

Risk is an essential consideration in investment **decision-making** because investors aim to **maximize returns** while minimizing the potential for loss. By understanding and assessing various types of risk, investors can make informed choices about the **composition and management of their investment portfolios**.

TYPES OF RISKS

Market Risk: Also known as **systematic risk or undiversifiable risk**, market risk is associated with the **overall performance of the financial markets**. It includes factors such as **economic conditions, interest rates, inflation, and geopolitical events** that can affect the prices of all securities in the market. Market risk cannot be eliminated through diversification.

Specific Risk: Also known as **unsystematic risk** or diversifiable risk, specific risk refers to risks that are specific to a **particular company or industry**. Examples include management risks, operational risks, competitive risks, and legal or regulatory risks. Specific risk can be reduced through diversification, as holding a portfolio of different securities can help offset the impact of individual company or industry-specific risks.

Credit Risk: Credit risk relates to the **potential for a borrower or issuer** of a security to default on their financial obligations. It is primarily associated with **fixed-income securities, such as bonds, where investors face** the risk of not receiving the promised interest payments or the repayment of principal.

Liquidity Risk: Liquidity risk refers to the **possibility of not being able to buy or sell an investment quickly** and at a fair price. Illiquid investments may have a limited market, making it **challenging to convert them into cash** when needed. This risk is particularly relevant for investments such as real estate, certain types of bonds, or investments in small companies.

Currency Risk: Currency risk arises when **investments are denominated** in a currency different from the investor's home currency. **Fluctuations in exchange** rates can impact the returns of these investments when converted back into the investor's home currency. Currency risk is especially relevant for international investments.

PRIMARY MARKET

the primary market refers to the market where **newly issued securities** are bought and sold for the first time. It is also known as the new issue market or the **IPO** (Initial Public Offering) market. The primary market plays a crucial role in **capital formation** for companies and **provides opportunities** for investors to participate in the initial offering of securities.

FEATURES AND FUNCTIONS OF THE PRIMARY MARKET:

Capital Formation: Companies raise capital in the primary market by issuing new securities, such as **stocks (equity) or bonds (debt)**. Through the issuance process, companies generate funds that can be used for various purposes, including **expansion, research and development, debt repayment, or general corporate purposes**.

Initial Public Offering (IPO): The primary market is most commonly associated with IPOs. An IPO occurs when a private company offers its shares to the public for the first time, transforming into a publicly traded company. In an IPO, the company typically works with **investment banks or underwriters** to determine **the offering price**, the number of shares to be issued, and the prospectus detailing information about the **company's operations, financials, and risks**.

Securities Offerings: In addition to IPOs, the primary market encompasses other forms of securities offerings. These include **rights issues**, where existing shareholders are offered the right to purchase additional shares at a **predetermined price**, and preferential allotments, where new shares are issued to a **specific group of investors**, such as existing shareholders or strategic investors.

Price Discovery: The primary market facilitates price discovery for newly issued securities. The initial offering price is **determined** through a process that involves market research, analysis of the company's **fundamentals, and investor demand**. The **pricing** reflects the perceived value of the securities and the market conditions at the time of the offering.

Underwriting: In an IPO, investment banks or underwriters play a significant role. They help the issuing company with the structuring, marketing, and distribution of the securities to potential investors. Underwriters also assume the **risk of purchasing** the securities from the company at an agreed-upon price and reselling them to investors.

Regulatory Compliance: Companies issuing securities in the primary market must comply with regulatory requirements set by the relevant **securities regulatory authority** in their jurisdiction. These requirements aim to protect investors' interests by ensuring adequate disclosure of **information and maintaining transparency** in the offering process.

Participation of Institutional and Retail Investors: The primary market provides opportunities for both **institutional investors** (such as mutual funds, pension funds, and insurance companies) and **retail investors** (individual investors) to participate in new securities offerings. Retail investors can access the primary market through brokerage firms or online platforms.

Participants of Primary Market

Issuing Companies: These are the companies that seek to raise capital **by issuing securities in the primary market**. Issuing companies may be new companies going public through an IPO or existing companies seeking additional funding through secondary offerings, such as rights issues or preferential allotments. The issuing companies work with underwriters and other intermediaries to prepare the necessary documentation, determine offering terms, and comply with regulatory requirements.

Underwriters/Investment Banks: Underwriters or investment banks play a crucial role in facilitating the issuance of securities in the primary market. They assist the **issuing companies in structuring the securities offering, determining the offering price**, and ensuring compliance with regulatory requirements. Underwriters also commit to purchasing the securities from the issuing company at a predetermined price and then resell them to investors. They bear the risk of any unsold securities.

Regulatory Authorities: Regulatory authorities, such as the **Securities and Exchange Commission (SEC) in the United States or the Securities and Exchange Board of India (SEBI)** in India, oversee and regulate the primary market activities. They enforce securities laws, review and approve the offering documents, and ensure fair and transparent practices in the issuance and distribution of securities. Regulatory authorities aim to protect investors' interests and maintain the integrity of the primary market.

Investors: Investors are the individuals, institutions, or organizations that participate in the **primary market by purchasing newly issued securities**. They may include institutional investors, such as **mutual funds, pension funds, insurance companies, and other financial institutions, as well as retail investors, which are individual investors**. Investors assess the offering documents, including the prospectus, financial statements, and other relevant information, to make informed investment decisions. They subscribe or apply for the securities during the offering period.

Registrar and Transfer Agents: Registrar and transfer agents maintain **records of securities ownership and facilitate the transfer of securities** from the issuing company to the investors. They manage the process of updating the ownership records, issuing share certificates or statements of holding, and processing changes in ownership due to buying, selling, or transferring securities.

Market Intermediaries: Market intermediaries, such as **brokers and investment advisors**, play a role in **connecting** the issuing companies and investors. Brokers help investors in subscribing to the securities offering and facilitate the buying and selling of securities. Investment advisors provide guidance and advice to investors regarding the suitability of the securities offering based on **their investment objectives and risk profile**.

FUNCTIONS OF UNDERWRITING

Assisting the Issuing Company: Underwriters work closely with the issuing company to facilitate the securities offering. They provide **expertise in structuring the offering and help determine the appropriate size** and type of securities to be issued. Underwriters assist the company in preparing the necessary documentation, including the prospectus and other disclosure materials, ensuring compliance with regulatory requirements.

Pricing the Securities: Underwriters play a significant role in pricing the securities being offered. They assess various factors such as **market conditions, demand** for the securities, and the **financial position of the issuing company** to determine the offering price. The underwriter aims to set a price that is attractive to investors while ensuring a reasonable return for the issuing company.

Assuming the Risk: Underwriters assume the risk associated with the securities offering. They commit to **purchasing the securities from the issuing company** at a predetermined price, known as the **underwriting price or the offer price**. By doing so, underwriters provide assurance to the issuing company that the securities will be **sold and funds** will be raised, even if investor demand is lower than expected.

Distribution to Investors: Underwriters are responsible for **distributing the securities** to investors. They leverage their **network and relationships with institutional and retail investors** to market and sell the securities. Underwriters may allocate the securities among different types of investors, ensuring broad participation and a fair distribution.

Stabilization Activities: In some cases, underwriters engage in stabilization activities to **support the price of the newly issued securities** in the immediate aftermarket. Stabilization activities involve **purchasing additional shares** in the secondary market to create temporary demand and maintain stability in the share price. This helps to **mitigate volatility** and support investor confidence.

Syndicate Formation: Underwriters often form a syndicate, which is a **group of investment banks or financial institutions** that collectively underwrite and distribute the securities. Syndicates are formed for large or complex offerings to share the underwriting risk, leverage expertise, and expand distribution capabilities.

Due Diligence: Underwriters conduct due diligence on the issuing company to ensure that the **information provided** in the offering documents is **accurate and complete**. They review the company's **financial statements, business operations, legal documentation**, and other relevant information to assess the company's creditworthiness and the risk associated with the securities being offered.

TYPES OF UNDERWRITING

Firm Commitment Underwriting: In firm commitment underwriting, the underwriter or underwriting syndicate commits to **purchasing the entire offering of securities** from the issuing company at a **predetermined price**. The underwriter guarantees the sale of the securities to the market, assuming the risk of any unsold securities. This type of underwriting provides certainty to the issuing company but places a **significant risk** on the underwriter.

Best Efforts Underwriting: In a best efforts underwriting, the **underwriter agrees to use its best efforts to sell the securities** on behalf of the issuing company, but **without a guarantee** of fully subscribing to the offering. The underwriter does not assume the risk of unsold securities. Instead, they receive a commission or fee based on the amount of securities sold. Best efforts underwriting places more risk on the issuing company, as the underwriter is not obligated to purchase any unsold securities.

All-or-None Underwriting: In an all-or-none underwriting, the **underwriter sets a minimum level of subscription** that must be met for the offering to proceed. If this **minimum** threshold is not reached, the offering is **canceled**, and all funds collected from investors are returned. This type of underwriting protects the issuing company by ensuring that the entire offering is sold, but places risk on the underwriter to find sufficient investor demand.

Standby Underwriting: Standby underwriting is commonly used in **rights offerings**. Under this arrangement, the underwriter **agrees to purchase any unsubscribed securities** in a rights offering, ensuring that the issuing company receives the expected capital. The underwriter guarantees the sale of the securities not subscribed by existing shareholders.

Underwriting Syndicate: An underwriting syndicate is formed when **multiple underwriters** collaborate to underwrite and distribute the securities. The **syndicate shares** the underwriting risk, as well as the responsibilities of pricing, marketing, and selling the securities. Syndicates are often formed for large or complex offerings, leveraging the expertise and distribution capabilities of multiple underwriters.

LISTING OF SECURITIES

Stocks: Common and preferred stocks represent **ownership shares in a company**. They offer potential **capital appreciation and dividend income**.

Bonds: Bonds are **debt** securities issued by **governments, municipalities, and corporations**. They pay interest over a specified period and return the principal at maturity.

Mutual Funds: Mutual funds pool money from **multiple investors** to invest in a diversified portfolio of stocks, bonds, or other securities. They offer investors a convenient way to gain exposure to various assets.

Exchange-Traded Funds (ETFs): ETFs are similar to mutual funds but **trade on stock exchanges**. They can track specific indices or sectors and provide investors with diversification and liquidity.

Options: Options are derivative securities that give the **holder the right**, but not the obligation, to **buy or sell an underlying asset** at a **predetermined price** within a specified period.

Futures: Futures contracts are **agreements** to buy or sell an underlying asset at a predetermined price on a **future date**. They are commonly used to hedge against price volatility or speculate on price movements.

Commodities: Commodities like **gold, oil, natural gas, agricultural products, and metals** can be traded as securities. They are often used for diversification and as a hedge against inflation.

Real Estate Investment Trusts (REITs): REITs are companies that own, operate, or **finance income-generating real estate**. They allow investors to access real estate assets without direct ownership.

Foreign Exchange (Forex): Forex securities involve trading different **currencies** against each other. They are commonly used for currency speculation and hedging.

Derivatives: Derivatives encompass a broad range of securities, including **options, futures, swaps, and forward contracts**. They derive their value from an underlying asset or benchmark.

Pricing of Issues

Fundamental Analysis: Fundamental analysis involves evaluating the intrinsic value of a security based on factors such as financial statements, industry analysis, management quality, competitive position, and overall economic conditions. This analysis helps investors estimate a **fair value for the security**.

Technical Analysis: Technical analysis focuses on analyzing historical price and volume data to identify patterns and trends in the market. It utilizes various charting techniques and indicators to predict future price movements and determine **entry and exit points** for securities.

Market Comparables: In this approach, the pricing of issues is determined by **comparing the security** to similar securities in the market. This includes analyzing factors such as **price-to-earnings (P/E) ratios, price-to-book (P/B) ratios, dividend yields**, and other relevant financial metrics of comparable companies or securities.

Discounted Cash Flow (DCF) Analysis: DCF analysis is a valuation method that estimates the **present value** of a security by discounting the expected future cash flows it will generate. The future cash flows are adjusted for the **time value of money**, and a discount rate is applied to reflect the risk associated with the investment.

Option Pricing Models: Option pricing models, such as the Black-Scholes model, are used to price options and other derivative securities. These models consider factors such as the underlying **asset price, strike price, time to expiration, volatility, and risk-free interest rate** to calculate the fair value of the option.

Supply and Demand: The **pricing of issues** is also influenced by the forces of supply and demand in the market. If there is high demand for a security relative to its supply, the price is likely to increase, and vice versa.

Macroeconomic Factors: Macroeconomic factors such as **interest rates, inflation, GDP growth, and geopolitical events** can impact the pricing of issues. Changes in these factors can affect the overall market sentiment and investors' willingness to pay for securities.

Prospectus

Legal Requirement: A prospectus is often a legal requirement for companies that want to raise capital through the issuance of securities. It serves as a disclosure document that provides investors with relevant information to make informed investment decisions.

Offering Details: The prospectus outlines the details of the investment offering, such as the type of securities being offered (stocks, bonds, etc.), the number of securities available, the offering price, and any associated fees or expenses.

Company Information: A prospectus provides comprehensive information about the issuing company, including its history, business model, management team, financial statements, and risk factors. This information helps investors evaluate the company's fundamentals and assess its growth prospects.

Investment Objectives: The prospectus describes the investment objectives of the security being offered. It outlines the intended use of the funds raised and the strategies the company or fund will employ to achieve its goals. This helps investors determine if the investment aligns with their own objectives and risk tolerance.

Risk Disclosure: A prospectus includes a section that highlights the potential risks associated with the investment. It provides an overview of the specific risks that investors may face, such as market volatility, regulatory changes, industry-specific risks, and financial risks. Understanding these risks helps investors assess the potential downside of the investment.

Legal and Regulatory Information: The prospectus includes information about legal and regulatory requirements, including the applicable securities laws, tax implications, and any restrictions or limitations on the securities being offered. This information ensures that investors are aware of the legal framework and obligations associated with the investment.

Investor Rights and Protections: The prospectus outlines the rights and protections afforded to investors, such as voting rights, dividend rights, redemption or conversion options, and any potential conflicts of interest. Understanding these provisions helps investors make informed decisions and protect their rights as shareholders or security holders.

Transparency and Accountability: By providing comprehensive and standardized information, a prospectus promotes transparency and accountability in the investment process. It ensures that investors have access to the necessary information to evaluate the investment opportunity and hold the issuing company or fund accountable for its representations.