Direct V/s. indirect investing

- In **Direct investment**, investor buys and sells securities themselves, typically through brokerage accounts. Active investors may prefer this type of investing.

- In **Indirect investment**, investors buy and sell shares of investment companies, which in turn hold portfolio oh securities. Individual who are not active may prefer this type of investing.

The primary difference between these two types of investing is that applying direct investing investors buy and sell financial assets and manage individual investment portfolio themselves. Consequently, investing directly through financial markets investors take all the risk and their successful investing depends on their understanding of financial markets, its fluctuations and on their abilities to analyze and to evaluate the investments and to manage their investment portfolio.

Contrary, using indirect type of investing investors are buying or selling financial instruments of financial intermediaries (financial institutions) which invest large pools of funds in the financial markets and hold portfolios. Indirect investing relieves investors from making decisions about their portfolio. As shareholders with the ownership interest in the portfolios managed by financial institutions (investment companies, pension funds, insurance companies, commercial banks) the investors are entitled to their share of dividends, interest and capital gains generated and pay their share of the institution's expenses and portfolio management fee. The risk for investor using indirect investing is related more with the credibility of chosen institution and the professionalism of portfolio managers. In general, indirect investing is more related with the financial institutions which are primarily in the business of investing in and managing a portfolio of securities (various types of investment funds or investment companies, private pension funds). By pooling the funds of thousands of investors, those companies can offer them a variety of services, in addition to diversification, including professional management of their financial assets and liquidity.

Investment environment and investment management process

Investment environment

Investment environment can be defined as the existing investment vehicles in the market available for investor and the places for transactions with these investment vehicles. Thus further in this subchapter the main types of investment vehicles and the types of financial markets will be presented and described.

➢ Investment vehicles

The most important characteristics of investment vehicles on which bases the overall variety of investment vehicles can be assorted are the return on investment and the risk which is defined as the uncertainty about the actual return that will be earned on an investment. Each type of investment vehicles could be characterized by certain level of profitability and risk because of the specifics of these financial instruments. Though all different types of investment vehicles can be compared using characteristics of risk and return and the most risky as well as less risky investment vehicles can be defined. However the risk and return on investment are close related and only using both important characteristics we can really understand the differences in investment vehicles.

The main types of financial investment vehicles are:

- Short term investment vehicles;
- Fixed-income securities
- Common stock;
- Speculative investment vehicles;
- Other investment tools.

- **Short - term Investment**: vehicles are all those which have a maturity of one year or less. Short term investment vehicles often are defined as money-market instruments, because they are traded in the money market which presents the financial market for short term (up to one year of maturity) marketable financial

assets. The risk as well as the return on investments of short-term investment vehicles usually is lower than for other types of investments. The main short term investment vehicles are:

- Certificates of deposit;
- Treasury bills;
- Commercial paper;
- Bankers' acceptances;
- Repurchase agreements.

- **Fixed-income securities:** are those which return is fixed, up to some redemption date or indefinitely. The fixed amounts may be stated in money terms or indexed to some measure of the price level. This type of financial investments is presented by two different groups of securities:
    - Long-term debt securities
    - Preferred stocks.

- **The common stock**: is the other type of investment vehicles which is one of most popular among investors with long-term horizon of their investments. Common stock represents the ownership interest of corporations or the equity of the stock holders. Holders of common stock are entitled to attend and vote at a general meeting of shareholders, to receive declared dividends and to receive their share of the residual assets, if any, if the corporation is bankrupt. The issuers of the common stock are the companies which seek to receive funds in the market and though are "going public". The issuing common stocks and selling them in the market enables the company to raise additional equity capital more easily when using other alternative sources. Thus many companies are issuing their common stocks which are traded in financial markets and investors have wide possibilities for choosing this type of securities for the investment. The questions important for investors for investment in common stock decision making.

- **Speculative Investment**: vehicles following the term "speculation" (see p.8) could be defined as investments with a high risk and high investment return. Using these investment vehicles speculators try to buy low and to sell high, their primary concern is with anticipating and profiting from the expected market

fluctuations. The only gain from such investments is the positive difference between selling and purchasing prices. Of course, using short-term investment strategies investors can use for speculations other investment vehicles, such as common stock, but here we try to accentuate the specific types of investments which are more risky than other investment vehicles because of their nature related with more uncertainty about the changes influencing the their price in the future.

Speculative investment vehicles could be presented by these different vehicles:

• Options;

• Futures;

• Commodities, traded on the exchange (coffee, grain metals, other

Commodities);

Other investment tools:

• Various types of investment funds;

• Investment life insurance;

• Pension funds;

• Hedge funds.

➢ Investment companies/ investment funds:

They receive money from investors with the common objective of pooling the funds and then investing them in securities according to a stated set of investment objectives. Two types of funds:

• Open-end funds (mutual funds),

• Closed-end funds (trusts).

- **Open-End Funds**: Have no pre-determined amount of stocks outstanding and they can buy back or issue new shares at any point. Price of the share is not determined by demand, but by an estimate of the current market value of the fund's net assets per share (NAV) and a commission.

- **Closed-End Funds**: Are publicly traded investment companies that have issued a specified number of shares and can only issue additional shares through a new public issue. Pricing of closed-end funds is different from the pricing of open-end funds: the market price can differ from the NAV.

- **Insurance Companies**: Are in the business of assuming the risks of adverse events (such as fires, accidents, etc.) in exchange for a flow of insurance premiums. Insurance companies are investing the accumulated funds in securities (treasury bonds, corporate stocks and bonds), real estate. Three types of Insurance Companies: life insurance; non-life insurance (also known as property-casualty insurance) and reinsurance. During recent years investment life insurance became very popular investment alternative for individual investors, because this hybrid investment product allows to buy the life insurance policy together with possibility to invest accumulated life insurance payments or lump sum for a long time selecting investment program relevant to investor's future expectations.

- **Pension Funds**: Are an asset pools that accumulates over an employee's working years and pays retirement benefits during the employee's nonworking years. Pension funds are investing the funds according to a stated set of investment objectives in securities (treasury bonds, corporate stocks and bonds), real estate.

- **Hedge Funds**: Are unregulated private investment partnerships, limited to institutions and high-net-worth individuals, which seek to exploit various market opportunities and thereby to earn larger returns than are ordinarily available. They require a substantial initial investment from investors and usually have some restrictions on how quickly investor can withdraw their funds. Hedge funds take concentrated speculative positions and can be very risky. It could be noted that originally, the term "hedge" made some sense when applied to these funds. They would by combining different types of investments, including derivatives, try to hedge risk while seeking higher return. But today the word "hedge' is misapplied to these funds because they generally take an aggressive strategies investing in stock, bond and other financial markets around the world and their level of risk is high.