# Stock Market [*]

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## Introduction

Even as a debate continues over the relative advantages of stock market over banks in financing investments on the one hand and of corporates preference for internal resources versus external sources on the other, and the stock market's ability to monitor corporate managements due to several factors, developing countries have been advised by the multilateral bodies to foster stock markets. Besides allocating resources efficiently, developing countries have been told that stock markets will enable them implement their privatisation programmes and attract portfolio capital flows. Foreign portfolio investments are in turn likely to deepen the stock markets and contribute to greater stability, especially investment done by investment funds that specialise in emerging markets and which are backed by international experience and extensive research. Their operations are expected to enable corporates to raise resources cheaply by pushing up the price-earning ratios. In order to attract foreign investors, while business entities are forced to improve accounting and reporting standards the authorities are expected to upgrade the trading and delivery standards which again help improve the functioning of stock markets. The emphasis on portfolio capital flows is also in line with the official development assistance yielding place to flows on private account.

From the beginning of the early 'eighties, along with liberalisation and consequent enhanced role assigned to the private sector, India too embarked upon giving prominence to the stock market. While during the 'eighties financing the private sector was the driving force, privatisation of public enterprises and attracting foreign portfolio capital additionally came to the fore during the 'nineties. The experience at promoting stock markets has been quite a mixed one. The variety of scams the Indian stock market faced during the 'nineties are so well known that they hardly need to be elaborated here. Following the major stock scam of 1991-92, the Bombay Stock Exchange Sensitive Index (Sensex), the barometer of the Indian stock

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market, fell steeply. A quick recovery followed the entry of foreign institutional investors (FIIs) towards to the end of 1992. The recovery in share prices led to a boom in the primary market. Due to severe regulatory failure, this was followed by what is termed as the primary market scam. Subsequently, the market remained low key during 1995 to 1998 barring some upward movements which could not be sustained over long periods.

In contrast, 1999 marked a major improvement in the sentiment in the Indian stock market. On the eve of the Budget 1999-2000, the BSE Sensex closed at 3234. It was 5741 on February 28, 2000 – an increase of 77 per cent. In between, Sensex reached the all-time high of 5151 on October 11, 1999 and scaled the further peak of 6160 on February 14, 2000. The main reasons for this increase, as noted by the *Economic Survey 1999-2000*, are: phenomenal spurt in information technology stocks in major markets abroad; reduction of long term capital gains tax from 20 to 10 per cent for resident Indians; exemption from income tax for all income received in the hands of investors from mutual funds introduced in the Budget 1999-2000; and improvement in the overall economic performance. The *Survey* also acknowledged the contribution of foreign institutional investors, albeit indirectly, to this buoyant mood. Probably acknowledging their role, the Budget 2000-2001 proposed to raise the upper investment limit for FIIs in a single company from 30 to 40 per cent. The government, however, admitted the increasing volatility in the stock market and enumerated the additional steps taken by the Securities and Exchange Board of India (SEBI) to contain it and also conceded that the recovery had much to do with the 'golden triangle' comprising of information technology companies, pharmaceuticals and consumer non-durables (also known as Fast Moving Consumer Goods – FMCG). The *Survey* noted further that there was a substantial increase in resource mobilisation by mutual funds and the primary market was on the path of recovery. This paper seeks to examine the claims and limitations cited by the *Survey* with a view to draw the implications for the longterm development of the Indian stock market.

**Primary Market**

The *Economic Survey* suggested that the primary market was on the path of recovery as the number of issues and the amounts raised marked an improvement in 1999 compared to 1998. The figures released by SEBI for the 11 months Apr 1999 – Feb 2000 show that while the number of issues increased from 51 to 82, the amount raised increased from Rs. 5,146 crores to Rs. 7,289 crores or by about 42 per cent. However, the public issue amount rose by 23 per cent. (See Table-1) These figures do not obviously represent a meaningful revival of the primary market due to the low base for comparison and especially in the context of the substantial gains recorded in the market barometers like the Sensex.

**Table -1**
**Capital Raised by Issue Type**

(Amount Rs. Crores)

| Type of Issue | Apr 98-Feb 99 | | Apr 99-Feb 00 | | Increase in Amount | |
|---|---|---|---|---|---|---|
| | No. | Amount | No. | Amount | Amount | Per cent |
| A. Public | 29 | 4,662.11 | 55 | 5,733.10 | 1,070.99 | 22.97 |
| B. Rights | 22 | 484.39 | 27 | 1,555.89 | 1,071.50 | 221.21 |
| Total (A+B) | 51 | 5,146.50 | 82 | 7,288.99 | 2,142.49 | 41.63 |

Source: Based on SEBI, *Monthly Bulletin*, February 2000.

Another important issue is how widespread is the 'revival' of the primary market. The government did concede that the revival was much to do with the information technology (IT) company issues. Indeed, excluding banks and financial institutions, the IT sector accounted for 40 per cent of the capital raised. The combined share of IT, pharmaceuticals and entertainment sectors was 58 per cent of the total. Exclusion of banks and financial institutions for comparison purposes is justified because while this sector raised a little more than Rs. 3,600 crores during Apr 1999-Feb 2000, an overwhelming portion of this was on account of fixed income bonds. From an analysis of large issues, it turns that more than 80 per cent of the amount raised by them was through bond issues, the remaining being equity.

Since the total amounts also include the amounts raised through rights issues, it may be more relevant to examine the importance of the three sectors in public issues. Out of the 62 offer documents cleared by SEBI for public issues between September 1999 and the middle of March 2000, IT, pharmaceuticals and entertainment sectors cover as many as 54 issues with IT alone accounting for 46 issues. The corresponding figures for the offer documents filed for public issues between January 2000 and the middle of March 2000 (which provide a glimpse of the shape of things to come) are 49, 46 and 39. Interestingly, 28 of the 39 IT issues are from the Southern region, especially Hyderabad. Further, newspaper reports suggest that a number of entertainment sector companies are planning public issues during 2000-2001. The fact, therefore, remains that the primary market is quite narrow as it is fed by the euphoria created by the windfall gains from the IT sector. The 'revival' has further been supported by relaxation of issue criteria from actual payment of dividend to ability to pay dividend, falling interest rates and funding of public issues by banks (which supported high premium and over subscription by multiple times). Manufacturing companies have gained very little in the process. Incidentally, SEBI lowered the minimum public offer for IT issues from 25 to 10 per cent to further contribute to this trend. Recently, this relaxation was extended to the entertainment sector as well.

In the backdrop of increase in the number of issues, those appraised remained almost the same during April-Feb of 1998-99 and 1999-2000. In percentage terms the appraised issues declined from 25 to 15 per cent, casting serious doubts on the quality of the public issues. Even the minimum track record of ability to pay dividend is being circumvented. The promoters may be taking advantage of the craze for IT and entertainment sector stocks and the investors could be in for a rough time ahead. The type of pre-issue transactions the companies are made to enter prior to the issue even in case of 'appraised' issues whether for property or dependence for business clearly indicate the making of another primary market scam.

**Mutual Funds**

Allied to the primary market and which seems to have had a major influence on the trends in the secondary market in 1999 is the role of mutual funds (MFs). While the government's objective in offering tax concessions to equity-oriented MFs in its Budget 1999-2000 was to rescue the Unit Trust of India's (UTI) flagship scheme, namely US-64, the benefit has been reaped extensively by the private sector mutual funds. During April 1999-February 2000, the private sector accounted for nearly 70 per cent of gross mobilisations and 76 per cent of mobilisations on net terms. Data available from the mutual fund industry association suggests that correspondingly there was a substantial jump in the net assets of private sector mutual funds. In a little more than a year, the share of private sector more than tripled and reached nearly one-fourth of the total assets of MFs. (See Table-2) Even within the private sector, MFs under full or partial control of foreign fund managers gained substantially. In fact, MFs associated with foreign fund managers, account for 90 per cent of assets under the private sector MFs. Another important development is that not only a number of funds promoted sector specific schemes corresponding to the golden triangle, a number of other schemes have come to rely on the triangle even though they do not call themselves as such. Having come to rely so heavily on a few sectors, MFs obviously have developed a vested interest in the fortunes of these sectors and contributed to the already high concentration in the secondary market. Implications of these developments for the Indian stock market and consequently for the economy, demand special attention. Some indications of this may be seen in the trends in the secondary market described below.

**Secondary Market**

The Survey exudes a sense of satisfaction that the stock market remained buoyant over a fairly long period in 1999. The Survey also hinted at the price volatility in the secondary market. Has the secondary market recovery been accompanied by improving or worsening volatility? This question is important for the long-term stability of the market. The fact is that the volatility increased in 1999-2000. While the 30-share Sensex did reveal high volatility, what is more important is that even the broad-based 100-share National Index of the BSE too exhibited a similar phenomenon. The volatility was the highest in the first three months of 2000. (See Table-3) It is logical to expect that the situation would have been worse but for the 8 per cent restriction on price changes in individual scrips.

**Table-2**

**Assets under the Management of Different Categories of Mutual Funds**

(Rs. Crores)

| Category | At the end of 1998 | At the end of Feb 2000 | Share in Total (%) 1998 | Share in Total (%) Feb 2000 |
|---|---|---|---|---|
| (1) | (2) | (3) | (4) | (5) |
| A. Unit Trust of India (UTI) | 54,339 | 69,089 | 82.63 | 64.54 |
| B. Bank Sponsored MFs (6) | 4,504 | 8,384 | 6.85 | 7.83 |
| C. Institutions (4) | 1,993 | 3,486 | 3.03 | 3.26 |
| D. Private Sector incl. | 4,924 | 26,084 | 7.49 | 24.37 |
| - *Indian Companies (5)* | *776* | 2,697 | 1.18 | 2.52 |
| - *JVs: Predominantly Indian (7)* | *2,163* | 9,944 | 3.29 | 9.29 |
| - *JVs: Predominantly Foreign (9)* | *1,985* | 13,443 | 3.02 | 12.56 |
| Total (A+B+C+D) | 65,760 | 107,043 | 100.00 | 100.00 |

Source: Based on the data provided by the Association of Mutual Funds in India (AMFI) at its website www.amfiindia.com

Note: (i) Figures in brackets indicate the number of funds; (ii) Assets under the management of UTI are at book value; and (iii) JVs: Joint Ventures.

**Table –3**

**Share Price Volatility at BSE**

| Year | Percentage of days on which the BSE National Index Experienced to the Number of Days Traded: A day's High and Low differed by 3 % or more | Percentage of days on which the BSE National Index Experienced to the Number of Days Traded: A day's Close was lower or higher by 3 per cent or more over the previous Close |
|---|---|---|
| (1) | (2) | (3) |
| 1991-92 | 4.83 | 10.05 |
| 1992-93 | 8.56 | 14.06 |
| 1993-94 | 1.40 | 7.80 |
| 1994-95 | 0.00 | 0.43 |
| 1995-96 | 1.75 | 1.73 |
| 1996-97 | 6.69 | 4.96 |
| 1997-98 | 3.69 | 4.51 |
| 1998-99 | 16.46 | 10.70 |
| 1999-00 | 25.50 | 12.75 |
| [Jan -Mar 2000] | 46.77 | 25.81 |

Source: Generated from daily high, low and closing values of BSE 100 share National Index.

Note: Excluding the trading days for which the corresponding index values are not available.

The volatility seems to be related to at least four factors. *One*, the market is becoming increasingly polarised. Studies at the Institute for Studies in Industrial Development (ISID) identified the FIIs' strategy of converging on information technology (IT), consumer non-durables (FMCG) and pharmaceuticals in 1998 was in the main responsible for the emergence of what is now being officially referred to as the 'golden triangle'. Simultaneously, share prices of other manufacturing sectors, especially of basic and capital goods industries, suffered serious reversal. The extent of variation in valuation can be gauged from the fact that in mid-February 2000, out of the 304 product/activity groups for which price-earning (P/E) ratios are available, in case of six, the ratio was more than 100 and in case of another five it was more than 50. For as many as 196, it was less than 10. The six with the highest P/E ratios are: Entertainment and Electronic media (765); Large Computer Software Companies (431); Magnetic Tapes and Cassettes (281); Computer Software Converts (161); Large Telecommunication Equipment (128); and Computer Education (125). The skewed valuation was accompanied by high concentration in trading to such an extent that computer software and hardware companies accounted for nearly 35 per cent of turnover in 1999. Together with pharmaceuticals, media and FMCG, computer industry claimed almost 60 per cent of trading values at BSE. The turnover is concentrated in a few companies. Top 100 companies account for over three-fourths of the transactions and over 93 per cent of the value traded at BSE. In spite of the spurt towards the end of 1999, nearly sixty per cent of the listed companies are not traded at BSE.

*Two*, the foreign institutional investors who are known to be associated with high volatility returned to the Indian stock market in 1999 in a big way. Compared to net outflow of Rs. 1,585 crores during 1998-99, net investment on their account was Rs. 8,993 crores during Apr-Feb 2000. *Three*, mutual funds emerged following the concessions offered by the budget. Since most of the private sector mutual funds are under the direct influence of FIIs, it can be expected that stock prices would be affected not only by net FII investments but also by the size of funds under control of their local affiliates. Even local funds have started following the FII investment pattern.

*Lastly*, another development during 1999 which affected share price movement in India is the listing of Infosys Technologies and Satyam Infoway, a subsidiary of Satyam Computers, on NASDAQ (National Association of Securities Dealers Automated Quotation) of USA. It is now acknowledged in the stock market circles that share prices of IT companies in India, the prime factor behind the recent boom, are influenced by the NASDAQ. This phenomenon is going to be increasingly prominent as more Indian companies get traded on foreign stock exchanges. It is pertinent that the crash of BSE Sensex by 360 points on April 4, 2000 was preceded by a fall in Nasdaq Index by almost equal number of points. The fall was also triggered by the fears that FIIs would withdraw following the notices sent to a few FIIs registered in

Mauritius by the Income Tax department. This clearly shows how the Indian stock market has come to rely on FIIs on one hand and its relationship with NASDAQ due to the importance attached to technology stocks in India. An implication of these developments is that just as the smaller Indian cousins of the Bombay Stock Exchange and the National Stock Exchange (NSE) are suffering in comparison, these 'big brothers' are going to be at a disadvantage vis-à-vis their much bigger brothers in the developed countries. London Stock Exchange and NASDAQ have indeed intensified their poaching operations with advertisements in national dailies and personal visits to India. This relationship further became evident when BSE Sensex fell heavily on April 17, 2000 following a huge fall at NASDAQ on the previous trading day. While political instability and the Kargil episode may have contributed to the price fluctuations in the earlier part of 1999-2000, they have little to do with the volatility that is witnessed in the second half, especially in 2000.

**Some Implications**

The recovery in share prices in 1999 is artificial to the extent that it is propped up by tax concessions and hot money. The base is quite narrow and it would continue to be so as long as the market is influenced by considerations other than fundamentals. Even the increased resource mobilisation in the primary market is limited to very few sectors. Moreover, the type of 'disclosures' in issue documents clearly indicate that another primary market scam is in the making. Instead of exuding a sense of satisfaction and indulging in self-congratulation for the 'revival' of the primary market, the authorities should take urgent steps before this becomes a menace. The market's reliance on the FII-introduced preference for the golden triangle has led to high concentration in the number of transactions and market turnover which in turn is responsible for the high volatility. This selectivity has resulted in the remaining ones being relatively highly undervalued or illiquid. Since in an overwhelming number of companies there is either nil or very little trading, investors hardly have a chance to learn the real value of their shares. Lack of liquidity also means that the investors cannot exit from a company even after realising that the prospects of capital appreciation or dividend earnings are very poor. From the individual investors' point of view these are non-performing assets. Unfortunately, these are not highlighted as much as those of banks and financial institutions.

SEBI reduced the minimum public offer level from 25 to 10 per cent initially for IT sector issues and lately for media issues. If the public offer is only 10 per cent what is the purpose of coming to the public? Can't the companies which could raise such a high proportion of the funds, mobilise the remaining small amounts all by themselves without approaching the public? In practice, low levels of public offer help support high premium, lead to over-subscriptions, enable maintain high stock prices later on by keeping the supply of tradable shares limited and finally let the promoters have unassailable control over the companies. One could say that listing makes Employee Share Options attractive and the institutional investors and venture capital funds would not in the first place support the project but for the anticipated capital gains that would be realised on listing. In such a situation, the justification of resource mobilisation is relegated to the background while the promoters and financiers get unduly rewarded. The premium amount is often so high that it makes the companies' balance sheets attractive overnight through building up of reserves and high book values. The promoters could also oblige influential persons by offering them shares before the public issue.

Contrary to expectations, foreign portfolio investors have not caused greater depth in the Indian stock market. They indeed led to focussing on very few sectors and on a few companies. The initial appeasement of FIIs by offering them lower capital gains tax has ultimately led to reduction of capital gains tax for the domestic investors also thereby denying the exchequer its due. Growing concentration of trading in a few sectors reduced the stability base of the stock markets. The expectation that by adding liquidity to local markets, foreign investments would reduce the volatility which results from the thinness of the markets in developing economies has been thus proven unfounded.

Heavy reliance on FIIs to prop up share prices is evident from the fact that the government recently nullified the notices issued to a few FIIs which claimed residence in Mauritius. Far from this, it should have taken a firm stand and ascertained the antecedents of even those who have been officially recognised as 'residents' of Mauritius. Does one become eligible to benefit from the double taxation avoidance treaty by merely having an office in Mauritius? It is surprising to note that in one of the entities which invested in India through Mauritius, the 100 Founder Shares (out of the total 5,00,00,000) issued to Mauritian nominees (possibly to qualify for residence status) not only do not carry voting rights but also do not have right to share in profits! A number of foreign investors – not just a few FIIs – have set up their offices in Mauritius to take advantage of the treaty. Indeed, the situation has become so ridiculous that according to official statistics, Mauritius is the single largest source of foreign direct investment (with one-third share in total inflows during 1996-97 to 1998-99) for India while the share of USA was only one-fifth!

To understand the real cost of FII investments, it is high time that the government discloses detailed data on FII operations instead of merely handing out gross inflows/outflows and purchases/sales figures. It is also time to assess the gains from foreign portfolio investments whether for domestic resource mobilisation, strengthening of the Indian stock market, help enable dis-investment or for providing balance of payment support. The government's swift assurance that for taking advantage of the treaty with Mauritius, the residence certificate issued by Mauritius is sufficient casts serious doubts about its willingness to monitor FII operations objectively, disclosure if any of the results of the monitoring and its ability to take disciplinary action in case of serious violations by the FIIs. Indeed, *Hindu Business Line* (April 6, 2000) pointed out that SEBI's investigations against some FIIs for alleged hammering down of the price of State Bank of India at the time of launching its GDR, four years back, are yet to come to a conclusion. Similar is the case with an FII which is reported to have fuelled panic in the market over UTI's US-64 in 1998. It was suggested that even after identifying the FII and the government deciding that the FII would be informally black listed, the FII continues to be in contention for selling public sector disinvestments.

The emergence of private sector MFs has added another dimension to the role of FIIs in the Indian stock market. An implication of MFs gaining strength in the Indian stock market could be that unlike individual investors, whose monies they manage, MFs can create market trends whereas the small individual investors can only follow the trends. The situation becomes complicated if the funds gain a vested interest in certain sectors by floating sector specific funds. Since they will have to beat the standard reference market indices to show that they are better at investment, FIIs and MFs registered in India thrive on uncertain market conditions and by creating waves. If they too settle for steady returns, obviously there will be little difference between an individual investor and a fund. NASDAQ President indeed identified the institutions tendency to "roll their funds from one sector to another" as one of the causes for the volatility. (*Hindu Business Line, April 6, 2000*) Even UNCTAD was concerned about the possible distortions that foreign portfolio investments might introduce due to the pressure on them to secure capital gains.

Stock markets are known to appeal to gambling instincts. The volatility has added fuel to this fire as investors are forced to seek quick gains because they are not sure of what is going to happen next. It looks as if returns are counted daily as in a casino instead of on longer time periods -- after all Net Asset Values (NAVs) of MFs are reported every trading day. The very low delivery ratios in the stock market are a clear reflection of this phenomenon. Progressive de-materialisation and introduction of rolling settlement are unlikely to improve the situation in real terms as unstable markets force investors to be on guard all the time. In the uncertain circumstances investors are likely to play safe because of which it is most likely that trading will get concentrated further among a few top companies. The volatility is essentially due to FIIs, MFs and integration with global markets and often does not have any relationship with fundamentals of the Indian economy or the companies concerned. Stock market's role of monitoring, disciplining and supporting good managements has little relevance in such situations.

Will the funds, whether FIIs or India-based MFs, having an eye on NAVs, contribute to good corporate governance as it is made out to be and that their presence will be helpful for the smaller shareholders who for reasons of high cost cannot participate in monitoring of the managements? If at all the FIIs are more likely to act as insiders as companies have to keep them in good humour lest their share prices are hammered down. Also, with multiple funds under charge of a single FII, the possibility of manipulation through intra-FII dealings has increased substantially. One is also not sure of how much of the FII money I return of flight capital and of NRIs. In any case, effective manipulation of the market and insider trading seem to have passed on from *desi* traders and Indian industrialists to foreign high-tech financial wizards.

The recent trends suggest that the Indian stock market may weaken its relationship with the domestic economy. Can the developing countries rely on the wisdom of such a stock market, especially when it starts reacting to external factors, for industrialising their economies is a question that needs to be considered in greater detail. To the extent this phenomenon has been introduced and accentuated by FII operations it gives raise to a doubt whether foreign portfolio investments would serve the objective of local stock market development or the tangible benefit from them would only confine to getting the balance of payment support along with its attendant risks. Stock markets will have to be developed as a part of domestic corporate financing options. Attracting foreign portfolio investors cannot be a substitute for domestic policy formulation and institutional development. A strong domestic base is a prerequisite for providing depth and spread to the stock market and to enable it to counter any precipitative action by the FIIs not based on fundamentals. The only safeguard can be Indian public financial and investment institutions holding large shares and in their capacity for direct intervention. The size of the holdings and internal resources with the public institutions will be an important factor in containing the volatility induced by FIIs. The heavy emphasis on trading in high-profit and quick-yielding sectors may indicate that for financing infrastructure, and long gestation projects, India may not be able to rely on the stock market. Similar is the case with a vast majority of small and medium companies. Even from this perspective, the role of development financial institutions should not be undermined. Excessive reliance on foreign portfolio capital, almost to the point of capitulation, is harmful and would not let the developing country stock markets respond to host country needs.