CHAPTER 1
INTRODUCTION

The dynamism of the emerging business environment demands the explicit recognition and management of risks especially in the field of corporate securities. A few decades ago investing was the sport of a privileged few. Today, it is a national pastime. Everything in today’s fast paced world is proved to change, and that includes the world of securities. With the opening up of the Indian Stock Market to foreign institutional investors and the entry of public and private mutual funds in a big way, the equation of investment has undergone far-reaching changes. The Indian markets are increasingly exposed to global influences, which have increased its volatility.

Money and material prosperity are the means to the basic happiness of a man. Wealth is like the Holy Grail. Man has searched for it for centuries and the quest continues today which is the engine for risk taking and risk containment. The surplus money is not meant for just ‘savings’, but to participate in the wealth creation process. Well-managed savings can contribute to the earnings and so everyone has to adopt a scientific approach to savings, its investment and risk management. The investors have realised that there is no short cut to acquiring money.
Properly managed investment in equities will always give higher returns than any other form of investment, though they are volatile in the short run. Ultimately every investment carries an inherent risk of failure. Stocks as a class have been considered the most risky financial instrument, as there are continuous ups and downs in the market. At present there is rigorous transformation in the capital market. The professionals are getting into the stock game. Also, the markets are getting institutionalised. A dynamic business environment has made future outcomes in the market unpredictable and risk has become an inherent part of it. ‘Risk’ can be defined as the volatility of expected future outcomes. The greater the volatility of expected returns, the greater is the risk. The essence of risk management is to reduce the volatility of these future outcomes.

Investors have to bear a certain degree of risk to earn reasonable returns. The value maximisation involves both returns and risks and a balance between the two. When the risk must be borne, prudence lies in the reduction of the area of uncertainty within which an investor is operating. Because of the growing complexity of operations in the stock market investors would have to rapidly equip themselves with a variety of knowledge, intensive skills and
appropriate techniques of risk management. Risk management has become imperative for operations in the capital market.

**Problem in Brief**

Risk taking is integral to any investment decision especially investment in corporate securities. Investors make investments in corporate securities expecting a fairly reasonable return by way of capital appreciation and dividend. There is a fair chance of investors’ expectations being fulfilled on many occasions. However, the market is vicious. World wide events affect domestic interest rates and domestic economic activity, movements in exchange rates can suddenly change the competitive position of corporates. Inflation and interest rate fears bring the market down. If the economy shows signs of slowing down, the market obviously comes down too. The crisis ridden Indian market seems to be under siege on all fronts. The Indian market in a situation of crunch can suddenly turn turbulent and trap the investors. Panic can set in and drive investment values down for an entire market without any fundamental economic cause other than the simple fear that ‘the market will go down further’. Also, the volatility of the markets is an accepted phenomenon, as high growth begets high volatility.
It is almost impossible to predict the day-to-day prices of stocks and it is even harder to decide when to buy, hold or sell. Despite much mathematical analysis, there is no way to know the level of risk associated with a scrip. There is no perfect model to predict accurately the price of any stock to help in precise buy and sell decisions. It is very difficult to determine whether a fall in prices is a temporary or permanent situation. Further more, equity investments need time to blossom. In this scenario perception and management of risk becomes crucial for investors.

Today, the stock market is dominated by generally clueless investors. They are irrational and invest in securities without retrospective and prospective analysis of risk factors. Most investors fail in the stock market because they let their emotions drive their actions in the market. People muster enough courage to invest in the stock market only after the prices have been rising for sometime. Most of them do the worst thing-they could buy high and sell low. The relevance and importance of risk management becomes clear in this context. The absence of a well-laid down risk management mechanism and clearly understood risk appetites can pull down an investor without having an idea of how and when to come to terms with losses.
All these show the need for a different perspective and an environment where risk elements are to be explicitly recognised, measured and accounted for and managed. No studies have been conducted in the state of Kerala with regard to the above aspects of investment. At this juncture the analysis of management of risk factors by investors in Kerala will be ameliorating and enriching the investors and other operators in the stock market. It will facilitate them to understand the complications of the operations in the stock market, to resolve their problems and to become more confident, diligent, and flourishing and hence the study is relevant.

Objectives of the Study

Following are the important objectives of the study.

1. To study the nature and significance of various corporate securities.

2. To study and evaluate the existing theories and techniques of evaluating securities.

3. To study the various types of risks and hazards of investing in corporate securities.

4. To study and evaluate the methods and practices adopted by investors to counter total risk and its factors.
5. To study the role of Securities and Exchange Board of India (SEBI) and stock exchange in protecting the interests of investors and redressing their grievances.

6. To study the criteria for investment decisions.

7. To make recommendations on the basis of the study.

Hypothesis

The following hypotheses were developed for the purpose of the study.

H1. : The capacity to bear risk depends on the gender.

H2. : Investors depend wholly on the capital market for their livelihood.

H3. : There is no gender difference in dealing with political risk.

H4. : Political risk being taken into consideration at the time of investment decision and the loss incurred due to political risk are independent.

H5. : Portfolio diversification and attainment of expected rate of return are independent.

H6. : Applying stock evaluation theories is not effective in attaining the investors' expected rate of return.
H7. : There is no gender difference regarding investment in the secondary market.

H8. : Age of Investors and investment in the secondary market are independent

H9. : With increase in experience in the stock market operations, people tend to speculate..

H10. : The diversion of funds from the stock market and the objectives of investment are independent.

H11. : There is no difference between primary market and secondary market regarding the diversion of funds from the stock market.

H12. : Diversion of funds from the stock market has no association with the type of share in which investment is made.

H13. : Most of the speculative transactions result in loss.

H14. : Youngsters are more involved in speculation than the old people.

H15. : Involvement in speculation and diversion of funds from the capital market are independent.
Variables studied

The dependent and independent variables of the study are listed below:

<table>
<thead>
<tr>
<th>Dependent variable (DV)</th>
<th>Independent variable (IV)</th>
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<tbody>
<tr>
<td>1. Capacity to bear risk</td>
<td>gender</td>
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<td>2. Precautions to cover political risk</td>
<td>Experience in stock market operations</td>
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<tr>
<td>a) No activity</td>
<td></td>
</tr>
<tr>
<td>b) Wait &amp; watch</td>
<td></td>
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<td>c) Panic selling</td>
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<td>3. Loss due to political risk</td>
<td>Management of political risk</td>
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<td>4. Expected rate of return</td>
<td>1. Diversification</td>
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<td></td>
<td>2. Theories of evaluation of shares.</td>
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<td>5. Investment in shares</td>
<td>Experience</td>
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<td>6. Investment in secondary market</td>
<td>Gender</td>
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<td>7. Investment in secondary market</td>
<td>Age</td>
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<td>8. Deciding factors of investment in shares</td>
<td>Experience</td>
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<td>a. Management of the co.</td>
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b. Earning Per Share

c. Dividend

d. Track record price

9. Type of share selected

a. Highly volatile shares

b. Growth shares

c. Less volatile shares

d. Income shares

10. Diversion of funds from the capital market

1. Objectives of investment

a. capital appreciation,

b. liquidity,

c. dividend,

d. safety)

2. Investment in the primary and secondary markets.

3. Type of share in which investment is made.

Database and Methodology

The required data for the conduct of the study was collected from primary and secondary sources. Primary data was collected through personal interview with the investors. Stratified random
sampling and multi-stage random sampling methods were applied in the selection of 300 respondents comprising the cross section of the population. A structured interview schedule was prepared for collecting the information.

The secondary data for the study was collected from the published journals and magazines like the stock journal of the Cochin Stock Exchange, The Capital Market, The Investment Week, the Business World etc., publications of Securities and Exchange Board of India and dailies like the Business Line and The Economic Times etc.

Survey Design

For the purpose of the study a sample of 300 investors were selected at random from the state of Kerala by dividing the state into three zones namely, The North zone, The Central zone and the South zone. From the North zone of the state, the districts of Kozhikode, from the Central zone, the district of Ernakulam and from the South zone the district of Thiruvananthapuram were selected for the reason that most of the investors are residing in these districts. Seventy-five respondents were selected from the districts of Kozhikode and Thiruvananthapuram each. From the district of Ernakulam 150 respondents were selected, as there is concentration of investors in and around Ernakulam because of the presence of the Cochin Stock Exchange.
Pilot Study

The first step in the process of the data collection was a pilot study. For this, 25 investors from the district of Ernakulam were selected and a questionnaire was issued to them to fill in duly. An informal talk was also held with these investors. On the basis of the pilot study, necessary modifications were made to the questionnaire and then it was finalised. The pilot study also envisaged an insight to conduct field survey for collecting primary data.

Collection and Analysis of Data

The collected data were edited, coded and then entered into a master chart by the investigator. MS Excel programme was applied for achieving the same. Each item of the data was strictly checked for its accuracy before being entered into the master chart. Tables were prepared and using these as the guidepost, the data were analysed with reference to the objectives and hypotheses of the study. Care was taken to employ the analytical tools depending upon the type of the data. The tools applied in the present study are chi-square distribution test and correlation. Statistical Program in Social Science (S.P.S.S.) has been used for the analysis.
Resume of the Work Done

Following is the summary of the work done.

a. Analysis of the profile of investor respondents

b. Analysis of the effect of experience of investors in the stock market operations on investment decisions.

c. Participation of investors in stock market operations

d. Reasons for not actively operating in the stock market

e. Management of risks by investors - political risk, bad delivery, delayed delivery and delayed payment, risk of odd-lots, default risk, Inflation risk, market risk, vanishing companies finance short sale, etc.

- Evaluation of budgets, diversification, application of theories.
- Revision of portfolios, seeking advice from brokers, attending meetings, etc.

f. Investor Protection

g. Analysis of criteria for investment decisions.

Reference Period

The reference period of the survey is one year commencing from first October 1999 to 30th September 2000.
Concepts and Definitions used in the study

*Bear* – A bear is a speculator who takes a pessimistic view of the future. He sells shares with the hope of buying them later at lower prices.

*Bear market* - A bear market is a falling market, which is characterised by a lot of bear activity.

*Blue Chips* - Large technologically advanced companies having high reputation.

*Bull* – A bull is an optimistic speculator who buys shares in the hope selling them later at a higher price.

*Bull market* - A rising market.

*Capital market* - A market for raising funds for capital formation and investment. It refers to a market for long-term capital. Capital market consists of -

a) Primary market (Market for new issues) and

b) Secondary market (Market for old issues)

*Carry forward/badla*- The facility of postponing a transaction till the next settlement day by paying badla charges.

*Corporate securities* - The securities issued by the joint-stock companies in the private sector. These include equity shares, preference shares and debentures.
Cyclical companies - Companies, which are cyclical in nature. They benefit or suffer from economic conditions.

Derivative instruments - A derivative is an instrument whose value is derived from the value of underlying assets which can be commodities, currency, stocks, stock indices, etc.

Default risk - Company's failure to pay principal or interest on debentures, deposits, etc.

Dematerialisation - Conversion of physical certificates into electronic form.

Fundamental Analysis - An approach adopted by investors for taking investment decisions. The fundamentalists try to estimate the intrinsic worth of a share by evaluating a lot of information about the past performance and expected future performance of companies.

Growth Companies - Growth oriented companies, having a proven record of growth in the past, like drugs, electrical, electronics, etc. They are most likely to grow in the future also.

Hedging - A mechanism to reduce risks.

Investor - An investor commits his funds for a longer period and waits for his return.
**Long and short positions** - Indicate whether you have a net overbought position (long) or oversold position (short).

**Market capitalisation** - The combined value of all securities listed in a particular stock exchange on a particular date.

**Market risk** - Risk due to investors' reaction to price sensitive events.

**Margin money** - A deposit against a possible future loss of value.

**Portfolio** - A collection of securities held together as investment.

**Regulator** - The body authorised to regulate the capital market and to protect the interests of investors - SEBI is a regulator.

**Risk Management** - The process of identifying and evaluating risks and selecting techniques to adapt to risk exposures.

**Risk Premium** - The reward for holding the risky portfolio rather than the risk free asset.

**Random theory** - (Efficient market theory). According to this theory, a change occurs in the price of a stock only because of certain changes in the economy, industry or company. Information about these changes alters the stock prices immediately. This theory presupposes that the markets are efficient and competitive.

**Rolling settlement** - Under rolling settlement, the settlement period is reduced to one week.
Speculators - Those who aim at profit from price changes in the short-term.

Technical analysis - Used for taking investment decisions by predicting the future price of a share on the basis of a study of price movements in the past. Technical analysts use charts and graphs of price movements.

Volatility - Rapid change (in prices)

Nature and Significance of Corporate Securities

Corporate securities constitute the medium of raising the capital, which is required for a joint stock company. The securities are classified into

(1) Ownership securities and (2) Creditorship securities.

Ownership securities consist of

(a) Equity shares and (b) Preference shares.

1. Ownership Securities

(a) Equity Shares

Equity represents an ownership position in a corporation. It is a residual claim in the sense that creditors and preference shareholders must be paid as scheduled before equity shareholders can receive any payment. Risk is highest with equity shares and so must
be its expected return. When investors buy equity shares, they receive certificates of ownership as proof of them being part owners of the company. There has been a great demand for shares of companies with growth prospects. The main advantages of investing in equity shares are listed below.

1. Potential for profit

The potential for profit is greater in equity shares than in any other investment in security. Current dividend yield may be low but scope of capital gain is great.

2. Limited liability

In corporate form of organisation, its owners have, generally, limited liability. They are not further liable for any failure on the part of the corporation to meet its obligations.

3. Hedge against inflation

Equity share is a good hedge against inflation though it does not fully compensate for the declining purchasing power. But, when interest rates are high, shares tend to be less attractive and prices tend to be depressed.
4. Free transferability

The owner of shares has the right to transfer his interest to someone else. The buyer should ensure that the issuing corporation transfers the ownership in its books so that dividend, voting rights and other privileges will accrue to the new owner.

5. Share in the growth

The major advantage of investment in equity shares is its ability to increase in the value by sharing in the growth of the company profits over the long run.

In the security market, equity shares are the most romantic of all the form of securities. The attitude of investors to equity shares has varied from extreme pessimism to optimism from time to time.

b. Preference shares

Preference share is a hybrid security that is not heavily utilised by corporations as a means of raising capital. It is hybrid because it combines some of the characteristics of debt and some of equity. A preference share represents a particular portion of the share capital, which has been endowed with certain preferences and limitations. The usual preferences given to the holders of preference shares are the following.
1. Preference as regards income

The preference shareholders have a priority claim over the earnings of the company. The ordinary shareholders cannot be given any dividends unless the specific rate of dividend is set apart for the preference shareholders. The preferential claim may be cumulative or no cumulative.

2. Preference as regards assets

Preference shares always involve preference as to dividends but not necessary as to assets. Where preference as to assets is not specified in the Articles of Association of the corporation, the assumption is that preference shareholders will have no prior claim over and above the ordinary shareholders as regards the distribution of assets at the time of the company’s liquidation. Preference as regards assets enables the holder to have his capital returned from the company at the time of liquidation before the ordinary shareholders put forward their claims.

3. Preference as regards conversion

The idea of conversion privilege is usually to give protection to the preference shareholders in the early life of the company with an opportunity in future to enjoy the results of its success. It affords an
opportunity to the preference shareholders for the retirement of their shares through conversion into ordinary shares.

4. Preference as regards redemption

When the preference shares are redeemable at the option of the issuing company, they are known as redeemable preference shares. They are a good source for raising semi-permanent finance. The issuing company can take the advantage of low money market rates because the preference shares with high rate of dividend can easily be redeemed when the money market rates are favourable.

2. Creditorship securities

Creditorship securities, represented in the form of debentures and bonds, have got a definite and significant place in the financial plan of a company. A debenture may be regarded as an acknowledgement of a debt by a company, usually issued under common seal and it may be unsecured or secured by a fixed or floating charge on the assets of the company. Debentures and bonds have a great significance in company finance. Through debentures the corporation is enabled to have the capital without giving any control to their holders. There is a certainty of finance for a specific period and the company can adjust its financial plan accordingly. An opportunity
is provided to the corporation to trade on equity and thus increase the return for equity holders.

There are individuals and institutional investors who by their very temperament prefer to minimise risk. For them the security of capital is more important than the uncertain high rate of return on capital. Such investors always prefer debentures to other assets. The debentures have a great market response during depression or when the possibilities of inflationary profits are rare.

Limitations of the Study

It is observed during the survey that some of the sample respondents were reluctant to give correct information. Therefore the analysis suffered from non-sampling error.

Since it was a qualitative study, quantification of data became a difficult task.

It is, but natural that any research investigation suffers from certain, limitations especially when the answers are the subjective response of a group of people on whom the market sentiments have a powerful influence. People are generally not willing to co-operate with such studies when they themselves are innocent victims of scams or sluggishness of the market.
Further, the study is limited to the risk management of equity shares only due to the voluminous nature of the topic.

Despite the limitations, the study will be very useful to investors, brokers and other players in the market.

**Presentation of the study**

The present thesis is organised in six chapters including the introductory chapter, which describes the objectives, methodology, hypotheses set, the variables studied, the limitations of the study, etc.

The second chapter describes ‘risk management’, its objectives and importance. It also explains the risk management in the Indian scenario.

An account of the available literature on risk management is included in the third chapter.

The next two chapters comprise the analysis of primary data, their results and interpretations. The sixth chapter contains the findings and conclusions of the study and suggestions to protect the interests of investors and to revive both the primary and secondary markets.
Footnotes


2. Ibid


4. Ibid

5. Ibid.