MPRA
Munich Personal RePEc Archive

Savings and Investments: Theoretical Underpinnings of Investment Theories of Finance and the Taxation Regime on Investments in United Kingdom.

Dissanayake, D.M.N.S.W.

University of Kelaniya, Sri Lanka

24 August 2012

Online at https://mpra.ub.uni-muenchen.de/40855/
MPRA Paper No. 40855, posted 26 Aug 2012 15:54 UTC

Savings and Investments: Theoretical Underpinnings of Investment Theories of Finance and the Taxation Regime on Investments in United Kingdom.

D.M.N.S.W.Dissanayake
Department of Commerce and Financial Management
Faculty of Commerce and Management Studies
University of Kelaniya
Sri Lanka.
neelacksha911@gmail.com

Abstract

Each and every individual require money not only for day today activities but also for investment needs as well. Having the investment might be the correct explanation for an individual since by this he is able to get the improved life for his prospect. Basically this assessment discusses some theoretical underpinnings of savings and investments. These two notions are topical contexts in behavioral research. Basically the notion of investment theory comprises with theories such as Efficient Market Hypothesis, Greater Fool Theory, Fifty Percent Principle, Odd Lot Theory, Rational Expectations Theory, Prospect Theory (Loss-Aversion Theory), and the Short Interest Theory. Investment strategies can be classified into four categories, namely; the fundamental approach, the psychological approach, the academic approach and the electric approach. A detailed analysis has given pertaining to those approaches. Further a detailed analysis has also given pertaining to the UK tax regime on investments.

Key Words: Investments, Investment theories, Savings, Taxation regime.

JEL Classification: E22, O16, H2.

Introduction

Personal Savings and Investments

Among the notions of behavioral research, savings and investments are highly ranked, (Bidewell, 2003). Numbers of studies have been conducted in order to assert the adverse repercussions of unplanned personal savings and investments, (Lavelle, 1999) (Sampson, 1999) & (Whittaker, 1992). The notion of investments can be defined in different perspectives, such as finance and economics. In the perspective of finance, investment is all about putting money into something (i.e. security etc) with an expectation of positive gains, (Wikipedia, 2012). The most important aspect under financial perspective is, financial investment is made soon after a thorough analysis of gains and losses of the particular investment. In contrast, the economic investment is done without a thorough analysis of the gains and losses expected, (Wikipedia, 2012). This might be in terms of gambling or speculating. The idea of investment is highly concerns to deferring consumption and savings, (Wikipedia, 2012). The area of finance, the investment defines as a commitment of money by means of a collateralized lending or depositing.

The main investment theories in finance

Beattie, (2011), defined seven investment theories that need to be discussed. They are, Efficient Market Hypothesis, Greater Fool Theory, Fifty Percent Principle, Odd Lot Theory, Rational Expectations Theory, Prospect Theory (Loss-Aversion Theory), and the Short Interest Theory.

Efficient Market Hypothesis

Efficiency of capital markets

According to Brigham and Ehrhardt (2007), the efficient market is where, which holds two conditions, where, stock prices are available at equilibrium and it is unfeasible for an investor to beat the market. The notion of efficient market hypothesis can be simply defined as a situation where all the prices of securities are fully available and reflect all the information, (Fama, 1991). The basic principle for the efficient market hypothesis is the cost of getting prices to reflect information is always zero, (Grossman and Stiglitz (1980)). It is considered that the marginal benefits of acting on information are not lies beyond the marginal costs of a given security, (Jensen (1978)). Further, it is considered that, the efficient market hypothesis condition fails when there is a full trading cost and positive information exists, (Fama, 1991). Besides, according to Brigham and Ehrhardt (2007), there are three levels of efficient markets.

Firstly, the weak form efficiency, semi-strong from efficiency and the strong form efficiency. As mentioned above, the market is considered efficient, when all stock prices are effectively reflect all available information, (Brigham and Ehrhardt, 2007). This condition stimulates an important question that needs to be evaluated. Which is what the type of information available is? Following illustration provides a detailed analysis of levels of efficient market levels.

***Weak Form Efficiency*:** this is the basic level. It is considered that all information contained is all about the past movements of stock prices and it is fully reflecting the current market prices, (Brigham and Ehrhardt, 2007) (Hadi, 2006). If this condition exists in the market, it is not required to reflect recent stock price movements, and it is no use. Literature states that several studies have been conducted to assert the stock prices move randomly or not. Robert (1959) and Osborne (1959) asserted that the stock movements are in a random walk.

***Semi-Strong Form Efficiency*:** this is the scenario of current market prices would reflect all publicly available information, (Brigham and Ehrhardt, 2007). If this condition happens, it is not required to produce financial statements since; market prices have adjusted accordingly, (Hadi, 2006). Under this circumstance, investors tend to obtain returns purely predicted by the security market line. Most importantly, when semi strong exists, market information release to the market, and stock prices will only respond if the information is dissimilar from what had been expected form that particular stock. In fact, semi strong form efficiency is pertaining for accounting professionals, (Hadi, 2006).

***Strong Form Efficiency*:** this is the situation where all the current market prices reflect all the pertaining information on stock prices irrespective of the availability, (either private or public). It is considered that (even for insiders) it is hard to obtain abnormal profits consistently, (Hadi, 2006).

Greater Fool Theory

The theory proposes that the investor can earn profits when there is an investor (greater fool) who is buying shares / investment at a higher price. This implies that one can earn profits form an overpriced stock as long as someone is willing to pay more than the payment that you are willing to pay. The greater fool theory proposes that the valuations in stocks have been ignored. Ignoring the data is considered as a riskier activity.

Fifty Percent Principle

The principle envisages that, before ongoing, an experiential tendency will experience a price alteration of one-half to two-thirds of the modification in price. This means that the stock has risen by 20% with a gain, it will fall back with 10% before ongoing to rise.

Odd Lot Theory

This is all about selling old stocks. These are small lots held by small investors. The basic assumption in this theory is that the small investors are usually wrong. Further it is assumed that small investors are more movable than big funds, and therefore small investors are able to react to harsh news faster.

Rational Expectations Theory

The theory states that the group of actors in a financial system will act in ways that do the accepted thing to what can rationally be predictable in the future. That is, a being will invest, pay out, etc. consistent with what he or she reasonably considers will occur in the prospect. By doing so, that individual generates a self-fulfilling prediction that assists produce the potential event. Even though this conjecture has turned out to be quite vital to economics, its usefulness is uncertain.

Prospect Theory

Theory states that people's awareness of gain and loss are tilted. That is to say, people are more frightened of a loss than they are confidantes by a gain. If a person is known a choice of two diverse forecasts, they will choose the one that they believe has fewer of chance of finishing in a loss, before the one that presents the most profits. In fact, this theory is significant for financial experts and investor.

Short Interest Theory

The theory states that an elevated small attention is the forerunner to a go up in the stock's price and, at primary fleeting look, appears to be groundless. Common sense proposes that a stock with a high elevated small interest – that is to say, a stock that a lot of investors are short selling – because this is for a correction.

The financial needs and decision making processes of investment orientated individuals

Each and every individual require money not only for day today activities but also for investment needs as well. Having the investment might be the correct explanation for an individual since by this he is able to get the improved life for his prospect. In addition, there are so a lot of populace who akin to to have the most excellent security for their prospect life and by having the asset he can obtain the defense so that he be able to exist with no trouble and get the comfort. This is the right obsession for him to survive his life with no any complex things. Investing might be by means of the worth properties, jewelry, lands, gold and investments in securities.

Basically, investors would have varied investment plans with the main intend to attain greater performance, in other words this is all about attaining a higher rate for the investment. Mainly, there are four investment strategies that can be identified. Firstly, **the fundamental approach**. This is all about concerning the intrinsic value of the investment. The notion of intrinsic value of a security is the price which is determined by the economic wide factors. These economic wide factors can be ascertained by a proper evaluation of the related industry and company. Secondly, **the Psychological approach**, the basic premise under Psychological approach is that the investor believes that the stock prices are guided by emotions. The physic value is considered as more important than intrinsic values. Some of the technical analysis tools are heavily used in this approach; these are bar charts, point charts, moving averages, etc. Third approach can be defined as **Academic approach.** The basic assumptions of this approach are, stock prices are considered as rationale and efficient. Therefore it is considered that current market prices would reflect all its intrinsic values all the time. In other words, intrinsic value=current market prices. A random fashion is expected among the stock prices and those changes are independent of each other. So therefore one can make predictions on future prices based on current prices. Finally, it is assumed that there is a linear relationship among risk and return. Final approach is **the electric approach**. Fundamentally, this approach draws upon above mentioned three approaches. Some of the basic rules are, to establish benchmarks fundamental analysis would help. And also the technical analysis would help to measure the mood of the current investor.

The financial needs and decision making processes of large corporations

Financial needs of companies are diverse. In fact it covers a wide area of prerequisites. Followings are some commonly appreciated needs of finance for large companies. To expand the business, to buy equipments, premises, stocks, pay bills, to cover a fall in demand, to pay workers, and to start new business. Basically, these financial needs can be fulfilled by means of internally or externally generated funds of the company.

Gniewosz, (1990) postulated some of the principles of investing for corporate investors. The study was conducted with the perspective of an organization. It addressed that the company should assess the business environment prior to make the investment decision. And also it is vital to recognize the importance of minimizing the risk of investing, (Gniewosz, 1990).

The role and the functions of fund managers

The notion of fund management encompasses with varied aspects such as managing mutual trusts, pension funds, trust funds and hedge funds, (Investopedia). It is believed that, to qualify in this position, a high level of educational and professional experience is required. Investors who are working with fund managers are expected to view the investment with a long term perspective to be efficient. Finally, the quality of the fund managed is solely depending on the fund manager's competencies. Monitoring and managing the funds/ securities are known as the primary goals of fund managers, (citation). Adding to that, managing fund needs to be done in way of maximizing gains of customers or investors. The plan and approach that is put into practice is also to be strongly observed so that in the longer run, risks on losing out on main dividends can be kept away from. The fund manager should from a certified company he is liable to conduct the assessment of the fund, (Franklin, 2008). Finally, the manager recommends the most appropriate investment to the client.

The budget of the investment is merely depends on the asset portion that is made by the fund manager for his investors. In fact there are several ways to invest in a fund. Basically, it depends on the risk that the investor is willing to take. Another important aspect of the fund manager's tasks is to diversify the investment. This is due to mitigate the risk predicted. Most importantly, it is advisable to investors to invest more than one security, (Franklin, 2008). The diversification is a lucrative strategy to implement since the loss that is being occurred from an investment is compensated from another profitable investment. The performance of a fund is considered as the main test for fund management and for the fund management firm. Generally, the performances of a fund is compared with another fund since is reflects the ability of the fund manager. Therefore investors use to say that the fund managers are Gods in the perspective of mutual fund management, (Franklin, 2008).

The role of the taxation regime on investments

Taxation in the UK

The taxation in the UK mainly involves a minimum payment to two different levels in the economy, namely, the local government and the central government, (Encyclopedia, 2012). The central government income comprises with national insurance, income tax, corporate tax, fuel duty and value added tax. Further the local government portion comprises with the grants donated from the central government. As per the recent facts, the government revenue was totaled to 39.2 % of the gross domestic product, (Encyclopedia, 2012). The history of the taxation system dated back to the 17th century. The income tax was firstly announced in the Britain by William Pitt the Younger in the presentation of the budget in December 1798, (Encyclopedia, 2012).

FTSE 100 Index

The index is informally known as the '**footsie,** (Encyclopedia, 2012), (Brannigan, 2012). This is share index of 100 listed companies in the London stock Exchange (hereafter, LSE). Most importantly, to list in this the highest market capitalization is required. Moreover, the index is maintained by the FTSE Group. It is an independent company jointly owned by the LSE and the financial times. In fact, it has been registered as a limited liability company. The index was initiated on 3 January 1984, (Brannigan, 2012) through a base point of 1000. In fact the index recorded the highest value is 6950.6, on 30 December 1999, (Encyclopedia, 2012). Soon after the financial crisis of 2007-2010 the index was incorporated with a dramatic decline to 3,500 in 2009 March. Since 2011 February the index showed a significant peak totaling to a maximum value of 6,091.33 on 8th February, 2011, (Encyclopedia, 2012). And once more the index showed a sharp decline to 5000 in 23 September 2011. A downgrading from any of the FTSE indexes is able to contain a very unenthusiastic result on shares with investors moving away, (Brannigan, 2012)

Table 01: the 10 largest FTSE 100 companies measured by market capitalisation as of 9 March 2011

Rank	Company	Sector	Market capitalisation (£ billion)
1	BHP Billiton	Mining	148
2	Royal Dutch Shell	Oil and gas	135
3	HSBC	Financial services	118
4	Vodafone Group	Telecommunications	93
5	BP	Oil and gas	91
6	Rio Tinto Group	Mining	86
7	GlaxoSmithKline	Pharmaceuticals	61
8	Unilever	Consumer goods	56
9	British American Tobacco	Tobacco	49
10	BG Group	Oil and gas	49

Source: Encyclopedia, 2012, *FTSE 100 Index*

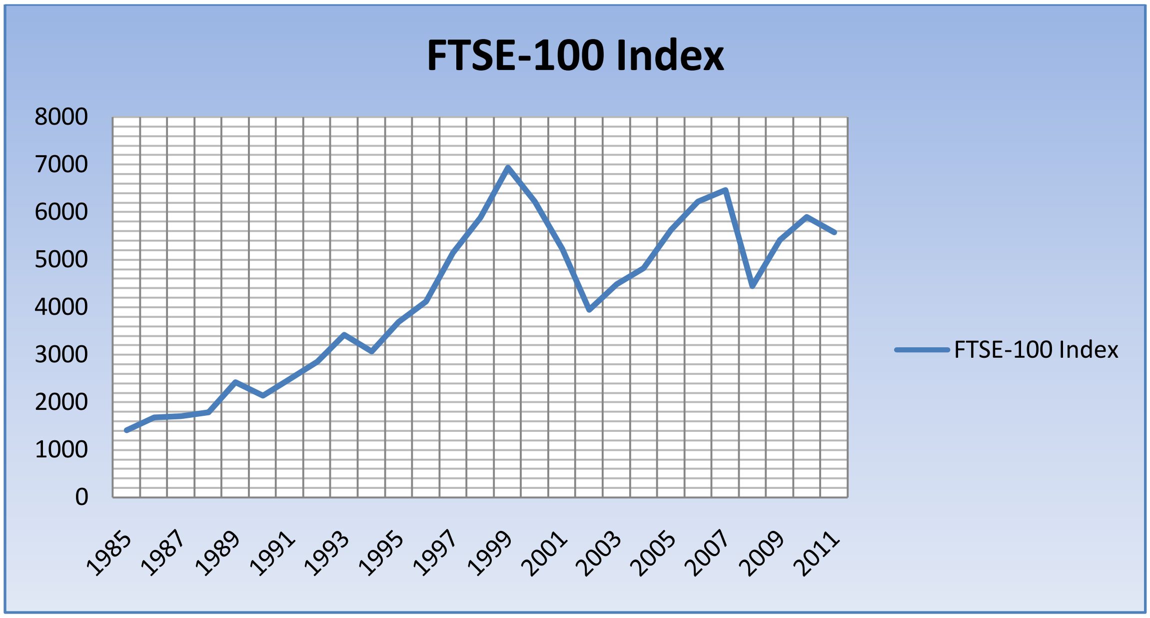
Table 02: FTSE-100 Index since 1984.

Year	FTSE-100 Index		FTSE All Shares Index	
	% Change	Index	% Change	Index
2011	-5.6	5572	-6.7	2858
2010	9.0	5900	10.9	3063
2009	22.0	5413	25.0	2761
2008	-31.3	4434	-32.8	2209
2007	3.8	6457	2.0	3287
2006	10.7	6221	13.2	3221
2005	16.7	5619	18.1	2847
2004	7.5	4814	9.2	2411
2003	13.6	4477	16.6	2207
2002	-24.5	3940	-25.0	1894
2001	-16.2	5217	-15.4	2524
2000	-10.2	6223	-8.0	2984
1999	17.8	6930	21.2	3242
1998	14.5	5883	10.9	2674
1997	24.7	5136	19.7	2411
1996	11.6	4119	11.7	2014
1995	20.3	3689	18.5	1803
1994	-10.3	3066	-9.6	1521
1993	20.1	3418	23.3	1682
1992	14.2	2847	14.8	1364
1991	16.3	2493	15.1	1188
1990	-11.5	2144	-14.3	1032
1989	35.1	2423	30.0	1205
1988	4.7	1793	6.5	927
1987	2.0	1713	4.5	870
1986	18.9	1679	22.1	833
1985	14.7	1413	15.0	682

Source: 'Annual Abstract of Statistics' 2000 edition. Office for National Statistics.

Above table depicts the changes occurred to the index since 1984. As mentioned above the index was initiated in 1984. As per the identifications of the above table no 02, it can be postulated that the index was faced to numerous changes within the time period. FTSE-100 was totaled to 1413 in 1985 and it has gradually increased to 5572 in 2011.

Figure 01: Fluctuations of the FTSE-100 index within the period of 1985-2011



Source: Research data.

Recommendation

According to the above evaluation, one can identify that the index has an increase within the period. And within the period of 1985-1995 the index was incorporated with a slight increase and from 1995 onwards the index was corresponded with a steep increase to 7000 in the year of 1999. From 1999 onwards the index showed a steep decline to 4000 within the period of 1999-2003. From 2003 onwards the index showed slight increase and decrease within the period of 2003-2011. Eventually the index was remained at 5572 incorporating a moderate level of ever recorded

.

Reference

Beattie, A. (2011, August 17). *7 Controversial Investing Theories*. Retrieved from http://www.investopedia.com/articles/financial-theory/controversial-financial-theories.asp

Bidewell, J. W. (2003). *Decision making in personal investment*. (Doctoral dissertation), Available from University of Sydney. Retrieved from http://ses.library.usyd.edu.au/handle/2123/517

Brannigan, E, M. (2012, February 3). *What Is the FTSE?* Retrieved April 15, 2012, from http://ezinearticles.com/?What-Is-the-FTSE?&id=6844321

Brigham, E. F., & Ehrhardt, M. C. (2007). *Financial management- theory and practice*. (11 ed., pp. 238-376). India:

Encyclopedia. (2012, April 02). *Taxation in the United Kingdom*. Retrieved from http://en.wikipedia.org/wiki/Taxation_in_the_United_Kingdom

Encyclopedia. (2012, March 21). *Ftse 100 index*. Retrieved from http://en.wikipedia.org/wiki/FTSE_100_Index

Fama, E. F. (1991). Efficient capital markets: I1. *THE JOURNAL OF FINANCE*, *XLVI*(05), 1575-1617.

Franklin. (2008, November 07). *The Role of a Fund Manager*. Retrieved from http://www.financemarkets.co.uk/boards/the-role-of-a-fund-manager-2030.html

Gniewosz , G. (1990). The share investment decision process and information use: An exploratory case study. *Accounting and Business Research* ,*20*(79), Retrieved from http://www.tandfonline.com/doi/abs/10.1080/00014788.1990.9728880

Hadi, M. M. (2006). Review of capital market efficiency: Some evidence from Jordanian market. *International Research Journal of Finance and Economics*, (03), 13-27.

HEFCE. (2003). *Investment Decision Making*. Retrieved from http://www.hefce.ac.uk/pubs/hefce/2003/03_17.htm

Investopedia. (n.d.). *Fund manager*. Retrieved from http://www.investopedia.com/terms/f/fundmanager.asp

Jensen C.M., *The Journal of Finance*, Vol. 23, No. 2, Papers and Proceedings of the Twenty-Sixth Annual, Meeting of the American Finance Association Washington, D.C. December 28-30,

1967. (May, 1968), pp. 389-416. Stable URL: http://links.jstor.org/sici?sici=0022-1082%28196805%2923%3A2%3C389%3ATPOMFI%3E2.0.CO%3B2-G

Lavelle, P. (1999, April 14). Sit down and do the sums, *The Sydney Morning Herald*, p. 10M.

Osborne, M. 1959. Brownian Motion in the Stock Market. Operation Research. pp. 145-173.

Roberts, Harry V. 1959. Stock-Market Patterns and Financial Analysis: Methodological Suggestions. Journal of Finance. Vol. XIV No. 1 pp. 1-10.

Sampson, (1999, March 31). Cold comfort, *The Sydney Morning Herald*, p. 2M.

Sanford J. Grossman; Robert J. Shiller *The American Economic Review*, Vol. 71, No. 2, Papers and Proceedings of the Ninety-Third Annual Meeting of the American Economic Association. (May, 1981), pp. 222-227. Stable URL: http://links.jstor.org/sici?sici=0002-8282%28198105%2971%3A2%3C222%3ATDOTVO%3E2.0.CO%3B2-8

Smith, H. (2011, November 10). *New UK investment trust company tax regime - final regulations*. Retrieved from http://www.herbertsmith.com/NR/rdonlyres/0B1F1421-2EDE-4893-92E8-173EBD662CBA/0/NewUKInvestmentTrustCompanyTaxRegime10November.htm

Whittaker, N. (1999). *Making money made simple!* East Roseville, NSW: Simon & Schuster.

Wikipedia. (2012, April 08). *Investment*. Retrieved from http://en.wikipedia.org/wiki/Investment