*Salma Banu, Dept of Commerce & Management, Paper: Investment Management, VI Sem BBM*

## Sovereign bond

A **government bond** or **sovereign bond** is a bond issued by a National Government, generally with a promise to pay periodic interest payments called coupon payments and to repay the face value on the maturity date. The aim of a Government bond is to support Government spending. Government bonds are usually denominated in the country's own currency, in which case the Government cannot be forced to default, although it may choose to do so. If a Government is close to default on its debt the media often refer to this as a sovereign debt crisis.

The terms on which a Government can sell bonds depend on how creditworthy the market considers it to be. International credit rating agencies will provide ratings for the bonds, but market participants will make up their own minds about this.

## Risks associated with sovereign bond

### Credit risk

A government bond in a country's own currency is strictly speaking a risk-free bond, because the government can if necessary create additional currency in order to redeem the bond at maturity.

### Currency risk

Currency risk is the risk that the value of the currency a bond pays out will decline compared to the holder's reference currency.

### Inflation risk

Inflation risk is the risk that the value of the currency a bond pays out will decline over time. Investors expect some amount of inflation, so the risk is that the inflation rate will be higher than expected.

## Exchange Traded funds

Exchange Traded Funds (ETFs) are mutual funds listed and traded on stock exchanges like shares. Index ETFs are created by institutional investors swapping shares in an index basket, for units in the fund. Usually, ETFs are passive funds where the fund manager doesn’t select stocks on your behalf. Instead, the ETF simply copies an index and endeavours to accurately reflect its performance. In an ETF, one can buy and sell units at prevailing market price on a real time basis during market hours.

**Index funds**

Index funds are those funds which are traded on the floor of stock exchange , and investment in this fund will be as per index of the stock exchange. The main advantage of index funds for investors is that the investors need not require a lot of time to manage as the investors don't have to spend time analysing various stocks or stock portfolios. Many investors also find it difficult to beat the performance of the S&P 500 Index due to their lack of experience/skill in investing.

**Advantages of Index funds**

**Low costs**

Because the composition of a target index is a known quantity, relative to actively managed funds, it costs less to run an index fund.

**Simplicity**

The investment objectives of index funds are easy to understand. Once an investor knows the target index of an index fund, what securities the index fund will hold can be determined directly. Managing one's index fund holdings may be as easy as rebalancing every six months or every year.

**Lower turnovers**

Turnover refers to the selling and buying of securities by the fund manager. Selling securities in some jurisdictions may result in capital gains tax charges, which are sometimes passed on to fund investors. Even in the absence of taxes, turnover has both explicit and implicit costs, which directly reduce returns on a dollar-for-dollar basis. Because index funds are passive investments, the turnovers are lower than actively managed funds.

**No style drift**

Style drift occurs when actively managed mutual funds go outside of their described style (i.e., mid-cap value, large cap income, etc.) to increase returns. Such drift hurts portfolios that are built with diversification as a high priority. Drifting into other styles could reduce the overall portfolio's diversity and subsequently increase risk. With an index fund, this drift is not possible and accurate diversification of a portfolio is increased.

**Disadvantages Index funds**

**Losses to arbitrageurs**

Index funds must periodically "rebalance" or adjust their portfolios to match the new prices and market capitalization of the underlying securities in the stock or other indexes that they track.

**Common market impact**

One problem occurs when a large amount of money tracks the *same* index. According to theory, a company should not be worth more when it is in an index. But due to supply and demand, a company being added can have a demand shock, and a company being deleted can have a supply shock, and this will change the price.

**Possible tracking error from index**

Since index funds aim to match market returns, both under- and over-performance compared to the market is considered a "tracking error". For example, an inefficient index fund may generate a positive tracking error in a falling market by holding too much cash, which holds its value compared to the market.

**Bombay stock exchange**

The Bombay Stock Exchange (BSE) is the first and largest securities market in India and was established in 1875 as the Native Share and Stock Brokers' Association. Based in Mumbai, India, the BSE lists close to 6,000 companies and is one of the largest exchanges in the world, along with the New York Stock Exchange (NYSE), NASDAQ, London Stock Exchange Group, Japan Exchange Group, and Shanghai Stock Exchange.

**Functioning of Bombay stock exchange**

In 1995, the BSE switched from an open-floor to an electronic trading system. There are more than a dozen electronic exchanges in the U.S. alone with the New York Stock Exchange (NYSE) and Nasdaq being the most widely known. Today electronic systems dominate the financial industry overall, offering fewer errors, faster execution, and better efficiency than traditional open-outcry trading systems. Securities that the BSE lists include stocks, stock futures, stock options, index futures, index options, and weekly options. The BSE's overall performance is measured by the Sensex, an index of 30 of the BSE's largest stocks covering 12 sectors.

**National Stock Exchange**

The National Stock Exchange of India Limited (NSE) is the leading stock exchange of India, located in Mumbai. The NSE was established in 1992 as the first dematerialized electronic exchange in the country. NSE was the first exchange in the country to provide a modern, fully automated screen-based electronic trading system which offered easy trading facility to the investors spread across the length and breadth of the country.

**Functions of national stock exchange**

The NSE was set-up with an express objective to fulfil the following functions:

- Establishing a nation-wide trading facility for equities, debt and other hybrid instruments.
- Ensuring equal access to investors across the nation through an appropriate communication network.
- Providing a fair, efficient and transparent securities market to investors using electronic trading systems.
- Enabling shorter settlement cycles and book entry settlements systems, and
- Meeting the current international standards of securities markets.

**Sensex**

The BSE SENSEX (also known as the S&P Bombay Stock Exchange or Sensitive Index or simply the SENSEX) is a free-float market-weighted stock market index of 30 well-established and financially sound companies listed on Bombay Stock Exchange. These 30 companies are known as Blue chip companies. The 30 component companies which are some of the largest and most actively traded stocks, are representative of various industrial sectors of the Indian economy. Published since 1 January 1986, the S&P BSE SENSEX is regarded as the pulse of the domestic stock markets in India. The base value of the SENSEX was taken as *100* on 1 April 1979 and its base year as *1978–79*. On 25 July 2001 BSE launched DOLLEX-30, a dollar-linked version of the SENSEX.

**CNX Nifty**

The CNX Nifty (Nifty) is one of two main stock market indices of the Indian stock market. This category lists the stocks that are now on the list.

**Dow Jones**

The Dow Jones Industrial Average (DJIA), Dow Jones, is a stock market index that measures the stock performance of 30 large companies listed on stock exchanges in the United States. Although it is one of the most commonly followed equity indices, many consider the Dow to be an inadequate representation of the overall U.S. stock market compared to broader market indices such as the S&P 500 Index or Russell 3000 because it only includes 30 large cap companies, is not weighted by market capitalization, and does not use a weighted arithmetic mean.

**S & P index**

The S&P 500, or simply the S&P, is a stock market index that measures the stock performance of 500 large companies listed on stock exchanges in the United States. It is one of the most commonly followed equity indices, and many consider it to be one of the best representations of the U.S. stock market. The average annual total return of the index, including dividends, since inception in 1926 has been 9.8%; however, there were several years where the index declined over 30%.The index has posted annual increases 70% of the time.

**LIBOR**

The London Inter-bank Offered Rate is an interest-rate average calculated from estimates submitted by the leading banks in London. Each bank estimates what it would be charged were it to borrow from other banks. The resulting rate is usually abbreviated to **Libor** or **LIBOR**, or more officially to ICE LIBOR (for Intercontinental Exchange Libor).

**Junk Bonds**

A high-yield bond (non-investment-grade bond, speculative-grade bond, or junk bond) is a term in finance for a bond that is rated below investment grade. These bonds have a higher risk of default or other adverse credit events, but offer higher yields than better quality bonds in order to make them attractive to investors.

**Hedge Funds**

A hedge fund is an investment fund that pools capital from high net worth individuals or institutional investors and invests in a variety of assets, often with complicated portfolio-construction and risk management techniques. It is administered by a professional investment management firm, and often structured as a limited partnership, limited liability company, or similar vehicle. Hedge funds are generally distinct from mutual funds and regarded as alternative investments, as their use of leverage is not capped by regulators, and distinct from private equity funds, as the majority of hedge funds invest in relatively liquid assets. However, funds which operate similarly to hedge funds but are regulated similarly to mutual funds are available and known as liquid alternative investments.

The term "hedge fund" originated from the paired long and short positions that the first of these funds used to hedge market risk. Over time, the types and nature of the hedging concepts expanded, as did the different types of investment vehicles. Today, hedge funds engage in a diverse range of markets and strategies and employ a wide variety of financial instruments and risk management techniques.

**ADR**

An American depositary receipt (ADR and sometimes spelled *depository*) is a negotiable security that represents securities of a company that trades in the U.S. financial markets. Shares of many non-U.S. companies trade on U.S. stock exchanges through ADRs, which are denominated and pay dividends in U.S. dollars and may be traded like regular shares of stock. ADRs are also traded during U.S. trading hours, through U.S. broker-dealers. ADRs simplify investing in foreign securities by having the depositary bank "manage all custody, currency and local taxes issues".

**GDR**

A global depository receipt (GDR) is a general name for a depositary receipt where a certificate issued by a depository bank, which purchases shares of foreign companies, creates a security on a local exchange backed by those shares. They are the global equivalent of the original American depositary receipts (ADR) on which they are based. GDRs represent ownership of an underlying number of shares of a foreign company and are commonly used to invest in companies from developing or emerging markets by investors in developed markets.

**Derivatives**

In finance, a derivative is a contract that derives its value from the performance of an underlying entity. This underlying entity can be an asset, index, or interest rate, and is often simply called the "underlying". Derivatives can be used for a number of purposes, including insuring against price movements (hedging), increasing exposure to price movements for speculation or getting access to otherwise hard-to-trade assets or markets. Some of the more common derivatives include forwards, futures, options, swaps, and variations of these such as synthetic collateralized debt obligations and credit default swaps. Most derivatives are traded over-the-counter (off-exchange) or on an exchange such as the Chicago Mercantile Exchange, while most insurance contracts have developed into a separate industry. In the United States, after the financial crisis of 2007–2009, there has been increased pressure to move derivatives to trade on exchanges. Derivatives are one of the three main categories of financial instruments, the other two being stocks (i.e., equities or shares) and debt (i.e., bonds and mortgages).

**Mutual Funds**

A mutual fund is an open-end professionally managed investment fund that pools money from many investors to purchase securities. These investors may be retail or institutional in nature.

**Types of Mutual Funds**

Mutual funds are also classified by their principal investments as money market funds, bond or fixed income funds, stock or equity funds, hybrid funds or other. Funds may also be categorized as index funds, which are passively managed funds that match the performance of an index, or actively managed funds. Hedge funds are not mutual funds as hedge funds cannot be sold to the general public and lack various standard investor protections.

**Advantages of Mutual Funds**

- Increased diversification: A fund diversifies holding many securities.

This diversification decreases risk.

- Professional investment management: Open-and closed-end funds hire portfolio managers to supervise the fund's investments.
- Ability to participate in investments that may be available only to larger investors. For example, individual investors often find it difficult to invest directly in foreign markets.
- Service and convenience: Funds often provide services such as check writing.
- Government oversight: Mutual funds are regulated by a governmental body.

- Transparency and ease of comparison: All mutual funds are required to report the same information to investors, which makes them easier to compare to each other.
- Lower cost: The cost of a single investor to buy a stock or a bond is lower than investing individually.
- Flexibility: Mutual funds enables changes portfolio with market conditions change.

**Disadvantages of Mutual Funds**

Mutual funds have disadvantages as well, which include:

- Fees
- Less control over timing of recognition of gains
- Less predictable income
- No opportunity to customize