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As a country, India is averse to risk. Keeping the principal safe is by itself an objective for many an 'investor'. Any 'investment' scheme with a 'guarantee' of returns however less it may be is a sure shot seller in our financial markets.

What is risk?

Risk is any deviation from expectation. Unfortunately it is not an absolute measure when compared between 2 different people. For one who expects a return of 8% and actually gets 7% there is a risk. For a person who expects 24% and gets 21% there is the same risk. It does not matter that there is a threefold difference in absolute terms ($3 \times 8 = 24$; $3 \times 7 = 21$).

This brings in confusion to investors' minds because they see only the absolute values. A person who expects 8% thinks that he is taking a low risk and so his expectations have to be met more than a person who expects 28%. But the game of investing has a different set of rules.

The person who expected 8% and ended up at 7% may in reality be a far greater loser.

Forms of risk

Investors have to face risk in different forms like interest rate risk, reinvestment risk, trading risk, inflation risk, market risk and company risk. Each of these risks has its own ways of action on the investor. Based on the risk that is operating currently an investor may have to switch their funds between different investment tools.

For example, an investor who only wants to preserve the capital (principal) faces inflation risk. If the investor saves Rs.1 lakh and also ensures that the 1 lakh is safe always by earning a 7.75% interest rate (by investing in a bank

deposit today), he/she is losing money at close to 2-3% because the inflation is at close to 10% overall (not to frighten the investor with the food items inflation which is above 15%).

Protecting the principal thus cannot be a reasonable objective for an investor, unless it is for the short term. A person who wants protect the principal for making a house down payment after 5 months, wanting to buy a bike after 3 months, who has her daughter to be married off in the next 4 months, who has elderly sick parents are all justified in keeping their money safe as the requirement for them to make use of their money could arise at any time.

Is taking high risk equal to getting high returns?

No way. Ask any person who has gambled and lost his/her money. Taking high risk does not guarantee high returns.

But the opposite is true – if one wants high returns the risk taken has to be higher. Here is where the concept of diversification helps us. Diversification is the age old advice of not putting all our eggs in the same basket. By making investments in different asset classes like land and building, equity mutual funds and ULIPs, one could plan for the long term. For the short term one can diversify across bank deposits, company deposits and debt mutual funds. 5 to 10% of one's assets (excluding real estate) can be in gold and silver (not jewellery) to hedge against inflation.

Regular investments

By going for a regular and planned investment on a monthly, weekly or fortnightly basis, the vagaries of the market can be overcome. This concept is called Cost Averaging. By investing in an equity mutual fund for example a regular amount of say Rs.1000/- one does not have to bother about the fluctuation in the market due to a Government change, or global downturn or a stock market scam, or war in any part of the world or a major policy change by the Government.

The reason is that when the equity market is going down, the investment of Rs.1000/- buys more mutual fund units and when the market is going up the value of all the units grow. This makes regular investment a winner when the market goes down and also when the market goes up.

Time is the solution not timing

To time the market for making a right investment is difficult and is in fact the Trillion Dollar question. But by allowing time to work in one's favour one is always a winner. It is a proven fact for our stock market that over any 5 years period there is always a return much greater than the bank deposit rate in that period. This is including the 5 year period ending during the peak of the global melt down during 2008-2009.

Risk is a mind game

For one to make use of time, to get better return, one has to have the tenacity to keep investing the Rs.1000/- even when the market is going down. One should not be pressured by peers who are shouting about their losses and asking to put the money out when at least the 'principal is safe'.

At the same time one has to have the mental maturity to identify and accept that one has made a wrong choice when an investment has not given expected returns for a longtime. To make good the loss one has made in an investment from the same investment is difficult in the investment game. One has to learn from the mistakes and move on.

Risk taking in India

The quantum of bank deposits in India is a whopping Rs.41 lakh crores. In comparison the quantum invested by Indians in equity oriented mutual funds is a mere Rs.2 lakh crores. The numbers say a lot about our risk taking and our expectations in terms of returns. It is time to start investing in different investment avenues for different purposes than to use the bank deposit as the sole investment tool for all purposes.

Concept of Securities

Paper [certificates](#) (definitive securities) or electronic records ([book](#)-entry securities) evidencing ownership of equity (stocks) or debt obligations (bonds). A document; historically, a physical [certificate](#) but increasingly electronic, showing that one owns a portion of a [publicly-traded company](#) or is owed a portion of a debt issue. Securities are [tradable](#). At their most basic, securities

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In general, any evidence of an interest in corporate stock or stock rights or an interest in any note, bond, debenture or other evidence of indebtedness issued by a government or corporation.

For certain tax purposes, however, the definition is more limited.

Property that serves as collateral for a debt, such that defaulting on the debt will result in the creditor seizing and selling the property.(2) Under what has come to be known as “the modified Howey rule,” an investment contract or other instrument commonly known as a security is defined as “an investment in a common venture premised on a reasonable expectation of profit to be derived from the entrepreneurial or managerial efforts of others.” This definition includes many real estate investments that, if not specifically exempted under some provision of federal law, are susceptible to SEC regulation and oversight for the investment itself, the persons marketing the investment, or both. The Howey rule arose out of a Supreme Court case interpreting sales of interests in an orange grove in Florida—a real estate sale arrangement held to be a security.

An instrument representing ownership (stocks), a debt agreement (bonds), or the rights to ownership (derivatives) in a corporation or another entity.

A security is essentially a contract that is assigned a value and traded. Examples of a security include a note, stock, preferred share, bond, debenture, option, future, swap, right, or warrant or virtually any other financial asset.

A [security](#) representing the [debt](#) of the company or government [issuing](#) it. When a company or government issues a bond, it borrows [money](#) from the [bondholders](#); it then uses the money to [invest](#) in its operations. In exchange, the bondholder receives the principal amount back on a [maturity date](#) stated in the

[indenture](#), which is the agreement governing a bond's terms. In addition, the bondholder usually has the right to receive [coupons](#) or payments on the bond's [interest](#). Generally speaking, a bond is [tradable](#) though some, such as [savings bonds](#), are not. The interest rates on [Treasury securities](#) are considered a [benchmark](#) for interest rates on other [debt](#) in the United States. The higher the interest rate on a bond is, the more [risky](#) it is likely to be.

There are several different kinds of bonds. The most basic division is the one between [corporate bonds](#), which are issued by private companies, and government bonds such as Treasuries or [municipal bonds](#). Other common types include [callable bonds](#), which allow the issuer to [repay](#) the [principal](#) prior to maturity, depriving the bondholder of future coupons, and [floating rate notes](#), which carry an interest rate that changes from time to time according to some benchmark. Along with [cash](#) and [stocks](#), bonds are one of the basic types of [assets](#).

Bonds are debt securities issued by corporations and governments. A certificate that provides evidence of a debt or obligation

Bonds are, in fact, loans that you and other investors make to the issuers in return for the promise of being paid interest, usually but not always at a fixed rate, over the loan term. The issuer also promises to repay the loan principal at maturity, on time and in full.

Because most bonds pay interest on a regular basis, they are also described as fixed-income investments. While the term bond is used generically to describe all debt securities, bonds are specifically long-term investments, with maturities longer than ten years.

A debt investment in which an investor lends money to an entity (corporate or government) that borrows the funds for a defined period at a fixed interest rate. Bonds are used by companies, municipalities, states, and U.S. and foreign governments to finance a variety of projects and activities. Bonds commonly are referred to as fixed-income securities and are one of the three main asset classes, along with stocks and cash equivalents.

The indebted entity (issuer) issues a bond stipulating the stated interest rate (coupon) to be paid and a date when the loaned funds (bond principal) are to be returned (maturity date). Interest on bonds usually is paid every six months (semiannually); bond categories include corporate bonds, municipal bonds, and

U.S. Treasury bonds, notes, and bills (“Treasuries”). Two features of a bond—credit quality and maturity—are the principal determinants of the interest rate of a bond. Bond maturities can range from a 90-day Treasury bill to a 30-year government bond. Corporate and municipal bonds typically go out 3 to 10 years.

Bonds refer to debt instruments bearing interest on maturity. In simple terms, organizations may borrow funds by issuing debt securities named bonds, having a fixed maturity period (more than one year) and pay a specified rate of interest (coupon rate) on the principal amount to the holders. Bonds have a maturity period of more than one year which differentiates it from other debt securities like commercial papers, treasury bills and other money market instruments.

Terminology

Used in Bond Market	Meaning in General Terms
Bonds	Loans (in the form of a security)
Issuer of Bonds	Borrower
Bond Holder	Lender
Principal Amount	Amount at which issuer pays interest and which is repaid on the maturity date
Issue Price	Price at which bonds are offered to investors
Maturity Date	Length of time (More than one year)
Coupon	Rate of interest paid by the issuer on the par/face value of the bond
Coupon Date	The date on which interest is paid to investorstd-txt

Types of Bonds

1. Classification on the basis of Variability of Coupon

I. Zero Coupon Bonds

Zero Coupon Bonds are issued at a discount to their face value and at the time of maturity, the principal/face value is repaid to the holders. No interest (coupon) is paid to the holders and hence,

there are no cash inflows in zero coupon bonds. The difference between issue price (discounted price) and redeemable price (face value) itself acts as interest to holders. The issue price of Zero Coupon Bonds is inversely related to their maturity period, i.e. longer the maturity period lesser would be the issue price and vice-versa. These types of bonds are also known as Deep Discount Bonds.

II. **Treasury Strips**

Treasury strips are more popular in the United States and not yet available in India. Also known as Separate Trading of Registered Interest and Principal Securities, government dealer firms in the United States buy coupon paying treasury bonds and use these cash flows to further create zero coupon bonds. Dealer firms then sell these zero coupon bonds, each one having a different maturity period, in the secondary market.

III. **Floating Rate Bonds**

In some bonds, fixed coupon rate to be provided to the holders is not specified. Instead, the coupon rate keeps fluctuating from time to time, with reference to a benchmark rate. Such types of bonds are referred to as Floating Rate Bonds.

For better understanding let us consider an example of one such bond from IDBI in 1997. The maturity period of this floating rate bond from IDBI was 5 years. The coupon for this bond used to be reset half-yearly on a 50 basis point mark-up, with reference to the 10 year yield on Central Government securities (as the benchmark). This means that if the benchmark rate was set at $i_{t+\frac{1}{2}}X_{t+\frac{1}{2}}\%$, then coupon for IDBI's floating rate bond was set at $i_{t+\frac{1}{2}}(X + 0.50)i_{t+\frac{1}{2}}\%$.

Coupon rate in some of these bonds also have floors and caps. For example, this feature was present in the same case of IDBI's floating rate bond wherein there was a floor of 13.50% (which ensured that bond holders received a minimum of 13.50% irrespective of the benchmark rate). On the other hand, a cap (or a ceiling) feature signifies the maximum coupon that the bonds issuer will pay (irrespective of the benchmark rate). These bonds are also known as Range Notes.

More frequently used in the housing loan markets where coupon rates are reset at longer time intervals (after one year or more), these are well known as Variable Rate Bonds and Adjustable Rate

Bonds. Coupon rates of some bonds may even move in an opposite direction to benchmark rates. These bonds are known as Inverse Floaters and are common in developed markets.

2. Classification on the Basis of Variability of Maturity

I. Callable Bonds

The issuer of a callable bond has the right (but not the obligation) to change the tenor of a bond (call option). The issuer may redeem a bond fully or partly before the actual maturity date. These options are present in the bond from the time of original bond issue and are known as embedded options. A call option is either a European option or an American option. Under an European option, the issuer can exercise the call option on a bond only on the specified date, whereas under an American option, option can be exercised anytime before the specified date.

This embedded option helps issuer to reduce the costs when interest rates are falling, and when the interest rates are rising it is helpful for the holders.

II. Puttable Bonds

The holder of a puttable bond has the right (but not an obligation) to seek redemption (sell) from the issuer at any time before the maturity date. The holder may exercise put option in part or in full. In rising interest rate scenario, the bond holder may sell a bond with low coupon rate and switch over to a bond that offers higher coupon rate. Consequently, the issuer will have to resell these bonds at lower prices to investors. Therefore, an increase in the interest rates poses additional risk to the issuer of bonds with put option (which are redeemed at par) as he will have to lower the re-issue price of the bond to attract investors.

III. Convertible Bonds

The holder of a convertible bond has the option to convert the bond into equity (in the same value as of the bond) of the issuing firm (borrowing firm) on pre-specified terms. This results in an automatic redemption of the bond before the maturity date. The conversion ratio (number of equity of shares in lieu of a convertible bond) and the conversion price (determined at the time of conversion) are pre-specified at the time of bonds issue.

Convertible bonds may be fully or partly convertible. For the part of the convertible bond which is redeemed, the investor receives equity shares and the non-converted part remains as a bond.

3. Classification on the basis of Principal Repayment

I. Amortising Bonds

Amortising Bonds are those types of bonds in which the borrower (issuer) repays the principal along with the coupon over the life of the bond. The amortising schedule (repayment of principal) is prepared in such a manner that whole of the principle is repaid by the maturity date of the bond and the last payment is done on the maturity date. For example - auto loans, home loans, consumer loans, etc.

II. Bonds with Sinking Fund Provisions

Bonds with Sinking Fund Provisions have a provision as per which the issuer is required to retire some amount of outstanding bonds every year. The issuer has following options for doing so:

- i. By buying from the market
- ii. By creating a separate fund which calls the bonds on behalf of the issuer

Since the outstanding bonds in the market are continuously retired by the issuer every year by creating a separate fund (more commonly used option), these types of bonds are named as bonds with sinking fund provisions. These bonds also allow the borrowers to repay the principal over the bond's life.

Investing in Bonds

Many people invest in bonds with an objective of earning certain amount of interest on their deposits and/or to save tax. Bonds are considered to be a less risky investment option and are generally preferred by risk-averse investors. Though investors should not get overtly confident of investing in bonds as bond prices are also subject to market risk. For example, bond prices have a negative correlation with interest rates due to which any increase in interest rates can lead to a fall in bond prices and vice-versa. Thus, it is recommended that investors should consider the risk-return factor (i.e. the expected return for the given level of risk) before investing.

Investments Eligible for Deductions

Holders of certain bonds are eligible to claim deduction from their taxable income. A list of such deposits is mentioned hereunder:

1. Interest on Government Securities, National Savings Certificate (issues VI, VII and VIII), Development Bonds, Development Bonds and 7 year National Rural Development Bonds
2. Interest on Post Office Term Deposits, Recurring Deposits Accounts and National Savings Schemes (as referred to in National Savings Scheme Rules, 1992)
3. Dividends received from a co-operative society
4. Income from investments in UTI (up to assessment year 1999-2000)
5. Interest on deposits with a banking company or a co-operative bank
6. Interest on deposits with a co-operative society made by a member of the society
7. Interest on deposits with housing boards
8. Interest from deposits made under A.E. (C, D.) Act & C.D.S. (I.T.P.) Act.
9. Interest on notified debentures of any co-operative society, any institution or any public sector company.
10. Interest on deposits with a financial corporation which is engaged in providing long-term finance for industrial development in India and which is eligible for deduction under Section 36(l)(viii) [up to assessment year 1999-2000, the corporation is approved by Central Government].
11. Interest on deposits with a public company formed and registered in India with the main object of carrying on the business of providing long-term finance for construction or purchase of houses in India for residential purposes and which is eligible for deduction under Section 36(l)(viii) [up to assessment year 1999-2000, the company is approved by the Central Government under Section 36(l)(viii)].
12. Interest on deposits with Industrial Development Bank of India.
13. Interest on deposits under National Deposit Scheme. Income in respect of units of mutual fund specified under Section 10(23D) [up to assess. year 1999-00].
14. Interest on deposits under Post Office (Monthly Income Account) Rules