COURSE GUIDE

ENT728
BASIC FIANACIAL LITERACY

Course Team Dr. Sheu Abdullahi Araga (Course Writer)
Department of Financial Studies
Faculty of Management Sciences
National Open University of Nigeria

Dr Omojefe OKE GODFREY
Department of Banking and Finance (Co writer)
Faculty of Management Sciences
University of Port Harcourt, River

Dr Taiwo Abdulahi O
Dept of Cooperative Economics & Management (Co writer)
Faculty of Management Sciences
Nnamdi Azikwe University, Awka

Prof. Yusuf Babatunde (Course Editor)
Department of Accounting & Finance,
Lagos State University Ojo

Dr. Lawal Kamaldeen A. A (H.O.D)
Department of Entrepreneurial Studies
Faculty of Management Sciences
National Open University of Nigeria

Dr. Osoba B s (Dean)
Faculty of Management Sciences
National Open University of Nigeria

NATIONAL OPEN UNIVERSITY OF NIGERIA

National Open University of Nigeria
Headquarters
University Village
Plot 91 Cadastral Zone
Nnamdi Azikiwe Expressway
Jabi, Abuja.

Lagos Office
14/16 Ahmadu Bello Way
Victoria Island, Lagos

e-mail: centralinfo@noun.edu.ng
URL: www.noun.edu.ng

Published by:
National Open University of Nigeria

ISBN:

Printed: 2019

CONTENTS

INTRODUCTION

ENT728: Basic Financial Literacy is a semester course work of two credit units. It will be available to all Post graduate diploma students in the Department of Entrepreneurial Studies, Faculty of Management. The course consists of 4 modules involving the subject area of Basic Financial Literacy.

The course guide tells you what the course is all about and the relevant materials that you require to make your study very successful. Other vital information contained in this course guide deals with Assessment which consists of the Tutor- Market Assignments, and written examination.

The Course Contents

The course contents consist of basic financial literacy encompassing various areas that are very pertinent to the understanding of finance.

Course Aims

The aims of this course are to expose you to the knowledge of how to evaluate projects either as a project initiator or an evaluator. It aims to sharpen your skills in the evaluation of either new projects or existing projects with a view to deciding whether they meet certain predetermined investment criteria.

Course Objectives

At the end of this course you should be able to:

- discuss the intricacies of basic finance
- explain the basic elements of finance
- make use of knowledge of basic elements of finance.
- discuss the usefulness of basic financial literacy

The Course Materials

The main components of the course are:

1. The Course Guide
2. Study Units
3. References/Further Readings
4. Assignments

Study Units

There are 18 units in this course and they should be studied carefully

Module 1

Unit 1: Meaning, Nature And Types Of Investment
Unit 2: Venture Creation

Unit 3: Diversification As A Basis Of Investment Portfolio
Unit 4: Investing Wisely In Capital Market Using Hedging

Module 2

Unit 5: Investing Wisely In Capital Market Using Arbitrage
Unit 6: Investing Wisely In Capital Market Using Speculation
Unit 7: Investment In Derivatives
Unit 8: Investment Portfolio In Properties And Commodities

Module 3

Unit 9: Leveraging On Debts & Venture Capital In Creating Wealth
Unit 10: Intellectual Property And Royalties
Unit 11: Financial Market Instruments
Unit 12: Capital Gains And Continuous Cash Flows
Unit 13: Building Personal Cash Flows (Savings)

Module 4

Unit 14: Personal Financial Planning
Unit 15: Maintaining Savings Account For Cash Reserves
Unit 16: Planning For Contingency Fund
Unit 17: Insurance And Risk Hedging
Unit 18: Understanding Tax Issues

Module 1 provides you with the necessary background knowledge on investment. The remaining module 2 to 4 focus attention on the subject matter of basic elements of finance Each study unit will take at least two hours and it includes: introduction, objectives, main content, exercise, conclusion, summary, references and the Tutor-Marked Assignments (TMAs).
You are required to study the materials, reflect on them and do the exercises. You should also read the textbooks and other recommended materials in each study unit.

Assignments
In each unit, you will find some self assessment exercises which you are required to do. The self assessment exercises will enable you to have a better understanding of what you have studied.

Assessment:
As a student of the Open and Distance Learning (ODL) system, you are expected to access your learning ability by the extent of your understanding of the units and the entire course. This assessment prepares you for the final examination. The final examinations will come at the end of the course. You are expected to write this examination whose score together with what you made in the TMAs will form the course grade.

Tutor-Marked Assignment

In doing the Tutor-Marked Assignments, you are expected to apply what you have learnt in the contents of the study unit. The TMAs are expected to be computer base for grading. They constitute 30% of the total score.

Final Examination and Grading

At the end of the course, you will write the final examination. It will attract the remaining 70%. This makes the final score to be 100%.

Summary

The course ENT 728 – Basic Financial Literacy will expose you to the knowledge and understanding of how to evaluate projects. When you complete the course, you would have been armed with the necessary knowledge required to evaluate investment opportunities.

MAIN CONTENT

UNIT 1: MEANING, NATURE AND TYPES OF INVESTMENT

CONTENTS

1.0 INTRODUCTION

This initial study unit of the course material is used to discuss the nature and type of investment. Investment is very important for the fact that it can be used to generate additional income. However, some elements of risk are inherent in any form of investment but risks vary from one investment to another. Therefore, the choice of investment is informed by the degree of risk involved but this can be ameliorated with a combination of investments. In this unit, discussion is on the meaning and nature of investment and the characteristics of investment. In addition, the various types of investment are also discussed.

2.0 OBJECTIVES

After studying this unit, you should be able to:

- Explain the term investment
- Identify and discuss the characteristics of investment
- Mention and explain types of investment

3.0 MAIN CONTENT

3.1 MEANING AND NATURE OF INVESTMENT

The term investment is fraught with many definitions but such expositions recognize the fact that investment requirements financial commitments, which implies that funds will have to be expended by the person who is investing. In general terms, therefore, investment involves spending of money with the hope of reaping some financial benefits. According to economists, investment is regarded as savings embarked upon as a result of "delayed consumption."

Furthermore, investment is also recognized as the deployment of financial resources towards enhancing a person's income or increasing the level of earnings from investible products in the future. For instance, investment takes place when certain amount of money is deposited in an account in the bank. According to economists, equipment acquired by a firm for production with which to earn income from its operations in the long run is an investment.

In finance, an investment involves utilization of funds in acquisition of financial assets such as stocks, bonds, bullion, real properties, and precious items. This holds that "practice of investment" implies acquisition of a product of financial value with expectation of generating desired returns in the future. An investment in good financial investment is fraught with reasonable level of market liquidity. In order to assess the value of a financial investment, a mechanism known as valuation becomes relevant.

Beattie (2017) posits that the term investment refers to something that is acquired with money with the expectation to generate income or profit from it. The author identifies three basic groups of investments such as ownership investment, lending investment, and cash investment.

SELF ASSESSMENT EXERCISE 1

Explain the term Investment.

3.2 CHARACTERISTICS OF INVESTMENT

The nature of financial many investments can exhibit the following characteristics or features.

1. Earnings

The fundamental purpose of investment is to generate earnings. In other words, any form of investment is undertaken with the anticipation of making returns, which is the essence of any action in acquiring any financial product or sinking funds in investible commitment. In respect of financial products, the earnings can come in terms of some interest, capital gain over and above the principal amount invested and dividend from stock. The earning from investment can be expressed as follows:

Earnings = Prevailing Price of Stock less Original price

The capital gain as an instance of earnings is measured by the disparity between original price of the investible product and current market of the product. Basically, the earnings from financial products in investment is a function of many factors such as nature of the financial product, type of stock, the firm's line of business (petroleum, manufacturing or banking, etc.), state of the economy, and prevailing government policy, among others.

Hence, the essence of investment hinges on expected returns, which may be in form of capital gain or investment income that include dividends, interest, and rental income, among others. Investors normally desire higher level of returns but such returns are associated with riskier investments.

2. Risk of Loss

In most cases, safety of investment can only be guaranteed if is done in financial products such as government security and firms with high networth. Financial products like government loan stock, bonds, treasury bills and treasury certificates, which are normally floated by government are known as gilt-edge securities because of their safety. Financial products of high networth companies are regarded as blue chip securities of their yields and high likelihood of safety.

The stocks of banks are generally fraught with some risk of loss of the volatile nature of their operations. Therefore, such stocks command affordable prices. In comparison, the stocks of oil companies are of less risk of loss because of their stable nature of operations. However, such stocks particularly of oil majors command higher prices and higher yields or earnings.

When investing in debt instruments (such as debenture, bond, etc.) of a company in blue chip companies or government authority, the risk of loss of the investment is less as a result of their secured operations, besides the inherent fixed interest payable on them. However, investment in ownership stocks (as financial products) such as equity or preference shares, the risk inherent in them is more. This is as a result of their unsecured nature and variability of their return and agency problem inherent in the companies. Factors such interest rate, tax on capital gains and dividends, inflation also affect returns from such investment.

3. Safety of Investment

Security of investment is very important. Security of investment herein refers to the protection or safety of the amount invested and the expected earnings. Security issue is very germane to choice of investment. While investing, you have to consider the safety of your funds and the probability that the expected gains will be earned invariably. Capital gains, for instance, cannot materialize if the capital itself is lost due to mismanagement of the firm's affairs by the managers, fraud and fraudulent practices by staff, bad corporate governance, labour unrest, and pilferage of firm's assets, etc. External factors such as economic downturn, volatile exchange rate, inflationary pressure, high interest rate, and unstable economic policies by the government, among others, can also affect realization of funds or capital invested.

4. Liquidity of Investment

Liquidity means the ease with which an investment can be converted into cash. The level of liquidity of an investment depends on many factors. The investor can always desire to convert the investment into physical cash in meeting urgent commitments. The ability of the investor to do so depends on the level of liquidity of the financial asset being held. The financial assets that are very liquid are the marketable securities such as treasury bills and treasury certificates as well as other government securities and to some extent, the stocks and debentures of blue chip companies.

SELF ASSESSMENT EXERCISE 2

Mention and explain the characteristics of Investment.

3.3 TYPES OF INVESTMENT

Beattie (2017) identifies some forms of investment which include ownership investment, lending investment,

3.3.1 Ownership Investment

This type of investment revolves around committing your funds in: capital market securities such as stocks (buying shares in companies through initial public offer (IPO) or stock brokers as dealers in stock exchange, subscribing to loan stocks of government and corporate bodies; establishing your own business entity or going into partnership with others to form business entity; committing your funds in acquisition of landed property (ownership of a real estate); and precious metals and objects.

i) Stocks

These are shares purchased as part ownership in companies. Certificates are normally issued as proof of ownership of such capital market securities. These shares can be equity stocks for ordinary shareholders or preference shares for preferred treatment for dividends and claims from the business.

ii) Derivatives

A derivative refers to a financial product which has its value dependent on the outcome of the original financial product as investment by the managers of the funds. Derivative products can be used for: insuring against price movements such as in the case of hedging; guiding against exposure to price movements for speculation; and as a means of having leeway to some other hybrid assets or markets (Crawford, and Sen, 1996; Koehler, 2005).

These investible instruments which you can commit your funds into include: common derivatives such as options, swaps, futures, and forwards; and collateralized debt obligations; credit default swaps. All these derivatives are normally traded on a stock exchange or over the counter (Koehler, 2005).

iv) Business Ventures

The money that is used in starting and running a business is an investment. Entrepreneurship is one of the hardest investments to make because it requires more than just money. Consequently, it is also an ownership investment with extremely large potential returns. By creating a product or service and selling it to people who want it, entrepreneurs can make huge personal fortunes. Bill Gates, founder of Microsoft and one of the world's richest men, is a prime example.

v) Real Estate

This involves investment in buying or building houses, apartments and other landed property with the purpose of leasing them out. Such items of investment can be acquired, restructured and then resell them. The house that you own and make use of as your residence does not qualify as an investment because it is not built or purchased for business purpose; not for generating revenue and profit. However, they are susceptible to some elements of risk such as damage and destruction arising from natural disasters.

vi) Precious Metals and Objects

Some people cultivate the habit of engaging in collection and preserving precious metals (gold, diamond, etc) and objects (such as paintings by renown painters) with the intention of reselling them in the future. The intention is to earn profits from them as their value appreciates. Precious metals and collectibles are not necessarily a good investment for a number of reasons, but they can be classified as an investment nonetheless. However, these objects are also susceptible to some elements of risk such as damage and destruction arising from natural disasters. They is also risk of physical depreciation that requires restoration before their sale invariably. These risks affect their values, and therefore can affect their eventual profits intended in the investment.

3.3.2 Lending Investments

This involves subscribing and investing in debt instruments of corporate entities such as *bonds* and *debentures*. These debt investments attract periodic earnings from interest payment by the companies using the funds to run their operations. The principal amount invested in them is paid back to you after their maturity date. Investment in debt instruments (bonds and debentures) is known for relatively lower risk when compared to ownership investments stocks and their returns (interests) are fixed. Stockholders can incur loss by not getting their money back in the event of the firm being declared bankrupt. Nevertheless, bond and debenture holders usually get their invested money back in case of insolvency.

3.3.3 Marketable Security Investment

Marketable securities refer to money market financial instruments that are easily convertible to physical cash. There are varieties of these financial instruments in which you can subscribe or invest. Some are called funds being handled by investment companies while others are usually floated by the apex bank (central bank) on behalf of the government. The ones being floated by the apex bank include Treasury bills and Treasury certificates.

i) Treasury bill

According to Investopedia (2012), a Treasury bill (T-bill) refers to short term debt obligation that is taken by the government through the apex bank. T-bill normally has a maturity date of some months but less than one year. It is normally issued by the apex bank on behalf of the government to raise funds for meeting shortfalls in revenue with which to finance recurrent government expenditure. The T-bill is a money market financial instrument that is usually denominated in thousands of the country's currency meant to be purchased in multiples of such denomination. An example can be a denomination of N1,000 in Nigerian currency if issued by the Central Bank of Nigeria for the Nigerian government. Interest is paid on regular basis till the maturity date when the principal amount invested on it by the investors is repaid.

You can purchase new T-bills at auctions as conducted by the apex bank for the government or old ones previously issued and held by investors through the secondary market. The T-bills that are purchased at auctions are normally priced through a competitive bidding process, at a discount from the par value. When you redeem your own T-bills at maturity date, you will be paid the par value or face value; resulting in a difference between the purchase price and the par value, which is the gain.

ii) Treasury Securities

Treasury securities are obligations of the government. They are issued to cover government budget deficits (excess of expenditures over revenues) and to refinance maturing government debt. The most common are bills, notes, and bonds. Treasury bills have original maturities of I year or less, while notes are for 1 to 10 years, and bonds have maturities greater than 10 years.

iii) Government agency securities:

Securities issued by an agency of the federal government particularly in the U.S. with implicit backing of the federal government. Repurchase agreements are essentially collateralized loans. A financial institution with large holdings of Treasury securities sells some portion of them for a predetermined period of time to obtain liquidity and promises to repurchase the securities at the end of that period. On the other side of the transaction is an institution with excess liquidity. The amount of the transaction is relatively large, and the interest rate is below the federal funds rate. The lower rate is justified, because the transaction is collateralized by government securities.

SELF ASSESSMENT EXERCISE 3

Differentiate between ownership investment and lending investment.

4.0 CONCLUSION

This unit of the course material has provided you with the basic knowledge about investment. Investment essentially involves deployment of financial resources towards enhancing a person's income or increasing the level of earnings from investible products in the future. It also connotes acquiring asset(s) with money in the expectation of generating income or profit from them.

Inherent in investment are the elements of risk. Therefore, when investing, you have to assess the risk involved in a financial instrument compared to the expected returns before committing your funds. Generally, therefore, considerations in investment include: risk of loss of investment; expected earnings or return from investment; safety of the funds invested; and liquidity in terms of degree of availability of the funds whenever you need the money.

5.0 SUMMARY

In this initial study unit of the course material, you have been taught the following topics:

- Meaning and Nature of Investment
- Characteristics of Investment
- Ownership Investment
- Lending Investment
- Marketable Security Investment

In the next study unit, you will be taken through venture creation.

6.0 TUTOR MARKED ASSIGNMENT

1. What is investment?
2. List and explain the characteristics of investment.
3. Compare and contrast ownership investment and lending investment

Answers to Self –Assessment Exercises

1. Explain the term Investment

Investment refers to the deployment of financial resources towards enhancing a person's income or increasing the level of earnings from investible products in the future. In other words, investment refers to something that is acquired with money with the expectation to generate income or profit from it.

2. Mention and explain the characteristics of Investment

1**.** Earnings

The fundamental purpose of investment is to generate earnings or any form of investment is normally undertaken with the anticipation of making returns. This return is the essence of any action in acquiring any financial product or sinking funds in investible commitment. The earning from investment can be expressed as follow:

Earnings = Prevailing Price of Stock less Original price

2. Risk of Loss

In most cases, safety of investment can only be guaranteed if is done in financial products such as government security and firms with high networth. Financial products like government loan stock, bonds, treasury bills and treasury certificates, which are normally floated by government are known as gilt-edge securities because of their safety. Financial products of high networth companies are regarded as blue chip securities of their yields and high likelihood of safety.

When investing in debt instruments (such as debenture, bond, etc) of a company in blue chip companies or government authority, the risk of loss of the investment is less as a result of their secured operations, besides the inherent fixed interest payable on them. However, investment in ownership stocks (as financial products) such as equity or preference shares, the risk inherent in them is more.

3. Safety of Investment

Security of investment herein refers to the protection or safety of the amount of investment and the expected earnings. Security issue is very germane to choice of investment. While investing, you have to consider the safety of your funds and the probability that the expected gains will be earned invariably.

4. Liquidity of Investment

Liquidity means the ease with which an investment can be converted into cash. The level of liquidity of an investment depends on many factors. The investor can always desire to convert the investment into physical cash in meeting urgent commitments. The ability of the investor to do so depends on the level of liquidity of the financial asset being held. The financial assets that are very liquid are the marketable securities such as treasury bills and treasury certificates as well as other government securities and to some extent, the stocks and debentures of blue chip companies.

3. Differentiate between ownership investment and lending investment.

Ownership investment involves around committing your funds in: capital market securities such as stocks (buying shares in companies through initial public offer (IPO) or stock brokers as dealers in stock exchange, subscribing to loan stocks of government and corporate bodies; establishing your own business entity or going into partnership with others to form business entity; committing your funds in acquisition of landed property (ownership of a real estate); and precious metals and objects.

On the other hand, lending investment involves subscribing and investing in debt instruments of corporate entities such as *bonds* and *debentures*. These debt investments attract periodic earnings from interest payment by the companies using the funds to run their operations. The principal amount invested in them is paid back to you after their maturity date. These investment instruments are known for relatively lower risk when compared to ownership investments stocks and their returns (interests) are fixed. Stockholders can incur loss by not getting their money back in the event of the firm being declared bankrupt. Nevertheless, bond and debenture holders usually get their invested money back in case of insolvency.

7.0 REFERENCES AND FURTHER READINGS

Crawford, G. and Sen, B. (1996). Derivatives for Decision Makers: Strategic Management Issues, New Jersey: John Wiley & Sons

Investopedia (2012). What is a 'Treasury Bill? Accessed on 10 January, 2017 from http://www.investopedia.com/terms/t/treasurybill.asp#ixzz4dCGLXsAV

Koehler, C. (2005). The Relationship between the Complexity of Financial Derivatives and Systemic Risk, Working Paper: 10–11.

UNIT 2: VENTURE CREATION

CONTENTS

1.0 INTRODUCTION

The existence of almost all business entities is often as a result of the strategic role of the entrepreneurs. Therefore, the creation of such business undertakings owes it to the actions of the entrepreneurs. Hence entrepreneurs initiate required actions to create business ventures from their uncanny foresights in recognizing the potential requirement or desire for specific products (goods or services) in certain underserved markets. Venture creations result in the subsistence of almost all business entities, emerging from the uncommon attitudes towards assuming risks by some industrialists in every economy around the world. In this study unit of the course material, you are being taken through the discussion on creation of ventures in particular and the strategic role of entrepreneurs in such task generally.

2.0 OBJECTIVES

After studying this unit, you should be able to:

- Explain and explain the term venture creation
- Identify and discuss the stages involved in process of venture creation
- List and explain responsibilities of entrepreneurs in venture creation

3.0 MAIN CONTENT

3.1 MEANING OF VENTURE CREATION

The connotation of venture creation, as provided by the Cambridge Dictionary (2017), refers to the process of converting a new idea or technology into a business undertaking which can succeed and is invariably capable of attracting investors. This implies that potential entrepreneurs that are interested in identifying possible business ideas normally pay attention to everything in various media (print and electronic) which can be exploited to create business ventures.

Swier (2007) posits that venture creation refers to an action initiated for starting business venture with the intent of filling the gap between an initiative and a “capitalized business. Relatedly, most venture capitalists will only be interested in investing in a venture that portrays great fundamentals such as: competent management, profitable market, novel product, and reasonable quantum of sales revenue or turnover. To lay credence to this view, Gordon (2012) posits that venture creation process is an outcome of two interrelated stages of “discovery and exploitation.”

Furthermore, Swier (2007) observes that venture creation involves a process just like a manufacturing process because venture creation process ideas coupled with necessary productive inputs such as human efforts and technology into desired products for the consumers. Such venture becomes fundable venture once it can meet the current desires, needs, wants and aspirations of the target and potential markets.

Basically, as espoused by Swier (2007), the worth of a venture creation does not just involve creating ventures. More significantly, the establishing ventures should go through a process which decides whether or not the venture possesses a feasible and marketable product in available or emerging market. In addition, the venture should have a plan that is practically attainable based on available resources including the critical one, the capital.

The fundamental approach to venture creation (Bhave, 1994) involves generating business ideas through some stages which include: internally and externally stimulated opportunity recognition; commitment to physical creation; set-up of production technology; organization creation; product creation; connecting with potential markets, and generating customer feedback.

SELF ASSESSMENT EXERCISE 1
Explain the term venture creation.

3.2 Process of Venture Creation

There are various versions of the process of venture creation as formulated by many writers. Some of these versions are identified and discussed below.

3.2.1 Deakins Model of Venture Creation Process

The steps involved in venture creation based on the classification by Deakins and Freel (2009), the updated version of Deakins in 1999.

i) Idea Formulation

This involves developing business ideas which can be influenced by family and friends. This calls for creativity in terms of the entrepreneur's ability to link ideas to business that were not discovered previously (Deakins & Freel, 2009). Formulating business idea is very time-consuming which goes through refinement. The entrepreneur can find it necessary to discuss his business ideas with people like family, friends and experts. It is also necessary to research on them before arriving on a selected one.

ii) Opportunity Recognition

This is regarded as the key stage in the new venture process. It involves stumbling on business opportunity and capitalizing on it to form business entity. Opportunity recognition is influenced by factors such as role models, cultural attitudes to risk and failure, changing socio-economic and technical environments. For instance, a business opportunity can be discovered form a change in the environment like a political decision by the government. It is argued that the cultural environment of the entrepreneur should be appropriate towards encouraging him/her to take risks that are associated with new venture. In essence, such an environment is supposed to be facilitative to encourage entrepreneurship. Based on the evaluation of a business opportunity, the entrepreneur takes a decision on whether or not to go ahead in establishing the venture.

iii) Pre-start Planning and Development

This stage involves embarking on market research, scouting for finance, finding partners and social capital for the new venture. The market research and information gathering become critical for establishing the new venture. The other preparatory procedures include raising funds, dealing with legal matters, exploring for a management team, linking skills to responsibilities, planning the entry strategy, and detailing out the business plan.

iv) Establishment and Launch

This stage is embedded in "intellectual property rights process, timing and role of serendipity." The choice of the entry point on time, according to Deakins and Freel (2009), is critical for the venture's success when intellectual property rights issues are concerned. During this stage, there are important activities to be carried out. Such actions include: learning in dealing with "customers, suppliers, bank officials, marketing efforts, patenting procedures and gaining experience" generally.

v) Post-Entry Development

This stage requires that the entrepreneur engage in necessary networks and taking appropriate steps for ensuring that the new venture gains credibility. This is the most critical issue that the entrepreneur faces in establishing the new venture in terms of the rating of the venture by customers, suppliers, etc. The first timer as an entrepreneur can make mistakes in respect of administrative and operational decisions. Comparatively, the experienced entrepreneur being brought into the new venture at this stage can help the inexperienced entrepreneur to obliterate such teething problems. The experienced partner can help raise awareness and publicity as well as the much needed network. Marketing efforts in this stage should not be overlooked as it is critical to gain new customers and to keep the existing ones.

3.2.2 Hult Model of Venture Creation Process

The Hult Model involves an iterative process in which there are five phases as identified and explained below. However, as observed by Brettl, Kleinert and Karamatova (2010), regardless of the sequential approach of the model, it is feasible to go back in the process.

i) Idea Phase

The idea phase represents the beginning of the new venture creation. This does not imply that the business idea is not well developed yet but this stage provides the base towards the penchant of the entrepreneur to establish a new venture.

ii) Test and Persuasion Phase

During this stage, the potential entrepreneur will be interest in testing or discussing his/her business idea with the family, good friends and colleagues. It has been argued that empirical findings provide a favourably feedback from the entrepreneur's background helps to encourage the achievement of the business idea. Basically, this second stage can be appreciated as a learning phase whereby the entrepreneur acquires the elementary information in legal realm and accounting.

iii) Preparation Phase

This phase requires that the entrepreneur engages in juggling figures (calculations), preparing relevant budgets, analyzing the market situation and invariably assessing the production process. Professional consultants can be contacted by the entrepreneur towards solving some jigsaw puzzles that may arise in the working process.

iv) Start-up Phase

This phase in the creation of the new venture usually calls for a starting point, "a triggering event" that encourages the entrepreneur towards finally implementing his/her business idea. It represents a crucial event, which can turn out to be "positive or negative in nature." For example, exploring the leasing of business premises, machinery and equipment may pose a daunting task. The response of the owners can be positive or negative and the search continues until success smiles on the face of the entrepreneur.

v) Ongoing Business Phase

During this phase, the entrepreneur is expected to have contacts for resources such as capital funds, personnel, and other productive inputs like technology, raw materials, business premises, machinery and equipment. All these inputs will enable the entrepreneur to continue the implementation of his/her business idea. In the course of the new venture getting stabilised, the entrepreneur is still expected to devote much of his his/her moments and endeavor in steering the affairs of its operations. This becomes obvious so that success of the business can be guaranteed. All the necessary future moves such as entering into new markets by the entrepreneur in the business are expected to be in accordance with professional advice of the consultants.

3.2.3 Bhave Model of Venture Creation Process

The process of venture creation, according to Bhave (1994), involves stages such as opportunity recognition; commitment to physical creation; set-up of production technology; organization creation; product creation; connecting with potential markets, and generating customer feedback. These stages are discussed below.

i) Opportunity Recognition Stage,

Business concept creation incorporates the opportunity stage of the venture creation process. This is in essence involves converting a new idea or technology into a business undertaking, which is the foundation of the creation of any business venture by an entrepreneur. The recognition for business is normally internally and externally stimulated by the entrepreneur. He or she may already be working under an employer in which case the issue of stumbling on the venture idea arises in the course of work, which is called intrapreneurship. The idea of venture creation can even arise during industrial attachment, particularly for the graduates from Polytechnics and universities, during which they learn how to convert theoretical knowledge into practical products that are beneficial to mankind. For instance, engineering students have the opportunity of experiencing the workability of inverter in relation to conserving electricity in practical terms. And this experience can stimulate them to float companies for the production of inverters.

ii) Technology Set-Up Stage

This is embedded in the acquisition and setting up of production technology for the venture. This implies that the stage involves the purchase and establishment of the required (production) technology for the operations of the business undertaking. And it calls for the commitment towards physical creation of the required technological facility for the purpose of production of products (goods or services). All business undertakings in the modern time revolve around technology, which in itself is very dynamic. Since technology keeps on changing, an entrepreneur who wants to establish a new venture must embrace effective and efficient way of carrying out business operations with the latest cutting edge technology. In essence, new ventures must embrace latest technology for efficient production of goods and services, and particularly for timely (online real time) delivery of services to the customers in the target and potential markets.

iii) Organization Stage

This stage involves establishing the management structure of the venture with which to steer the affairs and ensure success and profitable operations of the business. The entrepreneur, more often than not, assumes the leadership position while bringing in some supportive personnel for the operations. The initial organizational structure is the simple line organization while it assumes larger dimension, such as functional structure, over time in the growth process of the venture.

Swier (2007) succinctly observes that the most significant characteristic of a venture creation is the management. The personnel that stir the daily affairs of the venture must sound pedigrees in terms skills (highly qualified) and uncanny commitment as well as entrepreneurial attitude for the business undertaking to succeed. The basic thing is based on finding very valuable human resources and giving them appropriate orientation regarding their strategic roles in the operations of the venture.

iv) Product Creation Stage

The novel idea inherent in venture creation has this as its core variable because this serves as the base for the operationalisation of the whole essence of the creation. The product to be produced from the venture emanates from the need to serve the gap identified in the existing production and marketing scenario. The gap as identified in the opportunity stage leads to novel idea regarding the type of product to produce and offer to the potential consumers or customers. The creation can be an enhancement in the existing product or a totally new product to satisfy the need and want of the target market.

v) Exchange Stage

This stage involves connecting with potential markets for the products of the venture. At this stage, information already generated from market research becomes very valuable. Marketing, in fundamental terms, involves getting the right products (goods and services) to the right market at the right time at the right price. This implies that after the production of the products from the new venture, the entrepreneur has to determine and fix appropriate price and push them out to the target markets through appropriate channels of distribution. Furthermore, the entrepreneur then takes decisions to deliver the products at appropriate time to the target market. The entrepreneur does not restrict the distribution of the products to only the target market, but he/she takes decision to reach other (potential) markets for the products to ensure marketing stability, expansion, and competitive leverage over competitors in the industry.

vi) Customer Feedback Stage

This stage involves generating information from the customers or users of your product (goods or services) regarding the performance; whether they are meeting their expectation or desires which motivate them to patronize such products.

In most cases, entrepreneurs do introduce distinct elements of novelty at each stage of the process of venture creation particularly in the areas of technological setup, product creation, exchange or connecting with the customers, and dealing with the ideas on improvement from the dealers and customers. Basically, the variations in the product concepts, technological utilization, commercialization of products from the venture, and recognition being accorded to the dealers and customers serve to differentiate one entrepreneurial undertaking from another.

SELF ASSESSMENT EXERCISE 2

Identify and discuss the stages involved in venture creation process according to Bhave (1994).

3.3 Role of Entrepreneur in Venture Creation

The entrepreneur constitutes the driving force for the recognition of a venture idea. Hence he/she assumes an important responsibility in the venture creation process (Brettl, Kleinert and Karamatova, 2010). An entrepreneur, as an industrialist, is regarded as a change agent in terms of acting to assume the risk inherent in the formation of a business venture. In order to create venture by an entrepreneur, he/she must possess uncanny forethought towards recognizing the potential requirement or desire for specific products (goods or services). Basically, creating a venture takes an unremitting progression which requires dogged commitment by the entrepreneur in creating the venture and introducing its products to the target markets effectively and efficiently.

The strategic role of the entrepreneur in creating a new venture revolves around the following responsibilities.

i) Idea Generation

It is the responsibility of an entrepreneur to begin with the inventing business ideas. This implies that the entrepreneur has onerous task of identifying and evaluating the business opportunities. Since this task is a difficult one, an entrepreneur is expected to search for inputs from all individuals around him/her such as friends, relatives, co-workers, members of the public, business or marketing consultants (if fund is available for it), and the media. The twin element of idea generation is the assessment of such ideas by the entrepreneur to arrive at the most advantageous, feasible and profitable venture prospect.

Fundamental issues inherent in assessment of business ideas include questions such as is the opportunity: worthwhile for investment; satisfactorily advantageous; practically profitable; competitively feasible; fraught with daunting risks; and above all, does the creator possess required personal skills and acumen to initiate and bring the venture into fruition.

ii) Developing a Business Plan:

Another important responsibility of the entrepreneur in venture creation involves the packaging a detailed business plan for the venture. The business plan becomes very significant to the accomplishment of the objectives of any new venture. This is in view of the fact that the business plan serves as the point of reference with which to assess whether the business venture is progressing or not as far as the predetermined goals and objectives are concerned. Some level of commitment is required of the entrepreneur in coming up with the business plan which can measure up to known standards and invariably stand the test of time.

iii) Generating Required Financial and Material Resources

A crucial responsibility of the entrepreneur in venture creation involves generating the needed financial and material resources for the new venture. More often than not, the initial capital of the business which is regarded as seed money is expected to be provided by the entrepreneur. The venture has to be at the stage of startup before the move to raise capital to cope with its operational requirements. The initial or seed money, as opined by Swier (2007), is normally required for market research, product development, and building management infrastructure. The entrepreneur is also expected to search for the needed human (personnel), technological and other material resources for the operations of the new venture.

iv) Establishing Management for the Venture

Another crucial responsibility of the entrepreneur in venture creation involves the management of the new venture. The entrepreneur has to employ capable hands with required qualifications, skills, and mental attitudes for the operations of the new venture. Once the required personnel are in place, the entrepreneur takes decisions on the organizational structure that best fits the nature of operations of the new venture

v) Developing Strategic Plans for the Future

This crucial responsibility of the entrepreneur in venture creation involves engaging in strategic planning for the future position of the new venture. The entrepreneur has the onerous task of taking decisions on the future potentials of the business which enables him to project the future growth and development. Herein, the entrepreneur becomes proactive in terms of planning for the stability, expansion, and funding of the future growth and development; whether through the use of venture capital, initial public offer or private placement of its shares to prospective investors.

SELF ASSESSMENT EXERCISE 3
List and explain responsibilities of entrepreneurs in venture creation.

4.0 CONCLUSION

This unit of the course material has provided you with the basic knowledge about the creation of ventures which arises from the actions of entrepreneurs. This implies that entrepreneurs constitute the architects in the creation of business undertakings because they initiate required actions to create ventures from the preserved need to fill gaps resulting from underserved markets. To create any venture, there is a specific process to follow with stages such as: opportunity recognition; commitment to physical creation; set-up of production technology; organization creation; product creation; connecting with potential markets, and generating customer feedback. In order to ensure the success of the new venture, entrepreneurs assume certain responsibilities like: generating venture idea, **d**eveloping a business plan; generating required financial and material resources; establishing management for the venture; and developing strategic plans for the future.

5.0 SUMMARY

In this initial study unit of the course material, you have been taught the following topics:

- Meaning of venture creation;

- Process of Venture Creation; and
- Role of Entrepreneur in Venture Creation.

In the next study unit, you will be taken through diversification as a basis of investment portfolio.

6.0 TUTOR MARKED ASSIGNMENT
1. Explain the term venture creation
2. Compare and contrast the stages of venture creation in Deakins Model and Bhave Model.
3. Mention reasons why entrepreneur's role is still very relevant after the creation of a venture.

Answers to Self-Assessment Questions

1. Explain the term venture creation.
Venture creation refers to an action initiated for starting business venture with the intent of filling the gap between an initiative and a "capitalized business. Furthermore, venture creation involves a process just like a manufacturing process because venture creation process ideas coupled with necessary productive inputs such as human efforts and technology into desired products for the consumers. Such venture becomes fundable venture once it can meet the current desires, needs, wants and aspirations of the target and potential markets.

The worth of a venture creation does not just involve creating ventures but establishing ventures should go through a process that decides whether or not the venture possesses a feasible and marketable product in available or emerging market. In addition, the venture should have a plan that is practically attainable based on available resources including the critical one, the capital.

2. Identify and discuss the stages involved in venture creation process according to Bhave (1994).

The relevant stages in the process of venture creation as identified by Bhave (1994) are discussed as follows:

i) Opportunity Recognition Stage,

Business concept creation incorporates the opportunity stage of the venture creation process. This is in essence involves converting a new idea or technology into a business undertaking, which is the foundation of the creation of any business venture by an entrepreneur. The recognition for business is normally internally and externally stimulated by the entrepreneur.

ii) Technology Set-Up Stage

This stage involves the purchase and establishment of the required (production) technology for the operations of the business undertaking. And it calls for the commitment towards physical creation of the required technological facility for the purpose of production of products (goods or services). All business undertakings in the modern time revolve around technology, which in itself is very dynamic. Since technology keeps on changing, an entrepreneur who wants to establish a new venture must embrace effective and efficient way of carrying out business operations with the latest cutting edge technology.

iii) Organization Stage

This stage involves establishing the management structure of the venture with which to steer the affairs and ensure success and profitable operations of the business. The entrepreneur, more often than not, assumes the leadership position while bringing in some supportive personnel for the operations. The initial organizational structure is the simple line organization while it assumes larger dimension, such as functional structure, over time in the growth process of the venture.

iv) Product Creation Stage

The novel idea inherent in venture creation has this as its core variable because this serves as the base for the operationalisation of the whole essence of the creation. The product to be produced from the venture emanates from the need to serve the gap identified in the existing production and marketing scenario. The gap as identified in the opportunity stage leads to novel idea regarding the type of product to produce and offer to the potential consumers or customers. The creation can be an enhancement in the existing product or a totally new product to satisfy the need and want of the target market.

v) Exchange Stage

This stage involves connecting with target and potential markets for the products of the venture. At this stage, information already generated from market research becomes very valuable. The entrepreneur takes decisions, after the production of the products from the new venture, to fix appropriate price, select appropriate channels for distribution, and ensuring timely availability of the products in the target and potential markets.

vi) Customer Feedback Stage

This stage involves generating information from the customers or users of your product (goods or services) regarding the performance; whether they are meeting their expectation or desires which motivate them to patronize such products.

3. Role of Entrepreneur in Venture Creation

The strategic role of the entrepreneur in creating a new venture revolves around the following responsibilities.

i) Idea Generation
It is the responsibility of an entrepreneur to begin with the inventing business ideas. This implies that the entrepreneur has onerous task of identifying and evaluating the business opportunities. Since this task is a difficult one, an entrepreneur is expected to search for inputs from all

individuals around him/her such as friends, relatives, co-workers, members of the public, business or marketing consultants (if fund is available for it), and the media. The twin element of idea generation is the assessment of such ideas by the entrepreneur to arrive at the most advantageous, feasible and profitable venture prospect.

ii) Developing a Business Plan:

Another important responsibility of the entrepreneur in venture creation involves the packaging a detailed business plan for the venture. The business plan becomes very significant to the accomplishment of the objectives of any new venture. This is in view of the fact that the business plan serves as the point of reference with which to assess whether the business venture is progressing or not as far as the predetermined goals and objectives are concerned.

iii) Generating Required Financial and Material Resources

A crucial responsibility of the entrepreneur in venture creation involves generating the needed financial and material resources for the new venture. More often than not, the initial capital of the business which is regarded as seed money is expected to be provided by the entrepreneur. The venture has to be at the stage of startup before the move to raise capital to cope with its operational requirements. The initial (seed) money is normally required for market research, product development, and building management infrastructure. The entrepreneur is also expected to search for the needed human (personnel), technological and other material resources for the operations of the new venture.

iv) Establishing Management for the Venture

Another crucial responsibility of the entrepreneur in venture creation involves the management of the new venture. The entrepreneur has to employ capable hands with required qualifications, skills, and mental attitudes for the operations of the new venture. Once the required personnel are in place, the entrepreneur takes decisions on the organizational structure that best fits the nature of operations of the new venture

v) Developing Strategic Plans for the Future

This crucial responsibility of the entrepreneur in venture creation involves engaging in strategic planning for the future position of the new venture. The entrepreneur has the onerous task of taking decisions on the future potentials of the business which enables him to project the future growth and development. Herein, the entrepreneur becomes proactive in terms of planning for the stability, expansion, and funding of the future growth and development; whether through the use of venture capital, initial public offer or private placement of its shares to prospective investors.

7.0 REFERENCES/FURTHER READINGS

Bhave, M. P. (1994). A process model of entrepreneurial venture creation, *Journal of Business Venturing*, 9(3): 223-242.

Brettl, E., Kleinert, V. and Karamatova, L. (2010). The New Venture Creation Process in Cooperation with Science Park Jönköping, Bechelor Thesis in Business Administration, submitted to JÖn Köp Ing Int E Rn At Io Nal Bus Ine S S S Ch Oo L, Jönköping University. Accessed on from 19 March, 2017 from http://www.diva-portal.org/smash/get/diva2:322911/FULLTEXT01

Cambridge Business English Dictionary (2017). Cambridge: Cambridge University Press. Accessed on 19 March, 2017 from http://dictionary.cambridge.org/ dictionary/english/ venture-creation.

Corno, F., Lal, R. and Colombo, S. (2014). Entrepreneurship & New Venture Creation Key Elements of the Entrepreneurial Ecosystem Facilitating the Growth of ICT Entrepreneurs in Italy, *European Scientific Journal*, *Special edition*, 2: 330-345.

Deakins, D., & Freel, M.S. (2009). *Entrepreneurship and small firms* (5th ed.). London: McGraw-Hill.

Gordon, S. R. (2012). Dimensions of the Venture Creation Process: Amount, Dynamics and Sequences of Action in Nascent Entrepreneurship. PhD Thesis submitted to Australian Centre for Entrepreneurship Research, School of Management, QUT Business School, Queensland University of Technology, Australian. Accessed on 19 March, 2017 from http://eprints.qut.edu.au/58078/1/Scott_Gordon_Thesis.pdf

Hult, M., Jerreling, A., & Lindblom, G. (1991). *Öka nyföretagandet: teorier, modeller, vägledning.* Växjö: Högskolan.

Swier, R. (2007). Startup Florida, What is Venture Creation? Accessed on 19 March, 2017 from http://startupflorida.blogspot.com.ng/2007/06/what-is-venture-creation.html.

UNIT 3: DIVERSIFICATION AS A BASIS OF INVESTMENT PORTFOLIO

CONTENTS

1.0 INTRODUCTION

This study unit of the course material is used to expose you to the important issue of investment in the capital market. Since your money should stay with generating additional income, you have to invest it on securities being offered in the capital market. Value investment is also discussed in this study because you cannot just hold stocks without monitoring the pulse of the capital market to take advantage of price fluctuations. Furthermore, the study unit is also used to discuss the use of diversification towards ensuring wise investment of your money in the capital market, and the ways to avoid inappropriate diversification.

2.0 OBJECTIVES

After studying this unit, you should be able to:

- Define investment
- Explain value investment
- Discuss diversification in capital market investment
- Mention and explain advantages and disadvantages of diversification

- List and explain ways to avoid inappropriate diversification

3.0 MAIN CONTENT

3.1 Meaning of Investment

In general terms, investment in finance implies having to commit your money or to allocate your fund money in investible securities, financial instruments or all forms of business ventures (e.g., acquiring rental assets, estate undertaking, etc.) with the expectation of reaping some benefits in the future.

In finance, the major benefit from investment is the return on the fund invested. The return may consist of capital gain and/or investment income that include other financial benefits such as dividends, interest, and rental income, among others. The projected economic return is the appropriately discounted value of the future returns. This is because the future financial benefits are subject to the time value of money causing fluctuation in such value. The historic return comprises the actual capital gain and/or income over a period of time.

Investment generally results in acquiring assets such as financial assets, productive assets, and estate assts. In the case of financial assets, if they are available at prices worth investing, it is normally expected either to generate income or to appreciate in value because they can be sold at higher prices before, their maturity dates.

Generally, you invest with the intention of generating higher returns. Such undertakings are normally associated with riskier investments. Financial assets therefore, range from low-risk, low-return investments, such as government securities (e.g., loan stick and bond) to those with higher risk and higher expected commensurate reward, such as emerging markets stock investments.

Basically, investors are normally or often advised to adopt an investment strategy and diversify their portfolio, combination of investment assets in both the capital market and money market because diversification has the statistical effect of reducing overall risk in investment.

SELF ASSESSMENT EXERCISE 1
Explain the term Investment.

3.2 Value Investment

A value investor buys undervalued securities while he sells overvalued ones out of his investment portfolio in the capital market. In order to identify undervalued securities, a value investor uses analysis of the financial reports of the issuer to evaluate the security. Basically, value investors employ accounting ratios such as earnings per share and sales growth, to identify securities trading at prices below their worth.

The price to earnings ratio, or earnings multiple, is a particularly significant and recognized fundamental ratio, with a function of dividing the share price of stock, by its earnings per share. This will provide the value representing the sum investors are prepared to expend for each dollar of company earnings. This ratio is an important aspect, due to its capacity as measurement for the comparison of valuations of various companies. A stock with a lower price to earnings ratio will cost less per share, than one with a higher price to earnings ratio, taking into account the same level of financial performance; therefore, it essentially means a low price to earnings ratio is the preferred option.

An instance, in which the price to earnings ratio has a lesser significance, is when companies in different industries are compared. An example; although, it is reasonable for a telecommunications stock to show a price to earnings ratio in the low teens; in the case of hi-tech stock, a price to earnings ratio in the 40s range, is not unusual. When making comparisons the price to earnings ratio can give you a refined view of a particular stock valuation.

For investors paying for each dollar of a company's earnings, the P/E ratio is a significant indicator, but the price-to-book ratio (P/B) is also a reliable indication of how much investors are willing to spend on each dollar of company assets. In the process of the P/B ratio, the share price of a stock is divided by its net assets; any intangibles, such as goodwill, are not taken into account. It is a crucial factor of the price-to-book ratio, due to it indicating the actual payment for tangible assets and not the more difficult valuation, of intangibles. Accordingly, the P/B could be considered a comparatively, conservative metric.

A popular valuation metric is earnings before interest, tax, depreciation and amortization (EBITDA), with application for example to valuing unlisted companies and mergers and acquisition.

For an attractive investment, for example a company competing in a high growth industry, an investor might expect a significant acquisition premium above book value or current market value, which values the company at several times the most recent EBITDA. A private equity fund for example may buy a target company for a multiple of its historical or forecasted EBITDA, perhaps as much as 6 or 8 times.

In certain cases, an EBITDA may be sacrificed by a company, in order for the pursuance of future growth; a strategy frequently used by corporate giants. This is a business decision that can impact negatively on buyout offers, founded on EBITDA and can be the cause of many negotiations, failing. It may be recognized as a valuation breach, with many investors maintaining that sellers are too demanding, while buyers are regarded as failing to realize the long-term potential of, expenditure or acquisitions.

SELF ASSESSMENT EXERCISE 2

Explain the term Value Investment.

3.3 Diversification of Investment as a Basis for Portfolio

3.3.1 Meaning of Diversification

Investment diversification is regarded as one of the basic building blocks of a solid portfolio. Diversification is associated with the cliché that you should "not put all your eggs in one basket." This is the basic principle that informs a key element of portfolio diversification.

In basic terms, diversification is a technique that reduces risk by allocating investments among various financial instruments, industries and other categories. It aims to maximize return by investing in different areas that would each react differently to the same event.

Most investment professionals posit that, although it does not guarantee against loss, diversification is the most important component of reaching long-range financial goals while minimizing risk.

There are mainly two types of risk that are associated with investment in the capital market. These are systemic risk and unsystematic risk. *Systematic* or the *market risk* is associated with the firm's operations; causes of systematic risk include inflation rates, exchange rates, political instability, war and interest rates. This type of risk is not specific to a particular company or industry, and it cannot be eliminated or reduced through diversification. This type of risk is undiversifiable, which implies that investors must accept it. The *unsystematic risk* is specific to a company, industry, market, economy or country; it can be reduced through diversification. The most common sources of unsystematic risk are business risk and financial risk. These forms of risk are susceptible to diversification such as carrying a portfolio of stocks to obliterate unnecessary losses, and as such they diversifiable. Thus, the aim of diversification is to invest in various assets so that they will not all be affected the same way by market events.

SELF ASSESSMENT EXERCISE 3
Explain the term Diversification.

3.3.2 Using Diversification in Investment

A basic diversified portfolio might include several investment categories such as stocks, bond and cash. Your allocation to each of these broad categories should be based upon your investment goals, your tolerance for risk, and your time horizon for needing the use of the money. In short your asset allocation should be an outgrowth of your financial plan. Investment diversification involves a portfolio strategy that calls for combining a variety of assets to reduce the overall risk of an investment portfolio.

Reason for diversification of investment is not far-fetched. Assuming you have a portfolio (combination) of only Bank A stocks. If it is brought to the public knowledge that the bank's workers are going on an indefinite strike, and that all operations and branches of the bank will not be allowed by the union to function. The implication is that share prices of the bank stocks will drop. Your portfolio will experience a noticeable drop in value.

However, if you counterbalanced the banking industry stocks with a couple of oil company stocks, only part of your portfolio (that of Bank A) would be affected. In fact, there is the likelihood that the oil company stock prices would climb, as government announces rise in price of petrol corresponding to rise in the price of crude oil in the world market.

Nevertheless, you could diversify even further because there are many risks that affect both bank and oil. An event that reduces any form of operations in the banking industry hurts Bank A and by extension its stock price. Therefore, to achieve superior diversification, you would want to diversify across many industries; not only different types of companies but also different types of industries. The more uncorrelated your stocks are, the better.

Furthermore, it is also important that you diversify among different classes of securities. Different financial assets such as bonds and stocks will not react in the same way to adverse events. A combination of asset classes will reduce your portfolio's sensitivity to market volatility. Generally, the bond and equity markets move in opposite directions. Therefore, if your portfolio is diversified across both areas, unpleasant movements in one will be offset by positive results in another.

Furthermore, there exists additional types of diversification, and many synthetic investment products have been created to accommodate investors' risk tolerance levels. However, these products can be very complicated and are not meant to be created by beginner or small investors. For those who have less investment experience, and do not have the financial backing to enter into hedging activities, bonds are the most popular way to diversify against the stock market.

Nevertheless, even the best analysis of a company and its financial statements cannot guarantee that it could not adverse results from operations, and thereby investment in the firm lost. Hence diversification cannot obliterate a loss, but it can reduce the impact of fraud and bad information on your portfolio.

Basically, owning five stocks (diversification) is better than owning one, but there comes a point when adding more stocks to your portfolio ceases to make a difference. Debate arises over how many stocks are needed to reduce risk while maintaining a high return. The most conventional view argues that an investor can achieve optimal diversification with only 15 to 20 stocks spread across various industries.

In the final analysis, diversification can help you manage risk and reduce the volatility of a financial asset's price movements. However, you have to understand the fact that no matter how diversified your portfolio is, risk can never be eliminated completely in capital market investment.

Fundamentally, you can reduce risk associated with individual stocks, but general market risks affect nearly every stock; so it is also important to diversify among different asset classes. The important point is that you have to find a medium between risk and return. This ensures that you achieve your financial goals while still getting a good rest of mind.

3.3.3 Advantages and Disadvantages of Diversification

3.3.3.1 Advantages of Diversification

The advantages of investment diversification include the following.

i) Risk Management

One advantage of diversification is risk management. Risk management is one of the essentials to successful investing. If you lose in some stocks, such can be counterbalanced with gains from other securities or for you to get back to breakeven. Diversification through asset allocation may be the most important investment strategy an investor can master. Basically, therefore, the benefit of diversification involves lowered overall portfolio risk without lowering portfolio returns.

ii) Portfolio Optimization

Portfolio optimization is achieved by placing a larger percentage of high return investments in a diversified portfolio. This is due to the fact that proper diversification lowers the overall risk of a portfolio. You can place more aggressive assets in the portfolio. This implies that an investor who is willing to take a given amount of risk can invest more aggressively with a properly diversified portfolio as opposed to a non-diversified portfolio.

Since investment diversification involves the strategy of combining financial assets in such a way as to reduce the overall risk of a portfolio, it implies that to achieve investment diversification assets are allocated in such a way as to spread them in a variety of stocks industries.

3.3.3.2 Disadvantages of Diversification

i) Diversification Double Dip

This is one fallacy of diversification. Diversification is the sort of thing that suffers from what is called “double dip” because too much of a good thing can turn sour. In fact, empirical evidence portrays that most of the benefit of increased diversification, as measured by the standard deviation of returns, goes away once a portfolio has between 20 and 30 securities in it.

ii) Diversification’s Downside Danger

This is the second fallacy of diversification. Many investment brokers like to sell the notion of diversification as buying and holding two or more assets whose values don’t rise or fall together. They want investors to imagine it is practicable or possible. The danger is that if there is recession in the economy, almost all the stocks of quoted companies would lose their values. This happens between 1929 and 1932 during the Great Depression in the United States of America due to excessive speculation in the capital market.

SELF ASSESSMENT EXERCISE 4

Mention and explain advantages and disadvantages of diversification.

3.4 Ways to Avoid Inappropriate Diversification

i) Too many investments

It is very advisable that you keep your stock holdings down to a manageable number of investments; a number as few as 20 and not more than 30, in reasonable amount of funds without investing too much in a few stocks. In addition, the holdings should be diverse in the wisdom that the value of these funds or securities should not be tightly coupled with one another. Buying stock in 20 different commercial banks will not diversify your portfolio but acquiring 20 stocks in different sectors and industries will ensure appropriate diversification. Hence having fewer investments in terms of stock investment implies that you will have an easier time making sense of it all.

ii) Buying foreign funds and stocks.

Many foreign-stock investment vehicles have historically performed poorly. If you own stocks in large multinational corporations, you are already getting enormous exposure to overseas economies. Empirical evidence abound to show that investment in such corporations could go awry because of their expose to weakness in the economies of countries apart from their home countries; home country being advance economy while the other countries are mainly developing economies struggling to survive. Managements of such corporations are paying much closer attention and getting far better insights into their overseas business interest than the action you can take to monitor their performance, which may be difficult for to understand. More so, the attention of their management even goes beyond what any foreign-stock mutual fund manager ever could.

iii) Diversifying based on market capitalization

Small rise in market capitalization and large fall in market capitalization should be capitalized for investment diversification. It is advisable to find strong corporate entities such as blue chip companies and invest in them regardless of what the total market capitalization is showing.

iv) Buying illiquid and high-fee investments.

Hedge funds and mutual funds are two favourites of the investment traders who tout diversification. The former are sold as “go-go high-octane vehicles” and the latter as “super-safe dividend” plays with zero volatility. On average, both perform poorly over time.

4.5 Conclusion

Investment in finance implies having to commit your money or to allocate your fund money in investible securities, financial instruments or all forms of business ventures. In value investing, you offload securities with higher prices and buy stocks with lower prices. Diversification involves having a combination of many classes of investment particularly in capital market securities. A basic diversified portfolio might include several investment categories such as stocks, bond and loan stock, among others. In finance, diversification refers to the process of allocating investment funds in such a way that reduces the exposure to any one particular asset or risk. A common path towards diversification is to reduce risk or volatility by investing in a variety of assets. Diversification is one of two general techniques for reducing investment risk.

5.0 SUMMARY

In this study unit of the course material, you have been taught the following topics:

- Meaning of Investment;
- Value Investment;
- Meaning of Diversification;
- Using Diversification in Investment;
- Advantages of Diversification;
- Disadvantages of Diversification; and
- Ways to Avoid Inappropriate Diversification

In the next study unit, you will be taken through investing wisely in capital market using hedging.

6.0 TUTOR MARKED ASSIGNMENT

1. Explain the term Investment.
2. Discuss the process of value investment.
3. Explain the term Diversification.
4. Mention and explain advantages and disadvantages of diversification.

Answers to Self-Assessment Exercises

1. Explain the term Investment.

Investment involves allocating your fund or money in investible securities, financial instruments or all forms of business ventures (e.g., acquiring rental assets, estate undertaking, etc.) with the expectation of reaping some benefits in the future. In finance, the major benefit from investment is the return on fund invested. The return may consist of capital gain and/or investment income that include other financial benefits such as dividends, interest, and rental income, among others.

2. Explain the term Value Investment.

Value investment involves buying undervalued securities while selling overvalued ones out of the investment portfolio in the capital market. In order to identify undervalued securities, a value investor uses analysis of the financial reports of the issuer to evaluate the security. Basically, value investors employ accounting ratios such as earnings per share and sales growth, to identify securities trading at prices below their worth.

3. Explain the term Diversification.

Diversification is a technique that reduces risk by allocating investments among various financial instruments, industries and other categories. It aims to maximize return by investing in different areas that would each react differently to the same event.

Most investment professionals posit that, although it does not guarantee against loss, diversification is the most important component of reaching long-range financial goals while minimizing risk.

There is systemic risk or the market risk as associated with the firm's operations caused by inflation rates, exchange rates, political instability, war and interest rates. This type of risk is not specific to a particular company or industry, and it cannot be eliminated or reduced through diversification, that is, undiversifiable.

There is unsystematic risk that is specific to a company, industry, market, economy or country, and it can be reduced through diversification. Sources of this risk include business risk and financial risk, and they diversifiable. Thus, the aim of diversification is to invest in various assets so that they will not all be affected the same way by market events.

4. Mention and explain advantages and disadvantages of diversification.
Advantages of investment diversification include the following.

i) Risk Management

One advantage of diversification is risk management. Risk management is one of the essentials to successful investing. If you lose in some stocks, such can be counterbalanced with gains from other securities or for you to get back to breakeven.

ii) Portfolio Optimization

Portfolio optimization is achieved by placing a larger percentage of high return investments in a diversified portfolio. This is due to the fact that proper diversification lowers the overall risk of a portfolio. You can place more aggressive assets in the portfolio.

Disadvantages of Diversification include the following

i) Diversification Double Dip

Diversification is the sort of thing that suffers from what is called "double dip" because too much of a good thing can turn sour. There is evidence portrays that most of the benefit of increased diversification goes away once a portfolio has between 20 and 30 securities in it.

ii) Diversification's Downside Danger

Many investment brokers like to sell the notion of diversification as buying and holding two or more assets whose values don't rise or fall together. The danger is that if there is recession in the economy, almost all the stocks of quoted companies would lose their values.

7.0 REFERENCES/FURTHER READINGS

Elton, E. J. and Gruber, M. J. (1977). Risk Reduction and Portfolio Size: An Analytic Solution, Journal of Business, 50: 415-37

Douglas, M. (1990). *The Disciplined Trader*, New York: New York Institute of Finance.

Jorion, P. (2009). *Financial Risk Manager Handbook* (5 ed.), New Jersey: John Wiley and Sons.

Kenneth G. Winans, K. G. (2015). 5 Big Mistakes Investors Make When They Diversify. Accessed on 14 January, 2017 from http://www.forbes.com/sites/janetnovack/ 2015/02/05/5-big-mistakes-investors-make-when-they-diversify/#2a69136f2f43

Kondor, P. (2009). Risk in Dynamic Arbitrage: Price Effects of Convergence Trading, *Journal of Finance*, 64 (2): 638–658.

Lowenstein, R. (2000). *When genius failed: The rise and fall of Long-Term Capital Management*, New York: Random House.

Mahdavi Damghani, B. (2013)a. The Non-Misleading Value of Inferred Correlation: An Introduction to the Cointelation Model, *Wilmott*, 2013 (1): 50–61.

Mahdavi Damghani, B. (2013)b. De-arbitraging With a Weak Smile: Application to Skew Risk, *Wilmott*, 2013 (1): 40–49.

Niederhoffer, V. (2005). *Practical Speculation*, New Jersey: John Wiley & Sons Inc., 2005.

Schwager, J. D. (2013). *Trading with the Market Wizards: The Complete Market Wizards Series,* New Jersey: John Wiley & Sons 2013.

Siegel, J. (2003). What is an Asset Price Bubble? *European Financial Management.* 9(1): 11–24

Shleifer, A. and Vishny, R. (1997). The limits of arbitrage, *Journal of Finance,* 52: 35–55.

Stark, B. J. (1983). *Special Situation Investing: Hedging, Arbitrage, and Liquidation*, New York, NY: Dow-Jones Publishers.

Sullivan, A. and Sheffrin, S. M. (2003). Economics: Principles in action, Upper Saddle River, New Jersey 07458: Pearson Prentice Hall.

Teeter, P. and Sandberg, J. (2017).Cracking the enigma of asset bubbles with narratives, *Strategic Organization.* 15 (1): 91–99.

Wohlner, R. (2013). Here's Why Diversification Matters, U.S. News & World Report. Accessed on 14 January, 2017 from http://money.usnews.com/money/blogs/the-smarter-mutual-fund-investor/2013/05/31/heres-why-diversification-matters

Xiong, W. (2001). Convergence trading with wealth effects, *Journal of Financial Economics*, 62: 247–292.

UNIT 4: INVESTING WISELY IN CAPITAL MARKET USING HEDGING

CONTENTS

1.0 INTRODUCTION

In respect of investing wisely in capital market, hedging is also useful toward making returns on your fund. It is advisable to engage services of brokerage firms (as traders in financial market) since they are professionals in such market. This study unit of the course material, therefore, is mainly used to expose you to the meaning and process of using hedging in investment as far as the capital market securities are involved. Furthermore, the unit also discusses the advantages and disadvantages of using hedging to ensure investing profitably in the capital market.

2.0 OBJECTIVES

After studying this unit, you should be able to:

- Define hedging in capital market;
- Discuss the process of using hedging for profitable investment in capital market;
- Mention and explain advantages of hedging; and
- List and discuss disadvantages of hedging.

3.0 MAIN CONTENT

3.1 Meaning of Hedging

A hedge is an investment which is undertaking in order to reduce the risk of adverse price movements in a financial asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract. In other words, a hedge is an investment position which is intended for use in offsetting potential losses or gains that may be incurred by a companion investment. In simple terms, a hedge is used to reduce any substantial losses that may occur in investment which has to do with financial assets in the capital market.

A hedge is an investment position which is intended for use in offsetting potential losses or gains that may be incurred by a companion investment. In simple terms, a hedge is used to reduce any substantial losses that may occur in investment, which has to do with financial assets in the capital market.

A hedge can be constructed from many types of financial instruments, including stocks, exchange-traded funds, insurance, forward contracts, swaps, options, many types of over-the-counter and derivative products, and futures contracts.

Hedging is the practice of taking a position in one market to offset and balance against the risk adopted by assuming a position in a contrary or opposing market or investment.

SELF ASSESSMENT EXERCISE 1
Explain the term Hedging.

3.2 Using Hedging in Investment

Equity in a portfolio can be hedged by taking an opposite position in futures. To protect your stock picking against systematic market risk, futures are shorted when equity is purchased or a long future when stock is shorted.

One way to hedge is the market neutral approach. In this approach, an equivalent naira amount in the stock trade is taken in futures – for example, by buying N10,000 worth of say First Bank shares and shorting N10,000 worth of All Share Index; the index in which the bank's share trades in Nigerian Stock Exchange.

Another way to hedge is the beta neutral. Beta is the historical correlation between a stock and an index. If the beta of First Bank stock is 2, then for a N10,000 long position in bank, an investor would hedge with a N20,000 equivalent short position in the All Share Index.

In respect of hedging a stock price, a common hedging technique used in the financial market is the long/short equity technique. The scenario is this:

A stock trader who believes that the stock price of Company A will rise over the next month, due to the company's new and efficient method of producing products, buys Company A shares with the intention to earn profit from their expected price increase, as he believes that shares are currently underpriced. However, if Company A operates in a highly volatile industry, there is a risk of a future event that affects stock prices across the whole industry, including the stock of Company A along with all other companies.

Since the trader is interested in the specific company, rather than the entire industry, he has to hedge out the industry-related risk by short selling an equal value of shares from Company A's direct, yet weaker competitor, Company B.

The first day the trader's portfolio is as given below:

- Long 1,000 shares of Company A at N1 each
- Short 500 shares of Company B at N2 each

The trader has sold short the same value of shares (the value, number of shares × price, is N1, 000 in both cases).

If the trader was able to short sell an asset whose price had a mathematically defined relation with Company A's stock price, for example, a put option on Company A shares, the trade might be essentially riskless. In this case, the risk would be limited to the put option's premium.

On the second day, a favorable news story about the industry’s products is published and the value of all the products stock goes up. Company A’s stock increases by 10% because it is a stronger company, while that of Company B increases by just 5%:

- Long 1,000 shares of Company A at N1.10 each: N100 gain
- Short 500 shares of Company B at N2.10 each: N50 loss (in a short position, the investor loses money when the price goes up)

The trader might regret the hedge on day two, since it reduced the profits on the Company A’s position. But on the third day, an unfavorable news story is published about the health effects of the products, and all prices of stocks crash: 50% is wiped off the value of the industry’s products in the course of a few hours. Nevertheless, since Company A is the better company, it suffers less than Company B:

Value of long position (Company A):

- Day 1: N1,000
- Day 2: N1,100
- Day 3: N550 => (N1,000 − N550) = N450 loss

Value of short position (Company B):

- Day 1: −N1,000
- Day 2: −N1,050
- Day 3: −N525 => (N1,000 − N525) = N475 profit

Without the hedge, the trader would have lost N450 (or N900 if the trader took the N1,000 he has used in short selling Company B's shares to buy Company A's shares as well). But the hedge – the short sale of Company B results in a profit of N25 during a dramatic market collapse.

Hedging can be used in other different ways such as foreign exchange trading. The stock example above represents a typical sort of hedge, known in the industry as a *pairs trade* due to the trading on a pair of related securities. As the practitioners in the capital market become more sophisticated, along with the mathematical tools used to calculate values or models, the types of hedges have increased greatly.

SELF ASSESSMENT EXERCISE 2

Discuss Hedging as it relates to using it for investing wisely in the capital market.

3.3 Advantages and Disadvantages of Hedging

3.3.1 Advantages of Hedging

i) Lower risk of investment

The main advantage of the hedge is that it lowers the risk of an investment significantly. If an investor makes an investment in which variables are out of his control -- as is the case in nearly any investment -- then he stands to lose money if things do not go as he planned. A hedge can help him offset these losses and thus reduce any unwanted risk.

ii) Flexibility in its investment option

Hedge funds are extremely flexible in their investment options because they use financial instruments generally beyond the reach of mutual funds.

iii) Easily best managed investment fund

The flexibility in hedge funds, which includes use of hedging strategies to protect downside risk, gives hedge funds the ability to best managed investment risks. This is linked to performance incentives available for hedge fund managers who manages and shares the rewards as well as risks with the investors.

iv) Exposure to markets that can easily forecast future trends

Hedges are particularly popular with companies that have exposure to certain markets, such as commodities or interest rates. For instance, airlines and railroads spend substantial amounts for fuel for their operations, and so hedging future fuel costs can protect them against a spike in the market price for energy products.

v) Less volatile than individual stocks

Hedge funds can be less volatile than individual stocks or mutual funds because: hedge funds are particularly popular with companies that have exposure to certain markets; it lowers the risk of an investment significantly; and its ability to best managed investment risks because of performance incentives available for hedge fund managers.

3.3.2 Disadvantages of Hedging

i) Higher minimum investment amount required

Hedge fund normally requires a very high minimum amount, which is way only high networth individuals, pension funds, endowment funds, insurance funds, corporate funds can utilize this investment route.

ii) Higher risk

Hedge funds mostly take higher risk to generate higher returns which increases the risk of losing money. One wrong huge investment decision can lead to huge losses for the entire hedge funds.

iii) Lower liquidity

Hedge funds have lower liquidity compared to other funds in the market. The investors cannot buy or sell instantly whenever they want.

iv) Mispricing

The price of the hedge fund units is decided by the management itself which can lead to mispricing of the hedge fund net asset value, and because of this, buyers can end up paying more than actual or the seller can end up receiving less than the actual amount.

v) Short selling and margin calls

Hedge funds have huge exposures in the short selling and margin calls which carries very high risk of losing money.

vi) Low regulation

All hedge funds are very much unregulated which increases the possibility of unfair trade practices (e.g., trade on insider information) and publishing of wrong information about the performance. Investors have become worst affected.

vii) Lower risk management

Hedge funds normally have very low risk management process in place which makes them more vulnerable during any financial crisis or liquidity crisis situation.

viii) High management fees

Hedge funds normally charge very high management and performance fees if the performance is good, which reduces the effective return to the investors significantly.

ix) Management section bias

The management normally selects the best performing hedge while publishing the performance report every time and ignore the worst performed hedge funds to make the performance report more attractive to investors. The worst affected hedge funds are withdrawn from the market without anyone noting it except the investors who lose the invested money. The selection of best performing funds is done to attract potential investors and to increase the asset under management which serves as the most important parameter of a hedge fund.

SELF ASSESSMENT EXERCISE 3
What are the Advantages and Disadvantages of Hedging?

4.5 Conclusion

Hedging is another strategy that can be used to take advantage of wise investment in the capital market. When you are making a large investment, it is advisable to use a hedge investment. Such investment provides a kind of insurance policy designed to protect you in the event that your large investment collapses. The financial hedge provides protection, guarding you against significant losses. Yet, hedges are not always useful and, if injudiciously purchased, can be a waste of money. The relative advantages and disadvantages of a hedge depend greatly on the situation in which the hedge is applied, as well as the hedge cost. In some situations, a hedge will be absolutely necessary to make sure that you as investor will remain financially solvent, regardless of what happens. In other cases, it merely signals an overcautious investor cutting into his own

5.0 SUMMARY

In this study unit of the course material, you have been taught the following topics:

- Meaning of Hedging;
- Using Hedging in Investment;
- Advantages of Hedging; and
- Disadvantages of Hedging

In the next study unit, you will be taken through investing wisely in capital market by using arbitrage.

6.0 TUTOR MARKED ASSIGNMENT

1. Explain the term Hedging.
2. Discuss the process of using Hedging in Investment.
3. Identify and explain advantages and disadvantages of Hedging.

Answers to Self Assessment Exercises

1. Explain the term Hedging.

A hedge is an investment which is undertaking in order to reduce the risk of adverse price movements in a financial asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract. In other words, a hedge is an investment position which is intended for use in offsetting potential losses or gains that may be incurred by a companion investment. In simple terms, a hedge is used to reduce any substantial losses that may occur in investment which has to do with financial assets in the capital market.

2. Discuss Hedging as it relates to using it for investing wisely in the capital market.

Equity in a portfolio can be hedged by taking an opposite position in futures. To protect your stock picking against systematic market risk, futures are shorted when equity is purchased or a long future when stock is shorted.

One way to hedge is the market neutral approach. In this approach, an equivalent naira amount in the stock trade is taken in futures – for example, by buying N10,000 worth of say First Bank shares and shorting N10,000 worth of All Share Index; the index in which the bank's share trades in Nigerian Stock Exchange.

Another way to hedge is the beta neutral. Beta is the historical correlation between a stock and an index. If the beta of First Bank stock is 2, then for a N10,000 long position in bank, an investor would hedge with a N20,000 equivalent short position in the All Share Index.

In respect of hedging a stock price, a common hedging technique used in the financial market is the long/short equity technique.

3. What are the Advantages and Disadvantages of Hedging?

Advantages of Hedging include the following.

i) Lower risk of investment

The main advantage of the hedge is that it lowers the risk of an investment significantly. If an investor makes an investment in which variables are out of his control -- as is the case in nearly any investment -- then he stands to lose money if things do not go as he planned. A hedge can help him offset these losses and thus reduce any unwanted risk.

ii) Flexibility in its investment option

Hedge funds are extremely flexible in their investment options because they use financial instruments generally beyond the reach of mutual funds.

iii) Easily best managed investment fund

The flexibility in hedge funds, which includes use of hedging strategies to protect downside risk, gives hedge funds the ability to best managed investment risks. This is linked to performance incentives available for hedge fund managers who manages and shares the rewards as well as risks with the investors.

iv) Exposure to markets that can easily forecast future trends

Hedges are particularly popular with companies that have exposure to certain markets, such as commodities or interest rates. For instance, airlines and railroads spend substantial amounts for fuel for their operations, and so hedging future fuel costs can protect them against a spike in the market price for energy products.

v) Less volatile than individual stocks

Hedge funds can be less volatile than individual stocks or mutual funds because: hedge funds are particularly popular with companies that have exposure to certain markets; it lowers the risk of an investment significantly; and its ability to best managed investment risks because of performance incentives available for hedge fund managers.

Disadvantages of Hedging include the following

i) Higher minimum investment amount required

Hedge fund normally requires a very high minimum amount, which is way only high networth individuals, pension funds, endowment funds, insurance funds, corporate funds can utilize this investment route.

ii) Higher risk

Hedge funds mostly take higher risk to generate higher returns which increases the risk of losing money. One wrong huge investment decision can lead to huge losses for the entire hedge funds.

iii) Lower liquidity

Hedge funds have lower liquidity compared to other funds in the market. The investors cannot buy or sell instantly whenever they want.

iv) Mispricing

The price of the hedge fund units is decided by the management itself which can lead to mispricing of the hedge fund net asset value, and because of this, buyers can end up paying more than actual or the seller can end up receiving less than the actual amount.

v) Short selling and margin calls

Hedge funds have huge exposures in the short selling and margin calls which carries very high risk of losing money.

vi) Low regulation

All hedge funds are very much unregulated which increases the possibility of unfair trade practices (e.g., trade on insider information) and publishing of wrong information about the performance. Investors have become worst affected.

vii) Lower risk management

Hedge funds normally have very low risk management process in place which makes them more vulnerable during any financial crisis or liquidity crisis situation.

viii) High management fees

Hedge funds normally charge very high management and performance fees if the performance is good, which reduces the effective return to the investors significantly.

ix) Management section bias

The management normally selects the best performing hedge while publishing the performance report every time and ignore the worst performed hedge funds to make the performance report more attractive to investors.

7.0 REFERENCES/FURTHER READINGS

Elton, E. J. and Gruber, M. J. (1977). Risk Reduction and Portfolio Size: An Analytic Solution, Journal of Business, 50: 415-37

Douglas, M. (1990). *The Disciplined Trader*, New York: New York Institute of Finance.

Jorion, P. (2009). *Financial Risk Manager Handbook* (5 ed.), New Jersey: John Wiley and Sons.

Kenneth G. Winans, K. G. (2015). 5 Big Mistakes Investors Make When They Diversify. Accessed on 14 January, 2017 from http://www.forbes.com/sites/janetnovack/2015/02/05/5-big-mistakes-investors-make-when-they-diversify/#2a69136f2f43

Kondor, P. (2009). Risk in Dynamic Arbitrage: Price Effects of Convergence Trading, *Journal of Finance*, 64 (2): 638–658.

Lowenstein, R. (2000). *When genius failed: The rise and fall of Long-Term Capital Management*, New York: Random House.

Mahdavi Damghani, B. (2013)a. The Non-Misleading Value of Inferred Correlation: An Introduction to the Cointelation Model, *Wilmott*, 2013 (1): 50–61.

Mahdavi Damghani, B. (2013)b. De-arbitraging With a Weak Smile: Application to Skew Risk, *Wilmott*, 2013 (1): 40–49.

Niederhoffer, V. (2005). *Practical Speculation,* New Jersey: John Wiley & Sons Inc., 2005.

Schwager, J. D. (2013). *Trading with the Market Wizards: The Complete Market Wizards Series,* New Jersey: John Wiley & Sons 2013.

Siegel, J. (2003). What is an Asset Price Bubble? *European Financial Management.* 9(1): 11–24

Shleifer, A. and Vishny, R. (1997). The limits of arbitrage, *Journal of Finance,* 52: 35–55.

Stark, B. J. (1983). *Special Situation Investing: Hedging, Arbitrage, and Liquidation*, New York, NY: Dow-Jones Publishers.

Sullivan, A. and Sheffrin, S. M. (2003). Economics: Principles in action, Upper Saddle River, New Jersey 07458: Pearson Prentice Hall.

Teeter, P. and Sandberg, J. (2017).Cracking the enigma of asset bubbles with narratives, *Strategic Organization.* 15 (1): 91–99.

Wohlner, R. (2013). Here's Why Diversification Matters, U.S. News & World Report. Accessed on 14 January, 2017 from http://money.usnews.com/money/blogs/the-smarter-mutual-fund-investor/2013/05/31/heres-why-diversification-matters

Xiong, W. (2001). Convergence trading with wealth effects, *Journal of Financial Economics,* 62: 247–292.

UNIT 5: INVESTING WISELY IN CAPITAL MARKET USING ARBITRAGE

CONTENTS

1.0 INTRODUCTION

This study unit of the course material is used to expose you to other strategies that can be employed in respect of investing wisely in capital market. These other strategies include arbitrage and speculation. Just like other ones treated in preceding units, the use of these two strategies, arbitrage and speculation, it is advisable also to engage services of brokerage firms (as traders in financial market) since they are professionals in such market. This study unit, therefore, is mainly used to discuss the concepts of arbitrage and speculation as far as using them in investment in the capital market securities are involved.

2.0 OBJECTIVES

After studying this unit, you should be able to:

- Define arbitrage
- Discuss the process of using arbitrage in investment

3.0 MAIN CONTENT

3.1 Meaning of Arbitrage

Arbitrage refers to the practice of taking advantage of a price difference between two or more financial markets. This involves striking a combination of matching deals that capitalize upon the imbalance between the two financial markets, the profit being the difference between the two market prices. Basically, it is the possibility of a risk-free profit after transaction costs. For instance, an arbitrage is present when there is the opportunity to instantaneously buy a security at a low price in one market and sell at a high price in another market.

Essentially, arbitrage may refer to the expected profit. However, some losses may occur in the process of engaging in arbitrage. And there are always risks in arbitrage, some of which may be minor such as fluctuation of prices that resulting in decreased profit margins. Some of such risks in arbitrage may be major such as devaluation of a currency or derivative.

In another perspective, an arbitrage involves taking advantage of differences in price of a single asset or identical cash-flows. In common use, it is also employed to denote to differences between similar assets, relative value or convergence trades, as it is the case in merger arbitrage. Arbitrage as a term is mainly applied to trading in financial instruments such as bonds, stocks, derivatives, commodities and currencies.

SELF ASSESSMENT EXERCISE 1
Explain the term Arbitrage.

3.2 Using Arbitrage in Investment

In respect of conditions for arbitrage, it is only possible when one of these three conditions exit: the same asset (financial security) does not trade at the same price on all markets, known as "the law of one price"; two assets with identical cash flows do not trade at the same price; and an asset with a known price in the future does not today trade at its future price discounted at the risk-free interest rate or the asset has significant costs of storage.

Arbitrage is not simply the act of buying a product in one market and selling it in another for a higher price at some later time. The transactions must occur simultaneously in order to avoid exposure to market risk, or the risk that prices may change on one market before both transactions are complete. In practical terms, this is generally possible only with securities and financial products that can be traded electronically, and even then, when each leg of the trade is executed the prices in the market may have moved. Missing one of the legs of the trade and subsequently having to trade it soon after at a worse price, is called 'execution risk' or more specifically 'leg risk'.

In the simplest example, any good sold in one market should sell for the same price in another. Traders may, for example, find that the price of wheat is lower in agricultural regions than in cities, purchase the good, and transport it to another region to sell at a higher price. This type of price arbitrage is the most common, but this simple example ignores the cost of transport, storage, risk, and other factors. Accurate arbitrage requires that there be no market risk involved. Where securities are traded on more than one exchange, arbitrage occurs by simultaneously buying in one and selling on the other.

Therefore, in order to invest wisely in financial market, arbitrage can be useful toward making returns on your fund. Since banks and brokerage firms (called arbitrageurs) are favourably disposed in engaging in arbitrage, you can make arrangement with the latter (brokerage firm) to trade with your funds in arbitrage on your behalf but at a fee, serving as their own commission.

SELF ASSESSMENT EXERCISE 2
Discuss the process of using Arbitrage in investment.

4.5 Conclusion

The transactions in arbitrage must occur simultaneously in order to avoid exposure to market risk, or the risk that prices may change on one market before both transactions are complete. In practical terms, this is generally possible only with securities and financial products that can be traded electronically, and even then, when each leg of the trade is executed the prices in the market may have moved. It is advisable to engage services of brokerage firms (as traders in financial market) since they are professionals in such market.

5.0 SUMMARY

In this study unit of the course material, you have been taught the following topics:
- Meaning of Arbitrage; and
- Using Arbitrage in Investment;

In the next study unit, you will be taken through discussion on investment in speculation.

6.0 TUTOR MARKED ASSIGNMENT
1. What is Arbitrage in investment?
2. Discus the process of using Arbitrage in Investment;

Answers to Self-Assessment Exercises

1. Explain the term Arbitrage.

Arbitrage involves taking advantage of differences in price of a single asset or identical cash-flows. Arbitrage as a term is mainly applied to trading in financial instruments such as bonds, stocks, derivatives, commodities and currencies. The transactions must occur simultaneously in order to avoid exposure to market risk, or the risk that prices may change on one market before both transactions are complete. In practical terms, this is generally possible only with securities and financial products that can be traded electronically, and even then, when each leg of the trade is executed the prices in the market may have moved.

2. Discuss the process of using Arbitrage in investment.

Arbitrage is not simply the act of buying a product in one market and selling it in another for a higher price at some later time. The transactions must occur simultaneously in order to avoid exposure to market risk, or the risk that prices may change on one market before both transactions are complete. In practical terms, this is generally possible only with securities and financial products that can be traded electronically, and even then, when each leg of the trade is executed the prices in the market may have moved. Missing one of the legs of the trade and subsequently having to trade it soon after at a worse price, is called 'execution risk' or more specifically 'leg risk'.

7.0 REFERENCES/FURTHER READINGS

Elton, E. J. and Gruber, M. J. (1977). Risk Reduction and Portfolio Size: An Analytic Solution, Journal of Business, 50: 415-37

Douglas, M. (1990). *The Disciplined Trader*, New York: New York Institute of Finance.

Jorion, P. (2009). *Financial Risk Manager Handbook* (5 ed.), New Jersey: John Wiley and Sons.

Kenneth G. Winans, K. G. (2015). 5 Big Mistakes Investors Make When They Diversify. Accessed on 14 January, 2017 from http://www.forbes.com/sites/janetnovack/ 2015/02/05/5-big-mistakes-investors-make-when-they-diversify/#2a69136f2f43

Kondor, P. (2009). Risk in Dynamic Arbitrage: Price Effects of Convergence Trading, *Journal of Finance*, 64 (2): 638–658.

Lowenstein, R. (2000). *When genius failed: The rise and fall of Long-Term Capital Management*, New York: Random House.

Mahdavi Damghani, B. (2013)a. The Non-Misleading Value of Inferred Correlation: An Introduction to the Cointelation Model, *Wilmott*, 2013 (1): 50–61.

Mahdavi Damghani, B. (2013)b. De-arbitraging With a Weak Smile: Application to Skew Risk, *Wilmott*, 2013 (1): 40–49.

Niederhoffer, V. (2005). *Practical Speculation*, New Jersey: John Wiley & Sons Inc., 2005.

Schwager, J. D. (2013). *Trading with the Market Wizards: The Complete Market Wizards Series*, New Jersey: John Wiley & Sons 2013.

Siegel, J. (2003). What is an Asset Price Bubble? *European Financial Management.* 9(1): 11–24

Shleifer, A. and Vishny, R. (1997). The limits of arbitrage, *Journal of Finance,* 52: 35–55.

Stark, B. J. (1983). *Special Situation Investing: Hedging, Arbitrage, and Liquidation*, New York, NY: Dow-Jones Publishers.

Sullivan, A. and Sheffrin, S. M. (2003). Economics: Principles in action, Upper Saddle River, New Jersey 07458: Pearson Prentice Hall.

Teeter, P. and Sandberg, J. (2017).Cracking the enigma of asset bubbles with narratives, *Strategic Organization.* 15 (1): 91–99.

Wohlner, R. (2013). Here's Why Diversification Matters, U.S. News & World Report. Accessed on 14 January, 2017 from http://money.usnews.com/money/blogs/the-smarter-mutual-fund-investor/2013/05/31/heres-why-diversification-matters

Xiong, W. (2001). Convergence trading with wealth effects, *Journal of Financial Economics*, 62: 247–292.

UNIT 6: INVESTING WISELY IN CAPITAL MARKET USING SPECULATION

CONTENTS

1.0 INTRODUCTION

This study unit of the course material is used to expose you to other strategies that can be employed in respect of investing wisely in capital market. These other strategies include arbitrage and speculation. Just like other ones treated in preceding units, the use of these two strategies, arbitrage and speculation, it is advisable also to engage services of brokerage firms (as traders in financial market) since they are professionals in such market. This study unit, therefore, is mainly used to discuss the concepts of arbitrage and speculation as far as using them in investment in the capital market securities are involved.

2.0 OBJECTIVES

After studying this unit, you should be able to:

- Define arbitrage
- Discuss the process of using arbitrage in investment

3.0 MAIN CONTENT

3.1 Meaning of Speculation

Another way to invest wisely in financial market involves the use of speculation. Speculation can be useful toward making returns on your fund. It is advisable to engage services of brokerage firms (as traders in financial market) since they are professionals in such market.

This involves investment in stocks, property, bonds, etc., in the hope of gain but with the potential risk of loss. Basically, speculation in finance also refers to the practice of engaging in risky financial transactions in an attempt to earn profit from short term fluctuations in the market value of a tradable financial instrument. This is rather different from attempting to earn profit from the underlying financial attributes embodied in the instrument such as capital gains, dividends, or interest.

SELF ASSESSMENT EXERCISE 1

Explain the term Speculation.

3.2 Using Speculation in Investing

In speculation, dealers (the speculators) in financial market pay little attention to the fundamental value of a security and instead focus purely on price movement. Speculation can, in principle, involve any tradable good or financial instrument. Speculators are particularly common in the markets for stocks, bonds, currencies, and derivatives, among others.

Speculators play one of four basic roles in financial markets along with: hedgers who engage in transactions to offset some other pre-existing risk; arbitrageurs who seek to profit from situations where fungible instruments trade at different prices in different market segments; and investors who seek profit through long-term ownership of an instrument's underlying attributes.

In essence, speculation is simply a higher risk form of investment. In some literature, speculation is more narrowly as investment posture not characterized by hedging. Therefore, a speculator is a trader in financial market who does not get involved in hedging, but who trades with the objective of achieving profits through the successful anticipation of price movements. The emphasis herein is that speculators serve important market functions, but engaging in excessive speculation is regarded as being harmful to the proper functioning of futures markets.

A prototypical defensive investor refers to the one who is interested mainly in safety plus freedom from anxiety. However, it is argued that some speculation is necessary and unavoidable, for in many common-stock situations, there are substantial possibilities of both profit and loss, and the risks therein must be assumed by someone. Hence many long-term investors, even those who buy and hold for decades may be classified as speculators, except that only the rare few ones who are primarily motivated by income or safety of their principal amount of investment and not eventually selling at a profit.

Speculation usually involves more risks than ordinary investment; it is a hybrid investment undertaking. The price-stabilizing role of speculators is well recognized in the capital market; they take actions which tend to even out price-fluctuations due to changes in the conditions of demand and/or supply, by possessing superior foresight.

SELF ASSESSMENT EXERCISE 2

Discuss the process of using speculation in investment.

3.3 Advantages and Disadvantages of Speculation

3.3.1 Advantages of Speculation

i) Speculation can be used to mitigate risk in the underlying asset, by entering into a derivative contract whose value moves in the opposite direction to their underlying position and cancels part or all of it out.

ii) It can be used to create option ability where the value of the derivative is linked to a specific condition or event, for instance, the underlying asset reaching a specific price level.

iii) It can be used to access or gain exposure to the underlying asset where it is not possible to trade in the underlying.

iv) It provides some leverage or gearing such that a small movement in the underlying asset value can cause a large difference in the value of the derivative.

v) Speculation can be used to make a reasonable level of profit if the value of the underlying asset moves the way they expect; for instance, moves in a given direction, stays in or out of a specified range or reaches a certain level.

vi) It can be used to switch asset allocations between different asset classes without disturbing the underlying assets, as part of transition management of investment.

vii) It can be used to avoid paying taxes. This is because it is a derivative contract. Therefore, it can be used by an investor to receive steady payments such as being based, for instance, on London interbank offer rate (LIBOR) while avoiding paying capital gain tax and keeping the stock.

3.3.2 Disadvantages of Speculation

i) Speculation that goes wrong can wipe out a financial institution such a stock broking firm or bank such that a trader who engages in speculation will make the firm to incur enormous sum of money.

ii) Speculation can make an individual investor to become bankrupt in loosing enormous amount of money when a natural disaster occurs to destroy the underlying asset of the transaction.

SELF ASSESSMENT EXERCISE 3

List the Advantages of Speculation

4.5 Conclusion

In speculation, the investor or trader in financial market does not get involved in hedging, but who trades with the objective of achieving profits through the successful anticipation of price movements. The emphasis herein is that speculators serve important market functions, but engaging in excessive speculation is regarded as being harmful to the proper functioning of futures markets. Speculation can be useful toward making returns on your fund. It is advisable to engage services of brokerage firms (as traders in financial market) since they are professionals in such market.

5.0 SUMMARY

In this study unit of the course material, you have been taught the following topics:

- Meaning of Speculation;
- Using Speculation in Investment;
- Advantages of Speculation; and
- Disadvantages of Speculation.

In the next study unit, you will be taken through investment in derivatives.

6.0 TUTOR MARKED ASSIGNMENT

1. Explain the process of using Speculation in Investment.
2. Mention the advantages and disadvantages of Speculation

Answers to self-assessment exercises

1. Explain the term Speculation.

This involves investment in stocks, property, bonds, etc., in the hope of gain but with the potential risk of loss. Basically, speculation in finance also refers to the practice of engaging in risky financial transactions in an attempt to earn profit from short term fluctuations in the market value of a tradable financial instrument. This is rather different from attempting to earn profit from the underlying financial attributes embodied in the instrument such as capital gains, dividends, or interest.

2. Discuss the process of using speculation in investment.

Speculation can be useful toward making returns on your fund but it is advisable to engage services of brokerage firms (as traders in financial market) since they are professionals in such market. They serve as speculator for capital securities.

The speculator as a trader in financial market does not get involved in hedging, but only trades with the objective of achieving profits through the successful anticipation of price movements. The emphasis herein is that speculators serve important market functions, but engaging in excessive speculation is regarded as being harmful to the proper functioning of futures markets.

3. List the Advantages of Speculation

i) Speculation can be used to mitigate risk in the underlying asset, by entering into a derivative contract whose value moves in the opposite direction to their underlying position and cancels part or all of it out.

ii) It can be used to create option ability where the value of the derivative is linked to a specific condition or event, for instance, the underlying asset reaching a specific price level.

iii) It can be used to access or gain exposure to the underlying asset where it is not possible to trade in the underlying.

iv) It provides some leverage or gearing such that a small movement in the underlying asset value can cause a large difference in the value of the derivative.

v) Speculation can be used to make a reasonable level of profit if the value of the underlying asset moves the way they expect; for instance, moves in a given direction, stays in or out of a specified range or reaches a certain level.

vi) It can be used to switch asset allocations between different asset classes without disturbing the underlying assets, as part of transition management of investment.

vii) It can be used to avoid paying taxes. This is because it is a derivative contract. Therefore, it can be used by an investor to receive steady payments such as being based, for instance, on London interbank offer rate (LIBOR) while avoiding paying capital gain tax and keeping the stock.

7.0 REFERENCES/FURTHER READINGS

Elton, E. J. and Gruber, M. J. (1977). Risk Reduction and Portfolio Size: An Analytic Solution, Journal of Business, 50: 415-37

Douglas, M. (1990). *The Disciplined Trader*, New York: New York Institute of Finance.

Jorion, P. (2009). *Financial Risk Manager Handbook* (5 ed.), New Jersey: John Wiley and Sons.

Kenneth G. Winans, K. G. (2015). 5 Big Mistakes Investors Make When They Diversify. Accessed on 14 January, 2017 from http://www.forbes.com/sites/janetnovack/ 2015/02/05/5-big-mistakes-investors-make-when-they-diversify/#2a69136f2f43

Kondor, P. (2009). Risk in Dynamic Arbitrage: Price Effects of Convergence Trading, *Journal of Finance*, 64 (2): 638–658.

Lowenstein, R. (2000). *When genius failed: The rise and fall of Long-Term Capital Management*, New York: Random House.

Mahdavi Damghani, B. (2013)a. The Non-Misleading Value of Inferred Correlation: An Introduction to the Cointelation Model, *Wilmott*, 2013 (1): 50–61.

Mahdavi Damghani, B. (2013)b. De-arbitraging With a Weak Smile: Application to Skew Risk, *Wilmott*, 2013 (1): 40–49.

Niederhoffer, V. (2005). *Practical Speculation*, New Jersey: John Wiley & Sons Inc., 2005.

Schwager, J. D. (2013). *Trading with the Market Wizards: The Complete Market Wizards Series*, New Jersey: John Wiley & Sons 2013.

Siegel, J. (2003). What is an Asset Price Bubble? *European Financial Management.* 9(1): 11–24

Shleifer, A. and Vishny, R. (1997). The limits of arbitrage, *Journal of Finance,* 52: 35–55.

Stark, B. J. (1983). *Special Situation Investing: Hedging, Arbitrage, and Liquidation*, New York, NY: Dow-Jones Publishers.

Sullivan, A. and Sheffrin, S. M. (2003). Economics: Principles in action, Upper Saddle River, New Jersey 07458: Pearson Prentice Hall.

Teeter, P. and Sandberg, J. (2017).Cracking the enigma of asset bubbles with narratives, *Strategic Organization.* 15 (1): 91–99.

Wohlner, R. (2013). Here's Why Diversification Matters, U.S. News & World Report. Accessed on 14 January, 2017 from http://money.usnews.com/money/blogs/the-smarter-mutual-fund-investor/2013/05/31/heres-why-diversification-matters

Xiong, W. (2001). Convergence trading with wealth effects, *Journal of Financial Economics,* 62: 247–292.

UNIT 7: INVESTMENT IN DERIVATIVES

CONTENTS

1.0 INTRODUCTION

In this study, you are being exposed to the discussion on derivative. This is still another way through which you can invest wisely in the financial market, particularly the capital market such as the use of derivative. This is a kind of hedging involving a contract of which its value depends on the performance of the capital market asset involved. The other forms derivatives include index and interest rate, often regarded as fundamental to the contract. Reasons for the use of derivatives include insuring against price movements, which is precisely hedging, increasing exposure to price movements for speculation, and getting access to otherwise complex capital market assets.

2.0 OBJECTIVES

After studying this unit, you should be able to:

- Explain derivatives
- Mention the characteristics of derivatrives
- List and explain the two types of derivatives
- Identify and discuss the common variants of derivatrive contracts

- List uses of derivatrives

3.0 MAIN CONTENT

3.1 Meaning of Derivatrives

Conceptually, a derivative refers to a contract that originates its value from the performance of an underlying entity. This underlying entity refers to financial basics such as asset, index, or interest rate. This is often regarded as fundamental. There abound a number of purposes for which derivatives can be used. One purpose involves insuring against price movements, which is hedging. The other purpose involves increasing exposure to price movements for speculation. Furthermore, another purpose involves getting access to otherwise 'hard-to-trade' assets or markets. There are common derivatives that include forwards, futures, options, and swaps. There are variations of derivatives that include synthetic collateralized debt obligations and credit default swaps (Crawford and Sen, 1996; Hull, 2006).

Most derivatives are transacted over-the-counter, that is, off-exchange or on a stock exchange, which is found in the Bombay Stock Exchange. Basically, most insurance contracts have developed into a separate industry. Derivatives constitute one of the three main categories of financial instruments, and the other two categories are stocks (such as equities or shares) and debt instruments such as bonds and mortgages (Crawford and Sen, 1996; Hull, 2006).

Derivatives can be used either for risk management, that is, to hedge on underlying asset by providing equalizing compensation in case of an undesired event. This serves as a kind of protection or for speculation, which involves making a financial stake. Hedging herein is a judicious aspect of operations and financial management for many companies across many industries. The protection offers managers and investors a risky opportunity to increase profit, which may not be properly disclosed to stakeholders.

SELF ASSESSMENT EXERCISE 1
Discuss the term Derivative.

3.2 Characteristics of Derivatrives

Derivatives involve contracts that subsist between two parties, which incorporate specific terms (Kiff, J., Elliott, J., Kazarian, E., Scarlata, J., Spackman, C., 2009; Simkovic, M., 2011) such as the following:

i) Dates;
ii) Maturing values;
iii) Clarifications of the fundamental variables;
iv) Parties' contractual obligations; and
v) Notional amount under which payments are to be made between the parties.

The assets as derivatives include commodities, stocks, bonds, interest rates and currencies, but they can also be other types. Basically, the components of a firm's capital structure such as bonds and stock can also be considered derivatives, and they are examples of options, with the underlying being the firm's assets. Financial derivatives can also be regarded as cash flows that are discounted to present value. The market risk associated in the fundamental asset is attached to the financial derivative through contractual agreements, and therefore, the asset can be traded separately. However, the fundamental asset does not have to be acquired (Partnoy, F. and Skeel, Jr., D. A., 2007).

Derivatives therefore allow the breakup of ownership and participation in the market value of an asset. This also provides a considerable amount of freedom regarding the contract design. That contractual freedom provides for the modification of the participation in the performance of the underlying asset almost arbitrarily. Thus, the participation in the market value of the fundamental asset, which can be effectively weaker, stronger (leverage effect), or implemented as inverse. This implies that specifically the market price risk of the fundamental asset can be controlled in almost every situation (Partnoy, F. and Skeel, Jr., D. A., 2007).

There are distinct groups of derivative contracts such as highlighted below:

a) Privately traded over-the-counter (OTC) derivatives such as swaps that do not go through an exchange or other intermediary; and
b) Exchange-traded derivatives (ETD) that are traded through specialized derivatives exchanges or other exchanges.
c) Option products like interest rate swaps that provide the buyer the right, but not the obligation to enter the contract under the terms specified.

Derivatives are also broadly categorized in the following ways:

i) By the relationship between the underlying asset and the derivative (such as forward, option, swap), which as lock products obligate the contractual parties to the terms over the life of the contract;
ii) The type of underlying asset (such as equity derivatives, foreign exchange derivatives, interest rate derivatives, commodity derivatives, or credit derivatives);
iii) The market in which they trade (such as exchange-traded or over-the-counter); and
iv) Their pay-off profile.

SELF ASSESSMENT EXERCISE 2

Identify the characteristics.

3.3Types of Derivative

Two broad types of derivative can be identified as mentioned and discussed below.

3.3.1 Over-the-Counter (OTC) derivatives

Over-the-Counter derivatives are contracts that are transacted and privately sold directly between two parties, without going through any stock exchange or any other intermediary as far as the transaction is concerned.

There are some products available in the financial markets that are subject to this type of dealing. Examples of these products include: swaps, forward rate agreements, exotic options as well as and other exotic derivatives. The over-the-counter derivative market seems to be the largest market for derivatives. This market is largely unregulated in relation to disclosure of information between the parties in the dealings. This is because the over-the-counter market comprises banks and other highly well-informed parties like the hedge funds. Information on volume of transactions on over-the-counter is also very difficult. This is due to the fact that transactions do occur in secrecy or private; such activity not being visible on any stock exchange.

3.3.2 Exchange-Traded Derivatives (ETD)

Exchange-traded derivatives refer to those derivatives as financial instruments that are transacted through specialized derivatives exchanges or other exchanges. The derivatives exchange is the type of market in which individuals transact homogeneous contracts that have been defined by the exchange. The derivatives exchange acts as an intermediary to all related trades. The exchange takes initial margin from both parties to the trade by serving as a guarantee.

The largest derivatives exchanges in the world by volume of transactions include the following:
i) Korea Exchange, listing KOSPI Index Futures & Options;
ii) Eurex listing a wide range of European products such as interest rate and index products;
iii) CME Group that comprises Chicago Mercantile Exchange, Chicago Board of Trade and New York Mercantile Exchange.

SELF ASSESSMENT EXERCISE 3
Differentiate between Over-the-Counter (OTC) derivatives and Exchange-Traded Derivatives (ETD).

3.4 Common Variants of Derivatrive Contracts

Some of the common variants of derivative (Stever, Upper and von Peter, 2007) contracts are as follows:

i) Forwards

This type of derivative is a personalized contract between two parties in which payment takes place at a specific date in the future at today's pre-determined price as agreed upon by both parties.

ii) Futures

These are derivatives in which the contracts to buy or sell a specified asset on a future date at a price specified today. Hence a futures contract differs from a forward contract in respect of the fact that the futures contract is a homogeneous contract that is normally written by a clearing house which operates an exchange where the deal can take place; purchased and disposed of. This implies that the forward contract is a non-standardized contract written by the parties themselves.

iii) Options

These are contracts that offer the owner the right, but not the obligation, to buy, in respect of a call option or sell in respect of a put option, a specified asset. The price at which the sale takes place is known as the strike price, and is specified at the time the parties enter into the option. The option contract also incorporates a maturity date.

There are variations in different climes. In respect of a European option, the owner has the right to require the sale to take place on (but not before) the maturity date. And in respect of the US option, the owner can require the sale to take place at any time up to the maturity date. In the event that the owner of the contract exercises this right, the counter-party has the obligation to carry out the transaction.

There are two types of options contract. (i) This is the call option in which the buyer has a right to buy a certain quantity of the underlying asset, at a specified price on or before a given date in the future, but he has no obligation to carry out this right. (ii) There is the put option contract in which the buyer of a put option has the right to sell a certain quantity of an underlying asset, at a specified price on or before a given date in the future, but he has no obligation to carry out this right.

iv) Binary options

These are derivatives in relation to options that are contracts which provide the owner the opportunity for an "all-or-nothing" profit from the contract.

v) Warrants

This is different from the frequently used short-dated options which have a maximum maturity period of one year. The warrants contracts also exist on the basis of long-dated options which are generally transacted over the counter.

vi) Swaps

Swap derivatives refer to contracts which involve the exchange of cash (flows) on or before a specified future date. This is based on the fundamental value of currencies exchange rates, bonds rates, interest rates, commodities exchange, stocks or other assets. This is also the *swaption* as frequently associated with swap. This is basically an option on the forward swap. Swaptions are like call and put options, and they are of different types such as *receiver* and *payer*. In respect of a *receiver* swaption, there is an option in which one can receive fixed and pay floating. And in respect of a *payer* swaption, one has the option to pay fixed and receive floating.

Swaps are basically in two categories such as identified and discussed below.

a) **Interest rate swap**:- This mainly necessitates swapping only the interest inherent in the cash flows using the same currency between the two parties.

b) Currency swap:- In respect of this kind of swapping, the cash flow between the two parties involved incorporates both principal and interest. And the principal amount (money) that is involved in swap is in different currency for both parties.

SELF ASSESSMENT EXERCISE 4
Mention and explain common variants of Derivatrive Contracts

3.5 Uses of Derivatrives
Derivatives are used (Mengle, 2007) for the following transactional dimensions:

i) Hedge or mitigate risk in the underlying asset, by entering into a derivative contract whose value moves in the opposite direction to their underlying position and cancels part or all of it out;

ii) Create option ability where the value of the derivative is linked to a specific condition or event, for instance, the underlying asset reaching a specific price level;

iii) Obtain exposure to the underlying asset where it is not possible to trade in the underlying, for instance, weather derivatives;

iv) Provide leverage (or gearing), such that a small movement in the underlying asset value can cause a large difference in the value of the derivative;

v) Speculate and make a profit if the value of the underlying asset moves the way they expect (e.g. moves in a given direction, stays in or out of a specified range, reaches a certain level);

vi) Switch asset allocations between different asset classes without disturbing the underlying assets, as part of transition management; and

vii) Avoid paying taxes. For example, an equity swap allows an investor to receive steady payments such as being based, for instance, on London interbank offer rate (LIBOR) while avoiding paying capital gains tax and keeping the stock.

SELF ASSESSMENT EXERCISE 5
Mention various reasons for the use of derivatives.

4.0 Conclusion

Derivative is another way through which you can invest wisely in the capital market, is a kind of hedging that involves a contract in which its value depends on the performance of the capital market asset involved. Hence forms derivatives include asset, index and interest rate that are often regarded as fundamental to their contract. There are peculiar reasons for the use of derivatives by the investors or traders, who are purely speculators. Such reasons include: insuring against price movements, which is precisely hedging; increasing exposure to price movements for speculation; and getting access to otherwise complex capital market or assets. And uses of derivatives also include: mitigate risk in the underlying asset; create option ability where the value of the derivative is linked to a specific condition or event; obtain exposure to the underlying asset where it is not possible to trade in the fundamental; provide leverage (or gearing) on the value of the derivative asset; and speculate and make a profit if the value of the underlying asset moves the way as expected or predicted.

5.0 SUMMARY

In this study unit of the course material, you have been taught the following topics:

- Meaning of Derivatrives;
- Characteristics of Derivatrives;
- Types of Derivative;
- Common Variants of Derivatrive Contracts; and
- Uses of Derivatrives.

In the next study unit, you will be taken through investment portfolio in properties and commodities.

6.0 TUTOR MARKED ASSIGNMENT

1. Discuss the term Derivative.
2. Identify the characteristics.
3. Mention various reasons for the use of derivatives.

Answers to Self-Assessment Exercises

1. Discuss the term Derivative.

A derivative refers to a contract that originates its value from the performance of an underlying entity. This underlying entity refers to financial basics such as asset, index, or interest rate. This is often regarded as fundamental. There abound a number of purposes for which derivatives can be used. One purpose involves insuring against price movements, which is hedging. The other purpose involves increasing exposure to price movements for speculation. Furthermore, another purpose involves getting access to otherwise ‘hard-to-trade’ assets or markets. There are common derivatives that include forwards, futures, options, and swaps. There are variations of derivatives that include synthetic collateralized debt obligations and credit default swaps

2. Identify the characteristics.

Derivatives have the following characteristics.

i) Dates
ii) Maturing values
iii) Clarifications of the fundamental variables
iv) Parties' contractual obligations
v) Notional amount under which payments are to be made between the parties

3. Differentiate between Over-the-Counter (OTC) derivatives and Exchange-Traded Derivatives (ETD).

Over-the-Counter derivatives are contracts that are transacted and privately sold directly between two parties, without going through any stock exchange or any other intermediary as far as the transaction is concerned.

On the other hand, Exchange-traded derivatives refer to those derivatives as financial instruments that are transacted through specialized derivatives exchanges or other exchanges. The derivatives exchange is the type of market in which individuals transact homogeneous contracts that have been defined by the exchange. The derivatives exchange acts as an intermediary to all related trades. The exchange takes initial margin from both parties to the trade by serving as a guarantee.

4. Mention and explain common variants of Derivatrive Contracts

i) Forwards

This type of derivative is a personalized contract between two parties in which payment takes place at a specific date in the future at today's pre-determined price as agreed upon by both parties.

ii) Futures

These are derivatives in which the contract to buy or sell a specified asset on a future date at a price specified today. Hence a futures contract differs from a forward contract in respect of the fact that the futures contract is a homogeneous contract that is normally written by a clearing house which operates an exchange where the deal can take place.

iii) Options

These are contracts that offer the owner the right, but not the obligation, to buy, in respect of a call option or sell in respect of a put option, a specified asset. The price at which the sale takes place is known as the strike price, and is specified at the time the parties enter into the option. The option contract also incorporates a maturity date.

iv) Binary options

These are derivatives in relation to options that are contracts which provide the owner the opportunity for an “all-or-nothing” profit from the contract.

v) Warrants

This is different from the frequently used short-dated options which have a maximum maturity period of one year. The warrants contracts also exist on the basis of long-dated options which are generally transacted over the counter.

vi)Swaps

Swap derivatives refer to contracts which involve the exchange of cash (flows) on or before a specified future date. This is based on the fundamental value of currencies exchange rates, bonds rates, interest rates, commodities exchange, stocks or other assets.

5. Mention various reasons for the use of derivatives.

i) Hedge or mitigate risk in the underlying asset, by entering into a derivative contract whose value moves in the opposite direction to their underlying position and cancels part or all of it out.

ii) Create option ability where the value of the derivative is linked to a specific condition or event, for instance, the underlying asset reaching a specific price level.

iii) Obtain exposure to the underlying asset where it is not possible to trade in the underlying, for instance, weather derivatives.

iv) Provide leverage (or gearing), such that a small movement in the underlying asset value can cause a large difference in the value of the derivative.

v) Speculate and make a profit if the value of the underlying asset moves the way they expect (e.g. moves in a given direction, stays in or out of a specified range, reaches a certain level).

vi) Switch asset allocations between different asset classes without disturbing the underlying assets, as part of transition management, and

vii) Avoid paying taxes. For example, an equity swap allows an investor to receive steady payments such as being based, for instance, on London interbank offer rate (LIBOR) while avoiding paying capital gains tax and keeping the stock.

7.0 REFERENCES/FURTHER READINGS

Crawford, G. and Sen, B. (1996). Derivatives for Decision Makers: Strategic Management Issues, New York*:* John Wiley & Sons.

Hull, J. C. (2006). Options, Futures and Other Derivatives (6th ed.). New Jersey: Prentice Hall.

Kiff, J., Elliott, J., Kazarian, E., Scarlata, J., Spackman, C. (2009). Credit Derivatives: Systemic Risks and Policy Options, IMF Working Papers (WP/09/254).

Mengle, D. (2007). Credit Derivatives: An Overview, *Economic Review (FRB Atlanta)*, 92(4)*:* 123-153.

Partnoy, F. and Skeel, Jr., D. A. (2007). The Promise and Perils of Credit Derivatives, *University of Cincinnati Law Review*, 75: 1019–1051.

Simkovic, M. (2011). Leveraged Buyout Bankruptcies, the Problem of Hindsight Bias, and the Credit Default Swap Solution, *Columbia Business Law Review*, 2011(1): 118-201.

Stever, R, Upper, C. and von Peter, G. (2007). *BIS Quarterly Review*, Bank for International Settlements.

UNIT 8: INVESTMENT PORTFOLIO IN PROPERTIES AND COMMODITIES

CONTENTS

1.0 INTRODUCTION

In the preceding study unit of the course material, we have discussed investment in derivatives. In this study unit, the discussion is on Investment in property and commodities. The former involves investing funds in real estate such as buying a house, renovating it, and reselling necessarily at a price greater than the initial cost, which results in profit. The latter investing in commodities involves committing investment funds in agricultural produce (e.g., soybeans, grains), precious stones, energy, and livestock. The means of investing in commodities include futures, stocks, mutual funds and index funds, and Exchange traded funds and exchange traded notes.

2.0 OBJECTIVES

After studying this unit, you should be able to:

- Explain Investment in Properties
- List and discuss sources of information for investment in property
- Mention and explain sources of cash flows in property investment

- Discuss risk management in property investment
- Explain foreclosure in property investment
- Discuss investment in commodities
- Identify and explain commodity investment channels
- Mention the types of commodities for investment
- Discuss the means of investing in commodities

3.0 MAIN CONTENT

3.1 INVESTMENT IN PROPERTIES

Investment in property involves investment which is aimed at diversifying your holdings beside stocks and bonds. For instance, investment in property can take the form of buying a house, renovating it, and reselling necessarily at a price greater than the initial cost, which results in profit. An investor can also acquires a building, renovates the structure, and then rents the apartments in it out to prospective occupiers. This arrangement brings in revenue on monthly, quarterly, half yearly or yearly or the basis of the laid down agreement between the lessor and the leasee. Such building or structure so acquired by the investor can as well be redeveloped into office spaces of different sizes for the purpose of renting them for generating periodic incomes to the investor. Renting of apartments to occupiers either for office accommodation or residential accommodation generates a steady periodic income just like a classic dividend-paying utility stock. Any price appreciation of the property becomes a bonus.

Basically, real estate refers to a form of asset that has some relative limited liquidity when compared to other forms of investment. Investment in real estate involves investment in property. Hence this form of investment involves acquisition on ownership basis for purpose of rental or sale at a price higher than the original cost. In related terms, real estate development involves taking appropriate steps to create some improvement on realty property, which forms an aspect of real estate investment strategy.

In the absence of mortgage financing, real estate investment can be capital intensive. Furthermore, this type of investment is said to be highly dependent on cash flow, that is, calls for streams of cash investment being sunk either for fresh development of structures (buildings) or for restructuring the existing ones for commercial use.

Real estate investment can be risky in nature, as a form of investment. One factor that can make real estate investment to result in failure is the absence of due diligence by the investors before plunging into such investment. However, it should be understood that the initial cash inflows are meant to take care of capital outlay and the preliminary expenses. Therefore, such initial cash inflows do not constitute profits for the investors. Furthermore, there is the issue of “flipping” practice whereby short term profit is desired by the speculators investors in real estate investment without required efforts. This is related to the former factor in some way because investors tend to overlook the fact that every investment has gestation period before profit generation. Profits in investment generally come after using the initial cash inflows to write off the preliminary expenses.

At the instance of locating a desired property for investment, an investor carries out the necessary preliminary investigation and verification of the condition and status of the property; called due diligence. The next step is for the investor to engage in negotiation regarding the price of the property and sale terms, with the owner or the agent. Once an agreement is reached, a contract of sale is then executed.

Some investors engage the services of real estate agents and real estate lawyers in using their professional status to facilitate the acquisition of the property. In most cases, some property investors prefer the services of lawyers instead of estate agents who could collude with phoney (unauthentic) owners of landed properties to dupe.

In the process of the transactions on real estate, the prospective investor will propose a formal offer to acquire the property and payment of "earnest money" to the seller. This is done at the commencement of negotiation so that to ensure a reserve of the investor's rights to complete the transaction if eventually the price and terms of sale are satisfactorily negotiated. Such initial deposit or payment, in some instances, may or may not be refundable, and it is regarded as a sign of the seriousness of the investor's intent to purchase.

In addition to the initial deposit, there are other terms regarding the offer which usually include some contingencies that give the investor the opportunity and time to carry out the due diligence, inspect the property, and obtain financing, among other requirements before the final purchase. In the interim regarding the contingency period, the investor usually possess the right to void the offer without penalty, and thereby get refund of the initial deposits (earnest money). In case, the period of contingencies elapses, rejecting the offer to purchase usually involves forfeiture of the initial deposits (earnest money). It can also calls for the payment of other penalties.

SELF ASSESSMENT EXERCISE 1
Describe real estate investment.

3.1.1 Sources of Information for Investment in Property

In many economies, the real estate markets are well structured as comparable to organized markets such as financial markets. This is because the real estate market has many instruments as products. This implies that individual properties are distinctive and cannot be interchanged directly. In essence, this singular factor constitutes an obvious challenge for investors who are prospecting to appraise prices of properties and implied investment opportunities.

Therefore, getting desirable properties in which to commit funds for the investment poses some daunting work and competition among investors in respect of acquisition of individual properties, which may be highly inconsistent because of information asymmetries in the real estate markets.

Such scenario in the real estate market tends to magnify transactional risk. Paradoxically, this also serves as avenue of opportunities for investors towards acquiring properties at good deal prices. Nevertheless, a variety of evaluation techniques are available with which to determine the value of properties before committing funds into it.

The most visible channels through which information on investment in properties can be obtained include the following:

(i) Market listings

This involves Listing Service, Commercial Information Exchange or publications in the media.

(ii) Property Magazines

In Nigeria, there are some publications that are specifically devoted to property information in the country's markets.

(iii) Estate Agency Services

The agency services are being provided by the Real estate agents and Real estate brokers. Some legal firms in Nigeria are also involved in providing estate agency services. All these charge appropriate commissions for their services.

(iv) Mortgage Banks and other Banks

Mortgage banks are specifically created to provide information and also facilitate investment in real estate.

(v) Public Auction

This involves announcements by the auctioneers regarding the sale of landed properties or estates in some choice locations in a specific country or other countries around the world.

(vi) Public Information on Private sales

The real estate agents can put up information on the sale of real estate for the owners. The owners of such properties can engage in such sale of their properties without the involvement of estate agents.

(vii) Real estate Speculators

These are regarded as intermediaries who profit from transactions on landed properties without taking possession of such properties. This is the practice of flipping in real estate business or market.

SELF ASSESSMENT EXERCISE 2

Mention and explain the various sources through which information on investment in properties can be obtained.

3.1.2 Sources of cash flows in Property Investment

An investment in property is capable of generating some revenue in form of cash inflows to the investor. Such sources of cash inflows are in four different ways such as highlighted and explained below.

1. Net operating income

This refers to the summation of all positive cash inflows from rents and other sources of ordinary income generated by a property, then minus the amount of ongoing expenses such as maintenance, utilities, fees, taxes, and other operating costs. The cost of servicing of debt, if acquired through mortgage is normally considered in this respect. On the bsis of this, a capitalization rate can be calculated as the ratio of net operating income to the purchase price of the asset; expressed as a percentage. This capitalization rate is a common measure of the performance of an investment property.

2. Tax shelter offsets

These occur in some three ways such as depreciation, which may sometimes be accelerated, tax credits, and carryover losses which tend to reduce tax liability charged against income from other sources for a period of about three decades. It is instructive to not that some tax shelter benefits can be transferable; it all depends on the laws governing tax liability in a particular economy in which the property is located.

3. Equity build-up

This refers to the increase in the investor's equity ratio as the portion of debt service payments devoted to principal accrue over time. Equity build-up counts as a positive cash flow from the asset where the debt service payment is made out of income from the property, rather than from independent income sources.

4. Capital appreciation

This refers to the rise in the prevailing price (market value) of the property over a period of time, being realized as a cash inflow whenever the property is sold. Capital appreciation can be very unpredictable unless it is part of a development and improvement strategy.

Speculation involves purchasing of a property for which the majority of the projected cash flows are expected from capital appreciation; indicative of rise in prices, rather than other sources is considered and not investment.

SELF ASSESSMENT EXERCISE 3

List and discuss the various sources of cash flows in Property Investment.

3.1.3 Risk Management in Property Investment

The real estate investment calls for a strategy in terms of management and evaluation of risk involved in the business.

Risks in this form of investment can occur in many different ways regarding every stage of the investment process. Some risks are identified below with strategies for mitigating them in real estate investment.

Figure 1: Risks in Property Investment and strategies for mitigating them

Form of Risk	Strategy for Mitigation
i. Fraudulent sale	Verification of ownership and taking insurance policy on purchase title.
ii. Adverse possession	Acquire a boundary survey from a licensed surveyor or from relevant government department.
iii. Environmental contamination	Obtain environmental survey, test for contaminants such as lead paint, asbestos, soil contaminants, among others.
iv. Building system failure	Ensure full inspection before making the purchase and making regular maintenance.
v. Overpayment in price	Use third party judgment and perform discounted flow in purchase analysis; not relying on current market appreciation.
vi) Economic downturn	Acquire properties with distinct features to stand out from competition; control cost structure; make tenants sign long term leases.
vii) Destruction of property by tenants	Screen potential tenants and use experienced estate managers.
viii) Market decline	Acquire properties based conservative approach on understanding that the market might decline and rental income may also decrease.
ix) General wear and tear	Constant maintenance using professionals; plumbers, builders, electricians, carpenters, etc.

x) Fire, flood, personal Injury	Take insurance policy on the property for these risks.

Source: Wikipedia (2017). Accessed on 10 September, 2017 from

3.1.4 Foreclosure in Property investment

A property in the possession of buyer can become a foreclosure if he or she (the home owner) fails to make a mortgage payment for at least three months (90 days). Some investors and companies do engage in transactions in respect of purchasing properties that are in foreclosure.

Such properties can be acquired prior to the foreclosure auction (pre-foreclosure) or at the venue of foreclosure auction, normally carried out in the eyes of the public. In case the property is acquired during the process of the foreclosure auction, the property ownership of will be returned back to the lender that originally owns the mortgage on the property.

However, at the instance of the property being sold at the foreclosure auction and the foreclosure process is sealed, the lender may keep the proceeds to satisfy their mortgage and any legal costs that they incurred. The bank that is involved in the foreclosure is under obligation to continue to respect the tenancy agreement if there is a tenant in the property. However, usually as a rule, the bank would desire the property be vacant so as to sell it more easily. This implies that foreclosed property, also known as distressed assets, are regarded as worthwhile investments. This arises from the fact that the bank or mortgage company involved would not be like to sell the property for more than is pledged against it.

SELF ASSESSMENT EXERCISE 4

Discuss the term Foreclosure in Property Investment.

3.2 Investment in Commodities

Commodities constitute an important channel through which to diversify a portfolio in investment beyond traditional securities such as shares, bonds, debentures, etc. Such investment can be either for the long term, or as a place to invest cash during unusually volatile or bearish stock markets. In most cases, trading in commodities traditionally moves in opposition to stocks.

Gold as a precious metal in the commodity market drives most dealings because of its attractive for reasons such as being reliable, dependable metal with conveyable value. In sharp contrast to securities such as stock and bonds. Hence, investors who try to avoid volatile or bearish stock markets typically find metals attractive which encourages them in terms of scrambling to transfer their funds to precious metals such as gold, which has historically been viewed as a hedge against high inflation and currency devaluation (Credio, 2017).

Energy commodities are also attractive in commodities markets. Global economic developments and reduced oil outputs from wells around the world can lead to upward surges in oil prices, as investors weigh and assess limited oil supplies with ever-increasing energy demands. Economic downturns, production changes by the Organization of Petroleum Exporting Countries (OPEC) and emerging technological advances (such as wind, solar and biofuel) that aim to supplant (or complement) crude oil as an energy purveyor should also be considered.

Grains and other agricultural products have a very active trading market. They can be extremely volatile during summer months or periods of weather transitions. Population growth, combined with limited agricultural supply, can provide opportunities to ride agricultural price increases.

3.2.1 Commodity Investment Channels

Basically, some commodities exchanges (Credio, 2017) have either merged or gone out of business but still there are some multitudes of commodities exchanges around the world. While most of them trade in a few different commodities, some other ones specialize in single group of commodities. The London Metal Exchange only deals in metal commodities, going by its name.

There are some commodities in the U.S but the most popular exchanges include those being managed by CME Group. This emanated from the merger of Chicago Mercantile Exchange and Chicago Board of Trade in 2006. Amongst these exchanges are the New York Mercantile Exchange and Intercontinental Exchange in Atlanta and the Kansas City Board of Trade.

(i) Abuja Securities and Commodities Exchange
(ii) Africa Mercantile Exchange
(iii) Bhatinda Om & Oil Exchange Bathinda
(iv) Brazilian Mercantile and Futures Exchange
(v) Chicago Board of Trade
(vi) Chicago Mercantile Exchange
(vii) Commodity Exchange Bratislava, JSC
(viii) Dalian Commodity Exchange
(ix) Dubai Mercantile Exchange
(x) Dubai Gold & Commodities Exchange
(xi) Euronext.liffe
(xii) Ethiopia Commodity Exchange
(xiii) Hong Kong Mercantile Exchange
(xiv) Indian Commodity Exchange
(xv) Intercontinental Exchange
(xvi) Iranian Oil Bourse
(xvii) Kansas City Board of Trade
(xviii) London Metal Exchange
(xix) Minneapolis Grain Exchange
(xx) Multi Commodity Exchange
(xxi) National Commodity and Derivatives Exchange
(xxii) National Multi-Commodity Exchange of India Ltd
(xxiii) National Food Exchange
(xxiv) National Spot Exchange
(xxv) New York Mercantile Exchange
(xxvi) New York Board of Trade

(xxvii) Rosario Board of Trade
(xxviii) Tokyo Commodity Exchange
(xxix) Winnipeg Commodity Exchange

Commodity trading in the exchanges normally requires predetermined standards towards smooth execution of trades devoid of physical inspection. Hence it the responsibility of all parties to keep to the established norms regarding the terms and conditions that commodities must meet and proper for dealings in such exchanges. This is to avoid bad reputation for the Exchanges and traders themselves. Such established norms include quality, grades, colour, time of delivery, and at times, the country of origin for the commodities, among others.

The basic economic rules also apply in the dealings of commodities such as the interplays of demand and supply, which drive the commodities markets. Hence, when the quantity supplied is low, the demand will be driven upwards, which results in higher prices, and vice versa. Basically, any disruptions in supply of the commodities (e.g., widespread health scare among cattle) might lead to instability generally in markets thus leading to shocks and demand becomes unpredictable for livestock. Similarly, any global economic development and technological advances often impact on prices of the commodities. Fundamentally, therefore, the emergence of economies such as China and India in terms of their significant manufacturing feat has resulted in the declining availability of industrial metals like steel, for the other economies around the world (Credio, 2017).

3.2.2 Types of Commodities for Investment

According to Investopedia (2017), types of commodities that are for dealing in commodities markets include the following categories:

1) Metals:- these include gold, silver. platinum, diamond, and copper;

2) Energy:- these include crude oil, heating oil, natural gas and gasoline;

3) Livestock and Meat:- these include lean hogs, pork bellies, live cattle and feeder cattle; and

4) Agricultural:- these include corn, soybeans, wheat, rice, cocoa, coffee, cotton and sugar.

3.2.3 Means of Investing in Commodities

1. Futures

Invest in commodities in this wise involves future contract, which is an agreement to buy or sell, in the future, a specific quantity of a commodity at a specific price. Futures are available on every category of commodity. There are two types of investors participating in the futures markets such as: commercial or institutional users of the commodities; and speculators

Commercial or institutional users of the commodities are manufacturers and service providers using futures as part of their budgeting process, to normalize expenses and reduce cash flow-related headaches. They are hedgers using the commodity markets to take a position that will reduce the risk of financial loss due to a change in price. For instance, the airline sector as a large industry secures massive quantity of aviation fuel at stable prices for planning purposes. This makes airline companies to engage in hedging through futures contracts, as they purchase fuel at fixed rates (for a period of time) to avoid the market volatility of crude and gasoline. Another example is the farming cooperatives which also utilize futures.

Speculators are mainly individuals who speculate in the hope of profiting from changes in the price of the futures contract. Speculators are fond of typically concluding their stake before the contract is due and never take actual delivery of the commodity, for example, on grain and oil, among others.

2. Stocks

Another way of investing in commodities involves using stocks of companies in industries related to a commodity in some way such as oil which could be directed at drillers, refiners, tanker companies or diversified oil companies. Investors who have been discouraged by the gold bug could purchase stocks in mining companies, smelters or refiners, and any firm that deals with bullion generally.

Equity stocks are regarded as being less prone to volatile price swings when compared with futures. Acquisition of stocks can be easy, which can be held, traded and tracked, while it is possible to stake in a particular sector. It is instructive to note that investors need to carry out research towards ensuring that a particular firm is a good investment as well as a good commodity play.

Stock options requiring only smaller investment compare to buying stocks directly, constitute good invest in commodities. This is because risk is limited to the cost of the option, and the price movement will not usually directly reflect the underlying stock.

3. Mutual Funds and Index Funds

Mutual funds can invest in stocks of companies involved in commodity-related industries, such as energy, agriculture or mining. And just like the stocks they invest in, the fund shares may be affected by factors other than commodity prices, including stock market fluctuations and company-specific risks. A small number of commodity index mutual funds invest in futures contracts and commodity-linked derivative investments, thus providing more direct exposure to commodity prices.

4. Exchange Traded Funds and Exchange Traded Notes

Exchange traded funds (ETFs) and exchange traded notes (ETNs) trade like stocks, and they afford investors to participate in commodity price fluctuations without investing directly in futures contracts. Commodity exchange traded funds usually track the price of a particular commodity or group of commodities that constitute an index by using futures contracts. Exchange traded funds are unsecured debt which are designed to imitate the price fluctuation of a particular commodity or commodity index, and are backed by the issuer. A special brokerage account is not required to invest in any of these investment vehicles.

SELF ASSESSMENT EXERCISE 5

Mention and explain means of investing in commodities

4.0 CONCLUSION

There are some other ways through investment can be made. These are in the areas of properties and commodities. Investment in property involves investing funds that is aimed at diversifying your investment holdings, which can take the form of real estate investment such as buying a house, renovating it, and reselling necessarily at a price greater than the initial cost, which results in profit. There are many commodity exchanges around the world through which you can investment in commodities of which the Abuja Commodity Exchange is one of them. On the other hand, investing in commodities is in area of committing investment funds in agricultural produce (e.g., soybeans, grains), precious stones, energy, and livestock. The means of investing in commodities include futures, stocks, mutual funds and index funds, and Exchange traded funds (ETFs) and exchange traded notes (ETNs). In these types of investments, expert advice is strong advised to be considered so as to avoid making your funds go down the drain with recovery.

5.0 SUMMARY

In this initial study unit of the course material, you have been taught the following topics:

- Investment in Properties
- Sources of Information for Investment in Property
- Sources of cash flows in Property Investment
- Risk Management in Property Investment
- Foreclosure in Property investment
- Investment in Commodities
- Commodity Investment Channels
- Types of Commodities for Investment
- Means of Investing in Commodities

In the next study unit, we shall discuss using leveraging on debts and venture capital in creating wealth .

6.0 TUTOR MARKED ASSIGNMENT

1. Mention and explain the various sources through which information on investment in properties can be obtained.

2. List and discuss the various sources of cash flows in Property Investment.

3. Mention and explain means of investing in commodities

Answers to Self Assessment Exercises

1. Describe real estate investment.

Real estate refers to a form of asset that has some relative limited liquidity when compared to other forms of investment. Investment in real estate involves investment in property. Hence this form of investment involves acquisition on ownership basis for purpose of rental or sale at a price higher than the original cost.

In related terms, real estate development involves taking appropriate steps to create some improvement on realty property, which forms an aspect of real estate investment strategy. Furthermore, this type of investment is said to be highly dependent on cash flow, that is, calls for streams of cash investment being sunk either for fresh development of structures (buildings) or for restructuring the existing ones for commercial use.

2. Mention and explain the various sources through which information on investment in properties can be obtained.

The most visible channels through which information on investment in properties can be obtained include the following:

(i) Market listings
This involves Listing Service, Commercial Information Exchange or publications in the media.

(ii) Property Magazines
In Nigeria, there are some publications that are specifically devoted to property information in the country's markets.

(iii) Estate Agency Services
The agency services are being provided by the Real estate agents and Real estate brokers. Some legal firms in Nigeria are also involved in providing estate agency services. All these charge appropriate commissions for their services.

(iv) Mortgage Banks and other Banks
Mortgage banks are specifically created to provide information and also facilitate investment in real estate.

(v) Public Auction
This involves announcements by the auctioneers regarding the sale of landed properties or estates in some choice locations in a specific country or other countries around the world.

(vi) Public Information on Private sales

The real estate agents can put up information on the sale of real estate for the owners. The owners of such properties can engage in such sale of their properties without the involvement of estate agents.

(vii) Real estate Speculators
These are regarded as intermediaries who profit from transactions on landed properties without taking possession of such properties. This is the practice of flipping in real estate business or market.

3. List and discuss the various sources of cash flows in Property Investment.

An investment in property is capable of generating some revenue in form of cash inflows to the investor. Such sources of cash inflows are in four different ways such as highlighted and explained below.

i. Net operating income
This refers to the summation of all positive cash inflows from rents and other sources of ordinary income generated by a property, then minus the amount of ongoing expenses such as maintenance, utilities, fees, taxes, and other operating costs. The cost of servicing of debt, if acquired through mortgage is normally considered in this respect. On the bsis of this, a capitalization rate can be calculated as the ratio of net operating income to the purchase price of the asset; expressed as a percentage. This capitalization rate is a common measure of the performance of an investment property.

ii. Tax shelter offsets
These occur in some three ways such as depreciation, which may sometimes be accelerated, tax credits, and carryover losses which tend to reduce tax liability charged against income from other sources for a period of about three decades. It is instructive to
not that some tax shelter benefits can be transferable; it all depends on the laws governing tax liability in a particular economy in which the property is located.

iii. Equity build-up
This refers to the increase in the investor's equity ratio as the portion of debt service payments devoted to principal accrue over time. Equity build-up counts as a positive cash flow from the asset where the debt service payment is made out of income from the property, rather than from independent income sources.

iv. Capital appreciation
This refers to the rise in the prevailing price (market value) of the property over a period of time, being realized as a cash inflow whenever the property is sold. Capital appreciation can be very unpredictable unless it is part of a development and improvement strategy. Speculation involves purchasing of a property for which the majority of the projected cash flows are expected from capital appreciation; indicative of rise in prices, rather than other sources is considered and not investment.

4. Discuss the term Foreclosure in Property Investment.

A property in the possession of buyer can become a foreclosure if he or she (the home owner) fails to make a mortgage payment for at least three months (90 days). Some investors and companies do engage in transactions in respect of purchasing properties that are in foreclosure. Such properties can be acquired prior to the foreclosure auction (pre-foreclosure) or at the venue of foreclosure auction, normally carried out in the eyes of the public. In case the property is acquired during the process of the foreclosure auction, the property ownership of will be returned back to the lender that originally owns the mortgage on the property. However, at the instance of the property being sold at the foreclosure auction and the foreclosure process is sealed, the lender may keep the proceeds to satisfy their mortgage and any legal costs that they incurred.

5. Mention and explain means of investing in commodities

i. Futures

Invest in commodities in this wise involves future contract, which is an agreement to buy or sell, in the future, a specific quantity of a commodity at a specific price. Futures are available on every category of commodity. There are two types of investors participating in the futures markets such as: commercial or institutional users of the commodities; and speculators

ii. Stocks

Another way of investing in commodities involves using stocks of companies in industries related to a commodity in some way such as oil which could be directed at drillers, refiners, tanker companies or diversified oil companies. Investors who have been discouraged by the gold bug could purchase stocks in mining companies, smelters or refiners, and any firm that deals with bullion generally. Equity stocks are regarded as being less prone to volatile price swings when compared with futures. Acquisition of stocks can be easy, which can be held, traded and tracked, while it is possible to stake in a particular sector. It is instructive to note that investors need to carry out research towards ensuring that a particular firm is a good investment as well as a good commodity play.

iii. Mutual Funds and Index Funds

Mutual funds can invest in stocks of companies involved in commodity-related industries, such as energy, agriculture or mining. And just like the stocks they invest in, the fund shares may be affected by factors other than commodity prices, including stock market fluctuations and company-specific risks. A small number of commodity index mutual funds invest in futures contracts and commodity-linked derivative investments, thus providing more direct exposure to commodity prices.

iv. Exchange Traded Funds and Exchange Traded Notes

Exchange traded funds (ETFs) and exchange traded notes (ETNs) trade like stocks, and they afford investors to participate in commodity price fluctuations without investing directly in futures contracts. Commodity exchange traded funds usually track the price of a particular commodity or group of commodities that constitute an index by using futures contracts. Exchange traded funds are unsecured debt which are designed to imitate the price fluctuation of a particular commodity or commodity index, and are backed by the issuer. A special brokerage account is not required to invest in any of these investment vehicles.

7.0 REFERENCES AND FURTHER READING

Bytom Lauricella (2009, November 2). Gold Mutual Funds Vs. Gold ETFs: It Depends on the Goal. Wall Street Journal, US.

Credio, G. (2017). Commodities Trading: An Overview, Investopedia. Accessed on 10 January, 2017 from http://www.investopedia.com/investing/commodities-trading-overview/#ixzz4fXERoO2Y

Garner, C. (2010). *A Trader's First Book on Commodities*, New Jersey: Financial Times Press.

Investopedia (2017). Commodities Trading: An Overview. Accessed on 10 January, 2017 from http://www.investopedia.com/investing/commodities-trading-overview/#ixzz4fXERoO2Y

O'Sullivan, A. and Sheffrin, S. M. (2003). *Economics: Principles in Action*, Upper Saddle River, NJ: Pearson Prentice Hall.

Sackheim, M., Schmidtberger, M. and Munsell, J. (2006). DB Commodity Index Tracking Fund: An Innovative Exchange-Traded Fund, Futures Industry, May/June 2006.

Stringham, E. (2003). The Extralegal Development of Securities Trading in Seventeenth Century Amsterdam, *Quarterly Review of Economics and Finance*, 43(2): 321 342.

UNIT 9: LEVERAGING ON DEBTS & VENTURE CAPITAL IN CREATING WEALTH

CONTENT

1.0 INTRODUCTION

Investment in business implies the use of capital, which is the funding for the operations of the venture. The capital structure is made up of two parts. The first one is the owners' capital or owners' equity and the second one is the debts capital. Debts refer to funds which have to be secured from outside sources such as commercial banks, microfinance banks, private lenders, and cooperative societies, among others. In this study unit, therefore, the discussion is on using debts, other people's money, and venture capital to create wealth through investment.

2.0 OBJECTIVES

After studying this unit, you should be able to:

- Differentiate between equity capital and debt capital
- List and explain sources of debt capital
- Explain venture capital
- Mention advantages of venture capital
- Discuss the nature of funding from venture capitalists

- List and explain financing stages of venture capital

3.0 MAIN TEXT

3.1 EQUITY CAPITAL AND DEBT CAPITAL

Equity capital refers to the owners' contribution to the capital funding of the business. Such contribution is normally in form of shareholding called ordinary shares. The ordinary share is a unit of capital ownership in a firm in terms of equity investment by the shareholders. The ordinary shares do attract returns at the end of the trading period (normally 12 months). It accords its holders right of ownership in the asset of the firm. The ordinary shareholder can vote in the annual general meeting of the firm. Currently in a public company no single individual is allowed to own more than ten percent of the total issued shares of the firm. The ordinary share is assets (a financial asset) that are traded at will. Normally dividends can be paid as return to holders of ordinary shares.

Debt capital refers to the amount of funds in the structure of the capital that is borrowed from outside sources of financing. This capital is entitled to periodic interest payment, and principal repayments of the original amount borrowed, from the operations of the business Examples include term loans from commercial banks. Some other debts only attract periodic payment of interest rates while the whole amount of principal is repaid after the maturity date of the debts. Examples are debentures and bonds. There exist also the preference shares. The implication of debt capital is that lenders have a legal right to interest on a loan and repayment of the capital irrespective of the success or failure of a business.

SELF ASSESSMENT EXERCISE 1
Differentiate between equity capital and debt capital.

3.1.1 SOURCES OF DEBT CAPITAL

1. Preference Shares
The preference shares are debt instruments in a firm. The holders of preference share are not owners of the firm since they cannot vote in the AGM of their firm. Preference share attract fixed dividend or interest. For example, a ten percent preference share of N150,000 will attract a finance interest of N15,000. However, the preference share is also regarded as shares in firm depending on the nature of the preference share. There are several forms of preference shares. There is the cumulative preference share, participating preference share convertible preference share, redeemable preference shares etc.

2. Debentures
These are long term debt securities normally offered for public subscription. They generally attract a fixed rate of return called interest. Most times Debentures are securities in a particular asset of the firm in such case tagged secured debenture. An unsecured debenture is one not

secured on any particular asset of the firm. Debentures are mostly sold either at premium or at discount.

3. Bonds

Bonds are sometimes issued with stock warrants attached. Warrants are options to purchase common stock at a specified price up to a specified date. Should the bondholder decide to exercise the option and purchase stock, it is not necessary to surrender the underlying bond. Again, bondholders will exercise their warrants only if the market value of the stock exceeds the specified (exercise) price of the warrant. Bonds are an important source of capital for the federal government, states and municipalities, and private corporations. However, private-sector equity financing in the form of common stock has historically been a more important source of financing.

4. Mortgages

Mortgages are long-term loans that are secured by real property. They are long-term liabilities collateralized by real property. Commonly, monthly payments are made that fully repay both principal and interest over the term of the loan. Mortgages are issued to purchase real estate. Commercial mortgages are used to finance real estate for business purposes, such as office buildings and shopping malls. These mortgages have consistently grown faster than multifamily-dwelling mortgages and even faster than home mortgages.

5. Bank Term Loan

This refers to the loan facility being granted by commercial banks, which is meant to be used in the operations of the business for a period of time in years. Such loan is normally repaid on periodic basis; on reducing balance basis until the remaining amount is paid at the end of the repayment period. The loan facility also attracts payment of interest on periodic basis, say, every three months, six months, depending on the term of agreement between the bank and the business.

SELF ASSESSMENT EXERCISE 2

List and explain the available sources for raising debt capital.

3.2 VENTURE CAPITAL

New ventures normally generate initial capital called seed capital through personal savings and loans from relations, friends, and cooperative societies. Furthermore, such business setups do also seek funds from angel investors and accelerators. Once the business survives the initial teething problems and grows, it can then seek additional funding from venture capital firms.

Venture capital (VC) is a form of private equity that involves financing being provided by firms which engages in such form of funding businesses. Such funds are normally provided for firms that are deemed to have high growth potential, and actually demonstrate to have high growth in respect of number of employees and annual revenue, or even both indices. The firms that engage in venture capital funding invest in early-stage businesses with the sole intention of taking up part of the equity (an ownership stake) in such companies for their investment.

The venture capitalists assume some risk of financing the risky start-ups with the hopes such firms in which they invest their funds will become successful. More often than not, the venture capitalists prefer firms in innovative technology or business model, usually in high technology industries; information technology (IT), clean technology or biotechnology.

Venture capitalists will provide financing in the interest of generating some return through a subsequent exit such as the company selling shares to the public in an initial public offering (IPO) or going into merger and acquisition, which is called a "trade sale" of the company.

The venture capital firms usually secure significant control over the company decisions for their investment because of the high risk that they assume by investing in smaller and early-stage companies. This is besides the significant portion of the companies' ownership and the value. In some companies that are considered to be highly valued startups, venture capitalists contribute more than financing for these early-stage firms. In addition, VCs also often provide strategic advice to the firm's executives on its business model and marketing strategies.

SELF ASSESSMENT EXERCISE 3
Explain the term Venture Capital.

3.2.1 Advantages of Venture capital financing

1. Venture capital fund enhances the growth of new business startups for the fund provided that is purely private equity in nature.

2. Venture capital funding does not constitute any regular financial obligations for the firm because it is not a debt financing.

3. The venture capital framework can also be used by both private and public sectors in establishing an institution that can systematically create business networks for the new firms and industries.

4. The institutional setup can aid in identify promising new firms and thereby offer them with needed funding.

5. The venture capital firms usually provide technical expertise, mentoring, marketing expertise, and business models.

6. The venture capital scheme ensures successful operations of the companies in which the capitalists invest their funds.

7. Venture capital schemes can turn into channels for networks in designing and building products in their domain.

SELF ASSESSMENT EXERCISE 4
Mention the advantages of venture capital financing.

3.2.2 Nature of Funding from Venture Capitals

Obtaining venture capital is very much different from raising debt or a loan. Venture capital constitutes an invested in exchange for an equity stake in the business. The return of the venture capitalist as a shareholder depends on the growth and profitability of the business. In general terms, this return can be earned when the venture capitalist sells off its shareholdings in the process of the initial public offer; sale of shares to other investors through the capital market.

There is the issue of being very selective by venture capitalists, when investing in firms because they normally look for the sought-after qualities such as innovative technology, potential for rapid growth, and a well-developed business model as well as an impressive management team. Furthermore, venture capitalists are most interested in ventures with exceptionally high growth potential. They consider such companies as the only opportunities that are mostly capable of providing financial returns and a successful exit within their own required time frame ranging within a period of less a decade.

In order to ensure wise investment, venture capitalists take some other step before providing for funds for illiquid investment. Since they would not want to extend their time frame to gain the required harvest of returns, venture capitalists usually carry out detailed investigation (due diligence) prior to their investment.

The venture capitalists also nurture the companies in which they invest in order to increase the likelihood of reaching an initial public offer stage when market valuations are favourable to them. Basically, the venture capitalists provide assistance at four stages in company's development such as idea generation, startups, ramp up, and exit.

The fact that there are no public exchanges for the listing the securities of venture capitalists, private companies normally meet venture capital firms and other private equity investors in several ways. Such ways include the followings:

- i) Warm referrals from the investors' trusted sources and other business contacts;
- ii) Investor conferences and symposia;
- iii) Summits where companies pitch directly to investor groups in face-to-face meetings;
- iv) “Speed Venturing” that is likened to speed-dating for capital where the investor decides within some minutes whether he wants a follow-up meeting.
- v) Some new private online networks have emerged in provide additional opportunities for meeting investors.

The quest for high returns by the venture capitalists makes venture funding somehow expensive source of capital for companies. It is therefore, most ideal for businesses that have large up-front capital requirements, which cannot be funded through other sources of finance. This is particularly applicable to companies that are associated with intangible assets such as software and other intellectual property businesses; their value is always unverified. Hence, this accounts for the reason why venture capital is mostly found in the fast-growing businesses such as technology and life sciences (biotechnology) areas.

The venture capitalists are normally interested in companies having the qualities which they desire seek. And such qualities include the following:

i) a solid business plan;
ii) a good management team;
iii) investment and passion from the founders;
iv) a good potential to exit the investment before the end of their funding cycle; and
v) a minimum returns in excess of forty percent annually.

3.2.3 Financing stages of Venture Capital

Basically, six stages are involved in venture round financing being provided by venture capitalists. Such phases of funding are said to approximately correspond to the stages of a company's development.

1. Seed funding

This is the earliest round of financing needed to prove a new idea, often provided by angel investors. Equity crowd funding is also available in advanced economies as an option for seed funding.

2. Start-up

This involves the early stage firms that need funding for expenses associated with marketing and product development.

3. Growth (Series A round)

This involves early sales and manufacturing funds. This is where the where typically, the VCs come in for financing. Series A can be likened to the first institutional round. The subsequent forms of investment rounds are regarded as Series B, Series C and so on. This is a period during which most companies will have the most growth.

4. Second-Round

This involves provision of working capital for early stage companies that are selling product, but not yet making profits. This can also be regarded as Series B round and others.

5. Expansion

This is regarded as mezzanine financing. Such funding is meant for the expansion of a company that has just started earning profits

6. Bridge Financing

This is provided is when a startup seeks funding in between full venture capital rounds. The sole purpose is for the firm concerned to raise smaller amount of money instead of a full round and usually the existing investors participate.

SELF ASSESSMENT EXERCISE 5
Mention and explain various types of venture capital financing.

4.0 CONCLUSION

You have been taken the discussion on how to make use of debt financing to create wealth through business undertaking. Investment in business implies the use of capital, which is the funding for the operations of the venture. The capital structure is made up of two parts. The first one, as you have seen from the discussion, is the owners' capital or owners' equity while and the second one is the debts capital Debts involves the use of capital funds from outside sources such as commercial banks, microfinance banks, private lenders, and cooperative societies, among others. Venture capital is normally introduced into a business at certain stage of its operations, which can also be used to create wealth in the business.

5.0 SUMMARY

In this study unit, we have discussed topics such as:
3.1 Equity Capital and Debt Capital
3.1.1 Sources of Debt Capital
3.2 Venture Capital
3.2.1 Advantages of Venture Capital Financing
3.2.2 Nature of Funding from Venture Capitals
3.2.3 Financing Stages of Venture Capital

In the next study unit, we shall discuss intellectual property and royalties.

6.0 TUTOR MARKED ASSIGNMENT

1. List and explain the available sources for raising debt capital.
2. Mention and explain various types of venture capital financing.

Answers to SEAs

1. Differentiate between equity capital and debt capital.

Equity capital refers to the owners' contribution to the capital funding of the business. Such contribution is normally in form of shareholding called ordinary shares. The ordinary share is a unit of capital ownership in a firm in terms of equity investment by the shareholders. The ordinary shares do attract returns at the end of the trading period (normally 12 months). It accords its holders right of ownership in the asset of the firm. The ordinary shareholder can vote in the annual general meeting of the firm.

Debt capital refers to the amount of funds in the structure of the capital that is borrowed from outside sources of financing. This capital is entitled to periodic interest payment, and principal repayments of the original amount borrowed, from the operations of the business Examples include term loans from commercial banks. Some other debts only attract periodic payment of interest rates while the whole amount of principal is repaid after the maturity date of the debts. Examples are debentures and bonds. There exist also the preference shares. The implication of debt capital is that lenders have a legal right to interest on a loan and repayment of the capital irrespective of the success or failure of a business.

2. List and explain the available sources for raising debt capital.

1. Preference Shares
The preference shares are debt instruments in a firm. The holders of preference share are not owners of the firm since they cannot vote in the AGM of their firm. Preference share attract fixed dividend or interest. For example, a ten percent preference share of N150,000 will attract a finance interest of N15,000. However, the preference share is also regarded as shares in firm depending on the nature of the preference share. There are several forms of preference shares. There is the cumulative preference share, participating preference share convertible preference share, redeemable preference shares etc.

2. Debentures
These are long term debt securities normally offered for public subscription. They generally attract a fixed rate of return called interest. Most times Debentures are securities in a particular asset of the firm in such case tagged secured debenture. An unsecured debenture is one not secured on any particular asset of the firm. Debentures are mostly sold either at premium or at discount.

3. Bonds
Bonds are sometimes issued with stock warrants attached. Warrants are options to purchase common stock at a specified price up to a specified date. Should the bondholder decide to exercise the option and purchase stock, it is not necessary to surrender the underlying bond. Again, bondholders will exercise their warrants only if the market value of the stock exceeds the specified (exercise) price of the warrant. Bonds are an important source of capital for the federal government, states and municipalities, and private corporations. However, private-sector equity financing in the form of common stock has historically been a more important source of financing.

4. Mortgages

Mortgages are long-term loans that are secured by real property. They are long-term liabilities collateralized by real property. Commonly, monthly payments are made that fully repay both principal and interest over the term of the loan. Mortgages are issued to purchase real estate. Commercial mortgages are used to finance real estate for business purposes, such as office buildings and shopping malls. These mortgages have consistently grown faster than multifamily-dwelling mortgages and even faster than home mortgages.

5. Bank Term Loan

This refers to the loan facility being granted by commercial banks, which is meant to be used in the operations of the business for a period of time in years. Such loan is normally repaid on periodic basis; on reducing balance basis until the remaining amount is paid at the end of the repayment period. The loan facility also attracts payment of interest on periodic basis, say, every three months, six months, depending on the term of agreement between the bank and the business.

3. Explain the term Venture Capital.

Venture capital (VC) is a form of private equity that involves financing being provided by firms which engages in such form of funding businesses. Such funds are normally provided for firms that are deemed to have high growth potential, and actually demonstrate to have high growth in respect of number of employees and annual revenue, or even both indices. The firms that engage in venture capital funding invest in early-stage businesses with the sole intention of taking up part of the equity (an ownership stake) in such companies for their investment.

The venture capitalists assume some risk of financing the risky start-ups with the hopes such firms in which they invest their funds will become successful. More often than not, the venture capitalists prefer firms in innovative technology or business model, usually in high technology industries; information technology (IT), clean technology or biotechnology. Venture capitalists will provide financing in the interest of generating some return through a subsequent exit such as the company selling shares to the public in an initial public offering (IPO) or going into merger and acquisition, which is called a "trade sale" of the company.

4. Mention the advantages of venture capital financing.

1. Venture capital fund enhances the growth of new business startups for the fund provided that is purely private equity in nature.

2. Venture capital funding does not constitute any regular financial obligations for the firm because it is not a debt financing.

3. The venture capital framework can also be used by both private and public sectors in establishing an institution that can systematically create business networks for the new firms and industries.

4. The institutional setup can aid in identify promising new firms and thereby offer them with needed funding.

5. The venture capital firms usually provide technical expertise, mentoring, marketing expertise, and business models.

6. The venture capital scheme ensures successful operations of the companies in which the capitalists invest their funds.

7. Venture capital schemes can turn into channels for networks in designing and building products in their domain.

5. Mention and explain various types of venture capital financing.

1. Seed funding

This is the earliest round of financing needed to prove a new idea, often provided by angel investors. Equity crowd funding is also available in advanced economies as an option for seed funding.

2. Start-up

This involves the early stage firms that need funding for expenses associated with marketing and product development.

3. Growth (Series A round)

This involves early sales and manufacturing funds. This is where the where typically, the VCs come in for financing. Series A can be likened to the first institutional round. The subsequent forms of investment rounds are regarded as Series B, Series C and so on. This is a period during which most companies will have the most growth.

4. Second-Round

This involves provision of working capital for early stage companies that are selling product, but not yet making profits. This can also be regarded as Series B round and others.

5. Expansion

This is regarded as mezzanine financing. Such funding is meant for the expansion of a company that has just started earning profits

6. Bridge Financing

This is provided is when a startup seeks funding in between full venture capital rounds. The sole purpose is for the firm concerned to raise smaller amount of money instead of a full round and usually the existing investors participate.

7.0 REFERENCES/FURTHER READING

Ante, S. E. (2008). *Creative Capital: Georges Doriot and the Birth of Venture Capital.* Cambridge, MA: Harvard Business School Press.

Metrick, A. (2007). *Venture Capital and the Finance of Innovation*, New York: John Wiley & Sons.

Ross, W. J. (2008). *Corporate Finance*, 8th Edition, New Jersey: McGraw-Hill publishing.

Röhm, P., Köhn, A., Kuckertz, A. and Dehnen, H. S. (2017). A world of difference? The impact of corporate venture capitalists’ investment motivation on startup valuation, *Journal of Business Economics*.

UNIT 10: INTELLECTUAL PROPERTY AND ROYALTIES

CONTENTS

1.0 INTRODUCTION

The preceding study unit, we have discussed leveraging on debts and venture capital in creating wealth. There are other ways through which you can create wealth for yourself such as invention and creativity, and engaging in technological advancement, among others with which to earn royalties. In this study unit, therefore, we shall discuss intellectual property and royalties.

2.0 OBJECTIVES

After studying this unit, you should be able to:

- Explain the term intellectual property
- Identify and discuss intellectual property rights
- Discuss the justification for intellectual property
- Explain royalties
- Identify and discuss situations warranting payment of royalties
- Mention and explain factors determining rate of royalty

3.0 MAIN CONTENT

3.1 INTELLECTUAL PROPERTY

Intellectual property is regarded as the creations of the intellect for which a monopoly is granted to the designated owners by law. By implication, intellectual property rights constitute the rights conferred on the creators of intellectual property. These rights include trademarks, copyrights patents, industrial designs, and trade secrets, in some jurisdictions. The artistic works include music and literature, discoveries, inventions, words, phrases, symbols, and designs, which all come under the protection of the intellectual property (Bettig, 1996; Arai, 2000).

Intellectual property, according to World Intellectual Property Organization (2017), refers to creations of the mind like inventions, literary and artistic works, designs, symbols, names and images that are used in the world of commerce. Furthermore, the IP organization maintains that Intellectual property is protected in law (e. g., by patents, copyrights, and trademarks) which enables people to earn recognition or financial benefit from their creations. The main purpose of IP system is towards fostering an environment in which creativity and innovation can thrive.

According to The Free Dictionary (2017), intellectual property refers to the intangible rights protecting the products of human intelligence and creation like copyrightable works, patented inventions, trademarks, and trade secrets. In other words, intellectual property is a term that is used to describe a wide variety of property created by musicians, authors, artists, and inventors. The law of intellectual property essentially includes laws on intangibles such as copyrights, patents, and trademarks law, which is for the purpose of encouraging the development of art, science, intellectual ideas, and information technology. This is used to confer certain property rights to all artists and inventors in sciences and technology.

The IP laws grant these rights to artists and inventors towards protecting them from infringement and unauthorized utilization and misuse of their creations. For instance, trademarks and service marks are used to protect distinguishing features like names or package designs that are associated with particular products or services from commercial realm.

Some facts of law in relation to the intellectual property (The Free Dictionary, 2017) are as highlighted below.

i) Intellectual property laws are not in the category of criminal law jurisdiction *per se*. However, some copyright laws authorize criminal penalties.

ii) Although the body of intellectual property law is concerned with prevention and compensation, both of which are in the realm of civil matters. It implies therefore, that the owner and not the government, is responsible for enforcement.

iii) Intellectual property laws provide the owners with the power to enforce their property rights in civil court.

iv) Such laws provide for damages when in the cases of unauthorized use or misuse

v) Such laws also provide for injunctions, or court orders, to prevent unauthorized use or misuse of the rights.

SELF ASSESSMENT EXERCISE 1

What is Intellectual Property? Mention the facts of law relating to Intellectual Property.

3.2 INTELLECTUAL PROPERTY RIGHTS

The rights for the intellectual property are provided in some laws regulating it. These rights are discussed below based on the various types of intellectual property.

1. Work of Art

The intellectual property right (The Free Dictionary, 2017) confers on the owners some exclusive right to profit from a work for a particular limited period of time. In respect of *copyrighted* material, the exclusive right lasts for 70 years beyond the death of the author. In the case of the length of the right, it can vary for *patents*, but in most cases, it lasts for 20 years. *Trademark* rights are exclusive for ten years and can be continually renewed for subsequent ten-year periods.

The intellectual property that is protected by copyright laws must be fixed in a tangible form. For example, a musician may not claim copyright protection for a melody unless it has been written down or somehow actualized and affixed with a recognizable notation or recorded. Relatedly, a formula or device advanced by intellectuals may not receive patent protection unless it has been presented appropriately, and it must satisfy several tests for such to qualify for patent coverage. A symbol may not receive trademark protection unless it has been placed on goods or used in connection with services.

2. Copyrights

According to WIPO (2017), copyright involves a legal term that is used to describe the rights that creators have over their literary and artistic works. Works covered by copyright range from books, music, paintings, sculpture and films, to computer programs, databases, advertisements, maps and technical drawings.

Infringement of copyright is said to occur whenever someone exercises the exclusive rights of the copyright owner without the owner's permission. The infringement needs not be intentional. The copyright owners usually prove infringement in law court by providing that copying occurred and that such replication amounted to impermissible appropriation. These showings require that an analysis and comparison of the copyrighted work and the disputed work must be shown. However, many basic rules also relate to infringement of certain works. For instance, a character created in a particular copyrighted work may not receive copyright protection unless the character is developed in great detail and the other character in the disputed work closely resembles that original character (The Free Dictionary, 2017).

The copyright laws (The Free Dictionary, 2017) grant to authors, artists, composers, and publishers the exclusive right to produce and distribute expressive and original work. In t6his wise, only the expressive pieces, or writings, may qualify to receive copyright protection. For instance, writing needs not be words on paper; in copyright law, it could be a painting, sculpture, or other work of art. It is instructive to note that the writing element merely requires that a work of art, before receiving copyright protection, must be reduced to some tangible form. By implication, this may be on paper, on film, on audiotape, or on any other tangible medium that can be reproduced, that is, copied.

Basically, the writing requirement element is to ensure that copyrighted material is capable of being reproduced. Hence, in the absence of this requirement, artists could not be expected to know whether they were infringing on the original work of another. Furthermore, the writing requirement is also meant to enforce the copyright rule that ideas cannot be copyrighted; only the individualized expression of ideas can be protected.

Fundamentally, the copyrighted material must be original implying that there must be something sufficiently new about the work that sets it apart from previous similar works. Hence, if the variation is substantial, which is more than trivial, the work will merit copyright protection.

A copyrighted material can receive some varying degrees of protection. The scope of protection in this wise is generally limited to the original work that is in the writing. An instance is this: if an artist creates a carving of a natural phenomenon like the moon, he may not prevent others from making sculptures of such. The exception is this: the sculptor may prevent others from creating sculptures of the phenomenon that are exact replicas of his own sculpture.

There are some exclusive rights (The Free Dictionary, 2017) that are conferred in copyright protection, on the copyright holder are as presented below.

(i) Reproduce the copyrighted work,
(ii) Create derivative works from the work,
(iii) Distribute copies of the work,
(iv) Perform the work publicly, and
(v) Display the work.

In the case of the first two rights, they are protected whether they are infringed either or violated in public or in private. The last three rights can be infringed on only if they are violated in public. The term public showing is legally recognized as a performance or display to a "substantial number of persons" outside of friends and family (The Free Dictionary, 2017).

Some exceptions abound in exclusive rights of the copyright holder. The most important one is the "fair use" doctrine. This doctrine grants the general public to use copyrighted material without permission in certain situation such as in some educational activities, some literary and social criticism, some parody, and news reporting. The degree of fair in a particular depends on a number of factors like: its usage for profit; the percentage of the copyrighted material used; whether the work is fictional in nature; and what economic effect that the usage has on the copyright owner. The internet sites set up for free downloading of materials cannot an exception to the rule of exclusive rights of copyright owners (The Free Dictionary, 2017).

3. Patents

A patent, according to WIPO (2017) refers to an exclusive right conferred on an inventor for his invention. In general terms, a patent provides the patent owner with the right to decide how, or whether, the invention can be used by others. Essentially, in exchange for this right, the patent owner makes technical information about the invention publicly available in the published patent document.

In respect of the patent laws, they encourage private individuals towards investment in new technologies. This is because they grant the artists the right to forbid all others to produce and distribute technological information that is new, useful, and non-obvious. Essentially, therefore, the statutory requirements for patent protection are more stringent when compared with those for copyright protection. Furthermore, due to the fact that patent protection for commercial products or processes does confer a tremendous market advantage to businesses, those seeking patents often find opposition to their applications (The Free Dictionary, 2017).

4. Trademarks

The term trademark, according to WIPO (2017), refers to a sign capable of distinguishing the goods or services of one enterprise from those of other enterprises. Trademarks date back to ancient times when craftsmen used to put their signature or "mark" on their products.

Trademark laws, according to The Free Dictionary (2017), allow businesses to protect the symbolic information that relates to their goods and services, by preventing the use of such features by competitors. To receive trademark protection, a mark usually must be distinctive. *Distinctiveness* generally applies to any coined or fanciful word or term that does not closely resemble an existing mark. A mark generally will not receive trademark protection if it is a common or descriptive term used in the marketplace.

To receive trademark protection, a mark must be used in commerce. If two or more marketers claim ownership of a certain mark, the first user of the mark will usually receive the protection. When the mark is known to consumers only in a limited geographic area, though, it may not receive protection in areas where it is unknown.

Infringement occurs if a mark is likely to cause confusion among consumers. In determining whether confusion is likely, the court examines a number of factors, including the similarity between the two marks in appearance, sound, connotation, and impression; the similarity of the goods or services that the respective marks represent; the similarity of the markets; whether the sale of the goods or services is inspired by impulse or only after careful consideration by the buyer; the level of public awareness of the mark; whether shoppers are actually confused; the number and nature of similar marks on similar goods or services; the length of time of concurrent use without actual confusion on the part of shoppers; and the variety of goods or services that the mark represents.

5. Trade Secrets

Trade secret refers to any formula, pattern, device, or compilation of information that provides a business advantage over competitors who do not use or know of it. A strategy to increase worker productivity, for example, is a trade secret. Trade secrets do not receive patent protection because they are not inventive. Trade secret laws are included in intellectual property laws for the simple fact that, just like other intellectual property laws, they prevent the unauthorized use of certain intangible subject matter.

The right of publicity is the right of a person to control the commercial value and exploitation of his or her name, voice, or likeness. Because right-of-publicity laws promote artistic and commercial pursuits, they are included among intellectual property law. These laws are usually reserved for celebrities and other public figures whose name and image are important to their career. In allowing celebrities the right to control the commercial use of their name, voice, and image, right-of-publicity, the laws protect the commercial potential of such entertainers.

6. Industrial Design

An industrial design constitutes the ornamental or aesthetic aspect of an article. A design may consist of three-dimensional features, such as the shape or surface of an article, or of two-dimensional features, such as patterns, lines or color.

SELF ASSESSMENT EXERCISE 2
Mention and explain some Intellectual Property Rights.

3.3 JUSTIFICATION FOR INTELLECTUAL PROPERTY

There are several arguments (Moore, 2011) that justify intellectual property such as identified and explain below.

(i) Personality theory:- This theory posits that intellectual property is an extension of an individual.
(ii) Utilitarian Theory:- This believes that intellectual property stimulates social progress and pushes people to further innovation.
(iii) The Lockean argue that intellectual property is justified based on deservedness and hard work of the inventors.

These varied theoretical justifications for private property which have been used to argue for the essence intellectual property are elaborated on as follows:

3.3.1 Natural Rights/Justice Argument

This view is based on Locke's exposition that a person has a natural right over the labour and/or products which is produced by his/her body. Hence, in appropriating these products is regarded as unjust. However, Locke had never explicitly stated that natural right applied to products of the mind but it is possible to apply his argument to intellectual property rights. Nevertheless, it would be unjust for people to misuse another person's ideas. Locke's argument for intellectual property is based upon the idea that people have the right to control that which they create. Essentially, the argument is that people own their ideas and such this right of ownership extends to what they create. This implies that intellectual property ensures this right when it comes to production (*World Intellectual Property Organization, 2011)*.

3.3.2 Utilitarian-Pragmatic Argument

On this basis of this rationale, it is argued that a society that protects private property is more effective and prosperous than societies that do not. Innovation and invention in the modern American society, for instance, has been attributed to the development of the patent system (Reisman, 1996). In providing innovators with "durable and tangible return on their investment of time, labor, and other resources", intellectual property rights seek to maximize social utility (*Spinello, 2007)*. The presumption is that rights promote public welfare by encouraging the "creation, production, and distribution of intellectual works". On the whole, utilitarians argue that without intellectual property, there would be a lack of incentive to produce new ideas. Hence, systems of protection such as intellectual property optimize social utility (Maskus, 2000; Greenhalgh and Rogers, 2010).

3.3.3 Personality Argument

This view is hinged on basis of argument by Hegel. The philosopher argued that "Every man has the right to turn his will upon a thing or make the thing an object of his will, that is to say, to set aside the mere thing and recreate it as his own". European intellectual property law is shaped by this notion that ideas are an "extension of oneself and of one's personality". Personality theorists argue that by being a creator of something, one is inherently at risk and vulnerable for having their ideas and designs stolen and/or altered. Hence, intellectual property protects these moral claims that have to do with personality (Reisman, 1996; *World Intellectual Property Organization, 2011)*.

SELF ASSESSMENT EXERCISE 3
Mention and explain the three arguments relating to Intellectual Property Rights.

3.4 ROYALTIES

According to Encyclopedia of Business Terms (2007), royalties refer to some payments that are made by one company (the licensee) to another company (the licensor) in exchange for the right to use intellectual property (or physical assets), which are owned by the licensor. A classical example of intellectual property that qualifies for royalty is the Windows operating system for personal computers invented by the software giant, Microsoft; a means of managing files and performing computer operations. Furthermore, computer manufacturing firms such as IBM and Compaq pay royalties to Microsoft in exchange for their usage of the Windows operating system in their computers.

Furthermore, a royalty has been regarded as a payment that is made by one party such as the user (licensee or franchisee) of a patented right to the owner of the right (called licensor or franchisor) for the continuing usage of that asset. Royalty becomes some form of compensation to the holders of the rights, which is legally binding. Such payments are usually based on agreement in respect of percentage of the earnings (e.g., gross or net revenues) accruing from the usage of the right. The payment can also be based on a fixed price per unit of the product sold in respect of the usage of the unique right

A royalty (Investopedia, 2017) refers to the payment to the holder of a right or owner of an asset for the using the property. Examples of such rights include patents, copyrighted works, franchises or natural resources. The payment is normally made to the legal owner of the property, patent, copyrighted work or franchise. This involves the consideration that must be made by those who desire to put such property into use for purposes of generating revenue or other commercial activities.

3.4.1. Situations Warranting Payment of Royalties

According to Encyclopedia of Business Terms (2007), there are other common situations in which royalties are to be paid to the right holders. These situations are identified and discussed below.

1. Inventions and Discoveries

Royalties are normally paid for the holders of rights for their inventions and discoveries by the various users of the intellectual property. Examples are technological innovations (robots, drones, etc) and internet softwares like the Windows operating system for personal computers invented by Microsoft Corporation.

2. Designing in the Fashion Industry

Designers of fashionable materials such as dresses, shoes and bags, among others, do license the right to use their names on items of clothing to companies, in exchange for royalties. This implies that, for instance, they can sign a contract with fashion firms that produce jeans in order to allow such firms to emboss the designer's name on the products.

3. Book Publishing

Authors of books and other material prints are normally entitled some payment in advance on future royalties which is based on percentage of sales price. The authors are entitled to receive further royalties on periodic basis necessarily after sufficient sales are made with which to cover the advance payment.

4. Music and Songwriting

Royalties are normally paid to the holders of music copyright and songwriters by radio stations and any other parties who make use of such copyrighted materials for commercial benefits. The royalty for music takes the following forms:

(i) Royalties from "print rights;"
(ii) Mechanical royalties from the recording of composed music on CDs and tape;
(iii) Performance royalties from the performance of the compositions/songs on stage or television through artists and bands; and
(iv) Synch (for synchronization) royalties from using or adapting the musical score in the movies, television advertisements, etc. and

5. Electronic Media

Royalties are normally paid in the television industry, cable (satellite) network services (e.g., Direct TV and cable television services) to copyright holders so that they can broadcast those channels over their systems.

6. Mining Industry

The oil and gas companies in the petroleum industry do pay landowners or the government some royalties based on rate agreed upon by both parties or at prevailing rates for the right to extract natural resources. This is applicable to crude petroleum and natural gas being extracted from the landowner's property or the government. Such comparable agreements do exist in the mining industry for other minerals like copper and silver.

SELF ASSESSMENT EXERCISE 4
What is Royalty? Mention and explain situations warranting payment of royalties.

3.4.2 Factors Determining Rate of Royalty

The rate at which a royalty is determined is influenced by many factors. Such factors are as follows:

i) Market drivers and demand structure

ii) Territorial extent of rights
iii) Exclusivity of rights
iv) Level of innovation and stage of development
v) Sustainability of the technology
vi) Degree and competitive availability of other technologies
vii) Inherent risk
viii) Strategic need
ix) The portfolio of rights negotiated
x) Fundability
xi) Deal-reward structure (negotiation strength)

4.0 CONCLUSION

You have been to learn in this study unit that intellectual property involves the creations of the intellect for which a monopoly is granted to the designated owners by law. This implies that intellectual property rights constitute the rights conferred on the creators of intellectual property. These rights include trademarks, copyrights patents, industrial designs, and trade secrets, in some jurisdictions. Closely related to intellectual property is the issue of royalties. These are payments made by one company (the licensee) to another company (the licensor) in exchange for the right to use intellectual property (or physical assets), which are owned by the licensor. A good example of intellectual property that qualifies for royalty is the Windows operating system for personal computers invented by the software giant, Microsoft; a means of managing files and performing computer operations.

5.0 SUMMARY

In this initial study unit of the course material, you have been taught the following topics:

- Intellectual Property
- Intellectual property rights
- Justification for Intellectual Property
- Natural Rights/Justice Argument
- Utilitarian-Pragmatic Argument
- Personality Argument
- Royalties
- Situations Warranting Payment of Royalties
- Factors Determining Rate of Royalty

In the next study unit, you will be taken through financial market instruments.

6.0 TUTOR MARKED ASSIGNMENT

1. What is Intellectual Property? Mention the facts of law relating to Intellectual Property.
2. Mention and explain some Intellectual Property Rights.
3. What is Royalty? Mention and explain situations warranting payment of royalties.

Answers to SAE

1. What is Intellectual Property? Mention the facts of law relating to Intellectual Property.

Intellectual property is regarded as the creations of the intellect for which a monopoly is granted to the designated owners by law. By implication, intellectual property rights constitute the rights conferred on the creators of intellectual property. These rights include trademarks, copyrights patents, industrial designs, and trade secrets, in some jurisdictions. The artistic works include music and literature, discoveries, inventions, words, phrases, symbols, and designs, which all come under the protection of the intellectual property (Bettig, 1996; Arai, 2000).

Some facts of law in relation to the intellectual property (The Free Dictionary, 2017) are as highlighted below.

- i) Intellectual property laws are not in the category of criminal law jurisdiction *per se*. However, some copyright laws authorize criminal penalties.
- ii) Although the body of intellectual property law is concerned with prevention and compensation, both of which are in the realm of civil matters. It implies therefore, that the owner and not the government, is responsible for enforcement.
- iii) Intellectual property laws provide the owners with the power to enforce their property rights in civil court.
- iv) Such laws provide for damages when in the cases of unauthorized use or misuse
- v) Such laws also provide for injunctions, or court orders, to prevent unauthorized use or misuse of the rights.

2. Mention and explain some Intellectual Property Rights.

i. Work of Art

The intellectual property right (The Free Dictionary, 2017) confers on the owners some exclusive right to profit from a work for a particular limited period of time. In respect of *copyrighted* material, the exclusive right lasts for 70 years beyond the death of the author. In the case of the length of the right, it can vary for *patents*, but in most cases, it lasts for 20 years. *Trademark* rights are exclusive for ten years and can be continually renewed for subsequent ten-year periods.

ii. Copyrights

According to WIPO (2017), copyright involves a legal term that is used to describe the rights that creators have over their literary and artistic works. Works covered by copyright range from books, music, paintings, sculpture and films, to computer programs, databases, advertisements, maps and technical drawings.

Basically, the writing requirement element is to ensure that copyrighted material is capable of being reproduced. Hence, in the absence of this requirement, artists could not be expected to know whether they were infringing on the original work of another. Furthermore, the writing requirement is also meant to enforce the copyright rule that ideas cannot be copyrighted; only the individualized expression of ideas can be protected.

iii. Patents

A patent, according to WIPO (2017) refers to an exclusive right conferred on an inventor for his invention. In general terms, a patent provides the patent owner with the right to decide how, or whether, the invention can be used by others. Essentially, in exchange for this right, the patent owner makes technical information about the invention publicly available in the published patent document.

iv. Trademarks

The term trademark, according to WIPO (2017), refers to a sign capable of distinguishing the goods or services of one enterprise from those of other enterprises. Trademarks date back to ancient times when craftsmen used to put their signature or "mark" on their products.

v. Trade Secrets

Trade secret refers to any formula, pattern, device, or compilation of information that provides a business advantage over competitors who do not use or know of it. A strategy to increase worker productivity, for example, is a trade secret. Trade secrets do not receive patent protection because they are not inventive. Trade secret laws are included in intellectual property laws for the simple fact that, just like other intellectual property laws, they prevent the unauthorized use of certain intangible subject matter.

vi. Industrial Design

An industrial design constitutes the ornamental or aesthetic aspect of an article. A design may consist of three-dimensional features, such as the shape or surface of an article, or of two-dimensional features, such as patterns, lines or color.

3. Mention and explain the three arguments relating to Intellectual Property Rights.

i. Natural Rights/Justice Argument

This view is based on Locke's exposition that a person has a natural right over the labour and/or products which is produced by his/her body. Hence, in appropriating these products is regarded as unjust. However, Locke had never explicitly stated that natural right applied to products of the mind but it is possible to apply his argument to intellectual property rights. Nevertheless, it would be unjust for people to misuse another person's ideas. Locke's argument for intellectual property is based upon the idea that people have the right to control that which they create. Essentially, the argument is that people own their ideas and such this right of ownership extends to what they create. This implies that intellectual property ensures this right when it comes to production (*World Intellectual Property Organization, 2011)*.

ii. Utilitarian-Pragmatic Argument

On this basis of this rationale, it is argued that a society that protects private property is more effective and prosperous than societies that do not. Innovation and invention in the modern American society, for instance, has been attributed to the development of the patent system (Reisman, 1996). In providing innovators with "durable and tangible return on their investment of time, labor, and other resources", intellectual property rights seek to maximize social utility (*Spinello, 2007)*. The presumption is that rights promote public welfare by encouraging the "creation, production, and distribution of intellectual works". On the whole, utilitarians argue that without intellectual property, there would be a lack of incentive to produce new ideas. Hence, systems of protection such as intellectual property optimize social utility (Maskus, 2000; Greenhalgh and Rogers, 2010).

iii. Personality Argument

This view is hinged on basis of argument by Hegel. The philosopher argued that "Every man has the right to turn his will upon a thing or make the thing an object of his will, that is to say, to set aside the mere thing and recreate it as his own". European intellectual property law is shaped by this notion that ideas are an "extension of oneself and of one's personality". Personality theorists argue that by being a creator of something, one is inherently at risk and vulnerable for having their ideas and designs stolen and/or altered. Hence, intellectual property protects these moral claims that have to do with personality (Reisman, 1996; *World Intellectual Property Organization, 2011)*.

4. What is Royalty? Mention and explain situations warranting payment of royalties.

Royalties refer to some payments that are made by one company (the licensee) to another company (the licensor) in exchange for the right to use intellectual property (or physical assets), which are owned by the licensor. A classical example of intellectual property that qualifies for royalty is the Windows operating system for personal computers invented by the software giant, Microsoft; a means of managing files and performing computer operations.

i. Inventions and Discoveries

Royalties are normally paid for the holders of rights for their inventions and discoveries by the various users of the intellectual property. Examples are technological innovations (robots, drones, etc) and internet softwares like the Windows operating system for personal computers invented by Microsoft Corporation.

ii. Designing in the Fashion Industry

Designers of fashionable materials such as dresses, shoes and bags, among others, do license the right to use their names on items of clothing to companies, in exchange for royalties. This implies that, for instance, they can sign a contract with fashion firms that produce jeans in order to allow such firms to emboss the designer's name on the products.

iii. Book Publishing

Authors of books and other material prints are normally entitled some payment in advance on future royalties which is based on percentage of sales price. The authors are entitled to receive further royalties on periodic basis necessarily after sufficient sales are made with which to cover the advance payment.

iv. Music and Songwriting

Royalties are normally paid to the holders of music copyright and songwriters by radio stations and any other parties who make use of such copyrighted materials for commercial benefits.

v. Electronic Media

Royalties are normally paid in the television industry, cable (satellite) network services (e.g., Direct TV and cable television services) to copyright holders so that they can broadcast those channels over their systems.

vi. Mining Industry

The oil and gas companies in the petroleum industry do pay landowners or the government some royalties based on rate agreed upon by both parties or at prevailing rates for the right to extract natural resources. This is applicable to crude petroleum and natural gas being extracted from the landowner's property or the government. Such comparable agreements do exist in the mining industry for other minerals like copper and silver.

7.0 REFERENCES/FURTHER READING

Alderman, John. 2001. Sonic Boom: Napster, P2P, and the Battle for the Future of Music. New York: Perseus.

Arai, H. (2000). "Intellectual Property Policies for the Twenty-First Century: The Japanese Experience in Wealth Creation", WIPO Publication Number 834 (E).

Bettig, R. V. (1996). Critical Perspectives on the History and Philosophy of Copyright. In R. V. Bettig, Copyrighting Culture: The Political Economy of Intellectual Property. (pp. 9–32). Boulder, CO: Westview Press.

Burgunder, Lee B. 2002. "Reflections on *Napster*: The Ninth Circuit Takes a Walk on the Wild Side." *American Business Law Journal* 39 (summer): 683–707.

Byrne, John G. 1995."Changes on the Frontier of Intellectual Property Law: An Overview of the Changes Required by GATT." *Duquesne Law Review* 34 (fall): 121–37.

De George, R. T. (1998). 14 Intellectual Property Rights. In George G. Brenkert and Tom L. Beauchamp (eds.), The Oxford Handbook of Business Ethics, 1st ed.1, Oxford, England: Oxford University Press, 415–416.

Encyclopedia of Business Terms (2007). Royalties. Accessed on 25 September, 2017 from https://www.inc.com/encyclopedia/royalties.html

Goldstein, Paul. 2002. *Copyright, Patent, Trademark, and Related State Doctrines: Cases and Materials on the Law of Intellectual Property.* 5th ed. New York: Foundation Press.

Greenhalgh, C. & Rogers M., (2010). *Innovation, Intellectual Property, and Economic Growth,* New Jersey: Princeton University Press.

Gray, Megan E., and Will Thomas DeVries. 2003. "The Legal Fallout from Digital Rights Management Technology." *Computer and Internet Lawyer* 20 (April): 20–35.

Investopedia (2017). What is a Royalty? Accessed on 25 September, 2017 from http://www.investopedia.com/terms/r/royalty.asp#ixzz4tmch4yvy

Letterman, G. Gregory. 2001. *Basics of International Intellectual Property Law.* Ardsley, N.Y.: Transnational Publishers.

Maskus, K. E. (2000). Intellectual Property Rights and Economic Development, *Case Western Reserve Journal of International Law*, 32(3): 471-506.

McJohn, Stephen M., and Roger S. Haydock. 2003. *Intellectual Property: Examples and Explanations.* New York: Aspen.

Merriden, Trevor. 2001. Irresistible Forces: The Business Legacy of Napster and the Growth of the Underground Internet. New York: John Wiley and Sons.

Moore, Adam, Intellectual Property. The Stanford Encyclopedia of Philosophy (Summer 2011 Edition), Edward N. Zalta (ed.),

Reisman, G. (1996). *Capitalism: A Complete & Integrated Understanding of the Nature & Value of Human Economic Life*, Ottawa, Illinois, 388–389

Spinello, Richard A. (January 2007). "Intellectual property rights". Library Hi Tech. 25(1): 12–22

The Free Dictionary (2017). The Gale Group, Inc. Accessed on 8 September, 2017 from http://legal-dictionary.thefreedictionary.com/Intellectual+Property

Vaidhyanathan, Siva. 2001. *Copyrights and Copywrongs: The Rise of Intellectual Property and How It Threatens Creativity*. New York: New York Univ. Press.

World Intellectual Property Organization (2011). Human Rights and Intellectual Property: An Overview.

World Intellectual Property Organization (2017). What is Intellectual Property? Accessed on 25 September, 2017 from http://www.wipo.int/about-ip/en/

UNIT 11: FINANCIAL MARKET INSTRUMENTS

CONTENTS

1.0 INTRODUCTION

There are financial instruments that can be issued and used to run the operations of a corporate entity. Such instruments are traded in the financial markets. This implies that financial market refers to the type of market that is being used to deal in financial instruments. Some of these instruments are used for raising short term funds before being repaid back to the investors. There are other ones that are issued and used to raise funds for a long term period. The transactions on the former group of instruments take place in the money market while the transactions on the latter group of instruments take place in the capital market. In this study unit, therefore, we shall discuss all these financial instruments.

2.0 OBJECTIVES

After studying this unit, you should be able to:

- Explain financial market
- List and explain money market instruments
- Mention and discuss capital market instruments

3.0 MAIN CONTENT

3.1 CONCEPTUALIZATION OF FINANCIAL MARKET

The financial market exists for the purpose of mobilization and intermediation of fund. This implies that through the financial market, funds are transmitted from the surplus sector of the economy to the deficit unit of the economy. The funds as mobilized in this market might be a short term basis or a long term basis, depending on the nature of instrument involved and the method of transaction.

The operations of the financial market involve commercial banks, merchant banks, the development banks, finance houses and individuals such as stock brokers and investors. The Financial markets are generally categorized into two namely: the money market for raising short term funds and the Capital market for raising long term funds.

The maturity of financial instruments that are traded differentiates markets determines the nature of the market segments. If the securities traded are short-term instruments, the market is called a money market. When maturities exceed one (1) year, the market is considered a capital market. Another differentiation is whether the securities are new (offered in the primary market) or already existing (traded in the secondary market). When bills are sold to the public for the first time, the sale takes place in a primary money market. Investors buy or sell existing bills through dealers and these transactions occur in secondary money markets. A counterpart in the capital market would be an initial public offering of common stock; a primary capital market transaction. The subsequent exchange of stock through stockbrokers occurs in the secondary capital market.

SELF ASSESSMENT EXERCISE 1
Explain the term Financial Market.

3.1 MONEY MARKET AND INSTRUMENTS

The money market is the financial market in which financial instruments are traded with maturity of up to one (1) year. Money markets enable market participants to borrow or lend liquid assets and thereby meet needs for cash or investment of cash. The money market is characterized by availability of liquid assets. These are assets that may be converted into cash quickly, without significant loss of value. Investing excess liquid assets, that is, lending, reduces the opportunity cost of holding cash or cash equivalents. Borrowing short-term funds eliminates disruption that would be caused by temporary cash flow deficits.

Trading in such instruments also involves opportunity cost in respect of holding cash. The opportunity cost refers to that rate of return that could be earned if the next best alternative to cash were held by an investor, that is, that rate of return that is forgone when an investor holds cash. The federal government uses the money market to implement certain phases of monetary policy such as adjustments to the money supply. It does this through the Central Bank which establishes government objectives with respect to the money supply, interest rates, and credit availability.

The most widely traded money market instruments include Treasury bills, Repurchase agreements, Negotiable certificates of deposit, Commercial paper, and Bankers acceptances. Among all these instruments, the last three are traded in physical form. The remaining instruments are kept track of in book-entry form (electronic record keeping) with written confirmations.
Money market instruments have certain qualities that make them useful for wholesale (large) transactions such as follows:

i) Liquidity
This describes the ability to convert an asset into cash with relative ease while not significantly depressing its price in the process. It is perhaps the most important quality.

ii) Default risk

This is the risk of non-payment of principal or interest, which must be minimal in order for the security to be considered a safe haven for excess liquidity.

iii) Short time to maturity

This is given that adverse price movements attributable to interest rate changes are smaller for shorter-term assets, which helps ensure that interest rate changes will not affect the security's market value materially.

Money market instruments include the following:

1. **Treasury Securities**

Treasury securities are obligations of the government. They are issued to cover government budget deficits (excess of expenditures over revenues) and to refinance maturing government debt. The most common are bills, notes, and bonds. Treasury bills have original maturities of I year or less, while notes are for 1 to 10 years, and bonds have maturities greater than 10 years.

2. **Treasury bills (T-bills):**

Treasury securities are short-term obligations of the government with original maturities of 1 year or less. Treasury bills and other Treasury securities (with less than 1 year of remaining life) are the most important instruments in money markets.

3. **Federal Funds**

Federal funds are not formal securities. They are immediately available funds that are loaned or borrowed among financial institutions. Such funds are borrowed between financial institutions, usually for a period of 1 day -overnight.

4. **Call money:**

These are loaned funds that are repayable upon the request of either party. All transactions go through one of the licensed companies such as in Japanese. The term of a call money loan can range from a half-day to 7 days. Half- day money is borrowed at 9:00 A.M. and repaid at 1:00 P.M. or borrowed at 1:00 P.M. and repaid at 3:00 P.M. Unconditional money is repaid the following day. Fixed maturity money is repaid in 2 to 7 days.

5. **Overnight call Money and other short-term deposits**

These are traded in inter-bank market, an aspect of the money market (short-term exchange of liquid assets) for banks with no intermediary. Overnight call money and other short-term deposits are the common vehicles, and collateral is rarely required.

Some discount houses, or instance, in the United Kingdom have traditionally served to provide short-term credit in the U.K. banking system by entering into call money arrangements with individual banks. Banks with surplus funds lent them to discount houses, and banks in need of liquidity called in their discount house loans. More recently, however, a parallel set of money markets has developed.

6. **Repurchase agreement (repo):**

This is an agreement between buyer and seller in the sale of securities to reverse the transaction in the future at a specified date and price. These transactions commonly involve Treasury securities, but they may also involve government agency securities. Repurchase agreements are typically as short term in nature as federal funds (or call money). Overnight, term, or continuing basis repurchase agreements are all negotiated. Unlike collateralized federal funds transactions, in which title to the securities does not change, in a repurchase agreement title does transfer to the purchaser.

7. **Government agency securities:**

Securities issued by an agency of the federal government particularly in the U.S. with implicit backing of the federal government. Repurchase agreements are essentially collateralized loans. A financial institution with large holdings of Treasury securities sells some portion of them for a predetermined period of time to obtain liquidity and promises to repurchase the securities at the end of that period. On the other side of the transaction is an institution with excess liquidity. The amount of the transaction is relatively large, and the interest rate is below the federal funds rate. The lower rate is justified, because the transaction is collateralized by government securities.

8. **Negotiable Certificates of Deposit**

This is a financial instrument issued by a bank documenting a deposit, with principal and interest repayable to the bearer at a specified future date. The negotiable certificate of deposit is a bearer instrument and a term deposit but not demand deposit. Overtime, banks were able to increase the rate paid on negotiable CDs to attract more deposits as the need arose. This innovation brought widespread adoption of bank liability management, which enables banks to attract funds by offering higher interest rates and thereby changing their deposit base.

9. **Banker's acceptance:**

This is a time draft or postdated instrument payable to a seller of goods, with payment guaranteed by a bank. In these instruments, the credit of the bank substitutes for the credit of the purchaser, and the seller is ensured payment. Further, unlike an open trade credit arrangement (in which the seller provides credit for a period of time), the seller need not wait for payment. A banker's acceptance is immediately negotiable; the seller can either receive discounted payment at the accepting bank or hold the draft until the date of maturity. Banker's acceptances are particularly important in international trade with Maturities are 1, 3, or 6 months. Average maturity is 3 months.

SELF ASSESSMENT EXERCISE 2

Mention and explain instruments of money market.

3.3 CAPITAL MARKET AND INSTRUMENTS

These are markets in which financial instruments with maturities greater than 1 year are bought and sold. Corporations secure financing through capital markets by selling long-term claims on their firms, whether in the form of bonds (liabilities) or stock (equity). Governments go to capital markets for operating funds, and households use them for residential mortgage financing. This describes the capital market instruments that are issued and traded within national boundaries.

1. Ordinary Shares

The ordinary share is a unit of capital ownership in a firm in terms of equity investment by the shareholders. The ordinary shares do attract returns at the end of the trading period (normally 12 months). It accords its holders right of ownership in the asset of the firm. The ordinary shareholder can vote in the annual general meeting of the firm. Currently in a public company no single individual is allowed to own more than ten percent of the total issued shares of the firm. The ordinary share is assets (a financial asset) that are traded at will. Normally dividends can be paid as return to holders of ordinary shares. There exist also the preference shares.

2. Preference Shares

The preference shares are debt instruments in a firm. The holders of preference share are not owners of the firm since they cannot vote in the annual general meeting of their firm. Preference share attract fixed dividend or interest e.g. ten percent preference share of N150,000 will attract a finance interest of N15,000 . However, the preference share is also regarded as shares in firm depending on the nature of the preference share. There are several forms of preference shares. There is the cumulative preference share, participating preference share convertible preference share, redeemable preference shares etc.

3. Debentures

These are long term debt securities normally offered for public subscription. They generally attract a fixed rate of return called interest. Most times Debentures are securities in a particular asset of the firm in such case tagged secured debenture. An unsecured debenture is one not secured on any particular asset of the firm. Debentures are mostly sold either at premium or at discount.

4. Development Loan Stock

These are financial instruments that allow the government to borrow money for a long period of time up to 25 years, bearing interest and capital repayment, thereon. The principal amount can only be repaid back to the holder after the maturity date but the interest is normally on periodic basis as contained in the prospectus of the offer. The instrument is normally issued by the central bank on behalf of the government.

5. Bonds

Bonds are sometimes issued with stock warrants attached. Warrants are options to purchase common stock at a specified price up to a specified date. Should the bondholder decide to exercise the option and purchase stock, it is not necessary to surrender the underlying bond. Again, bondholders will exercise their warrants only if the market value of the stock exceeds the specified (exercise) price of the warrant. Bonds are an important source of capital for the federal government, states and municipalities, and private corporations. However, private-sector equity financing in the form of common stock has historically been a more important source of financing.

Municipal bonds include all debt instruments issued by local, county, and state governments. Issuers use proceeds from the sale of municipal bonds to finance public utilities, school construction, roads, transportation systems, and industrial development. An appealing feature is that municipal bond interest payments to the holder are exempt from federal income taxation.

6. Mortgages
Mortgages are long-term loans that are secured by real property. They are long-term liabilities collateralized by real property. Commonly, monthly payments are made that fully repay both principal and interest over the term of the loan. Mortgages are issued to purchase real estate. Commercial mortgages are used to finance real estate for business purposes, such as office buildings and shopping malls. These mortgages have consistently grown faster than multifamily-dwelling mortgages and even faster than home mortgages.

Self-Assessment Exercise 3
List and explain the various instruments being used to raise funds through the capital market.

4.0 CONCLUSION

The Financial Market exists for the purpose of mobilization funds, which are transmitted from the surplus sector of the economy to the deficit unit of the economy. The funds as mobilized in this market might be a short term basis or a long term basis, depending on the nature of instrument involved and the method of transaction. The financial market is divided into two distinct parts such as capital market and money market. These distinct markets have their peculiar financial instruments, each group reflecting peculiar maturity dates. Such financial instruments are not just for the use of the corporate entities but are also available for government use in raising funds for operations.

5.0 SUMMARY

In this study unit, we have discussed topics such as:

- Conceptualization of Financial Market;
- Money Market and Instruments; and
- Capital Market and Instruments.

In the next study unit, we shall discuss personal financial planning.

6.0 TUTOR MARKED ASSIGNMENT

1. Mention and explain instruments of money market.
2. List and explain the various instruments being used to raise funds through the capital market.

Answers to Self Assessment Exercises
1. Explain the term Financial Market.
Financial market exists for the purpose of mobilization and intermediation of fund. This implies that through the financial market, funds are transmitted from the surplus sector of the economy to the deficit unit of the economy. The funds as mobilized in this market might be a short term basis or a long term basis, depending on the nature of instrument involved and the method of transaction. The operations of the financial market involve commercial banks, merchant banks,

the development banks, finance houses and individuals such as stock brokers and investors. The Financial markets are generally categorized into two namely: the money market for raising short term funds and the Capital market for raising long term funds.

2. Mention and explain instruments of money market.
The money market instruments include the following:
i) Treasury Securities
Treasury securities are obligations of the government. They are issued to cover government budget deficits (excess of expenditures over revenues) and to refinance maturing government debt. The most common are bills, notes, and bonds. Treasury bills have original maturities of I year or less, while notes are for 1 to 10 years, and bonds have maturities greater than 10 years.

ii) Treasury bills (T-bills):
Treasury securities are short-term obligations of the government with original maturities of 1 year or less. Treasury bills and other Treasury securities (with less than 1 year of remaining life) are the most important instruments in money markets.

iii) Federal Funds
Federal funds are not formal securities. They are immediately available funds that are loaned or borrowed among financial institutions. Such funds are borrowed between financial institutions, usually for a period of 1 day -overnight.

iv) Call money:
These are loaned funds that are repayable upon the request of either party. All transactions go through one of the licensed companies such as in Japanese. The term of a call money loan can range from a half-day to 7 days. Half- day money is borrowed at 9:00 A.M. and repaid at 1:00 P.M. or borrowed at 1:00 P.M. and repaid at 3:00 P.M. Unconditional money is repaid the following day. Fixed maturity money is repaid in 2 to 7 days.

v) Overnight call Money and other short-term deposits
These are traded in inter-bank market, an aspect of the money market (short-term exchange of liquid assets) for banks with no intermediary. Overnight call money and other short-term deposits are the common vehicles, and collateral is rarely required.

Some discount houses, or instance, in the United Kingdom have traditionally served to provide short-term credit in the U.K. banking system by entering into call money arrangements with individual banks. Banks with surplus funds lent them to discount houses, and banks in need of liquidity called in their discount house loans. More recently, however, a parallel set of money markets has developed.

vi) Repurchase agreement (repo):
This is an agreement between buyer and seller in the sale of securities to reverse the transaction in the future at a specified date and price. These transactions commonly involve Treasury securities, but they may also involve government agency securities. Repurchase agreements are typically as short term in nature as federal funds (or call money). Overnight, term, or continuing basis repurchase agreements are all negotiated. Unlike collateralized federal funds transactions,

in which title to the securities does not change, in a repurchase agreement title does transfer to the purchaser.

vii) Government agency securities:
Securities issued by an agency of the federal government particularly in the U.S. with implicit backing of the federal government. Repurchase agreements are essentially collateralized loans. A financial institution with large holdings of Treasury securities sells some portion of them for a predetermined period of time to obtain liquidity and promises to repurchase the securities at the end of that period. On the other side of the transaction is an institution with excess liquidity. The amount of the transaction is relatively large, and the interest rate is below the federal funds rate. The lower rate is justified, because the transaction is collateralized by government securities.

viii) Negotiable Certificates of Deposit
This is a financial instrument issued by a bank documenting a deposit, with principal and interest repayable to the bearer at a specified future date. The negotiable certificate of deposit is a bearer instrument and a term deposit but not demand deposit. Overtime, banks were able to increase the rate paid on negotiable CDs to attract more deposits as the need arose. This innovation brought widespread adoption of bank liability management, which enables banks to attract funds by offering higher interest rates and thereby changing their deposit base.

ix) Banker's acceptance:
This is a time draft or postdated instrument payable to a seller of goods, with payment guaranteed by a bank. In these instruments, the credit of the bank substitutes for the credit of the purchaser, and the seller is ensured payment. Further, unlike an open trade credit arrangement (in which the seller provides credit for a period of time), the seller need not wait for payment. A banker's acceptance is immediately negotiable; the seller can either receive discounted payment at the accepting bank or hold the draft until the date of maturity. Banker's acceptances are particularly important in international trade with Maturities are 1, 3, or 6 months. Average maturity is 3 months.

3. List and explain the various instruments being used to raise funds through the capital.
The capital market instruments include the following:
i. Ordinary Shares
The ordinary share is a unit of capital ownership in a firm in terms of equity investment by the shareholders. The ordinary shares do attract returns at the end of the trading period (normally 12 months). It accords its holders right of ownership in the asset of the firm. The ordinary shareholder can vote in the AGM (Annual General Meeting) of the firm. Currently in a public company no single individual is allowed to own more than 10% of the total issued shares of the firm. The ordinary share is assets (a financial asset) that are traded at will. Normally dividends can be paid as return to holders of ordinary shares. There exist also the preference shares.

ii. Preference Shares
The preference shares are debt instruments in a firm. The holders of preference share are not owners of the firm since they cannot vote in the AGM of their firm. Preference share attract fixed dividend or interest e.g. 10% preference share of N100,000 will attract a financing interest of N10,000. However, the preference share is also regarded as shares in firm depending on the

nature of the preference share. There are several forms of preference shares. There is the cumulative preference share, participating preference share convertible preference share, redeemable preference shares etc.

iii. Debentures

These are long term debt securities normally offered for public subscription. They generally attract a fixed rate of return called interest. Most times Debentures are securities in a particular asset of the firm in such case tagged secured debenture. An unsecured debenture is one not secured on any particular asset of the firm. Debentures are mostly sold either at premium or at discount.

iv. Development Loan Stock

These are financial instruments that allow the government to borrow money for a long period of time up to 25 years, bearing interest and capital repayment, thereon. The principal amount can only be repaid back to the holder after the maturity date but the interest is normally on periodic basis as contained in the prospectus of the offer. The instrument is normally issued by the central bank on behalf of the government.

v. Bonds

Bonds are sometimes issued with stock warrants attached. Warrants are options to purchase common stock at a specified price up to a specified date. Should the bondholder decide to exercise the option and purchase stock, it is not necessary to surrender the underlying bond. Again, bondholders will exercise their warrants only if the market value of the stock exceeds the specified (exercise) price of the warrant. Bonds are an important source of capital for the federal government, states and municipalities, and private corporations. However, private-sector equity financing in the form of common stock has historically been a more important source of financing.

Municipal bonds include all debt instruments issued by local, county, and state governments. Issuers use proceeds from the sale of municipal bonds to finance public utilities, school construction, roads, transportation systems, and industrial development. An appealing feature is that municipal bond interest payments to the holder are exempt from federal income taxation.

vi. Mortgages

Mortgages are long-term loans that are secured by real property. They are long-term liabilities collateralized by real property. Commonly, monthly payments are made that fully repay both principal and interest over the term of the loan. Mortgages are issued to purchase real estate. Commercial mortgages are used to finance real estate for business purposes, such as office buildings and shopping malls. These mortgages have consistently grown faster than multifamily-dwelling mortgages and even faster than home mortgages.

7.0 REFERENCES/FURTHER READINGS

Akinde, M. A. O. (2006). *Fundamentals and Practice of Business Finance,* Lagos: Abioudun-Kinson Nigeria Ltd.

Arnold, G.C. (2004). The *Financial Times Guide to Investing*: The Definitive Companion to Investment and the Financial Markets, 2nd Edition, London: Financial Times.

Arnold, G. (2005). *Corporate Financial Management*, London: Financial Times/Prentice Hall Inc.

Blake, D. (2000). *Financial Market Analysis*, New York: Wiley.

Frank, W. and Alan, S. (2002). *Business Accounting,* London: Pitman Publishing.

Okijo, Y. (2000). *Financial Management*, Lagos: Laco Publishers.

Oye, A. (2005). *Financial Management*, Third edition. Lagos: El-Toda Ventures Ltd.

Robert, O. I. (1999). *Financial Management Made Simple,* Lagos: ROI Publishers.

Terry, L. (2003). *Management Accounting*, London: Gulidfold and King’s Lynn.

UNIT 12: CAPITAL GAINS AND CONTINUOUS CASH FLOWS

CONTENTS

1.0 INTRODUCTION

Cash inflow can be realized from investment assets such as real estate, bonds, and stocks, among others. Such stream of incomes constitutes some kind of wealth, which can be generated from spreads like arbitrage. On the other hand, capital gains are generated from an appreciation on the value of investment assets such as stocks, which involves speculation. In this study unit, we are going to discuss such two issues namely cash flows and capital gains. The essence of the discussion is for you to equip yourself with the knowledge in terms of using it for taking advantage of investments, such as real estate and stock, which can generate for you both constant cash inflows and capital gains.

2.0 OBJECTIVES

After studying this unit, you should be able to:

- Differentiate between cash flow and capital gains
- Explain capital gains investing
- Identify and discuss principles of capital gains investing
- Discuss leveraging on debts for investment in real estate
- Explain mortgage financing in property investment
- Discuss borrowing from private lender for investment
- Explain real estate crowding fund

3.0 MAIN CONTENT

3.1 CASH FLOW AND CAPITAL GAINS

Cash flow involves generating regular income from investment assets such as real estate, bonds, and stocks, among others. Capital gains are generated from an appreciation on the value of investment assets. For example, capital gains can be generated by buying stocks, involves speculation, hoping that the value (market price) appreciates and then selling them at the higher value for a gain. In a similar breadth, an investor can commit funds in assets like real estate, gold, silver, and even commodities with hope that their prices appreciate and then sell them for capital gains (Antone, 2017).

Cash flows constitute some kind of wealth, which can be generated from spreads (arbitrage). Arbitrage, as you have learned from Unit 6 in this study material, comes from leverage because arbitrage is form of leveraged strategy in investment. The analysis herein implies that you can leverage on investments using appropriate strategies to guarantee constant cash flows with which to enhance your personal networth. The constant cash flows serve as some kind of security in case of emergency which involves immediate use of money. The cash inflows constitute liquid asset, which is always available to meet transactional cash demand and precautional needs as well as speculative purposes.

According to Gardon (2014), in the investment world, there are two basic principles such as investing for capital gain and investing for cash flow. In order to ensure successful investment, the investor has to define his purpose by making a choice between the two. The capital gain may take some time to materialize while cash flows from investment can be generated with a short time. For instance, acquiring a building and restructuring it within some months can start generating cash inflows in a short time. Risk involved in property investment is very minimal. This is not comparable to generating cash flows through speculation or arbitrage, which is very risky because the investor can loose all the amount of investment.

SELF ASSESSMENT EXERCISE 1
Distinguish between cash flows and capital gains.

3.2 Capital Gains Investing

According Gardon (2014), there is a remarked difference between capital gains investing and the game of speculation. The author posits that capital gains investing is the art of buying and selling an asset for a profit such as profit realized from buying a stock and sell it at a higher price per share. This implies that that being successful at capital gains investing mainly depends on your ability to identify undervalued assets. Nevertheless, while there is an element of risk of speculation when investing for capital gains, the investing principle is never about speculating.

Successful capital gains investors are not known for engaging in buying and hope that the asset just appreciates for gains. Capital gains investing is a principle of buying below retail value and waiting for the asset to rise (its stage of maturity). This implies that it is not the game of buying at, or even above, retail price and hoping that inflation will occur to make a profit. This involves speculating while the initial one is investing. Investors who invest for capital gains engage in researching for assets to be sure that they are trading below their intrinsic value.

Basically, a good way to understand capital gains investing (Gardon (2014) is by reference to value investment. In respect to value investment, investors assess certain aspects of an asset in order to determine the inherent upside potential in the future. Investment for capital gains involves carrying investigation on an asset to make sure that such is not already overpriced. Hence, some criteria would be brought into before investing in it.

For instance, when investing in stocks, you have to take appropriate precaution. Since the stock market is inundated with numerous types of industries, the first thing to do is to only invest in the industries you understand well. Investing in industries like stocks of firms producing mobile phones, which you cannot predict with certainty, should not be contemplated.

SELF ASSESSMENT EXERCISE 2
Explain capital gains investing.

3.2.1 Principles of Capital Gains Investing

There are some principles which serve as best practices in capital gains investing. Such principles are as follows:

i) Sell the stock not just because the value of the share has appreciated. The reason for selling the stock should be such that the asset is not worth the criteria which motivated you to buy it in the first instance.

ii) Do not sell a particular stock just because the market suffers downturn. You should always keep in mind the market always fixes itself somehow in the course of time.

iii) Do not engage in speculation. Regardless of the information you receive from analysts regarding taking up some stocks, you need to be sure that it meets your investment criteria before committing your funds. Make sure that the stock is really undervalued. Anything other than that is called speculating.

iv) Engage in personal research a lot and only buy a few stocks at the same time, and try to diversify your investment portfolio. A successful investor in capital gains investing spends more time researching than investing.

v) When you are investing for capital gains, you should ensure that you have a positive cash flow. This is because capital gains investing requires due diligence and patience. Speculation becomes tempting in the absence of a positive cash flow.

SELF ASSESSMENT EXERCISE 3

What are the basic principles guiding capital gains investing?

3. 3 LEVERAGING ON DEBTS FOR INVESTMENT IN REAL ESTATE

Based on leveraging the purchase of an investment property, the required periodic payments to service the debt facility spell some negative cash inflow right from the time of purchase. This is sometimes referred to as the “carry cost” of the investment. Therefore, in order to ensure profitable operations, the real estate investors must take appropriate steps to manage their cash flows to create enough positive returns from the property towards offsetting the carry costs.

3.3.1 Mortgage financing in property Investment

In property investment, in most cases, a large portion of the purchase price is financed using debt financial instrument such as a mortgage loan. Such loan or debt is usually collateralized by the property itself. The amount of the purchase price financed by debt is referred to as leverage. By implication the equity contribution by the investor in real estate is the amount financed by the investor's own capital. Such contribution can be in form of cash or other asset transfers. The ratio of leverage to total appraised value (or loan to value), for a conventional mortgage, refers to the measure of risk that the investor is taking by using leverage to finance the purchase of a property.

Investors in properties usually seek to reduce their equity requirements and increase their leverage. This is to ensure that their return on investment (ROI) is maximized. Commercial banks and other financial institutions as lenders, usually have minimum equity requirements for real estate investments. Such equity contribution in real estate investment in terms of financing can be about one fifth of the appraised value. Furthermore, the investors who are seeking low equity contribution can explore alternate financing arrangements, as part of the purchase of a property, such as seller financing, seller subordination, and private equity sources, among others.

3.3.2 Borrowing from Private Lender for property investment

In the event that the investment in property requires substantial repairs, for instance, traditional lenders like commercial banks may not be willing to lend on a property. One option that is left for the investor is borrowing from a private lender such as utilizing a short term bridge facility like a “hard money loan” from a lender. The term hard money loan is usually a short term loan for which the “hard money lender” charges a much higher interest rate due to the higher risky nature of the facility. Nevertheless, hard money loans are usually at a much lower loan-to-value ratio than the conventional mortgage loans.

3.3.3 Real Estate Crowding Fund

Another means of ensuring investment in real estate with some sort of raising equity financing in smaller amounts is through the real estate crowd funding. This equity financing method involves pooling funds, through accredited investors, together in a special purpose vehicle for all or part of the equity capital needed for the acquisition. This is very much in practice in the US.

SELF ASSESSMENT EXERCISE 4

Mention and explain the various ways through which an investor can leverage on debts for earning constant cash flows in estate.

4.0 CONCLUSION

You have learned from this study unit that there is basic difference between cash flows investment and capital gains investing. A beginner in investment, from our discussion, is should go into investment for cash flow until such a time that he or she has a constant source of positive cash flow and can manage their emotions and expectations. Furthermore, an indepth understanding of the mechanism of the stock markets is required to make it in capital gains investing. Besides, if you're planning for retirement, cash flow investing is considered to be better suited for you since it guarantees a constant income. Capital gains investing, on the other hand, is recommended for people who have constant flow of income such as salary, and not yet preparing for retirement. A constant flow of income will enable such people to stick to their investing habits regardless of the situation. Nevertheless, some degree of risk should be expected particularly when investing for capital gains.

5.0 SUMMARY

In this study unit, we have discussed topics such as listed below:

- Cash Flow and Capital Gains;
- Capital Gains Investing;
- Principles of Capital Gains Investing;
- Leveraging on Debts for Investment in Real Estate;
- Mortgage Financing in Property Investment;
- Borrowing from Private Lender for Property Investment; and
- Real Estate Crowding Fund

6.0 TUTOR MARKED ASSIGNMENT

1. Distinguish between cash flows and capital gains.

2. Mention and explain the various ways through which an investor can leverage on debts for earning constant cash flows in estate.

Answers to SAEs

1. Distinguish between cash flows and capital gains.

Cash flow involves generating regular income from investment assets such as real estate, bonds, and stocks, among others while capital gains are generated from an appreciation on the value of investment assets. For example, capital gains can be generated by buying stocks, involves speculation, hoping that the value (market price) appreciates and then selling them at the higher value for a gain. In a similar breadth, an investor can commit funds in assets like real estate, gold, silver, and even commodities with hope that their prices appreciate and then sell them for capital gains.

2. Explain capital gains investing.

Capital gains investing is the art of buying and selling an asset for a profit such as profit realized from buying a stock and sell it at a higher price per share. This implies that that being successful at capital gains investing mainly depends on your ability to identify undervalued assets. Nevertheless, while there is an element of risk of speculation when investing for capital gains, the investing principle is never about speculating.

Successful capital gains investors are not known for engaging in buying and hope that the asset just appreciates for gains. Capital gains investing is a principle of buying below retail value and waiting for the asset to rise (its stage of maturity). This implies that it is not the game of buying at, or even above, retail price and hoping that inflation will occur to make a profit. This involves speculating while the initial one is investing. Investors who invest for capital gains engage in researching for assets to be sure that they are trading below their intrinsic value.

For instance, when investing in stocks, you have to take appropriate precaution. Since the stock market is inundated with numerous types of industries, the first thing to do is to only invest in the industries you understand well. Investing in industries like stocks of firms producing mobile phones, which you cannot predict with certainty, should not be contemplated.

3. What are the basic principles guiding capital gains investing?

i) Sell the stock not just because the value of the share has appreciated. The reason for selling the stock should be such that the asset is not worth the criteria which motivated you to buy it in the first instance.

ii) Do not sell a particular stock just because the market suffers downturn. You should always keep in mind the market always fixes itself somehow in the course of time.

iii) Do not engage in speculation. Regardless of the information you receive from analysts regarding taking up some stocks, you need to be sure that it meets your investment criteria before committing your funds. Make sure that the stock is really undervalued. Anything other than that is called speculating.

iv) Engage in personal research a lot and only buy a few stocks at the same time, and try to diversify your investment portfolio. A successful investor in capital gains investing spends more time researching than investing.

v) When you are investing for capital gains, you should ensure that you have a positive cash flow. This is because capital gains investing requires due diligence and patience. Speculation becomes tempting in the absence of a positive cash flow.

4. Mention and explain the various ways through which an investor can leverage on debts for earning constant cash flows in estate.

1. Mortgage financing in property Investment

In property investment, in most cases, a large portion of the purchase price is financed using debt financial instrument such as a mortgage loan. Such loan or debt is usually collateralized by the property itself. The amount of the purchase price financed by debt is referred to as leverage. By implication the equity contribution by the investor in real estate is the amount financed by the investor's own capital. Such contribution can be in form of cash or other asset transfers. The ratio of leverage to total appraised value (or loan to value), for a conventional mortgage, refers to the measure of risk that the investor is taking by using leverage to finance the purchase of a property.

Investors in properties usually seek to reduce their equity requirements and increase their leverage. This is to ensure that their return on investment (ROI) is maximized. Commercial banks and other financial institutions as lenders, usually have minimum equity requirements for real estate investments. Such equity contribution in real estate investment in terms of financing can be about one fifth of the appraised value. Furthermore, the investors who are seeking low equity contribution can explore alternate financing arrangements, as part of the purchase of a property, such as seller financing, seller subordination, and private equity sources, among others.

2. Borrowing from Private Lender for property investment

In the event that the investment in property requires substantial repairs, for instance, traditional lenders like commercial banks may not be willing to lend on a property. One option that is left for the investor is borrowing from a private lender such as utilizing a short term bridge facility like a “hard money loan” from a lender. The term hard money loan is usually a short term loan for which the “hard money lender” charges a much higher interest rate due to the higher risky nature of the facility. Nevertheless, hard money loans are usually at a much lower loan-to-value ratio than the conventional mortgage loans.

3. Real Estate Crowding Fund

Another means of ensuring investment in real estate with some sort of raising equity financing in smaller amounts is through the real estate crowd funding. This equity financing method involves pooling funds, through accredited investors, together in a special purpose vehicle for all or part of the equity capital needed for the acquisition; as is the practice in the US.

7.0 REFERENCES AND FURTHER READING

Antone, G. (2017). Cash Flow vs. Capital Gains. Accessed on 20 September, 2017 from http://www.noteworthyusa.com/cash-flow-vs-capital-gains/

Gardon, M. (2014). Cash Flow vs. Capital Gains Investing: The Two Investing Paths. Access on 20 September, 2017 from https://www.thesimpledollar.com/cash-flow-capital-gains-investing-the-two-investing-paths/

UNIT 13: BUILDING PERSONAL CASH FLOWS (SAVINGS)

CONTENTS

1.0 INTRODUCTION

This study unit of the course material is used to discussed the nature and scope of building personal cash reserves which essentially involves saving of money by individuals for future use. The need to build personal cash reserves can be for specific reasons. These reasons for maintaining personal cash reserves can be explained in relation to the popular economic postulations such as precautionary motive, transaction motive, speculative motive, and portfolio motive. These motives for building personal cash flows in form of maintaining cash reserves, in essence, underscore the importance of savings generally. There are different ways through saving can be effected by individuals, and there are some differences between saving and savings as espoused in this study unit. Lastly, the unit also exposes you to the fact there is immense benefit that can be derived from saving to individuals and the economy at large.

2.0 OBJECTIVES

After studying this unit, you should be able to:

- Define and explain the term Saving
- Discuss the importance of saving.
- Identify the different methods of saving money
- Mention the differences between saving and savings
- List and explain reasons for building personal cash flows

3.0 MAIN CONTENT

3.1 Meaning of Saving

Building personal cash flows essential involves the act of saving money towards maintaining cash reserves for future utilization. The Chambers Dictionary, 10th edition (2006) explains saving as being economical by reserving money for future use. Furthermore, the dictionary further explains that saving also refers to the money laid or set aside for future use. This implies that saving presupposes that the person involved tries to avoid being extravagant and wasteful in spending. In essence, to build personal cash reserves or maintain savings of money means that a person imbibes thrift instead of engaging in wasteful and unrestrained spending of money. And in order to develop saving habit, a person has to be economical in the use of money; being frugal or engage in frugality.

Savings can also be done with thrift and credit society or a cooperative society. The amount of money saved with any of this society is subject to earnings. A cooperative society as an aggregation of cooperators who pooled their funds together through regular saving does offer a potent means of building the personal cash flows for the members. In agricultural economy, savings might take the form of holding back some quantity of produce harvested as seeds or seedlings meant for in the next planting season. In fact, this is the usual practice among the famers particularly in the developing and underdeveloped economies.

SELF ASSESSMENT EXERCISE 1
Explain the term Saving.

3.2 Importance of Saving

Saving that gives rise to savings can be used for ensuring investment either by establishing business entity with its funds by the owner of the money or being borrowed by investors and customers for business operations. Nevertheless, increased saving does not always correspond to increased investment.

For instance, if savings are kept under the mattress, that is, otherwise not deposited into a financial intermediary such as a bank, there is no chance for those savings to be recycled as investment by business. This means that saving may increase without increasing investment, possibly causing a short-fall of demand. This does lead to implications such as a pile-up of inventories, a cut-back of production, lull in employment, and low aggregate income in the economy and thus a recession instead of economic growth.

In the short term, if saving falls below investment, it can lead to a growth of aggregate demand and an economic boom. In the long term if saving falls below investment, it eventually reduces investment and detracts from future growth. Future growth is made possible by foregoing present consumption to increase investment. However savings kept in a mattress at home cannot generate additional funds to the owners of the funds. This is because the money is not available as loan to the investors who can recycle the funds through the commercial banks or government through the central bank.

In respect of earnings on savings in the bank, classical economist posit that interest rates would adjust to equate saving and investment, while avoiding a pile-up of inventories of output in the economy (general overproduction). Furthermore, the classical economists postulate that a rise in saving would cause a fall in interest rates, stimulating investment, and therefore, investment would always equal saving.

In another perspective, Keynesian economists argue that neither saving nor investment is very responsive to interest rates, that is, that both were interest inelastic so that large interest rate changes are needed to re-equate them after overtime. Furthermore, the Keynesians posit that it is the demand for and supplies of stocks of money that determine interest rates in the short run. Thus, saving could exceed investment for significant amounts of time, causing a general and a recession in the economy.

3.3 Different Methods of Saving Money

Saving in another perspective refers to the part of income that is not spent, which involves deferred consumption. There are many methods of saving that include the following:

i) Putting money aside in a savings account;
ii) Reserving money in deposit account;
iii) Setting money aside in a pension account regularly;
iv) Committing money into an investment fund; and
v) Putting money into cooperative fund.

Saving is also regarded as the practice of reducing personal expenditures, such as recurring costs. In respect of personal finance, saving generally connotes a low-risk preservation of money, as in a deposit account as opposed to investment in which risk is a lot higher. Broadly in economics terms, saving refers to any income that is not used for immediate consumption but reserved for future use.

SELF ASSESSMENT EXERCISE 3

Mention the different methods of saving money.

3.4 Differences between Saving and Savings

The distinction between saving and savings is often misunderstood to the extent that economists and investment professionals often use the two terms interchangeably. Nevertheless, in some ramifications, saving differs from savings. The differences are highlighted as follows:

i) Saving is an act of increasing one's assets while the savings refers to one part of one's assets, usually deposits in savings accounts or to all of one's assets.
ii) Saving refers to an activity occurring over time, which is known as “flow variable.” On the other hand, savings refers to something that exists at any one time, known as a stock variable.

iii) The part of a person's income that is spent on mortgage loan repayments is not spent on present consumption and is, therefore, saving.

iv) Saving is closely related to physical investment, in that the former (saving) provides a source of funds for the latter (investment). But by not using income to buy consumer goods and services, the cash resources so saved constitute savings, which can be invested to produce fixed capital, such as factories and machinery.

v) Saving is very vital towards building the amount of savings that an individual can maintain. Such accumulated funds can be utilized for acquisition of fixed capital or committed in outright investment.

SELF ASSESSMENT EXERCISE 4

Explain the differences between saving and savings.

3.5 Reasons for Building Personal Cash Flows

There are obvious reasons which can motivate or induce you to build your personal cash flows such as savings. These reasons can broadly be categorized into three main purposes such as precautionary motive, transaction motive, speculative motive, and portfolio motive. All these are discussed as follows.

3.5.1 Transaction Motive

The transactions motive for money demand involves the need for liquidity, which refers to the need to hold money for use in day-to-day transactions in the near future. This need arises when income is received only occasionally, for instance, once in every month in discrete amounts but expenditures occur continuously.

Nevertheless, the amount of money a person desires to hold for transactions is also likely to depend on the prevailing nominal interest rate, which is a strong motivating factor. This arises due the lack of synchronization in time between when purchases are desired and when salary is actually paid. In other words, while workers may get their salary paid only once a month they generally make purchases almost on daily basis, and hence need money, over the course of the entire month.

The most well-known example of an economic model that is based on such considerations is the Baumol-Tobin model. In this model, an individual receives his/her income periodically, for example, only once per month. However, the person wishes to make purchases continuously; on daily basis. The person could carry his/her entire income with his/her at all times and use it to make purchases. Nevertheless, in this case the person would be giving up the (nominal) interest rate that he/she can get by holding the income in the bank.

The optimal strategy involves holding a portion of one's income in the bank and portion as liquid money. The money portion is continuously spent (or run down) as the individual makes purchases while he/she makes periodic but costly trips to the bank to replenish the holdings of money. Basically, therefore, the demand for money resulting from the Baumol-Tobin model is based on the fact that the demand for real balances depends on both the income and the desired level of transactions, and on the nominal interest rate.

3.5.2 Precautionary Motive

This motive involves a desire to hold cash in order to be able to deal effectively with unexpected events that require cash outlay. In essence, it is the motive for people or firms to hold money in case of emergencies, as opposed to the transaction motive where they hold money to use for some definite transaction in the future or the speculative motive where they hold money in the form of investments because they hope to make a capital gain.

In another perspective, precautionary motive refers to the desire of individuals to keep money (or cash) for unforeseen contingencies. This implies that people wish to hold some cash with which to provide for the risk of unforeseen events such as sickness, accident, and happenstance that requires urgent financial attention. The amount of money being held under this motive depends on the nature of individual and the conditions in which he/she lives. The demand for money for precautionary purpose is also closely related to the level of income. This implies that the high the level of income, the more money (or cash balances) that will be held for contingencies by the individuals.

In case of transaction motive, money is held for ordinary transactions while in precautionary motive, cash is kept to meet unforeseen transactions for contingencies. These are commitments that are not normally envisaged by individuals. Furthermore, under transaction motive, holding money is very convenient and value of money, in terms of other goods, is relatively certain. However, under precautionary motive, holding money depends on the degree of uncertainty, which implies that money is kept in the events of war or financial and less money during normal conditions. In general, the cash balances held for transaction and precautionary motives are directly dependent on the level of income.

3.5.3 Speculative Motive

Speculative Motive refers to the desire of individuals to keep cash balance as an alternative to financial assets such as bonds. Under this motive, it is presumed that people can hold their wealth either in form of bonds or in the form of cash balances. By implication, the decision to hold money in cash balances or bonds depend on te expectations about changes in the rate of interest or capital value of assets (bond) in future.

This reason for the demand for money is based on the fact that people can take advantage of investing their money or stock of savings in investible instruments in order to generate more money. Keynes (1923), in respect of laying out speculative reasons for holding money, stresses the choice between money and bonds. Accordingly, Keynes argues that if people expect the future nominal interest rate (the return on bonds) to be lower than the current rate they will then reduce their holdings of money and increase their holdings of bonds. Furthermore, Keynes stresses that if the future interest rate falls, then the price of bonds will increase and the investors will have realized a capital gain on the bonds they purchased.

The above analysis implies that the demand for money, on speculative basis, in any period of time will depend on both the current nominal interest rate and the expected future interest rate. This is in addition to the standard transaction motives which depend on income. In related terms, the fact that the current demand for money can depend on expectations of the future interest rates has implications for volatility of money demand. If these expectations eventually occur, as in Keynes' view, they are likely to change erratically and cause money demand to be quite unstable.

3.5.4 Portfolio Motive

This motive for holding cash is associated with the speculative motive but it entails more than the latter. The portfolio motive also focuses on demand for money over and above that required for carrying out transactions as espoused by Tobin (1956). He considered a situation where people decide to hold their wealth (not consumed) in a form of a low risk–low return asset (money) or high risk–high return asset such as bonds or equity shares. Basically, people desire the choice of a mix of these two types of assets (called portfolio), which is based on the risk associated with the expected return on such assets.

However, for a given expected rate of return, more risk averse individuals will prefer for money as a greater part of the assets in their portfolio. Similarly, given a person's degree of risk aversion, a higher expected return (nominal interest rate plus expected capital gains on bonds) will cause agents to shift away from safe money and into risky assets. Like in the other motivations above, this preference will create a negative relationship between the nominal interest rate and the demand for money.

This discussion is indicative of the fact that the Tobin model is based partly on the subjective rate of risk aversion as well as the objective degree of risk of other assets, which is measured by the standard deviation of capital gains and losses resulting from holding bonds and/or equity shares.

SELF ASSESSMENT EXERCISE 5

Mention and explain the three main reasons for building personal cash flows in form of saving.

4.0 CONCLUSION

This unit of the course material has provided you with the basic ideas on the nature of building personal cash flows. This is mainly related to savings whereby you set aside some amount of your income for saving in the bank. Alternatively such amount of money can be saved with thrift and credit society or a cooperative society of your choice. There are some advantages accruing from saving your money a cooperative society such earning interest and gaining access to loan or credit facility. The issue of accessing loan or credit facility from a cooperative for which you are a member is easier than obtaining loan form a commercial bank based on your savings. Building personal cash flows, as you have learned from this study unit, is also associated with motives for holding money as opposed to spending all the amount of your income. These reasons include precautionary motive, transaction motive, speculative motive, and portfolio motive.

5.0 SUMMARY

In this initial study unit of the course material, you have been taught the following topics:

- Meaning of Saving
- Importance of Saving
- Different Methods of Saving Money
- Differences between Saving and Savings
- Precautionary Motive for Building Personal Cash Flows;
- Transaction Motive for Building Personal Cash Flows;
- Speculative Motive for Building Personal Cash Flows; and
- Portfolio Motive for Building Personal Cash Flows.

In the next study unit, you will be taken through personal financial planning.

6.0 TUTOR MARKED ASSIGNMENT

1. Identify your personal reasons for engaging in savings.
2. What are methods of saving?
3 Identify the differences between saving and savings
4. Mention and explain the basic motives for holding cash.

Answers to Self-Assessment Exercises

1. Explain the term Saving.

Saving refers money laid or set aside for future use, which implies that saving presupposes that you try to avoid being extravagant and wasteful in spending and thereby building your personal cash reserves.

2. Explain the importance of saving.

Saving that gives rise to savings can be used for ensuring investment either by establishing business entity with its funds by the owner of the money or being borrowed by investors and customers for business operations.

3. Mention the different methods of saving money.

Different methods of saving money are as follows:

i) Putting money aside in a savings account;
ii) Reserving money in deposit account;
iii) Setting money aside in a pension account regularly;
iv) Committing money into an investment fund; and
v) Putting money into cooperative fund.

4. Explain the differences between saving and savings.

The differences are highlighted as follows:

i) Saving is an act of increasing one's assets while the savings refers to one part of one's assets, usually deposits in savings accounts or to all of one's assets.

ii) Saving refers to an activity occurring over time, which is known as “flow variable.” On the other hand, savings refers to something that exists at any one time, known as a stock variable.

iii) The part of a person's income that is spent on mortgage loan repayments is not spent on present consumption and is, therefore, saving.

iv) Saving is closely related to physical investment, in that the former (saving) provides a source of funds for the latter (investment). But by not using income to buy consumer goods and services, the cash resources so saved constitute savings, which can be invested to produce fixed capital, such as factories and machinery.

v) Saving is very vital towards building the amount of savings that an individual can maintain.

5. Mention and explain the three main reasons for building personal cash flows in form of saving.

The main reasons for building personal cash flows include the following motives.

i) Precautionary motive:- This motive involves a desire to hold cash in order to be able to deal effectively with unexpected events that require cash outlay. In essence, it is the motive for people or firms to hold money in case of emergencies, as opposed to the transaction motive where they hold money to use for some definite transaction in the future or the speculative motive where they hold money in the form of investments because they hope to make a capital gain.

ii) Transaction motive: - The transactions motive for money demand involves the need for liquidity, which refers to the need to hold money for use in day-to-day transactions in the near future. This need arises when income is received only occasionally, for instance, once in every month in discrete amounts but expenditures occur continuously.

iii) Speculative motive: - This reason for the demand for money is based on the fact that people can take advantage of investing their money or stock of savings in investible instruments in order to generate more money. This involves using the amount held for speculating on bonds and other investible (financial) instruments.

iv) Portfolio Motive:- The portfolio motive also focuses on demand for money over and above that required for carrying out transactions, which holds that people can decide to hold their wealth (not consumed) in a form of a low risk – low return asset (money) or high risk – high return assets such as bonds or equity shares. Basically, people desire the choice of a mix of these two types of assets (called portfolio), which is based on the risk associated with the expected return on such assets.

7.0 REFERENCES/FURTHER READINGS

Benchimol, J. and Fourçans, A. (2012). Money and Risk in a DSGE Framework: A Bayesian Application to the Eurozone, *Journal of Macroeconomics*, 34 (1): 95–111.

Benchimol, J., (2015). Money in the production function: a new Keynesian DSGE perspective, *Southern Economic Journal*, 82(1): 152-184.

Benchimol, J. (2016). Money and monetary policy in Israel during the last decade. *Journal of Policy Modeling*, 38 (1): 103–124.

Goldfield, S. M. and Daniel E. Sichel (1990). *The Demand for Money, Handbook of Monetary Economics*, Elsevier.

Judd, J. P. and Scadding, J. L. (1982). The Search for a Stable Money Demand Function: A Survey of the Post-1973 Literature," *Journal of Economic Literature*, 20(3): 993-1023.

Kotlikoff, L. J. (2008). Saving. In Henderson, D. R. Concise Encyclopedia of Economics (2nd ed.), Indianapolis: Library of Economics and Liberty.

Sriram, S. S. (2001). A Survey of Recent Empirical Money Demand Studies, IMF Staff Papers, 47(3). *International Monetary Fund*. 334-365.

Walsh, C. E. (1998). *Monetary Theory and Policy*, Cambridge: The MIT Press.

UNIT 14: PERSONAL FINANCIAL PLANNING

CONTENTS

1.0 INTRODUCTION

This study unit of the course material is used to expose you to the workings of planning personal finances, which are necessary towards managing your money in effective and efficient manner. The unit is also used to identify the necessary issues involved in personal financial planning. Such considerations are necessary towards ensuring that you: understand the reason for conserving money; plan for the amount to save on periodic basis; decide on convenient time to start the savings; can use to budget in managing your money; and can diversify investment securities for your fund, among others. Furthermore, the unit also discusses the basic steps that are involved in personal financial planning process.

2.0 OBJECTIVES

After studying this unit, you should be able to:

- Define planning personal finances
- List and explain basic issues in personal financial planning
- Mention and discuss the steps involved in personal financial planning process

3.0 MAIN CONTENT

3.1 Meaning of Planning Personal Finances

Generally, financial planning involves a wide variety of issues in relation to management of money that are cover terms such as budgeting, expenses, debt, saving, retirement and insurance among others. The understanding how these terms are interrelated, and affect each other is imperative towards laying the groundwork for a solid financial foundation for you and your family.

Personal finance planning refers to the financial management which an individual or a family unit performs with which to budget, save, and spend monetary resources over time. The process takes into consideration various financial risks and future life events. In the process of planning personal finances, it is necessary for the individual to consider the suitability to his or her needs in respect of a range of: banking products; areas of investment; and insurance products. This also calls for participation and monitoring or individual-or employer-sponsored retirement plans, social security benefits (if available), and income tax management. Banking products include deposit account, savings account, credit cards, and consumer loans; investment private equity products include stock, bonds, and mutual funds; and insurance products include life policy, health insurance policy, and disability insurance policy.

SELF ASSESSMENT EXERCISE 1
What do you understand by personal finance planning?

3.2 Basic Issues in Personal Financial Planning

There are some important considerations that constitute simple tips for getting what you want from your money in terms of managing it effectively and efficiently.

1. Purpose of Conserving Money

For the initial issue, it is important to understand why money is important to you so as to guide you on every financial planning decision. Once you know the reason for conserving money, you could begin to make financial decisions that can enable you achieve the purpose. For instance, if the purpose of conserving money is for retirement income and spending like annuity, you have to take decision to fully fund the annuity (retirement) savings accounts on regular basis. If it is for the purpose of purchasing a house, you take decision to engage in mortgage savings. Furthermore, if the purpose of conserving money is for future education of the kids, you have take decision on how to create savings account for children education.

2. Decision on Amount of Regular Savings

The Decision on the purpose of conserving money will lead you in taking decision on the amount of money to commit to regular savings. Basically, the amount of money to save on regular basis largely depends on the amount of your income. Furthermore, the amount of regular savings also depend on the amount that you desire to devout to personal expenses at the instance of receiving the income (or salary).

The foundation of the decision is your income. This considers the amount of income that you earn regularly, your total personal expenses, and the net balance of the income; necessarily setting aside an amount of money for contingency regardless of whether you are single or having a family. It is instructive to note that commitments to the extent family members in financial terms should be factored into the equation of income and expenses to arrive at the amount of regular savings.

3. Decision on the Starting Point

The next issue to consider, after the decision on the amount of money to be committed in regular savings, is to assess your worth financially in respect of when it is feasible for you to commence the savings. The issue of your liabilities particularly the ones that are in form of outstanding debts and the ones that fall due for payment in subsequent periods must be taken cognizance of. So the scope of consideration becomes wider when all the necessary financial commitments to be offset and when they will be totally paid is germane to the decision.

4. Use Budgeting as a Tool

Spending decisions are not to be based on emotional reasons. More often than not, people engage in emotional spending before looking for evidence to support the decision. Budgeting for all your expenses and financial commitments is very germane to effective savings. In essence, you should try to be more deliberate about your purchases. Budgeting is very useful in helping you to turn around bad spending habits.

Budgeting should therefore, be seen as a tool for tracking your personal spending. Basically, the process of tracking your spending actually is hinged on awareness, which affects a behavioural change that enables you to structure your spending to align with your goals.

5. Save as Much as Possible.

When engaging in savings you do not have overstretch your finances by try to deprive yourself of the necessities of life. However, it is necessary to cut unnecessary expenses by not indulging in mundane things. For instance, you can cut down on monthly expenditure on internet data, which only enables you to chat with your friends and relations on social media platforms. Instead of spending amount of N2000 on monthly internet data, you can cut it to only N1000. There are so many other things on which you devout money that are not of necessity to wellbeing. The periodic expenses on such mundane things should be scaled down so that you can have reasonable amount of money to save on periodic basis.

6. Buy Life insurance Policy

It may be necessary to engage in life insurance policy if you so desire and your religion does not forbid you from doing so. The life insurance policy has dual advantage among others. Firstly, the policy can enable you secure loan facility with which to operate a business venture. Secondly, the life insurance policy enables you to pay less income tax because it is tax exempted just like allowances for your family. Therefore, taking life insurance policy provides you with a definite means of savings, which can be recouped in the future by you or your family, depending on the type of policy to which you may subscribe.

7. Utilizing Insurance Policy as Protection and Investment

Generally, insurance involves the analysis of how to protect a household from unforeseen risks. These risks can be divided into liability, property, death, disability, health and long-term care.

Some of these risks may be self-insurable while most will require the purchase of an insurance contract. Determining how much insurance to get, at the most cost effective terms requires knowledge of the market for personal insurance. Business owners, professionals, athletes and entertainers require specialized insurance professionals to adequately protect themselves. Since insurance also enjoys some tax benefits, utilizing insurance investment products may be a critical piece of the overall investment planning.

8. Pay off your Debt

It is necessary not to default in paying your debts or postpone repayment of debts deliberately. It has been argued that paying off debts is a great investment. Basically you have to consider the cost associated with borrowing beside the principal amount of repayment. The debts that are not repaid on their due dates or deliberately ignored has two elements of financial implication. Firstly, the principal amount will remain the same or can be compounding if the debt is taken on compound interest basis. Secondly, the interest element too will be rising or compounding. In total sum, the amount that is due for repayment in the future will be so enormous to the extent that the debtor will become helpless; resorting only to bankruptcy. Therefore, the additional money saved from paying debts on regularly basis is available for savings and investment. Hence it is argued that "paying off debt is a great investment."

9. Invest like a scientist.

The basic formula for successful investment from your savings involves some considerations. Firstly, diversify your portfolio, that is, appropriate combinations of investment. This is because it is too risky to invest in one kind of security. The advice is that you go with index funds or exchange-traded funds that contain hundreds of stocks, instead of one or two or even ten stocks. This strategy goes to lessen the risk that any one stock can hurt you.

Secondly, keep your costs low. Empirical evidence shows that the only one reliable predictor of how well an investment performs is cost. Basically, the more you pay for your investments, the less money you'll end up keeping. Therefore, look for inexpensive securities. Thirdly, recognize the correlation between risk and reward. The greater risk you take the higher potential return. It is important to recognize that: you'll likely earn more for stocks than for bonds; you'll probably make more via small companies than large ones; and you'll most likely have greater returns from financially weak companies than strong ones.

10. Make use of a Financial Adviser

The real purpose of having a financial adviser is to preclude you from being unemotional about your own money. Smartness in planning and managing your money does not preclude you from being emotional about your money. The financial adviser will help you avoid any potential mistakes.

11. Stick to Your Goals

You should try to stick to your financial and investment goals; stick to your portfolio of stock. The financial plan in the first place will help you stick to your goals. Another thing is that of automating your decisions so you don’t have to rely on yourself to keep making good choices over and over again. Lastly you have to be sure that you leave your plan alone. You have to cultivate financial and spending discipline. Do not indulge in inanities. Curtail your spending habits by spending only on necessities.

12. Tax planning

Typically, the income tax is the single largest expense in a household. Managing taxes is not a question whether or not taxes will be paid, but *when and how much*. The government gives many incentives in the form of tax deductions and credits, which can be used to reduce the lifetime tax burden. Most modern governments use a progressive tax. Typically, as one's income grows, a higher marginal rate of tax must be paid. Understanding how to take advantage of the myriad tax breaks when planning one's personal finances can make a significant impact.

SELF ASSESSMENT EXERCISE 2
List and explain basic issues in Personal Financial Planning.

3.3 Personal Financial Planning Process

The key component of personal finance is financial planning, which is a dynamic process that requires regular monitoring and reevaluation. In general terms, the process involves five steps such as outlined and discussed below.

1) Assessment

A person's financial situation is assessed by compiling simplified versions of financial statements including balance sheet and income statements. A personal balance sheet lists the values of personal assets (e.g., car, house, clothes, stocks, bank account), along with personal liabilities (e.g., credit card debt, bank loan, mortgage). A personal income statement lists personal income and expenses.

2) Goal setting

It is necessary to have multiple goals that include a mix of short- and long-term goals. For example, a long-term goal would be to "retire at age 65 with a personal net worth of some million of naira in the bank account. And a short-term goal would be to save some money for purchasing a new car in the next six months. Setting financial goals helps to direct financial planning. Goal setting is done with an objective to meet specific financial requirements.

3) Plan Creation

The financial plan details how to accomplish the goals. It could include, for example, reducing unnecessary expenses, increasing the employment income, or investing in the stock market.

4) Execution

Execution of a financial plan often requires discipline and perseverance. It may be necessary to seek assistance from professionals such as accountants, financial analysts, investment advisers, and lawyers.

5) Monitoring and reassessment

On the basis of passage of time in reaction to the financial plan execution, it is advisable that the financial plan is monitored for possible adjustments or reassessments. It may be necessary to institute some milestones for the monitoring and evaluation of the execution of the financial plan.

SELF ASSESSMENT EXERCISE 3
Mention and explain five steps involved in personal financial planning process.

4.0 CONCLUSION

This unit of the course material has provided you with insight into the need to plan for your finances in order to have meaningful living during your working days and even after retirement. In addition, the basic issues involved in planning for personal finance such as the amount to save, when to start saving, budgeting for the funds, execution of the plan, and monitoring as well as evaluation, among others, are vital in financial planning. All said, it is also necessary to consider tax plan, paying off debts to avoid financial hiccups, taking up insurance policies for yourself, the family and your property.

5.0 SUMMARY

In this study unit of the course material, you have been taught the following topics:

- Meaning of Planning Personal Finances;
- Basic Issues in Personal Financial Planning; and
- Personal Financial Planning Process

In the next study unit, you will be taken through capital gains and continuous cash flows.

6.0 TUTOR MARKED ASSIGNMENT

1. What is Differentiate between cash savings and cash investment.
2. Discuss the nature of savings account.
3. Mention the differences between savings account and current account.

Answers to Self Assessment Exercises

1. What do you understand by personal finance planning?

Personal finance planning refers to the financial management which an individual or a family unit performs with which to budget, save, and spend monetary resources over time. The process takes into consideration various financial risks and future life events. In the process of planning personal finances, it is necessary for the individual to consider the suitability to his or her needs in respect of a range of: banking products; areas of investment; and insurance products.

2. List and explain basic issues in Personal Financial Planning.

i. Purpose of Conserving Money

For the initial issue, it is important to understand why money is important to you so as to guide you on every financial planning decision. Once you know the reason for conserving money, you could begin to make financial decisions that can enable you achieve the purpose.

ii. Decision on Amount of Regular Savings

The Decision on the purpose of conserving money will lead you in taking decision on the amount of money to commit to regular savings. Basically, the amount of money to save on regular basis largely depends on the amount of your income. Furthermore, the amount of regular savings also depend on the amount that you desire to devout to personal expenses at the instance of receiving the income (or salary).

iii. Decision on the Starting Point

The next issue to consider, after the decision on the amount of money to be committed in regular savings, is to assess your worth financially in respect of when it is feasible for you to commence the savings. The issue of your liabilities particularly the ones that are in form of outstanding debts and the ones that fall due for payment in subsequent periods must be taken cognizance of. So the scope of consideration becomes wider when all the necessary financial commitments to be offset and when they will be totally paid is germane to the decision.

iv. Use Budgeting as a Tool

Spending decisions are not to be based on emotional reasons. More often than not, people engage in emotional spending before looking for evidence to support the decision. Budgeting for all your expenses and financial commitments is very germane to effective savings. In essence, you should try to be more deliberate about your purchases. Budgeting is very useful in helping you to turn around bad spending habits.

v. Save as Much as Possible.

When engaging in savings you do not have overstretch your finances by try to deprive yourself of the necessities of life. However, it is necessary to cut unnecessary expenses by not indulging in mundane things.

vi. Buy Life insurance Policy

It may be necessary to engage in life insurance policy if you so desire and your religion does not forbid you from doing so. The life insurance policy has dual advantage among others such as using it to secure loan and being treated as tax deductible.

vii. Utilizing Insurance Policy as Protection and Investment

Insurance is necessary to protect a household from unforeseen risks. These risks can be divided into liability, property, death, disability, health and long-term care. Some of these risks may be self-insurable while most will require the purchase of an insurance contract. Determining how much insurance to get, at the most cost effective terms requires knowledge of the market for personal insurance. Since insurance also enjoys some tax benefits, utilizing insurance investment products may be a critical piece of the overall investment planning.

viii. Pay off your Debt

It is necessary not to default in paying your debts or postpone repayment of debts deliberately. It has been argued that paying off debts is a great investment. Basically you have to consider the cost associated with borrowing beside the principal amount of repayment. The debts that are not repaid on their due dates or deliberately ignored has obvious implications.

ix. Invest like a scientist.

The basic formula for successful investment from your savings involves some considerations. It is important to diversify your portfolio, that is, appropriate combinations of investment. This is because it is too risky to invest in one kind of security. The advice is that you go with index funds or exchange-traded funds that contain hundreds of stocks, instead of one or two or even ten stocks. This strategy goes to lessen the risk that any one stock can hurt you.

x. Make use of a Financial Adviser

The real purpose of having a financial adviser is to preclude you from being unemotional about your own money. Smartness in planning and managing your money does not preclude you from being emotional about your money. The financial adviser will help you avoid any potential mistakes.

xi. Stick to Your Goals

You should try to stick to your financial and investment goals; stick to your portfolio of stock. The financial plan in the first place will help you stick to your goals. Another thing is that of automating your decisions so you don’t have to rely on yourself to keep making good choices over and over again. Lastly you have to be sure that you leave your plan alone. You have to cultivate financial and spending discipline. Do not indulge in inanities. Curtail your spending habits by spending only on necessities.

xii. Tax planning

Typically, the income tax is the single largest expense in a household. Managing taxes is not a question whether or not taxes will be paid, but *when and how much*. The government gives many incentives in the form of tax deductions and credits, which can be used to reduce the lifetime tax burden. Most modern governments use a progressive tax. Typically, as one's income grows, a higher marginal rate of tax must be paid. Understanding how to take advantage of the myriad tax breaks when planning one's personal finances can make a significant impact.

3. Mention and explain five steps involved in personal financial planning process.

The five steps involved in personal financial planning process as are follows.

i) Assessment

A person's financial situation is assessed by compiling simplified versions of financial statements including balance sheet and income statements. A personal balance sheet lists the values of personal assets (e.g., car, house, clothes, stocks, bank account), along with personal liabilities (e.g., credit card debt, bank loan, mortgage). A personal income statement lists personal income and expenses.

ii) Goal setting

It is necessary to have multiple goals that include a mix of short- and long-term goals. For example, a long-term goal would be to "retire at age 65 with a personal net worth of some million of naira in the bank account. And a short-term goal would be to save some money for purchasing a new car in the next six months. Setting financial goals helps to direct financial planning. Goal setting is done with an objective to meet specific financial requirements.

iii) Plan Creation

The financial plan details how to accomplish the goals. It could include, for example, reducing unnecessary expenses, increasing the employment income, or investing in the stock market.

vi) Execution

Execution of a financial plan often requires discipline and perseverance. It may be necessary to seek assistance from professionals such as accountants, financial analysts, investment advisers, and lawyers.

v) Monitoring and reassessment

On the basis of passage of time in reaction to the financial plan execution, it is advisable that the financial plan is monitored for possible adjustments or reassessments. It may be necessary to institute some milestones for the monitoring and evaluation of the execution of the financial plan.

7.0 REFERENCES/FURTHER READINGS

Ariely, Dan (July 2009).The End of Rational Economics, Harvard Business Review. Accessed on 14 January, 2016 from https://www.aicpa.org/interestareas/ personalfinancialplanning/… pdf

Kwok, H., Milevsky, M., and Robinson, C. (1994) Asset Allocation, Life Expectancy, and Shortfall, *Financial Services Review*, 1994, vol 3(2), pg. 109-126.

Opdyke, J.D. (2010). Complete Personal Finance Guidebook, The Wall Street Journal Guidebook, New York: Crown Publishing Group.

Tahira, K. H. (2009). Personal Finance: Past, Present, and Future, Social Science Research Network. Iowa State University - Department of Human Development and Family Studies: 4–16.

UNIT 15: MAINTAINING SAVINGS ACCOUNT FOR CASH RESERVES

CONTENTS

1.0 INTRODUCTION

This study unit of the course material is used to expose you to the fact that saving in respect of personal finance involves nominal conservation of money for future use. A deposit account paying interest is typically used to hold money for future needs. And such savings can be utilized to make a capital purchase or for investment purposes. This study unit also incorporates the nature of savings account in which accumulated funds can be kept. Furthermore, this unit also features advantages as well as disadvantages that are inherent in savings account, and the differences between savings account and current account.

2.0 OBJECTIVES

After studying this unit, you should be able to:

- Differentiate between cash savings and cash investment
- Discuss the nature of savings account
- Mention the features of savings account
- Identify the advantages and disadvantages of savings account
- Mention the differences between savings account and current account

3.0 MAIN CONTENT

3.1 Cash Savings versus Cash Investment

The act of saving in respect of personal finance corresponds to nominal conservation of money for future use. A deposit account paying interest is typically used to hold money for future needs. Such savings constitutes an emergency fund, which can be utilized to make a capital purchase or for use in meeting others purposes.

Within personal finance, money that is used to purchase shares, committed in an investment fund or used to buy any asset where there is an element of capital risk is regarded as an investment. This is an important distinction because the investment risk can cause a capital loss when the investment is realized, unlike cash savings.

Cash savings accounts are considered to have minimal risk. In many economies around the world, all commercial banks are required to maintain deposit insurance, which is normally issued by the deposit insurance corporations or agencies as the case may be. The deposit insurance corporation is normally established to prevent the loss of cash deposits in the event of a bank failure. The notable bank failure is at the instance of the Great Depression in the United States of America within 1929-1932. The advent of deposit insurance arrangement has come to prevent such great loss occurring ever again.

The terms saving and investment are used interchangeably, in many instances. For example, many deposit accounts are regarded as investment accounts by some commercial banks for the purposes of marketing. Basically, on one hand, money that is invested (or saved) in cash is regarded as savings. On the other hand, if money is invested (or committed) in any type of asset which can fluctuate in nominal value, then it is regarded as an investment.

A savings account is a kind of bank account held at a retail bank or other designated bank that pays interest but cannot be used directly as money in the narrow sense of a medium of exchange, for example, by writing a cheque. These accounts let customers set aside a portion of their liquid assets while earning a monetary return. For the bank, money in a savings account may not be callable immediately and, in some jurisdictions, does not incur a reserve requirement. Cash in the bank's vaults may thus be used, for example, to fund interest-paying loans.

Current account is used to keep money in the bank but its funds can be accessed by the owner of the account every time he/she desires with the use of cheque. The owner of current account can make payments through standing orders with the bank. The owners of current accounts, in most cases, are not entitled to interest payments by the bank on their standing balances. On the contrary, they are associated with commission on turnover on the basis of the number of transactions on the account in a given period of time.

SELF ASSESSMENT EXERCISE 1

Differentiate between cash savings and cash investment

3.2 Nature of Savings Account.

Savings account refers to a bank account on which interest is paid. Traditionally, savings account is the type of account for which a bankbook is used to record deposits, withdrawals, and interest payments. Savings accounts are normally opened towards encouraging the people to conserve money and collect their cash for use in the future.

In general terms, savings account involves keeping money in bank account or other depository institution account: from which withdrawals can be made; interest accrues on the account balance; does not have any maturity date; and usually does not require a minimum balance.

These features, though not exhaustive, explain the nature of savings account.

Commercial banks, microfinance banks, and other type of bank as the case may be in some other countries like State bank of India, Bank of India, etc. accept cash for the purpose of savings for individual savers. In some other countries around the world, just like in Nigeria in the past, postal departments of the General Post Offices accept deposits by way of opening saving bank account with them for individual savers.

The saving account is generally opened in banks by: salary earners; the persons who have a fixed regular income; and those who depend on transfer incomes from their other people such parents and relations or the government in countries where some people are entitled to social security payments. Furthermore, the savings account facility is also given to students, senior citizens, and pensioners, among other groups of people.

In Nigeria, savings account can be opened by going through the necessary formalities in commercial banks, mortgage banks, and microfinance banks. The initial amount required for deposit varies from N1,000 to N5,000, depending on the particular bank being patronized by an individual. The saving account holder is allowed to withdraw money from the account as and when required. The interest which is given on saving accounts is sometime attractive, but often nominal. Presently, the rate of interest ranges between 2% to 5% per annum, on the average, in Nigeria.

In general terms, the interest rates can also be negotiated just like in the case of fixed deposits account; varying according to the amount of money being deposited in the saving account, scheme opted for, and its maturity range. It is also subject to current trend of banking policies in any country.

Some individuals use savings accounts to save up money for a specific goal, such as a down payment on a home or a future vacation. Others have no specific plans for the money, but use the account as a way to store their cash in a safe place while earning a return on it. Some savings accounts are used as an emergency fund, allowing an individual or family to save money safely to be used in case of emergency circumstances, such as job loss or hospitalization. An ATM card can often be linked to a savings account, but this card can only be used at automated teller machines, not as a debit card to buy things at stores.

3.3 Features of Savings Account

Generally, the main features of savings account in bank include the following.

1. The main objective of saving account is to promote savings.
2. There is no restriction on the number and amount of deposits.
3. Withdrawals are allowed subject to certain restrictions in some instances.
4. The money can be withdrawn either by withdrawal slip or cheque of the respective bank.
5. The rate of interest payable is very nominal on saving accounts. At present it is between 2% to 5% per annum, on the average, in Nigeria.
6. Saving account is of continuing nature. There is no maximum period of holding.

7. A minimum amount is required, by some banks, to be kept in savings account to keep it functioning.
8. There is no loan facility associated with savings account.
9. Electronic clearing System (ECS) or E-Banking is available which with effect payment for electricity bill, telephone bill and other routine household expenses.
10. Generally, equated monthly installments (EMI) for housing loan, personal loan, car loan, etc., are paid (routed) through saving bank account.

However, some countries such as Nigeria require details of accounts to be furnished to the Financial Intelligence agency in the event that the amount being deposited exceeds a bench mark of five millions of naira. Also in India, mandatory Permanent Account Number details are required to be furnished for doing cash transactions exceeding 50,000 rupees.

SELF ASSESSMENT EXERCISE 2

What are the features of a savings account?

3.4 Advantages and Disadvantages of Saving Account

3.4.1 Advantages of Saving Account

The advantages of saving account include the following. i) Savings accounts are easy to obtain because they generally do not require much formalities such as referees.

ii) They are a safe way to store money in a bank instead of keeping the cash under the mattress or inside the pillows.

iii) They often attract some small amount of interest on the money deposited in the accounts.

iv) The interest payable generally for savings account is more than that of current accounts (checking accounts), if at all it attracts any interests, or money market instruments.

v) Savings account encourages savings habit among salary earners and others who have fixed income or transfer earnings.

vi) It enables the depositor to earn income by way of saving bank interest.

vii) Savings account helps the depositor to make payment by way of transfers or issuing cheques where available.

viii) It shows total income of salary earners and other persons who are savers during the year.

ix) Savings account passbook acts as an identity and residential proof of the account holder.

x) It provides a facility such as Electronic fund transfer (EFT) to other people's accounts.

xi) It aids to keep records of all online transactions carried out by the account holder.

xii) It provides immediate funds as and when required through ATM.

3.4.2 Disadvantages of Savings Accounts

While savings account has advantages, it also has some disadvantages which are highlighted as follows.

i) The liquidity of a savings account as one of its key benefits also makes the funds too readily available, which could tempt you to spend them.

ii) Savings account attracts payment of lower interest rates than the current account.

iii) Savings account is not ideal for use in keeping funds over a long period of time unlike the fixed deposit accounts.

iv) Savings account is not associated with the chequeing system in most cases because only a few banks provide cheques for savings accounts.

v) Some banks may introduce restrictions on withdrawals and the least balance to be maintained in savings accounts.

SELF ASSESSMENT EXERCISE 3
What are the advantages of a savings account?

3.5 Differences between Savings Account and Current Account

In deposit terminology, the term savings Account refers to a bank account opened with a deposit of liquid funds and without having a given maturity date. Savings accounts usually have some restrictions on the number of withdrawals per statement period, and they tend to pay a relatively low rate of interest. The amount required to open savings account can be very minimal but a substantial amount of money is required to open a current account.

Although the terms of specific savings Accounts can vary among financial institutions and countries, savings Accounts tend to differ from checking accounts because they cannot usually be used as money by allowing the account holder to make a virtually unlimited number of withdrawals per statement cycle via check or debit card. For example, in some countries, only up to six withdrawals from a Savings Account can be made per statement cycle without incurring a penalty, although the number of deposits per cycle is generally not limited.

There are specific requirements that are associated with current accounts. These requirements include provision of references or referees, referees must be current accounts holders, and some banks such as in Nigeria, the referees must not be salary accounts holders even if they are current accounts.

Savings Accounts are provided by retail banks, savings and loan corporations and credit unions that are usually regulated within the country in which they operate. Savings accounts are used by individuals and businesses around the world as a means of storing their liquid funds for future use. On the other hand, current accounts are usually reserved for those who much money such as wealthy individuals, high networth individuals, institutions, businesses and corporate entities.

Current or cheque account does not attract interest payments but the holders are charged commission on turnover (COT) on regular or monthly basis depending on the volume of transactions on the account. Current accounts can be operated with commercial banks, merchant banks, microfinance banks, and other financial institutions depending on the country involved.

Substantial investment security is provided by savings Accounts held with reputable and insured financial institutions, but as a result of this perceived lack of risk, they usually only offer a low nominal rate of return or interest to the holder on deposits. Higher returns on Savings Accounts can sometimes be obtained from online savings accounts, but the risks in doing so may be greater, especially if the financial institution taking the deposit is uninsured and or poorly capitalized.

Savings account holders in Nigeria are only restricted in withdrawing their money by leaving a minimum balance but in some other banks, no restrictions are imposed due to stiff competition in the banking industry. However, holders of Savings Accounts in the United States, for instance, are permitted only up to six withdrawals per statement cycle without incurring a penalty. Nevertheless, the number of deposits per cycle into a Savings Account is generally not limited.

In Nigeria, savings account depositors are insured by their banks with the National Deposit Insurance Corporation (NDIC) against bank distress or failure. This ensures savings account depositors' access to prescribed refund in any eventuality. Furthermore, In the United States, savings account deposits are protected up to a certain amount by the Federal Deposit Insurance Corporation or FDIC when made with FDIC member financial institutions.

4.0 CONCLUSION

This unit of the course material has provided you with the basic fact that the act of saving in respect of personal finance corresponds to nominal conservation of money for future use. A deposit account paying interest is typically used to hold money for future needs. Money that is used to purchase shares, committed in an investment fund or used to buy any asset where there is an element of capital risk is regarded as an investment. Savings account refers to a bank account with features such as: interest payment by the bank; issuance of a bankbook to record deposits, withdrawals, and interest payments; and lack of loan facility, among others. Savings account encourages savings habit, enables depositor to earn income, helps depositor to make payments, and shows total income of salary earners and other persons during the year, among others. Savings account differs from current account in areas such requirements for opening the accounts, amount required for initial deposits, and payment of interest, among others.

5.0 SUMMARY

In this study unit of the course material, you have been taught the following topics:

- Cash Savings versus Cash Investment;
- Nature of Savings Account;
- Features of Savings Account;
- Advantages and disadvantages of Saving Account; and
- Differences between Savings Account and Current Account

In the next study unit, you will be taken through personal financial planning.

6.0 TUTOR MARKED ASSIGNMENT

1. Differentiate between cash savings and cash investment

2. Discuss the nature of savings account
3. Mention the differences between savings account and current account

Answers to Self-Assessment Exercises

1. Differentiate between cash savings and cash investment

The terms saving and investment are used interchangeably, in many instances. For example, many deposit accounts are regarded as investment accounts by some commercial banks for the purposes of marketing. Basically, on one hand, money that is invested (or saved) in cash is regarded as savings. On the other hand, if money is invested (or committed) in any type of asset which can fluctuate in nominal value, then it is regarded as an investment.

2. What are the features of a savings account?

The main features of savings account in bank include the following.

i) The main objective of saving account is to promote savings.
ii) There is no restriction on the number and amount of deposits.
iii) Withdrawals are allowed subject to certain restrictions in some instances.
iv) The money can be withdrawn either by withdrawal slip or cheque of the respective bank.
v) The rate of interest payable is very nominal on saving accounts. At present it is between 2% to 5% per annum, on the average, in Nigeria.
vi) Saving account is of continuing nature. There is no maximum period of holding.
vii) A minimum amount is required, by some banks, to be kept in savings account to keep it functioning.
viii) There is no loan facility associated with savings account.
ix) Electronic clearing System (ECS) or E-Banking is available which with effect payment for electricity bill, telephone bill and other routine household expenses.
x) Generally, equated monthly installments (EMI) for housing loan, personal loan, car loan, etc., are paid (routed) through saving bank account.

3. What are the advantages of a savings account?

The advantages of saving account include the following.

i) Savings accounts are easy to obtain because they generally do not require much formalities such as referees.
ii) They are a safe way to store money in a bank instead of keeping the cash under the mattress or inside the pillows.
iii) They often attract some small amount of interest on the money deposited in the accounts.
iv) The interest payable generally for savings account is more than that of current accounts (checking accounts), if at all it attracts any interests, or money market instruments.
v) Savings account encourages savings habit among salary earners and others who have fixed income or transfer earnings.
vi) It enables the depositor to earn income by way of saving bank interest.
vii) Savings account helps the depositor to make payment by way of transfers or issuing cheques where available.
viii) It shows total income of salary earners and other persons who are savers during the year.
ix) Savings account passbook acts as an identity and residential proof of the account holder.
x) It provides a facility such as Electronic fund transfer (EFT) to other people's accounts.

xi) It aids to keep records of all online transactions carried out by the account holder.
xii) It provides immediate funds as and when required through ATM.

7.0 REFERENCES/FURTHER READINGS

Akrani, (2011). Savings Account: Meaning, Features, Advantages. Accessed on 14 January, 2016 from http://www.businessdictionary.com/definition/savings-account.html

Coila, B. (2016). What Is Definition of Savings Account? Accessed on 14 January, 2016 from http://www.livestrong.com/article/58780-definition-savings-account/

Dell'Amore, G. (1983). Household Propensity to Save. In Arnaldo Mauri (ed.). Mobilization of Household Savings, a Tool for Development, Finafrica, Milan.

Kotlikoff, Laurence J. (2008). Saving. In David R. Henderson, Concise Encyclopedia of Economics (2nd ed.). Indianapolis: Library of Economics and Liberty.

Modigliani, F. (1988). The Role of Intergenerational Transfers and the Life-cycle Saving in the Accumulation of Wealth, *Journal of Economic Perspectives*, 2, 1988.

UNIT 16: PLANNING FOR CONTINGENCY FUND

CONTENTS

1.0 INTRODUCTION

This study unit of the course material is used to expose you to the important issue of planning for contingency fund, which is also regarded as emergency fund in some literature. Building emergency fund is very essential toward meeting contingencies, which are not envisaged when they will actually take place and involves the use of amount of money. In planning for emergency funds, certain strategies which are to be taken into considerations, such that the regular contribution can be reasonable and the fund being kept in accessible ways, are also discussed in this unit. Furthermore, the unit also discusses the ideal ways through which to invest the contingency fund.

2.0 OBJECTIVES

After studying this unit, you should be able to:

- Define of contingency fund
- List and explain two types of contingency fund
- Mention and discuss commitments qualifying for contingency fund
- Identify and explain essential qualities of contingency fund
- Discuss the accumulating your emergency fund
- Identify and explain wise ways for investing the emergency fund

3.0 MAIN CONTENT

3.1 Meaning of Contingency Fund

An integral tenet of good financial planning for an individual involves preparing for the future due to its uncertain nature. Therefore, an indispensable constituent of a concrete financial plan for you is a contingency fund or an emergency fund.

A contingency or an emergency fund is premeditated to cover a financial shortfall with which to take care of an unexpected financial commitment in the foreseeable future. Your emergency fund can serve as an avenue to secure the money you need when you find yourself in dire strait. Since a contingency must be reliable, this therefore, requires that it needs to be held in form of guaranteed investments. This implies that savings accounts are good for emergency funds, while stocks are bad.

A contingency or emergency fund, in general terms, also needs to be held in liquid assets, otherwise short-term, accessible investments. Ideally, you would not need to use the money in your emergency fund o any flimsy commitments, and hence you will have to maintain it for the long-term commitment. Nevertheless, this delicate balance creates an interesting challenge; a long-term account holding short-term, low-interest bearing investments.

It is instructive to note that an emergency fund is not supposed to be a slush fund set aside for large entertainment and leisure purposes. The desire to acquire a new big TV screen cannot be regarded as an emergency regardless the fact that your old TV breaks down.

When you build up some money for contingency purposes, you are bound to have peace of mind. Your money is readily available because it will just be waiting to be called into use when occasion arises. The availability of the fund precludes you from scrambling to come up with money you need and you don’t have to turn to personal loans, which may not be readily available to cover the emergency. Sometime your emergency fund may not be big enough to cover everything but it can still help in reducing the amount of money you must look for from friends and family.

In terms of large your emergency fund should be, personal finance experts recommends that the contingency fund contain three months’ worth of expenses. In this economic hard time, the advice is to have at least six months’ worth of expenses saved up. However, building an emergency fund can be difficult during a trying economy. If you are trying to get out of debt, one approach is to first build up a reasonable sum for emergency fund, and then redirect your efforts toward eliminating your debt. In the event that you are debt-free, you have to continue building your emergency fund further.

In respect of determining what constitutes six months’ worth of expenses, you have to add up the amount you spend each month in your household budget categories and multiply by six. In this respect, make sure you include the amount you pay on your debts or mortgage, utilities, car loans, insurance, groceries, and other essential expenditures. It is also advisable to include entertainment items and incidentals that crop up during the month as well.

Furthermore, you should account for bills or other expenses that only come due once or a few times per year, for instance, your motor insurance and other paper renewals as well as amount being spent on changing car tyres on periodic basis or once every year.

Basically, therefore, the amount of money you put in each of your short and long-term emergency funds will depend on what you can afford and what you're comfortable with. For instance, you can keep about N2,000 in the short-term fund, while building up six months' worth of expenses in the long-term fund.

SELF ASSESSMENT EXERCISE 1
What is Contingency Fund?

3.2 Types of Contingency Fund

Contingency fund can be categorized into main areas such as short-term and long-term. Such distinction is essential towards ensuring that the fund is invested in such a way that will enhance return on the money in investment.

3.2.1 Short-term Contingency Fund

The Short-term Contingency Fund is the type of fund that is invested just for a few days before being liquidated. The essence of the short-term contingency fund should be in an accessible account, which will probably bear little interest. The most important consideration herein is accessibility. You may want an account that is attached to debit card and check-writing privileges as well. The purpose of your short-term emergency fund is for smaller emergencies such as car repairs or replacing a major appliance that has become dysfunctional. It can also be used as a connection to get you through the few days until you can access your long-term emergency funds in case of a more extreme situation.

3.2.2 Long-term Contingency Fund

A long-term emergency fund allows you to save for large-scale emergencies occasioned by events such as loss of job and major natural disaster like an earthquake or fire, and thereby earn a slightly higher level of interest. Accessibility to the fund is still important for consideration. However, it is appropriate to choose investments that take some months or years to liquidate as long as you have a short-term emergency fund to cover you in the interim.

SELF ASSESSMENT EXERCISE 2
Differentiate between short-term contingency fund and long-term contingency fund.

3.3 Commitments Qualifying for Contingency Fund

In order to ensure that your contingency fund is there when you need it, you need to be able to identify a true emergency. A true emergency is a situation that requires some sort of immediate action, and that can affect your long-term well-being or impact the viability of an important asset such as your home.

Some situations that constitute true emergencies might include the following events.

i) Health related emergency

Emergency on health related ground normally warrants saving for particularly if you are not qualified for treatment under health insurance scheme. Therefore, you can save money on health related issues and put less strain on your emergency fund.

ii) Need to travel or finance other arrangements

Such sudden need for travelling can arise as a result of a family emergency, such as a death in the extended family system as is the case in the African tradition. In some cases, you may have to go for loan in order to finance the huge amount involved in meeting burial expenses. This can happen when one's parent is involved. In some cases, you may have to renovate the family house or even build a new one before burial could take place while expenses would be incurred in keeping the dead body in the mortuary.

iii) Major unexpected car repairs

This happens often in terms of meeting for damages caused by a car accident or paying for a new engine. Routine car maintenance, however, should be scheduled into your monthly budget. You could even follow vehicle maintenance tips being published in some newspapers in order to save money.

iv) Failure of a major appliance

Emergency can arise in relation to breakdown of major household appliances such as failure of the deep freezer, the furnace (for heating the house) suddenly stops working or the major security door has serious problem. You may need to pay for replacement for any of these emergencies quickly as it occurs.

v) Large and unexpected home repairs

A major home repair may occur as a result of occurrence of natural disasters such as tornado, earthquake, landslide, and volcanic eruption. Such occurrence can spell major destruction to your property, and in some instances, people do lose their entire buildings. In the latter case, reconstruction becomes inevitable. In a minor scenario, if a tree branch falls on your home arising from rainstorm, you will have carry out repairs on the damaged part of the building. Home repairs are vital to address immediately since your home is often your biggest asset. Hence it is also advisable for homeowner to take insurance policy in which the risk is transferred to the insurance company.

SELF ASSESSMENT EXERCISE 3
Mention and discuss commitments qualifying for contingency fund.

3.4 Essential Qualities of Contingency Fund

There are essential qualities or considerations for contingency fund that can make it meaningful and available whenever it is needed to meet expenses. Such qualities are as discussed below.

1. Low Risk

Basically, investments often realize a rate of return that is directly proportional to how much risk they carry. This is why you'll need to be satisfied with low-interest bearing accounts in your emergency fund. In this regard, current account, savings, and money market investments as well as bank cash deposits and even physical cash are viable choices.

Just make sure your bank accounts or bank-guaranteed investments carry the deposit insurance policy. Treasury bills, notes, and bonds have traditionally been good options for safe investments as well. But since the guarantee attached to government-issued instruments has come into question, these may be treated as a very low-risk investment option. This is because government securities are regarded as gilt-edged securities because they are risk free or carry no risk and always guaranteed in respect of their repayment and interest payment.

The same holds true for other highly rated bond and bond funds such as those being issued by blue chip corporate entities. Such investments may constitute a portion of your long-term emergency fund, depending on how comfortable you are in taking risk.

2. Liquidity

This represents how quickly your assets can be converted to usable cash. For instance, a savings account is 100% liquid because it is already in cash and available anytime and anywhere you want it. Bonds, though, have to be sold before you can use them and you must wait for the cash settlement period to pass, one day for government issued securities, three days for all others.

In some cases, cash products can also be problematic. Cash deposits, for example, come with penalties if you withdraw money earlier than the agreed maturity date. It is necessary to understand the penalties of cash deposits you are considering or already own, since they can and do differ. Like bonds, cash deposits should constitute a portion of your long-term emergency fund.

3. Accessibility

To have access to your fund can sometimes be very difficult. The use of ATM can be problematic because your fund can be trapped, debited but did not dispense cash. In order to resolve this problem, you will have to fill a resolution form at the bank and then wait for almost one month or three months, if another bank ATM machine has been used, before your money can be credited back to your account.

This experience is one reason it is advisable to create a short-term and a long-term emergency fund. The short-term account can be accessed immediately. And for bigger issues, the short-term account has enough to hold you over while you wait for the long-term funds to mature.

It is advisable that you cultivate the habit of keeping cash on hand, making sure you have a savings withdrawal booklet, and ideally ensure that cheque-writing privileges are attached to your short-term emergency fund. This enhances your accessibility to your money at any time in virtually any place.

SELF ASSESSMENT EXERCISE 4

Identify and explain essential qualities of contingency fund.

3.5 Accumulating Your Emergency Fund

The task of accumulating the contingency fund can be very difficult because it involves commitment in terms of making regular contribution to the fund. Therefore, one of the most integral aspects to building an emergency fund is the large amount of money you must contribute on regular basis. This implies that you are not supposed to fund your emergency account all at once. This involves gradual accumulation that will eventually become a large sum of money; that is building it up a little at a time. The most important thing is to get started and to remain consistent so that over time you can reach your emergency fund goal.

There are some essential considerations that can help you for effective accumulation of your emergency fund. Such considerations are as identified and discussed below.

i) Break it down.

You have to take decision on how much you want in your emergency fund and figure out how much you can put in each month. Then, the next decision is simply to determine how long it will take to reach your target based on your monthly contribution. Breaking it down this way can make saving for your emergency fund and other goals to become more manageable.

ii) Use wasted money

Some amount of money being spent on social media and other forms of indulgence can amount to mere wastes. This implies that each household wastes some percentage of its income each month. You should determine the money leaks in your budget, for instance, in some items of expenditure such as excessive consumption of drinks, over-ordering food at restaurants, and leaving the lights on, among others. Take necessary steps to avoid them, and then use that money to build up your emergency fund.

iii) Make it a standing order

Schedule regular payments from your savings or current account to your emergency fund can be simplified by way of standing order. The standing order involves giving instructions to the bank to be deducting the regular amount from your income (salary) and transfer it to your contingency fund. This calls for financial discipline on your part that is inevitable if only you want to build a meaningful contingency fund. The transfer of the regular amount to your contingency fund becomes automatic. This approach saves you the trouble of having to remember to do it yourself every month.

iv) Enhance your account with dividend earnings

Dividends from your stock investments are not just for spending; you can also use them to enhance your emergency fund. Try to build an investment portfolio that includes dividend paying stocks, and deposit those dividends in your emergency fund. This is not the fastest way to fund your emergency account. Nevertheless, do ensure that you are doing other things as well.

v) Use spare change

It is advisable that you have your entire family to be emptying the change from their pockets, perhaps including their small denominations such as five naira and ten naira notes into a savings jar to being kept at home at the end of each day. This enhances your contingency fund especially well if you use mostly cash. At the end of each month, take the money in the savings jar and add it to your emergency fund. It is instructive to note that by using this technique to supplement or boost your emergency fund does not mean that you depend on it entirely to facilitate you towards achieving your goal.

vi) Celebrate milestones

It is also advisable that you celebrate milestones in the process of building your contingency fund. Obviously, this implies that when you reach a milestone, reward yourself with a small treat, such as attending movies or buying a new book or dress for yourself. It is instructive to keep track of your goals and mark special achievements. Even taking a shot at cooking a fun celebratory dinner at home, instead of eating out, can be a good way to reward and motivate yourself to keep going in the task of building the contingency fund.

3.6 Investing the Emergency Fund

It is always profitable to entrust your contingency fund in viable outlets that you can access whenever it is needed. Any contingency fund that cannot be accessed by way of writing a cheque or withdrawing the money through ATM or just simply pulling it out of a safe goes into your long-term emergency fund. It is advisable that you keep your larger, long-term emergency fund in a high-yield deposit accounts or fixed accounts in order to get a slightly higher rate of return.

One strategy that you can exploit is to put a portion of your long-term fund in high-quality bonds. By doing so, you can achieve a better rate of return with minimal risk and can liquidate into cash within a few days should you run into an emergency that requires a large amount of money. You can keep your smaller, short-term emergency fund in savings account at a local bank such as microfinance bank. The yield is not as high or comparable with that of the bond but you can be sure of easy access to your money immediately.

Some people also create a cash deposit arrangement in their long-term fund. You can create a cash deposit arrangement by purchasing multiple cash deposits such that one matures every month, or every three months, or at any other interval of your choice. In this way, you are sure of when the money will become available and you will only lose the interest on one cash deposit, as opposed to all of them, should you need to access this money in emergency. Moreover, a cash deposit arrangement allows you to access higher yields that only accompany long-term cash deposits. However, a cash deposit arrangement should only make up a portion of your long-term emergency fund so you can avoid any penalties associated with premature access.

In advance economies, people can consider using a credit card for an emergency if they cannot access their emergency funds in time. Nevertheless, they do so only if they can use credit cards that rewards wisely by paying off the full balance before the due date.

4.0 CONCLUSION

This unit of the course material has provided you with insight into the need to plan for building emergency fund is very essential toward meeting contingencies, which are not envisaged when they will actually take place and involves the use of amount of money. In planning for emergency funds, certain strategies are to be taken into consideration such that the regular contribution can be reasonable, and the fund being kept is accessible. A contingency fund can therefore, make a difference between financial failure and financial success. It is therefore, advisable that you develop financial discipline to accumulate contingency fund. The fund will prepare you for unexpected setbacks and reduce your dependence on borrowing money that in most cases comes at high interest rates. Furthermore, ensure that you carefully examine your expenses and use the information to develop the emergency fund goal; see how much you can save each month and identify unnecessary expenses, or wasteful money. It is also necessary that you make a plan to build up an emergency fund and decide how you want it allocated. Above all, ensure that you use your emergency money wisely.

5.0 SUMMARY

In this study unit of the course material, you have been taught the following topics:

- Meaning of Contingency Fund
- Short-term Contingency Fund
- Long-term Contingency Fund
- Commitments Qualifying for Contingency Fund
- Essential Qualities of Contingency Fund
- Accumulating Your Emergency Fund
- Investing the Emergency Fund

In the next study unit, you will be taken through insurance and risk hedging.

6.0 TUTOR MARKED ASSIGNMENT

1. Differentiate between short-term and long-term contingency fund.
2. List and explain commitments that qualify for contingency fund
3. Mention and discuss essential Qualities of Contingency Fund

Answers to Self-Assessment Exercises

1. What is Contingency Fund?

A contingency or an emergency fund is premeditated to cover a financial shortfall with which to take care of an unexpected financial commitment in the foreseeable future. Your emergency fund can serve as an avenue to secure the money you need when you find yourself in dire strait. Since a contingency must be reliable, this therefore, requires that it needs to be held in form of guaranteed investments. This implies that savings accounts are good for emergency funds, while stocks are bad.

2. Differentiate between short-term contingency fund and long-term contingency fund.

The Short-term Contingency Fund is the type of fund that is invested just for a few days before being liquidated. It should be in an accessible account, which will probably bear little interest. The most important consideration herein is accessibility. The purpose of your short-term emergency fund is for smaller emergencies such as car repairs or replacing a major appliance that has become dysfunctional. It can also be used as a connection to get you through the few days until you can access your long-term emergency funds in case of a more extreme situation.

A long-term emergency fund, on the other hand, allows you to save for large-scale emergencies occasioned by events such as loss of job and major natural disaster like an earthquake or fire, and thereby earn a slightly higher level of interest. Accessibility to the fund is still important for consideration but it is appropriate to choose investments that take some months or years to liquidate as long as you have a short-term emergency fund to cover you in the interim.

3. Mention and discuss commitments qualifying for contingency fund.

i) Health related emergency

Emergency on health related ground normally warrants saving for particularly if you are not qualified for treatment under health insurance scheme. Therefore, you can save money on health related issues and put less strain on your emergency fund.

ii) Need to travel or finance other arrangements

Such sudden need for travelling can arise as a result of a family emergency, such as a death in the extended family system as is the case in the African tradition. In some cases, you may have to go for loan in order to finance the huge amount involved in meeting burial expenses.

iii) Major unexpected car repairs

This happens often in terms of meeting for damages caused by a car accident or paying for a new engine. Routine car maintenance, however, should be scheduled into your monthly budget. You could even follow vehicle maintenance tips being published in some newspapers in order to save money.

iv) Failure of a major appliance

Emergency can arise in relation to breakdown of major household appliances such as failure of the deep freezer, the furnace (for heating the house) suddenly stops working or the major security door has serious problem. You may need to pay for replacement for any of these emergencies quickly as it occurs.

v) Large and unexpected home repairs

A major home repair may occur as a result of occurrence of natural disasters such as tornado, earthquake, landslide, and volcanic eruption. Such occurrence can spell major destruction to your property, and in some instances, people do lose their entire buildings.

4. Identify and explain essential qualities of contingency fund.

i) Low Risk

Basically, investments often realize a rate of return that is directly proportional to how much risk they carry. This is why you'll need to be satisfied with low-interest bearing accounts in your emergency fund. In this regard, current account, savings, and money market investments as well as bank cash deposits and even physical cash are viable choices.

ii) Liquidity

This represents how quickly your assets can be converted to usable cash. For instance, a savings account is 100% liquid because it is already in cash and available anytime and anywhere you want it. Bonds, though, have to be sold before you can use them and you must wait for the cash settlement period to pass, one day for government issued securities, three days for all others.

iii) Accessibility

To have access to your fund can sometimes be very difficult. The use of ATM can be problematic because your fund can be trapped, debited but did not dispense cash. In order to resolve this problem, you will have to fill a resolution form at the bank and then wait for almost one month or three months, if another bank ATM machine has been used, before your money can be credited back to your account.

7.0 REFERENCES/FURTHER READINGS

Ariely, Dan (July 2009).The End of Rational Economics, Harvard Business Review. Accessed on 14 January, 2016 from https://www.aicpa.org/interestareas/ personalfinancialplanning/…pdf

Kwok, H., Milevsky, M., and Robinson, C. (1994) Asset Allocation, Life Expectancy, and Shortfall, *Financial Services Review*, 1994, vol 3(2), pg. 109-126.

Marquit, M. (2016). How to Start & Build Up Your Emergency Fund in Savings. Wall Street Journal, New York. Accessed on 14 January, 2016 from www.moneycrashers.com/start-build-emergency-fund-savings/

Opdyke, J.D. (2010). Complete Personal Finance Guidebook, The Wall Street Journal Guidebook, New York: Crown Publishing Group.

Tahira, K. H. (2009). Personal Finance: Past, Present, and Future, Social Science Research Network. Iowa State University - Department of Human Development and Family Studies: 4–16.

UNIT 17: INSURANCE AND RISK HEDGING

CONTENTS

1.0 INTRODUCTION

In the preceding study unit, we discussed planning for contingency funds. This is related to a plan to take care of unforeseen circumstances which are themselves shrouded in risks of business and our lives generally. Therefore, it is pertinent for you to take a legal scheme that will enable you to hedge against risks. This, given the fact that risk refers to any situation whereby there is uncertainty about what outcome will occur in the future; regarding business operations in particular. The subject matter of our discussion in this study unit, therefore, is centred on insurance and risk hedging.

2.0 OBJECTIVES

After studying this unit, you should be able to:

- Explain and explain the term investment
- Identify and discuss the characteristics of investment
- Mention and explain types of investment

3.0 MAIN CONTENT

3.1 CONCEPTUALIZATION OF INSURANCE

Insurance refers to a means with which take protection from financial loss in business generally. The scheme provides a framework for risk management. First and foremost, insurance scheme is appropriated to hedge against the risk of a contingent, uncertain loss. Risk itself risk refers to any situation which involves uncertainty about what outcome will occur.

In business, some form of risk or a loss is certain to occur. Hence, it becomes obvious that a businessman has to plan to hedge the risk or mitigate it in advance and treat the measure as a definite cost to the business. Nevertheless, in the event of uncertainty about the occurrence of a loss, risk would come into play since uncertainty breeds calamity and consequential burden on the business and its fortunes.

Basically, insurance involves pooling funds from several insured entities (known as exposures) to compensate for the losses that may incur. The insured entities are therefore protected from risk for a fee, with the fee being contingent on the frequency and severity of the event occurring. For qualification of an insurable risk, the risk insured against must meet certain characteristics. Insurance scheme is regarded as a financial intermediary, which is a commercial enterprise and a major part of the financial services industry.

The entity providing insurance policy, which engages in insurance business, is known as *an insurer, insurance company, or insurance carrier*. The individual or entity who subscribes to insurance policy against risks is the insured or policyholder. Fundamentally, the insurance transaction involves the insured who assumes a guaranteed and known relatively small loss in the form of payment to the insurer in exchange for the insurer's promise to compensate the insured in the event of a covered loss. The loss may or may not be financial, but it must be reducible to financial terms. And it must involve something in which the insured secures an *insurable interest* occasioned by ownership, possession, or pre-existing relationship.

The insured who takes a policy by receiving an insurance contract, which is known as *insurance policy*, entailing the conditions and circumstances under which the insured will be financially compensated. The sum of money being charged by the insurer to the insured for the coverage established in the insurance policy is called the *premium*. In the event that the insured suffers a loss, which is potentially covered by the insurance policy, the insured submits a claim to the insurer for processing by a *claims adjuster*.

SELF ASSESSMENT EXERCISE 1
Explain the term Insurance.

3.1.1 Legal Principles of Insurance Contract

In the process of taking insurance policy by a company, an entity or even an individual, there are basic legal requirements that must be upheld. Such legal principles of insurance include the following.

1. **Indemnity**:– the insurance company indemnifies, or compensates, the insured in the case of certain losses only up to the insured's interest. To "indemnify" Implies making whole again, or to be reinstated to the position that one was in, to the extent possible, prior to the happening of a specified event or peril. Accordingly, life insurance is generally not considered to be indemnity insurance, but rather "contingent" insurance, that is, a claim arises on the occurrence of a specified event

2. **Insurable interest**:– the insured typically must directly suffer from the loss. Insurable interest must exist whether property insurance or insurance on a person is involved. The concept requires that the insured have a "stake" in the loss or damage to the life or

property insured. What that "stake" is will be determined by the kind of insurance involved and the nature of the property ownership or relationship between the persons. The requirement of an insurable interest is what distinguishes insurance from gambling.

3. **Utmost good faith**:– also known as uberima fides, it implies that the insured and the insurer are bound by a good faith bond of honesty and fairness. Material facts must be disclosed.

4. **Contribution**:– insurers which have similar obligations to the insured contribute in the indemnification, according to some method.

5. **Subrogation:**– the insurance company acquires legal rights to pursue recoveries on behalf of the insured; for example, the insurer may sue those liable for the insured's loss. The Insurers can waive their subrogation rights by using the special clauses.

6. **Proximate cause**:– the cause of loss (the peril) must be covered under the insuring agreement of the policy, and the dominant cause must not be excluded.

SELF ASSESSMENT EXERCISE 2

List and explain the legal principles involved in the contract of insurance.

3.1.2 Methods of insurance

In practical terms, some methods of insurance are as list and explained below.

i) Co-insurance

This implies that all classes of risks insured with insurance company are shared between insurers or insurance companies.

ii) Dual insurance

This implies that risks having two or more policies with same coverage would not pay separately, that is on individual policies; a concept called contribution. The insurance companies, by implication, would contribute together to make up the policyholder's losses. However, in case of contingency insurances like life assurance, dual payment is allowed.

iii) Self-insurance

This refers to situations where companies or organizations retain their risk management in the operations of their business or entities without the need to transfer it to insurance companies.

iv) Reinsurance

This implies circumstances in which the magnitude of risk insured against by some companies is too high for a single insurance company to bear. Therefore, the insurer transfers some part of or all risks to another insurer called reinsurance company or reinsurer.

SELF ASSESSMENT EXERCISE 3

List and explain methods of insurance.

3.2 CHARACTERISTICS OF INSURABLE RISKS

Generally, a risk which is insurable or qualified to be insured by corporate entities or private companies shares seven common characteristics such as listed and explained below.

1. Large number of similar exposure units

Since insurance operates through pooling resources, the majority of insurance policies are provided for individual members of large classes, allowing insurers to benefit from the law of large numbers in which predicted losses are similar to the actual losses. Exceptions include The Lloyd's of England is an exception to this rule. Lloyd's is renowned for insuring the life or health of actors, sports figures, and other famous individuals. Nevertheless, all exposures will have particular differences, which may lead to different premium rates.

2. Definite loss

This implies that the loss takes place at a *known time*, in a *known place*, and from a *known cause*. The classic example is death of an insured person on a life insurance policy. Fire, automobile accidents, and worker injuries may all easily meet this criterion while other types of losses may only be specific in theory. An instance is the Occupational disease, which may involve prolonged exposure to injurious conditions for which no specific time, place, or cause is identifiable. Instructively, the time, place, and cause of a loss should be clear enough that with sufficient information, the insurer could objectively verify all three elements.

3. Accidental loss

This connotes that the event that constitutes the trigger of a claim should be fortuitous, or at least outside the control of the beneficiary of the insurance. The loss should be pure, in the sense that it results from an event for which there is only the opportunity for cost or loss. All events that contain speculative elements like ordinary business risks or gambling through lottery, etc, are generally not considered insurable.

4. Large loss

This implies that the size of the loss must be meaningful from the perspective of the insured. Insurance premiums need to cover both the expected cost of losses, plus the cost of issuing and administering the policy, adjusting losses, and supplying the capital needed to reasonably assure that the insurer will be able to pay claims. For small losses, these latter costs may be several times the size of the expected cost of losses. There is hardly any point in paying such costs unless the protection offered has real value to a buyer.

5. Affordable premium

This connotes that in the likelihood that an insured event is so high, or the cost of the event so large, that the resulting premium is large relative to the amount of protection offered, then it is not likely that the insurance will be purchased, even if on offer. Furthermore, as the accounting profession formally recognizes in financial accounting standards, the premium cannot be so large that there is not a reasonable chance of a significant loss to the insurer. If there is no such chance of loss, then the transaction may have the form of insurance, but not the substance.

6. Calculable loss

There are two elements that must be at least estimable, if not formally calculable: the *probability of loss*, and the *attendant cost*. Probability of loss is generally an practical exercise. Cost has more to do with the ability of a reasonable person in possession of a copy of the insurance policy, and a proof of loss associated with a claim, presented under that policy, to make a reasonably definite and objective evaluation of the amount of the loss recoverable as a result of the claim.

7. Limited risk of catastrophically large losses

This connotes that insurable losses are ideally independent and non-catastrophic. This implies that the losses do not happen all at once, and individual losses are not severe enough to bankrupt the insurer. Insurer companies may prefer to limit their exposure to a loss from a single event to some small portion of their capital base. The capital constrains insurers' ability to offer earthquake insurance just like wind insurance in hurricane zones. However, in a country like the US, the risk associated with flood is insured by the federal government. In commercial fire insurance, it is possible to find single properties whose total exposed value is well in excess of any individual insurer's capital constraint. Therefore, such property insurance policies are generally shared among several insurers, or are insured by a single insurer who syndicates the risk into the reinsurance market.

SELF ASSESSMENT EXERCISE 4
Mention and discuss the fundamental characteristics of insurable risks.

3.3 TYPES OF INSURANCE POLICY

There are many insurance policies that are available for purchase by individual companies. And any risk that can be quantified can potentially be insured. Specific kinds of risk that may give rise to claims are known as *perils*. An insurance policy will set out in detail which perils are covered by the policy and those ones that are not covered. Below are non-exhaustive lists of the many different types of insurance that exist.

Generally, business insurance takes a number of different forms, such as the various kinds of professional liability insurance, also called professional indemnity (PI). There is the business owner's policy, which packages into one policy many of the kinds of coverage that a business owner needs.

1. Auto insurance

Automobile insurance protects the policyholders against financial loss in the event of an incident involving a vehicle they own, such as in a traffic collision. The coverage of the policy generally includes: property coverage, for damage to or theft of the car; liability coverage, for the legal responsibility to others for bodily injury or property damage; and medical coverage, for the cost of treating injuries, rehabilitation and sometimes lost wages and funeral expenses.

2. Gap insurance

Gap insurance covers the excess amount on a auto loan in an instance where your insurance company does not cover the entire loan. Depending on the company's specific policies it might or might not cover the deductible as well. This policy is designed for use by those who put low down payments, have high interest rates on their loans, and those with 60-month or longer terms. Gap insurance is typically offered by a finance company when the vehicle owner purchases their vehicle, but many auto insurance companies offer this coverage to consumers as well.

3. Income protection insurance

Under this type of coverage, there are some constituent policies such as enumerated below.

i) Disability insurance policy

Disability insurance policies provide financial support in the event of the policy holders becoming unable to work because of disabling illness or injury. It provides monthly support to help pay such obligations as mortgage loans and facility associated with credit cards. Short-term and long-term disability policies are available to individuals, but considering the expense, long-term policies are generally obtained only by those with at least six-figure incomes, such as doctors, lawyers, etc. Short-term disability insurance covers a person for a period typically up to six months, paying a stipend each month to cover medical bills and other necessities.

ii) Long-term disability insurance

Long-term disability insurance covers an individual's expenses for the long term, up until such time as they are considered permanently disabled and thereafter Insurance companies will often try to encourage the person back into employment in preference to and before declaring them unable to work at all and therefore totally disabled.

iii) Total disability insurance

Total disability insurance provides benefits when a person is permanently disabled and can no longer work in their profession, often taken as an adjunct to life insurance.

iv) Workers' compensation policy

Workers' compensation insurance replaces all or part of a worker's wages lost and accompanying medical expenses incurred because of a job-related injury.

4. Casualty insurance

Casualty insurance is a policy that insures against accidents, not necessarily tied to any specific property. It is a broad spectrum of insurance that a number of other types of insurance could be classified, such as auto, workers compensation, and some liability insurances.

i) Crime insurance

Crime insurance is a form of casualty insurance that covers the policyholder against losses arising from the criminal acts of third parties. For example, a company can obtain crime insurance to cover losses arising from theft or embezzlement.

ii) Terrorism Insurance

Terrorism Insurance is a policy that provides protection against any loss or damage caused by terrorist activities. This is very popular in the US established in the wake of September 2011 incident; It is meant as a federal program providing a transparent system of shared public and private compensation for insured losses resulting from acts of terrorism.

iii) Kidnap and ransom insurance

Kidnap and ransom insurance is designed to protect individuals and corporations operating in high-risk areas around the world against the perils of kidnap, extortion, wrongful detention and hijacking.

iv) Political risk insurance

Political risk insurance is a form of casualty insurance that can be taken out by businesses with operations in countries in which there is a risk that revolution or other political conditions could result in a loss.

5. Life insurance

This policy also known as life assurance policy provides a monetary benefit to a decedent's family or other designated beneficiary. It may specifically provide for income to an insured person's family, burial, funeral and other final expenses. Life insurance policies often allow the option of having the proceeds paid to the beneficiary either in a lump sum cash payment or an annuity. In most states, a person cannot purchase a policy on another person without their knowledge.

Annuities provide a stream of payments and are generally classified as insurance because they are issued by insurance companies. They are regulated as insurance, and require the same kinds of actuarial and investment management expertise that life insurance requires. Annuities and pension that pay a benefit for life are sometimes regarded as insurance against the possibility that a retire will outlive his or her financial resources. In that sense, they are the complement of life insurance and, from an underwriting perspective, are the mirror image of life insurance.

Certain life insurance contracts accumulate cash values, which may be taken by the insured if the policy is surrendered or which may be borrowed against. Some policies, such as annuities and endowment policies, are financial instruments to accumulate or liquidate wealth when it is needed.

6. Property insurance

Property insurance provides protection against risks to property, such as fire, theft or weather damage. This may include specialized forms of insurance such as fire insurance, flood insurance, earthquake insurance, home insurance, inland marine insurance or boiler. The term *property insurance* may, like casualty insurance, be used as a broad category of various subtypes of insurance such as aviation insurance, crop insurance, and fidelity bond policy, among others.

Home insurance, also commonly called hazard insurance or homeowners insurance provides coverage for damage or destruction of the policyholder's home. In some geographical areas, the policy may exclude certain types of risks, such as flood or earthquake that require additional coverage. Maintenance-related issues are typically the homeowner's responsibility. The policy may include inventory, or this can be bought as a separate policy, especially for people who rent housing. In some countries, insurers offer a package which may include liability and legal responsibility for injuries and property damage caused by members of the household, including pets.

7. Marine insurance

Marine insurance and marine cargo insurance cover the loss or damage of vessels at sea or on inland waterways, and of cargo in transit, regardless of the method of transit. When the owner of the cargo and the carrier are separate corporations, marine cargo insurance typically compensates the owner of cargo for losses sustained from fire, shipwreck, etc., but excludes losses that can be recovered from the carrier or the carrier's insurance. Many marine insurance underwriters will include "time element" coverage in such policies, which extends the indemnity to cover loss of profit and other business expenses attributable to the delay caused by a covered loss.

8. Liability insurance

Liability insurance is a very broad superset that covers legal claims against the insured. Many types of insurance include an aspect of liability coverage. For example, such policy will normally include liability coverage which protects the insured in the event of a claim brought by someone who slips and falls on the property; automobile insurance also includes an aspect of liability insurance that indemnifies against the harm that a crashing car can cause to others' lives, health, or property. The protection offered by a liability insurance policy is twofold: a legal defense in the event of a lawsuit commenced against the policyholder. And there is the indemnification. This is payment on behalf of the insured in relation to a settlement or court verdict. Liability policies typically cover only the negligence of the insured, and will not apply to results of willful or intentional acts by the insured.

9. Credit insurance

Credit insurance repays some or all of a loan when the borrower is insolvent. Specific types include the following:

a) Mortgage insurance insures the lender against default by the borrower. Mortgage insurance is a form of credit insurance, although the name "credit insurance" more often is used to refer to policies that cover other kinds of debt.
b) Many credit cards offer payment protection plans which are a form of credit insurance.
c) Trade credit insurance is business insurance over the accounts receivable of the insured. The policy pays the policy holder for covered accounts receivable if the debtor defaults on payment.
d) Collateral protection insurance (CPI) insures property (primarily vehicles) held as collateral for loans made by lending institutions.

SELF ASSESSMENT EXERCISE 5
List and explain various types of insurance policy.

4.0 CONCLUSION

This unit of the course material has provided you with the basic knowledge about the fact that business operations are shrouded in risks of uncertainty nature of the future. This implies that you should to take a legal scheme that will enable you hedge against such risks. This, as you have understood, is because risk involves any situation whereby there is uncertainty about the outcome of occurrences in the future; regarding business operations in particular. There are many insurance policies which are available for various types of risk in business operations, as have been highlighted and discussed in this study unit. We also discussed the fact that insurance policy involves a contract requiring that certain inherent principles must be taken into consideration in the course of entering into such policy. This is to avoid entering into unforeseeable insurance contract.

5.0 SUMMARY

In this initial study unit of the course material, you have been taught the following topics:

4 Conceptualization of Insurance
5 Legal Principles of Insurance Contract
6 Methods of Insurance
7 Characteristics of Insurable Risks
8 Types of Insurance Policy

In the next study unit, you will be taken through understanding tax issues.

6.0 TUTOR MARKED ASSIGNMENT

1. What is investment?
2. List and explain the characteristics of investment.
3. Compare and contrast ownership investment and lending investment

7.0 REFERENCES AND FURTHER READING

Gregory D. Squires (2003) Racial Profiling, Insurance Style: Insurance Redlining and the Uneven Development of Metropolitan Areas, *Journal of Urban Affairs*, 25(4): 391–410.

Seaman, S. M. and Kittredge, C. (1997). Excess Liability Insurance: Law and Litigation. *Tort & Insurance Law Journal*, 32 (3): 653–714.

Schindler, R. M. (1994). Consumer Motivation for Purchasing Low-Deductive Insurance. *American Marketing Association Marketing and Public Policy Conference Proceedings*, Chicago, IL, 4: 147–155.

UNIT 18: UNDERSTANDING TAX ISSUES

CONTENT

1.0 INTRODUCTION

Government, all over the world needs revenue to fund and control their economic activities. One of the sources of revenue is taxation. Tax is normally imposed on the citizens, business organizations and corporate entities in order to generate revenue. Tax is collected from the incomes of the workers and the profits of the business organizations and corporate entities, which constitute direct tax. There are other forms of tax (indirect tax) being imposed by the government. Such forms of tax include value added tax (VAT), capital gain tax, property tax, and betting tax, among others. In this study unit, we shall discuss taxation and tax issues.

2.0 OBJECTIVES

After studying this unit, you should be able to:

- Explain the essence of tax payment
- Explain taxation and fiscal regulations in Nigeria
- Discuss the Tripod of the Nigerian Tax System
- Identify and discuss major tax issues in Nigeria

3.0 MAIN CONTENT

3.1 MEANING AND ESSENCE OF TAXATION

In order to properly understand the subject matter, let us remind ourselves about the meaning of the focal word ‘tax’. Tax has been defined as ‘a monetary charge imposed by the Government on persons, entities, transactions and properties to yield revenue’. That is the primary way the society allocates the burden of government to its people. Tax is a powerful tool for achieving economic and social policy objectives of government and it is a means of transferring resources from the private to the public sector.

A standard definition of tax is that it is “a compulsory exaction from a taxpayer paid in cash or in kind to the government to provide for the public services of common interest without particular regard to the particular benefit received by the taxpayer.”

Taxation is undoubtedly a veritable instrument for national development. Apart from being a major source of revenue for government to provide goods and services needed by the people, tax policies, can and do stimulate economic growth and job creation through its impact on investment and capital formation in the economy. In this respect, reform of the tax system that ensures effectiveness, equity, and efficiency are necessary conditions for a healthy public finance.

3.1.1 Objectives of a Tax System

i) To promote fiscal responsibility and accountability
ii) To facilitate economic growth and development
iii) To provide the government with stable resources for the provision of public goods and services
iv) To address inequalities in income distribution
v) To provide economic stabilization
vi) To correct market failures or imperfections

SELF ASSESSMENT EXERCISE 1

Define Tax and list the objectives of a tax system.

3.2 TAXATION AND FISCAL REGULATIONS IN NIGERIA

The Nigerian Tax System has undergone significance changes in recent times. The tax laws are being reviewed with the aim of repelling obsolete provisions and simplifying the main ones. Under the current Nigerian law, taxation is enforced by the three (3) tiers of government i.e. federal, state and local government with each having its sphere clearly spelt out in the taxes and levies Decree 1998. The importance of tax regulation cannot be overemphasized as most transactions with any ministry, department, or government agency cannot be concluded without evidence of tax clearance, that is, a tax clearance certificate certifying that all taxes due for the three immediately preceding years of assessment have been settled in full. The main bodies recognized by law as tax authorities in Nigeria are the Federal Board of Inland Revenue, State Board of Internal Revenue and Joint Tax Board. A List of taxes and levies for collection by the three tiers of government has been approved by government and published by the Joint Tax Board (JTB) as follows:

1. Taxes collectible by the federal government

i. Companies Income Tax
ii. Withholding Tax on Companies
iii. Petroleum Profit Tax
iv. Value Added Tax (VAT)
v. Education Tax
vi. Capital Gains Tax – Abuja residents and corporate bodies.
vii. Stamp duties involving a corporate entity

viii. Personal income tax in respect of

a) Armed forces personnel
b) Public personnel
c) Residents of Abuja FCT
d) External Affairs Officer and
e) Non Residents.

2. Taxes/Levies Collective by State Government

i. Personal Income Tax

Pay as you earn (PAYE)

a) Direct (Self and government) assessment
b) Withholding tax (individuals only)

ii. Capital gain tax
iii. Stamp duties (instruments executed by individuals)
iv. Pools betting, lotteries, gaining and casino tax
v. Road taxes
vi. Business premises registration
vii. Rates in markets where state fiancés are involved
viii. Naming of street registration fee in state capital

3. Taxes/Levies collective by local government

i. shops and kiosks rates
ii. On and of liquor license
iii. Slaughter slab fees
iv. Marriage, birth and death registration fees

3.3 THE TRIPOD OF THE NIGERIAN TAX SYSTEM

The Nigeria tax system, like any tax system, is a tripartite structure which comprises of: Tax Policy, Tax Legislation and Tax Administration. Tax policy forms the basis for tax laws while tax administration is the implementation of the tax laws. This shows that in a bid to establish an effective and efficient tax system that will make taxation the pivot for national development, appropriate tax policies and legislations should be put in place and adequately implemented.

3.3.1 Meaning of National Tax Policy

The National Tax Policy is a document which sets broad parameters for taxation and ancillary matters connected with taxation. It is a clear statement on the principles governing tax administration and revenue collection. It therefore, provides a set of guidelines, rules and modus operandi that would regulate taxation in Nigeria.

3.3.2 Objectives of National Tax Policy

The objectives of the National Tax Policy are to address the myriad of problems bedeviling the Nigerian tax system. It is aimed at creating a tax system that will contribute to the well-being of all Nigerians and taxes which are collected by Government, should directly Impact on the lives of the citizens. This can be accomplished through proper and judicious utilization of the revenues collected by government.

The tax system, as envisaged by the National Tax Policy, is expected to meet the following objectives:

i) To promote fiscal responsibility and accountability

ii) To facilitate economic growth and development

iii) To provide the government with stable resources for the provision of public goods and services

iv) To address inequalities in income distribution.

v) To provide economic stabilization.

vi) To pursue fairness and equity.

vii) To correct market failures.

The Policy document was launched and given credence to in April 2012. However, in a bid to give legal backing to tax policy, there is need to fully crystalise its tenets into more tax laws enacted by the national assembly.

SELF ASSESSMENT EXERCISE 2

What are the objectives of national tax policy in Nigeria?

3.4 Major Tax Issues in Nigeria

According to the World Bank's Doing Business 2011 report, Nigeria ranks 137 out of 183 countries surveyed on the ease of doing business and 134 on the ease of paying taxes. In the 2010 report, Nigeria ranked 134 and 131 on the ease of doing business and paying taxes respectively. Nigeria has been slipping back consistently on the ease of Paying Taxes index which is a function of three main indicators - number of tax payments, time required to comply with tax obligations and total tax rate. The following have been considered to be among the major tax issues in Nigeria:

i) Multiplicity of taxes

This means paying similar taxes on the same or substantially similar tax base. Examples of multiple taxes include Companies Income Tax, Information Technology Tax (NITDA Levy), Education Tax, Nigerian Content Development Levy all of which are based on income or profits and Value Added Tax, Sales Tax and Hotel Consumption Tax all based on sales. Multiple taxes should be distinguished from numerous taxes which mean many but different taxes on different tax bases. Numerous taxes are likely to occur in a federation like Nigeria. To address multiple and numerous taxation earmark taxes should be reduced to the barest minimum and approved list of taxes should be streamlined and adhered to by all tiers of government.

ii) Essence dividend tax

The relevant provision of the law is usually interpreted and applied by the tax authorities to levy tax on a company whose dividend exceeds taxable profit regardless of whether the profit being distributed has already suffered tax (as in the case of dividend income received by a holding company or taxed retained earnings) or whether the profit is tax exempt (as in the case of pioneer profit and capital gains on stocks). The section should be amended to specifically exclude taxed profits and profits exempt from tax.

iii) Input VAT restriction

Claimable input VAT is limited to VAT on inventory. Input VAT on services, overhead and fixed assets are not creditable but must be expensed or capitalised as the case may be. This increases the true cost of VAT borne by taxpayers on goods and services consumed much beyond the 5% nominal rate. Input VAT should be allowed as claimable on all items except where the taxpayer is the final consumer or does not produce VATable output.

Deduction of VAT at source otherwise known as withholding VAT: The deduction of VAT at source by government and companies in the oil and gas sector from payments to their vendors leaves such vendors with claimable input VAT without adequate output VAT thereby resulting in a perpetual refund position. The obligation for government agencies and oil companies to deduct VAT at source should be removed and compliance by vendors should be enforced using information provided in the VAT and withholding tax returns of the service recipients/customers.

iv) Tax dispute resolution and due process

Where a taxpayer is aggrieved, there is no recourse in most cases as states do not have a body of appeal commissioners in place and the tax appeal tribunal at the federal level is yet to be fully operational. This leaves the taxpayer with the unattractive option of directly approaching the High Court. Also, notwithstanding the due process clearly laid down in the tax legislation, many tax authorities especially at the state and local government levels rarely follow due process in their activities. They often harass and intimidate taxpayers without regard to the provisions of the law. Appeal tribunals and body of appeal commissioners should be constituted and functional at all times. It is critical for due process purposes to establish and enforce a tax assessment and appeal procedure that is independent, fair and efficient to all taxpayers. Speedy resolution of tax disputes is a key factor which must be addressed urgently. The slow pace of tax adjudication in Nigeria makes tax compliance more difficult and exposes the taxpayer to a higher risk of penalty and interest. Government should consider issuing a Taxpayer Bill of Rights or Taxpayers' Charter to include taxpayer obligations, as well as a commitment to professional and legitimate behaviour by tax consultants and tax officials.

v) Personal reliefs and allowances

The Personal Income Tax Act (PITA) provides for a number of tax reliefs and allowances but most of these are unrealistically low such as Children Allowance of N2,500 per child subject to a maximum of 4 children, Utility N10,000, Entertainment N6,000, Transport Allowance N20,000, Rent Allowance N150,000, Meal Subsidy N5,000, and Dependant Relative N2,000. Reliefs and allowances should be reasonable and in tune with current reality. As much as possible, allowances should be a percentage of earnings rather than an absolute amount which has the risk of becoming unreasonably low with time due to inflation and slow reviews and amendments to tax laws in Nigeria.

vi) Reverse charge of VAT

This is a system whereby the recipient of a VATable supply is required to self assess VAT on imported services. This provision does not exist in the Nigerian VAT Act but is being introduced by the FIRS through Information Circulars which are not binding. This is a loophole in the tax law as certain imported services where the provider does not have to be physically present in

Nigeria can legally escape VAT. The VAT Act should be amended to specifically require the Nigerian recipient of imported services to self account for VAT under reverse charge system.

vii) Tax transparency and accountability

Tax is a compulsory levy designed to generate revenue for public expenditure including infrastructure. Tax paying culture is poor in Nigeria due largely to the lack of transparency and accountability on the part of government as taxpayers' money is rarely seen at work. When people have to pay taxes and also provide their own infrastructure this effectively increases tax rates and costs to taxpayers. Government should be transparent and publish detailed information on tax collection and application of the revenue generated on a regular basis as a mark of accountability and fiscal responsibility. This will encourage voluntary compliance.

viii) Stamp duty

The Act is very ambiguous as to coverage and applicability. A given transaction could fall under more than one category with different rates. Government should assess the level of revenue being generated from stamp duty and if it does not produce substantial revenue, it should be abolished. Alternatively the act should be redrafted for clarity and practicability and restricted to significant transactions such as land and shares. Also, taxpayers should not be forced to pay stamp duty to states where the payment is legally due to the federal government as in the case of land transfer involving a company.

ix) Introduction of new taxes

Different taxes are sometimes introduced in a haphazard manner contrary to the new National Tax Policy. There should be a mechanism to pass all proposed tax laws through a central body perhaps the Joint Tax Board in addition to the existing procedures in place to ensure arbitrary tax laws which are disconnected with the overall policy direction are not introduced.

SELF ASSESSMENT EXERCISE 3

Mention and explain the major tax issues in Nigeria.

4.0 Conclusion

Tax is regarded as a monetary charge imposed by the government on persons, entities, transactions and properties to yield revenue, which is the primary way the society allocates the burden of government to its people. In other words, involves a compulsory exaction from a taxpayer paid in cash or in kind to the government to provide for the public services of common interest without particular regard to the particular benefit received by the taxpayer. In the Nigerian context, the three tiers of government impose and collect distinct types of tax. There are issues that are inherent in the country’s tax system. These include problems such as: multiplicity of taxes; essence dividend tax; input vat restriction; tax dispute resolution and due process; personal reliefs and allowances; reverse charge of vat; tax transparency and accountability; stamp duty; and introduction of new taxes.

5.0 Summary

In this last study unit of the course material, you have been taught the following topics:

- Meaning and Essence of Taxation
- Taxation and Fiscal Regulations in Nigeria
- The Tripod of the Nigerian Tax System
- Major Tax issues in Nigeria

6.0 Tutor-Marked Assignment

List and discuss 5 major tax issues in Nigeria.

Answers to self assessment exercises

1. Define Tax and list the objectives of a tax system.

Tax is regarded as a monetary charge imposed by the government on persons, entities, transactions and properties to yield revenue, which is the primary way the society allocates the burden of government to its people. In other words, involves a compulsory exaction from a taxpayer paid in cash or in kind to the government to provide for the public services of common interest without particular regard to the particular benefit received by the taxpayer.

The objectives of a tax system include the following:
i) To promote fiscal responsibility and accountability
ii) To facilitate economic growth and development
iii) To provide the government with stable resources for the provision of public goods and services
iv) To address inequalities in income distribution
v) To provide economic stabilization
vi) To correct market failures or imperfections.

2. What are the objectives of national tax policy in Nigeria?

The tax system, as envisaged by the National Tax Policy, is expected to meet the following objectives:
i) To promote fiscal responsibility and accountability
ii) To facilitate economic growth and development
iii) To provide the government with stable resources for the provision of public goods and services
iv) To address inequalities in income distribution.
v) To provide economic stabilization.
vi) To pursue fairness and equity.
vii) To correct market failures.

3. Mention and explain the major tax issues in Nigeria.

The major tax issues in Nigeria include the following:

i) Multiplicity of taxes

This means paying similar taxes on the same or substantially similar tax base. Examples of multiple taxes include Companies Income Tax, Information Technology Tax (NITDA Levy), Education Tax, Nigerian Content Development Levy all of which are based on income or profits and Value Added Tax, Sales Tax and Hotel Consumption Tax all based on sales.

ii) Essence dividend tax

The relevant provision of the law is usually interpreted and applied by the tax authorities to levy tax on a company whose dividend exceeds taxable profit regardless of whether the profit being distributed has already suffered tax (as in the case of dividend income received by a holding company or taxed retained earnings) or whether the profit is tax exempt (as in the case of pioneer profit and capital gains on stocks). The section should be amended to specifically exclude taxed profits and profits exempt from tax.

iii) Input VAT restriction

Claimable input VAT is limited to VAT on inventory. Input VAT on services, overhead and fixed assets are not creditable but must be expensed or capitalised as the case may be. This increases the true cost of VAT borne by taxpayers on goods and services consumed much beyond the 5% nominal rate. Input VAT should be allowed as claimable on all items except where the taxpayer is the final consumer or does not produce VATable output.

Deduction of VAT at source otherwise known as withholding VAT: The deduction of VAT at source by government and companies in the oil and gas sector from payments to their vendors leaves such vendors with claimable input VAT without adequate output.

iv) Tax dispute resolution and due process

Where a taxpayer is aggrieved, there is no recourse in most cases as states do not have a body of appeal commissioners in place and the tax appeal tribunal at the federal level is yet to be fully operational. This leaves the taxpayer with the unattractive option of directly approaching the High Court. Also, notwithstanding the due process clearly laid down in the tax legislation, many tax authorities especially at the state and local government levels rarely follow due process in their activities. They often harass and intimidate taxpayers without regard to the provisions of the law. Appeal tribunals and body of appeal commissioners should be constituted and functional at all times.

v) Personal reliefs and allowances

The Personal Income Tax Act (PITA) provides for a number of tax reliefs and allowances but most of these are unrealistically low such as Children Allowance of N2,500 per child subject to a maximum of 4 children, Utility N10,000, Entertainment N6,000, Transport Allowance N20,000, Rent Allowance N150,000, Meal Subsidy N5,000, and Dependant Relative N2,000. Reliefs and allowances should be reasonable and in tune with current reality. As much as possible, allowances should be a percentage of earnings rather than an absolute amount which has the risk of becoming unreasonably low with time due to inflation and slow reviews and amendments to tax laws in Nigeria.

vi) Reverse charge of VAT

This is a system whereby the recipient of a VATable supply is required to self assess VAT on imported services. This provision does not exist in the Nigerian VAT Act but is being introduced by the FIRS through Information Circulars which are not binding. This is a loophole in the tax law as certain imported services where the provider does not have to be physically present in Nigeria can legally escape VAT. The VAT Act should be amended to specifically require the Nigerian recipient of imported services to self account for VAT under reverse charge system.

vii) Tax transparency and accountability

Tax is a compulsory levy designed to generate revenue for public expenditure including infrastructure. Tax paying culture is poor in Nigeria due largely to the lack of transparency and accountability on the part of government as taxpayers' money is rarely seen at work. When people have to pay taxes and also provide their own infrastructure this effectively increases tax rates and costs to taxpayers.

viii) Stamp duty

The Act is very ambiguous as to coverage and applicability. A given transaction could fall under more than one category with different rates. Government should assess the level of revenue being generated from stamp duty and if it does not produce substantial revenue, it should be abolished. Alternatively the act should be redrafted for clarity and practicability and restricted to significant transactions such as land and shares. Also, taxpayers should not be forced to pay stamp duty to states where the payment is legally due to the federal government as in the case of land transfer involving a company.

ix) Introduction of new taxes

Different taxes are sometimes introduced in a haphazard manner contrary to the new National Tax Policy. There should be a mechanism to pass all proposed tax laws through a central body perhaps the Joint Tax Board in addition to the existing procedures in place to ensure arbitrary tax laws which are disconnected with the overall policy direction are not introduced.

7.0 REFERENCES AND FURTHER READINGS

Adam, J. H. (1989). Longman Dictionary of Business English, 2nd edition, Harlow: Longman Group UK Limited.

Anaesoronye, M. (2013, June 12). “Tin makes Tax System Convenient for Taxpayers”, *Business Day Newspaper*, 11(115): 27.

Odusola, A. (2006). Tax Policy Reforms in Nigeria – Research Paper No. 2006/3, United Nations University – *World Institute for Development Economies Research*.

Ogbonna, G.N. (2010). Burning Issues and Challenges of the Nigerian Tax Systems with Analytical Emphasis on Petroleum Profits Tax.

Ogbonna, G.N. and Ebimobowei, A. (2012): Impact of Tax Reforms and Economic Growth of Nigeria: A Time Series Analysis, *Current Research Journal of Social Sciences*, 4(1-2), 1-4.

Soyode, L. and Kajola, S.O. (2006). *Taxation – Principles and Practice in Nigeria*, Ibadan: Silicon Publishing Company.