CHAPTER I
INTRODUCTION

The investor population in India\(^1\) has increased substantially during the last two decades. These investors can be categorised based on their size of investment, the frequency of investing etc. Of these, those who are more vulnerable to or more affected by risk are the small and the occasional investors.

An investor in the securities of corporate firms, unlike the buyers of marketed goods and services, cannot examine directly the firm in which he invests. He can only observe its financial statements. To some extent the information contained in the published statements of firm and share valuations depend on the accounting processes of firms.\(^2\) If financial information supplied by firms is deficient in critical respects, the investment choice of persons and the market prices of securities will be based on fiction rather than on facts.

Investor’s confidence is an essential pre-requisite for the growth of capital markets. Confidence gets generated only if both the primary and secondary markets are efficient and transparent in their functioning and the interest of the investors is fairly protected by a rule based regime through well developed in-built control mechanisms or regulations by appropriate bodies.

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\(^1\) Markets: The Economic Times, Feb 18, 1997, p.12. Though no accurate official estimate of the number of investors has been made so far in the country, it can be placed around 50 million.

Till recently, most of the financial products launched in India were company driven, with the investor taken for granted. This was working well only till recently. In the long run, an investor driven marketing strategy may be necessary, failing which the financial sector will lose most of its small investors as it happened in the consumer goods markets.

The initial generation of investible resources takes place in the primary market. For the growth of investment, it is essential that this market is fair to the contributors of resources. Investors should gain the confidence that they are not being cheated and that their interest is fully protected except for the business risk borne by them. This lack of trust was reflected in capital market operations during the year 1997-98 which exhibited subdued conditions.

SOME RECENT TRENDS IN THE CAPITAL ISSUES MARKET

The number of equity issues declined substantially from 1598 issues in 1995-96 to 805 issues in 1996-97, to 89 issues in 1997-98. Of this, rights issue were 41 and remaining 48 issues were made by issuing Prospectus. The amount of capital raised through the issue of equity shares amounted to Rs.1162.4 crore in 1997-98 as compared to Rs.6116 crore in 1996-97 and Rs.11997.3 crore in 1995-96. Thus, there was a decline of 90.31% and 49.02% in 1997-98 and 1996-97 respectively as compared to 1995-963.

There was also a decline in the amount of capital raised through the issue of debentures but the decline was not steep when compared to equity issues. It declined from Rs.3970.1 crore in 1995-96 to Rs.1971.6 crore in 1997-

98. The decline in equity issue was 90.31% and that in debentures was 50.3% as compared to the corresponding amounts in the year 1995-96. One reason attributable to investors preferring debentures could be the assured returns on debentures and decline in capital value appreciation in the equity market during this period.

The public sector private placement market however flourished during 1997-98 as corporate entities raised substantial resources, especially through fixed income securities. The amount of capital mobilised through this market by public sector companies increased from Rs.12,573 crore in 1996-97 to Rs.18,370 crore in 1997-98. Thus, the amount of capital raised in the equity market and private placement market was in the ratio of about 6:94.

The primary market remained depressed throughout 1998-99 due to cautious attitude both by the investors and corporates. Thus the major factors contributing to a dull capital market were the reduced demand for funds from corporates, lack of investor support and enhanced private placement activity.

The performance of mutual funds other than the Unit Trust of India (UTI) also remained discouraging. UTI mobilised Rs.2119 crore in 1997-98 as against a reverse flow of funds of Rs.3043 crore in 1996-97. The total amount mobilised by mutual funds was to the tune of Rs.3,305.4 crore in 1997-98.4

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4 As against a reverse flow of funds of Rs.1811.3 Crore in 1996-97. The public sector mutual funds were reported to have had a short fall of Rs.1331 crore on their assured return schemes which has to be made good as at the end of 1998. The Economic Times, 17.5.99.
INVESTOR RISKS AND THE REGULATIONS

The form in which a person's wealth is held is a consequence of choice, whether the choice is exercised by analysis and deliberation or by simple inertia. The process of choice itself represents the selection among alternatives of a specific course of action having future consequences. If the choice has to be other than random, an actor will require to appraise the expected future consequences of alternative courses of action. The object of any choice is the attainment of some specific end, or in most cases, the attainment of several specific ends jointly. But as choice is always directed towards a future period of time of which the chooser has uncertain knowledge at the time of choice, the consequences and effects which are the ends of choosing are beliefs or expectations only. However carefully a course of action may be chosen, therefore, there always exists the possibility of "risk" that the expected consequences of a choice may not be justified by subsequent events.

For an investor to choose assets in regard to expected risks and return, he must first perceive differences among the assets in at least a risk-return space.

An investor, while investing in the shares of a company, does so with certain expectations about the performance of the company, the prospects of income from the investment and/or the capital growth of the securities that he

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6 Ibid p.68.

holds and the corporate benefits that accrue to him. While making this important investment decision, he must have taken note of and duly evaluated the corresponding risks that go with such expectations.

One such risk is that the expectations of the investor on income and/or growth of the securities may not materialise. He may face the risk of losing the initial investment also. Also, in order to realise the value of such securities, the only recourse may be the market. On the other hand, if he invests in debt instruments, he has recourse against the company, then there is the market and also a time for redeeming them. Apart from these major risks, an investor also faces the risk of running into problems with the trading and transfer of securities. With the growth of the intermediate institutions in the markets and the onset of deregulation, there has been a corresponding loss in the moral intimacy between the client and the firm.

The investor, in order to take these risks boldly and to make an intelligent choice of investment, needs adequate information on certain aspects which may include the past performance of the company, the future expectations as well as a justification of the risk factors as perceived by them. "The conditions to be satisfied are that any investor shall be able to have similar and up-to-date knowledge of all firms in which he may invest, and that the financial statement on which investors depend shall be intelligible to anyone who knows what economic resources and legal rights are". It is known that no one can safely buy or sell securities without having an intelligent basis

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honest publicity... Delayed, inaccurate and misleading reports are the tools of unconscionable market operator". In practice, of late, it has been found that the information disclosed by many companies are grossly inadequate and misleading. At the New York Stock Exchange (NYSE) one hundred and fifty senior people spent two to three days each quarter at a conference centre for over a two to three year period, assessing and identifying the ethical standards of capital markets. It was felt that no one can operate or serve the market ethically without Integrity, Excellence, Respect for people and Sensitivity to customers. These values must permeate all levels and operations of the investment industry. Mr. Phellan believes that "a truly ethical person observes a stricter sense of standards than merely legal ones".

Companies, while inviting capital have the duty to disclose all material facts so that investors would have a better idea of factors that might affect the value of their investments. Investors have the right to know what they are buying before they actually buy. Companies, therefore, have a moral duty which has been translated into a legal duty by various regulations to disclose material information. Fraud, either by conveying false information or by silence can lead to vigorous prosecution and imposition of heavy penalties by the courts. It is also felt that small investors are unable to clearly understand the complicated or technical language in which Prospectus is presented. Companies, therefore have an obligation to see that their communications are clear and accessible to both the small and the professional investors.

Though investors consider all the information as provided by the company to fulfil the SEBI requirement of information disclosure, there are other factors that are also taken into consideration which does not fit into any logical explanations. This is especially true in the case of small investors who in most cases blindly follow the bigger or professional investors. Gustave Le Bon observed that when investors form a group, they do not act very rationally. The most striking peculiarity of the crowd, according to him is that "whoever be the individual who compose it, however like or unlike be their mode of life, their occupation, their character or their intelligence, the fact that they have been transformed into a group puts them in possession of a sort of collective mind which makes them feel, think and act in a manner quite different from that in which each individual of them would feel, think and act were he in a state of isolation".

Financial cannibalism takes place on a massive scale wherein promoters of worthless stock take possession of vast wealth and employ all means of high-pressure salesmanship at their convenience.

This is what happened in the Indian stock market during 1992 when the prices of shares doubled and quadrupled. The BSE Index soared from 1900 to 2300 and onto 4300 without any logical reasons for the rise.

An example may be mentioned here. Karnataka Ball Bearings - a Company whose share was quoted in the low 20's for a long time. Sparked by a rumour that the big bull of the time, Harshad Mehta was buying the shares, the price rose to Rs.60, then Rs.68 and went upto Rs.180 all in a matter of 10 days. When it was heard that the rumour about Harshad Mehta's interest in
the share was false, the price plunged to Rs.50 in 4 days. The price had risen on the flimsiest of excuses and the crowd comprising of otherwise intelligent, logical and rational human beings acted mostly irrationally and illogically.

This sort of a behaviour among the investors was evident whenever political uncertainty threatened the sensex in the stock markets. This has also resulted in the individual investor choosing at least to partially divert his funds to institutions for administration on his behalf viz., the mutual funds.

This diversion also reflects the feeling that he lacks the requisite portfolio management expertise, that necessary information on companies he might invest in is not available to him on the same basis as it is to the professional, that the commitment of time and energy needed to become both informed and skillful is great or that transactions cost for the investor is excessive.

The information group on primary market under the chairmanship of Shankar N.Acharya suggested the institution of improved institutional arrangements including stringent testing requirements, adoption and strict enforcement of disclosure norms and standardisation of accounting norms in line with Generally Accepted Accounting Principles (GAAP) and the introduction of safety net/exit options in order to revive investors' confidence in the market by ensuring transparency and facilitating investor discipline.\textsuperscript{10}

\textsuperscript{10} Reserve Bank of India Bulletin, June '97 p.80
The group suggested that a company going for public issue should not have any outstanding warrants or preference shares. The auditors should be made accountable for the information certified by them. Intermediaries must be made strictly accountable for defaults by client issues with SEBI\textsuperscript{11} being empowered under the Act to blacklist individuals. The cost of equity issues should be reduced by popularising book building, reducing the number of mandatory collection centres, mandating the offer through depository and printing the application form in newspapers. The concept of 'at par' should be dispensed with in respect of the equity shares.

It is also suggested that, "the market should be the major factor in deciding which businesses... and government receive capital and which products or services are funded. If all works well, society’s objectives for fairness in allocating capital, stability and opportunity for gaining wealth in conjunction with the right of private ownership are presented\textsuperscript{12}.

Proper definition and measurement of risk are the basic problems in understanding investment risk. Although risk is relevant to the uncertainty of future events, and more risk implies more uncertainty, risk is a personal concept reflected by the view point of a particular investor.\textsuperscript{13}

\textsuperscript{11} Discussed later in Chapter IV.


This necessitates an understanding of the perception of the investor about the risk associated with an investment, his expectations from the investment and his general demographic characteristics to get a sharper picture. There is an ongoing evolution in the thinking among the investment professional on how best to serve the individual investor.

In this context, this study will have a positive value because of the dearth of knowledge surrounding the Indian investor. It will also help in filling the gaps in the existing literature dealing with Indian Investors.

LITERATURE REVIEW

Going by the past literature on this subject it may be said that investor behaviour as a subject of research commenced about three decades back and the different aspects especially how an investor makes the decision, individual investor's attitudes and personality have been examined. There are also several studies on capital market regulations. Besides, the subject of 'risk' - its identification, measurement and role in decision making has always remained elusive and researchers have approached both quantitative and behaviour approaches in this process. In India where the phenomenon of shareholders and their behaviour has not been felt for long - partly because of the government regulated industrial investment regime atleast upto 1990 and it is only after that a process of liberalisation and privatisation began. The literature review as such has to be mostly based on the studies done in the Western countries. Much has to be done about the investors in India and it has to be done in the context of existing regulations, the need for expanding the investor base and the changing capital market. Chapter II is therefore devoted
for presenting and reviewing of the relevant past literature and it may be said here that the present study will be useful in understanding some aspects of the investor behaviour in India.

NATURE OF THE PROBLEM

The nature of the problem essentially is what makes an effective communication but this is to be examined in the context of understanding the risk and the decision to invest in shares. What is that a prospective investor looks for or what piece(s) of information clicks the decision? While information cannot be condensed, elaborate explanations amount to information overload. There are many pieces of information other than what is (statutorily required to be) published which might influence the investment decision. Professional money managers often seem to make up their minds in a split second, but what pushes them over the line of decision is an incremental bit of information which, added to all the slumbering pieces of information filed in their minds, suddenly makes the picture whole.¹⁴ There is also a possibility of information deliberately or unintentionally leading to misleading information and there may be a problem from the user's side - one may also by his own conviction rely on certain aspect only. There is also another basic problem viz whether information can be used to evaluate risk or take affordable risk at all. No amount of information will be useful to a person who is not prepared or who cannot afford more than natural risks. If one strongly believes in astrology as is the case with many in this country, it also makes much of the information redundant!

INFORMATION, RISK AND INVESTMENT DECISION

Cognitive psychologists and artificial intelligence experts have determined that people have very limited capabilities for processing information. While a few of these studies have involved business executives, it is known that when anyone is faced with choosing among a number of alternatives described in terms of several attributes, only a few attributes are considered.\(^{15}\) In an investment decision, it would be useful to know how many factors or attributes are taken into account. Furthermore, it would also be useful to know which factors are considered more important than the others, and how they are combined to reach an overall choice. If only one factor is considered, does expected income from the investment or some chance of loss of the investment dominate? How much attention does expected return receive compared to variation in returns? Do gains or losses serve as focal points?

At the time of choice the appraised prospects of securities which are evaluated are subjective and are expectations. In conjunction with one's present preference for the variety of prospects offered by securities, they are the criteria of investment choice. But they are subjective and transient. They are an incident in a continuing stream of feelings and experiences, continually influenced by the diversity of forces to which an individual himself is subject. They are a product of his perceptions.\(^{16}\)

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Perception stems from knowledge and experiences of events and things. It follows that success in investing is a function of knowledge and judgement rather than of knowledge alone. Judgement aids in perceiving more interrelationship or to perceive given relationships more clearly. "Preliminary judgements... are made without all the facts being written down and analysed. It is easy to say that they are based on 'hunch', and leave it at that. But a hunch may not be something plucked out of thin air; it may be the result of a great deal of subconscious sifting of ideas, information and experience".17

Whether information is regarded as the basis of investment decisions or as the basis of experience by which the judgements of investing persons will be improved, continuously up-to-date and relevant information remains practically necessary to successful investment choice and adaptation.18

Investor protection is fundamental for the healthy growth of the capital market. Protection is not to be conceived of as a system which guarantees to an investor that his investment will not diminish in value or that the return on his investment will remain assured for all time.

An investor who enters the capital market, and particularly the equity market, must understand that there are risks that are inherent in the very nature of the market. If he wishes to secure the benefits provided by the market, he must also accept these risks. Investor protection, however, demands that the potential investor is provided with all the information that is

18 Smith R.G.E, op.cit p.75.
necessary to make an informed investment decision - taking into consideration the risks and the benefits of the proposed investment. Adequacy of disclosure, thus, becomes the cornerstone of a healthy capital market.

The role of the regulatory agencies, both in India and abroad, in ensuring adequate disclosure of information to the prospective shareholders has also been elaborately studied.

OBJECTIVES OF THE STUDY

The broad purpose of the study is to probe into the risk related information in an investment decision. The communicability of the correct and relevant information is important. Information overload also disturbs the investor's assessment of risk and his attitude towards risk-whether he is a risk taker or avoider is also relevant here.

The specific objectives of the study are:

1. To examine the regulations and guidelines relating to share issues in general and those pertaining to transparency in providing information in particular;
2. To explain the information which may be considered to be relevant or irrelevant in the assessment of risk.
3. To find out the types of information that are associated with high/low risk; and
4. To explain the perceptual selectivity in the information-risk association in the investment decision process.
For this kind of problem, the primary data are to be collected from investors and since people perceive the same information differently, a variety of interpretation is possible. An appropriate tool should help to select the most relevant type of information that most investors take into account for decision making. The existing legal regulations may be also evaluated in this context.

METHODOLOGY

a. DEVELOPMENT OF THE QUESTIONNAIRE

A structured questionnaire which requires the questions to be asked with exactly the same wording and in exactly the same sequence for all the respondents was used for this study.

The questionnaire consisted of three sections - section A through C. Section A consists of 25 statements which are some typical types of information given by companies in their advertisements inviting investment in shares. These are also the items of information required to be given by SEBI guidelines relating to issue of company shares. There are two parts in this section. In the first part, the respondents are asked to state whether the information is relevant or not in an overall investment decision. In the second part, the respondents are required to state the level of risk as perceived by them in each information from 'very high risk' to 'very low risk' on a 5 point Likert scale, irrespective of the relevance or irrelevance of the statement in making the investment decision.

The five-point Likert Scale is used because this technique measures the intensity of feelings. The respondent is usually asked to indicate his feelings
on a five-point scale ranging from strongly agree to strongly disagree. The
Likert technique produces an ordinal scale that generally requires non-
parametric statistics. This scale is highly reliable when it comes to a rough
ordering of people with regard to a particular attitude or attitude complex.

Section B contains ten general statements about risk and the respondent
was asked to mark their responses which varies from 'strongly agree' to
'strongly disagree'. These statements are not basically technical but a sort of
common sense questions.

Section C was designed to obtain certain personal information like
occupation, amount of investment in shares in the last three years, source of
obtaining information and whether he invests through secondary market also.

This information was collected to relate the above three demographic
characteristics of the investors with their varied perceptions. In order to
ensure that the investors were objective in their responses they were assured
of anonymity and their names or any other personal identity was not sought.

Ordinal scales have been incorporated in the questionnaire used for this
study. Whether it is to determine the degree of risk as perceived by the
investor in each piece of information given about the company or for assessing
their general perception about risk, respondents have been asked to give their
ratings on a pre-determined scale.

The questionnaire was initially pre-tested on a sample of 10 investors.
The pilot study was used to simplify the language of the questionnaire by
eliminating ambiguous terms, jargons and to prune the questionnaire. The questionnaire so arrived/formed was again tested on a sample of 25 investors. At this stage, the importance of language was recognised and the questionnaire was translated into Tamil to ensure that the respondents understand the questionnaire in the sense as it was originally meant. While distributing the questionnaire, the respondents were given the option of choosing one of the two languages with which they felt comfortable.

b. SAMPLE SIZE

The sample for the study consists of mostly ‘small investors’ - including those who invest occasionally, rely mostly on the information provided by the company and who do not have the expertise or resources beyond a certain level. At the same time, they were people who had been ‘in the market’ to have developed both a behaviour pattern and experience from which to respond. All the respondents were from the city of Madras (now Chennai) selected on a convenient sampling basis.

The sample size was primarily designed to cover 350 investors. In deciding the sample size, the fact of non-response had to be taken are of. In order to cover the non-response 500 questionnaire were issued.

Of the 500 questionnaires issued, 340 filled in questionnaires were collected back. Out of this 340 questionnaire 13 had to be discarded as unusable. Finally, 327 valid questionnaires formed the sample for this research study.
c. **TOOLS OF ANALYSIS**

The present study uses a series of simple quantitative analytical techniques, supplemented with qualitative comments. The use of quantitative techniques has been selective. The objective in using some of them has been to draw insights into the investor's perception about risk from the information made available to him.

The techniques used include:

a. Simple mean score for the various statements of information presented to the investors;

b. Weighted average score to identify the degree of risk attached to each of these statements;

c. Tests of significance (Chi square test) to examine whether there is any significant difference in the perceptions of investors based on their demographic characteristics; and

d. Factor Analysis to identify the factors

**Factor Analysis**

Factor analysis is a procedure that takes a large number of variables or objects and searches to see whether they have a small number of factors in common which account for their inter-correlation. Factor analysis has a number of possible applications which include data reduction, structure identification, scaling and data transformation.
Factor analysis can be used for reducing a mass of data to a manageable level. It reduces the attributes studied into a minimum number of factors that underline the attributes. These attributes can then be used in further analysis in place of the original analysis. The assumption is that at least some of the measures then finds the underlying structure of the redundancy by placing the measures on underlying factor or dimensions.

A researcher may wish to develop a scale on which subjects can be compared. A common problem in developing scales is in giving weights to the variables being combined to form the scale. Factor analysis helps the process by dividing the variables into independent factors. Each factor represents a scale measure of some underlying dimension. Further factor analysis gives the weights to use for each variable when combining them into a scale.

Further, in this study, the perception of investors with regard to the risk associated in investment in shares is not quantifiable in absolute terms. That is, they do not lend themselves to precise measurement like, for e.g., the sales turnover of a company, its profitability etc. Instead, these perceptions can be thought of as unifying constructs or labels that characterise responses to related groups of variables.

This will be evident after the responses to these statements across various respondents suggests that there is a strong correlation within each of the factor groups and each factor is clearly discriminant from one another. Hence for the present study on risk perception of investors, factor analysis technique is adopted.
SCOPE AND LIMITATIONS

The present study's main concern is about small and medium investors. David L. Scott\textsuperscript{19} in "Wall Street Words" defines small investor as a person of modest financial means who occasionally buys and sells securities, generally in relatively small amounts. A similar definition could be used to define the subjects of this study also.

In the Indian context, it may be further described as follows. A person who has acquired in about 10-12 years movable assets worth Rs. 5 lakh might have invested approximately 60\% in Jewellery, 30 - 35\% in Fixed Deposits (Banks), Annuities (Insurance) and another 5-8\% in Fixed Income Securities (Bonds) and the balance of 5-8\% in shares and stocks. Thus, a small investor, on a rough estimate, is a person who is likely to invest upto about Rs. 25-40 thousand in shares but his total investment in selected movable assets may be in the range of Rs. 5 lakhs. For him the major portion of investment is something else and certainly not shares or even bonds. The recent issues of bonds of Rs. 1000 each by IDBI prescribes that the minimum subscription should be for 5 bonds (at 14.5 \% interest). This is obviously aimed at making the issue attractive to 'small investors'.

Essentially, they are people who invest only occasionally and rely on the information they personally gather through newspaper advertisements and other published sources and seek professional or expert advise before making the investment decision if the costs are minimal. While examining the

relevance of information and the perception of risk in those information that is usually given by companies is alone considered.

The items of information presented to respondents were collected from a fairly large number of advertisements, application forms and abridged prospectuses.

The present study is subject to the following limitations:

1. The data for study was collected during 1997-98 when the capital market was sluggish.

2. The study is confined to the investors in the city of Madras (now Chennai) which is one of the four metropolitan cities in India. The findings must, therefore, be generalised with necessary caution.

3. The inferences on relevance of information and the related questions are based wholly on the perceptions of the investors. The opinions of the other two related groups, namely the companies making the issue and regulatory authorities are not sought.

4. The definition of the small investor is also hypothetical in nature. No official definition exists for this purpose. More than the size their "occasional investment in small sums" characterise this population.
CHAPTER ARRANGEMENT

The present study is presented in seven chapters as described below:

CHAPTER I: INTRODUCTION

The Introductory chapter presents the major focus of the study and its contemporary relevance. This is followed by a brief literature review, description about the nature of the problem, objectives of the study, methodology followed by scope and limitations of the study.

CHAPTER II: REVIEW OF LITERATURE

This chapter deals with past studies made in this area of research. It includes studies on capital market regulations, individual investor’s attitudes and personality and identification and measurement of risk.

CHAPTER III: RISK AND INFORMATION: SOME THEORETICAL ISSUES

Chapter III begins with the definition of risk for practical purposes and examines the nature of adequate information, incomplete information and information overload on the one hand and how risk is perceived in such a context on the other. The theoretical foundations that lead to identifying, evaluating and responding to risk are briefly examined.