The elusive retail investor: How deep can (and should) India's stock markets he?*

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That economic and financial liberalisation since the early 1990s have transformed India's stock markets cannot be denied. The Sensex, which stayed well short of the 5,000 mark for most of the 1990s, has since risen to cross 20,000 in 2008 and 25,000 more recently, with an associated climb in market capitalization. Underlying this has been the evidence that capital brought in by foreign institutional investors, combined with investments made by domestic financial institutions, corporates and high net worth individuals, has been largely responsible for increases in the volume and value of transactions and, therefore, in market indices and capitalisation.

This has also been the period when the Securities and Exchange Board of India has built and strengthened its market monitoring and regulatory apparatus, recording in the process significant success in increasing transparency and reducing market manipulation and fraud, while promoting market activity. Among its promotional endeavours is the pursuit of its mandate to increase retail investor participation, so as to offer new options for savings in financial assets and a means of mobilising small investor capital for investment.

Yet, the prevailing perception has been that the individual, small, 'retail' investor has been less important in the market. The definition of the retail investor in India has changed over time. Till August 2003, under the SEBI (Disclosure and Investor Protection) Guidelines, 2000,a retail investor was defined as an individual investor applying for allotment of 10 or less marketable lots in a fixed issue or up to 1000 units in a book built issue. Since the prices of share values in IPOs from different firms can vary, a definition of this kind based on number of shares applied for does not take into account the volume of investment made in any particular IPO by the investor concerned, though that is an important factor distinguishing the character of different investors. To take account of investment size, the retail investor was subsequently redefined to reflect her choice of stock by value. In August 2003 the definition was amended to include all individual investors applying for securities worth Rs. 50,000 or less, with that value being subsequently revised to Rs. 1,00,000 in March 2005 (and incorporated in the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009) and then to Rs. 2,00,000 in November 2010. The increases were partly in order to adjust for inflation. While such definitions have been used to target concessions to the retail investor, analysing the behaviour of investors demarcated on the basis of these definitions is difficult, because comprehensive information on retail investors identified in this manner is hard to come by.

Retail investors in global markets

Experience elsewhere in the world provides some grounds for regulators paying special attention to the retail investor, whose exposure to the market either through direct investments or through instruments issued by intermediaries like mutual and pension funds has been increasing.

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In those countries, the real difficulty is not so much the absence of the retail investor, but the often uninformed and at times contrarian and irrational behaviour of these investors. In addition, the market influence exerted by and market manipulation resorted to by certain large and dominant investors from time to time, are found to disproportionately and adversely affect the safety of the savings and the returns earned by retail investors. This would imply that even as India witnesses increased presence of retail investors in equity and debt markets, intervention to influence their behaviour and protect their interests, both from their own point of view and from that of the stability of the market, could become crucial.

However, in India, even presence cannot be taken for granted. Retail investor presence is likely to increase as per capita income in a country rises, since at any given level of inequality that would increase incomes and surpluses in the hands of those in the middle and upper-middle of the income distribution from where retail investors can be expected to come. But, this relationship does not seem to be exactly the same across contexts and time, with some middle income countries now reflecting a much greater presence of retail investors than the present day developed did when they were at the same level of development. So, if retail investor presence is considered important, intervention may be necessary.

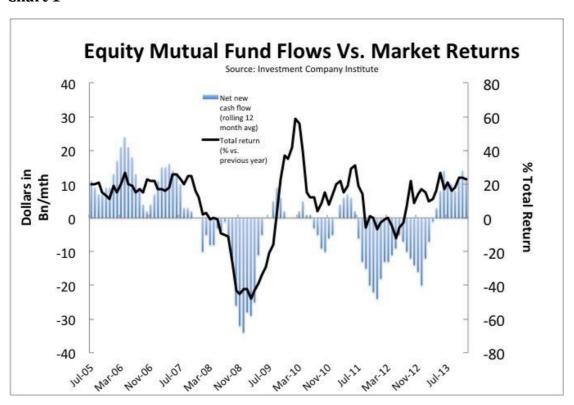
The United States is one country where the equity culture is considered to be widespread, and retail investor presence substantial. According to the latest *Survey of Consumer Finances* conducted by the Federal Reserve in 2013 (Bricker et al 2014), 48.8 per cent of US families were direct or indirect owners of publicly traded stock in 2013. Interestingly, even households in the bottom half of the income distribution had an average stock holding of \$53,000. Though this was around one-seventh of the average holding in the top decile of the population, it does point to widespread ownership (with concentration at the top) making the retail investor an important player. According to the Investment Company Institute (ICI) and the Securities Industry Association of the US, over 50 million U.S. households engage in some type of retail investing. The retail investor is here defined as an individual investor who purchases securities directly (including through brokers who trade on the basis of instructions from the individual investor or by investing in 'managed accounts' where the account manager makes the buy/sell decision on behalf of individuals).

In the US, small investors who prefer to use the mutual fund route to market entry, to benefit from fund manager expertise and the economies of scale exploited by these institutions, are not considered retail investors. In 2014, "36% of U.S. equities were held directly by households", but "that figure is inflated, since the Fed data include closely held companies and public-share holdings by nonprofits. Adjusting for those factors, it's likely that less than 30% of publicly traded stock is directly owned by individuals" (Reklaitis and Watts 2015). But, according to the ICI, individual investors in the US rely substantially on mutual funds, with households holding 89 per cent of mutual fund assets in 2014 (Constable 2015). Thus these investors should also be taken into account, making retail presence even more substantial.

However, the Institute finds (Constable 2015) that the behaviour of retail fund investors is contrarian: "Net inflows to equity funds tend to rise with stock prices, and net outflows tend to occur when stock prices fall." (See Chart 1). That is, retail investors tend to buy when prices are high and sell when they are low,

and are on average seen as failures when it comes to 'timing the market'. Thus, in the US, a 17-month bear run during the financial crisis, which began in October 2007 and ended in March 2009, caused the S&P 500 Index to fall by 56 per cent. During that period many retail investors reportedly exited at a loss. Over the 12 months to May 2009, \$213 billion flowed out of all types of equity mutual funds (Constable 2015). But starting March 2009 the Index soared once again, and yet during this period retail investors stayed away, either because they had burnt their fingers or because they did not have the wherewithal to exploit the rising market. Retail investors had pulled out \$661 billion from U.S. equity mutual funds and exchange traded funds between the end of 2007 and mid-2015, while institutional investors poured in \$665 billion, according to figures compiled by J.P. Morgan Asset Management. The proportion of US households exposed to the market had fallen from 53.2 per cent in 2007 to 48.8 per cent in 2013, and is reportedly still falling (Reklaitis and Watts 2015). When the US stock market was losing steam, from July 2014 through mid June 2015, mutual fund holders reportedly withdrew an estimated \$105.8 billion from domestic equity funds (Constable 2015). That would have meant substantial losses for those who entered the market when prices were high.

Chart 1



Source: Constable (2015).

Thus, even in the country where stock market exposure of households is the highest, retail investors seem to lose out on average from market participation. This is related to investor behaviour no doubt.

But, Rekalitis and Watts (2015) argue, "retail investors haven't necessarily been irrational in their reluctance to return to the market. After the financial meltdown in late 2008, Wall Street has been scrutinized as never before, even as regulatory changes are criticized by investor advocates as insufficient. Persistent problems include financial advisers who peddle investments that are unsafe for the average person; corporations that enrich their CEOs more than they do

shareholders; and a willingness by securities exchanges and regulators to let well-heeled investors buy access to data and information ahead of the general public." A poorly regulated market discourages the retail investor.

Some Asian examples

In some countries in Asia, such as Singapore, Malaysia and India, which were British colonies, stock markets existed for a long time. But they have become active only in recent times. In others, like Thailand, the stock market was developed as part of a process of expanding the role for markets in general, often based on advice from or persuasion by international financial institutions. Financial liberalization played a role in promoting market activity as is clear from the figures in Table 1 on trends in turnover ratios in some Southeast Asian countries in the years before the 1997 financial crisis.

Table 1: Turnover ratio in selected Asian countries

Turnover ratio in selected Asian countries						
Year	Singapore	Malaysia	Thailand			
1986	9.3	5.2	33.2			
1987	25.6	13.6	88.4			
1988	11.8	6.8	70.0			
1989	25.5	11.9	57.2			
1990	27.3	22.4	102.2			
1991	20.8	18.7	88.4			
1992	21.6	20.8	125.3			
1993	33.0	62.5	66.2			
1994	33.5	62.5	64.0			
1995	29.7	30.1	43.1			

Source: Maru (1997.)

Note: Turnover reflects the frequency of buying and selling stocks often calculated as the total value of shares traded during a period divided by the average market capitalization for the period. Average market capitalization is calculated as the average of the end-of-period values for the current period and the previous period.

In these countries too retail investors had a role to play. As early as in 1990, the proportions of stockholders in Singapore were over 30 percent for corporations, 20 percent for individuals, and 37 percent for nominees, including overseas and other institutional investors. In Malaysia, the composition of stockholders was 16 percent individuals, 38 percent nominees, and 46 percent financial institutions. Included in financial institutions are domestic institutional investors, while overseas institutional investors are included under nominees. Since many corporations held stocks to control companies, and financial institutions did not trade much, individuals were more active in trading stocks

(Maru 1997). While it is true that the role of foreign financial institutions in Asian markets has increased significantly in recent years, retail investors are still an important presence.

In July 2014, the Singapore Stock Exchange (SGX) declared that 68,000 new retail investors had joined the exchange in the previous 12 months, taking the total to 1.6 million accounts. Almost 52 per cent of the new accounts had holdings. Now there are a total of 1.6 million accounts on SGX. About a third of Singapore's working population is said to be into active stock trading (Sun 2015).

Nowhere in developing Asia is the presence of the retail investor more ubiquitous than in China. According to one estimate, retail investors account for 85 per cent of trading in China's markets (Shen and Goh 2015). As much as 81 per cent of retail investors (totalling around 200 million) claim they trade at least once every month. And the number had been growing prior to the July 2015 slump. More than 30 million new trading accounts were created in the first five months of 2015. It was this huge retail investor presence that pushed the government to intervene and halt the market decline in mid-2015. Foreign investors account for less than 2 per cent of Chinese share ownership. This is because of the distinctive trajectory along which the stock market evolved in China as part of the transition.

However, in many contexts, the fear is that retail investors are withdrawing from the market. As usual the picture is stark in China. According to China Securities Depository & Clearing Corp nearly a third of the country's individual investors—more than 20 million people—had exited the market once stock prices plunged in 2015. The number of retail investors holding stocks in their accounts fell from 75 million at the end of June 2015to 51 million at the end of July (Gu 2015).

In Singapore, over the 3 years ending July 2015, there has been a 4 per cent fall in retail investor participation on SGX. In Malaysia, a 2012 report in the *Business Times*(Sivalingam 2012) noted: "foreign institutional funds saw net buying of RM3.4 billion (S\$1.4 billion) in the Malaysian stock market last month while local retailers and institutional funds were net sellers, disposing of RM600 million and RM2.1 billion worth of shares respectively". The retail average daily value in Bursa Malaysia had declined from its peak of RM806 million in 2007 to RM283 million in 2008 before it climbed to RM442 million in 2011. However, the percentage of investors who are retail investors had declined from 37 per cent in 2007 to 26 per cent in 2011.

Thus, besides the shortfall in investor presence relative to potential, it is this whimsical behaviour of the investor that is a cause for concern. Not surprisingly policy has been geared to both attracting more retail investors to the market, as well as changing their investment behaviour so as to make them an anchor for relative market stability.

Objectives of regulation

Across the world regulators in charge of stock markets have both promoted retail investor interest in market investments and put in place means to protect them once they have entered the market. The essential principle followed by the Securities and Exchange Commission in the USA, for example, is to encourage

retail investor activity by, in the first instance, seeking to make markets fair and safe. Enforcement measures when actively implemented deter market manipulation and fraud. If that is not the case, retail investors would be hurt by larger players in the market and withdraw once they burn their fingers. In addition, measures are put in place to ensure that public companies listing in the market reveal all relevant financial and operational information to the public, and efforts undertaken to educate investors on how to study that information and make informed decisions.

In this framework of intervention, the role of the regulator is also to impose adequate penalties on those who violate the rules, take them to court when necessary and seize assets and return money to defrauded investors. Moreover, through fraud alerts, investors are warned against fraudulent operators and schemes, so as to prevent fraud before they affect retail investors.

At the global level too the International Organization Of Securities Commissions (IOSCO) emphasizes the role of investor education and financial literacy as a requirement for sound investment decisions. This becomes even more necessary today because financial innovation has made investment products extremely complex and near opaque. Hence, even when taking the help of investment advisors and financial intermediaries, retail investors need to have the ability to understand and evaluate the choices available so to avoid financial fraud. IOSCO's Committee 8 on Retail Investors has as its primary mandate engagement in retail investor education and promotion of financial literacy. It is also mandated to advise the IOSCO Board on retail investor protection matters and conduct research on investor protection policy.

Elsewhere, the Monetary Authority of Singapore (MAS) seeks to safeguard the interests of investors, particularly retail investors, in five ways:

- It demands stringent disclosure of information by issuers;
- Requires transparency in the information disclosed;
- Sets standards for intermediaries who sell investment products to provide quality financial advice;
- Promotes investor education, so that investors are empowered to make informed decisions.
- Provides affordable and accessible dispute resolution mechanisms for investors who feel aggrieved by the investment process.

As part of this effort the MAS has tried to address the problem that financial documents, such an IPO prospectus, for example, can run into hundreds of pages, with detailed descriptions about the company's business operations, its competitive environment, governance practices, and risk exposures, not to mention a full set of financial statements. Since retail investors cannot easily digest all this information it has introduced a new regulatory requirement for a Product Highlights Sheet to accompany offers of investment products that come with prospectuses. Its purpose is to convey key risks and product information in plain language and in a simple question-and-answer format.

SEBI 's strategy

The SEBI in India too, as part of promoting retail investor activity in the market, combines efforts at investor education and promoting financial literacy with a set of regulatory measures. Collaborating with exchanges, depositories and

various trade bodies like the Association of Mutual Funds of India (AMFI), SEBI has organised a number of investor education activities, the reach of which has widened over the years. Besides, campaigns, such as one on Collective Investment Schemes being broadcast through TV and Radio, seek to caution investors about schemes seeking to mobilise capital for speculative purposes by offering unrealistic returns. Regional Seminars on investor education, launched in 2011-12 have also sought to create awareness about such schemes. An innovative initiative in this area of financial education is a drive to conduct workshops using as resource persons teachers and lecturers specially trained for the purpose. More recently, SEBI has initiated a process towards drafting a National Strategy for Financial Education under the aegis of the Financial Stability and Development Council (FSDC).

SEBI has also adopted measures to expedite the process for redressal of investor grievances, and in 2011-12, it launched a new web based centralized grievance redress system called SCORES (SEBI Complaints Redress System).

Regulatory measures

These efforts at financial education have been combined with a number of measures aimed at ensuring the possibility, improving the ease and reducing the cost of retail investor entry and activity in stock markets. To start with, to make the application process more convenient for investors, it was decided to extend the reach of the Application Supported by Blocked Amount (ASBA) scheme, by mandating the Self Certified Syndicate Banks (SCSBs) to provide the facility in all their branches in a phased manner. Further, in 2012, SEBI allowed cash transactions in mutual fund schemes to the extent of Rs. 20,000 to help enhance the reach of mutual fund products among small investors, who may not be tax payers and may not have PAN numbers or bank accounts such as small farmers, small traders/businessmen and workers.

Taking account of the fact that 90 per cent of all mutual fund sales come from 15 large Indian cities, SEBI also allowed mutual fund companies to raise the expense ratio on their funds, by as much as 0.3 of a percentage point. This was to allow fund companies to use the extra earnings to sell their funds to and attract investors in smaller Indian cities.

Secondly, rules and guidelines in areas varying from disclosure to pricing that protect the small investor have been specified by SEBI at various points in time. The structure, design and contents of the Bid-cum-Application Form and Abridged Prospectus were also revised so as to provide information to investors in a user-friendly format.

Third, to ensure minimal access of retail investors to preferred IPOs, SEBI has reserved a share of new issues for them. Allocation of shares to retail individual investors has been increased from 25 per cent to 35 per cent of the total issue of securities in the case of book-built issues. The SEBI also modified the share allotment system, so that irrespective of application size, every retail individual investor gets allotted a minimum bid lot, subject to availability of shares in aggregate.

Finally, over time, SEBI has chosen to move beyond merely facilitating retail investor presence and "protecting" their interests, to incentivising retail investor participation in the markets. For example, in initial and follow-on public offers, SEBI allows a price discount for retail investors, which is usually limited to 5 per

cent of the offer price that institutional investors and high net worth individuals (HNIs) pay.

The reasons given for the SEBI's focus on the retail investor, even if not always clearly stated, are many. First, 'democratising' markets by bringing in retail investors is seen as a virtue in itself, and as conducive to better corporate governance. Second, retail domestic investors are seen as a force that can endow the market with a degree of stability, not being characterised by the volatile and whimsical behaviour of foreign institutional investors or large domestic speculators, for example. Third, a large presence of retail investors is seen as one of the ways in which the sluggish primary or IPO market can be activated, since retail investors in search of stocks to acquire would be willing to buy into them. And, finally, in a larger macroeconomic sense, bringing in the retail investor is seen as a way of redirecting savings away from unproductive physical investments (like gold), to financial savings, which either directly or through intermediaries like mutual funds go to finance productive investment.

Retail investor presence

The perceived inadequacy of retail investor presence is felt despite these efforts. As of now the general assessment is that retail investor interest in India's capital market has been far short of potential. A survey of household saving and investment behaviour conducted by the NCAER in 2011 found that households investing in bonds, debentures, equity instruments, mutual funds and derivatives totalled 24.5 million and constituted 10.74 per cent of all households in the country. The proportion of investor households was nearly 21 per cent in urban areas and 6 per cent in rural areas. Of these investors 43 per cent showed a preference for mutual funds, 22 per cent were exposed to bonds and debentures, another 22 per cent to the secondary market, 10 per cent invested in IPOs and less than 4 per cent in derivatives. In sum, though a significant share of investor households were exposed to the secondary equity market, they amounted to only 2.4 per cent of all households, with that figure falling to just above 1 per cent in terms of exposure to IPOs(NCAER 2011).

Retail investor presence appears smaller when assessed relative to population. A 2011 study from the Indian School of Business (De, Gondhi and Sarkar 2011) estimated that there were around 2.02 million retail investors in India, which was small relative to the Indian population (0.2 per cent). Other evidence also shows that retail investors constitute a miniscule share of the population. Thus, the study by De et al using a database covering transactions of all 755 stocks traded on the NSE between January 1, 2005 and June 30, 2006 found that the number of retail investors who engaged in at least one trade in this 18-month period was 2.5 million or 0.22 per cent of the Indian population.

However, there is evidence to the contrary as well. The number of tax payers who are registered with the stock exchange is rising. Exchange officials are reported to have declared in December 2012 (Shah 2012) that as per PAN number registrations with the BSE and the NSE, 14 million out of the 34 million tax payers were linked to one of the exchanges through 1,400 to 1,500 registered broking members. Many of these investors were retail participants from small towns that were not part of the top 50 cities in the country. Thus, retail

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¹ However, this was still a large number of retail investors even when compared with the US (1.24 million) and Japan (1.17 million).

participation among the 'tax-paying middle class' seems substantially higher than revealed by figures on retail participation relative to the population.

Moreover, retail investors seem to be a significant presence relative to all investors in markets. According to NSE officials (Shah 2012), in 2012, of the total cash market turnover, about 47 per cent was accounted for retail investors, with 24 per cent of the turnover being transactions from towns that are outside the top 50 cities. About 36 per cent of all retail participants were reportedly from such small towns. The cash market turnover in the equity segment was around 10-15 per cent of total turnover.

Also NSE figures suggest that6,50,000 new investors had been attracted to its trading platform during financial year 2011-12, adding to the 1.125 million such investors who were already connected. However, not all of the players are active participants and trade or invest on a daily basis. But in that year, non-tier cities accounted for Rs 11,61,273 crore or 44 per cent of retail cash market turnover.

In addition, contrary to the evidence from De et. al. (2011), turnover data seem to suggest that retail investors are important players in the Indian markets. Turnover data from the NSE (Table 2) indicate that in the years to 2010-11 the turnover recorded in the retail investor segment (as captured by the Average Gross Traded Value) exceeded that in the segments where institutional investors and proprietary traders where active. This could be due to either a larger number of trades by retail investors or the shares traded by retail investors being of higher average value or a combination of the two. To the extent that retail segment turnover is dominating total turnover because of a larger number of trades by a substantial (absolute) number of retail investors, the influence of retail investors on market behaviour would be significant. The high retail turnover also suggests that retail investors are more 'fickle', contributing to market volatility. However, that relative influence appears to be on the decline. The ratio of retail turnover to total turnover has actually declined from over 80 percent in 2003 to under 36 percent in 2013-14. The fall has been particularly sharp in the years after the global financial crisis. These were the years when FII presence in Indian markets increased substantially.

Table 2:Turnover Analysis								
	Institutional		Retail		Proprietar	У		
	Avg	%age	Avg	%age	Avg Gross	%age		
	Gross	Contribtn.	Gross	Contribtn.	Traded	Contribtn		
	Traded		Traded		Value (Rs.			
	Value		Value		Cr.)			
	(Rs. Cr.)		(Rs. Cr.)					
2009-10	397743	13.53	1493247	54.81	931287	31.66		
2010-11	618641	12.69	2396870	49.17	1859193	38.14		
2011-12	847559	16.22	2114543	40.47	2262854	43.31		
2012-13	909623	17.31	1929249	36.71	2416630	45.98		
2013-14	1050969	16.5	2279202	35.79	3038397	47.71		

Source: Annual Report NSE, Various issues.

To summarise, the absence of retail investors is really visible only with respect to the potential indicated by the number of households and the size of the population in India. However, the absolute number of such investors is high. Moreover, relative to those who could be considered potential "effective" market

participants with adequate surpluses, such as tax payers, participation is significant and seems to be rising. The real problems lie elsewhere. First, the high retail turnover in the cash segment suggests that retail investors, even when they participate, are fickle. And, second, even when registered, retail investors do not necessarily trade on a regular basis.

Financial savings and investment patterns

The shortfall in actual participation relative to potential is important because households in India (as elsewhere) are major contributors to the nation's savings. According to the National Accounts series with 2004-05 as base the ratio of net financial savings of households to GDP rose to a peak of 11.6 per cent in 2007-08, before the global financial crisis, fell to 10.1 per cent during the crisis year, then recovered to peak at 12 per cent in 2009-10, only to fall sharply to 7.1 per cent in 2012-13 (Chart 2). While this partly reflected the trend in overall savings, the share of household savings in gross financial savings of the nation as a whole fell sharply from 72.7 per cent in 2004-05 to 60.9 per cent in 2007-08, then rose to 74.7 per cent in 2009-10 and stood in 2012-13 at 72.7 per cent (the same level recorded in 2004-05).

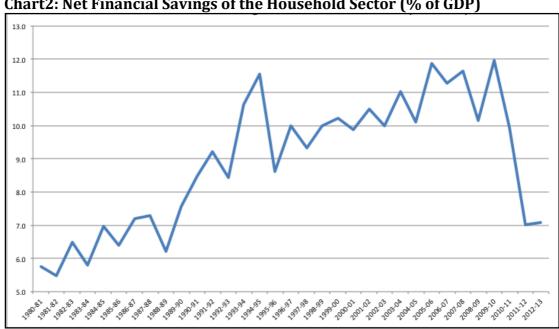


Chart2: Net Financial Savings of the Household Sector (% of GDP)

Source: Central Statistical Organisation, National Accounts Statistics, available at www. mospi.nic.in.

The national accounts statistics compute households' savings as the sum total of household financial savings and the savings of households in physical assets. As direct capital formation estimates from the household sector are not available, the value of household savings in physical assets is computed as a residual, by deducting independently estimated figures of capital formation in the public and private corporate sectors from an estimate of capital formation for the economy as a whole generated through a commodity flow approach.

This has two implications. The estimates of household savings in physical assets are less robust than desirable. And, those estimates include 'physical savings' by unincorporated enterprises, besides households *per se*. Partly as a consequence of these features, the relative share of financial and physical savings in the total savings of households fluctuate over a very broad range. Thus, over the period 2004-05 to 2012-13 the share of household physical savings in total household savings fluctuated between 48.1 per cent and 69.2 per cent, with no clear trend. Further, in the year 2008-09, when the global financial crisis is reported to have adversely affected economic activity in India, physical savings by households is reported to have risen by more than 40 per cent in nominal terms from Rs.5,38,137crore to Rs.7,59,846 crore.

1150000 950000 850000 750000 450000 250000 2004-05 2005-06 2006-07 2007-08 2008-09 2009-10 2010-11 2011-12 2012-13

Chart 3: Trends in Net and Gross Financial Savings of Households (Rs Crore)

Source: Central Statistical Organisation, *National Accounts Statistics*, available at www. Mospi.nic.in.

Such problems do not afflict the estimate of the financial savings component of household savings, which is calculated from holdings of different kinds of financial instruments and their distribution across sectors. It is widely accepted that the period since 2004-05 has been characterised both by a high degree of financial development in the Indian economy and by a credit boom in which household debt has increased considerably. While the former tendency is expected to encourage a shift to the safer, more transparent and higher yielding instruments that financial development is expected to generate, the latter by increasing household liabilities or debt would tend to reduce net financial savings. It would, therefore, be useful to see how financial development led by financial liberalisation has affected household savings behaviour.

Chart 3 presents the trends in the nominal value of gross and net household financial savings. There are two features of these trends that are noteworthy. First, as is to be expected, while financial savings by households have risen in nominal terms over the period at a compound annual rate of 9.4 per cent per annum, there is a clear dip in 2008-09 when the global financial crisis affected India. Second, the gap between gross and net financial savings has increased over the years, corroborating expectations based on the fact that household debt

has been increasing during these years. However, the overall trend is for a rise in net household financial savings.

30.0 80.0 70.0 22.4 60.0 17.2 16.1 50.0 15.2 15.0 13.2 12.5 surance funds 11.0 10.0 0.0 10.0 2004-05 2005-06 2006-07 2007-08 -8068-09 2009-10 2010-11 2011-12 2012-13

Chart 4: Distribution of Household Financial Savings (%)

Source: Central Statistical Organisation, *National Accounts Statistics*, available at www. Mospi.nic.in.

The question that remains is the degree to which households have chosen to park their financial savings in instruments directly or indirectly linked to the stock market. As Chart 4 shows, other than for two years, throughout the period 2004-05 to 2012-13, around 70 per cent of household savings in financial assets was in the category "Other", consisting of currency, bank and non-bank deposits or claims on government. So the first conclusion is that instruments through which households can be exposed directly or indirectly to the capital market (Shares and debentures, Insurance funds and Provident and pension funds) have on average accounted for between 30 and 33 per cent of household financial savings during this period. It is only in 2007-08 and 2009-10 that this figure moved up to around 42 per cent. Moreover, of those two years it was only in 2007-08 that the category Shares and debentures, which reflect direct stock market exposure, was the beneficiary, accounting for close to 10 per cent of household financial savings. Overall, it was only in the three years 2005-06 to 2007-08 that the share of Shares and debentures in total household financial savings was above 5 per cent.

Returns from stock markets seemed to have influenced the trend in household financial savings behaviour. Consider the period between 31 March 2005 and 31 March 2008. The Sensex rose from 6493 to 15644 or by 140 per cent, implying an average return of 47 per cent a year, for an investor who bought a Sensex bundle (of shares) on the former date and exited on the latter date. This was the period when the ratio of shares and debentures to total household financial savings rose from 6.1 per cent to 6.9 and a high 9.9 per cent. But those who stayed in the market subsequently would have registered substantial losses as the Sensex fell to around 8450 by end-November 2008 and did not cross the 10000 mark till April 2009. Depending on when an investor entered and exited the market, the yields could vary hugely. The resulting experience can be possibly seen as influencing the decision of many investors to stay out of the

market when the next boom occurred, resulting in a collapse and subsequent marginal recovery of the share of household financial savings that reflected direct exposure to the markets. (In fact Reserve Bank of India figures, which vary slightly from those reported by the CSO, show that the ratio of Shares and debentures to total financial savings fell from 4.2 per cent in 2012-13 to 2.3 per cent in 2013-14.)

Recent trends

The year 2015 was, however, an unusual one. The Sensex declined from a high of around 29,680 in late January to a low of around 25,200 in early September. Despite evidence of fluctuations, the trend is seen as a reflection of poor market performance. There is broad agreement that a pull-out by Foreign Institutional Investors (FIIs) was responsible for the decline. FIIs (as a group), which pumped as much as \$27 billion in the form of net investment into the markets over the year ended 19 September 2015 (as compared with \$21.5 billion over the previous year), pulled out \$3.1 billion over the period since August 1. That this underlies the market decline seems to be the dominant view.

What is less commented on, though recognised, is the fact that the decline in the Sensex would have been much greater but for a contrary entry of domestic, especially retail, investors into the market. This corresponds to the behaviour of US retail investors noted earlier. The ownership of domestic investors in the equity of BSE 500 companies stood at Rs. 19.21 lakh crore (around \$300 billion at Rs. 64 to the dollar) at the end of June 2015, as compared with Rs. 17.96 lakh crore (\$280 billion) at the end of March. Over this period, FII equity holding in the BSE 500 companies fell from Rs. 19.78 crore (\$309 billion) to \$19.4 crore (\$303 billion). It is to be expected that if this trend continues, non-promoter domestic investors will overtake FIIs as the largest group of investors in the BSE 500.²

Of the increase in the domestic ownership of equity in these companies, while domestic financial institutions accounted for around Rs. 75,000 crore (taking their share in equity of the BSE 500 to 11.1 per cent valued at Rs. 10.5 lakh crore), that of retail investors rose by as much as Rs. 52,000 crore, taking their share as a group to 9.2 per cent (valued at Rs. 8.73 lakh crore). Much of this entry is occurring through the mutual fund route, with net purchases by such funds totalling Rs. 22,121 crore during April to June 2015 and as much as Rs.46,760crore during April-August 2015 (Kant and Modak 2015).

http://economictimes.indiatimes.com/markets/stocks/news/equity-fund-inflows-near-record-as-retail-investors-return/articleshow/48182479.cms

²However, there is evidence to suggest that retail investor presence is less in the top 200 (BSE 200) rather than the top 500 (BSE 500). Mutual funds owned about 3.33 per cent of the stock market capitalisation compared with 25.3 per cent held by foreign institutional investors, as of March, according to an analysis of the constituents of the BSE 200 index by investment bank Kotak. But here too an outperformance by mutual funds, compared to the broader market, is helping to increase that proportion. URL:

Table 3:	Table 3: Shareholding structure of Sensex companies								
	Promoters	Dom Fis	Govt	Foreign Fis	Dom Corporates	Individuals	Individuals< 1 lakh	Others	
31/03/07	45.2	14.4	0.1	17.0	4.1	14.3	11.8	2.2	
31/03/08	45.7	14.6	0.1	16.1	4.4	13.5	11.0	2.2	
31/03/09	46.7	15.6	0.1	13.0	5.4	14.4	11.7	2.0	
31/03/10	47.3	15.2	0.1	14.5	4.9	13.5	10.8	1.9	
31/03/11	48.3	16.3	0.1	14.9	4.8	12.9	10.4	1.8	
31/03/12	49.0	16.1	0.1	15.9	4.6	12.5	10.1	1.8	
31/03/13	48.5	15.2	0.1	17.4	4.5	12.6	9.8	1.8	
31/03/14	50.9	14.8	0.1	18.2	4.1	12.5	9.5	2.1	
31/03/15	50.3	14.0	0.1	18.7	3.9	12.3	9.3	2.3	
Source: CN	Source: CMIE Prowess Database								

In the event, domestic investors owned 20.2 per cent of the BSE 500 companies in June 2015, surpassing the previous high of 20 per cent at the end of the March 2010 quarter. Domestic ownership of the country's top listed companies was up 1.34 per cent over the April-June quarter, which was the sharpest incremental rise in domestic participation since the quarter ended September 2008. However, over the long haul of a little more than 10 years from the quarter ended March 2005 to that ending June 2015, while FII holding in the BSE 500 had gone up from 14.2 to 20.4 per cent, that of domestic investors had only risen marginally from 19.6 to 20.4 per cent. Thus, foreign investors seem to have turned bearish towards the end of this period. The effective foreign institutional investor (FII) ownership in BSE 500 companies declined to 20.4 per cent at the end of the June quarter from 20.8 per cent in the previous quarter. This change in the relative interest of retail domestic investors and the FIIs is indeed noteworthy (Kant and Modak 2015).

This, however, is not reflected in trends in the shareholding structure of Sensex companies (Table 3). In their case the shares of promoters have risen from 45 per cent at the end of March 2007 to above 50 per cent starting end-March 2014, but the shares of both domestic financial institutions and individuals have been declining in recent years. Moreover, the share of foreign financial institutions has risen significantly since end March 2011.

Retail investor behaviour

Is domestic investor behaviour in general, and retail investor behaviour in particular, contrarian? Consider the evidence on mutual fund institutions. Mutual funds are important as they can serve as an important route through which retail investors can test and get acclimatized to equity markets and are even considered the preferred route to the market for retail investors. Interestingly though the number of mutual funds has risen since 1986-87 (till when the only one in existence was the Unit Trust of India), and there was some increase in funds mobilisation by mutual funds during the early 1990s, mutual fund activity got a substantial boost only in the years since 2003-04 (Chart 5), when stock market activity picked up significantly and the market was on average buoyant. But even after that there was much volatility in the mobilization by mutual funds net of redemptions, with the figure being negative in at least three of the years. Further, according to RBI figures, mutual fund mobilisation equalled or was 2.5 to 5.3 times mobilisation from the primary market during the three years ending 2014-15. Since not all primary market purchases are accounted for by mutual

funds, this implies that the ratio of mutual fund investments to contribution of mutual funds to purchases from the primary market is likely to be have been even higher. What this suggests is that, while retail investor participation through mutual funds has probably increased to an extent, this intermediation route takes their capital more to the secondary rather than the primary market.³

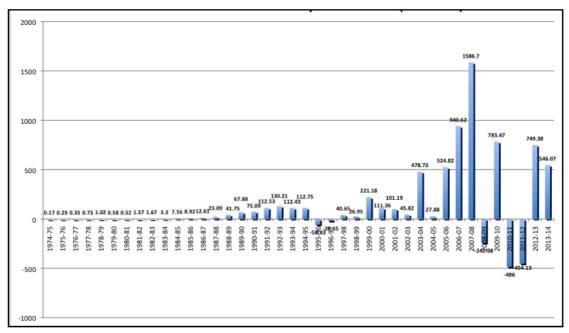


Chart 5: Net resource Mobilised by Mutual funds (Rs Billion)

Source: RBI, *Handbook of Statistics on the Indian Economy*, various issues.

This suggests that rather than serve as a check on irrational investing by retail investors, mutual funds benefit from any spike in retail investor activity through an increase in assets under their management and in their revenues. Thus, for example, between April and August 2015, while corporate performance was weak and expectations of performance depressed, small investors had, possibly in response to falling gold prices and depressed real estate markets, been putting their savings into equity mutual funds, which in turn were investing that money in the stock market. Between March and July 2015, investors have poured in Rs 45,127 crore into equity mutual funds. As a result, over April to August, equity mutual funds had invested Rs 39,205 crore in the stock market, whereas Foreign Institutional Investors, who had been driving the stock market for the last few years, had been net sellers and sold stocks to the tune of Rs 8,950 crore during those months (Data from study titled Exit The Fantasy, Enter The Reality, by Saurabh Mukherjea, Gaurav Mehta, Prashant Mittal and Sumit Shekhar of Ambit, quoted in Kaul 2015). Thus, contrary to what emerged from the ISB study, retail investors can also buy (rather than sell) when the market is peaking. In this case too the investor ends up making little or no money from investments in the stock market.

What is noteworthy is that in the period since March 2012 Assets under Management (AUM) of Mutual Funds, which were stagnating in the Rs.588,000crore to Rs 643,000 crore range for around 6 quarters, began registering a sharp increase to touch Rs.1,173,000 crore in the quarter ending 30

³ However, investment through mutual funds can be seen as a means to acclimatise the retail investor to the vagaries of the market, as a prelude to increased participation in that market.

June 2015 (Chart 6). It is this trend that triggered the view that retail investors were rushing into equity markets via the Mutual Fund route.

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Chart 6: Total Assets Under Management of Mutual Funds (Rs Cr end Qr)

Source: Association of Mutual Fund Institutions, *Annual Report*, various issues.

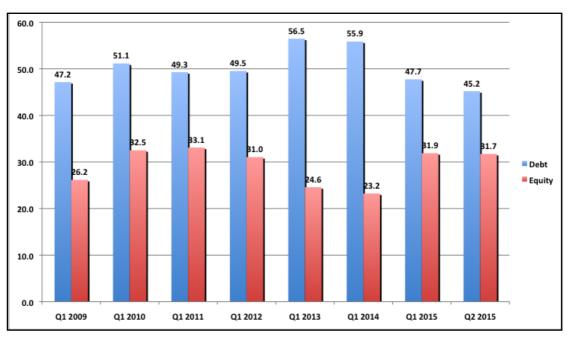
However in the post-March 2012 period equity oriented mutual funds saw their shares in total AUM initially decline and then just about regain their end-March 2012 levels (Chart 7). A similar trend was registered by Balanced Funds, through which investors obtain some equity exposure. Shares of Debt oriented Funds on the other hand increased initially, only to decline later and those of funds investing in Gilts rose marginally. It must be noted that debt oriented funds are favoured by corporates, which accounted for 57.74 per cent of AUM in the quarter ended June 2015. High Net worth Investors (HNIs, with investments exceeding Rs.5 lakh) accounted for another 32 per cent, whereas retail investors held just 7 per cent (Table 4).

The interest in equity via the mutual fund route is relatively recent as noted earlier. However, the share of retail investors in the AUM of equity-oriented funds was well over 65 per cent during the four years ending September 2013, and then declined over the next 23 months, but still remained at a high level of 53 per cent (Table 5). In absolute terms, AUMs under equity-exposed funds (Pure Equity and Balanced) have actually risen in recent quarters. Having peaked at Rs. Rs.230,000crore in the quarter ending 30 September 2010, the AUM value touched a low of Rs.178,000 crore in the quarter ending 30 September 2013, only to rise sharply to Rs.405,000 crore (or by 13 per cent) over the next five quarters ending 30 June 2015.

Table 4: Shares in Assets Under Management: Debt Oriented Funds (%)								
	Sep-	Sep-	Sep-	Sep-	Sep-	Sep-	Mar-	Jun-
	09	10	11	12	13	14	15	15
Corporates	64.06	66.33	57.72	53.87	56.3	55.68	57.02	57.74
Banks/FIs	13.62	5.21	2.3	1.48	1.07	1.15	1.09	1.5
FIIs	0.41	0.49	0.36	0.64	0.18	0.97	1.42	1.51
High Networth Individuals*	17.48	22.57	33.11	36.86	35.64	34.79	33.2	32.49
Retail	4.44	5.4	6.51	7.14	6.81	7.41	7.26	6.77

Source: Association of Mutual Fund Institutions, Annual Report, Various issues.

Chart 7: Share of Debt-Oriented & Equity-Oriented Funds in Total Assets (%)



Source: Association of Mutual Fund Institutions, Annual Report, various issues

Table 5: Shares in Assets Under Management: Equity Oriented Funds (%)									
		Sep-	Sep-	Sep-	Sep-	Sep-	Sep-	Mar-	Jun-
		09	10	11	12	13	14	15	15
Corporate	S	12.47	11.02	10.29	9.4	9.1	12.22	12.17	14.37
Banks/FIs		1.56	1.19	1.26	1.1	0.81	0.32	0.3	0.37
FIIs		0.64	0.63	0.59	0.71	1.59	1.52	1.45	1.33
High	Networth	19.68	20.61	20.58	19.3	21.53	27.77	30.36	31.38
Individuals	s*								
Retail		65.65	66.55	67.29	69.49	66.97	58.18	55.73	52.55

Source: Association of Mutual Fund Institutions, Annual Report, Various issues.

Explaining contrarian behaviour

What is noteworthy, and keeping with the contrarian behaviour of retail investors observed in many contexts, is the recent sudden increase in retail investor interest because the returns earned by retail investors in the secondary market was low during this period. The De et. al. (2011) study referred to above, concluded that (i) retail investor behaviour in India was characterised by two significant biases, termed the 'disposition effect' and 'overconfidence effect'; and (ii) this resulted in them incurring losses over the January 1, 2005 to June 30, 2006 period, with trading losses alone placed at Rs. 8,376 crore, and losses including commissions, transactions taxes, etc estimated at Rs. 20,700 crore.

The 'disposition effect' is reflected in the tendency for investors to sell assets in which they have registered gains and hold assets in which they are making losses, in the hope that they would register profits in time. This tendency is reinforced by the 'overconfidence effect', reflected in the tendency to recognise gains and feel proud about successful trades, but ignore losses and believe that holding on to a loss-making stock would eventually result in gains, once the distortions that neutralised expected gains disappear.

It must be noted, however, that while the first of these biases would be reflected in the transactions data, how the second 'psychological' or 'sociological' bias has been identified is unclear. But, what this evidence suggests is that those staying in an investment for long periods of time are likely to be net losers. That conclusion is important because of the view that returns from stockmarkets are higher in the long rather than short run and that "in the long run", perhaps of well above 10 years, returns from the stock market are better than those from other financial assets, including fixed deposits. Even if true, the ISB study suggests that this is unlikely to be a determining influence on household financial behaviour.

Stock market returns: A rudimentary analysis

Is there evidence to suggest that market returns tend to be higher in the long run? One crude way of assessing this is to consider a bundle of equities that combine stock included in the Sensex in the same proportions as that index. Movements in the Sensex would then reflect movements in the price of that bundle of active shares. Changes over different periods would capture the gains/losses made during that period by an investor in such a bundle. If we then estimate the *annualised* return that would have been garnered by an investor in such a bundle over continuous and consecutive 31-trading day periods (or each succeeding 31-day period in day-by-day data) starting January 1, 1990 and endingearly December 2015, the figure varies from a negative 99.8per cent (at the time of the crisis of 2008) and a positive 349123.7 per cent (during the Harshad Metha-scam-induced boom of 1992). The average annualised continuous and consecutive-31-day return over the whole period was 423.8 per cent (Table 6). As we move from a 31-day cycle to 365-days, that average annualised return falls to 30.2 per cent. But in this case too, the return varies from a negative 52.2 percent to a positive 465.3 per cent. What is true, however, is that the coefficient of variation in consecutive-period returns falls from 14.6 to 1.71.

Table 6: Stock market returns January 1990 to December 2015								
	Minimum Maximum Average Coeff. Coeff. variation							
30-day return	-99.8	349123.7	423.8	14.6				
365-day return	-52.2	465.3	30.2	1.7				
5-year return	-8.0	44.6	18.3	0.7				
10-year return	7.9	29.2	19.0	0.2				

Source: Computed from Sensex daily closing figures reported in CEIC Daily Database.

What happens when we consider much longer periods such as 5 or 10 years? In the case of 5 years the range over which the rate varies falls to between a negative 8.0 per cent and a positive 44.6 per cent, with an average of 18.3 per cent, and for 10 years from a now-positive low of 7.9 per cent to a high of 29.2 per cent with an average of 19.0 per cent. Thus, the average rate of return falls sharply when we move from shorter to longer investment periods, though the 5-year and 10-year returns show less variation with a coefficient of variation of 0.7 and 0.2 respectively. Thus, while the investment outcome depends on when an investor enters into and exits from the market, the probability of obtaining a return significantly different from the average is lower in the case of longer periods.

There are a few conclusions that can be derived from this exercise. First, it matters much for the magnitude of the return, where the period of investment falls in historical time, or when the investor chose to enter into and exit from the market. Second, movements in the Sensex suggest that the average annualised return is not and need not be higher for longer investment periods than for shorter ones, with the average nominal return falling as we move from 30 and 365 trading days to 5 and 10 years in terms of investment periods. But, it does appear that the variability of returns across periods with different entry and exit dates falls as we move from 30 trading day periods to 365 trading day periods and 5 and 10 years. So the probability that a longer-term investor would reap a better return than average (and perhaps higher than the short term investor) is higher, and such investors are shielded from losses to a greater degree.

These trends are of relevance because they suggest that higher returns are not guaranteed when staying invested for long and not all investors necessarily gain by staying in the market. This would suggest that returns per se need not encourage long-term retail investor presence in the secondary market. This is of relevance given the evidence on retail investor behaviour discussed earlier and the presumed importance of retail investor presence in the secondary market for three reasons First, because secondary market constitutes a stage in the participation of retail investors in securities markets, paving the way for investments by them in primary markets, where information may be more asymmetric, 'story stocks' that have a record and been written and spoken about and analysed in some detail absent, and risks greater. Secondly, because the presence of retail investors in secondary markets makes those markets more liquid, which strengthens primary markets by promising investors with an easy exit option either to book profits or cut losses. Finally, because it reduces the holdings of players who operate for speculative purposes, and therefore, reduces the influence they can exert in these markets.

Needless to say, this analysis is limited inasmuch as investors would not hold on only to the Sensex bundle over time. But it is relevant since the Sensex bundle is supposed to capture the state of the market as reflected by price movements in the most actively traded shares.

The primary market

There is a perception that retail investors would prefer investing in the IPO market since favoured stocks in the secondary market can be substantially overpriced and difficult to acquire. Moreover, the latter are stocks of companies whose track record is known and the performance of those stocks have been analysed. They, therefore, may be seen as stocks that have found their price level and do not promise much by way of capital gains. New equity issues on the other hand do. Preferred public offers would be IPOs from companies with a track record before they were listed, but others may also attract attention because of the absence of alternatives.

One problem is that the IPO market on the whole has been on the decline in India. So the case for incentivising retail investors emphasises the benefits for firms attempting to mobilize equity from the market. There is, however, a chicken and egg problem here. While retail investors can help expand and strengthen the primary market, rendering the market a source of finance for investment, unless the primary market is active and therefore a promising location for investment, retail investors are unlikely to enter. The problem is that as of now the retail market is not a consistently active segment of the capital market.

According to figures from the Reserve Bank of India, sums mobilised from the primary market for equity and debt rose from Rs. 2,760 billion (Rs. 26,601 crore) in 2010-11 to Rs. 3,611 billion in 2012-13 and Rs. 4,660 billion in 2014-15 (Chart 8). This implies that the ratio of capital mobilised in these forms (which exclude ADR/GDR issues) to Gross Fixed Capital Formation fluctuated between 29 and 34 per cent during 2011-12 and 2014-15. Those are by no means magnitudes to be scoffed at, and call for greater scrutiny.

What is remarkable is that, despite fluctuation a very large and sometimes dominant share of this capital was mobilised by the private sector. This points to the fact that mega-disinvestment issues by public sector companies (such as Coal India in 2010) were not the only source of this primary market buoyancy. What is not clear from the figures quoted thus far is whether this reflects a process of disintermediation in which investment is now being financed in significant measure by direct mobilisation of market funds by investors, rather than by investments and loans intermediated by the financial sector. Is corporate financing in India gradually shifting in favour of a more market-based model?

One reason this need not be true is that public issues can be subscribed to by promoters (especially in rights issues) as well as the government and government owned or sponsored financial institutions, with a relatively small direct financing role for the "public". Thus, even during the partly scam-induced, retail investor boom of the early 1990s, Reserve Bank of India data suggests that the absorption of new issues by promoters, governments, financial institutions and insurance companies exceeded 50 per cent of the total capital mobilised through that route. However, since then the role of the financial institutions in corporate financing has diminished and many have disappeared. Moreover, mutual funds are now the new intermediaries through which savers access capital markets, though the net funds mobilised by them has tended to be volatile and significantly negative (because of large redemptions) in some years.

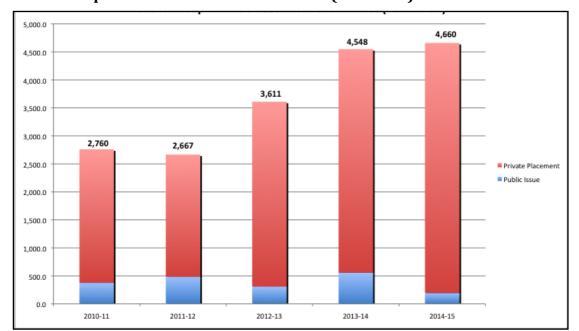


Chart 8: Capital Mobilised from the Market (Rs Billion)

Source: Handbook of Statistics on the Indian Economy, various issues.

The real twist, however, comes from two other sources. The first is that private placements of equity and debt instruments, rather than prospectus and rights issues of equity and the public issue of debt (debentures and bonds), accounted for an overwhelming share of the total new capital mobilised. Over the counter negotiations between large players and investors rather than market forces are likely to be more important here. The share of private placements in total capital mobilised fluctuated between highs of 82 per cent in 2011-12 and 96 per cent in 2014-15. This is an active market indeed, but it is not the stock and debt markets with trading desks and screens that seem to be delivering the capital.

A second, related characteristic is that debt rather than equity issues were the instruments that garnered much of the capital. The share of equity in the total capital mobilised in both the market and the private placement segments combined fell from its not too high value of 19 per cent in 2010-11 to 6 per cent in 2012-13 and then settled in the 8-9 per cent range over the next two years (Chart 9).

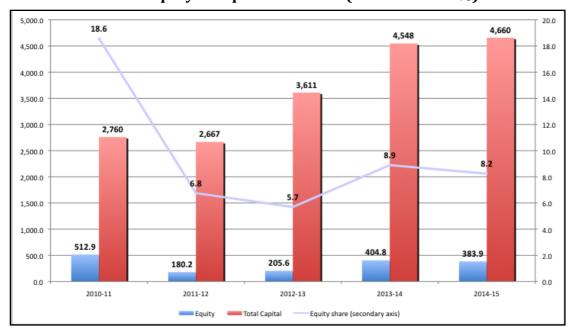


Chart 9: Share of equity in capital Mobilised (Rs billion and %)

Source: Handbook of Statistics on the Indian Economy, various issues.

Despite this limited and reduced activity in the primary market, it is interesting to note that retail investors have been active in this market. According to figures from Prime Database, for IPOs in the period since 2003, when allotment reservation for retail investors was introduced by SEBI, the ratio of retail applications for share issues to the declared size of the issue averaged more than 100 per cent in all but four of the 12 full years (Table 7). That implied that demand for new issues from retail investors exceeded availability, not just the reserved quantum, though this seems to have changed starting 2012.

Table 7: Retail subscription in IPOs								
	No of issues	cubecription oc						
2003	12	290.0	1.1					
2004	25	538.6	1.0					
2005	53	678.7	1.1					
2006	73	292.8	1.0					
2007	100	500.9	1.4					
2008	37	233.9	2.1					
2009	20	57.3	0.7					
2010	64	238.5	1.2					
2011	37	156.5	0.9					
2012	25	88.8	1.7					
2013	38	45.2	0.7					
2014	45	90.2	0.9					
2015 (to Oct)	57	69.5	0.8					

Source: Prime Database

If we examine the allotments to retail investors in IPOs since 2003, we find that the percentage of issues in which allotments were below the reservation amount,

which is indicative of lower retail investor interest, was very volatile, but in excess of 50 per cent only in one year (2013) and in most years below 40 per cent (Table 8). In all other issues, allotments were either equal to or in excess of the proportion reserved for retail investors. If despite this, there have been signs of slackening of IPO activity in the Indian market, that is partly the result of the overall market environment, influenced in substantial measure by foreign institutional investors and domestic financial institutions. However, here too the evidence is to the contrary in the most recent years. On the whole it appears, therefore, that it is not because retail investors are staying away from the primary market that the latter slumps, but rather that a slump in the IPO market may be encouraging retail investors to turn to other investment avenues.

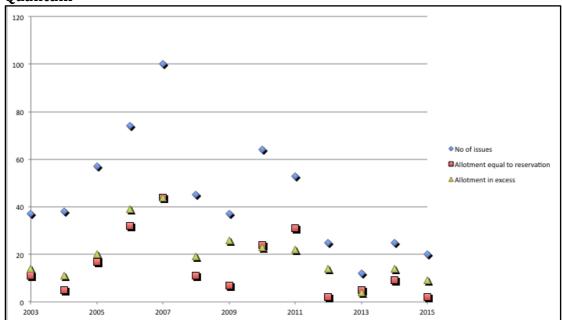
Table 8: Retail allotment relative to reservation								
	NO.	Allotment	Allotment	Allotment				
	OF	equal to	deficient	in excess				
	ISSUES	reservation						
2003	12	5	3	4				
2004	25	9	2	14				
2005	53	31	0	22				
2006	74	32	3	39				
2007	100	44	12	44				
2008	37	11	12	14				
2009	20	2	9	9				
2010	64	24	17	23				
2011	37	7	4	26				
2012	25	2	9	14				
2013	38	5	22	11				
2014	45	11	15	19				
2015	57	17	20	20				

Source: Prime Database

One indicator, though not definitive (see footnote 4) of market conditions is the number of issues in a year. Chart 10 suggests that there is a positive relationship between the number issues, which would be influenced by perceptions on market conditions, and the proportion of issues in which allotment equalled or exceeded the reserved quantum (Chart 10). It was the capital mobilization decisions of firms rather than the interest of investors that seemed to drive performance in the primary retail investor markets. This raises the question as to whether it was the reticence of firms to go in for IPOs or FPOs or the absence of retail investors in the market, which resulted in the low share of IPO investments in household financial savings.

⁴ 'Partly', because the decline in the number of new issues is attributed by some to the stricter requirements set for and more rigorous scrutiny of applications for IPOs by SEBI, rather than poor market conditions alone.

Chart 10: Scatter Plot of No. of Issues and Allotment Relative to reserved Ouantum



Source: Prime Database.

There was, of course, one factor that could have restrained retail investors: the low level of registered returns. According to one source (Nayyar 2015), the market for initial public offerings has performed poorly in India over the last decade. An analysis of 394 IPOs between 2003 and 2014 found that only 164 companies were trading over their offer price. However, being point-to-point estimates in a volatile series, these figures may not reflect the true picture.

There are two implications of importance to be derived from these trends. The first is that, whatever else we may say of equity markets in India, the primary market for equity either in the form of stock markets or the private placement route is still largely inactive, despite occasional signs of buoyancy. The period after 2011 has been particularly sluggish, even taking account of the fact that the figures for 2015 relate only to the first nine months. It is only the secondary market, which directly delivers nothing by way of capital for new investment, that is active. Unfortunately, that is the market into which the foreign investor capital that generates volatility flows. Secondly, to the extent that the primary market is significant, that seems to be the result of increased activity in the (private placement) debt market. The world economy is still awash with the cheap liquidity infused into the system in response to the financial crisis and economic recession. Exploiting that, players hoping to profit from differentials in interest rates between developed economies and emerging markets have discovered Indian debt markets as one among the lucrative sites for alternative investments. Those inflows too are volatile, as the flight of capital during the "taper tantrum" of 2013 amply illustrated. Increased uncertainty rather than increased financing for investment seems to be the benefit delivered by India's capital market.

Overall, households parking a large part of their savings, outside of insurance and pension funds, in short maturity and highly liquid financial assets, do not seem to operate with long time horizons, being influenced more by returns registered in much shorter periods. And here the stock market seems to be an extremely uncertain source of returns. This dissuades investors from enlarging their overall exposure to the market in India, and to the extent they do,

encourages them to invest only through intermediaries like mutual funds, insurance companies or pension fund managers. Insurance and provident and pension funds have always been more important than mutual funds. So were claims on government, especially in the period before 2004-05 when both capital invested and interest earned by small investors in National Saving Certificates, which could be bought without limit, were exempted from tax. When the exemption of interest rate payments from taxation up to Rs.20,000 (under section 80 L) was withdrawn, these instruments lost their attractiveness resulting in a decline in their share.

Thus, more than the inadequate presence of retail investors in equity markets there are other issues of relevance here. To start with, the presence of retail investors was also erratic, with their entry into the market coinciding with periods of (often misplaced or misdirected) market euphoria, and contrarian. Secondly, the retail investor's share in total investment value was low. Finally, the available evidence (such as in the ISB study quoted earlier) suggests that returns earned by retail investors when investing directly was low or absent, given their investment practices.

The implications of these observations need noting. To start with, the evidence seems to suggest that retail investors, if anything, follow the market, whether investing directly or adopting the mutual fund route, and tend to be erratic because their investments lag so much that they often obtain low returns. So there may not be any basis for the expectation that participation of retail investors would transform equity markets and enable them to perform their presumed functions better. Secondly, while the kinds of measures adopted by SEBI and other agencies to address the shortcomings of markets are indeed welcome, there do seem to be fundamental difficulties in designing measures that successfully incentivise consistent retail investor participation in markets. Thirdly, this supports the view that in the long run retail investors would in all probability expose themselves to the market largely through institutional devices such as mutual or pension funds. But even this institutional intermediation does not necessarily serve them well, and has on more than one occasion worked against retail investor financial interests.

Some policy implications

It should be clear from the above discussion that there are five important issues that policy aimed at enhancing retail investor presence and activity in equity and debt markets should address. First, it should identify and correct any impediments to retail investor entry and participation, taking into account the need of such investors to invest in small lots and their weakness relative to institutional and high net worth individuals when seeking to acquire shares. Second, it should strengthen regulation aimed at guarding against market manipulation and price rigging since losses sustained by retail investors as a result of such activity makes them withdraw from markets and stay out. Third, there is need to ensure that information disclosure by issuers of equity and listed companies is comprehensive and clear so as to allow retail investors to arrive at informed judgements on investment options. Fourth, it is necessary to educate investors not only on the potential savings opportunities in the market, but also on an evidence-based, sensible investment strategy. And, finally, it is necessary to strengthen the mutual fund distribution network in order to attract retail investors to the Indian Capital Markets.

On the first of these SEBI has already done much by way of requiring companies to increase the proportion of publicly held equity in total shareholding and reserving a reasonable proportion of shares issued in IPOs for retail investors. What is required is promoting greater activity in the IPO market, without diluting conditions to be met by issuers of new equity. Coordination with the government to set rules that require companies of a certain size and above to list and offer equity to the public, as a means of improving corporate governance, is one possibility.

Further, measures to ensure that the market is not dominated by big players who can influence, manipulate or rig prices in ways that adversely affect retail investors is a prime requirement. While SEBI has adopted a number of measures in pursuit of these objectives, there is more that can be done. In particular, there appear to be few cases in which the SEBI has brought to book and suitably penalised those indulging in unlawful and/or unethical practices, though that number has increased in recent years.

Strengthening and widening investor education is crucial. The issue is not merely that of educating investors on equity investment opportunities and using SEBI support for making informed decision, but also that of encouraging sensible investment practices that ensure returns to retail investors. Needless to say SEBI cannot take on an investment advisory role. But it can through education based on evidence-based research point to investment strategies that in the past have yielded better results. For example, if the argument that remaining in the market for the long haul ensures better returns is indeed valid, this must be demonstrated with historical evidence. and that evidence based recommendation must be incorporated into investor education modules.

Finally, since mutual fund institutions are important means of market engagement for retail investors, they must be encouraged to develop appropriate, transparent products that serve the asset building goals of smaller investor and build wide distribution networks for them. The distribution of mutual fund products through a wide network of bank branches spread across the country will be helpful.

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