

A proposal of
**RISK AND RETURN ANALYSIS IN COMMON STOCK
INVESTMENT**
(With special reference to Investment Portfolio of the common stock of Commercial Bank)

Proposal Submitted by

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Chapter-1

Introduction

1.1 BACKGROUND OF THE STUDY

Development of any country is directly related with its economic development. The economic development of the country in turn depends upon the capital formation and industrialization; Industrialization can be achieved through proper use of the funds and their investment in the productive sector. Scattered funds around the country can be collected through the financial institutions. Investment can be made through the stock market or capital market. Stock market is such financial market, which facilitates the buying and selling of the stock conveniently to all those who are interested in carrying out the transaction. It is assumed that development of stock market marks the development of country's financial sector and it finally helps in the growth of the nation. Hence it is very essential to have very sound and active stock market also helps to regulate various sector as well as it helps general public by providing the necessary information and services under one roof thus making it easy for them. Securities markets exist in order to bring together buyer and seller of securities meaning they are mechanism create to facilitate the exchange of financial assets.

Return is the main aim of investment and a certain degree of risk of risk is associated with it. Finance mostly deals on the monetary risk and return, which is the most affecting subject matter for an individual to large corporation. In recent years the field of finance has truly undergone a revolution and its one of the leading sector, stock market, has become a global phenomenon. Even in the least developed country like Nepal stock

market is being one of the important part of the national economy . In capitalistic economy, justification for encouragement of the stock market is taken not on the ideological background but also on the development that stock market expansion is partly a natural progression the development of a country's financial sector as long – team economic growth proceeds .

“So far as the securities (stock) market is concerned , it is an important constituent of capital market . It has a wide term embracing the buyers and sellers securities and resale of corporate securities.” Stock market is a financial market , which probably has the greatest glamour , and is perhaps the least understood . Some observers consider it as a legalized heaven for gambling and many investors consider stock market investing as a game in which the sole purpose is picking winners.” Having said this , stock market investment can be both rewarding and fun so long as sufficient time is given to appreciate its many facet and characteristics

“The Nepalese capital market has been passing through the transaction phase over the past few after since independence. There are various inconsistencies and hindrance existed on the way to smooth way of functioning of market. Not only that institutional bottlenecks are hampering the growth of capital, but at times, the existing imperfect national characteristics phenomerion deeply noted in socioeconomic system has undermine the proper trading in securities market . The arbitrarily quoting of stock price without fundamental and technical justification made market not to look alter the protection of investors.

The concept of financial institution in Nepal was introduced when the first commercial bank . Nepal Bank Limited , was established in 1937 . It was established under special Banking Act 1936 having elementary function of commercial bank Later in 1955 , the first central bank , named as Nepal Rastra Bank was established with an objective of supervising , protecting

and directing the function of commercial banking activities . Another commercial bank fully owned by HMG/N, named as Rastriya Banijya Bank got established in 1966 . The establishment of joint venture banks gave a new horizon to the financial sector of the country . Since 1984 , J.V.banks were established in different times with company act and their shares were listed in Nepal Stock Exchange Limited (NEPSE) . The focus of the study is those commercial banks whose shares are listed in NEPSE .

“There nature of bank funds and its payment depends and investment of funds are of short –term nature .As long-term investments are associated with higher risk , banks are confined to make short –term investment only .R.W. Goldsmith suggests that significance of commercial banks is greater in countries , of comparatively lower level of economic development . The shares of commercial banks in the net issues of all financial institutions is much higher in such countries in the ones with higher stage of economic development .”

Banking sector is the most dynamic part of economy , which collect unused funds and mobilize it in needed areas . It is the heart of trade , commerce and industry . In Nepalese context , commercial banks have comparatively good performance among the public limited companies . Because most of the banks are counted within the top ten position among the listed companies on the basis of amount traded , number of transaction , market capitalization , etc. Most of the banks are established with collaboration of foreign well-known banks . As a public limited company , Nepal Bank Limited (NBL) is only one Nepalese Commercial Bank which is listed in NEPSE. Besides this oldest bank there are eight other joint venture banks which are listed in NEPSE . As a public limited company a new J.V. Bank , Bank of Sion’s securities are not listed in NEPSE yet . Besides these , a government bank , Rastriya Banijya Bank , also plays a vital role in banking sector. “In Nepal altogether there are 13 commercial banks and their 461 branches in mid April 1999 “

In Nepal foreign joint venture banks perform better than Nepalese ones do. Because they have higher management efficiency and they can manage risk properly . Specifically , Nepalese banks have a high degree of internal (firm specific) risk .At the same time they have to bear more social obligation and government intervention than foreign banks. However, Nepalese banks have high potentialities to increase their performance by changing their risk attitude and by improving their internal management.

Risk is related to future and future is uncertain . But risk is management rather than uncertain. Company-specific risk (earning variability) and company's ability to service its debt burden are intimately related to the particular characteristics of the business or businesses in which the company operates. Moreover, they are affected by economic conditions – apart management's ability to generate satisfactory operating performance .

There are different types of securities as treasury bills, long-term government bonds, long-term corporate bonds, common stocks etc. Among these securities this study concerns with common stocks,” Common stocks represents a corporation to pay periodically whatever its board of directors deems appropriate as a cash dividend.”

Common-stock holders of a company are its ultimate owners . Collectively they own the company and it is assumed that ultimate risk is associated with ownership . So the common stock is known as risky security . But what is risk ? “ Risk is like pornography . It's hard to define, but you know it when you see it .” Investors invest in common stock for higher return . But their expected return may or may not change in realities. This uncertainty is a major risk to investors in stock market investment .

The return is income received on an investment , which is expressed as dividend ,plus any change in market price of the share (MPS) and usually expressed in percent . Both dividend and market price of the share are

uncertain figures . So , the actual return on investment in common stock may differ substantially from the expected return . “The variability , the riskier the security is said to be .” The market price of the share of a company is driven both by fundamental business values and stock market sentiment . For a given business , it is always worth attempting to identify which of these is driving its share price .

Generally, investors are risk averse . They seek higher return for more risk as risk premium . So the primary problem in investment is to identify the security which has low risk and high return . Although , return can not be increased substantially , risk can be reduced by diversification of funds in different stocks marketing a portfolio . Well diversification can eliminate the unsystematic risk , Which is not explained by general market movement . Systematic risk , which is associated with change in return on the market as a whole , can not be avoided by the diversification .

A systematic investment process should be followed to win the stock market .” Investment process describes how an investor should go about making decisions with regard to what marketable to invest in , how extensive the investment should be , and when the investment should be made . A five-step procedure for making these decisions forms the basis of the investment process . “

1. Set investment policy
2. Perform security analysis
3. Construct a portfolio
4. Revise the portfolio
5. Evaluate the performance of the portfolio .

Setting investment policy involves determining the investor’s objectives and the amount of his or her invest able wealth . But , the focuses on securities analysis and portfolio selection . Securities analysis involves examining a number of individual securities (or group of securities) within the broad categories of financial assets . There are many approaches in

securities analysis. Portfolio construction involves identifying those specific assets in which to invest , as well as determining the proportion of the investor's wealth to put into each one. Diversification involves constructing the investor's portfolio in such a manner that risk is minimized Subject to certain restrictions . Another step of portfolio revision concerns the periodic repetition of the previous three steps . That is over time the investor may change his or her investment objectives , which ,in turn, means that currently held .

Portfolio may on longer be optimum . Portfolio performance evaluation involves determining periodically how the portfolio in terms of not only the return earned ,but also the risk experienced by the investor . Thus appropriate measures of return and risk as well as relevant standards (or "bench marks") are needed ."

In Nepalese context , the institutional set up of securities market began along with the "Securities Exchange Center " (now Nepal Stock Exchange Ltd) in 1976. In spite of considerable development there are still more potentialities to be explored for the development of stock market in Nepal . Most of the potential investors and the shareholders (public) themselves are unknown or least understood about risk-return behavior of stock ." Most of the Nepalese investors are finding to invest in single security ." Due to lack of information and poor knowledge , market intermediaries exploit investors . So, many investors afraid to invest in stocks . People participation in security investment and its dynamic trading plays a vital role in overall economic development . For this purpose potential investors must be able to analyze risk and return of individual stock and portfolio as well . This will increase their confidence and ultimately increase stock investment and increase the degree of market efficiency , which is essential to speeding economic development of the nation .

1.2 STATEMENT OF THE PROBLEM

Due to the lack of information and poor knowledge , individual investor is manipulated or exploited by the financial institutions or other market intermediaries to such an extent that investing in common stocks is intolerably hazardous . But investors are responsible to make rational investment decision rather than switching blame to others. For this purpose, knowledge is essential. Investors, attitude and perception also plays a vital role in rational decision . Previous research shows that “in Nepal most of the investors their fund in single security rather they can be benefited by investing in portfolio of securities through diversification of risk .” Not only general public but commerce or business administration cannot perfectly analyze the risk and return in stock market investment. There are no any separate institutions , which gives such valuable information that accelerate the stock investment and market efficiency .

Government policy is less encouraging in creating proper investment situations . Some plans and policies are not implemented . There are no strong commitment towards increasing public investment in policy makers and government . Investors are the main bases for any company , they are they are the source of revenue as a customer for the stockbrokers and financial intuitions , and ultimately they are the backbone of economic development of the nation . But any above body has no any effective program to develop investors knowledge .

People feel more risk in stock investment than its real risk . To built their confidence unbiased analysis and information about it is a must . Unavailability of a simple and clear way or technique to analyze risk and return of individual stock and portfolio is therefore being a major weakness to increase stock investment and stock market efficiency as well .

1.3 OBJECTIVE OF THE STUDY

The main objectives of the study are as follows :

1. One of the major objective of the study is to describe the risk, return and other relevant variable which are very important in making decision about stock investment. Study will also identify the unseen problem facing by the individual investors.
2. Another main objective is to analyze the risk and return of the common stocks and their portfolio in a simple way . Study will also analyze the volatility of different stocks and other relevant variables that should be considered while deciding investment in stocks .
3. Lastly the study aims to provide suggestive package, some practical ideas and materialize recommendations based on the analysis of the data .

1.4 NEED OR SIGNIFICANCE OF STUDY

As discussed above main target of the study is potential investor who wants to invest in security but repel by imaginary or unreal risk . So the study will be more significant for exploring and increasing stock investment . Study not only used as partial fulfillment of T.U. course of MBA , but it also will provide little contribution to Nepalese Stock Market development .

After the political change in 2046 BS, people participation in security investment and stock trading increased unexpectedly . But the attraction did not proceed long Because they had been entered in stock market without proper analysis but due to the exaggeration and rumors about it . Now , most of the participants repel from the stock market . This situation indicates that there is a high potentiality on stock investment . These potentialities can change into fruitful investment by increasing transparency increasing information flow and developing analytical power of public stock investors , which ultimately increase national economic health . Thus study will fulfill a little need in this aspect .

The study will also open many doors to further research in the area of investment and asset management for business .

1.5 HYPOTHESES

This study will test the following hypotheses : (The hypotheses tests are based on student's test)

Hypothesis 1

Null Hypothesis (H₀): There is no significant difference between the portfolio return of the common stocks of commercial and overall market portfolio return . In other words , average return on common stocks of commercial banks is equal to the market return .

Alternative Hypothesis (h): There is a significant difference between the portfolio return of the common stocks of commercial banks and overall market portfolio return . In other words average return on common stocks of commercial banks is not equal to the market return .

Hypothesis 11

Null Hypothesis (H₀) : There is no significant different between the portfolio beta of commercial banks and beta . In other words , portfolio beta of commercial banks is equal to 1 (i.e. market beta)

Alternative Hypothesis (H₁): There is a significant difference between the portfolio beta of commercial banks and market beta . In other words , portfolio beta of commercial banks is not equal to 1 .

1.6 LIMITATION OF THE STUDY ;

Major limitation of the study is the differential coverage of data . For analysis , data availability differs in various periods . Bank of kathmandu's data is available for two years 2054/56. NBB and EBL's data are available for 4 years .

Another limitation of the study is the variation data published from various sources . Fiture published by NEPSE and companies differ to some extent However , in this study NEPSE is taken as basis source of data .

The study is to fulfill the partial requirement of MBS course of Tribhuvan University, Nepal So, the study cannot cover all the dimensions of the subject matter and cannot penetrate the extreme depth also . A student as a researcher , the study is unbiased , but resource and time period is limited .

1.6 ORGANIZATION OF THE STUDY

This study has been organized in five chapters, each devoted to some aspects of analysis of risk & return on investment in J.V. banks. The titles of each of these chapters are summarized and the contents of each of these chapters of this study are briefly mentioned here.

Chapter – I: Introduction

Chapter – II: Review of Literature

Chapter – III: Research Methodology

Chapter – IV: Data Presentation and Analysis

Chapter – V: Summary, Conclusion and Recommendations

Chapter One: The introduction chapter includes introduction, background of the study, statement of problem, objective of the study, significance of the study, of the study, limitation of the study, a profile of GC and design of the study.

Chapter Two: It focuses on review of literature. It contains the conceptual framework and past research literature relevant to materials management and/or this study.

Chapter Three: The third chapter deal with research methodology to be adopted for study consisting introduction, research design, population

and sample, nature and sources of data, data collection procedures, research variables and tools and techniques employed.

Chapter Four: This chapter contains data presentation, analysis and interpretation by using financial and statistical tools and major findings of this study.

Chapter Five: It covers summary, conclusion and recommendation of this study.

The bibliography and appendices will be incorporated at the end of the study.

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