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A Comparative Analysis of Selected Financial Instruments to Solve Investors Dilemma

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Abstract - The economic development of a country depends upon the savings done by its households, individuals or corporate houses who channelizes their savings in some productive avenues i.e., in an economy there is a regular flow of funds from the investors(savers) to the users of the fund which leads to creation of wealth. This flow of funds is mobilized through financial markets in some financial instruments such as bonds, mutual funds, public provident fund(PPF), bank deposits etc. Accordingly, a rational investor has to make a decision regarding the best investment instrument available to him. Thus, the paper attempts to state the various factors that should be kept in mind before investing. The paper also tries to compare the various financial instruments on the basis of these factors and thereby stating the suggestions as to which is the best instrument available to the investor as per his needs.

Keywords - ***financial instruments, investors, mutual funds, returns, risk, taxation.***

I. INTRODUCTION

The Indian financial system nurtures the savings among investors and channels them to their optimum and effective use through financial instruments. These financial instruments are those instruments which are used for raising funds for corporate entities. Investments in financial assets consists of:

a. Securitized investments like shares, bonds, debentures, govt. securities, mutual funds, etc.

b. Non-securitized investments like bank deposits, post office deposits, insurance, provident funds, etc. [1].

They can also be classified into:

a. Money market instruments like treasury bills, commercial papers, commercial bills etc. which are for short run and
b. capital market instruments like equity, bonds etc. which are for long run.

They all are available to investors for earning returns and beating the inflation. However, all these investment avenues have their own pros and cons. So, a rational investor tries to balance these benefits and shortcomings before investing in them.

Section 1 of the paper introduces the various types of financial instruments. Section 2 talks about the factors that influence the decision of investing. Section 3 of the paper contains a table which compares these investment avenues on certain parameters and the analysis of the table is also mentioned and finally section 4 lays down key findings, suggestions and conclusion of the paper.

II. REVIEW OF LITERATURE

- Potter, (1971) identifies some factors i.e. dividends, growth, investment for saving purposes, quick profits and professional investment management that affect investors perception towards their investment decisions.
- Saha, Asish and Murthy. (1994) In the study conducted by them, they identified the factors i.e., return, safety, liquidity and capital appreciation plays an important role in the investment decisions [8].
- Gupta (1994) surveyed household investor with the objective to find investors preferences for various financial assets. The findings of the study helped the policy makers to design various financial products for future [3].
- Sikidar, Sujit and Singh, A.P. (1996) they stated that because of tax benefits mutual funds are preferred by the salaried and self-employed individuals [10].
- SEBI – NCAER Survey (2000) was carried out and some of the findings of the survey are: Mode of investments vary as per the risk perception of the investor; Bank Deposit appeals most of the investor and MFs have still not became lucrative to for small investors [9].
- Rajeswari, T. R. and Moorthy, V. E. R. (2005) The study revealed that the most preferred vehicle for investment is bank deposit. Mutual funds and equity were on fourth and sixth number respectively. The survey also revealed

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that most of the investors invest on their own or are influenced by relatives, friends or newspaper articles.

- Das Bhagaban, Mohanty Sangeeta, Chandra Nikhil (2008) have thrown light on the behavioral aspect of Indian retail investors towards mutual funds and life insurance policies during post-liberalization period [2].
- Ramakrishna Reddy, G. and Krishnudu (2009) Study argued that the primary motive of investments of the small and retail investor is to have regular income in the form of either dividends or interests. Other secondary motives are capital gains, tax benefits, and speculative profits.
- Mehta, P.U. (2012) in his survey found that the most popular avenues of investments are savings account, insurance, gold, mutual funds, PPF and GPF. He also found that factors like tax exemption, flexibility, market trend, reliability, affordability also plays role apart from the usual risk and return as a factor [5].
- Rathnamani., V. (2013) in his study concluded that many investors prefer to invest in mutual funds so as to have high return at lower risk, better safety and liquidity [7].
- Kamweshwari, K. (2013) In her survey in Vishakhapatnam, it was inferred that 75% investors prefer growth funds, 13% prefer balanced schemes and finally 11% prefer income schemes [4].
- Thomas and John. (2014) in his thesis found that short-term investors look for safety of their money whereas, medium-term investors invest for tax benefits [12].

III. OBJECTIVES OF THE PAPER

The study has the following objectives: -

1.To make the retail investors aware about the various financial instruments available to them.

2.To state the various factors affecting investment decisions.

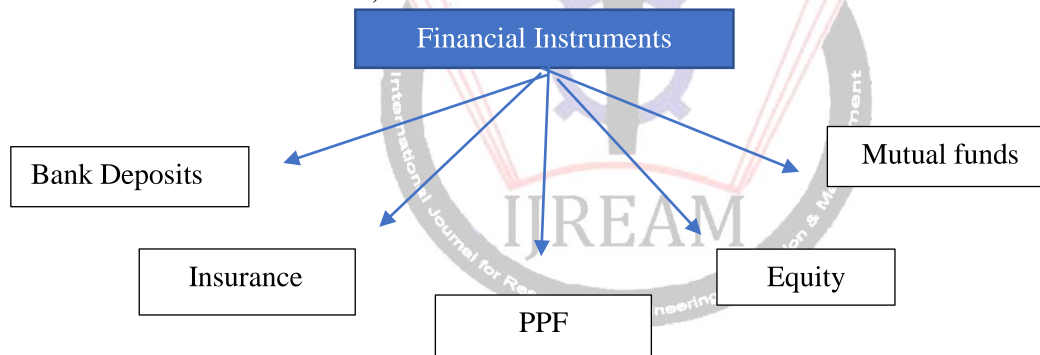
3.To compare the various financial instruments on the basis of stated factors.

4.Suggesting the best instruments available to the investor with regard to his needs.

IV. RESEARCH METHODOLOGY

The study used an exploratory research technique based on past literatures from journals, magazines, newspaper articles, etc. which are related to investments and financial decision making. According to the objective of the study, the research design used is descriptive in nature.

SECTION 1, VARIOUS FINANCIAL INSTRUMENTS AVAILABLE:



***1. BANK DEPOSITS* -**Several investors are comfortable placing money in banks only as either fixed deposits or savings account. Money kept in a bank is safe and in today's time provides interest at the rate of 6-7% pa on fixed deposits and 3-4%pa on savings account. One can withdraw money from his account as and when required and thus provides high liquidity.

***2. INSURANCE*-** It is a form of risk management used to hedge against the risk of uncertainty or contingency. The insurance transaction involves the guaranteed and known amount of payment to the insured in case of any mishap in exchange of some premiums paid to insurer earlier. However, in today's scenario people assume insurance as an investment instrument also which gives a return of 3-4%(far below the average inflation rate of 10 years and thus giving us negative real interest) and is highly illiquid in nature.

***3. PPF (PUBLIC PROVIDENT FUND)*-** It is a savings-cum-tax-saving instrument in India, introduced by the Ministry of Finance in 1968.The aim of the scheme is to mobilize small savings and giving reasonable returns combined with income tax benefits. The scheme is fully guaranteed by the Central Government and thus is completely risk free. In this the investor can earn up to 7-8%pa return but the money would be locked for 15 years. Also returns are tax free.

4. EQUITY/STOCK MARKET - Share of a company represents the ownership right of the investor in the company and the capital appreciation and/or dividends received from the company becomes the return for the investors. Investments in stock market can lead to instant gains if speculations are correct but it is the riskiest mode. Also, the returns are taxable

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(In the budget of 2018 the government announced the CGT on equity investments).

***5. MUTUAL FUNDS* -** An investment mode which is gaining a lot of popularity in recent times is MFs. It is a professionally managed trust that pools the money obtained from the people and invest them in stocks, bonds, etc. on their behalf. This mode can cater the needs of almost every kind of investors from risk avers to risk takers and from short term investors to long term investors. It provides the benefits of diversification and compounding of returns as well. However, the short-term gains are taxed and since indirectly the investments are done in stock market only so it is little risky.

Thus, these are the certain financial instruments in which a person can invest but an investor cannot blindly jump into any of them without having the knowledge of the factors which can impact his decision and returns.

SECTION 2, FACTORS AFFECTING INVESTMENT DECISIONS

There are certain parameters that one should consider before investing in any asset. These are-

***1. LIQUIDITY*-**It can be described as the degree to which an asset can be quickly bought or sold in the market without affecting the asset's price i.e. the ability to convert the asset into cash without losing its value. Generally short-term instruments are more liquid than long run instruments. So, instruments such as savings account, equity, MFs are liquid whereas, real estate, insurance comes under the category of illiquid assets [1].

***2. RETURNS*-**A return in its simplest terms, is the money made or lost on an investment. Rate of return is the proportion of profit earned from an investment during a periodic interval of time, expressed as a percentage. Returns could be of two type-Real return and nominal return. A financial product should always provide returns at the rate over and above the inflation rate. Returns from certain instruments are Bank deposits-7%pa approx., Mutual funds-approx. 14-15% over a long run, PPF-7.25%pa approx.

***3. RISK*-**Risk implies future uncertainty or deviation from expected outcome i.e. it measures the uncertainty that an investor is willing to take to realize a gain from an investment [1]. Risk is of two type-Systematic risk and non-systematic risk. It is the most important aspect that needs to be considered and accordingly, an investor could be risk averse or risk taker. There is always a tradeoff between risk and return. Higher the risk, more will be the return and vice versa.

***4. TAXATION ASPECT*-**Every individual has to pay certain income tax depending upon his income. So, they invest in various instruments like PPF, insurance, ELSS funds etc. to save taxes. By investing in such instruments, they can save taxes on their income of Rs. 1,50,000. However, all these instruments have a certain lock-in period. For example-PPF has a lock-in period of 15 years, ELSS has 3 years.

***5. TIME HORIZON*-** Before investing, the investor should be clear about his tenure of investments. Ideal time of investment should be at least 3-4 years to earn a decent return. However, there are certain instruments for short run as well like bonds, savings account, treasury bills etc. but the return from them is comparatively less. Other factors could be capital outlay, regular income requirements, etc.

Thus, these are the certain factors that needs to be kept in mind to make rational decision while investing. For choosing a perfect instrument, an investor should be clear about his needs and goals.

Section 3, Comparing various financial instruments on the basis of the stated factors:

Criteria	Bank deposits(FDs)	Equity	Mutual Funds	Insurance	PPF
Returns	Near inflation(6-7%pa)	No fixed return as they are highly volatile	Above inflation (12-15%pa at least) if invested for 3-4 years	Below inflation(3-4%pa)	Near inflation(7-8%pa)
Risk	Low	Very High	Depends on the type of fund	Low	Low
Liquidity	Moderate	Very High	Very high	Low	Low
Taxation	Tax is applicable if the interest increases from Rs10,000pa and can't be used to get tax exemption under section 80C	15%pa flat tax for short term profits and now CGT is also applicable and it is also not useful for section 80C	Taxes only up to 1 year at the rate of 15%pa. ELSS are tax free with a lock-in of 3 years and can be used for 80C deduction	Proceeds from them are tax free (except in certain conditions). Also, Life insurance premium can be used for 80C deduction	Can be used to claim deduction under section 80C but has a lock-in of 15years. Partial withdrawal after 5 years
Capital outlay(Min)	Rs.1000	No min amount	Rs.500 in case of SIP and Rs.5000 in case of lumpsum	No min premium.	Rs.500 yearly

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ANALYSIS OF THE TABLE-

Looking at the table which compares the various financial instruments on certain parameters it can be seen that when it comes to returns, it is the highest in the case of mutual funds (if invested for 2-3 years) because of compounding effect. After MFs, it is PPF followed by bank deposits. One can invest in equity also but there the returns are highly unpredictable. Also, one should not invest in insurance for the sake of returns because it gives negative returns i.e. below the inflation level thus the investor is losing his purchasing power. Taking about risk, it is the highest for stock market investments followed by mutual funds because in MFs, indirectly investor s investing in stock market only. The risk is low in MFs because of rupee cost averaging. Bank deposits, PPF and insurance have a very low risk. Coming on to liquidity as a factor, it is highest in case of MFs and stock market investments but is least in bank deposits (Fixed deposits), PPF and insurance because PPF has a lock-in period of 15 years however, in certain conditions investor can withdraw some amount after completion of 5 years and also for insurance, one cannot withdraw before the maturity date but if withdrawn before maturity, then heavy penalty is levied. Next, for the investor having taxable income, they can opt for MFs ELSS, life insurances and PPF to save the taxes. If we analyze the table the PPF apart from taxation benefit gives return up to 7-8% but the money gets locked up for 15 years. Similarly, insurance generally gives a return of 4-5% whereas, MFs having a lock in of only 3 years give 12-15% approx. pa returns. Lastly, the minimum capital outlay for all the stated instrument is quite low.

SECTION 4, KEY FINDINGS AND SUGGESTIONS-

An investor should keep in mind his needs and accordingly he should decide the apt instrument for himself. The paper would suggest the followings-

1. One can infer from the paper that MFs are best for tax saving purposes. So, if the investor has the aim of saving taxes, then ELSS funds are recommended because, the lock-in period is the least and the average return of 10 years is 20-25% which is the highest among tax saving instruments.

2. From the table it can be concluded that bank deposits are the safest option if the tenue of investment is less. So, the paper would suggest that if the investor is completely risk averse and wants to invest for a short run then he should go for bank deposits (either FDs or RDs) but if his investment tenure is for long run then, he should opt for debt funds. The paper also suggests that if the investor is risk averse and doesn't need liquidity for few years then he can also choose PPF instead of bank deposits or debt funds.

3. We can also infer from the table that MFs and stock market offers highest liquidity as we can pull out our money from them very easily in case of some emergency. So, the paper suggests that if the investors main aim is to earn returns without compromising on the liquidity then he should opt for these investments.

4. If the investor is investing for speculative purposes only and wants to get instant gains then he should go for equity investments.

5. Also, if we see the returns from the insurance, then its real return is in negative. Thus, it is suggested that an insurance policy should be taken only as a loss mitigating instrument and not for investment or saving purposes. Keeping in view the stated need of insurance, its always beneficial to go for term plans rather than endowment plans.

6. We can also infer from the paper that MFs are less risky than stock market So, if the investor wants to invest in stock markets but is new in the market, have limited capital taker then, he should put his bet on mutual funds as it will give him the benefit of diversification as well as MFs are handled by professionals.

LIMITATIONS OF THE STUDY

Analysis of only selected financial instruments is done in the paper however, in financial market other instruments are also available like derivatives, NSCs, etc. in fact, through financial engineering new instruments can also come in the market and accordingly the suggestions might get change. Also, the above suggestions are for retail investors only.

V. CONCLUSION

After analyzing the various instruments and the basis of investments it can be concluded that mutual funds are the best option available for investors if their horizon is for more than 2 years. For every kind and for every need of an investor, there is a specific kind of mutual fund which is available. Example, for the investments having a tenure of 2-3 years, the investors can invest in debt funds, for the tenure of 3 to 5 years they can invest in balanced funds and for long run they can go for equity funds. Apart from the varieties available to cater all sort of demands, other advantages of MFs include diversification, professionally managed funds, greater liquidity, etc. However, by going with the famous quote i.e. we should not put all the eggs in one basket, it is always advisable to not invest all the savings in one instrument. So, the investors can opt for other instruments as well as per his needs. At the same time the investor should keep 20% of its savings in the form of cash or cash equivalents also.

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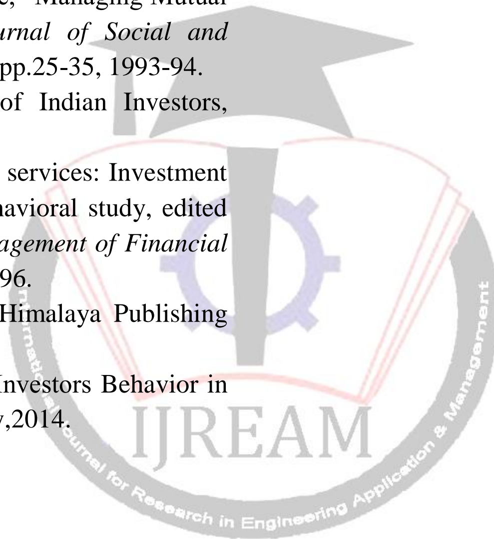

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