The Retail Investor as Anchor*

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2015 has not been a good year in India's stock markets. The Sensex, for example, has declined from a high of around 29,680 in late January to a low of around 25,200 in early September. Despite evidence of fluctuations, that was a reflection of poor performance. There is broad agreement that a pullout by Foreign Institutional Investors (FIIs) was responsible for the decline. FIIs (as a group) which pumped as much as $27 billion in the form of net investment into the markets over the year ended 19 September 2015 (as compared with $21.5 billion over the previous year), pulled out $3.1 billion over the period since August 1. That this underlies the market decline seems to be the dominant view.

What is less commented on, though recognised, is the fact that the recent decline in the Sensex would have been much greater but for a contrary entry of domestic, especially retail, investors into the market. The ownership of domestic investors in the equity of BSE 500 companies stood at Rs. 19.21 lakh crore (around $300 billion at Rs. 64 to the dollar) at the end of June 2015, as compared with Rs. 17.96 lakh crore ($280 billion) at the end of March. Over this period, FII equity holding in the BSE 500 companies fell from Rs. 19.78 crore ($309 billion) to $19.4 crore ($303 billion). Of the increase in the domestic ownership of equity in these companies, while domestic financial institutions accounted for around Rs. 75,000 crore (taking their share in equity of the BSE 500 to 11.1 per cent valued at Rs. 10.5 lakh crore), that of retail investors rose by as much as Rs. 52,000 crore, taking their share as a group to 9.2 per cent (valued at Rs. 8.73 lakh crore). Thus domestic investors in general and retail investors in particular, did help shore up markets.

In the event, domestic investors now own 20.2 per cent of the BSE 500 companies, surpassing the previous high of 20 per cent at the end of the March 2010 quarter. Domestic ownership of the country's top listed companies was up 1.34 per cent over the April-June quarter, which was the sharpest incremental rise in domestic participation since the quarter ended September 2008. In contrast, foreign investors seem to have turned bearish. The effective foreign institutional investor (FII) ownership in BSE 500 companies declined to 20.4 per cent at the end of the June quarter from 20.8 per cent in the previous quarter. This is contrary to the long term trend in which over the more than 10 years from the quarter ended March 2005 to that ending June 2015, while FII holding in the BSE 500 had gone up from 14.2 to 20.4 per cent, that of domestic investors had only risen marginally from 19.6 to 20.2 per cent.

Much of the recent inflow of domestic investment into the equity market is occurring through the mutual fund route, with net purchases by such funds totalling Rs. 22,121 crore during April to June 2015 and as much as Rs. 46,760 crore during April-August 2015. The point to note is that mutual fund mobilisation and investment has been erratic. Interestingly though the number of mutual funds has risen sharply since 1986-87 (till when the only one in existence was the Unit Trust of India), and there was some increase in funds mobilisation by mutual funds during the early 1990s, mutual fund activity got a substantial boost only in the years since 2003-04, when stock market activity picked up and the market was on average buoyant. But even after that there was much volatility in the mobilization by mutual funds net of redemptions, with the figure being negative in at least three of the years. Further, according to RBI figures, mutual fund mobilisation equalled or was 2.5 to 5.3 times total mobilisation of capital from the primary market during the three years ending 2014-15. Since not all primary market purchases are accounted for by mutual funds, this implies that the ratio of mutual fund investments to contribution of mutual funds to purchases from the primary market is likely to have been even higher. What this suggests is that, while retail investor participation through mutual funds has probably increased to an extent, this intermediation route takes their capital more to the secondary rather than the primary market.

This suggests that rather than serve as a check on irrational investing by retail investors, institutions such as mutual funds exploit any spike in retail investor activity to increase their assets under management (AUM) and their own revenues. Thus, for example, between April and August 2015, while corporate performance was weak and expectations of performance depressed, small investors had, possibly in response to falling gold prices and depressed real estate markets, been putting their savings into equity mutual funds, which in turn were investing that money in the stock market. Between March and July 2015, investors have poured in Rs 45,127 crore into equity mutual funds. As a result, over April to August, equity mutual funds had invested Rs 39,205 crore in the stock market, whereas Foreign Institutional Investors, who have been driving the stock market for the last few years, had been net sellers who sold stocks to the tune of Rs 8,950 crore during those months.

This evidence is surprising and goes against the idea that retail investors are almost missing from Indian equity markets. A 2012 study by the Indian School of Business estimated that there were around 2.02 million retail investors in India, which was small relative to the Indian population (0.2 per cent). However, this was still a large number of retail investors even when compared with the US (1.24 million) and Japan (1.17 million).

Other evidence shows that retail investors constitute a miniscule share of the population. Thus a study by Sankar De, Naveen R. Gandhi and Subrata Sarkar (2011), using a database covering transactions of all 755 stocks traded on the NSE between January 1, 2005 and June 30, 2006 found that the number of retail investors who engaged in at least one trade in this 18 month period was 25 lakh or 0.22 per cent of the Indian population.

Moreover, retail investor activity appears to be on the decline. The ratio of retail turnover to total turnover has actually declined from over 80 percent in 2003 to under 36 percent in 2013-14. The fall has been particularly sharp in the years after the global financial crisis.

What seems to emerge, therefore, is that retail investors are erratic in behaviour, entering the market at times when stock prices are rising and exiting well after those prices have peaked. It almost appears that retail investors respond with a lag to rising prices and returns in markets, and exit for long periods when the markets experience a downturn. This would imply that losses are substantial.

This could underlie the kind of behaviour noted in the study by Sankar De, Naveen R. Gandhi and Subrata Sarkar (2011), using a database covering transactions of all 755 stocks traded on the NSE between January 1, 2005 and June 30, 2006. The study concluded that (i) retail investor behaviour in India was characterised by two significant biases, termed the ‘disposition effect’ and ‘overconfidence effect’; and (ii) this resulted in them incurring losses over the January 1, 2005 to June 30, 2006 period, with trading losses alone placed at Rs. 8,376 crore, and losses including commissions, transactions taxes, etc estimated at Rs. 20,700 crore.

The ‘disposition effect’ is reflected in the tendency for investors to sell assets in which they have registered gains and hold assets in which they are making losses, in the hope that they would register profits in time. This tendency is reinforced by the ‘overconfidence effect’, reflected in the tendency to recognise gains and feel proud about successful trades, but ignore losses and believe that holding on to a loss-making stock would eventually result in gains, once the distortions that neutralised expected gains disappear.

It must be noted, however, that while the first of these biases would be reflected in the transactions data, how the second ‘psychological’ or ‘sociological’ bias has been identified is unclear. But, what this evidence suggests is that retail investors follow the market, whether investing directly or adopting the mutual fund route, and tend to be erratic because their investments lag so much that they often obtain low returns. So there may not be any basis for the expectation that participation of retail investors would transform equity markets and enable them to perform their presumed functions better. Secondly, while the kinds of measures adopted by SEBI and other agencies to address the shortcomings of markets are indeed welcome, there do seem to be fundamental difficulties in designing measures that successfully incentivise consistent retail investor participation in markets. Thirdly, this supports the view that in the long run retail investors would in all probability expose themselves to the market largely through institutional devices such as mutual or pension funds. However, there is no guarantee that such institutional intermediation would necessarily serve them well.

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