3 point agenda to bridge “trust deficit” & spur households’ equity investments

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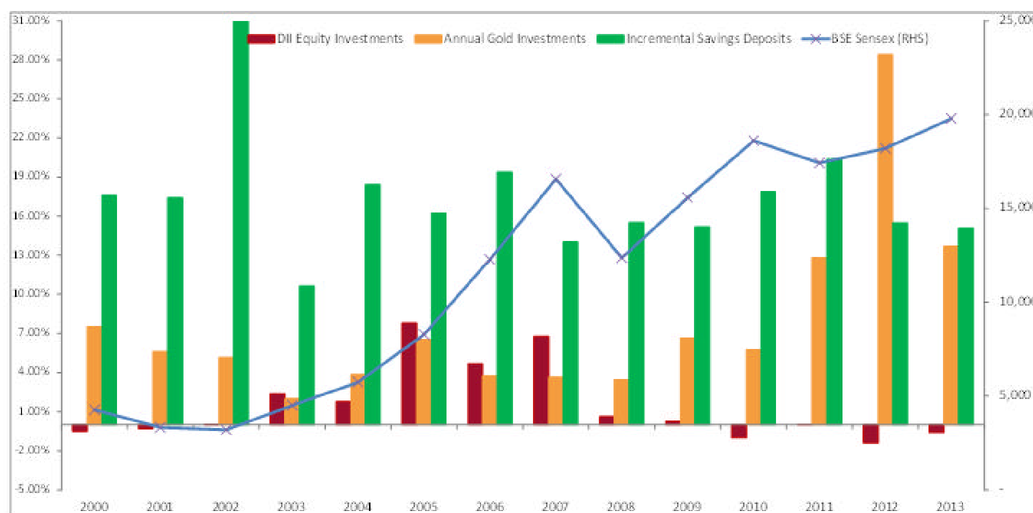
In 1602, the Dutch East India Company issued shares to the general public to raise capital and build the spice trade. This marked the genesis of the modern world equivalent of a stock market. For 400 years, the sacrosanct role of a stock market in a nation’s economy has been to mobilise household savings to raise capital for companies which then create more jobs and provide impetus to economic growth. While the core objective of a stock market is to channel household savings into productive economic use in businesses, the supplementary objective to act as an efficient price discovery mechanism is integral to its primary objective. This is achieved through the secondary market that enables investors to buy and sell shares and thereby establish a clearing price for securities. How does India fare in this critical aspect of channelling her large household savings to productive uses in the economy?

As the popular narrative goes, India began to unshackle from its socialist legacy to embark on an Anglo-Saxon model of economic development post the landmark 1991 budget of then finance minister Shri. Manmohan Singh. In 1990, India’s stock market capitalisation to GDP was 12%. It is now 70%. In today’s dollar value, the market capitalisation of India’s stock market has risen from $13 billion in 1990 to $1.5 trillion now, a 114 times increase. But these headline statistics hide more than they reveal. The rise in India’s stock market value is driven almost entirely by foreign investors. Between 2000 to 2013, foreign investors invested a net of $160 billion in the stock markets compared to a mere $17 billion by Indian investors, either through mutual funds or directly in stocks. Paradoxically, domestic investors withdrew money from the stock markets in 6 out of the 13 years between 2000 to 2013 when the GDP grew by 5 times, as did the BSE Sensex. When India was growing richer and when the stock markets were rising rapidly, Indians were not investing in the stock markets commensurate with their rising income levels. In this time period, Indian households bought $166 billion of additional gold (in current dollars), as much as foreign investment in the stock markets. On average between 2000 - 2013, for every 100 rupees added to GDP, Rs.18 went into savings bank account, Rs8 in gold accumulation and a paltry Rs1.50 in the equity markets. Clearly, Indian households are not enamoured with the equity asset class as they are with bank savings or gold which is neither predominantly an investment asset nor a hedge strategy in the Indian context.



SEBI’s annual state of the capital markets report over the past several years reveal household surveys of retail investors that cite lack of trust in the stock markets as the prime reason for such aversion to equity investing. Ignorance, awareness and cultural incompatibility of equities are posited as potential reasons for this “trust deficit”. Looking beyond glib phrases such as “trust deficit”, it is imperative we get down to the real reasons that

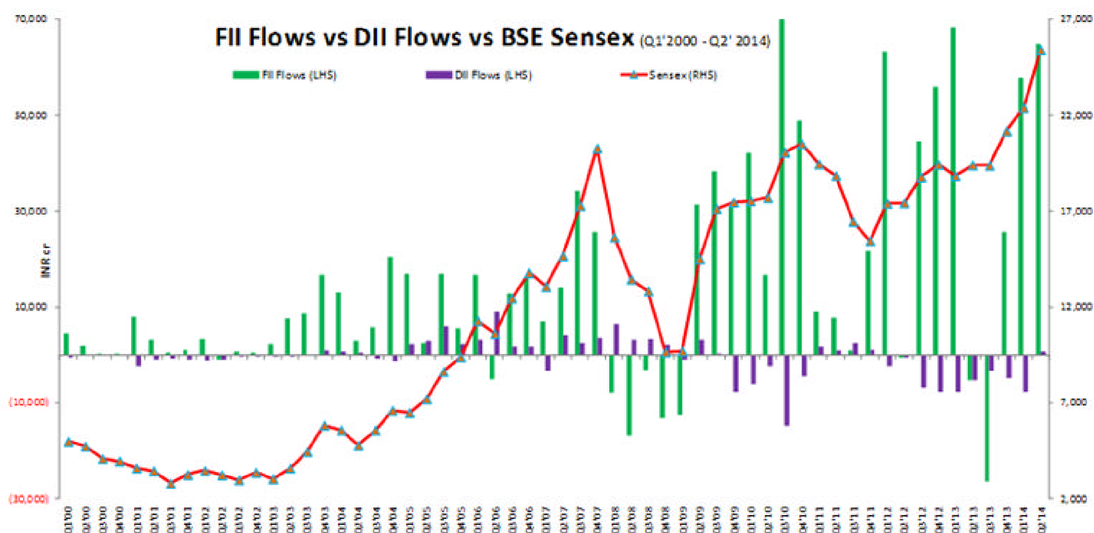
cause and exacerbate this household inhibition to investing in equities. These can be categorised in three broad buckets:

1. The structure of the Indian equity markets that is dominated by sophisticated foreign institutional investors leaving it vulnerable to global flows that move in and out of the markets rapidly. This breeds an innate sense of fear among domestic mutual fund and insurance investment managers with a constant need to second guess FII behaviour and its impact on market movements. This fear transcends down to household investors too, consciously and sub-consciously.
2. Perception of a cartelised market with most gains accruing to a small number of investors with a definitive information advantage. While one can argue with the merits of this perception, the fact that this perception is strongly entrenched is borne out by SEBI's own household surveys conducted annually. This notion that one has to be an "insider" to reap returns in equities is a big barrier for first time investors.
3. An overtly speculative nature of equity markets with notional volumes of equity derivatives trading being 15 times larger than trading in shares, the highest ratio in the world. Close to 90% of such volumes is by retail investors and proprietary traders that are merely speculating on stock price movements than any fundamental investment. While this is not to pass value judgement on one form of investment over another, the complexity of derivatives coupled with very small contract sizes has led to excessive speculative trading in the markets. A predominantly speculative capital market is adverse selective and primarily attracts other speculators, not investors and even scares away potential first time investors.

We will now delve deeper into each of these three issues and suggest low hanging policy tweaks that can potentially alleviate some of these bottlenecks.

Dominance of foreign flows and its indirect impact on retail investor flows into equities.

India's Reserve Bank Governor Dr. Raghuram Rajan has been apprehensive about the potential impact of rising interest rates in the US on emerging economies like India. Chief Economic Advisor Dr. Arvind Subramaniam has argued how emerging markets like India "consciously and enthusiastically embraced financial globalization" to soak up foreign capital flows during times of easy money and contended that emerging markets will have to brace the potential shocks of such capital outflows now. A simple multivariate regression analysis of quarterly market movements over the last 55 quarters (since Q1'00) and independent variables reveal that FII flows singularly explain such market moves. More striking is the negative correlation between foreign investor flows and domestic investor flows in the same period. There is an immediate need to strike a balance between foreign flows and domestic flows into the Indian equity markets to help mitigate catastrophic consequences of sudden foreign capital flight.

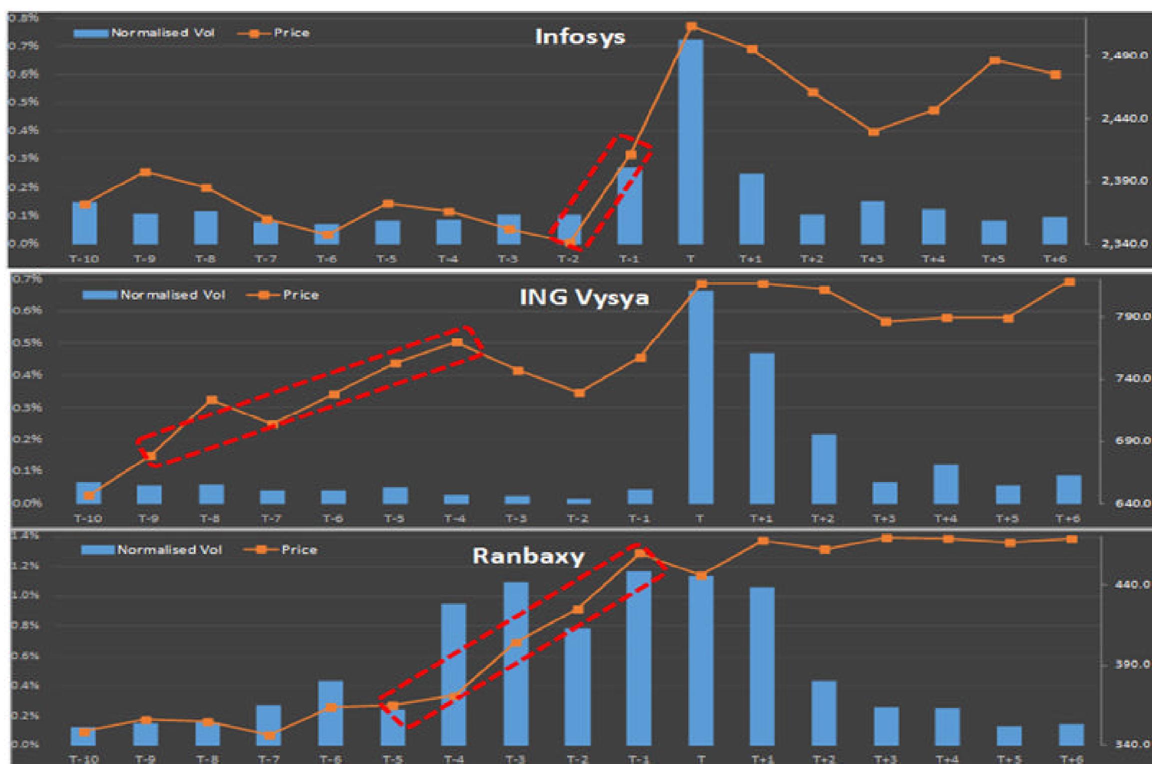


There have been repeated attempts in the past to lure a small percentage of the $125bn (Rs. 8.5 lakh crores) corpus of Employees' Provident Fund (EPF) into equity markets. Finally, on April 23, the Union Labour Ministry through a notification permitted the EPFO to invest a minimum of 5 per cent and a maximum of 15 per cent of its incremental deposits in equity or equity-linked instruments. This is a landmark decision that is expected to bring in Rs.5000 ($800mn) crores in the first year into the equity markets. While this may be a small percentage vis-à-vis the $15-

20bn of FII flows every year, this is a very important start that can potentially provide cushion to market impact on sudden FII outflows due to global factors. This ability to provide some downside protection and hence decrease market volatility due to external shocks is a significant move. If the EPFO investment in equities continues to grow every year as proposed, it can have an inordinate impact on domestic fund manager's confidence levels in staying invested in down cycles which will cascade down to households' confidence about equity as an asset class.

Perception of an "insider" market and the need to bridge this to restore credibility.

NR Narayana Murthy, co-founder of Infosys was re-appointed as Chairman of Infosys, two years after his retirement on Saturday June 1, 2013. One day prior, on May 31st, roughly $70mn (nearly Rs.350 crores) was bet on Mr. Murthy's return to Infosys, in the NSE and BSE combined. Ranbaxy Global, the pharmaceutical giant announced on Saturday Apr 6, 2014 that its board had, moments ago, approved a merger with SUN Pharma. Between 2nd and 4th April, three days before the board approval of the merger, nearly $200mn (Rs.1000 crores) were already wagered in the stock exchanges on this transaction. On November 20, 2014, after the closure of market trading hours, Kotak Mahindra bank announced its acquisition of ING Vysya bank. Again, some $100mn (Rs.500 crores) was already bet in the stock exchanges over the previous 15 days on this information. Amidst such blatant and rampant insider trading in multi-billion dollar blue-chip companies, it's easy to fathom why "rigged" and "manipulated" are the most often used adjectives to describe India's equity markets by the common household saver. When the beacon of corporate governance and a much adored company such as Infosys is subject to rampant insider trading on news such as return of Mr. Narayana Murthy, a decision that ostensibly only the board members and select few were privy to unlike a merger, it is easier to empathise with the feeling of distrust of equity markets. To be sure, lure of easy money on hot insider tips is not unique to the Indian capital markets. But the "karma free" nature of it is. While SEBI announced new insider trading rules on Nov 19th, 2014, it is not lack of rules that is the problem. It is the rigorous enforcement of it. The need to name, shame and punish the guilty is imperative to cleanse our markets and rebuild trust. SEBI with its scanty resources justifiably finds it hard to investigate insider trading cases. Some of this onus should be transferred to stock exchanges that can be bestowed with investigative and punitive powers to check and curb insider trading. While stock exchanges, prima facie, suffer from a conflict of interest in being dependent on their brokers for revenues while also policing them, these functions can be separated and executed efficiently. SEBI's inability to enforce insider trading laws is both a function of capacity as well as ability. The stock exchanges should be held as accountable for insider trading on their exchanges as their member brokers.



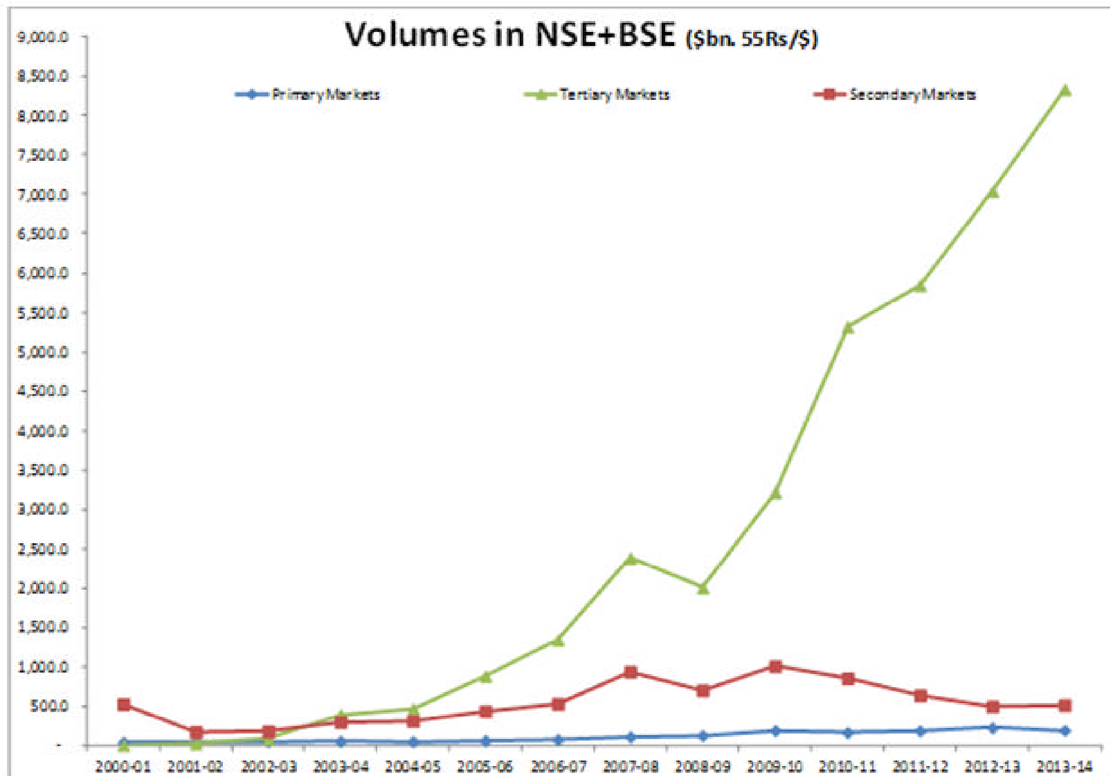
Speculative nature of the equity market attracts speculators, not investors.
Trading data of the Indian capital markets give the impression that the average Indian investor is extremely sophisticated with an insatiable need to hedge her market risk on a daily basis using complex derivative products. Derivatives trading volumes are nearly 15 times larger than shares trading. In CY'13, notional value of derivatives trading was 30 times the amount invested directly in companies and government bonds through primary offerings. As per NSE data, 83-87% of all derivatives trading (by value) is by retail investors and proprietary traders while sophisticated institutional investors account for a mere 13-17%. Derivative trading volumes have risen every year since 2001 when they were officially introduced by the stock exchanges and consistently, retail investors have accounted for 80-90% of such volumes every year. Indian capital markets have the second highest ratio of derivatives trading to shares trading in the world, next to Korea which introduced policies to curb such high trading by retail investors that it deemed speculative, unproductive and ominous. Is all this derivatives trading merely for hedging purposes or are they predominantly speculative? Illustratively, if one owns Infosys futures without owning any Infosys shares, it can be categorized as speculative. As of FY'14, 63% of the free float ownership of shares (non-promoter owned shares) in Indian stock markets is by foreign and domestic institutional investors, 18% by retail investors and the remaining by corporate bodies. In the derivatives market, a mere 17% of trading volumes is by institutional investors and 83% by retail and proprietary traders. If institutional investors own more than 60% of the free float market and hence ostensibly need to hedge their holdings using derivatives, inexplicably they account for a mere 17% of derivatives trading volumes. A logical conclusion from this is that derivatives trading by retail and proprietary traders are largely speculative to take bets on direction of prices vis-à-vis hedging risks of equity ownership.

Further, inexplicable tax policies have served to incentivise derivatives trading vis-a-vis investing in shares. Let's suppose you had Rs.1 lakh to invest in the capital markets today and you decide to invest in Infosys. You can buy Infosys shares on the stock exchange through your broker and take delivery of it in your demat account. Or you can choose to speculate on the Infosys stock price and buy an Infosys derivative through its future or option for a fraction of the actual stock price. At the end of this transaction, the transaction taxes paid to the Government of India would look like this:

Tax on Rs.1 lakh transaction (Current)		
INR	Buyer	Seller
Investing in shares	100	100
Day trading in shares	-	25
Speculatingm in Futures	-	10
Speculating in Options	-	17
Settlement of Options	125	-

This bizarre transaction tax structure that overtly incentivises speculation over investment is applicable across all categories of investors – individuals, Indian institutional investors and foreign investors. No surprise then that derivatives' trading volumes in India have grown at a annual compounded rate of 67% vis-à-vis share trading volumes' growth of 15%, in the 21st century.

A predominantly speculative capital market is adverse selective and primarily attracts other speculators, not investors. This breeds fear and suspicion in new retail investors desirous of entering the markets. It is time SEBI took cognisance of this inordinately high speculative derivative activity and shift its balance by increasing the duration and minimum investment size of derivatives' contracts. SEBI has issued a notification increasing the minimum contract size in derivatives to Rs.5lakh from the current Rs.1lakh. While this is still a small step, it is nevertheless a step in the right direction. Rationalizing the securities transaction tax structure to tax derivatives' buying at the same rate of 10 basis points as buying shares or higher can remove the tax arbitrage between speculating in derivatives and investing in equities which will hopefully help alter the skewed balance in favour of investing vis-à-vis speculative trading, in the longer run.



Prime Minister Modi and his government have made some laudable efforts in galvanising momentum for large initiatives such as stepping up manufacturing activity, building large scale urban and rural infrastructure, reforming the Railways, promoting inland waterways for movement of goods etc. Every one of these require significant capital investments that are both long term and steady. India has this unique predicament of its citizens investing a large part of their savings into unproductive assets such as gold while overseas Indians (NRIs) and foreign investors from outside have been sending large sums of money into India. 35% household savings of India's $2trillion economy can play a significant role in providing stable long term funds for India's development. Channelling these away from pillows and gold into companies and projects will require more than mere cajoling and coaxing. The policy measures outlined above may seem radical in its indirect link to bridging this "trust deficit" at first sight. However, it is time we move away from inane incrementalism to creative ways of luring domestic investors back into the equity markets.