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Research on the Indian Capital Market: A Review

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ABSTRACT

In this paper we present a review of research done in the field of Indian capital markets during the fifteen years from 1977 to 1992. The research works included in the survey were identified by two search procedures. Firstly, we wrote to 118 Indian university departments and research institutions requesting information on the works done in this field in their department/ institution. After three reminders, we obtained responses from 53 institutions. Simultaneously, we searched through various Indian journals in our library, located books listed in the library catalogue and traced through the list of references provided in various research works.

KEYWORDS Capital, Sensex, Natex, Indian stock market

Introduction:

A review paper on research done in any field invariably presents considerable difficulties. What comprises research? What should be the period of review? What should be the objective of a review? How does one ensure the coverage is comprehensive? It is clear that such questions as above are bound to generate varied answers. The difficulty of the task increases manifold in Indian conditions where institutional addresses are difficult to obtain at one place, ready bibliographies are rare, referencing in published research is hardly comprehensive, and reprints are difficult to obtain. We would therefore begin by briefly outlining the basis on which the review of research on Indian capital markets has been done in this paper.

Research Definition

It is not our objective to debate about what kind of work can be regarded as "research". For the purpose of the review, research has been defined as doctoral dissertations, papers published in academic journals, books (including expository, but excluding obviously popular books) and working papers or occasional unpublished papers (where such information was available) on Indian capital markets. We have not reviewed articles published in the popular media such as financial dailies, business magazines and other popular magazines and journals. We have also excluded dissertations for master's degrees, reports of government committees or commissions, seminar and conference papers. We have also largely excluded publications in foreign journals. It is possible that, in the process, the list of works reviewed may have excluded some excellent works published in popular media or included some sub-standard works published in academic journals. This narrowing of the coverage of the review on the above lines became necessary when we realized that it would be a truly Herculean task to include every kind of published and unpublished work on the Indian capital markets in and outside India.

Valuation of Stocks and Functioning of Indian Stock Market

The work in this area can be classified into three broad strands: a) those dealing with functioning of securities markets and financial institutions operating in these markets, b) those pertaining to the investment decision making process of individuals, and c) empirical work on Indian stock markets. One of the early works on functioning of stock markets and financial institutions was by Simha, Hemalata and Balakrishnan (1979). Bhole (1982) wrote a comprehensive book on the growth and changes in the structure of Indian capital markets and financial institutions. The book was subsequently updated and revised in 1992. Several books have been written on security analysis and investment in Indian stock markets: Bhalla (1983); Jain (1983), Sahni (1986), Singh (1986); Chandra (1990a), Raghunathan (1991), Avadhani (1992); Yasaswy (1985, 91, 92a, 92b) and Barua et al (1992). These books are primarily written for initiating lay investors to techniques for security analysis and management of investment portfolios. Basu & Dalal (1993), Barua & Varma (1993a) and Ramachandran (1993) have critically examined various facets of the great securities scam of 1992. Several studies, for example, Sahni (1985), Kothari (1986), Raju (1988), Lal (1990), Chandra (1990b), Francis (1991a), Ramesh Gupta (1991a,c, 1992a), Raghunathan (1991), Varma (1992a), L.C. Gupta (1992) and Sinha (1993) comment upon the Indian capital market in general and trading systems in the stock exchanges in particular and suggest that the systems therein are rather antiquated and inefficient, and suffer from major weaknesses and malpractices. According to most of these studies, significant reforms are required if the stock exchanges are to be geared up to the envisaged growth in the Indian capital market.

In his recent book, L.C. Gupta (1992) concludes that, a) Indian stock market is highly speculative; b) Indian investors are dissatisfied with the service provided to them by the brokers; c) margins levied by the stock exchanges are inadequate and d) liquidity in a large number of stocks in the Indian markets is very low. While evidently a painstaking work, the conclusions except `c' above seem to be built on wrong or questionable arguments. Mayya (1977), Barua and Raghunathan (1982) and Prabhakar (1989) examined empirically the hedge provided by stocks and bullion against inflation. These studies found that while gold provided complete hedge against inflation, silver and stock were only partial hedges against inflation. Rao and Bhole (1990) arrive at a similar conclusion about stocks. However, as these works pertain to the period prior to the booming 1980's and 1990's, the conclusion that stocks are not an inflation hedge is of doubtful validity today. A similar study covering the more recent years would be very useful as one may reach a very different conclusion. With a booming stock market since the second half of eighties and the stagnation in the international price of gold, such a study may find that stocks and not gold provide complete hedge against inflation.

The issue of inflation hedge has also been researched in the context of stocks. Varma (1991) compares the BSE National Index (Natex) which comprises 100 scrips with the Sensitive Index (Sensex) comprising 30 scrips and concludes that the Natex is a sluggish index which responds too slowly to market conditions. Changes which are reflected in the Sensex on any day are completely reflected in the Natex only by the next day. He finds that Sensex is more volatile than Natex. He concludes for this and other reasons that those who follow the Natex because of its greater comprehensiveness and theoretical ap-

peal may be mistaken. The Sensex needs to be taken more seriously as a sound market index.

These issues call for further research, especially since such questions have been raised by many, including the SEBI of late. On whether SEBI has been successful in improving the functioning of Indian stock markets, the conclusions are mixed. Francis (1991b), Barua (1993)). Dhillon (1993), in his doctoral dissertation studies the regulatory policies of Bombay Stock Exchange (BSE) over a four year period (July 1986 - June 1990). His findings show that regulatory authorities decide changes in their margin policy on the basis of market activity. He finds that the margins are prompted by changes in settlement returns, price volatility, trading volume and open positions. Granger causality results show that there is limited causality in the reverse direction: margin changes do not affect returns, and have only a limited impact on price volatility, trading volume and open positions. Event study methodology applied to daily margins show similar results, except that daily margin on sellers do not appear to be affected by market variables. Further, there is also evidence of under margining leading to excessively levered positions, thereby increasing the insolvency risk. The above results reveal that regulations through these instruments have had only a marginal impact on the dual objectives of controlling market activity and insolvency risk.

Very little theoretical work has been done in the field of equity valuation in the Indian context. Even when some work has been done, it is a mere extension of the well known works of Modigliani and Miller. For example, Raghunathan and Varma (1991) provide a reasonably comprehensive valuation model which captures most of the complexities and subtleties of real world. The model is capable of supporting both the Gordon and MM type assumptions about the investment policy of the firm. It allows for personal taxes with differential tax rates for dividends, interest, and capital gains. The model also takes into account flotation costs on debt and equity. Further, unlike other models which define capital gains as increase in the book value which in turn equals retained earnings, this model interprets capital gains as increase in the market value of the share. Finally, the model is modified to take into account the fact that inflation erodes the real value of the firm's assets, particularly the net monetary working capital.

Some of the other theoretical works on valuation pertain to the Indian debentures and bonds with unspecified conversion terms. These are discussed under the section on the valuation of bonds and debentures.

There are several empirical works pertaining to the pricing of equities. Pandey (1981) examines the impact of leverage on equity prices and concludes that Modigliani-Miller hypothesis is not supported. However, the risk proxy used in the paper, namely, coefficient of variation of net operating income, is highly questionable. Zahir and Yakesh (1982) find the dividend per share to be the most important variable affecting the share price, followed by dividend yield, book value per share, dividend coverage and the return on investment, in that order. Balakrishnan (1984) also finds that the current dividend and book value per share are more important determinants of market price as compared to earnings per share and dividend coverage.

Valuation of Bonds, Convertible Debentures and Market for Debt

In developed economies, bond markets tend to be bigger in size than the equity market. In India however, corporate bond market is quite small compared to the size of the equity market. One of the main reasons for this is that a large part of corporate debt, being loan from financial intermediaries, is not securitised. The picture however is undergoing a sea change in the last few years. An increasingly larger number of companies are entering the capital market to raise funds directly form the market through issue of convertible and non-convertible debentures. The deregulations on interest rates in the new liberalized environment is also resulting in innovative instruments being used by companies to raise resources from the capital markets.

While a variety of work has been done on convertible and non-convertible debentures, in view of the sea change in the regulatory regime, a fair amount of past work is only of historical significance, providing little guide to what kind of situation would prevail in the future. This has become a very critical area of research in Indian capital markets. Barua et al (1994) undertake a comprehensive assessment of the private corporate debt market, the public sector bond market, the Government securities market, the housing finance and other debt markets in India. The paper is mainly a diagnostic study of the state of the Indian debt market, recommending necessary measures for the development of the secondary market for debt. It highlights the need to integrate the regulated debt market with the free debt market, the necessity for market making for financing and hedging options and interest rate derivatives, and tax reforms.

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