securities and money after a trade is made through the broker, and also provides accounting for securities and money.

- Trustees are appointed when beneficiaries may not be able to directly supervise if money invested is being managed properly. Mutual funds and debentures have trustees.

- Credit rating agencies rate a debt security based on the ability of the company to service its interest and principal obligations on time. Ratings are periodically reviewed.

- Investment advisers help investors to make an informed choice of securities in a manner that is in sync with their long term goals.

Regulatory Framework For The Securities Market

Regulation of the capital markets happen at multiple levels. There is regulation by the nodal regulator, Securities and Exchange Board of India (SEBI). Additionally, the securities markets are also regulated by the RBI, Department of Economic Affairs (DEA) of the Ministry of Finance and Ministry of Corporate Affairs (MCA). In addition, the stock exchanges and the depositories also exercise first level regulation of securities market, apart from SEBI.

- Securities and Exchange Board of India (SEBI) is the principal regulator of the securities market and has 3 principal objectives viz. facilitating growth of capital

markets, protecting the interests of small investors and maintaining integrity of markets.

- Reserve Bank of India (RBI) regulates the money market segment of securities market. As the manager of the government's borrowing program, RBI is the issue manager for government debt. Exchange traded currency futures also come under RBI purview.

- Ministry of Corporate Affairs (MCA) regulates functioning of the corporate sector. It covers setting up of companies, functioning, audit and control. The issuance of securities is also subject to the provisions of the Companies Act 2013.

- Ministry of Finance (MOF) regulates markets through the Department of Economic Affairs. It broadly regulates capital markets and its participants and also initiates discussions on reforms and overseas the implementation of various governing acts.

Detailed Functions of SEBI

While SEBI broadly works to develop the market and to protect investor interest, its specific functions, inter alia, include the following.

- SEBI regulates the functioning of the stock exchanges and provides for direct or indirect control of all aspects of securities trading and functioning of stock exchanges. Stock exchanges are also required to send daily monitoring reports.

- SEBI has codified regulations that cover all activities and intermediaries in the securities markets, which includes brokers, sub brokers, investment bankers, depositories, depository participants, custodians, trustees, registrars etc.

- It oversees functioning of primary (IPO) markets. This includes general conditions for public and rights issuances, Institutional Placement Programme (IPP), Qualified Institutions Placement (QIP) etc; eligibility requirements, general obligations etc.

- Inspections of the intermediaries to ensure compliance with prescribed standards. SEBI can also order investigations into operations of any constituent of the securities market to prevent price manipulation, circular trading, insider trading, unfair practices etc.

Major Functions of The Securities Market

Securities markets are a barometer of the health and robustness of the economy and the investment scenario in the economy. Here are some of the key functions that securities markets perform.

- They enable efficient allocation of financial capital. By bringing investors, savers and issuers together, the securities market channel funds from those who are willing to take risk for the sake of returns to businesses that need capital to grow.

- Securities markets channelize the widespread and diverse savings of millions of small investors into long term wealth creation. Thus savings are productively employed enabling small investors to also participate in economic growth.
- An important function of securities market is that they provide liquidity to stocks and bonds that would have otherwise been illiquid. The availability of a liquid securities market also encourages investors and issuers to participate with greater confidence.
- Securities markets are an important platform for price discovery. Pricing of equities is lot more complex and securities markets manage to combine the wisdom of analysts, traders, investors and arbitrageurs to discover the real worth of an asset.

Securities Types And Characteristics

There are two broad types of securities that are issued by seekers of capital from investors:

- Equity
- Debt

While equity represents risk capital, debt represents more of an assured capital with lesser degree of risk. Equity capital has nothing like assured returns. Dividends are only paid out of profits and if the company performs well consistently then it also results in capital appreciation. Debt entails regular payment of interest as well as repayment of principal at the end of the tenure of the bond / debenture. Equity investors are the owners of the company while the debt investors are the creditors of the business. Equity investors can also participate in the management of the company and voting on resolutions.

Process of Investing In Equities

Equities offer a wide choice with over 4500 listed companies on the BSE. How do you go about selecting stocks to invest in? Here is the process.

Security selection: entails shortlisting of stocks based on screeners to reduce the sample. Then specific stock is selected based on business, future prospects, profit forecasts and intangible factors like management bandwidth and corporate governance.

Timing the market: is something you can do through the use of technical analysis. Charts are used to identify supports and resistances for stocks which guides on entry price, exit price and the price to place stop losses and reversal trades.

Industry group weighting: is suggested exposure to sectors like steel, automobiles, banking, IT, pharma etc and also to themes like high beta, cyclicals, brand strength, rate sensitives etc. Here is where sectoral risks come in.

Equity Research: is about in-depth research into the stock and institutional investors do very incisive in-house research before investing. Retail investors normally rely on their broker’s research teams for research ideas on stocks.

Equity Valuation and Approaches to Equity Research

Equity valuation is the output and equity research is the process to get there. We will look at approaches to equity valuation first and then look at the equity research process. There are essentially two approaches to valuation:

- Discounted cash flow models
- Relative valuation models

Discounted cash flow (DCF) models are based on the premise that value can be estimated by projecting future cash flows. In the DCF model, the cash flows are projected for the next 5 years. Sales numbers are projected and then specific heads of income statement are also projected based on realistic assumptions. DCF relies on free cash flows that are the profit adjusted for non-cash items with a provision made for future capital expenditure. The future cash flows are discounted by the cost of capital. Another approach is the dividend discount approach, but that is not a very acceptable model for valuation.

Relative valuation models are based on comparison of ratios of apples and apples like companies in the same industry or business segment. Some of the popular tools of relative valuation are P/E ratio, P/S ratio, P/BV ratio, P/CF ratio, EV / EBITDA ratio, Dividend yield etc. Normally, the valuations arrived at through the DCF model are ratified by relative valuation parameters to ensure that valuations are not divorced from sector reality.

Having understood approaches to valuation, let us also look at the various approaches to equity research and analysis.

Fundamental analysis is the study of the financial statements and information pertaining to a stock, to estimate the future potential. Fundamental analysis can either be top down or bottom up. In top-down your start with the economy, then the industry and finally the company. In bottom up, you identify the company first and ratify with macro analysis. Bottom approach is more suited for mid cap stocks.

Technical analysis entails the study of price and volume charts to identify the right levels of entry and exit. Technicals are based on the principle that past patterns tend to repeat and hence future price movements can be estimated by studying past patterns.

Eclectic analysis is a combination of fundamental and technical analysis. Here fundamental analysis is used to identify the right stock and technical analysis used to time the entry and exit in the market to fine tune the trade. Eclectic is most commonly used in practice.

The table below captures the key terms pertaining to equity research and analysis

Equity Term	Explanation
P/E ratio	It is the ratio of the stock price to EPS. The P/E is assigned to a stock by the market based on factors like growth, ROE, brand value etc. It is the value that market assigns for every rupee earned
P/BV ratio	It is the ratio of the stock price to the book value per share. This is more useful as a ratio in case of loss making companies (where P/E is not applicable) and in case of the banking sector
Dividend Yield	It is the dividend paid per share divided by the stock price. Dividend yield above 5% is attractive and normally acts as a support for the stock price
Earnings Yield	The earnings yield is the inverse of the P/E ratio. A stock with a P/E of 12 will have an earnings yield of 8.5%. Earnings yield is normally compared with bond yields to determine equity attractiveness
Risk reward ratio	It is the ratio of return that you will get for every unit of risk that the investor assumes. Equities are inherently riskier over the short term due to the risk of volatility in stock prices and earnings

Basic Characteristics and Concepts Pertaining To Debt Instruments

Debt is a claim of the investor / lender over the issuer / borrower. Debt capital can be created by borrowing from banks and other institutions or by issuing debt securities. Debt is a commitment to pay regular interest and to pay back the principal at the end of the

maturity tenure. The table below captures the key concepts pertaining to debt instruments for a quick understanding

Debt Term	Explanation
Face Value	It is value on the face of the debt security and is normally Rs.100 or Rrs.1000. Interest is paid on face value
Principal investment	It is the total investor outlay. If you buy 1000 bonds of face value Rs.100 then principal investment is Rs.100,000
Coupon Interest	It is the fixed rate of interest payable on the bond. 9% bond of face value Rs.1000 will pay Rs.90 interest per year
Maturity	The time period to redemption. A 5 year bond will be repayable at the end of 5 years
Interest accrued	It is the interest that is payable even though it is not paid in cash. Interest automatically accrues on the due dates
Coupon Yield	It is the interest on the bond divided by the price of the bond. If a Rs.1000 bond of 9% is trading in the market at Rs.960, then the coupon yield is Rs.90/960 = 9.375%

Yield to maturity	Yield to maturity or YTM is the most important concept in debt instruments. It is the IRR of the bond after considering time value. Future cash flows are discounted to the present at the current market yield
Time value of money	Money has time value as Rs.100 today is more valuable than Rs.100 after 1 year
Zero Coupon Bonds	These bonds don't pay intermediate interest but issue at a discount and redeem at par value. Interest accrues in this case
Callable Bonds	In these bonds, the issuer has the option to call back the bonds if the interest rates come down
Call markets	The short term money markets where institutions can lend and borrow short term money
Treasury Bills	Short term debt issued by the government and in India it includes 91-day and 364-day Treasury Bills
Gilts	They are short for government securities. They are considered to be high on safety as it is issued by the government
Yield curve	It is the relationship between term-to-maturity and yields. The yield curve is normally upward sloping

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Yield curve	It sis the relationship between term-to-maturity and yields. The yield curve is normally upward sloping