STOCK MARKET IN TURMOIL – LESSONS FOR INVESTORS

Prof. S. L. N. SIMHA
J. MULRAJ
Dr. AJAY SHAH

FORUM OF FREE ENTERPRISE
PENINSULA HOUSE, 235 DR. D. N. ROAD,
MUMBAI 400 001.

"Free Enterprise was born with man and shall survive as long as man survives".

— A. D. Shroff
1899-1965
Founder-President
Forum of Free Enterprise

STOCK MARKET IN TURMOIL – LESSONS FOR INVESTORS

I

The Stock Market Debacle

By

Prof. S. L. N. Simha*

The recent stock market scenario seems to be something like as under. After the hectic bullish of the early nineties petered out, there was again an attempt in recent months to take the market upwards, taking advantage, in particular, of the hype about information technology, and naturally supporting the purchases with bank borrowing, of a fraudulent sort in the case of the main bull operators. There are limits to artificial pushing the market up and then the bears started operating in a big way, at times this needing money or shares to deliver, which many institutions obliged.

In this bull-bear struggle, which is an eternal one, a large number of so-called genuine investors lost huge sums of money, which they had put blindly when the market had risen, unreasonably, especially in the case of information technology shares. All this happened with so many regulatory agencies in existence, with plenty of experience of such happenings before. Apparently, they were not alert, their sources of information inadequate and their assessment of the situation faulty. This is not all. Allegations have been made of the

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* The author, a renowned economist, was Principal Adviser, Reserve Bank of India. Courtesy : "Southern Economist", (Vol. 39, No. 23 & 24, April 1 & 15, 2001), published from Bangalore.

involvement of a leading mutual fund in the bull-bear struggles, adjusting its portfolio to suit the needs of the main speculator and providing financial assistance, directly or indirectly.

The SEBI is conducting an enquiry into the various aspects of the latest happenings in the stock market; we must await the report. It is too early to say whether that report would be thorough or whether an independent committee should go into the matter, including recommendations for a thorough reform of the capital market practices, instruments and institutions.

To me, it seems to be clear that the Government, the Reserve Bank and the SEBI are largely responsible for what has happened. I do not put much blame on stock market operators and speculators, because it is their business of speculate to the maximum possible extent, disregarding public interest for private benefit. The Governing Boards of stock exchanges have also to share a part of the blame, but the point to note is their poor functioning was not observed carefully by the supervisory and regulatory authorities, who must bear the primary responsibility for the poor management of stock exchange.

The Securities and Exchange Board of India (SEBI) has been doing a fairly good regulatory job, but its powers are rather limited as compared to, for instance, The Securities and Exchange Commission (SEC) of the U.S.A. By and large, SEBI has to toe the line of the Government, which means political influence in the functioning of an important regulatory body. Unfortunately, this is so in most regulatory authorities in India. They are not endowed with real independence to do a thorough job. Further, it would seem that in its anxiety to do promotional work in the capital and stock markets, SEBI neglected, unconsciously, the regulatory role, which calls for extreme alertness. Therefore, it has to accept some blame for the recent state of affairs.

I blame the Government and the Reserve Bank for several reasons. For almost two decades, the policy of the authorities has been to keep the stock markets bullish, in the belief that it would reflect the strength of the economy, help economic growth, promote saving, mobilize large funds for investment and stimulate inflow of funds from abroad. Fiscal concessions were offered from time to time with this end in view.

Monetary and credit policies also sought to promote the above objective. In particular, banks came to be given increasing freedom in the matter of lending against shares and other securities not only for other purposes but also for purchase of shares and securities and active two-way trading in them. There was lot of discretion given to banks in these matters, especially in the matter of margin requirements, all in the name of banking reform and autonomy for banks in their operations.

In fact, banks were also permitted to engage in share transactions, supposedly within limits, but with none to check these effectively. It has also been the practice for banks to engage in *badla* or carry-over transactions, which is nothing but active participation in share transactions. I doubt whether even today many people in Government, or for that matter in the RBI, understand that engaging in *badla* transaction is lending money without any margin, something very risky, in a period of sharp fluctuations in share prices.

It is also interesting to note that financial institutions and, what is worse, depository institutions such as the Stock Holding Corporation, are permitted to loan securities to bear operators to deliver securities, either because they cannot square up or they do not wish to do so, in the hope of the return of a bearish trend. All the mutual funds mention in their prospectus that they would engage in stock-lending activity, to augment their income, subject to regulations and guidelines. This is utterly wrong, because there can be, and human nature being what it is, there *will* be, collusion between stock market

speculators and financial institutions for unhealthy speculation. To loan shares means to help the bear operator, which is taking sides in the bull-bear tug-of-war. Moreover, the institutions run risks in such lending. Share prices may go up and the speculator may not be in a position to buy them and return them to the lending institution. This is not asset management, but the opposite. This should be prohibited.

It must be remembered that in God's creation, nothing is an unmixed blessing or curse. It is good to have a large number of financial intermediaries, good to give them a large measure of freedom of operations and good to have free inflow and outflow of funds, all in the name of a broad and highly liquid market, facilitating investment and developing the investment habit in a big way. But this very freedom also means that share transactions can move excessively now in one direction and now in another direction. In markets, generally, there is the herd instinct of sheep and goats; they all tend to run in the same direction and all into the same pit when luck goes against them!

The fact of the matter is that it is politically impossible to say what the correct level is of the price of any share. Share prices ought to reflect the future prospects of a company and not what has happened in the past, good or bad. No successful formula has been found in this behalf, notwithstanding enormous output of mathematical and econometrical analysis of the subject. In fact, 2-3 years ago some two economists were even awarded the Nobel Prize for work on this subject. Alas, the company—Long-Term Capital Management, a hedge fund, of which they were advisers and also partners, went into near bankruptcy and the two economists lost the entire Nobel Prize they had won!

If such is the fate of Nobel Prize winners, one can easily imagine the fate of the numerous asset management companies that are now required to be organised for every mutual fund and investment institution, under the SEBI

guidelines. My feeling is that many of these asset management committees comprise mostly retired employees of government and public sector financial institutions, to enable them to get additional income and lead comfortable lives!

As already mentioned, even if 'eminent and independent' experts are appointed, their ability to assess the true worth of shares is very limited. Therefore, what everyone does is to make a guess of what others are doing. That what the analysts, forecasters, model-builders and speculators are all doing is in effect this precious exercise, was expressed in a devastating manner, 65 years back, by that genius of an economist, John Maynard Keynes, in his epoch-making book, *The General Theory of Employment, Interest and Money.* While dealing with the subject of long-term expectations, he observed that the expert professionals and speculators are not concerned with what an investment is really worth, but with what the market thinks the proper value is, under the influence of mass psychology.

Let us quote him. What he said 65 years ago is very much true to-day also.

> Professional investment may be likened to those newspaper competitions in which the competitors have to pick out the six prettiest faces from a hundred photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole; so that each competitor has to pick, not those faces which he himself finds prettiest, but those which he thinks likeliest to catch the fancy of the other competitors, all of whom are looking at the problem from the same point of view. It is not a case of choosing those which, to the best of one's judgment, are really the prettiest, nor even those which average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects

the average opinion to be. And there are some, I believe, who practice the fourth, fifth and higher degrees.

The situation, however, is not entirely hopeless, especially for experts. Among other indicators, two ratios can be helpful, namely Price-earning ratio and Price-networth ratios. If the Price earning ratio is very high, which means low yield in ratio to market rates of interest, long-term in particular, it is some indication that the price is high and one should hesitate to buy; rather, it may mean that it is opportune to sell, at least a part of one's holding. The same conclusion emerges if the Price-networth ratio is very high.

The fact of the matter is that equity investment is not for a Tom, Dick or Harry. It is a very specialised job. Even specialists, as already mentioned, do not pass the test easily. Small savers should keep out of the stock markets altogether. Even the lower and upper middle class people should take the equity investment route through mutual funds, and that too in a marginal way. It is for this reason that T. T. Krishnamachari, the most brilliant of our Finance Ministers, set up the Unit Trust of India, as advised by the RBI, much work in this behalf having been done by this author. Of course, mutual funds too have fared badly, but on the whole they are safer than a small individual venturing out in this area. In any event, Government should stop the cult of equity investment on a mass scale.

The rather poor quality of corporate management, in general in the country, with comparatively poor transparency, poses unusual difficulties in the matter of engaging in equity business. Sound conventions do not exist in the matter of dividend distribution and capitalisation of reserves, which will help enlarge supply of shares and provide some stability.

I feel that it is wrong to think of endowing substantial autonomy in the matter of functioning of financial institutions, especially investment institutions. There has to be a great deal of regulation, because it is much easier to waste financial resources than physical resources. The harm from misuse of

financial resources is much greater than misuse of real resources. I know the authorities are becoming aware of this and are taking remedial action. But, as in many other areas, it has been a matter of not enough and rather late, in diagnosing and taking remedial action. I mention below the areas of action by the various regulatory agencies to minimise instability in the share market and help avoid financial loss to genuine investors, from the operations of speculators.

Financial intermediaries, especially stock exchanges, must do a better job of self regulation. We had an example of this in the Bombay Stock Exchange in the long span of years under the presidencies of K.R.P. Shroff and P. J. Jeejeebhoy, the functioning of both of whom I knew intimately.

It is well to note that, under no circumstances, will there be absolute stability of share prices. It is neither possible nor desirable. All that one can hope for is relative stability. Economic, financial and political developments, national and international, will affect share prices, especially in a world that is becoming globalised rapidly, with enormous movements of goods, services, securities and money across the national frontiers. Government should do nothing to help bullish or bearish movements; it must remain neutral, by and large. What is important is to prevent large-scale speculation, financed by borrowing of money and securities. At any time, bulls or bears will suffer losses; it must be ensured that they meet their obligations honourably, so that there is no disruption of the market, the financial system, and the economy generally.

We must begin with the regulation of bank credit. Excessive speculation can only take place with borrowed money or funds belonging to others, in particular financial institutions engaged in investment operations. Therefore, such credit needs to be restricted, if not totally denied. Such credit regulation is different from the general credit regulation which a central bank does as part of appropriate macroeconomic policies. Credit regulation to contain speculative activity needs an elaborate

system of inspection and alertness. In many countries, there are separate institutions for banking inspection and regulation to ensure that banks are managed with adequate liquidity and are conducted in a manner to safeguard the interests of depositors.

In India, although for many years now there have been suggestions for a separate institution for banking supervision and regulation, the Reserve Bank of India continues to be the sole authority in this regard. The time is more than ripe for the establishment of a separate statutory authority for the purpose. Of course, the Reserve Bank must be associated with this Authority, essentially in an advisory capacity. Such an Authority must also be responsible for the supervision and regulation of non-banking financial intermediaries. The Reserve Bank's performance in this regard has been disappoining. For a long time, the Reserve Bank remained inactive in spite of many warnings.

In the meanwhile, the RBI must organise a quick survey of the present position with regard to bank lending for stock market transactions and for other purposes too, against the security of shares. The survey should be completed in about two months. The findings of the survey should of great help in formulating regulations for control of credit for speculative and other transactions. I am of the view that, at least for some time, bank credit for share transactions and credit for other purposes against the security of share should be prohibited. The existing credits must be rapidly repaid.

The present institutional agency for the regulation of share markets and investment institutions generally is the Securities and Exchange Board of India (SEBI). The record of SEBI is like that of the curate's egg, good in parts. The organisation needs to be strengthened in terms of authority, the quality of staff and its alertness. While not exactly a toothless body, its powers are disappointing as compared to those of The Securities and Exchange Commission of the U.S.A. The

American institution is a quasi-judicial independent authority, whereas the SEBI is a subordinate body of Government, mainly the Ministry of Finance.

The SEBI statute must be changed to confer on the body substantial independence of the sort that SEC of the U.S.A. enjoys. The scope of its operations and the limitations of its authority should be laid down in the statute; it must not be a matter of discretion of the Government. The SEBI Board must comprise eminent experts, on the basis of a tenure of five years or so, with status and emoluments corresponding broadly to those of Governor and Deputy Governor of the RBI.

The SEBI must watch carefully the functioning of stock exchanges but their day to day functioning must be left to the stock exchange authorities. It is very important that the exchanges have an Executive Chairman with substantial independence to ensure fair trading, subject to broad guidelines given by the governing board and, of course, regulations prescribed by SEBI. The governing board of a stock exchange must concern itself mainly with matters relating to general administration and the provision of the requisite infrastructure, in keeping with technological developments in this behalf.

The efficient functioning of stock exchanges depends very much on the rules governing the mode of investment of transactions, prescription of margins to prevent overtrading and close watch on the activities of members with substantial short and long positions. It is also necessary to watch, simultaneously, the operations of investment institutions like the UTI and the various mutual funds. Periodic settlements, like a fortnight or three weeks, lead to the building up of large positions. Therefore, a relatively short rolling settlement system should be prescribed. There must also be uniform settlement periods in all the exchanges. In the present circumstances, it also looks desirable to prohibit the *badla* system or automatic carrying over of transactions from one settlement to the next, of course, with payment of contango or backwardation. Even

as credit for share transactions must be stopped, the loaning of shares and other securities by financial institutions should be prohibited.

In short, the stock exchange activity must reflect mainly genuine demand and supply rather than artificially generated speculative activity, especially financed by funds other than those of the speculators'. There will be cry that will affect the liquidity of the stock markets. What is the use of liquidity if it is accompanied by substantial instability now and then? With growing investment habit and an expanding economy, there is bound to be enough business of a genuine type to make for liquidity and price continuity. For this purpose, it is important to augment the supply of shares. In this connection, companies should be required to increase the supply of shares through both fresh issues of equity, including rights issues, and capitalisation of reserves.

Most companies prefer to build huge reserves without issuing bonus shares from time to time. This is wrong for many reasons including a misleading impression with regard to the dividend distributed as a percentage of share capital. Likewise, there must be conventions or even broad statutory provision for distribution of dividends. At present, there is total discretion to the Board of Directors. There are many other areas of the functioning of companies, such as restrictions on insider trading, which could contribute to the stability of the share market directly or indirectly. All this must form part of the code of corporte governance.

The interests of share holders must be safeguarded. In this connection, the present system of handing over shares in the case of sales and the cheques in the case of purchases, to the broker, is risky. In my view, these transactions should be done through banks. In other words, the broker's responsibility should end with locating the other broker for a transaction. The introduction of system of dematerialisation of shares should help this considerably. This is a matter that has several

angles, legal and procedural, and should be looked into urgently by an expert committee. Under no circumstances should genuine investors suffer a loss by defaults or misuse of funds on the part of brokers. This committee may look into the question whether instead of having many depositories, there should not be a single institution (with branches) formed by banks.

One of the causes of considerable volatility in the share market is the frequent inward and outward movement of institutional funds, with foreign affiliations. It is impracticable to place restrictions on the freedom of the institutions to buy and sell securities as they consider appropriate, according to their perception of the market. However, some restrictions may be placed on the sale proceeds moving out, such as that they must be held for a minimum period before repatriation. Fiscal provisions such as those relating to the treatment of capital gains and losses could also be considered in this behalf.

I also feel that the Government, the Reserve Bank, SEBI, the Stock exchanges and financial institutions, including the mutual funds, should launch a massive programme to educate people on the various aspects of investment, including in particular equity investment. The services of management institutions ought to be used for the purpose.

It seems to me that some of the financial institutions are becoming too big for efficient management and control. Also, they wield excessive power, which is dangerous in a democracy. This matter should be looked into by an expert group.

In conclusion, it is well to note that in this country, for several years now, undue importance has been given to the share price movements as an index of the country's economic performance and prospects, like the misguided importance we have given to cricket. Nor should equity investment be kept in a high pedestal; Government has in the past been guilty of creating a hype in this regard. It must assume a

position of substantial neutrality, while of course, pursuing proper macroeconomic policies that promote saving and investment.

In spite of the best care on the part of the authorities in the matter of supervision and self-regulation, there may be scams, bear raids, bull squeezes, and so on. Price fluctuations there will certainly be, sometimes large fluctuations, owing to a variety of economic and non-economic factors, domestic as well as external. Psychology plays a big role in the share markets. But so long as financial institutions are not involved in this, there need be no fear of a major impact on the capital market. Such scams, confined to some individuals, will peter out. In the present scam as well as the one a decade back, there has been involvement of financial institutions, in particular banks. It is where one feels sorry that the authorities did not learn lessons from the last scam, and take remedial measures adequately. Anyway, it is never too late to move in the matter, in particular strengthen the early warning systems.

I also feel that in the present system of stock markets in India, it will be unwise to introduce trading in derivatives in a big way. Trading in stock index futures may be all right, but not trading in other derivatives; we are not ready for it. Even in the developed countries, derivatives trading has grown to astronomical levels, without proper evaluation of their costs and benefits, and the massive risks, instability and crisis that may develop. Large-scale trading in derivatives seems to be developing more as a fashion and a way for middlemen to be employed, than a matter of great necessity. Let us not initiate their practices blindly.

Unhealthy developments in the share market, including sharp swings in prices to and fro, occur in highly developed countries too, with involvement of banks. We should not exaggerate the magnitude of such occurrences in our country, though the authorities should act quickly to identify the sources of trouble and take remedial and preventive measures, including speedy punishment of the guilty.

II

Some Rules for Investors

By

J. Mulraj*

Currently the stockmarkets are in a state of turmoil. To understand exactly what are the factors, it may be necessary to delve a bit into history of reforms of capital markets.

The stockmarket has seen a sea change over the last decade. When I entered the trading ring in 1985, on becoming a member of the Bombay Stock Exchange, we had a floor based trading system where entry was restricted to members and the their employees, on whose reliability and judgement an investor would have to depend.

Transactions were affected through an **open outcry system** resulting in a din of a magnitude that could cause partial deafness. In fact, if you promise not to tell her, I still use partial deafness as an excuse not to listen to my wife sometimes!

The transactions were put through with the help of jobbers, who gave two way quotes.

But now **the transaction side of the business has greatly improved.** Instead of the open outcry system we now have **screen based trading.** It may interest you to know that till today the New York Stock Exchange is based on open outcry system! It still manages to trade some 300 m. shares daily!

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* The author is a Financial Analyst and Columnist, "The Times of India", and Director, Capital Ideas Online. The text is based on a talk delivered on the subject at a public meeting under the auspices of the Forum of Free Enterprise on 18th April 2001 in Mumbai.

Introduction of a screen based system has contributed to better interpersonal relationships between investors and their brokers. For, the best bid and offer prices are now displayed on the screen prior to the transaction and it is the investor who has to decide whether or not to trade. He thus has **greater control over his investment destiny** than before.

The screen based trading system has also led to increasing transaction volume considerably, because the drudgery of paperwork has now been taken over by the trading terminal and software.

The **spread between the bid and offer price has also been reduced considerably,** as the jobber has been replaced with by many competitive bids from all brokers. This has also benefited investors by bringing down transaction costs.

Transaction costs have been brought down also because of other reasons. One is technology. The screen based trading system combined with computerized accounting makes it possible to scale up volumes of transactions, thus helping bring down costs per transaction yet give the broker his income. In fact transaction volumes have exploded not only in India but in other countries where electronic trading and settlement systems have been introduced. **On a good day we see transaction volumes that used to happen in an entire year in the 80s.**

Alongwith improvements in the transaction side of the business there have been several good initiatives on the **settlement side.** SEBI, the regulatory body, together with the central depository, have done commendable work in **introducing paperless trading systems.** This has not only reduced the risk of theft or loss in transit, but also the price risk which investors used to bear.

Another factor that has brought down the transaction costs considerably is the advent of **greater competition in brokerage,**

from foreign houses, as well as the advent of foreign investors. They, being larger players, have been able to negotiate much better rates from brokers and even individual investors have benefited from this.

Strangely, this did not happen in England post its Big Bang in 1987. There, although brokers cut brokerages for the large, institutional players, to a quarter per cent or less, they made up the difference by charging smaller, retail players a brokerage of 4 per cent! Thankfully for the individual investor, this has not happened in India.

Electronic trading, whether web based or through what are known as electronic communications network would help in further bringing down transaction costs by virtue of being electronic.

The arrival of foreign investors has also aided in a great **improvement in corporate governance,** though a lot still remains to be done. The large clout of institutional players compared to individual ones, has resulted in improved transparency and focus on enhancement of shareholder value.

With the arrival of mutual funds, there **has been a shift in corporate equity holding pattern towards institutional players,** and away from individuals. To my mind this, again, is a contributory factor in the volatility we see with alarming frequency, as institutional players tend to move en masse.

In the US, individuals used to own two thirds of corporate equity and institutions one third. Over the past thirty years, the ratio has reversed, with the spread of mutual funds.

The spread of mutual funds is a trend that is visible in India too. I am not too happy with the way mutual funds operate, not only in India, but also globally. This is because of two things, one is their **open ended, NAV nature,** and the other is what I term as a **fatal flaw,** and which I shall later elaborate on.

The current turmoil

This is the backdrop then to understand the domestic factors that resulted in the turmoil in our stock market in recent weeks. Alongwith domestic factors, there were also global ones.

In the global arena, the rise of venture capital funded new economy businesses was the most significant development. It started with the phenomenal success, in the early 90s of the IPO of Netscape, by its founder, Jim Clark, who interestingly, took his company public only to meet a down payment on a boat he was then building!

Venture capital then financed all sorts of new technology businesses, including the now infamous dotcoms, telecom companies and the plumbers of the wired world. In fact, the whole venture capital funding seems, in retrospect, to be like a tulip mania except that it did not originate with some group seeking to defraud investors.

Venture capital was so generous in its funding of new economy that the distinction between capital and profits was blurred, and funding of businesses continued despite huge losses. This resulted in a new paradigm of valuation of these businesses, based upon eyeballs rather than upon profits.

For investors there are a whole host of lessons to be learnt. For starters, existing brick and mortar businesses suffered in several ways. Products e.g. computers, produced by them were given away as freebies by venture capital funded dotcoms. The valuations of brick and mortar businesses was based upon the traditional yardstick of profits and was much lower than the new economy businesses which didn't have any. In fact, Jeff Bezos, the founder of Amazon, is quoted to having stated that he did not wish to make a profit lest his valuations would be done on a traditional basis! This is symptomatic of the mania that prevailed.

The venture capital funding, however, did produce a whole host of new technologies. Quite often, as in the case of Napster, these were disruptive technologies. What Napster did was to succeed in shaking up a moribund music industry which had become insensitive to the interests of both its suppliers of music (the artistes) as well as its customers. It gave the artistes a small share of 10 per cent as royalty and did not allow them to set the price for the product they created. It gave the customers no choice to select individual tracks; they had to buy the whole CD. Napster's peer to peer (p2p) technology platform changed all this. Artistes could set the price for any music sold by them through this platform, and keep 50 per cent of the price as royalty. Customers could download individual tracks.

Whilst the music industry has succeeded in blocking Napster, investors need to look out for such changes brought about by disruptive technologies. And the changes are occurring at an amazing pace, making the task of predicting the next change inordinately difficult for individual investors. They are thus driven into the arms of the mutual fund industry, in the hope, often belief, that such fund managers are better equipped to guide them.

This drive towards mutual funds, or institutionalization, has resulted in the shift in corporate ownership patterns, with two thirds of equity now held in institutional hands in the US, compared to a third, three decades ago. A similar shift is occurring in India as well. It is not always good, largely due to the way mutual funds are structured.

Most mutual funds, all over the world, are sold on an open ended basis allowing investors to enter and exit at or around the net asset value (NAV). This feature of open endedness, is a **marketing feature.** As a product feature it is in fact, counterproductive. In fact, I would be bold enough to state that the growth of the mutual fund industry in the US where it has overtaken the banking industry, is more of a marketing success

than a financial success. For, mutual funds have generally underperformed the markets.

One of the unintended consequences of open ended mutual funds is that **it leads to short termism.** For investors this is again another lesson to be learnt.

Because fund managers are susceptible to the whims of thousands of investors, they themselves have to take a short termish outlook and to invest accordingly. This in turn puts pressure on corporate managers to deliver short term results, quite often resulting in their making mistakes by losing sight of longer term objectives. Consider, for example, Lucent Technologies, which, after thirteen straight quarters of consistent outperformance, failed last year to meet analyst expectations and has stumbled over since. The CEO, now replaced, lost focus on the shift in technologies and didn't move fast enough into optics. He was driven by pressure from institutional shareholders to have a shorter term outlook than warranted by the business. We can see the same swings occurring here too, as, for example, when the share price of Infosys collapsed when forecasts for the current year were disappointing to analysts.

For investors such short termism has enormous implications. Share values get punctured by phenomenal amounts 40 per cent or more in a single day! That's in the US, in India, circuit breakers ensure that it is no more than 16.

Short termism is not only the consequence of pressures on managements to perform; it is also brought about by the stupendous technological changes that are occurring the world over. New ways of doing things and better products are being brought out thanks to strides in telecommunication and computational technology. This has collapsed the life cycles of businesses and even reduced the value of brands.

In India we have seen how some mutual fund managers were participants, willy nilly, in the K 10 technology stocks by virtue of the pressure of having to keep up with the Joneses that the open ended nature of their funds put upon them. If they don't manage to exit in time, it is their investors who suffer.

Their inability to exit in time emanates from the fatal flaw I made a mention of earlier. All over the world, mutual fund managers proceed on the assumption that it is their investors who have made a capital allocation decision for themselves. That is, when an investor invests in an equity fund, the manager makes an assumption that he has already decided to participate in equity to that extent, and so it is the job of the fund manager only to see that the funds are then invested in the best possible equity stocks at that point in time. In other words, by virtue of this fatal assumption, the fund manager considers it unnecessary to take a view on the market and sell in anticipation of a downslide even if he so judges. When the market starts to slide, and redemption requests start pouring in, there is a rush for the exit, adding to volatility.

Another factor that plays an important part in India is the structure of the largest domestic fund of all, the US 64. This fund has its own peculiar structure. Though it is open ended, the exit and entry prices are determined by the management. This in turn leads to less redemption pressure, for it converts the fund into more or less an assured return scheme which has the backing of the Government. To my mind, it has to move over immediately to an NAV based scheme, like all other funds, and it is unfortunate that the Deepak Parekh committee gave it five years in which to transit to such a method.

This absence of transparency in the largest mutual fund is what results in the feeling that it is used as a dumping ground for shares propped up by operators. And that this is the reason, perhaps, that it went into financial problems last year. Moving over to an NAV based regime immediately is necessitated.

I also wonder why all over the world, mutual funds never have to face their investors at an AGM, just like a company management does.

Another cause for the current turmoil in the stockmarket was the easing of acceptance standards by brokers. I have outlined how brokerage costs came down under pressure from institutions, as a consequence of reforms. In order to make up for lower rates, brokers needed to increase volumes, which they did, but at the cost, inevitably, of quality. Caution was often thrown to the winds, and brokers took on business from clients who had earlier been defaulters. The recent case of Amar Raja Batteries leads to this conclusion. Investors must learn not only to select brokers carefully but also to keep in constant touch with them and develop interpersonal relationships.

The current crisis has been fairly well analysed. One broker had shot into the limelight with his picks on technology stocks, aided in his buying by funding from banks, including co-operative ones. He was also aided by a few mutual funds either knowingly or unknowingly, in the attempt to keep up with the Joneses.

For this, perhaps, the management of the funds must give greater leeway to fund managers and reduce pressures to keep up with the Joneses. This behaviour reminds me of the two hunters who had a bear chasing them. One stopped to put on his jogging shoes. When the other asked him if he thought jogging shoes would help him outrun a bear, he coolly replied that he had only to outrun his colleague!

One of the reasons for the current crisis is the inadequacy of our regulatory and our legal systems to swiftly penalize those guilty of contractual violations. The ony way to correct this is to ensure that any person guilty of financial misdemeanour is blackmarked for it. Why can we not adopt a citizen number, like the social security number in the US, so that, with the use of electronics, a trail of financial behaviour can be obtained?

So in such an environment, what should an investor do?

Well, it is a tough world out there but some rules can help.

Michael Mouboussin, who is the chief economist at CSFB First Boston, has five rules of things to avoid doing. He says

- DON'T irrationally escalate commitments (i.e. buying to average in a share with poor prospects)
- DON'T be overconfident
- DON'T be overly influenced by how information is presented (clothes do not maketh the man here)
- DON'T fall into the confirmation trap (be honest and objective) and
- DON'T base judgements on irrelevant information, including historical prices or multiples (the past is only a guide.)

To these I shall add my own humble rules.

(1) **Know yourself:** It is important to know what sort of person you are, and what style of investing suits you. Are you fascinated by quick trading profits? Are you happy with shorting? Are you a buy and hold investor? A long term investor? What is long term? Your broker or investment advisor would generally console you, when the price of the recommended share halves shortly after you have bought it, that yours is an investment for the long term! No one actually defines long term, so I shall attempt to.

According to me, long term is that period of time it takes for you to forget who recommended the investment in the first place!

It is important to know the sort of investor you are, the sort of risks you are comfortable taking and to always remember the second rules which is

(2) **there is no free lunch.** This proposition may have been tested if the time of the lecture was 1 pm instead of 6. The point

is that equity investing is always a matter of risk and that there is no reward without risk.

It is becoming increasingly difficult for individual investors to assess the risk. This is because rapid changes in technology are shortening the life cycles of products and their profitable lives. Consider Pointcast, an online financial news service that was offered a whopping $100 m. for a buy out. It refused, wanting more. In a month, another new technology came in, which was superior, and this site's value fell to under $5 m. This is how valuations are rapidly and brutally shattered.

(3) **Seal your lips:** Its human nature to tell others what you have bought. I have discovered however, that this makes it tougher to change course if I find the share zigging instead of zagging. The fact that I have told someone makes it an ego issue and while dealing with markets it is better to leave the ego at home. Most investors make the mistake of averaging a bad share downwards. This is based on the premise that the market owes us investors a living and that it is duty bound to see that my cost price is once again reached.

(4) **The buffet rule:** If you go to a buffet lunch at the Taj, with your friend, would you get envious if he managed to get better value for money because of his larger appetite? You wouldn't, right? Why, then, do you not apply the same rule when it comes to investing? Its much better to set yourself a return target when you make the investment and then review the matter when the target is hit. If there are no compelling reasons, other than greed, for holding on once your target is met, why hold on? Some other investor may have a bigger risk appetite than yours and may possibly be able to sell at a higher price. Why grudge him that? Equally possibly, he may end up with constipation the next day. So don't let your happiness be marred by others.

5. **Don't spread yourself thin:** Don't have too many shares in your portfolio which you cannot track. I would say ten to fifteen

is more than enough for most investors. Stick to those you can understand. Warren Buffett has never invested in technology stocks because he could not understand it. He suffered sub par returns during 1999 and early 2000 as NASDAQ tried to disprove Isaac Newton. He is now grinning from ear to ear.

A lot of changes have occurred and lots more are on the way. It is all part of growing up. Although we have a 125 years history of stock trading in our country, we are still an underdeveloped market.

III

Handling a Crisis

By

Dr. Aajay Shah*

The media attention in the recent stock market crisis has been on the juicy tidbits: scandal at the BSE, CSE; the personality of Ketan Parekh; malfunctioning cooperative banks; surgery at SEBI, etc. However, lurking below this has been a profoundly dangerous systemic crisis.

Systemic crises are truly frightening events, which every country in the world has to face. The environment of a market crisis is composed of (a) sharp fall in prices, (b) impending bankruptcy by one or more large players with fears of payments crises, and (c) a sharp worsening of market liquidity. Every player has a lot to lose in a systemic crisis, and the sad fact is that the uncoordinated responses of all players serve to worsen the crisis:

- The clearing corporation sees high price risk and poor liquidity, so the Value at Risk models at the clearing corporation require greater collateral. This comes at a time when all players are stretched at the limits of their leverage and are least able to fork up collateral.

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* The author is an economist and a Professor at the Indira Gandhi Institute of Development Research, Mumbai. Courtesy : "Business Standard" (issue dated 4th April 2001). The author was one of the speakers at a public meeting on the subject held under the auspices of Forum of Free Enterprise in Mumbai on 18th April 2001.

- Naive investors (both retail and institutional) are often positive feedback traders; they believe that recent price changes will be repeated in the future. The depressing fact is that our financial industry has a large supply of poorly educated employees so it isn't hard to find such naive investors. Naive investors fear further price drops and rush to the exits. If there isn't a "sufficiently large" supply of smart investors who are on the other side, this generates further price drops.

- Banks find customers failing on margin calls for loans against shares portfolios, so their systems trigger off liquidation of collateral, which drives prices down.

- All banks nervously retreat towards "a smaller exposure to securities markets": lower loans, lower bank guarantees, etc. Top managements at many banks call a halt to these activities pending a full review of risk management procedures. This hits leveraged market participants at a time when they need capital the most.

- All these actions serve to suck out liquidity (i.e. raise transactions costs) from the market. High transactions costs lead to lower stock prices through the liquidity premium, thus directly exacerbating affairs. Fears about an unreliable supply of liquidity make firms close out positions and back away from trading, which hits stock prices.

The first question we should ask is clearly: "What is a superior market architecture which generates reduced vulnerability to systemic crises?" This is an important question, and a lot has been written about what can be done better — rolling

settlement, novation at the clearing corporation, exchanges which are not run by brokerage firms, etc.

However, that does not eliminate systemic crises, which will take place. In order to cope with them better, we need a well thought out plan about how a coordinated set of responses will be put into play, so as to help matters where possible. Even more important, a well thought out plan, which is articulated and agreed-upon in peacetime, will diminish wrong reactions by policy makers which actually make things worse when there is an outbreak of war.

Liquidity, liquidity, liquidity. The first focus of policy makers should be to fight for low transactions costs on the market. The goal should be to stay out of the vicious cycle of a drop in liquidity triggering off a drop in prices, which feeds on itself.

SEBI got this wrong. Let us review the evidence. Liquidity is measured by "market impact cost", which reflects the cost of transacting. (Market intermediaries like to measure transaction volume, which directly feeds them revenues, but from the viewpoint of the Indian economy, we care about transactions costs and not trading volume). I will focus on the transactions costs involved in doing a trade worth Rs. 5 million on the NSE-50 index on the largest exchange (NSE). This time-series (impact cost on the NSE-50 index on NSE) is the best measure of stock market liquidity in India.

Under normal circumstances, the impact cost for buying or selling Rs. 5 million of Nifty is around 0.2%. Markets tend to become illiquid when there is price volatility, so in the period from 27 Feb till 7 March, this rose to 0.25% (a degradation of liquidity of roughly 25%). On 8 March, SEBI came out with the strange policy measure: a ban on "short sales". This sharply

hit the liquidity of the market: from 8 March till 22 March, the impact cost was higher at 0.32, another degradation of roughly 25%. Thus SEBI and the market crisis take roughly equal credit for generating a sharp drop in market liquidity.

SEBI's ban on short selling was a clear failure of intellectual analysis. SEBI did not see that it's first role should be to protect market liquidity. Instead, it went by a silly argument that banning short sales helps obtain higher stock prices (it never does and it never will). The first thing that we can do to find our way out of this crisis is to reverse this ban.

Price limits can prove to be an important impediment to market liquidity: When a stock hits a limit, the securities market becomes completely illiquid, and economic agents become fearful through not knowing what the true price is. The existing price limit regime of 8% and 16% is basically a sensible one, but it would help to move that to (say) 12% and 24% under crisis conditions, to improve the supply of liquidity to the market.

Banking. There have been difficulties with certain banks, but the banking system as a whole is working fine, and the broad framework for prudential regulation with loans against shares or bank guarantees for brokers are quite fine. A lot has been written about how this crisis is like 1992, but it actually is not: in 1992, every major bank was party to the fixed income scandal. This time around, it is a highly isolated affair. Policy makers should be very careful to combine enforcement against fraud with an uninterrupted supply of credit from the banking system into the securities industry.

Avoiding a witch-hunt. In recent weeks I have seen a witch-hunt gathering momentum, where we have investigators from SEBI, CBI, ED, IT, RBI poking and probing at market

participants and at each other. We must be a law abiding country, and the people who have committed crimes should be punished. But in an atmosphere of a systemic crisis, it is important to be extremely controlled about it. Government should have a single team working with well defined goals, with no appearance of a witch-hunt. The longer that we have an atmosphere of a witch-hunt with market volatility in response to strange rumours swirling around, the longer it will take for economic agents to get back into comfortably participating on the market, and giving us sensible prices and liquidity.

In short, we have done a fairly poor job of dealing with this crisis, and we should learn how to do it better in the future.

The views expressed in this booklet are not necessarily those of the Forum of Free Enterprise.

“People must come to accept private enterprise not as a necessary evil, but as an affirmative good“.

— Eugene Black

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The Forum of Free Enterprise is a non-political and non-partisan organisation started in 1956, to educate public opinion in India on free enterprise and its close relationship with the democratic way of life. The Forum seeks to stimulate public thinking on vital economic problems of the day through booklets and leaflets, meetings, essay competitions and other means as befit a democratic society.

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Please write for further particulars to : The Secretary, Forum of Free Enterprise, Peninsula House, 2nd floor, 235 Dr. D. N. Road, Mumbai 400 001.

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