Risks and Prospects of Retail Investors in Indian Stock Market

C.A. (Dr.) Pramod Kumar Pandey
Associate Professor, National Institute of Financial Management, Faridabad, Haryana, India

ABSTRACT: This paper analyses the major inconsistencies prevalent in the Indian stock market and discusses the precautionary steps that a retail investors should take before investing. For the purposes of study, last ten years data has been taken into consideration. It has been found that Indian stock market is highly volatile. All five adverse factors viz. stock market scams, speculation, insider trading, P notes and prevalence of shell companies are dark sides for Indian stock market. In spite of many regulations and control, they still exist. This paper concludes that Retail investors should adopt due precautions while making direct equity investments. They should not focus on short term profit making and avoid the behavioural biases.

KEYWORDS: P note, option, future, speculation

I. INTRODUCTION

This paper analyses the major inconsistencies prevalent in the Indian stock market and discusses the precautionary steps that a retail investors should take before investing. Retail investment is growing at a faster rate. For the purposes of study, last ten years data has been taken into consideration. Retail investor is a person who buys small lots with his limited income, possesses lesser knowledge and skills and influenced by behavioural biases. The expectation of getting higher returns in a very short period of time is attracting more and more retail investors in Indian stock market since conventional modes of investments like Bank FDs and Public provident fund are not able to generate adequate returns. People ranging between age of 28 to 37 invest more in the stock market, Arup Kumar Sarkar and Dr. Tarak Nath Sahu [2017]. Among others, direct equity investments and mutual funds are gaining popularity among the retail mass. The behaviour of individual investor in Stock Market is significantly influenced by their demographic factors and Perceived Risk Attitude, Arup Kumar Sarkar and Dr. Tarak Nath Sahu [2017]. Indian capital market is in a trajectory of growth with lot of retail investors participating enthusiastically, Sashikala P. and Girish G. P. et al. [2015]. However, the fact cannot be denied that many retail investors have lost a lot of money in the hope of getting hand some returns.

II. RELATED WORK

1. Prof. Sanjay Sehgal, Dr. Namita Rajput and Mr Rajeev Kumar Dua, 2012, investigated about the impact of futures trading activity on stock price volatility and found that unexpected futures trading is significantly impacting the stock price volatility
2. Prof. Kamlesh M. Pandya, 2013, studied illegal insider trading in India and concluded that amongst all, insider trading is the most dangerous corporate crime
3. Mr. Gaurav Dawar and Ms. Swati Goyal, 2013 studied the corporate scams and concluded that the market is very efficient they absorb all the information regarding the event and thus there is no impact of the financial scams on the share prices of the company.
4. Hemkant Kulshrestha, 2014, conducted the study to evaluate the possibility of relationship between FI investment and Indian capital market. The study came out with the conclusion that FII have positive impact over Nifty and Sensex.
5. S. Sahul Hameed and M. Fowzia Sultana, 2015, studied P notes and concluded under the study that more than 50% of the funds are flowing through via P-notes and therefore an exhaustive reorganization is needed.
6. Sashikala P. and Girish G. P., 2015, worked on factors that influence the trading behavior of investors. They came with the conclusion that among other factors current price of the equity stock also plays a major role in his investment decisions.

7. Muhammad Anhar, 2015, found that investors’ expectation and investment risk have direct influence on Individual Stock Price Index.

8. Bishwajeet Bhattacharjee, Sumita Dave and Shikha Sondhi, 2016, studied about the movement of stock market in India. They selected monthly data for their study from January 2004 to May 2014. They found that Indian stock market is highly volatile and thus it is very difficult to predict the stock price behavior based on past trends.

III. RISK FACTORS IN THE INDIAN STOCK MARKET

Indian stock market is passing through high volatile phase due to cleaning exercises adopted by the Government of India. At times Indian stock market has been facing many inconsistencies like frequent stock market scams, insider trading, algorithmic trading, speculation, existence of shell companies, unaccounted investments through participatory notes (PNs/ODIs) etc. All these inconsistencies are impacting very adversely the Indian stock market.

Due to existence of speculations and other inconsistencies, fair pricing of equity shares is highly doubtful. The turnover of stock futures and stock options is increasing chronologically over the last few years as compared to cash equity segment (Chart-1). Securities Exchange Board of India is consistently taking measures to eliminate all such ills from Indian stock market. For example, in quite few months it has restricted ODIs/PNs except for hedging purposes in equity investments on one to one basis, banned trading in 331 suspected shell companies, also proposing to impose restrictions on excessive derivatives to cash equity segment.

Factors causing biases among retail investors

a. Steep rise or fall in price of equity shares in the past
b. Changes in stake by promoters in the company
c. Higher or lower demand on the derivative side
d. Changes in stake by Domestic institutional investors
e. Changes in stake by Foreign institutional investors
f. Rumors and sensations about merger and acquisition about company
g. Sharp increase in accounting profits
h. Changes in the volumes traded
i. Fluctuations in the stock indices like Nifty and Sensex

![Chart-1: Monthly average turnover of (Stock Futures and Options) and (cash equity) in cr.](image-url)
IV. THE IMPACT OF INCONSISTENCIES IN THE INDIAN STOCK MARKET

Indian stock market is not very safe for retail investors due to many inconsistencies that prevail from time to time. In the past the retail investors have lost a lot of their hard earned income. SEBI is making continuous efforts for cleaning up the Indian stock market from such irregularities. Let us have a glance of some of such inconsistencies as given below

Speculation: The term speculation implies intention to make profits in the short run through price movements of stocks both upwards and down wards. The speculators do not care fundamentals and long term prospects instead only concentrates on stock prices. They try to correlate the stock prices with its past movements, volumes traded, relies on rumors and sensations and insider trading. Speculators in fact play a zero sum game where the gain of one speculator is exactly equals to losses suffered by other speculators. From company’s point of view the stock prices are important because it will help it to fetch funds at lower costs from the market however from speculator’s point of view stock prices are only important because, it will generate short term profits. In an era of speculation, all the prior developed theories have lost its worthiness, Bishwajeet Bhattacharjee, Sumita Dave and Shikha Sondhi (2016). Speculation may be compared to gambling where win or loss can never be predicted. Due to speculation, the retail investors have lost a lot of their hard earned income. Equity derivatives to cash equity ratio has sharply increased in past few years which is a cause of concern (Chart-2) Speculation has the effect of creating excess liquidity in short run in the stock market.

In the financial year 2017-18, the situation has become grave when the monthly average turnover of equity derivatives has become around four times of turnover in cash equity segment (Chart-3). Some immediate action was required to clean up inconsistencies to protect the interests of innocent investors.

Participatory Notes (PNs/ODIs): Participatory note (PNs) is one of the popular means of indirectly entering into Indian capital market without disclosing identity to SEBI. Participatory note (PNs) refers to offshore derivative instruments (ODIs) which are issued by registered FIIs/FPIs, Foreign Banks and India based brokerage houses to

---

Copyright to IJIRSET

DOI:10.15680/IJIRSET.2017.0608248

16539
individual foreign investors or hedge funds. In case of P-notes, the underlying assets are derivatives. Indian capital market is significantly dominated by FIIs/FPIs. For the past few years, entry of unaccounted money in the form of ODIs/PNs has created disequilibrium in the Indian capital market. Mostly the sources of PNs/ODIs have been Singapore and Mauritius among other countries. These ODIs/ PNs have mostly been used for speculative purposes and thus innocent investors have lost a lot of money for these gimmicks. The SEBI is keeping close eyes on such PNs/ODIs. Due to continuous investigations and actions, notional value of PNs/ODIs is sharply coming down in year 2017 (Chart-4).

Shell companies: The term “Shell Company” has not been defined under the companies act, 2013. Normally Shell Company implies a company which has been created and used as a vehicle to avoid taxes and commit other frauds. These companies are involved in money laundering exercises to create black money and illegally raise the stock prices for personal benefits of a particular group of persons. At times these companies have also been found to violate the listing agreements and other laws of the country. SEBI has already banned 331 suspected companies. These companies were charged to divert their borrowings to foreign tax heaven countries and bringing back the same in the form of foreign investments. The existence of Shell Companies is creating unfair stock prices along with bringing distress to Government’s tax revenue. Now after the ban, the share prices of these companies have experienced a steep fall causing huge loss to investors.

Insider Trading: Insider trading means the act of buying or selling securities by promoters, directors, key managerial persons or other officers of the company who is suspected to have non publically available price sensitive information. It also includes communicating directly or indirectly any such information to other person. Increase in shareholdings by the promoters has the effect of creating confidence in the market. At times it has been found that retail investors invest in the company in which promoters increase their stakes. For the past few decades, the insider trading has impacted very adversely the Indian stock market. Small investors are worst sufferers from insider trading, Prof. Kamlesh M. Pandya et al. (2013). Insider trading is strictly prohibited in India and punishment may include fine or imprisonment or both. In the past SEBI has conducted investigations in many suspected cases to protect the interest of investors. It is also worth noting that mere possession of insider information at the time of trading is sufficient for a violation, Umakanth Varottil (2016).

Stock market scams: Indian stock market has witnessed many scams. One thing common in all such scam was manipulation of stock prices through creating false demand for shares. Many investors and mediators have not only lost their moneys but also lives. Most of the investors are aware about financial scams but they do not think that these scams affect investments a great deal, Mr. Gaurav Dawar and Ms. Swati Goyal (2013). One lesson that can be learnt from all such scams is investors should not attract towards making many in a very short period of time, instead they should exercise due caution and care before investing, should look into fundamentals of the company and invest with
long term vision for creating wealth. Below may be mentioned the ways and means adopted in various stock market scams in India:

- Borrowing money from banks for investing into shares
- Raising moneys in the name of fake firms
- Borrowing money for investing keeping the same shares as collaterals
- Showing false sales through fake invoices
- Borrowing money from public violating the SEBI regulations
- Raising money from public by offering to return them higher returns

V. FINDINGS AND ANALYSIS

Indian stock market is highly volatile. For the last ten years Nifty is growing at an average rate of 11.57%. The highest growth rate was seen in the year 2014-15 at 32.62% due to many reforms taken on the corporate governance, FPI regulations and reforms in banking and insurance sector. During this year growth rate in Future-Option segment was 45.52% and 54.16% in Cash Market segment. However the growth rate was negative in year 2011-12 due to global corrections triggered by Greece crisis.

All five adverse factors viz. stock market scams, speculation, insider trading, P notes and prevalence of shell companies are dark sides for Indian stock market. In spite of many regulations and control, they still exist. Whereas cash market (CM) segment has encountered four times negative growth rate, Nifty one time in last ten years, the growth rate in future and option (FO) has always been positive (Chart-5). Very surprisingly coefficient of variation (CV) of FO segment is lesser as against CM segment and Nifty. This shows that FO segment is more consistent than CM segment and Nifty. The biggest attractive points for FO segments are lower costs, higher return in shorter period. But as far risk is concerned, it is much riskier than cash market segment. Now the crucial question that should hit in a common mind is that why investment in FO segment is more consistent in spite of so high risk. One answer that appears could be lower cost and higher short term returns but at the same time another answer could be presence of insider information for which investors in these segments is quite sure of their returns or the fact that they have become more risk averse. Major findings of the study are given as under:

a. Indian stock market is largely impacted by foreign investments
b. Back door entry through PNs/ODIs is creating unaccounted money which has adverse impact on Indian economy
c. Speculative activities have increased many folds in year 2107 in Indian stock market
d. A new concept of Shell Company has emerged after demonetization for creating and hiding black moneys and avoiding taxes.
e. Insider trading instances are predominant in Indian stock market despite their prohibition.
f. Machine trading also called algorithmic trading is replacing the manual trading
g. Government is taking continuous steps to boost Indian stock market and remove inconsistencies
h. Despite all irregularities, the proportion of investments by retail investors has increased in Indian stock market.
ii. The existence of higher speculation is acting as hindrance in reaching the market at perfect valuations.
VI. CONCLUSION

There are many risk factors associated with direct equity investments. The SEBI is continuously taking steps to remove the ills and inconsistencies in the stock market. In fact, Investor education is the best way to empower investors and hence the issue needs special attention, Prof. Sanjay Sehgal, Dr. Namita Rajput, and Mr. Rajeev Kumar Dua (2012) and further a conducive environment and simplification of procedural formalities is required for the revival of the lost confidence of the investors, Dr. Mandeep Kaur and Tina Vohra (2012).

Retail investors should adopt due precautions while making direct equity investments. They should not focus on short term profit making and avoid the behavioural biases. A well diversified portfolio should be selected only after careful planning and in consultation with some equity expert. Company fundamentals should be given due weighted instead of short term price movements. Rather investing at one time, piece meal investments should be made. It is always desirable that initially they should enter the stock market through mutual funds. The Wealth can only be created in the long run.

REFERENCES

[12] www.nseindia.com
[13] Economic times various issues
[14] Business standard various issues
[15] Financial express various issues