

## CHAPTER II

### REVIEW OF LITERATURE

There is a vast body of literature by eminent scholars and financial experts on different aspects of the capital market. The literature available on capital market mainly deals with various aspects such as stock market efficiency, stock pricing, stock valuation and stock market operations. This chapter presents an overview of the important studies and literature on capital market.

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Baumol (1965) makes an important contribution to a better understanding of the performance of the stock market. His book represents a synthesis of past research and current thinking on the subject. It analyses in considerable detail both the short-run and long-run price equilibrating processes and points out important departures from the competitive ideal and the implications of these departures to stock market efficiency. Besides, Baumol offers his own hypothesis on the pricing of securities, and he sheds new light on the

overall efficiency of the stock market as a mechanism for allocating the nation's capital resources.

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overall efficiency of the stock market as a mechanism for allocating the nation's capital resources.

Bhatia (1970) has made an evaluative study of the New Issue Market (NIM) for the period 1958-1973. The role of the financial institutions in the NIM has been described and evaluated. The study shows that a new class of middle-income individual investors has emerged as an important supplier of the risk capital provide for his immediate cash needs. This is in agreement with the three motives of

liquidity. The growth of joint stock companies played an important role in the development of the new issue market. Besides, the government also passed various legislations to protect the interests of the investors. Of the various institutions involved in the organisation of the NIM, stock exchanges are the most important, because they provide a continuous market for issued securities.

and quantitative measures of resource allocation adversely affect, not only a Gupta (1972) in his book has studied the working of stock exchanges in India and has given a number of suggestions to improve its working. The study highlights the need to regulate the volume of speculation so as to serve the needs of liquidity and price continuity. It suggests the enlistment of corporate securities in more than one stock exchange at the same time to improve liquidity. The study also

wishes the cost of issues to be low, in order to protect small investors.

and the cost of capital. The study has important policy implications in

terms Rohatgi (1973) states that the basic function of the stock

market is to provide ready marketability or liquidity to holdings of

securities. The ideal stock market is one that can provide

instantaneous and unlimited liquidity. But it is reasonable to assume

that a prudent long-term investor in equities would provide for his

immediate cash needs. This is in agreement with the three motives of

liquidity preference. If so, one would expect not 'instant' liquidity,

but moderate liquidity. It will be unreasonable for any investor to

suppose that his equity holdings are as good as cash.

institutions on the efficiency of equity market. They also examine

the Mc Kinnon and Shaw (1973) advocate liberalisation of financial

markets. They argue that state intervention in setting interest rates

and quantitative measures of resource allocation adversely affect, not

only allocative efficiency but also depress the aggregate saving rate

in less developed economies.

before and after independence. The study reveals that listed stocks

covered Khan (1976) examines the role, and the cost of raising funds

from the market. The study goes on to suggest appropriate measures

to enable the NIM to play a part in consonance with the requirements

of the planned growth of industry. The core of the study deals with the new issues and company finance, the structure of underwriting, and the cost of capital. The study has important policy implications in terms of its relevance to the national economy. In the process of industrialisation, a developed NIM would be instrumental in forging an organic link between the collection and distribution of industrial capital.

Blume and Friend (1978) state that the proportion of stock owned by institutional investors in America has increased sharply, while that owned by individual investors has decreased. They analyse the effects of the shift in stock ownership from individuals to institutions on the efficiency of equity market. They also examine the pros and cons of numerous proposals for improving the securities market. Transactions by individuals have always been regarded as essential to both liquidity and the efficiency of the market.

Panda (1980) has studied the role of stock exchanges in India before and after independence. The study reveals that listed stocks covered four-fifths of the joint stock sector companies. Investment in securities was no longer the monopoly of any particular class or of a small group of people. It attracted the attention of a large number of

small and middle class individuals. It was observed that a large proportion of savings went in the first instance into purchase of securities already issued. In 1970s earned an extra normal return of nearly 2 per cent per month.

Gupta (1981) in an extensive study titled 'Return on New Equity Issues' states that the investment performance of new issues of equity shares, especially those of new companies, deserve separate analysis. The factor significantly influencing the rate of return on new issues to the original buyers is the 'fixed price' at which they are issued. The return on equities includes dividends and capital appreciation. The study presents sound estimates of rates of return on equities, and examines the variability of such returns over time. Investors were able to earn from their investments in equity shares of new companies.

The findings suggest that the market seems to function largely on a 'hit or miss' basis rather than on the basis of informed beliefs about the long-term prospects of individual enterprises. The main reason for the market's irrationality appears to be the preponderance of speculative influences over investment influences. Examined the applicability of Random Walk Hypothesis in describing share price behavior. Gujarathi (1981) answers the question of the risk-adjusted return in the new issue market. It is a significant work in the field of new issues in India. The difficulty of estimating the risk (Beta) of newly

issued securities forced Gujarathi to use complicated methodology for arriving at the risk-adjusted return. His conclusion is that investors in the new issue market in 1970s earned an extra normal return of nearly 2 per cent per month.

Gupta (1987) makes available a comprehensive analysis of the

geo. Chitale (1983) in his work has evaluated the underlying causes of the growing shortage of equity finance for funding new industrial enterprises in the private sector during the period 1960-1980. The available evidence suggests the emerging scarcity of risk finance, despite bullish trend in the price of select shares and over-subscription to a few issues of good companies. The study also evaluates the quantum and the kind of returns that investors were able to earn from their investments in equity shares of new companies.

The study brings out the dominant share of the metropolitan cities. The respective percentage shares as per data related to 1983-

Gupta (1985) in his pioneering work attempts to analyse share price behaviour in India in the context of efficient market hypothesis. (3.9). An important factor for the very meagre share of small towns

and villages in the country's share-holding population, according to Gupta, is the lack of infrastructure needed for facilitating share

applicability of Random Walk Hypothesis in describing share price transactions. behaviour under the Indian conditions.

Devakumar (1987) reveals that earlier to 1985, there were very few investors and they were knowledgeable. During the 1985 boom,

Cho (1986) argues that financial market liberalisation may remain incomplete without an efficient market for equity capital as a means of spreading risk and reward.

Gupta (1987) makes available a comprehensive analysis of the geographic distribution of corporate shareholders in India. The study shows that a process of 'securitisation' is going on in the Indian capital market. The spotlight of the study is on equity shareholders. It covers individual holders of industrial securities in India. It is based on a sample of 1,09,031 security holders drawn from 165 companies distributed over various regions of India.

The study brings out the dominant share of the metropolitan cities. The respective percentage shares as per data related to 1983-84 were; Bombay (35.3), Calcutta (10.0), Delhi (9.5) and Madras (3.9). An important factor for the very meagre share of small towns and villages in the country's share - holding population, according to Gupta, is the lack of infrastructure needed for facilitating share transactions.

Devakumar (1987) reveals that earlier to 1985, there were very few investors and they were knowledgeable. During the 1985 boom,

thousands of new investors invaded the market. The new investors suffered heavy losses compared to the professionals. A good number of new investors have walked out of the stock market to safer areas like UTI Units, NSC, etc. There is a mild shift of investment preferences to mutual funds also.

The most outstanding development is that share ownership has become a middle class phenomenon (75%). Nearly 6.5 percentage of the Indian households own shares and are mainly restricted to cities. The analysis reveals that nearly 75% of the shareowners are long-term investors. regression analysis shows that the nominal total return on equities in India has increased, but not in proportion to an increase in the rate of inflation. The coefficient of inflation is found to be nearer to zero than one. The real return on equity has been found negatively related to inflation throughout all periods. Thus equity share in India may only be a weak or partial hedge against inflation.

Gupta (1991) made an extensive survey of Indian share-owners, around mid-1990. It throws light on many unknown aspects of the market for shares and other financial assets. The study covers a wide range of aspects and has generated much new data on investors, their investment habits and preferences.

Singh and Hamid (1992) in a monograph on corporate financing patterns and structures in nine industrialising economies found that corporations in developing countries rely in general very heavily on external funds and on new issues of shares to finance their growth of net assets.

The study involved nearly 6000 households spread over more than 100 cities of India. According to the study there are around 38 lakh share-owning households and about 90 to 95 lakh share-owning individuals in India. The number of debenture-owning households is about 29 lakh and most of them are shareowners also.

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Jawahar Lal (1992) presents a profile of Indian investors and evaluates their investment decisions. He made an effort to study their familiarity with, and comprehension of financial information, and the extent to which this is put to use. The information that the companies provide generally fails to meet the needs of a variety of individual investors and there is a general impression that the company's Annual Report and other statements are not well received by them.

Singh and Hamid (1992) in a monograph on corporate financing patterns and structures in nine industrialising economies found that Mayer (1992) using company balance sheet data, found that corporations in developing countries rely in general very heavily on external funds and on new issues of shares to finance their growth of net assets. OECD countries and the roll of the stock market is very limited.

At the macro-economic levels, significant policy questions arise with respect to both savings and investment. In relation to savings, a major issue is whether the expansion of the stock markets and the growth of the share ownership has led to an overall increase in national savings rate, or has it simply involved a diversion from one instrument of savings (say bank deposits) to another (equity)? Similarly, with respect to investment, an important issue is whether high share price volatility on developing country stock markets adversely affects aggregate domestic investment.

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Mayer (1992) using company balance sheet data, found that internal resources finance bulk of corporate investment in major OECD countries and the roll of the stock market is very limited.

The study shows that the majority of investors are casual investors. The investors regard abridged prospectus as well as the investment journals as the prime source of information for their investment decisions. Investment decisions also depend upon perennial source of supply of funds. It mobilises the savings from the unoffical premium quoted in business magazines, expert analysis, market trends, political considerations, etc. different sectors of the economy like households, public and private corporate sectors. The number of investors increased from 20 lakhs in 1980 to 150 lakhs in 1990 (7.5 times). In financing of the project costs of the companies with different sources of financing, the contribution of the securities has risen from 35.01% in 1981 to 52.94% in 1989. In the total volume of the securities issued, the contribution of debentures / bonds in recent years has increased significantly from 16.21 per cent to 30.14 per cent. other popular avenues of investment

Subhash Chander and Ashwani Kansara (1994) have surveyed the perceived significance of the information contained in the abridged prospectus attached to the application form for shares/ debentures of companies. For an existing company, the information necessary for investment decisions could be obtained from newspapers, magazines, annual reports, prospectus etc. But for a new company, abridged prospectus is the main important document, which provides information for investment decisions.

The study shows that the majority of investors are casual investors. The investors regard abridged prospectus as well as the investment journals as the prime source of information for their investment decisions. Investment decisions also depend upon unofficial premium quoted in business magazines, expert analysis, market trends, political considerations, etc.

Bajpai (1994) establishes that, the liquidity aspect is an essential constituent of an efficient stock market, a sub-system of capital market. The growth of the equity cult in the 1980s was supported by the actual experience of the Indian investors. Equity prices between 1978 and 1993 have outperformed other popular avenues of investment.

The chance of lucrative capital gain along with annual return from equity investment attracted investors in a large scale towards primary and secondary capital markets. It highlighted the need for liquidity of investment. The fact is that only 6 per cent of the listed scrips remained on the active trading, and 28 per cent of them were traded once in a year just to satisfy the requirements of listing agreement.

money have a lag effect on stock return and hence, stock market is not found efficient with respect to monetary data.

Bhole (1995) in his paper, "The Indian Capital Market at Crossroads" finds that various categories of people in India have become preoccupied, rather obsessed with, the industrial securities market since the middle of the 1980s, particularly since the launching of the New Economic Policy (NEP) in the middle of 1991. The stock market has been regarded and projected as the barometer of the health of the economy. The essentiality of the growth or spread of equity culture or equity cult is being constantly stressed. Though the stock market activity has been subject to wide fluctuations, the long-term trend has been one of steep increase. An accelerating or exponential increase in new issues has occurred during the 80s and 90s. The investors' asset preference has somewhat shifted from deposits to industrial securities.

Market efficiency may be due to quick transmission of information along with reliable operational efficiency. Thus rapid informational network and operational efficiency may pave the way towards market efficiency. They consider provision for liquidity of capital.

Sahadevan and Thirpal Raju (1995) investigate into the lead-lag relationship between money supply and stock return in the Indian context. The study has attempted to trace the relationship between stock returns and money supply using monthly observations on SENSEX, RBI Index,  $M_1$  and  $M_3$  for a period spanning over 14 years ending March 1994. The results reveal that supply variations in

money have a lag effect on stock return and hence, stock market is not found efficient with respect to monetary data.

constraints prevent banks from providing funds for long-term

investment. Improving the functioning of secondary market trading

has the added advantage of facilitating the primary issuance of equity

shares. Amanulla and Kamaiah (1995) make an attempt to assess the

Indian stock market efficiency by using market integration

approaches. The results show that there is no evidence in favour of

market efficiency of Bombay, Madras and Calcutta Stock Exchanges,

while the results confirm the existence of market efficiency in

Ahmedabad and Delhi Stock Exchanges. from less than \$100 billion in

1983 to nearly \$2 trillion by 1993. Information flows, disclosure

requirements, auditing and accounting standards and the existence of

credit rating institutions have an important bearing on the

development and operations of capital markets. Thus rapid

informational network and operational efficiency may pave the way

towards market efficiency. They consider provision for liquidity of

capital and continuous market for securities as prime functions from

the point of view of investors. In an efficient market, all the relevant

information about a firm that is available to market participants is

expected to be fully and immediately absorbed and reflected in its

share price. Its effectiveness depends on the system's ability to

introduce financial innovations and instruments that facilitate,

stimulate and promote investment by entrepreneurs.

Feldman and Kumar (1995) explore the potential benefits of equity markets to developing countries. They argue that several constraints prevent banks from providing funds for long-term investment. Improving the functioning of secondary market trading has the added advantage of facilitating the primary issuance of equity shares.

When the Sensex peaked at 4547 on April 2, 1992, the aggregate market capitalisation amounted to Rs. 2,410 billion.

The combined capitalisation of some 389 emerging stock markets had increased dramatically from less than \$100 billion in 1983 to nearly \$2 trillion by 1993. Information flows, disclosure requirements, auditing and accounting standards and the existence of credit rating institutions have an important bearing on the development and operations of capital markets.

By September 12, 1994, the Sensex scaled a peak of 4643, up by 134%. But the aggregate market capitalisation rose even more steeply to Rs. 5,518 billion.

Bhatt (1995) describes the critical innovations that have shaped the evolution of different financial systems as well as the international capital market. His book formulates an analytical framework that links financial innovations to the development process. Its effectiveness depends on the system's ability to introduce financial innovations and instruments that facilitate, stimulate and promote investment by entrepreneurs.

The Economic Times' study (1995) suggests that the major factors leading to a sustained weakness in stock prices are excessive supply of equity shares and higher than apparent (P/E) levels of major stocks. Both imply a failure of the market.

When the Sensex peaked at 4547 on April 2, 1992, the aggregate market capitalisation amounted to Rs. 2,410 billion. And when the Sensex steadily fell to touch a bottom of 1980 on 27 April 1993, (56.5%) the aggregate market capitalisation declined only by 23% to Rs. 1859 billion. The bulk of this differential (56.5-23 = 33.5%) is due to the increase in the sheer quantity of shares.

By September 12, 1994, the Sensex scaled a peak of 4643, up by 134 %. But the aggregate market capitalisation rose even more steeply to Rs. 5,518 billion.

A CMIE (1995) study on Initial Public Offering (IPO) points out that average annualised returns obtained from issue date to list date by IPOs was 339%. But these returns fade away with time, so that after one-month of listing, they drop to 256%. Annualised

returns after three months fell to 206% and subsequently to 120% after one year from listing. Returns on IPOs are also highly volatile in the first few days of listing. By the end of sixty days from listing, the volatility drops to 25% of what it was in the first ten days of listing.

The study showed that the low P/E group outperformed the high P/E group in terms of returns in both the periods. During the bearish period they provided a negative return of 18% against a steep fall of 37% in the high P/E group.

Nagaraj (1996) identifies that capital market growth has changed domestic financial savings composition from bank deposits to shares and debentures, without favourably influencing domestic savings rate. Equity capital's share in the total market mobilisation declined, as bulk of such mobilisation is in the form of debt securities.

Financial Express (1997) study attempted to measure the returns which shareholders have obtained in the post-liberalisation period from various companies.

Roshan Jain (1996) raises the question whether one should invest in companies with a low price-earning ratio (P/E ratio) or a high P/E ratio. The objective of the study was to find out the returns if one had invested in either companies with low P/E or high P/E with Rate of Return (IRR) method, which measures all the inflows and outflows from a given share investment over a period. The study was based on all the listed companies at the BSE. Two periods were taken, the bullish phase from Nov. 1, 1993 to Nov. 30, 1994 when the Sensex rose from

relationship between major economic indicators and stock market

2648 to 4124 and the bearish phase of the year 1995 when the Sensex fell from 3910 to 3110. The factors considered are inflation, money supply, and growth in GDP, fiscal deficit and credit deposit ratio. To

find the trend in the stock markets, the BSE National Index of Equity Prices (Natex) which comprises 100 companies was taken as the index. The study shows that stock market movements are largely influenced by, broad money supply, inflation, C/D ratio and fiscal deficit apart from political stability. The study showed that the low P/E group outperformed the high P/E group in terms of returns in both the periods. During the bearish period they provided a negative return of 18% against a steep fall of 37% in the high P/E group, when the Sensex fell by 20.46%. During the bullish period, when the Sensex rose by 55.74%, the low P/E group provided a return of 122.09%, whereas the other group provided only 86.21%.

primary share issues made in the past two years. The study is based on primary share issues. A Financial Express (1997) study attempted to measure the returns which shareholders have obtained in the post-liberalisation period from various companies. The mission was to study the performance of some of the biggest and best run companies and to find out the investor-friendly ones. The technique used is the Internal Rate of Return (IRR) method, which measures all the inflows and outflows from a given share investment over a period.

Debjit Chakraborty (1997) in his study attempts to establish a relationship between major economic indicators and stock market

behaviour. It also analyses the stock market reactions to changes in the economic climate. The factors considered are inflation, money supply, and growth in GDP, fiscal deficit and credit deposit ratio. To find the trend in the stock markets, the BSE National Index of Equity Prices (Natex) which comprises 100 companies was taken as the index. The study shows that stock market movements are largely influenced by, broad money supply, inflation, C/D ratio and fiscal deficit apart from political stability.

A Finance Ministry study (1997) reveals a complete collapse of primary share issues made in the past two years. The study is based on primary share issues made by 2,012 companies between April 1994 and March 1996, of which 1,450 companies had been trading below their par value. Besides, 903 companies were trading below Rs.5/- per share. The study shows that the total loss at current price (taken in Oct. 1996) over the highest price recorded by these companies is about Rs.14,000 crore. Shares of 825 of these companies are traded very infrequently and many of them are not being traded at all.

Gupta (1997) deals with the problem of the prolonged and unprecedented stock market depression. The important question raised is why the market forces on their own are not able to correct themselves the Indian Stock Market? The study brings together

In most cases the pricing was manipulated by merchant bankers who were keen to somehow sell the issue to the public.

the price-earning ratios (P/E ratio). The study revealed that Indian shares were never so cheap over the last ten years as today.

According to a study, released by the CMIE (1997), in the first three-quarter of 1996 - 1997 till December 1996, public issues as a percentage of total funds mobilised, were down to 57%. The study

further illustrates that the proportion of rights issues was down to 16% during the first three-quarters of the 1996-'97 from 21% in 1995-

96. a number of studies on the different aspects of capital market

there is no specific comprehensive study on the attitudes, aspirations and perceptions of individual investors. The present study is an

attempt to fill this gap to a certain extent. With an objective to judge, what kind of issues from the primary market have provided returns to the investors, CMIE

analysed the returns of a random sample of rights issues. This

analysis clearly brought out the point that judicious investments do provide returns. The majority of the rights offerings, which have

given positive returns, outperformed the market.

Gupta (1997) deals with the problem of the prolonged and unprecedented stock market depression. The important question raised is why the market forces on their own are not able to correct themselves the Indian Stock Market? The study brings together

several aspects of the problem viz., the features of Indian trading system, the attitudes of retail investors and the long-term changes in the price-earning ratios (P/E ratio). The study revealed that Indian shares were never so cheap over the last ten years as today. The study also highlights the importance of the retail investors and the need for their adequate protection.

The review of the available literature shows that although there are a number of studies on the different aspects of capital market, there is no specific comprehensive study on the attitudes, aspirations and perceptions of individual investors. The present study is an attempt to fill this gap to a certain extent.

CHAPTER III

CAPITAL MARKET IN INDIA