



Investment



The Definition of Investment

Investment is defined as the commitment of current financial resources in order to achieve higher gains in the future. It deals with what is called uncertainty domains. From this definition, the importance of time and future arises as they are two important elements in investment. Hence, the information that may help shape up a vision about the levels of certainty in the status of investment in the future is significant. From an economic perspective, investment and saving are different; saving is known as the total earnings that are not spent on consumption, whether invested to achieve higher returns or not. Consumption is defined as one's total expenditure on goods and services that are used to satisfy his needs during a particular period. The values of investment or saving, as well as consumption, can be determined at the macroeconomic level, or at the individual level, through different statistical methods.

Real Assets and Financial Assets

Investment assets or mechanisms usually used in investment are classified into:

1. Real Assets.
2. Financial Assets.

Real Assets:

They are tangible assets used to produce goods or services, such as buildings, land, machinery, or cognitive assets that are utilized in the production of commodities or services.



Financial Assets:

Are claims on real assets or income produced by those assets. Examples include stocks and bonds which are alone no more than just worthless papers and do not directly contribute to the production of a commodity or service, but derive their value from the claims they carry. The evaluation of real assets differs in some way from financial assets due to their differences. Financial assets are more liquid, and have a more regulated market. They are also fragmented into small parts which makes it easier for a larger number of interested

people to enter the market. For example, let us compare between buying a car or a plot of land, and buying a stock. You need a lot of money to buy a car or a plot compared to buying one share in a particular company. It is also easier to sell the stock faster than the car or plot. Therefore, financial assets are more popular for many. You can say that the two kinds of assets (real & financial) have different elements that affect their evaluation, and both have their own market. The market related to the financial assets is called the financial market.

Financial Markets

Financial markets, like other markets, are specific places or locations where the buyer and seller meet in order to trade a particular commodity. These markets specialize in trading financial assets. A financial market might have a specific geographical location, or both parties (buyers and sellers) could meet electronically (online). Therefore, financial markets are divided, by location and environment, into two kinds:

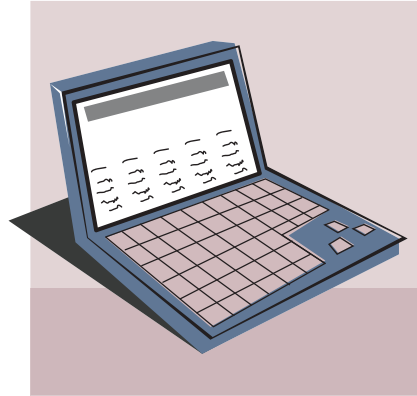
First:

Trading floors where trading takes place in a specific place or location on a physical platform, such as the New York Stock Exchange (NYSE).

Second:

Electronic Markets where transactions are carried out through an interactive electronic system linking trading halls to a central mainframe at the market to match between the seller and buyer during the working hours of this market; an example is the Saudi Stock Exchange.

Given the high efficiency of electronic trading systems shown in its managing lower costs and how it spreads easily, it was noted that most international financial markets are heading towards the abolition of trading floors and replace them with electronic trading systems.

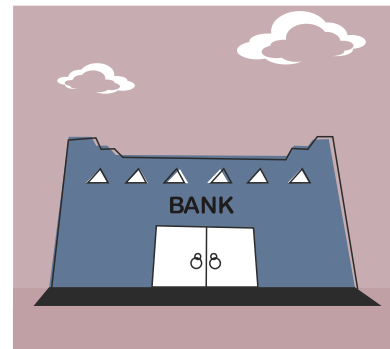


Markets are categorized according to the stage of issue as follows:

Primary Market:

It is a set of systems and institutions necessary for initiating, issuing, or registering securities before moving trading between investors. This market help in the issuance of securities.

New issues of shares, bonds or others are sold on the primary market, which means that it is the



market that issues the security's certificate after a company is established and offered its shares for public subscription or issued debt instruments.

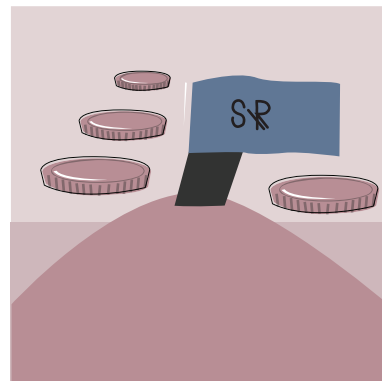
Through the primary market, the issuer obtains the needed funding by selling these new securities (shares, bonds or others), while the buyer gets the security. Investment banks are the main players in the primary market. They usually:

1. Advise the issuer on the volume of the issue and its relevance, timing, quality and other matters like how to obtain and choose financing options.
2. Carry out the executive tasks such as the actual issuing and registering of securities, and making the necessary communication with the stock exchange departments or other capital market committees.
3. Work as an “underwriter”; The investment bank buys the securities from issuers and resells them to the public. It can also help in selling the new security in exchange for commission or just settle for the task of distributing.

In the Saudi capital market, commercial banks serve as investment banks for the mean time.

Secondary Market:

It is the market where issued securities are bought and sold among traders. It is commonly known as the “stock exchange”, whether it has a specific central location or an automated system that executed trades electronically. Several other parties are related to the secondary market which help enhance its efficiency and performance such as: brokers, dealers, and research and consulting centers. The broker is the one who executes the buy and sell orders on the market by placing clients' orders in the Tadawul system. After the issuance of the Securities Business Regulations and the Authorized Persons Regulations, the role of brokerage has been restricted to licensed brokerage firms operating in the kingdom.



Speculation and Investment

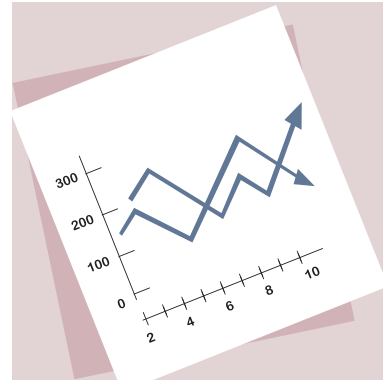
Speculation differs from investment as the speculator quickly gets in and out of the market (buying & selling) based on an accumulated experience about the market and more ability to analyze the impact of information on prices.

Speculators focus on achieving the greatest possible amount of instant profits which are usually accompanied by higher risk that may expose them to big losses. It is, therefore, useful for most traders especially small ones to be cautious of these higher risk that accompany speculations in the market compared to lower risk when adopting a long-term investment behavior.

So, investment is different from speculation since the investor's goal is to achieve annual returns on his investments by taking advantage of the increase in value over the investment period. On the other hand, the speculator hopes to take profit out of the buy-sell spreads in a short period of time.

Contrary to the speculator, when the investor makes a decision to buy or sell, he looks at the company's power and performance as well as its price and how it changed over a reasonable period. He also figures out the future performance assumptions based on the company's past

performance and links it to the economy and business environment to come up with a future picture of the company's performance and its competitiveness in achieving certain income and capital growth rates. The speculator, on the other hand, usually depends on technical analysis and personal anticipation taking advantage of the time factor and the speed and frequency of exiting and entering the market when making the buy or sell decision.

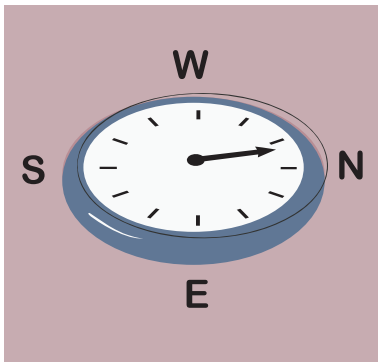


Classification of Investment

Investment classifications differ according to their objectives. Classification based on time standard is the most important one (investment term). Therefore, the market where short-term investment instruments are traded, and has a maturity of less than one year, is called the money market.

On the other hand, a market with investment instruments that has a maturity of more than one year are called the capital market. Debt instruments, deposits and other banknotes which have terms of one year or less are considered one of the investment instruments in the money market. Shares, however, are considered one of the capital market instruments because they do not have a specific term.

Returns vary according to the classification of the investment term. The longer the term, the higher the potential return. This makes the term component one of the investment decision making determinants.



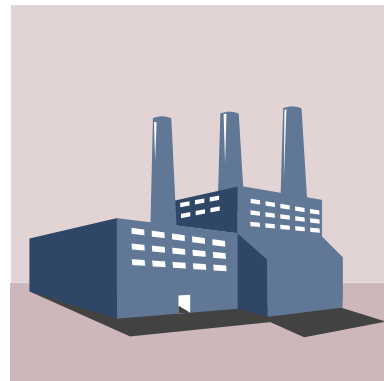
Determinants of Investment Decision-making

The investor usually looks for high returns in

any investment he wants to participate in, but knowing just the return is not enough to make an investment decision because of the absence of the other part of investment which is risk. So, the investor should know or estimate the risk and return to compare between two investments or more when willing to choose the best.

Return coupled with risk are the main determinants of the decision making process, and this is the result of the close relationship and parallel link between the two. The increase in risk leads to increased return, and lack of returns is the result of lower risk. In finance, this is called the “Risk-Return Trade-off” principle.

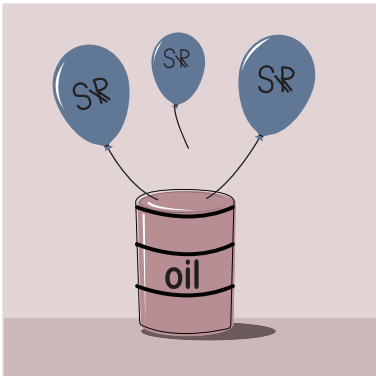
It means that it is essential for the investor to know the size of both expected risk and return without settling for just one. Since there are some factors that affect risk and return, the investor should recognize them and assess their effect on



the levels of risk and return to come up with a right investment decision. Risk are categorized according to their source as the following:

1. Business Risk:

It is the risk that comes from the nature of the industry. Every industry has several risk that affect it more than anything else. For example, companies in the petrochemical industry are more susceptible to factors affecting the industry like the change in the prices of raw materials used in manufacturing petrochemicals or the periodical price fluctuations of petrochemical products known in this sector. Other companies in different fields like agriculture, for instance, are affected by factors such as weather conditions like cold waves and frost or extreme heat or diseases and so on.



2. Economic Risk:

It is the risk resulting from changes in

macroeconomic factors such as rates of unemployment, inflation, government spending, budget deficits and so on. These risk affect almost all sectors, but they vary in the magnitude of the impact depending on the relevance of the industry type to any of the overall economic factors. The changing levels of government spending in the Kingdom, for example, affect all sectors of the economy. Nevertheless, firms and institutions working in construction and infrastructure, or those relying on public projects and contracts will be heavily impacted compared to others. Also, when the economy suffers from inflation, all economic sectors will be affected causing a decline in the overall performance of those sectors.



3. Interest Rate Risk:

It is the risk resulting from changes in interest rates in the financial system of the economy. This

risk affects the financial sector and the companies operating in it, particularly banks. The decrease in interest rates means that the possibility of borrowing is easier and less expensive, and this increases the earnings of those financial institutions.

4. Exchange Rate Risk:

The risk stemming from changes in currency exchange rates. Usually, companies working in the business of importing and exporting are more influenced by this type of risk. Companies that rely on foreign currencies when purchasing raw materials are more vulnerable to these risk, as well as companies that rely on exports to sell their products overseas.

5. Liquidity Risk:

The risk arising from the possibility of converting investment into cash (liquidating it). The higher the possibility of investment liquidation, the lower the risk and return. Shares of companies known for their outstanding performance, for example, are desirable to all investors as they can easily sell them at any time. Therefore, they have high liquidity, hence, their risk are low, and the return is less than others. The opposite is true; when investors find it difficult to liquidate their investments, their risk increase and this may result in higher returns for them.

6. Firm-Specific Risk:

The risk resulting from any factor that affects the institution itself such as buying a factory, a contraction in its products' market or a change in its performance and other company-specific factors. The decision to increase the company's capital for example is an internal matter that concerns the company itself and its result is just for it and nothing else.

The investor should, at any circumstances, realize the magnitude of these risks and recognize their impact on his investment and ability to handle them. It should be noted that there are other kinds of risks that are categorized according to their nature and source.

Methods of Measuring and Assessing Return and Risk

Return on investment (ROI) is defined as what the investor earns from the increase in the value of the invested asset and the cash income he gains over the investment period. It is calculated as follows:

$$\text{Return on Investment} = \frac{\text{Final value of investment} - \text{initial value of investment} + \text{cash distributions over investment period}}{\text{initial value of investment}}$$

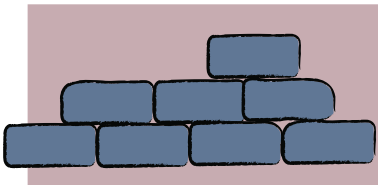
This simple equation takes into consideration not only the cash distributions gained over the investment period, but also the increase (or

decrease) in the invested asset value. If someone bought a share at 250 Riyals and sold it after one year at 295 Riyals and received cash distribution of 5 Riyals, the return on this investment during this period (one year) would be:

$$\frac{295 - 250 + 5}{250} = 20\%$$

Risk can be described and measured by the volatility in the invested asset. It is very hard to estimate risk as opposed to return. Risk is measured by variance. (σ^2) or standard deviation (σ). Variance (σ^2) is a measure of values' deviation from their average by calculating the "sum of squared differences of the values from the average, divided by the number of observations/periods". Standard deviation (σ) is the square root of the variation. From the value of return and the value of variance, the investor can accurately identify the coefficient of variation between returns and risk in the investment. It is done by dividing the value of the variance or risk by the return as follows:

$$\text{coefficient of variation} = \frac{\text{Risk}}{\text{Return}} = \frac{\sigma^2}{\text{Return}}$$



When the value of the coefficient of variation for an investment asset is higher compared to another, it indicates that the investment has more risk than returns. That is why the lowest coefficient of variation should be chosen. For example, we have two stocks (A) and (B), and their coefficient of variation was calculated based on the data of the equation as follows:

Investment coefficient of variation in stock (A) = 3
Investment coefficient of variation in stock (B) = 5

This means that stock (A) is better because there are 3 risk units for each return unit. On the other hand, stock (B) has 5 risk units for each return unit.



Building an Investment Portfolio and its Features

The investor aims to maximize his returns, but the association between the risk and return in a direct

relationship (return increases with increased risk) limits achieving this goal. It is known that the investor does not want increased levels of risk. Therefore, financial research has focused on creating a formula that can reduce risk to the lowest levels without compromising returns, or at least make the return/risk relationship in a changing status that does not reach the levels of full direct relationship. This is achieved by the principle of an investment portfolio which is based on diversification.

Definition of Investment Portfolio and its Building Steps

An investment portfolio can be defined as a group of investment assets, the formation of which is based on the investor's attitude towards the relationship between the risk and return, the contribution of each investment asset coming to the portfolio, or going out of it to the overall size of risk and the total return of the portfolio. The portfolio is made up of either a group of financial assets such as equities and bonds, or real assets like real estate, or both.

There are three steps to form a portfolio::

1. Setting the goals which the investor seeks to achieve under his impression towards risk and

return determinants.

2. Distributing assets in order to determine the proportions of capital he/she wants to invest in the different categories of available investment products.
3. Choosing assets by determining the name of each one.



Investment Portfolio Features

The most important feature of an investment portfolio is risk mitigation with the possibility of having a stable return as a result of the diversification principle. This feature cannot be achieved, unless the diversification is built on sound bases that are consistent with the principles of financial science. Diversification originally serves the investor in reducing the risk to their minimum, but it is not possible to eliminate all risk eventually. Risk, in this sense, are divided into two kinds:

- Systematic Risk
- Unsystematic Risk

Systematic Risk are those caused by factors that affect the entire market and not just a particular company or stock.

Unsystematic Risk, on the other hand, are those that affect the company or the stock itself.

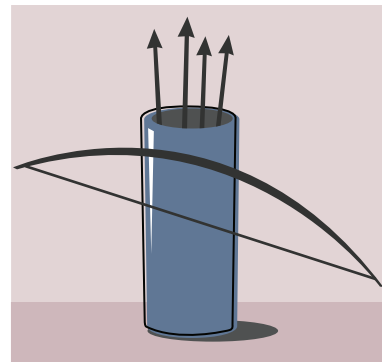
When building a portfolio, the investor should try to reduce or eliminate systematic risks by proper diversification. So, he will be observing only non-systematic risks and this reduces the aggregate risks.

Given that diversification is the basis on which a portfolio is built, it must be realized that there are different methods of how to diversify the portfolio. One way of diversification is done on a random basis by adding the types of investments regardless of any elements of assessment. This, without a doubt, cannot be an effective method in the markets with weak efficiency levels.

Another type of diversification is based on choosing the investments according to the degree of the correlation coefficient between the returns generated by a specific type of investment and other types of investments included in the

portfolio. When there is a direct relationship between returns on investments comprising the portfolio and the added type, then the risk to the total portfolio will be greater than if it is a reverse relationship (an increase in a variable leads to a decrease in another) or even an independent (there is no relationship between variables).

That is why it is always important to exactly know that degree of correlation coefficient in order to end up with lower risk while maintaining a specific level of returns. Diversification can be based on other fundamentals according to which the levels of risk and return change such as investment terms, maturity dates, the type of investment (stocks or bonds), the industry, the country, or the amount of liquidity and other factors that make a change in the amount of return or risk.





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