INDIAN HOUSEHOLD INVESTORS SURVEY – 2004

The Changing Market Environment
Investors' Preferences
Problems
Policy Issues

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Conducted by:
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PREFACE

1. Investor protection is as important an issue in India today as it was in 1980s and 1990s but the whole complexion of the problem has changed.

2. The structure as well as the functioning of the Indian securities market has been transformed beyond recognition since the 1990s. The profile of the investing public, the investment choices available, the market environment and the nature of problems bothering the investors are substantially different today from what they were 10-20 years ago.

3. The Ministry of Company Affairs had sponsored this massive study under the Investor Education and Protection Fund (IEPF) with the object of creating a deeper understanding of the ordinary investors' concerns, problems and needs. The study provides a firm foundation of facts for formulating policies for the protection and promotion of the small investors' interest. It will hopefully be of wide interest to all those interested in the development and reform of the Indian capital market.

Acknowledgements

4. The idea of this study originated in the course of my discussions with Dr. (Mrs.) Sheela Bhide, formerly Joint Secretary in-charge of IEPF, and Ms. Sucheta Dalal, well-known investigative journalist and writer. We have

received staunch support and valuable guidance from Mrs. Komal Anand, Secretary, Ministry of Company Affairs. She has taken keen personal interest in the study and is particularly eager to expand investor education programmes countrywide.

5. We are grateful for the kind help provided by Mr. Y.S. Mallik who succeeded Dr. (Mrs.) Bhide as Joint Secretary, in-charge of the IEPF. We greatly appreciate the encouragement and many useful suggestions offered by members of the IEPF Committee.

6. The distinguished members of the Society's Board of Governors have taken keen interest in this study. I had the benefit of their valuable comments and suggestions on the interim findings of the survey. I am specially indebted to Chairman Dr. Abid Hussain for being always ready to spare his valuable time for the affairs of the Society and to muster support for it.

7. The success of the massive household investors survey 2004, the largest ever of its kind, owes much to the dogged perseverance shown by our interviewers, who were mostly drawn from teachers / researchers at Universities / colleges and other professionals. It was because of their patience and persuasiveness that we were able to collect private financial data from households. There exists widespread reluctance to provide such private information to any outsiders. This is a

well-known problem in this kind of surveys. Almost 200 interviewers were involved. We owe sincere thanks to them.

8. Every completed questionnaire was scrutinised to identify deficiencies, inconsistencies, etc., and to get them rectified. About 10% of the questionnaires had to be rejected due to deficiencies. This work was looked after by our Senior Research Associate Mr. Sachit Gupta and by Data Supervisor Mrs. Raksha Sharma. The massive task of data entry and processing was carried out very ably by Research Associate Ms. Poornima Kaushik, Computer In-charge Ms. Monika Chopra, and Mr. Manoj Tyagi, Computer Operator. The entire Computer Programming for the project was done with great ingenuity and versatility by Mr. Utpal K. Choudhury. Both Ms. Poornima and Ms. Monika displayed great patience in preparing the tables, charts and several drafts of the Report. Mr. Manoj and Mr. Jayprakash Narayan looked after the heavy postal work. The excellent cooperation extended by all staff members lightened my burden.

9. A final word of disclaimer. The responsibility for the facts presented and the views expressed in this report is entirely that of the undersigned and not that of the Ministry of Company Affairs who had sponsored the study.

L. C. GUPTA
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ACRONYMS

AMFI	Association of Mutual Funds in India
BSE	Bombay Stock Exchange
B/S	Balance Sheet
CDSL	Central Depository Services Limited
CEO	Chief Executive Officer
DP	Depository Participant
DTCC	Depository Trust and Clearing Corporation
EPFO	Employees Provident Fund Organisation
EPS	Earning Per Share
FERA	Foreign Exchange Regulation Act
FFS	Flat Fee Structure
FII	Foreign Institutional Investor
GDP	Gross Domestic Product
GOI	Government of India
HNI	High Networth Individuals
IDBI	Industrial Development Bank of India
IEPF	Investor Education and Protection Fund
IPO	Initial Public Offering
MCA	Ministry of Company Affairs
MF	Mutual Fund
NAV	Net Asset Value
NCAER	National Council of Applied Economic Research
NSDL	National Securities Depository Limited
NSE	National Stock Exchange
OECD	Organisation for Economic Co-operation and Development
P/E Ratio	Price to Earnings Ratio
PSU	Public Sector Undertaking
SCMRD	Society for Capital Market Research and Development
SCRA	Securities Contracts (Regulation) Act
SEBI	Securities and Exchange Board of India
SEC	Securities and Exchange Commission
SHCIL	Stock Holding Corporation of India Limited
US-64	Unit Scheme - 1964
UTI	Unit Trust of India

Indian Numeral Terms Used

1 crore = 100 lakh = 10 million

100 crore = 1 billion

EXECUTIVE SUMMARY

Object of study

1. The present study attempts to deepen our understanding of the household investors' problems, needs and concerns regarding investment in capital market instruments in particular. Our findings have a bearing both on investor protection and on capital market's development. The study provides a firm foundation of facts, thereby facilitating a clearer understanding of problems. This will help in the formulation of appropriate policies and regulatory measures. The size of domestic population of stock market investors in India has stagnated for the last 5-6 years. The RBI data on household financial saving also shows that there has been a steady decline since 1992-93 in the percentage of saving flowing into private sector shares and bonds and even mutual fund units. Recognising the problem mentioned above, the Ministry of Company Affairs decided to sponsor this wide-ranging survey of household investors under the Investors Education and Protection Fund (IEPF).

Methodology and sample

2. The study is based on direct interviewing of a very large sample of 5908 household heads. Rigorous checks have been employed for ensuring genuineness and reliability of data. Among such checks was the use of two partially overlapping questionnaires, i.e. Questionnaire-1 filled through personal interview and supplementary Questionnaire-2 sent by post, along with Business Reply Envelope, directly to every interviewee at his/her residential address. A little over 200

interviewers, spread over about 90 cities/towns and across 24 states/union territories, were involved in the interviewing work.

Sample Households' Profile

3. In India, investment decision-making for the household, in the sense of nuclear family, lies primarily with the household head, directly and indirectly. A nuclear family, comprising husband, wife, children and other dependents, is the economic unit for the purpose of this survey. The Median monthly income of sample households is Rs. 15,070, Lower Quartile is Rs. 9,390 and Upper Quartile is Rs. 22,630. By and large, the sample comprises middle and upper-middle class households. They belong to a wide cross-section of occupations and are geographically dispersed all over India.

Probing the retail investors' worries

4. The study begins with an enquiry into the investors' biggest worries. Our questionnaire, addressed to household heads, provided a list of possible worries or concerns in order to identify their most important worries about the stock market. The policymakers and regulators need to be sensitised about the investors' worries. We have ranked the various worries in terms of the percentage of respondents identifying each worry. Such data enables us to determine the relative importance of each worry from the household investors' viewpoint.

5. The retail investors' greatest worry, which was identified by the highest percentage (around 30%) of our respondents, is "too much price volatility". The classification by income and age shows very high consistency of the data. The biggest worry of households in all income classes and all age-classes is found to

be the same with only a slight variation in the percentages. The second biggest worry is “too much price manipulation”. Nearly 1 in every 5 respondents was worried by too much manipulation, indicating rampancy of market manipulation. The third one is “corporate mismanagement / fraud”. About 1 in every 6 respondents was worried about corporate mismanagement and fraud. Closely competing for the fourth place are the worries relating to “unfair practices of brokers” and “too much insider trading”.

6. A comparison with the earlier surveys of 2001 and 2002 clearly suggests that price volatility, price manipulation and corporate mismanagement/fraud have persistently been the household investors’ top three worries in India.

7. **Notably, price volatility and manipulation, taken together, are the cause of worry for as many as 50% of respondents according to our surveys. Hence, the matter deserves serious consideration.**

8. These problems get manifested in the erratic behaviour of the secondary market. Such market behaviour has the effect of discouraging or even driving away the genuine investors from the market. The Indian secondary market has been notorious for speculative excesses. Rampant price manipulation and high volatility are rooted in excessive speculative tendencies.

9. **For the genuine long-term investors, too much volatility is a nightmare which disheartens them. That is why it is their**

most important worry even though Indian policy making and regulatory authorities tend to play it down.

Investors' perceptions about corporate governance

10. A large percentage (around 50%) of respondents had a negative opinion about company managements**,** around 30% had a positive opinion and a little above 20% answered "can't say". The negative opinions far exceed the positive ones for the sample as a whole as also for every income/age class. In other words, the number of households who have trust in company managements is far less than those who have no trust. This is so in every income-class and every age-class.

11. The household **investors' opinion is dominantly negative about company auditors too.** Again, this is true for every income-class and every age-class.

12. However, some hope is raised by the finding that more than one-half of the respondents were positive about the current efforts being made to improve corporate governance, even though tangible results have yet to be achieved.

13. In our opinion, since the typical Indian listed company is family-controlled, the corporate governance reform should be designed to deal with this specific Indian situation. Indian authorities have borrowed the definition of independent directors from U.K. and U.S., but have not ensured that such directors will be truly "independent of management," i.e. the controlling group in the Indian context. The so-called

independent directors have to depend on the controlling group for being nominated to the board. How can such directors be truly “independent of management”, to whom they are obliged for being elected to the board and on whom they depend for continuing as director? The recent *White paper on Corporate Governance in Asia,* prepared by the OECD, has strongly recommended that **“the legal and regulatory framework should ensure that non-controlling shareholders are protected from exploitation by insiders and controlling shareholders”, and that preventing such exploitation is “the most serious corporate-governance challenge.”**

Delisted companies

14. Most of the companies delisted by stock exchanges in India were due to violation of the listing agreement, implying corporate misgovernance. Our survey has attempted to find out the extent to which delisting of companies by Indian managements has affected the household investors. Our finding is that well over one-third (38%) of the respondents were shareholders of delisted Indian companies. The number of delisted companies is as high as 2000-2003, in addition to the Z-group companies.

15. Companies already delisted fall outside the SEBI’s regulatory authority. The respondents to our survey have many complaints against delisted companies. Of the respondents who held shares in delisted companies, 80% complained that such shares are unsaleable, 60% complained that share value had been

destroyed, 53% that these companies don't pay dividend and 63% that such companies do not send annual reports.

16. As mentioned earlier, 38% of our sample households held shares in delisted companies. Applying the same percentages to the total number of share-owning households in India means that around 30 lakh households would be having shares of some delisted companies. This is a frightening figure. Many of these would be dud companies, but not all.

Mutual funds as product innovation

17. Mutual funds were undoubtedly an important product innovation in the financial field. Historically, mutual funds, originally called unit trusts in the U.K., were invented for the mass of relatively small investors. However, a striking finding brought out by this study is that **a majority of retail investors in India do not regard mutual fund equity schemes as a superior investment alternative to direct holding of equity shares.** This is brought out very clearly by our analysis of investor preference from several different angles. For example, it was found the **percentage of households who owned equity shares directly is more than 2½ times the percentage of those who owned any mutual fund schemes.**

18. An investment game designed by us brought out that, of the available amount, the proportion allocated to direct ***equity* shareholding was nearly four times of the proportion allocated to mutual fund *equity schemes* and twice of the proportion allocated to all types of mutual fund schemes**

combined. Only the government savings schemes had a higher allocation than direct equity shares. Bank fixed deposits are also a highly preferred type of investment but less preferred than government savings schemes. There are very few takers for non-govt. company bonds. Bonds of PSUs and financial institutions are far more preferred than private sector bonds.

19. Our analysis shows that the mutual fund industry in India is an under-developed segment of the Indian financial markets. Mutual fund **equity schemes have accounted for well below one-fifth of total assets under management of mutual funds in India. The Indian mutual fund industry as a whole holds just around 2% of the market capitalization of listed equity shares. Households in India directly hold an average of 15% or perhaps more of the quoted equity. These macro figures tell us that mutual fund cult has yet to catch up in India.**

20. The income funds represented the largest component of mutual fund business in India since 1999 till recently. These funds have generally accounted for over 50% of the total mutual fund assets, except in 2004. Balanced funds accounted for around 25% of total assets in 1999 but declined steadily to just around 15% in 2002; and thereafter, they have been reduced to only about 3% because of winding up of US-64 scheme, which was by far the single largest balanced fund in Indian mutual fund industry.

21. A major shift in the MF industry's focus is represented by the rise of Liquid / Money Market Funds from the level of only about 2% of the total assets of Indian MF industry in 1999 to 40% in September 2004, becoming the largest chunk of mutual fund assets. The liquid funds cater mainly to the needs of corporate clients and high networth individuals. **Retail investors overwhelmingly prefer bank deposits rather than liquid / money market funds.** According to our household investors survey of 2004, only 3-4% of retail investors showed interest in liquid funds and around 5% in gilt funds, but these investors were prepared to invest no more than 1% of the total available sum in liquid / money market funds. Such funds are a substitute for bank fixed deposits.

22. The data compiled by AMFI indicates that **the mutual fund industry has shifted its focus towards corporates and high networth individuals and away from the retail investors. The reduced relative importance of retail business in the total MF business is explainable partly by the retail investors' disenchantment with mutual fund products and partly by business compulsions of the mutual fund organisations.**

23. Investors in mutual funds have been discouraged by nasty surprises many times since mid-1990s due to managerial incompetence, malpractices and frauds. The biggest shock was the US-64 crisis which caused heavy and widespread losses. Some foreign-sponsored funds under world-renowned managements, which had raised great expectations, proved to

be a flop. Many mutual fund managers trade too much. Too much churning of portfolios does not necessarily result in higher returns because of brokerage and other costs and lack of a long-term approach. Secret sharing of commissions between fund managers and market intermediaries is not unknown. The IT boom of 1999-2000 showed how mutual fund managers were as much susceptible to herd behaviour as the ordinary investors. Of course, some equity schemes have given excellent performance but these are relatively few.

24. A subtle point brought out by our analysis is that retail investors are not sufficiently familiar with mutual funds. In relative terms, there is much more unfamiliarity with mutual funds than with the share market among the retail investors.

Retail investors' share portfolio practices

25. Interestingly, the **typical extent of share portfolio diversification by retail investors lies in the narrow range of 3-10 companies' shares.** Our examination of the advantage of such narrow diversification shows it to be an "ideal diversification" for the retail investors from the practical viewpoint. Curiously, the typical extent of diversification is the same across all income classes and age-classes of our sample households. It works better than the more highly diversified mutual fund equity schemes, so much so that demand for mutual fund equity products has been seriously affected. This is an interesting finding of our study.

26. The study found that one-fifth of the sample households had only 1 or 2 companies in their share portfolio. Of course, this can hardly be regarded as diversification. Perhaps in most cases this may arise from occasional subscription to a glamorous or much trumpeted IPO. Such shareholders may not be very active investors in shares.

27. Roughly around 50% of households in all the five income classes held 3-10 companies in their share portfolios. Age-classwise analysis showed a broadly similar pattern. This suggests that the practice of **narrow diversification** (shareholding in 3-10 companies) is the dominant practice among retail shareholders in all income and age classes. Higher diversification beyond 10 companies is much less common. About one-sixth of total sample households held shares of 11-20 companies and about one-eighth of the sample held shares in more than 20 companies.

28. **Clearly, it is narrow diversification (portfolio comprising 3-10 companies) which is dominant or most popular in all income and age groups.** Even though mutual funds offer much greater diversification, most **retail investors find more advantage in direct holding of shares in a few selected companies.**

29. An important practical reason is that an average retail investor cannot effectively supervise too many companies. Further, a weighty advantage of direct shareholding vis-à-vis mutual fund equity schemes is that **direct investors do not**

have to pay the annual management fees and expenses charged by mutual funds. Such burden usually amounts to around 2.5% per annum of mutual fund portfolio value, in addition to the entry and exit loads. For the direct long-term investor, this makes considerable difference to net annual return from investment. A majority of retail investors are long-term oriented shareholders, if we exclude those who stated that they are not interested in shares for whatever reason.

30. No extent of portfolio diversification can reduce 'market risk', i.e. the whole market going up and down. However, such "risk" is turned into an "opportunity" by the mature investors practising narrow diversification. **In case of temporary fall in market prices, they buy more shares of the well-performing companies already in their portfolio, thereby reducing the average acquisition cost of the portfolio. A majority of respondents in all income and age groups have reported more satisfactory experience from direct shareholding than from mutual fund equity schemes.**

Middle-class investors: long term and conservative

31. Our findings suggest that the middle and the upper-middle class households in India are a conservative lot. It is also noteworthy that the predominance of long-term investors is significantly more in the higher income and higher age categories of household investors. On the whole, they do not generate much short-term speculative activity on the stock exchanges. Most of the speculative activity is the handiwork of stockbroking firms and market operators. A unique feature of

the Indian stock market is the power, influence and ubiquitousness of market operators. That the Indian stock market is overwhelmingly dominated by speculation is not due to the presence of middle-class investors but due to excessive proprietary trading by broking firms and market operators. SEBI should compile regular data on such proprietary trading.

32. Less than one-fifth of our respondents intended to hold shares for a **few days** only. About one-third of them intended to hold shares for **some months** but not exceeding one year. The largest proportion of our sample comprised investors who intended to hold the shares for some years.

Households' investment preferences

33. Equity share ownership had increasingly become a middle class phenomenon in India since around 1980s and received a great boost in the beginning of the 1990s after introduction of economic liberalisation. The abolition of Capital Issues Control and replacing it by a free-pricing system in 1992 opened the flood-gates for unscrupulous company promoters due to euphoric market conditions. The IPOs were lapped up avidly and indiscriminately by the investing public during most part of the period from 1992 to 1994. The widespread bad experiences led to withdrawal of the retail investors from the stock market for many years after the mid-1990s.

34. One simple measure of relative preference among various investment products is the market penetration of such products. Equity shares have achieved a much higher degree of

penetration among middle-class households compared to other capital market instruments. For example, shareowning households were nearly 74% among the sample households in the lowest income class (upto Rs. 10,000 per month), going up to more than 85% in the highest income class (above Rs. 25,000 per month). Age-class variation of sharownership among households had also about the same kind of range. Market penetration of equity shares is fairly flat across income-classes and also age-classes, showing only a very gradual rise with increase in income and age.

35. The percentage figures mentioned above are far higher than the average for the entire population which has a large component of poor and also illiterate households. To place the whole thing in a broad perspective, it may be noted that only 4-5 percent of all Indian *households* are shareowning households. Shareowning *individuals* hardly constitute 2% of India's total population.

36. The penetration achieved by mutual funds in the case of every income-class and age-class is only a fraction (one-third to one-half) compared to that of equity shares. Corporate bonds have lower penetration than mutual funds, except in the case of infrastructure tax-saving bonds among the tax-paying classes.

37. The substantial fall in interest rates over the last few years had led to a greater inclination among a majority of household investors towards equity shares, i.e. to accept higher risk in the

hope of higher return. This is clearly indicated by our survey of retail investors.

38. Our survey has revealed that majority shareowners in almost all income and age-classes have been shareowners for 10 years or more. This finding should be viewed in the context of portfolio diversification practices. The extent of **diversification does not increase beyond 10 companies for most of the investors despite their long experience as shareowners. Only in the highest income-class (above Rs 25,000 per month) and the elderly investors (over 60 years), the typical diversification of portfolios becomes 3-20 companies instead of 3-10 companies.**

39. Our survey brings out that the bulk of the present generation of Indian retail investors got their exposure to the vicissitudes of the equity market during the last 15 years, specially the 1990s. They have gone through many boom-bust market cycles and also witnessed the many incidents of market frauds and manipulative practices. While some of them became so disgusted that they vowed never to touch the stock market again, most others were less cynical and felt that it was a learning experience. They derived useful lessons and evolved practical approaches to equity investment.

40. The retail investors in India have become wiser, more sophisticated and discerning investors. They have begun to understand the amplitude and duration of the Indian stock

market's cyclical ups and downs and also the magnitude of daily gyrations. The popular TV news channels, which now regularly broadcast daily stock market report at prime time, have created greater awareness among ordinary investors about the market's behaviour and parameters.

41. **The recent boom of 2003-04 attracted the retail investors mostly as sellers rather than as buyers. Having become wiser from the mistakes of the past, the retail investors have become less gullible. They have started looking at IPOs with a magnifying glass. Very few IPOs are now able to pass muster. In recent times, a rise in the average P/E ratio to just 17-18, based on BSE Sensex and NSE Nifty companies, begins to ring an alarm bell for investors and market authorities, whereas an average P/E ratio of 30-40 in early 1990s was simplistically accepted because not many market participants understood the ratio.**

42. Retail investors have been encountering serious problems with the demat system. This has happened because the SEBI, in a hurry, made demat compulsory without giving due consideration to the realities of our socio-economic situation. The result is that India's demat system has not evolved as a voluntary business service, priced attractively for the mass of investors. It was forced down their throat. It is heavily tilted in favour of speculators and large market participants but against the retail investors. Its effect has been to gradually push out the retail investors from the equity market. The demat system was

never promoted by compulsion in the U.S. or U.K. It grew there gradually as investors became familiar with it and found it beneficial and economical to them.

43. Belatedly in February 2004, the SEBI recognised the problem of high demat charges in the case of small investors and constituted a Group on Reduction of Demat Charges. The Group recommended that the small investors should be charged on the basis of ad valorem only (instead of a fixed flat fee system) and that the charges, like account maintenance, should not be levied on small investors at all by DPs. The Group also recognised that the companies have really been the main beneficiaries of the depository system which has saved them huge cost incurred earlier on registration of share transfers. It recommended that all companies should pay a one-time fee to the Depository at 0.1% of their market capitalisation. The group's recommendations have yet to be fully implemented.

44. Not many people know *that despite the existence of the depository system in India for nearly eight years and despite demat form being made compulsory by SEBI for trading on stock exchanges, most of the small investors, who constitute the majority of shareholding population in India, have remained outside the share depository system.* This is true of many companies which have lakhs of shareholders and very active trading in their shares.

45. The number of shareholders having a depository account at the end of December 2004 is only a little over 70 lakh, whereas the total shareowning individuals in India, as per independent estimates provided by the Society for Capital Market Research and Development and by SEBI-NCAER survey, is around 2 crore. Even if we allow for some consolidation of shareholding by various members of the same family for economizing demat cost, it is reasonable to infer that a majority of individual shareowners of individual companies have not joined the depository system.

46. The Indian market regulatory authorities seem to have played down the fact that a majority of retail investors have remained outside the depository system. **No official agency has even tried to compile and provide company-wise official data on the percentage of the number of investors who continue to hold shares in the form of paper certificates and of those who hold in demat form.** The only figures being officially provided relate to the **amount** of equity share capital held in demat form and traded in demat form. The retail investors' problem has thus been swept under the carpet.

47. Our analysis shows that the single most important complaint of household investors about demat system is that **demat charges are too high**. One out of every five respondents mentioned this complaint. Households in all income and age-classes have this complaint. Notably, the proportion of complainants is distinctly higher, being 24-25%, among the elderly shareowners aged above 65 years compared to 16-17% among the young

shareholders aged 30 years or below. The annual custody and account maintenance charges penalise the small long-term holders of shares. They have the effect of squeezing them out from the equity market. This is already happening to some extent.

48. The over-all effect of the demat system has not been to attract a greater number of domestic retail investors into shareownership but the opposite. **The demat system has been very attractive to speculators and frequent traders.** For this and other reasons, the speculative trading volumes have grown enormously but the percentage of households' financial saving flowing into direct shareholding and mutual fund schemes has fallen to a negligible level.

Investor education

49. What should be the delivery mechanism and method for investor education programmes is an important problem in a vast and diverse country like India with many regional languages.

50. Most of even the educated English-knowing middle-class people are familiar only with simple forms of investments, like fixed deposits and government savings schemes. Their understanding about the share market and mutual funds is mostly poor. Hence, **investment education programmes are needed for large numbers of people across the country.**

51. The Ministry of Company Affairs (MCA) recognised this problem by giving it special attention under the Investor Education and Protection Fund (IEPF). We understand that the MCA intends to redouble its efforts in this direction. It is a laudable idea. Much more thought will have to be given in designing the content and delivery mechanism for investor education. We have elaborated it in detail in chapter 9 of this report.

52. Our survey data indicated that 68 per cent of our respondents have neither watched the T.V. programmes on investor education sponsored by the Ministry of Company Affairs nor attended any investor education seminars sponsored by SEBI. That is why we need to explore more effective ways and alternative delivery channels for investor education programmes. The internet is a potent tool for making this possible. There could be formal training “schools”, workshops, etc., based on today’s e-business model, catering to investors spread across the country.

53. It is well recognized that one should start the habit of saving and investing from early years of working life. Understandably, the first investments by a young person usually take the form of life insurance and bank fixed deposits. **One should also consider starting to invest small amounts in shares too because the returns can be higher** but learning is necessary for successful investing in shares.

54. A large number of **people lose money by investing in shares because** they may be investing at the wrong time, like the peak of a bull market, or their stock selection may not be based on sound

criteria. They may lack a historical perspective about the stock market's boom-bust characteristic and inherent volatility. Such perspective will guard the investors against being over-optimistic and will help them in evolving a sound long-term investment strategy. There is a definite **need for some formal and systematic training for investors during their working life even if they may not be investing significantly in shares at that time.**

55. **At younger age, the potential investors can be encouraged to experiment for a while taking small bets with share investment.** The young people have a long future before them. They will learn from mistakes. By the time they have grown and have substantial money to invest, they would be much better prepared for investing skilfully.

56. It is worth examining the methods adopted in the U.S. by the Securities and Exchange Commission (SEC) and by the Securities Industry Foundation for Economic Education. The SEC's Office of Investor education and Assistance organizes investors' "Town Meetings" in cities throughout the country to help the people learn how to save and invest wisely. The Securities Industry Foundation uses the novel method of Stock Market Game involving schools throughout the U.S. in a competition on fantasy stock-picking.

57. Based on the need felt by the respondents covered by our survey, we have drawn up a detailed list of topics for investor education, classified under broad heads (see Annexure to Chapter 9). We hope that this list will be very useful for the organizers of investor education programmes.

Chapter 1
INTRODUCTION

Objective

1.1 The present research study has been undertaken in order to deepen our understanding of the household investors' problems and needs. A better understanding in this regard will help in furthering the objectives of the Investor Education and Protection Fund (IEPF), administered by the Ministry of Company Affairs. The investors' problems and needs today are very different from what they were 10-15 years ago due to changes in the legal, technological and institutional arrangements of financial markets and the emergence of new investment products and sales practices.

Methodology and sampling

1.2 The investors' problems and needs can be best known from the investors themselves. Our methodology of study therefore relies primarily on in-depth interviews of investors through structured questionnaires covering a variety of interrelated aspects, such as the investor's socio-economic and financial position, including income and types of investment held, past experiences, future investment intentions, problems being felt with regard to the use of demat system, etc.

1.3 A countrywide survey of this kind is a rather difficult exercise, specially because many investors are reluctant to disclose their personal financial data to outsiders. We have tried to overcome this problem by informing the respondents that our objective is wholly focused on promoting the ordinary investors' interest and strengthening their protection, and that we are a non-profit body.

1.4 Collecting such data on countrywide basis from a large number of geographically dispersed households is a stupendous task. The data will be meaningful only if its reliability and genuineness is ensured. There have to be good built-in checks in the system of survey. We have conducted many such surveys since 1990 and have perfected the methodology. [1]

Two- stage questionnaire

1.5 The survey was actually conducted during May-October 2004 after recruiting field interviewers. A prominent feature of our method is a two-stage system of questionnaires, the first stage being a personally administered questionnaire through field interviewers, followed, in the second stage, by a differently structured second questionnaire mailed, along with Business Reply Envelop, directly to every respondent interviewed in the first stage. The second questionnaire is partially over-lapping the first as an in-built check against the possibility of fake interviewing. This, combined with several other checks, ensures a high level of reliability and genuineness of data.

Household as the economic unit

1.6 We treat the household, in the sense of nuclear family (husband, wife and dependents) as the economic unit for our purpose. The data was collected from Household Heads on behalf of the household as a whole.

[1] See L.C. Gupta, *Indian Shareowners: A Survey* (Society for Capital Market Research & Development, Delhi, 1991). The Survey covered a sample of 5822 households. See pp. 2-8.

Sampling procedure

1.7 Our sampling procedure was designed to overcome the problem due to widespread reluctance to disclose personal income and investments. To ensure near-randomness and countrywide cross-sectional representation, we have used a highly dispersed network of local interviewers, drawn mostly from college/university teachers, bank employees, and other professionals. Each interviewer was given instructions in the form of "Guidelines for Interviewers" and was to first submit 6 completed questionnaires as specimen for our scrutiny. Further questionnaires were sent to the interviewer in instalments and only if the questionnaires were being completed properly. Every completed questionnaire was scrutinised and the improperly filled questionnaires were returned.

1.8 The interviewers were required to conduct interviews in their neighborhood residential areas and not in offices. This helped to achieve more random sampling. The interviewing work often involved more than one visit to a household to suit the convenience and availability of the respondent. Given the widespread reluctance of households to disclose personal financial information, the sample covers only those households who were willing to cooperate in the survey by volunteering to provide the information required. Our method of sampling is good enough to give a feel of the entire system by covering the main stream of investors.

1.9 Admittedly, the sample does not represent the country's entire population but only the "universe of potential investors". Those below the poverty line or having little voluntary savings for financial investments or no ability to understand investments, like shares and bonds, had to be excluded, because they were irrelevant for the purpose of the present survey.

Sample size and characteristics

1.10 The survey covered 5908 households who were interviewed through Questionnaire-1. Of these, 1017 responded to the mailed questionnaire (Questionnaire-2). The respondents to the mailed questionnaire are thus a sub-set of the respondents to Questionnaire1. The two questionnaires have been analysed separately. [1] The results show a high degree of consistency and comparability.

1.11 Our sample is dispersed among 24 States/Union Territories and about 90 cities/places in India. The bulk of the sample comprises the middle and upper-middle class households. Nearly 200 field interviewers have co-operated in conducting the personal interviews. The composition of respondents by income, age, occupation and education is shown in the Appendix to this chapter in Tables 1.1–1.4. The distribution of sample households by states/union territories is shown in Table 1.5.

Chapter scheme

1.12 For the convenience of exposition, the findings of the study have been divided into three parts. Part 1 comprises chapters 2 to 4, dealing respectively with (a) investor's worries about the stock market, (b) their perceptions about corporate governance

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[1] An interesting and noteworthy point for researchers is that replies to directly mailed questionnaires, being entirely voluntary and left to convenience of the respondents, are more reliable and richer in comments than questionnaires filled through the help of interviewers. The personal interviews tend to be a hurried affair in practice because interviewees are often too busy to spare sufficient time.

and (c) how they have been affected by delisting of an unusually large number of companies in India in the last few years.

1.13 Part II comprises chapters 5 to 7 which are concerned with various aspects of investor's preferences and share portfolio practices. Chapter 5 is focused on investors' attitude towards mutual funds, often claimed by managers and theorists alike, as a superior alternative to direct investment in equity shares. The findings contradict the claim and point to the investors' relatively low preference for mutual fund products, compared to direct holding of equity shares. Chapter 6 throws new light on share portfolio practices of retail investors. There are hardly any other studies in this area. Chapter 7 goes deeper into household's investment preferences and also describes what we call "maturing of retail investors" and the emergence of 'discerning' investors.

1.14 Part III has two chapters. Chapter 8 highlights the retail investors' complaints and problems about the demat system, specially unjustly high demat charges. We show how this system has the effect of squeezing out the long-term retail investors from the equity market. Chapter 9 deals with the problem of educating the ordinary investors so that they can invest more wisely in order to provide for financial security. A more innovative approach is suggested.

1.15 The concluding Chapter 10 wraps up the study.

Table 1.1

SAMPLE COMPOSITION
BY HOUSEHOLD INCOME

S. No.	Monthly Income (Rs.)	Questionnaire 1		Questionnaire 2	
		No. of Respondents	Per cent	No. of Respondents	Per cent
1	Upto 10000	1587	26.86	242	23.80
2	10,001-15000	1352	22.88	222	21.83
3	15001-20000	1108	18.75	202	19.86
4	20001-25000	729	12.34	148	14.55
5	Over 25000	1132	19.16	203	19.96
	Total	**5908**	**100.00**	**1017**	**100.00**

Table 1.2

SAMPLE COMPOSITION
BY AGE OF HOUSEHOLD HEAD

S. No.	Age Groups (Years)	Questionnaire 1		Questionnaire 2	
		No. of Respondents	Per cent	No. of Respondents	Per cent
1	Upto 25	391	6.62	54	5.31
2	26-30	716	12.12	102	10.03
3	31-40	1645	27.84	276	27.14
4	41-50	1662	28.13	274	26.94
5	51-60	955	16.16	178	17.50
6	61-65	275	4.65	63	6.19
7	66-70	135	2.29	32	3.15
8	71 and above	100	1.69	38	3.74
	Not answered	29	0.49	Nil	Nil
	Total	**5908**	**100.00**	**1017**	**100.00**

Table 1.3

SAMPLE COMPOSITION
BY OCCUPATION(Questionnaire 1)

S. No.	Occupation	No. of Respondents	Per cent
1	Govt. Service	1313	22.22
2	Other service	1843	31.19
3	Own Business	1281	21.68
4	Professional Practice	579	9.80
5	Retired	540	9.14
6	Others	232	3.93
	Not answered	120	2.03
	Total	**5908**	**100.00**

Table 1.4

SAMPLE COMPOSITION
BY EDUCATION(Questionnaire 1)

S. No.	Education	No. of Respondents	Per cent
1	Graduate	5241	88.71
2	Non-Graduate	556	9.41
	Not answered	111	1.88
	Total	**5908**	**100.00**

Table 1.5

STATE-WISE DISTRIBUTION OF SAMPLE HOUSEHOLDS

S. No.	State/Union Territory	No. of Respondents	Per cent
1	Andhra Pradesh	671	11.36
2	Assam	167	2.83
3	Bihar	155	2.62
4	Chandigarh	48	0.81
5	Chhattisgarh	36	0.61
6	Delhi	414	7.01
7	Goa	67	1.13
8	Gujarat	504	8.53
9	Haryana	244	4.13
10	Himachal Pradesh	16	0.27
11	Jammu & Kashmir	10	0.17
12	Jharkhand	14	0.24
13	Karnataka	585	9.90
14	Kerala	260	4.40
15	Madhya Pradesh	99	1.68
16	Maharashtra	341	5.77
17	Orissa	64	1.08
18	Pondicherry	62	1.05
19	Punjab	78	1.32
20	Rajasthan	355	6.01
21	Tamil Nadu	593	10.04
22	Uttaranchal	42	0.71
23	Uttar Pradesh	545	9.22
24	West Bengal	538	9.11
	Total	**5908**	**100.00**

Chapter 2

THE HOUSEHOLD INVESTORS' MAIN WORRIES ABOUT STOCK MARKET

I. Introduction

Collapse of capital raising function

2.1 It is extremely important for the capital market policy making and regulatory authorities to understand the household investors' worries or concerns about the stock market. The reason is provided by the virtual collapse of the capital market as a source of corporate financing after the mid-1990s. We have not yet truly recovered from that collapse despite great technological strides in the market's trading system.

2.2 Dr. Rakesh Mohan, in a lecture on "Finance for Industrial Growth", made a similar point in the following words:

> "After the exuberance of the stock market in the mid-1990s and its decline thereafter, a large number of individual investors took flight to safety in bank deposits, safe retirement instruments and insurance. It remains to be seen when and how fast such savers return to the capital market so that it performs its intermediary function efficiently."[1]

2.3 He cited data to show that **public *equity* issues by non-government public limited companies declined from 1.1% of GDP during 1992-97 to merely 0.1% during 1998-2002 and further to 0.01% during 2002-03, i.e., far below what it used to be even during the 1980s, as shown below:[2]**

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[1] Lecture delivered by Dr. Rakesh Mohan at the Administrative Staff College of India, Hyderabad as reported in the *Reserve Bank of India Bulletin*, March 2004, pp. 319-39, esp. p. 334.

[2] See RBI Bulletin, March 2004, Table 9, p. 334.

Year	*New Equity Issues (Percentage of GDP)*
1980s	0.2
1990s	0.7
1992-93 to 1996-97	1.1
1997-98 to 2001-02	0.1
2002-03	0.01

By relating the amount of capital raised to the GDP, Dr. Rakesh Mohan has provided a very realistic picture of the phenomenal decline in capital market's role in the raising of capital**.** This has belied the expectation that the capital market's role in raising capital for corporate enterprises would progressively increase as a result of economic liberalisation introduced in 1991.

2.4 The RBI data shows that the percentage of households' financial saving going into private-sector shares and bonds, either directly or through mutual funds, has persistently declined since mid-1990s instead of rising. The RBI *Annual Report* 1999-2000, showed that 7.5%-8.5% of households' gross financial saving each year was invested *directly* in shares and debentures of private corporates in the boom years, 1992-93 to 1994-95 but the percentage declined steadily thereafter to a mere 1.6% in 1997-98 and 1.5% in 1998-99. It temporarily rose to 3.4% during the IT boom year, 1999-2000, but gradually slipped to just 0.7% in 2003-04.[3]

2.5 The households' *indirect* investment in private corporates through the UTI and other mutual funds also went down as percentage of financial savings, from 8.6% in 1992-93 to only

[3] *RBI Annual Report*, 2003-04, Appendix Table II.11, p. 260.

0.6% in 1997-98, rose temporarily to 4.2% in 1999-2000 (period of IT boom) and gradually slipped back to 0.7% in 2003-04.[4]

2.6 Considering both direct and indirect forms of investment by households in corporate shares and debentures, we find from RBI data that 17% of households' gross financial savings went into the private corporate share and bonds in 1992-93 but this came down to just 2.5% by 1998-99. Thereafter, it spurted temporarily to 7.6% in 1999-2000 and then slipped to 1.4% in 2003-04.

2.7 The household investors' disenchantment with corporate stocks and bonds is also indicated by the drying up of the new issues market. Public and rights issues of shares and bonds fell persistently from the peak of Rs. 27,632 crore during 1994-95 to as low as Rs. 4,570 during 1997-98 and remained relatively low around this level over the subsequent 7-8 years.[5]

2.8 The household (i.e. retail) investors account for the great bulk (around 85-90%) of India's gross domestic saving which is 23-24% of GDP. A little below one-half (around 45%) of the households' gross saving is in financial forms and the rest is in physical forms.[6] Many households have tended to withdraw from the stock market after mid-1990s because of bad experiences.

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[4] Ibid.
[5] SEBI *Annual Reports.*
[6] GOI, pre-budget Economic Surveys.

Recent bull market

2.9 Since around mid-2003, share prices have shown smart recovery and so also public issue activity. It can not, however, be asserted with confidence that the household (i.e. retail) investors, taken as a whole, have started making significant net addition to their equity shareholdings. Our data suggests that retail investors have used the recent bull market situation as an opportunity for exiting from the market. The prolonged market depression since mid-1990s had almost locked them in. The recent emergence of the bull market is attributable, not to the retail investors rushing back to corporate stocks but to the swelling FII inflows.

Probing the retail investors' mind

2.10 Our questionnaire for the household investors survey of 2004, addressed to household heads, inter alia, provided a list of possible worries or concerns with the idea of identifying their most important worries about the stock market[7]. We have ranked the various worries in terms of the percentage of respondents identifying each worry. Such data enables us to determine the relative importance of each worry from the household investors' viewpoint.

II. An Over-view of the Findings

2.11 Our analysis classifies the respondents by income-class and age-class. The findings are presented in Tables 2.1 and 2.2 respectively. As may be observed from these tables, the retail

[7] We have carried out two surveys earlier in 2001 and 2002, asking the household investors to indicate their 'single' most important worry. For details of these surveys, see L.C. Gupta, Naveen Jain and Utpal Choudhury, *India's Stock Market & Household Investors'* (Society for Capital Market Research & Development, Delhi, 2004) pp. 8-19.

Table 2.1

BIGGEST WORRIES OF HOUSEHOLD INVESTORS ABOUT INDIAN STOCK MARKET

Household Investors Survey - 2004

(Per cent of investors identifying the particular worry as biggest)

Income-classwise Analysis

Biggest worry	***All classes of sample households***	*Household income class (Rs. per month)* Upto 10,000	10,001–15,000	15,001–20,000	20,001-25,000	Over 25,000
		Percent of households column-wise				
1. Too much volatility (i.e. price fluctuation)	**29.06**	28.80	29.91	28.92	29.40	28.31
2. Too much price manipulation	**21.02**	21.57	19.55	20.70	21.55	21.96
3. Corporate mismanagement /fraud	**16.83**	16.12	16.58	17.51	17.96	16.76
4. Unfair practices of brokers	**13.14**	13.01	13.52	13.29	13.42	12.57
5. High demat costs	**7.22**	8.69	8.00	6.76	5.43	5.80
6. Too much insider trading	**12.74**	11.82	12.44	12.82	12.24	14.59
Column total	**100.00**	100.00	100.00	100.00	100.00	100.00
No. of respondents	**5,641**	1,514	1,294	1,065	682	1,086

Table 2.2

BIGGEST WORRIES OF HOUSEHOLD INVESTORS ABOUT INDIAN STOCK MARKET

Household Investors Survey - 2004

(Per cent of investors identifying the particular worry as biggest)

Age-classwise Analysis

	Biggest worry	***All classes of sample households***	*Age of household head(in years)*							
			Upto 25	26-30	31-40	41-50	51-60	61-65	66-70	71 and above
			Percent of households column-wise							
1	Too much volatility (i.e. price fluctuation)	**29.06**	30.25	31.24	28.02	29.12	29.30	27.86	28.20	25.77
2	Too much price manipulation	**21.02**	20.57	21.20	20.83	21.54	20.15	21.37	19.55	23.71
3	Corporate mismanagement/fraud	**16.83**	16.08	14.03	16.98	17.42	17.27	18.51	15.41	21.13
4	Unfair practices of brokers	**13.14**	11.72	13.96	13.77	12.89	12.85	12.40	13.91	11.34
5	High demat costs	**7.22**	7.22	6.20	7.03	6.98	7.63	9.54	10.90	6.70
6	Too much insider trading	**12.74**	14.17	13.37	13.36	12.04	12.80	10.31	12.03	11.34
	Column total	**100.00**	100.0	100.00	100.00	100.00	100.00	100.00	100.00	100.00
	No. of respondents	**5,641***	367	677	1,572	1,590	918	262	133	97

* Out of total sample respondents, a few did not provide information on their age. They have therefore, not been included in the individual age-classes but are included in the total sample.

investors' greatest worry, which was identified by the highest percentage (around 30%) of our respondents, is "too much price volatility". The classification by income and age shows very high consistency of the data. The biggest worry of households in all income classes (Table 2.1) and all age-classes (Table 2.2) is found to be the same with only a slight variation in the percentages. The second biggest worry is "too much price manipulation" and the third one is "corporate mismanagement / fraud". Closely competing for the fourth place are the worries relating to "unfair practices of brokers" and "too much insider trading", as shown in Tables 2.1 and 2.2. Many household investors, who are not frequent traders, were highly critical of the heavy demat costs, as brought out later by separate questions on the demat system. However, this problem is of a lower order than the other problems covered by Tables 2.1 and 2.2.

2.12 Nearly 1 in every 5 respondents was worried by too much manipulation, indicating rampancy of market manipulation. About 1 in every 6 respondents was worried about corporate mismanagement and fraud.

2.13 Since investors' perceptions go on changing as market conditions change, it is useful to compare the findings of the survey of 2004 with our earlier surveys of 2001 and 2002. Such comparison clearly suggests that price volatility, price manipulation and corporate mismanagement / fraud have persistently been the household investors' top three worries in India[8].

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[8] The surveys of 2001 and 2002 requested the respondents to indicate their "single greatest" worry. Some respondents had difficulty in picking just one worry and marked against two. The survey of 2004 proceeded slightly differently by asking respondents to indicate their TWO biggest worries. This is like allowing two "votes" to each respondent with the condition that the two votes shall be used but not in favour of the same "candidate". In order that the total votes are equal to the total number of respondents, each vote is counted as half a person (respondent). This makes the results of 2004 survey comparable with the surveys of 2001 and 2002 without in any way affecting the relative ranking of the various worries. For details of earlier surveys, see L.C. Gupta, Naveen Jain and Utpal Choudhury, *India's Stock Market & Household Investors 2001-04* (Society for Capital Market Research and Development, Delhi, 2004), pp. 12-13.

2.14 The year 2001 was a particularly turbulent year for the Indian stock market. It was marked by a spectacular market crisis in March 2001 due to blatant market manipulation by a big market operator, Ketan Parekh, a la Harshad Mehta. Soon to follow was another blow to the market due to a major crisis in the UTI's US-64 Unit Scheme.

2.15 The year 2002 saw some reduction in the level of volatility and manipulation but considerable increase in the investors' concern about corporate governance. Such increased concern was due to the winds blowing from the western countries, specially the U.S. The Enron and many other corporate scandals in the U.S. had a worldwide echo which reached Indian shores also. Of course, corporate governance has always been a serious problem area in India and even lending banks / financial institutions suffered on this account. However, there was lack of political will to rectify the problem. The severity of corporate governance reforms adopted in the U.S. made Indian authorities also to wake up.

2.16 More recently in India, the concern about price volatility and manipulation rose suddenly due to the wild gyrations of the Indian share index on May 17, 2004 (which came to be called 'Black Monday'). It was caused by large-scale net selling by FIIs on account of the prevailing political uncertainty at that time. Political stability was soon restored within a few weeks and the market sentiment went on improving appreciably thereafter. Nevertheless, such events surely increase the stock market's riskiness and to some extent dents the investors' general confidence. Our household investors' survey was started in May 2004 but the bulk of responses were received during July-September, 2004.

III. Price Manipulation and Volatility

Market's erratic behaviour

2.17 **Notably, price volatility and manipulation, taken together, are the cause of worry for as many as 50% of respondents according to our surveys. Hence, the matter deserves serious consideration.**

2.18 These problems get manifested in the erratic behaviour of the secondary market. Such market behaviour has the effect of discouraging or even driving away the genuine investors from the market. The Indian secondary market has been notorious for speculative excesses. Rampant price manipulation and high volatility are rooted in excessive speculative tendencies. Stockbrokers and market operators in India have considerable political clout and lobbying power. Perhaps for this reason, the governmental attitude has been rather lenient towards speculation. Such leniency is best exemplified by the non-implementation of physical settlement for single stock futures. A distinguished foreign observer, who visited India a few years ago, commented as follows:

> I gather from just a general perception that people (in India) are really mystified about the level of surveillance that we have in the U.S. to ensure the confidence of our markets. They find this difficult to grasp . . . . And there is this underlying sense (in India) that stock markets are just speculative places. . . . (rather than) very formal, capital raising, efficient mechanism.[9]

[9] See *An Interview with Carolyn Kay Brancato*, Director of the Conference Board's Global Corporate Governance Research Centre, in *Span*, November-December 1999, pp. 43-45. See specially p. 45.

2.19 In the heady debate before the abolition of the badla system and the introduction of the rolling settlement, P.N. Vijay, a well-known market specialist, commented as follows on the manner of speculation in Indian exchanges:

> They (the traders) have been protesting and so far they have been successful which is why the Rolling Settlement programme came to a grinding halt. Now SEBI has modified the Rolling Settlement and says it is prepared to allow a carry forward mechanism in the Rolling Settlement.... In the long run *this costless speculation that intra-settlement traders indulge* in is not healthy for the market. The whole attitude becomes short term as these traders are sitting on a self-created time bomb and are waiting to jump off. The volatility has gone up with some shares moving 10 or 15 percent in a day [10] (Emphasis added)

2.20 Short-term speculators and traders (as distinguished from genuine long-term investors) relish volatility as it provides them opportunities for highly leveraged and, therefore, potentially highly profitable, trading.

Effect on genuine investors

2.21 For the genuine long-term investors, too much volatility is a nightmare which disheartens them. That is why it is their most important worry even though Indian policy making and regulatory authorities tend to play it down.

[10] See *The Hindustan Times*, 8 October 2000

2.22 **The relevant measure of volatility from the viewpoint of long-term investors is not the daily volatility but the yearly volatility as indicated by the ratio between a year's High-to-Low price.** *The Economic Times* reports the preceding 52-week High / Low prices along with daily price quotations. The yearly High-to-Low ratio for most of the leading stocks in India is quite large, being 1.5:1 or 2:1 or even more. This means a loss of 30-50% in many cases if the investor purchased the stock at the year's high or it may mean a gain of 50-100% if the purchase was made at the year's low. Thus, the range of risk (the extent of gain or loss) is very wide.

Wide intra-day movements

2.23 Excessive speculative trading often leads to sharp **intra-day** price movements of 3-5% frequently and even 8-10% many times in the leading scrips. Such behaviour is at odds with the claim of our stock exchanges that India has deep and liquid markets and the impact cost for fairly large-sized orders is just around 0.1% of the average market price.[11] Given the large intra-day price movements, the low impact cost can be misleading. It provides no comfort to the genuine long-term oriented investors. *The problem of high intra-day share price movements is worthy of a special investigation by our share market authorities.*

Delivery-based trading

2.24 The Indian stock exchanges also claim that the spot market in stocks is a "pure delivery market" although delivery-based

[11] According to Indian Government's *Economic Survey 2002-03* (pp. 70-71), the market impact cost of trades for Rs. 50 lakh of Nifty had come down to around 0.1% of the normal price. It then adds: "This reflects a weighted average of the transactions costs when doing trades on each of the 50 stocks that make up the Nifty index". This is grossly misleading because this has no relation to delivery-based trades. The impact cost should be measured with reference to delivery-based trades.

trades in the cash market have been, on the average, only around 20% of the traded value. Around 80% is accounted for by non-delivery form of day-trading.[12]

IV. Concluding Comments

Wake-up call for Indian authorities

2.25 The Indian authorities don't seem to be worried by high volatility in itself; they are worried only when a market crisis looms large. **The official approach does not promote an efficient market in terms of allocational efficiency which is of utmost importance to the growth of the economy, and its productivity and international competitiveness. The majority of retail investors undoubtedly consider market volatility as their topmost worry** because they know from experience that they are usually the losers when the market is highly volatile.

2.26 The largest pension/provident fund organization in India, viz. the **Employees Provident Fund Organisation (EPFO), is extremely distrustful of putting even a penny in equity stocks despite the government's goading. It is reflection of the poor image of both our stock market and also of the poor standard of corporate governance** generally. By contrast, pension funds in the U.S. invest around one-half of the total fund in the form of equities. Before we ask the Indian pension authorities to invest in equities, we ought to ensure that the equity market functions in a healthy way. This will help

[12] See Government of India, *Economic Survey 2003-04,* pp. 66-9. It lauds the technological achievements such as: "In each second of trading in the NSE equity spot market, there are 80 transactions worth Rs. 31,646 each". It further claims that the "spot market is now pure delivery market without leveraged trading" but it omits to mention that delivery-based trades in the spot market account for only around 20% of the traded value. There is a mention of the NSE having achieved the third rank among the stock exchanges of the world in terms of number of trades. The number of trades in Indian exchanges are largely jacked up by day trading system requiring no delivery-based settlement at any time.

to induce the genuine retail investors also to invest a larger proportion of their savings in corporate stocks

What the economists say

2.27 Keynes had long ago drawn pointed attention to the serious damage to a country's economy due to excessive short-term speculation. He underlined that **a distinction of great importance lies between genuine investment interest and short-term speculative interest.** By genuine investment interest he meant the skilled and serious-minded investors who "purchase investments on the best genuine long-term expectations", and emphasized that *market efficiency depended on "whether or not they predominate in their influence over the game-players".*[13] *H*is famous remark is worth re-emphasizing:

> "Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubbles on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done".

2.28 Eminent economist Kaldor had argued that *the great majority among speculators are bound to be losers,* but they get tempted by the possibility of easy riches. His reasoning was as follows:

> ". . . even if speculation as a whole is attended by a net loss, rather than a net gain this will not prove, even in the long run, self-corrective. For the losses of a floating

[13] See J.M. Keynes, *The General Theory of Employment, Interest and Money,* Chapter on "The state of long-term expectation" and which contains a very detailed and insightful discussion on the problem. See also G. C. Harcourt, "Taming Speculators and Putting the World on Course to Prosperity", in *Economic and Political Weekly,* September 17, 1994, pp. 2490-92; and L.C. Gupta, P.K. Jain and C.P. Gupta, *Indian Stock Market P/E Ratios* (Society for Capital Market Research & Development, Delhi, 1998), pp. 51-2.

population of unsuccessful speculators will be sufficient to maintain permanently a small body of successful speculators; and the existence of this body of successful speculators will be a sufficient attraction to secure a permanent supply of this floating population. So long as speculators differ in their own degree of foresight, and so long as they are numerous, they need not prove successful in forecasting events outside; they can live on each other."[14]

2.29 The objective should be to build a stock market system which will benefit the economy as well as the mass of investors by attracting a growing volume of savings flow and allocating it efficiently to the most productive uses from the economy's viewpoint. The present design of the Indian stock market, however impressive from technological viewpoint, is faulty in an important respect – it is extremely attractive to speculators and market operators but it is able to garner only a pitiable proportion of the household saving. Its behaviour is characterized by too much price volatility and manipulation, which are the biggest worries of ordinary investors.

[14] Nicholas Kaldor, *Essays of Economic Stability and Growth* (London, 1960), p. 19.

Chapter 3

INVESTORS' PERCEPTIONS ABOUT CORPORATE GOVERNANCE

Why important

3.1 It is well recognised that a good system of corporate governance facilitates the flow of people's savings to corporate enterprises. By contrast, a weak system retards such flow. In the words of Dyck, "the measure of the strength of a corporate governance system is the extent and efficiency of investments in corporations."[15] Corporate governance reform has become a part of the national agenda in many countries.[16] In India, the SEBI has framed a Code of Corporate Governance which is being implemented through stock exchange listing rules (Clause 49) since February 2000. The clause has been revised very recently.

3.2 There is a tendency to assume that the Code has improved the corporate governance. As part of the present household investor survey, we have tried to evaluate the situation by examining the investors' perceptions in this regard. Our focus is on two distinct aspects of the operation of the corporate governance system, viz., (1) the corporate top management in terms of its accountability to the shareholders, and (2) the corporate auditors in terms if their role as 'independent watchdog' over the management on behalf of the "outside" shareholders.

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[15] I.J. Alexander Dyck, "Ownership Structure, Legal Protections and Corporate Governance," in the *Proceedings of Annual World Bank Conference on Development Economic, 2000* (World Bank, Washington, D.C. 2001), p. 294.

[16] See *Business Week* (Asia Edition), May 17, 2004, p. 47

Key questions

3.3 As the term "corporate governance" is not understood by ordinary people, our questionnaires used the language of the layman. Our first key question in this regard was as follows:

> **"Do you believe that Indian company managements are honest and sincere towards their shareholders?"**

The respondents were requested to place a tick against one of the three options, viz., (a) mostly yes, (b) mostly no, and (c) can't say.

3.4 Tables 3.1 and 3.2 present an analysis of the replies. The results have been computed for the whole sample and also for income-classes (see Table 3.1) and for age-classes (see Table 3.2). Notably, **the largest percentage (around 50%) of respondents had a negative opinion about company managements,** around 30% had a positive opinion and a little above 20% answered "can't say". The negative opinions far exceed the positive ones for the sample as a whole as also for every income/age class. That is, there are many more households who do not trust company managements than those who trust them. Even more striking is the fact that every income-class and every age-class tells the same story (see Tables 3.1 and 3.2).

3.5 **Company auditors** have a very crucial role in corporate governance. In this regard, our key question to the respondents was phrased as follows:

> **"Do you believe that shareholders can rely on company auditors in preventing financial irregularities by company managements?"**

3.6 Table 3.3 shows that household **investors' opinion is dominantly negative about company auditors too.** Again, this is true for every income-class and every age-class (Tables 3.3 and 3.4).

3.7 We asked respondents a third question as follows:

> **"Do you believe that Indian company managements are taking more care of the shareholders' interest than before?"**

Unlike the first two questions, more than one-half of the respondents were positive in their replies to our third question. Tables 3.5 and 3.6 present the findings income-classwise and age-classwise respectively. The findings may be interpreted to mean that the regulatory pressures on company managements have started working to some extent even though tangible results have yet to be achieved. There is some improvement in limited areas, like redressal of investors' grievances, as companies are required to report on grievances remaining unrectified. However, as our empirical findings have shown, the **totality of the picture about the corporate governance situation in India continues to be a matter of considerable concern.** Tangible achievement from the viewpoint of "outside" (i.e. non-management) shareholders is not much to talk about. More effective measures are needed from the ordinary shareholders' angle.

Indian situation in international perspective

3.8 In this regard, we are far behind the U.S. and U.K. In these countries, the power of CEOs to nominate board members has been taken away from them. Now, this power is vested in a sub-committee of the Board of Directors, usually called "nomination committee", chaired by an independent director and comprising mainly of independent directors. The institutional investors, who hold majority of voting stock in most of the large American and British listed companies, are an important influence on board composition. The institutions, as dominant shareholders, may sometimes dictate specific changes in the board. They may intervene directly also on crucial corporate decisions in many cases. They have, for example, forced several companies to withdraw proposals for granting over-lavish pay package to CEOs, to dismiss CEOs for poor performance, or to make changes in the board composition. **The institutions are openly adopting the posture of being guardians for small investors.** This is not yet happening to a desired extent in India.[17]

3.9 The Naresh Chandra Committee on Corporate Audit and Governance, in its report submitted to the Department of Company Affairs in January 2003, admitted that the promoters usually pack the board of directors with their cronies and indulge in many abuses, depriving minority shareholders of their rights. It observed:

> *"In the Indian context, not only a large number of retail investors, but also several creditors, especially financial institutions, will echo this sentiment."*[18]

The Committee narrated several kinds of frauds or tricks by which promoters transfer the shareholders' money into own coffers. It observed that even where no fraud was committed and

[17] In India, pubic-sector investment and financial institutions have generally avoided being outspoken or openly declaring their voting intentions even when the interest of minority shareholders is involved. Mr. Mark Mobious of Franklin Templeton Mutual Fund has declared the intention to push Indian companies to adopt more fair practices towards minority shareholders. He showed willingness to "gang up" or coordinate with other mutual funds, where necessary, as they do in the U.S. See *The Economics Times*, November 20, 2004.

[18] See the Naresh Chandra Committee Report, Para 1.12 – 1.14.

there was no destruction of value by the promoter-managers, "more often than not, wealth has not been fairly shared (with minority shareholders)".[19]

3.10 *In our opinion, since the typical Indian listed company is family-controlled, the corporate governance reform should be designed to deal with this specific Indian situation.* Indian authorities have borrowed the definition of independent directors from U.K. and U.S., but have not ensured that such directors will be truly "independent of management," i.e. the controlling group.

3.11 Unlike the British and American companies, most Indian companies, including the largest and well-established ones, have a controlling family-group which nominates all the board members. Hence, the independent directors have to depend on the controlling group for being nominated to the board. How can such directors be "independent of management", with whose support they have been elected and on whom they depend for continuing as director? The controlling groups would elect as directors only those whom they like and who may be expected to be 'pliable'.

Complexity of Indian situation

3.12 The complexity of corporate governance reform is admittedly greater in the family-controlled listed companies than in the other companies. The top management of a company which has no controlling group, can be dismissed and replaced if the outside shareholders (such as dominant institutional shareholders) so demand. In contrast, even the combined might of institutional

[19] Ibid.

shareholders cannot dislodge a controlling group, so long as the group holds majority of voting power.

3.13 In any case, the **corporate governance standards should not be lower for family-controlled companies which raise at least some part of their capital from the public.** Although the institutional shareholders in most of the Indian listed companies, including the largest ones, are minority shareholders, but being trustees for millions of small investors, they should be enabled to play a countervailing role to check self-serving practices of controlling groups. Protecting small investors is an important societal objective. This can be furthered only if the institutional shareholders are given more voice. There is no doubt that the **regulation of corporate governance needs to be considerably tightened in India.**

3.14 Recently, *The Economist* summed up the worldwide ongoing debate on corporate governance in a very illuminating way. It first posed the question "What exactly are directors supposed to be doing" and said that the "obvious" answer was "representing shareholders".[20] Next it asked whether this was best achieved when directors "aim to help the chief executive by offering advice on management or strategy", or when they view their main task to be "to monitor a firm's managers, and make sure they obey the rules, don't pay themselves too much and generally behave". It concluded that **"the primary function of independent board directors in a large public company is to monitor the firm's managers [the controlling family-group in**

[20] See *The Economist*, "Board of Directors : No More, Mr. Nice Guy", March 20, 2004, pp. 16-17

the Indian context] not to give strategic or managerial advice".

Biggest corporate - governance challenge

3.15 We may draw attention to the following pertinent recommendation made in the *White paper on Corporate Governance in Asia* as it is applicable to India:

> **"The legal and regulatory framework should ensure that non-controlling shareholders are protected from exploitation by insiders and controlling shareholders.** The corporate landscape in most Asian countries is characterized by concentrated ownership. In many Asian jurisdictions, there have been instances where controlling shareholders of family-dominated, publicly-listed companies and other enterprises with concentrated ownership have abused their control to exploit other shareholders. Regionally, exploitation of non-controlling shareholders has been identified as the most serious corporate-governance challenge."[21]

Institutional shareholders council

3.16 We suggest that a formal device which can be usefully adopted in India is to constitute an *Institutional Shareholders Council,* as in U.K. If business houses have associations / federations to represent their interests, the **institutional shareholders, in their capacity as shareholders of companies and as trustees for millions of small shareholders, should also establish a consultative mechanism for jointly evolving the institutional shareholders' policies in cases of companies having governance problems.** Such a Council can be a channel of communication between institutional shareholders, businessmen's federations and Governmental authorities on matters affecting institutional shareholders.

[21] Published in June 2003 under the auspices of the OECD's Centre for Cooperation with Non-Members, para 52-3, p. 15.

Table 3.1

DO YOU BELIEVE THAT INDIAN COMPANY MANAGEMENTS ARE HONEST AND SINCERE TOWARDS THEIR SHAREHOLDERS?

Household Investors Survey - 2004

Income-classwise Analysis

Answer		***All classes of sample households***	*Household income class (Rs. per month)*				
			Upto 10,000	10,001–15,000	15,001–20,000	20,001-25,000	Over 25,000
			Percent of households column-wise				
1.	Mostly yes	**29.11**	29.92	30.52	28.80	27.02	27.95
2.	Mostly not	**49.59**	45.83	47.11	51.27	54.32	53.15
3.	Can't say	**21.29**	24.24	22.37	19.93	18.66	18.90
Column total		**100.00**	100.00	100.00	100.00	100.00	100.00
No. of respondents		**5,894**	1,584	1,350	1,104	729	1,127

Table 3.2

DO YOU BELIEVE THAT INDIAN COMPANY MANAGEMENTS ARE HONEST AND SINCERE TOWARDS THEIR SHAREHOLDERS?

Household Investors Survey - 2004

Age-classwise Analysis

Answer		***All classes of sample households***	*Age of household head(in years)*							
			Upto 25	26-30	31-40	41-50	51-60	61-65	66-70	71 and above
			Percent of households column-wise							
1	Mostly yes	**29.11**	31.97	33.57	27.80	26.08	30.27	29.45	31.11	44.00
2	Mostly not	**49.59**	41.18	42.42	49.27	54.82	49.37	51.27	55.56	43.00
3	Can't say	**21.29**	26.85	24.02	22.93	19.10	20.36	19.27	13.33	13.00
Column Total		**100.00**	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
No. of respondents		**5,894***	391	712	1,644	1,660	948	275	135	100

* Out of total sample respondents, a few did not provide information on their age. They have therefore, not been included in the individual age-classes but are included in the total sample.

Table 3.3

DO YOU BELIEVE THAT SHAREHOLDERS CAN RELY ON COMPANY AUDITORS IN PREVENTING FINANCIAL IRREGULARITIES BY COMPANY MANAGEMENTS?

Household Investors Survey - 2004

Income-classwise Analysis

Answer	*All classes of sample households*	*Household income class (Rs. per month)* Upto 10,000	10,001–15,000	15,001–20,000	20,001-25,000	Over 25,000
		Percent of households column-wise				
1. Mostly yes	**28.87**	29.96	29.53	30.03	27.69	26.22
2. Mostly not	**43.67**	37.96	42.43	44.77	44.35	51.55
3. Can't say	**27.45**	32.07	28.04	25.20	27.96	22.23
Column total	**100.00**	100.00	100.00	100.00	100.00	100.00
No. of respondents	**5,857**	1,562	1,341	1,099	726	1,129

Table 3.4

DO YOU BELIEVE THAT SHAREHOLDERS CAN RELY ON COMPANY AUDITORS IN PREVENTING FINANCIAL IRREGULARITIES BY COMPANY MANAGEMENTS?

Household Investors Survey - 2004

Age-classwise Analysis

Answer	***All classes of sample households***	*Age of household head(in years)* Upto 25	26-30	31-40	41-50	51-60	61-65	66-70	71 and above
		Percent of households column-wise							
1 Mostly yes	**28.87**	34.90	32.06	28.41	26.86	28.68	29.41	24.44	29.29
2 Mostly not	**43.67**	34.11	37.15	44.96	46.33	42.65	52.57	50.37	42.42
3 Can't say	**27.45**	30.99	30.79	26.63	26.80	28.68	18.01	25.19	28.28
Column Total	**100.00**	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
No. of respondents	**5,857***	384	708	1,637	1,649	945	272	135	99

* Out of total sample respondents, a few did not provide information on their age. They have therefore, not been included in the individual age-classes but are included in the total sample.

Table 3.5

DO YOU BELIEVE THAT INDIAN COMPANY MANAGEMENTS ARE NOW TAKING MORE CARE OF THE SHAREHOLDERS' INTERESTS THAN BEFORE?

Household Investors Survey - 2004

Income-classwise Analysis

	Answer	*All classes of sample households*	*Household income class (Rs. per month)* Upto 10,000	10,001–15,000	15,001–20,000	20,001-25,000	Over 25,000
			Percent of respondents				
1.	Mostly yes	**54.64**	53.24	54.38	54.47	56.91	55.60
2.	Mostly not	**24.27**	23.89	23.86	24.54	22.79	25.98
3.	Can't say	**21.09**	22.86	21.77	20.99	20.30	18.42
	Column total	**100.00**	100.00	100.00	100.00	100.00	100.00
	No. of respondents	**5,838**	1,557	1,337	1,096	724	1,124

Table 3.6

DO YOU BELIEVE THAT INDIAN COMPANY MANAGEMENTS ARE NOW TAKING MORE CARE OF THE SHAREHOLDERS' INTERESTS THAN BEFORE?

Household Investors Survey - 2004

Age classwise Analysis

	Answer	*All classes of sample households*	*Age of household head(in years)* Upto 25	26-30	31-40	41-50	51-60	61-65	66-70	71 and above
			Percent of households column-wise							
1	Mostly yes	**54.64**	61.56	61.39	55.20	51.98	53.54	52.38	44.44	46.46
2	Mostly not	**24.27**	15.32	20.08	24.06	27.12	23.39	29.67	35.56	27.27
3	Can't say	**21.09**	23.12	18.53	20.74	20.90	23.07	17.95	20.00	26.26
	Column total	**100.00**	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
	No. of respondents	**5,838***	385	707	1,625	1,641	945	273	135	99

*Out of total sample respondents, a few did not provide information on their age. They have therefore, not been included in the individual age-classes but are included in the total sample.

Chapter 4

DELISTED COMPANIES

Violation of listing rules

4.1 Most of the companies delisted by stock exchanges in India were due to violation of the listing agreement,[22] implying corporate misgovernance. As this affects all their shareholders adversely, our survey has attempted to find out the extent to which delisting of companies has affected the household investors.

Estimate of affected retail investors

4.2 We asked respondents whether they are shareholders in any delisted companies controlled by Indian managements[23] and, if so, in what way they have suffered. Tables 4.1 and 4.2 present the findings. Table 4.1 shows that well over one-third (38%) of the respondents were shareholders of delisted Indian companies. The break-up by income and age-classes has some interesting features.

4.3 It may be observed from our analysis in Table 4.1 **that the percentage of households having shares of delisted companies steadily increases with income and age.** The increase is much sharper in the case of age classes; from 20% in the lowest age class (upto 25 years) to 50% in the case of the highest age-class

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[22] 303 companies were delisted from the BSE in the year April 2003-March 2004. Most of these companies were delisted for violation of the listing agreement, while a few were delisted after their merger or amalgamation with other companies. Of the 303 firms, 246 companies were delisted from the BSE in January 2004, after the SEBI's delisting guidelines came into force. These stocks were already suspended by the Sebi for violation of listing agreement clauses for more than five years. Forty-four companies were delisted after they had merged or amalgamated with other companies while another 13 companies were delisted after their parent company acquired more than a 90% stake. (*Business Standard,* April 9, 2004, as cited in *Capital Market Chronicle*, published by SHCIL, May 7, 2004 p. 24.

[23] Delisting of foreign-controlled companies involves very different issues and the reasons are different.

(above 71 years). The explanation for this is that more of the people in the higher income classes and higher age-classes became shareholders during the roaring bull market of early 1990s. A lot of bogus or unsound companies were floated during those years. Investors who entered the market in more recent years had become more cautious. There has also been tightening of the application of listing rules. This has induced many promoters to get their companies delisted. The SEBI has recently tried to stop the misuse of delisting by promoters at the cost of the shareholders.

4.4 The exact number of companies which have already been delisted is not known. Our rough guess is that such number may be as high as 2000 or even 3000, in addition to the Z-group companies. According to the *SEBI Annual Report 2001-02,* the total number of companies listed on the Indian stock exchanges was 9644 (excluding double counting of companies listed on two or more exchanges). The SEBI annual reports for subsequent years give no figure of listed companies.

4.5 The BSE had 6330 listed companies.[24] Of these, as many as 3500 were in Z group which comprises companies not complying with listing agreement. Companies already delisted fall outside the SEBI's regulatory authority. The respondents to our survey have many complaints against delisted companies, such as that shares are unsaleable, share value has been destroyed, companies are not paying any dividend and not sending annual reports. Table 4.2 presents the detailed data.

[24] See BSE, *The Stock Exchange Review*, October 2003, P-11

4.6 If we consider Tables 4.1 and 4.2 together, interesting inferences emerge. Of the respondents who held shares in delisted companies, 80% complained that such shares are unsaleable, 60% complained that share value had been destroyed, 53% that these companies don't pay dividend and 63% that such companies do not send annual reports. It may be observed from Table 4.2 that this pattern is true of all income and age classes.

4.7 A huge number of our respondents are shareholders of delisted companies. These companies have already gone out of SEBI's jurisdiction. They had made initial public offer and had collected money from the public mostly during the boom years of early 1990s. A rough estimate of the total number of shareowning households who held shares of delisted companies may be made as follows: Roughly 4% of total Indian households are estimated to be shareowners.[25] The number of shareowning households can be derived to be around 80 lakh out of a little over 20 crore total households in India. As many as 38% of our sample households held shares in delisted companies. Applying the same percentages to the total number of share-owning households in India means that around 30 lakh households would be having shares of some delisted companies. This is a frightening figure. Many of these would be dud companies, but not all.

4.8 Given such a large number of sufferers among ordinary investors, special provision in company law is needed to protect outside shareholders of delisted companies. These companies were not complying with the listing agreement, very often deliberately in order to get delisted and free the management from the strict

[25] The SEBI-NCAER Surveys have estimated the percentage to be almost twice which is definitely an over-estimate. See L. C. Gupta, C. P. Gupta and Naveen Jain, *Indian Households' Investment Preferences* (Society for Capital Market Research & Development, Delhi, 2001), pp. 120-21.

listing rules. Their managements should have been punished long ago. Not all these companies are bankrupt. From what we hear, many of them are running businesses. Their managements may be deriving lavish benefits from the companies in a variety of ways. In the U.S., many of these company managements would have been severely punished for playing a fraud on the shareholders.

Need for further research

4.9 *Delisted companies are a fit subject for a full-scale research study, specially to understand the true reasons why they were delisted, the motives of the management, the number of shareholders of individual delisted companies, the year in which they made public issue, their latest financial position as per annual reports, specially to find out whether the auditors' report had disclosed any financial irregularities and had certified the accounts on going-concern basis. The proposed study should also examine shareholders' complaints about these companies. This could be of great help in deriving regulatory lessons for the protection of investors.*

Legal changes needed

4.10 Certain changes in company law seem necessary to enable shareholder action against managements of delisted companies. The Companies Act, in Sections 397-408, presently provides that complaint about oppression or mismanagement can be made to the Company Law Board if at least 100 shareholders holding at least 10% of voting shares join hands to make such a complaint. When shareholders are dispersed, such action by shareholders is rarely possible. Experience has shown that the existing company law provisions are too cumbersome to be workable. *In the case of* *most delisted companies, prima facie there was mismanagement.* It is, therefore, suggested that present legal provision be amended as follows. A smaller number of, say, at least 20 shareholders, holding among them at least 5% of the equity share capital, should be allowed to make a complaint to the Company Law Board about oppression or mismanagement. Secondly, we also suggest that legal provision should specially facilitate class-action suits by shareholders against the directors and top executives of companies. Through class-action suits, shareholders should be enabled to claim damages due to mismanagement and fraud which had led to delisting of the company. Another suggestion worth considering is that delisted companies should be required to adopt the principle of proportional representation by single transferable vote for constituting their Boards of Directors. This will facilitate some outside shareholders' representation on the board of directors. These outsiders can keep a watch on the company management for protecting the interests of shareholders.[26]

[26] The Companies Act also allows companies to constitute their board of directors on the basis of proportional representation (usually by adopting a cumulative voting system) on the presumption that it will facilitate some representation of minority shareholders on the board of directors. Such representatives are expected to keep a check on the management, i.e. the controlling group. However, no company is known to have adopted this system. This fact is that no controlling group would voluntarily give up the absolute power enjoyed by it. Under the ordinary voting system, a shareholder is entitled to cast as many votes as the number of shares he holds. Suppose a total of 8 directors are to be elected. A person holding 51% shares can elect all the 8. The proportional representation system in the form of cumulative voting has been devised to prevent such monopolization of the board of directors by the majority shareowner. Under this system of voting, each stockholder has as many votes as is equal to the number of voting shares he owns, multiplied by the number of directors to be elected. In the above example, a person owning 1000 shares will have 1000×8=8000 votes. He may give all the votes to one candidate or may distribute his votes among the candidates of his choice in any way he sees fit. This may enable a group of minority shareholders to elect one or two directors, depending on the size of minority shareholding. See Section 265, Companies Act, 1956.

Table 4.1

PERCENTAGE OF HOUSEHOLDS WHO ARE SHAREHOLDERS IN ANY <u>DELISTED</u> COMPANIES CONTROLLED BY INDIAN MANAGEMENTS

Household Investors Survey - 2004

A. Income-classwise Analysis

Whether shareholders in delisted companies	*All classes of sample households*	*Household income class (Rs. per month)*				
		Upto 10,000	10,001–15,000	15,001–20,000	20,001-25,000	Over 25,000
		Percentage of households column-wise				
1. Yes	**37.61**	33.25	35.19	39.89	40.25	42.64
2. No	**62.39**	66.75	64.81	60.11	59.75	57.36
Column total	**100.00**	100.00	100.00	100.00	100.00	100.00
No. of Respondents	**5,773**	1,543	1,327	1,088	708	1,107

B. Age-classwise Analysis

Whether shareholders in delisted companies	*All classes of sample households*	Age of household head (in years)							
		Upto 25	26-30	31-40	41-50	51-60	61-65	66-70	71 and above
		Percentage of households column-wise							
1. Yes	**37.61**	20.00	21.54	35.22	45.34	41.09	50.00	49.62	50.00
2. No	**62.39**	80.00	78.46	64.78	54.66	58.91	50.00	50.38	50.00
Column total	**100.00**	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
No. of Respondents	**5,773***	375	701	1,607	1,621	937	270	133	100

* Out of total sample respondents, a few did not provide information on their age. They have therefore, not been included in the individual age-classes but are included in the total sample.

Table 4.2

PERCENTAGE OF HOUSEHOLDS WHO HAVE SUFFERED IN VARIOUS WAYS DUE TO BEING SHAREHOLDERS IN DELISTED COMPANIES

Household Investors Survey - 2004

A. Income-classwise Analysis

	How Suffered	***All classes of sample households***	*Household income class (Rs. per month)*				
			Upto 10,000	10,001–15,000	15,001–20,000	20,001-25,000	Over 25,000
			Percentage of households column-wise				
1.	Such shares are unsaleable	80.63	79.57	81.20	79.95	82.17	80.93
2.	The share value has been destroyed	60.30	57.59	62.61	62.44	60.14	59.11
3.	Such companies don't pay dividend	53.50	52.33	55.56	56.68	54.90	48.94
4.	These companies don't send even annual reports	62.60	61.87	60.90	64.98	63.29	62.50
	No. of Respondents	**2174**	514	468	434	286	472

B. Age-classwise Analysis

	How Suffered	***All classes of sample households***	*Age of household head(in years)*							
			Upto 25	26-30	31-40	41-50	51-60	61-65	66-70	71 and above
			Percentage of households column-wise							
1	Such shares are unsaleable	80.36	56.00	81.46	79.89	81.71	80.47	86.13	84.85	86.00
2	The share value has been destroyed	60.07	48.00	60.26	56.97	63.96	57.29	64.23	60.61	72.00
3	Such companies don't pay dividend	53.17	33.33	50.33	52.03	54.74	52.60	58.39	57.58	72.00
4	These companies don't send even annual reports	62.33	45.33	58.28	61.38	63.14	61.46	71.53	77.27	68.00
	No. of Respondents	**2174***	75	151	567	738	384	137	66	50

* Out of total sample respondents, a few did not provide information on their age. They have therefore, not been included in the individual age-classes but are included in the total sample.

Note: Some respondents ticked more than one suffering.

Chapter 5

INDIAN MUTUAL FUND INDUSTRY AND THE RETAIL INVESTOR

I. Introduction

Mutual funds as product innovation

5.1 Mutual funds were undoubtedly an important product innovation in the financial field, as an instrument of raising capital from the wider public for corporate enterprise growth. Historically, mutual funds, originally called unit trusts in the U.K., were invented for the mass of relatively small investors. Most such investors have inadequate knowledge and face difficulty, not only in choosing the right stocks but also in managing the risk because they can not achieve sufficient diversification with only a small amount to invest.[1] A striking finding brought out by this study is that **a majority of retail investors in India do not regard mutual fund equity schemes as a superior investment alternative to direct holding of equity shares.**

Layout of the chapter

5.2 Section II, which follows this brief introduction, will present the empirical findings. These findings are based on the industry's situation as prevailing today. Section III presents a flashback to indicate the enormity of the structural change in the Indian mutual fund industry in recent years. This has a bearing on the trend of change in the near future and the factors underlying the change. Concluding comments are offered in Section IV.

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[1] See L. C. Gupta, *The Changing Structure of Industrial Finance in India* (Claredon Press, Oxford, London 1969), p. 64. Even a novice investor, by investing a small sum in mutual fund units, immediately gets the advantage of diversifying his investment over scores, or hundreds, of companies, selected by full-time professional managers. The investor can easily follow the performance of his mutual fund investment by simply looking at the weekly reported NAV of his fund. If he needs money, he can liquidate the investment any day in the case of open-ended mutual fund schemes.

Empirical Evidence on Retail Investors' Preferences

5.3 A very important question on which we shall focus is**: Do the majority of Indian retail investors regard mutual fund equity schemes as being a superior investment alternative compared to direct shareholding?** In a sense, it tests the practical validity of the theory underlying the original purpose of mutual funds.

5.4 In India, the Unit Trust of India (UTI), created in 1964, had complete monopoly of mutual fund business upto 1988. The other MF organisations have a very short history because the MF industry was opened to limited competition in 1988 and almost free competition in the 1990s only.

5.5 In the U.S., where mutual funds have a long history, there exists much theoretical literature on whether mutual fund managers are actually able to "beat the market", i.e. secure a return higher than the market's average rate of return based on a representative market index.[2] Such an investigation can be hardly meaningful in India at the present stage of the industry. Hence, we decided to proceed from a different angle by examining the **retail investors' own perceptions about mutual funds as a vehicle for accumulating savings.** This is best brought out by determining the **retail investors'** preference between **mutual fund** products on the one hand and direct holding of equity shares on the other.

[2] Some perceptive market practitioners as well as scholarly studies in the U.S. had come to the conclusion that **most fund managers most of the time do worse than the market average** after allowing for management fees, expenses, and brokerage. The wide recognition of such failure led to the emergence of index funds. See Peter Lynch and John Rothchild, *Learn to Earn* (New York, 1995), pp. 124-5. See also Josef Lakonishok, Andrei Shleifer and Robert W. Vishny, "The Structure and Performance of Money Management Industry", in *Brookings Papers: Microeconomics,* 1992, pp. 339-391, sp. pp. 354-56.

5.6 Our method is based on interviewing of household heads, as already explained earlier in the Chapter 1.

Multi-dimensional analysis

5.7 In order to determine the investors' preferences reliably, we adopted a multi-dimensional approach by collecting from household heads a variety of information regarding their investment activities, such as:

(a) the investment types presently held by them;

(b) future investment intentions;

(c) their past experiences; and

(d) their choices of investment types in a hypothetical investment game. This game was devised because not many households are prepared to disclose the actual amount of their savings and investments. Our game used a notional sum and asked the investors to indicate how much of this sum would they like to 'bet' on each investment type. Even though hypothetical, it did throw more light on the households' thinking about the relative merits of a wide range of investment types. **The findings from all the angles show that the investor's preference for mutual fund products is far behind that for direct equity shareholding.**

5.8 The main findings are presented in this chapter for the total sample of households. Detailed disaggregated analysis by **income-class** and **age-class will be presented later in Chapter 7 along with a broader examination of households'** investment preferences.

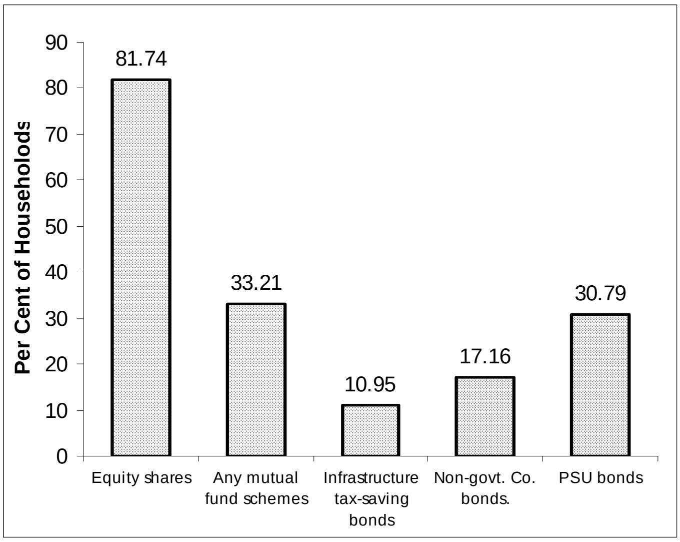
Investment types owned by households

5.9 The order of preferences for the various investment types can be determined on the basis of market penetration of each investment type. Our main focus is on capital market instruments, distinguished into the following five types: (a) direct equity shareholding, (b) mutual fund schemes (all types combined), (c) infrastructure tax-saving bonds, (d) non-govt. company bonds and (e) PSU bonds. The findings are shown in Chart 5.1 along with Table 5.1.

Table 5.1 and Chart 5.1

PERCENTAGE OF TOTAL SAMPLE HOUSEHOLDS OWNING VARIOUS CAPITAL MARKET INSTRUMENTS: (HOUSEHOLD INVESTORS' SURVEY 2004)

	Capital Market Instruments	Per cent of Households
(a)	Equity shares	81.74
(b)	Any mutual fund schemes	33.21
(c)	Infrastructure tax-saving bonds	10.95
(d)	Bonds/debentures of non-govt. Cos.	17.16
(e)	Bonds/debentures of PSUs	30.79
	No. of sample households	**5908**



Note: PSU = Public Sector Undertaking.

5.10 The most noteworthy finding in the present context is that the **percentage of households who owned equity shares directly is more than 2½ times the percentage of those who owned any mutual fund schemes.** Thus, on a very simple criterion of how popular the various investment types are, the mutual funds are far behind direct shareholding.

Future intentions

5.11 Our next criterion was based on the retail investors' future investment intentions with respect to capital market instruments. We asked them: **How likely are you to make "net addition" during the next one year to investment in** (1) equity shares, (2) mutual fund equity / growth schemes, (3) mutual fund income schemes and (4) private sector company bonds. (Likelihood was to be indicated in terms of “very likely,” “somewhat likely,” “not much likely,” and “not at all likely”)

5.12 It may be observed from Chart 5.2 and Table 5.2 that as high as 66.5% of sample households stated that they were likely (i.e. intending) to make “net addition” to their holding of equity shares during next one year but the corresponding figure was only 40.9% with respect to mutual fund investment (“Likely” is combination of “very likely” and “somewhat likely”). Thus, the percentage of households “likely” (i.e. intending) to invest in direct purchase of equity shares over next one year is more than 1½ times of those intending to invest in MF equity schemes. Detailed income-class and age-class analysis will be discussed in the broader context of investment preferences in Chapter 7 (see specially the Appendix to Chapter 7).

Households’ past experience of investment types

5.13 The percentage of households who described their past experience with direct equity investment as satisfactory (including very satisfactory) is significantly higher than the corresponding percentage in the case of MF equity schemes and also in the case of MF income schemes, as depicted in Table 5.3 and Chart 5.3. Detailed analysis by income-class and age-class is presented in the appendix to this chapter as Tables A5 (1) to A5 (8).

Table 5.2

ANALYSIS OF TOTAL SAMPLE HOUSEHOLDS ACCORDING TO HOW LIKELY THEY ARE TO MAKE NET ADDITION TO INVESTMENTS IN THE FOLLOWING TYPES DURING NEXT ONE YEAR?

(SURVEY 2004)

	How likely	*Percent of Responses*			
		Equity shares	*MF equity schemes*	*MF income schemes*	*Non-govt. co. bonds*
1.	Very likely	41.84	16.23	13.09	4.76
2.	Somewhat likely	24.67	24.68	21.52	8.43
	Subtotal (1+2)	*66.51*	*40.91*	*34.61*	*13.19*
3.	Not much likely	13.36	17.71	19.10	15.10
4.	Not at all likely	20.12	41.38	46.28	71.71
	Subtotal (3+4)	*33.48*	*59.09*	*65.38*	*86.81*
	Column total	**100.00**	**100.00**	**100.00**	**100.00**
	No. of Respondents	**5,597**	**4,867**	**4,758**	**4,624**

Chart 5.2
Intending Investors

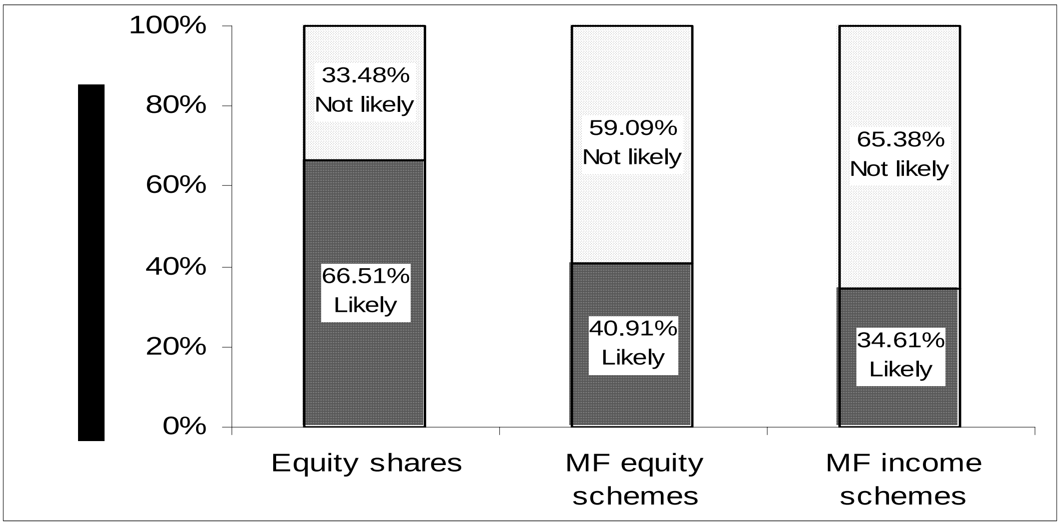


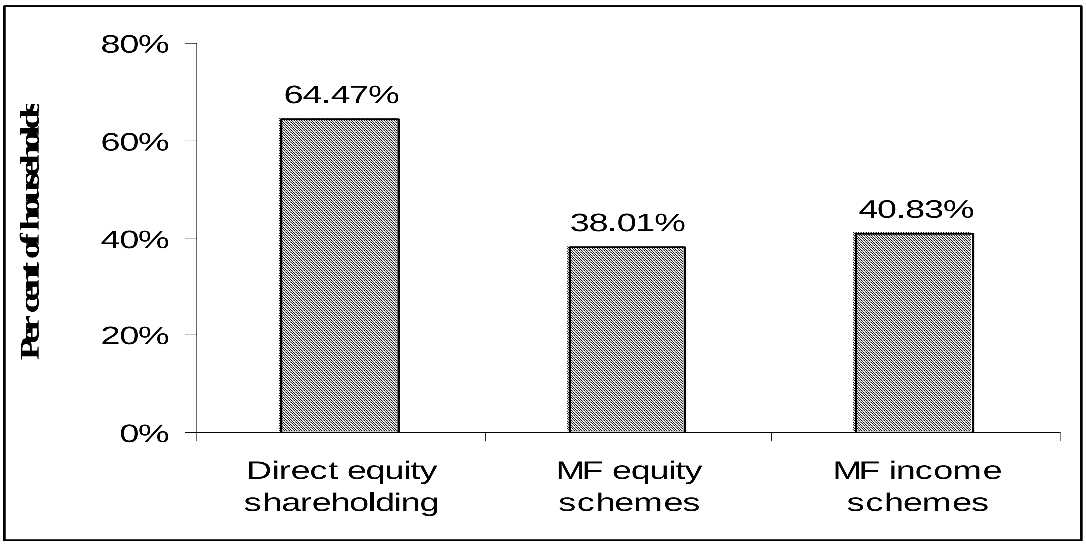
Table 5.3

ANALYSIS OF HOUSEHOLD INVESTORS ACCORDING TO HOW SATIFACTORY WAS THEIR EXPERIENCE OF INVESTING IN VARIOUS INVESTMENT TYPES

(SURVEY 2004)

		Percent of Responses			
	How satisfactory	*Equity shares*	*MF equity schemes*	*MF income schemes*	*Non-govt. co. bonds*
1.	Very satisfactory	10.88	6.16	5.06	1.67
2.	Satisfactory	53.59	31.85	35.77	17.76
	Subtotal (1+2)	*64.47*	*38.01*	*40.83*	*19.43*
3.	Not satisfactory	21.96	23.17	22.38	18.12
4.	Extremely unsatisfactory	4.49	7.88	6.30	10.01
5.	Can't Say/Not applicable	9.08	30.94	30.48	52.44
	Subtotal (3+4+5)	*35.53*	*61.99*	*59.16*	*80.57*
	Column total	**100.00**	**100.00**	**100.00**	**100.00**
	No. of Respondents	**1002**	**876**	**889**	**839**

Chart 5.3
Percentage of Households Who Had Satisfactory Past Experience with Specific Investment Types



Investment game

5.14 The Investment game was devised by us to peep into the investor's mind a little more deeply than is possible by head-count only. The game asked investors to allocate a notional sum of Rs. 100,000 among different investment types, chosen from a given list of 10 major types but restricting their allocation to not more than 5 types. The 10 types from which the respondents had to choose comprised not only capital market instruments but also bank fixed deposits and government savings schemes.

5.15 For practical reasons, we asked respondents to choose investment types from our restricted list only. This artificial restriction was intended to make the exercise easier and less time-consuming. The purpose of the game was to **understand the retail investor's relative preferences between any pairs of investment types** from our list. Even though the percentages are artificial (and would not match the national data on financial savings compiled by the RBI), they are good enough for comparisons within the given investment types.

5.16 Table 5.4 shows the percentage of the notional sum allocated to various investment types by all the sample households taken together. Chart 5.4 highlights that ***direct equity*** **shareholding gets nearly four times as much allocation as mutual fund** ***equity schemes*** **and twice as much allocation as all types of mutual fund schemes combined.** The sub-classes of mutual fund schemes are also shown in Chart 5.4. It may be observed from Table 5.4 that only the government savings schemes have a higher allocation than direct equity shareholding and that bank fixed deposits are also a highly preferred type of investment but less preferred than government savings schemes. There are very few takers for non-govt. company bonds. Bonds of PSUs and financial institutions are far more preferred than private sector bonds.

Table 5.4

ALLOCATION OF A NOTIONAL SUM OF RS. 100,000 BY SAMPLE HOUSEHOLDS AMONG SPECIFIC INVESTMENT TYPES

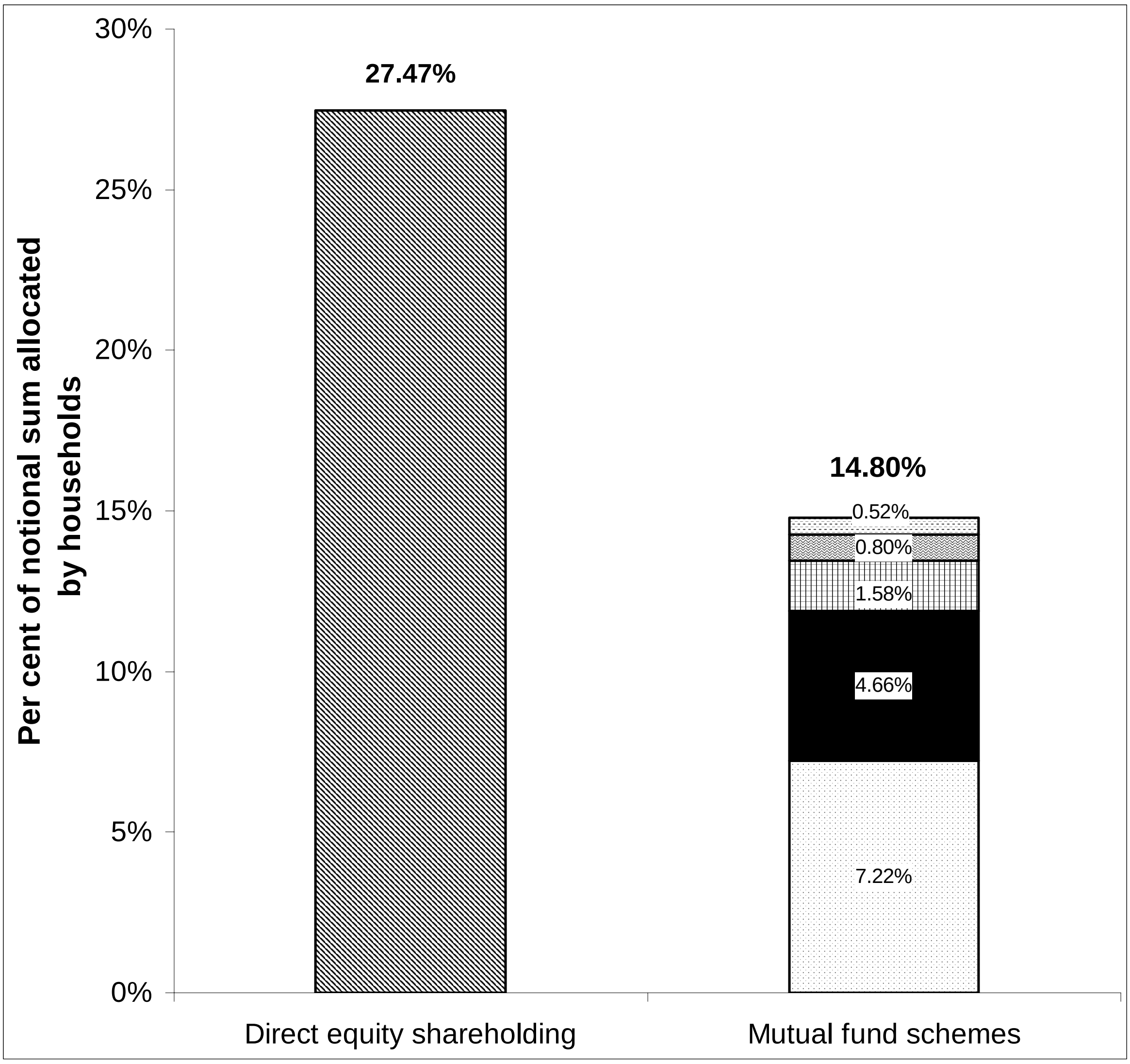
Investment types	Amount allocated (Rs.)	% of total amount	No. of respondents*	% of total respondents*
(a) Bank fixed deposits	**22,078,666**	**22.93**	697	72.38
(b) Equity shares	**26,453,063**	**27.47**	761	79.02
(c) Mutual fund equity / growth schemes	**6,949,374**	**7.22**	343	35.62
(d) Mutual fund income schemes	**4,486,206**	**4.66**	255	26.48
(e) Mutual fund balanced schemes	**1,521,896**	**1.58**	103	10.70
(f) Gilt funds	**770,556**	**0.80**	49	5.09
(g) Money market funds	**500,790**	**0.52**	32	3.32
Sub Total (c to g)	***14,228,822***	***14.78***	*782*	*81.21*
(h) Bonds/ debentures of non-govt. companies	**1,608,374**	**1.67**	99	10.28
(i) Bonds of govt. undertakings/ financial institutions	**5,445,577**	**5.65**	290	30.11
(j) Govt. saving schemes (PPF, NSC, P.O. schemes)	**26,485,498**	**27.50**	789	81.93
Total	**96,300,000**	**100.00**	**963**	

* Respondents were free to choose more than one investment type. Hence, the actual total of the column would exceed the number of respondents.

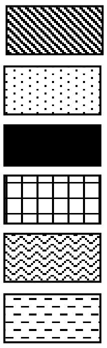
Note: Each household head was requested to allocate a notional sum of Rs 1,00,000 choosing not more than 5 investment types from the given list of 10 types.

Chart 5.4

Investment Game: Amount allocated to Direct Shareholding vs. MFs



Legend:



- Direct equity shareholding
- Mutual fund equity / growth schemes
- Mutual fund income schemes
- Mutual fund balanced schemes
- Gilt funds
- Money market funds

Table 5.5

ALLOCATION OF A NOTIONAL SUM OF RS. 100,000 BY SAMPLE HOUSEHOLDS AMONG THREE FORMS OF SHARE INVESTMENT

Household Investors Survey-2004

Form of share investment	Amount allocated	% of total amount	No. of respondents*	% of total respondents*
(a) **Direct holdings** of equity shares	**56,540,000**	**58.83**	917	95.42
(b) Mutual fund **index schemes** (i.e. index funds)	**14,060,500**	**14.63**	548	57.02
(c) Mutual fund **equity/growth schemes**	**25,499,500**	**26.53**	737	76.69
Total (all respondents)	**96,100,000**	**100.00**	**961**	

* *Respondents were free to choose more than one form. Hence, the actual total of the column would exceed the number of respondents.*

Note: Each household head was requested to give his/her preferred allocation among the three forms of share investment in his/her circumstances.

Chart 5.5
Allocation between Direct and Indirect Investment in Equity Shares

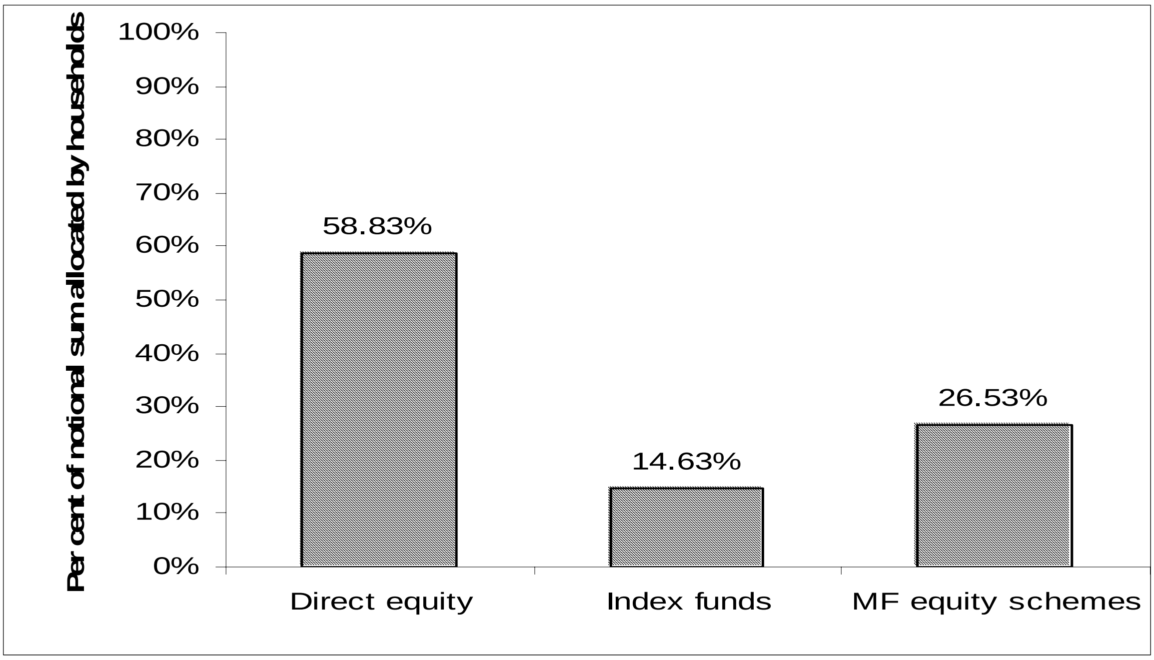


Table 5.6

PERCENTAGE ALLOCATION OUT OF A NOTIONAL SUM OF RS. 1,00,000 AMONG EQUITY INVESTMENT FORMS BY A SAMPLE OF HOUSEHOLD INVESTORS

Household Investors Survey – 2004

A. Income Class-wise Analysis

Form of Equity Investment	***All classes of sample households***	*Household income class (Rs. Per month)*				
		Upto 10,000	10,001 -15000	15,001-20000	20,001-25000	Over 25,000
	Percent Allocation of Amount Column-wise					
(a) Direct holdings of Equity Shares	**58.83**	58.19	57.56	62.10	56.29	59.56
(b) Mutual fund Index Schemes	**14.63**	17.20	15.19	13.56	15.35	11.56
(c) Mutual fund Equity/ Growth schemes	**26.53**	24.61	27.24	24.34	28.36	28.87
Total	**100.00**	100.00	100.00	100.00	100.00	100.00
Sample of respondents	**961**	228	206	191	141	195

B. Age-wise Analysis

Form of Equity Investment	***All classes of sample households***	*Age of household head(in years)*							
		Upto 25	26-30	31-40	41-50	51-60	61-65	66-70	71 and above
	Percent Allocation of Amount Column-wise								
(a) Direct holdings of Equity Shares	**58.83**	56.74	61.01	56.43	58.33	61.73	60.08	58.00	62.74
(b) Mutual fund Index Schemes	**14.63**	16.82	14.44	16.15	15.10	12.11	14.75	10.86	11.61
(c) Mutual fund Equity/ Growth schemes	**26.53**	26.44	24.55	27.41	26.57	26.16	25.17	31.14	25.65
Total	**100.00**	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
Sample of respondents	**961***	54	99	261	260	168	59	29	31

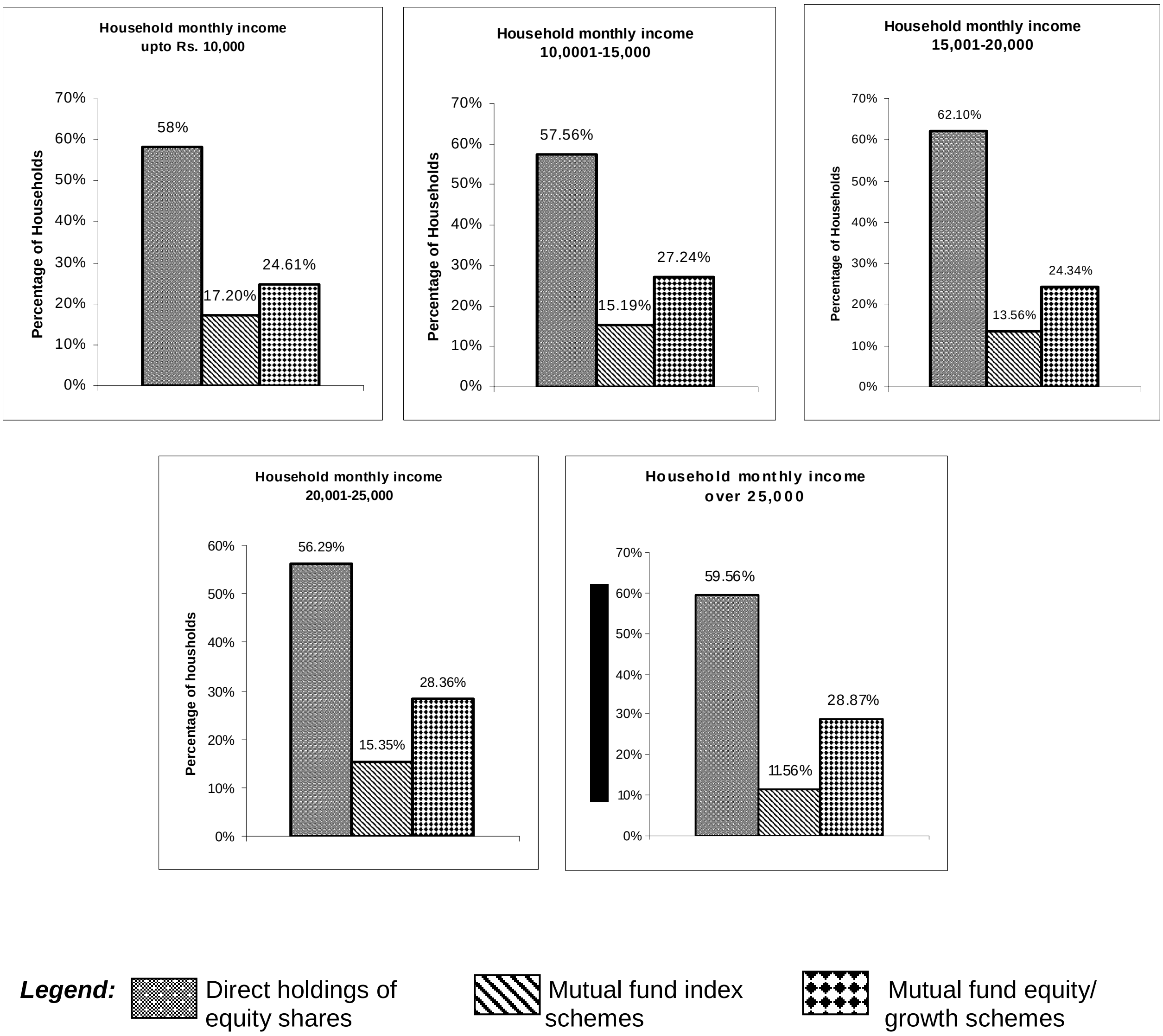
Explanatory Note:
Household heads were requested to allocate a notional sum of Rs. 1,00,000 according to what they thought would be the best combination in their circumstances. The analysis for the sample as whole has been carried out in terms of total amount allocated by the sample households.

* Out of total sample respondents, a few did not provide information on their age. They have therefore, not been included in the individual age-classes but are included in the total sample.

Chart 5.6A

<u>PER CENT OF SUM</u> OF RS. 1,00,000 ALLOCATED BY HOUSEHOLDS AMONG PARTICULAR FORMS OF EQUITY INVESTMENT

(Income-classwise Analysis)

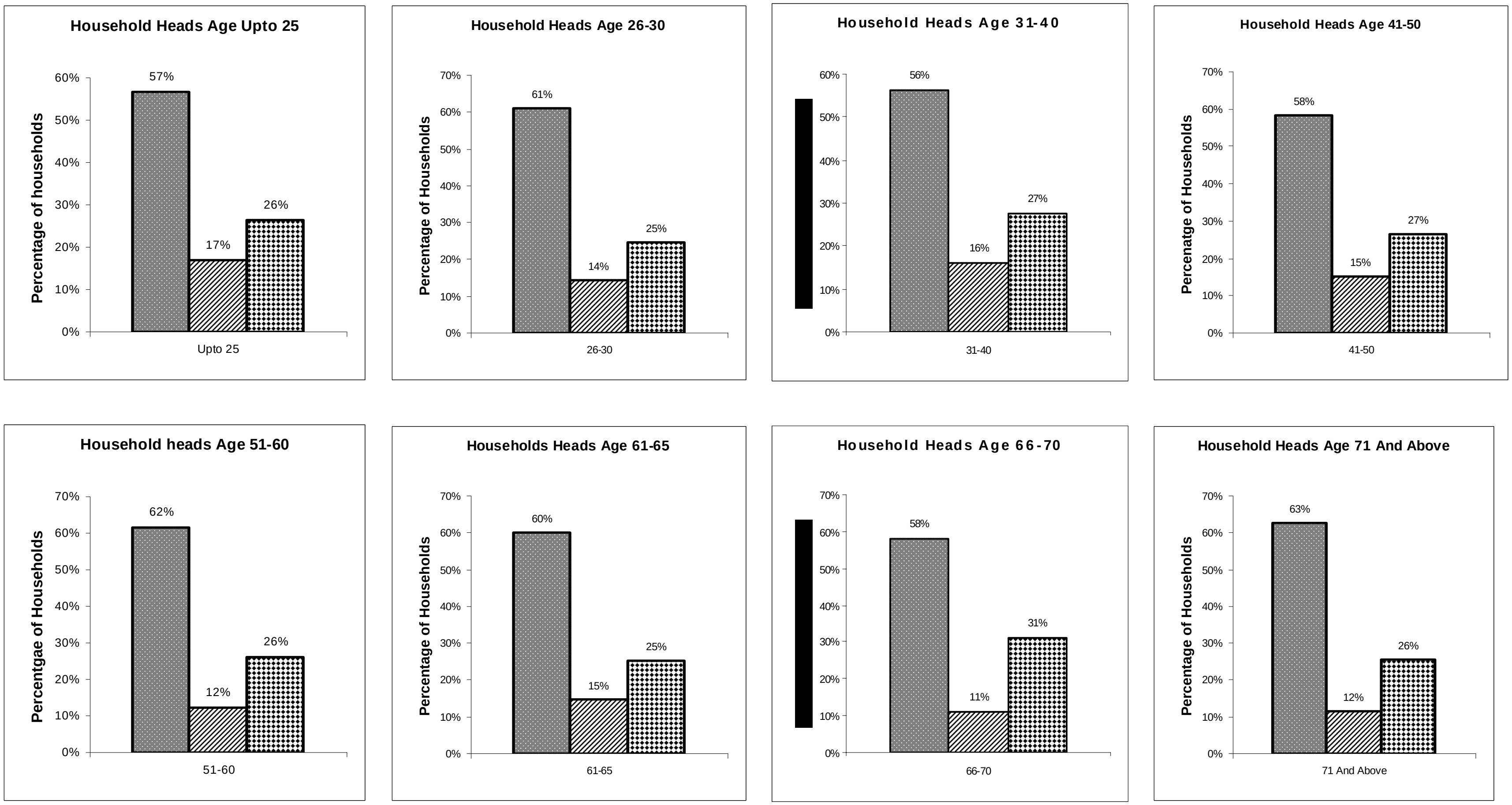


Note: Household heads were requested to allocate a notional sum of Rs 1,00,000 among various forms of equity investment according to what they thought would be best in their circumstances. The analysis for the sample as whole has been carried out in terms of number of households choosing the particular form.

Chart 5.6 B

<u>PER CENT OF SUM</u> OF RS. 1,00,000 ALLOCATED BY HOUSEHOLDS AMONG PARTICULAR FORMS OF EQUITY INVESTMENT

(Age-classwise Analysis)



Legend: Direct holdings of equity shares; Mutual fund index schemes; Mutual fund equity / growth schemes

Note: Household heads were requested to allocate a notional sum of Rs 1,00,000 among various forms of equity investment according to what they thought would be best in their circumstances. The analysis for the sample as whole has been carried out in terms of number of households choosing the particular form.

5.17 Chart 5.5 and Table 5.5 present the results of a similar game by restricting the allocation of the notional sum to three types only, viz., direct equity shareholding, index funds and other MF equity schemes, in order to determine the relative preferences within these three forms of equity investment. As may be observed, direct equity shareholding is far more preferred than investing through mutual fund equity schemes, including both index funds and other equity funds. This is true of all income-classes and age-classes (see Table 5.6 and Chart 5.6A / 5.6B).

5.18 **Thus, from all the angles of our analysis, the households' preference for direct shareholding far outweighs their preference for mutual fund equity schemes and even all mutual fund schemes taken together. This is so despite the theoretical advantages claimed by advocates of mutual funds. The reasons for this will be discussed in the concluding section IV. The mutual fund industry needs to do some hard thinking.**

III. The Changing Structure of Indian MF Industry

5.19 The mutual fund business was progressively opened to competition from 1988 onwards. This move gathered momentum after the adoption of economic liberalization in 1991 and the creation of SEBI as a statutory body in 1992. **Around this time, it began to be felt that all SEBI regulations, applicable to the newly established mutual funds, should also apply to the UTI in order to ensure a level-playing field but the process of change was not completed even by 2001.**

5.20 Upto the end of the 1990s, despite intensifying competition, the **UTI continued to be like Gulliver among Lilliputians. The assets under the UTI's management amounted to a little over Rs. 64,000 crore, forming almost two-thirds (64.7%, to be precise) of total assets of all Indian mutual funds** combined as on 31st December 2000.[4] This was just a few months before a crisis hit the UTI with the force of a tornado and virtually broke it up.[5]

US-64 crisis and after

5.21 Soon after the stock market scam of March 2001, there was an inside scam in the UTI. As a result, the UTI's US-64 Unit Scheme suddenly collapsed in July 2001. Its NAV plunged far below the sale price of the units and well below even the face value of the units. The scheme faced bankruptcy of a kind. There was much public outcry as millions of US-64 unitholders had to bear heavy losses. The government could not escape its responsibility because the UTI was always regarded as a public sector institution. A bail-out package for US-64 scheme was worked out to limit the losses of unitholders to some extent. The scheme was wound up in 2003 by giving Government Guaranteed 6.75% Tax Free Bonds to US-64 unitholders. This exchange involved an average loss of around 35-40% of the cost price paid by the unitholders.

5.22 **An important point to be noted is that the winding up of US-64 scheme meant that a sizable chunk of investors went out of the mutual fund industry. This scheme was the only mutual fund scheme held by many households.** Besides the US-64 scheme, the

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4 For a detailed historical account upto end of 2000, see L. C. Gupta and Utpal Choudhury, *How Good Are Mutual Funds* (SCMRD, Delhi, 2001), p. 88. The figures are based on AMFI data.

5 The UTI faced a milder crisis earlier in 1998. See Ibid., pp. 78-83. For subsequent events, see L.C. Gupta, Naveen Jain and Utpal Choudhury, *India's Stock Market & Household Investors 2001-04* (SCMRD, Delhi, 2004), pp. 26-29.

UTI's guaranteed income schemes have also mostly been wound up.[6]

The residual UTI

5.23 The remaining UTI schemes have been hived off and transferred to a new organizational set up, called UTI Mutual Fund. The assets under management of this new UTI Mutual Fund at the end of September 2004 amounted to Rs. 20,224 crore representing less than 15% of the total for the Indian mutual fund industry as a whole, compared to the erstwhile UTI's 64.7% share of all mutual fund assets at the end of 2000. There were 29 MF organizations operating in India as on September 30, 2004, managing a total of Rs. 1,53,108 crore assets, as per data provided by AMFI. The industry leadership, market shares and the composition of products and clients of the mutual fund industry have been changing very rapidly.

5.24 The change in the composition of mutual fund business has been quite drastic between 1999 and 2004, as brought out by Table 5.7 and specially Chart 5.7.

5.25 Table 5.7 shows that **equity schemes have accounted for well below one-fifth of total assets under management of mutual funds in India. The Indian mutual fund industry as a whole holds just around 2% of the market capitalization of listed equity shares. Households in India directly hold an average of 15% or perhaps more of the quoted equity. These macro figures tell us that mutual fund cult has yet to catch up in India.**

[6] See L. C. Gupta, Naveen Jain and Utpal Choudhury, *India's Stock Market and Household Investors, 2001-04* (SCMRD, Delhi, 2004), pp. 26-29.

Table 5.7

AMOUNT OF ASSETS UNDER MANAGEMENT OF MUTUAL FUNDS AS ON 30TH JUNE OF 1999 TO 2004

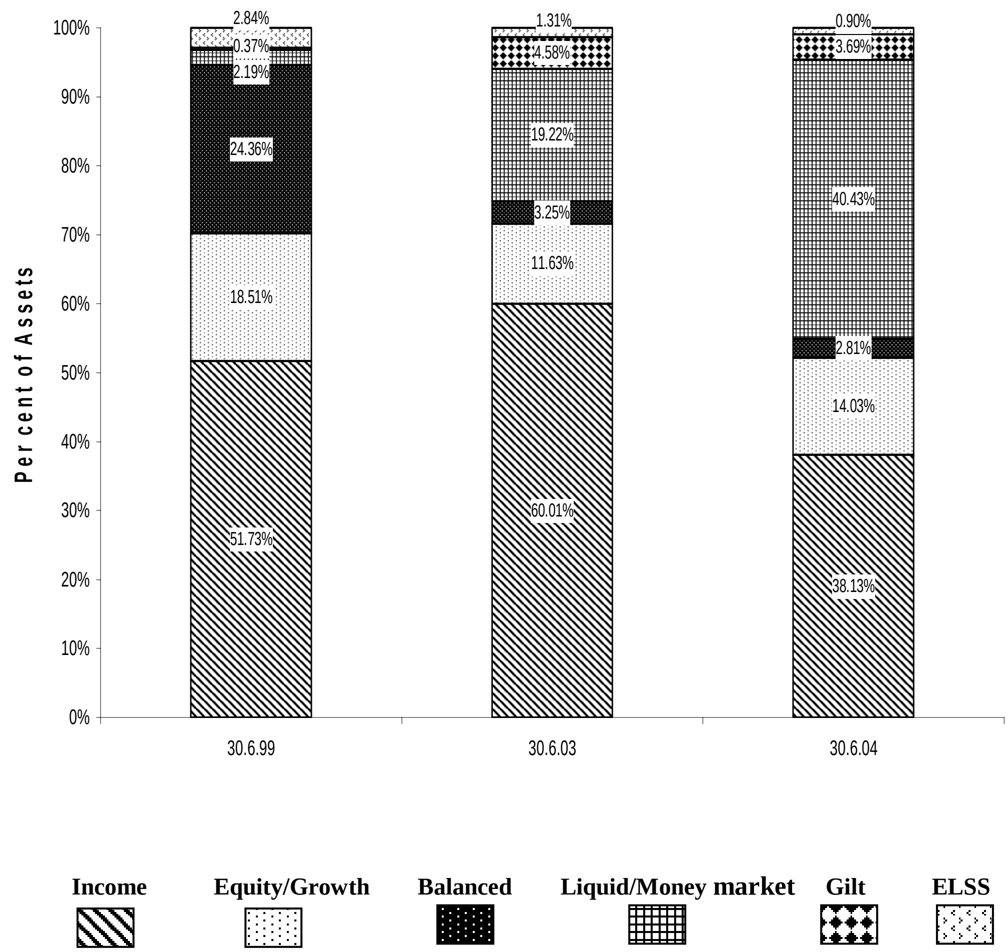
Type of fund	1999		2000		2001		2002		2003		2004	
	Rs. Cr.	*%*	*Rs. Cr.*	*%*	*Rs. Cr.*	*%*	*Rs. Cr.*	*%*	*Rs. Cr.*	*%*	*Rs. Cr.*	*%*
Income	38,730	51.73	49,530	45.98	54,565	55.71	55,205	54.82	62,871	60.01	59,431	38.13
Equity / Growth	13,855	18.51	25,572	23.74	12,760	13.03	14,393	14.29	12,181	11.63	21,869	14.03
Balanced	18,239	24.36	25,288	23.47	18,816	19.21	15,482	15.37	3,403	3.25	4,382	2.81
Liquid/ Money market	1,641	2.19	2,968	2.76	6,444	6.58	10,138	10.07	20,139	19.22	63,015	40.43
Gilt	280	0.37	2,091	1.94	3,264	3.33	3,972	3.94	4,793	4.58	5,746	3.69
ELSS*	2,126	2.84	2,279	2.12	2,104	2.15	1,513	1.50	1,375	1.31	1,402	0.90
Total	**74,871**	**100.00**	**1,07,728**	**100.00**	**97,953**	**100.00**	**1,00,703**	**100.00**	**1,04,762**	**100.00**	**1,55,845**	**100.00**

Source: Association of Mutual Funds in India (AMFI). The data relates to 30th June of each year.

* ELSS = Equity-linked savings scheme

Chart 5.7

Per Cent of Assets Under Management Under Various Types of Mutual Fund Schemes for Selected Dates



5.26 The income funds represented the largest component of mutual fund business in India since 1999 till recently. These funds have generally accounted for over 50% of the total mutual fund assets, except in 2004.

5.27 Balanced funds seem to fall between two stools. They were a significant component upto 2002. They accounted for around 25% of total assets in 1999 but declined steadily to just around 15% in 2002; and thereafter, they have been reduced to only about 3% because of winding up of US-64 scheme, which was by far the single largest balanced fund in Indian mutual fund industry.

5.28 A major shift in the MF industry's focus is represented by the rise of Liquid / Money Market Funds from the level of only about 2% of the total assets of Indian MF industry in 1999 to 40% in September 2004, becoming the largest chunk of mutual fund assets. The liquid funds cater mainly to the needs of corporate clients and high networth individuals. **Retail investors overwhelmingly prefer bank deposits rather than liquid / money market funds.** According to our household investors survey of 2004, only 3-4% of retail investors showed interest in liquid funds and around 5% in gilt funds, but these investors were prepared to invest no more than 1% of the total available sum in liquid / money market funds (see Table 5.4 above). Such funds are a substitute for bank fixed deposits.

5.29 The data compiled by AMFI indicates that **the mutual fund industry has shifted its focus towards corporates and high networth individuals and away from the retail investors.**[7] The reason is that mobilizing savings from small investors and mofussil areas is very expensive and, therefore, unattractive as a

[7] See *The Economic Times*, October 27, 2004, quoting the CEO of Taurus Mutual Fund.

business proposition. On the other hand, corporates and large clients can provide to the mutual fund a critical mass to recover its management costs. Thus, the **reduced relative importance of retail business in the total MF business is explainable partly by the retail investors' disenchantment with mutual fund products and partly by business compulsions of the mutual fund organisations.**

IV. Conclusions : A Critique of Mutual Funds

A contradiction

5.30 Mutual funds and retail investors were like "made for each other" and, therefore, the disenchantment of retail investors with MFs is a curious and surprising phenomenon. It contradicts the theory underlying mutual funds. The AMFI has recently expressed concern "that **households are not allocating their savings to the mutual fund schemes, particularly equity schemes".**[8] As we have noted earlier, **retail investors are no more the dominant class of clients served by the mutual fund industry.**

Investors' unhappy experiences

5.31 After the MF industry was opened to competition and many new kinds of "attractive" MF schemes were launched, a growing number of retail investors bought these mutual fund products for some time. Investors relied on the implicit, and sometimes explicit, promises made in the offer documents. In many cases, the promises made could not be honoured. In some cases, the sponsoring bank had to bail out the mutual fund and, in other

[8] See AMFI Update (Newsletter of the Association of Mutual Funds in India) July-September 2004.

cases, the investors had to grin and bear the loss. The first lot of new mutual funds were set up by public sector banks and financial institutions with deputed staff who had no experience of the relevant kind and who were only waiting for promotion in their parent organisations. It is not surprising that most such funds performed poorly.

Managerial incompetence, malpractices and herd behaviour

5.32 Investors in mutual funds have been discouraged by nasty surprises many times since mid-1990s due to managerial incompetence, malpractices and frauds. The biggest shock was the US-64 crisis which caused heavy and widespread losses. Some foreign-sponsored funds under world-renowned managements, which had raised great expectations, proved to be a flop.

5.33 Many mutual fund managers trade too much. We came across an annual report of one equity mutual fund which claimed with pride that their whole investment portfolio turns over during a year as if active trading was synonymous with intelligent fund management! Too much churning of portfolios does not necessarily result in higher returns because of brokerage and other costs and lack of a long-term approach. Secret sharing of commissions between fund managers and market intermediaries is not unknown. The IT boom of 1999-2000 showed how mutual fund managers were as much susceptible to herd behaviour as the ordinary investors. Of course, some equity schemes have given excellent performance but these are relatively few. [9]

[9] Value Research, a reputed organization, devoted to the analysis of mutual funds, has developed a system of mutual fund ratings. See their monthly journal, *Mutual Fund Insight.*

Unfamiliarity factor

5.34 A subtle point brought out by our analysis is that **retail investors are not sufficiently familiar with mutual funds. In relative terms, there is much more unfamiliarity with mutual funds than with the share market among the retail investors.** Unfamiliarity with an investment type affects the investor's confidence level. Our all-India Household Survey of 2004 revealed that as high as 40-45% of respondents did not at all intend to make "net addition" to investment in MF equity schemes and MF income schemes. The corresponding figure for direct equity shareholding was only about 20% (see Table 5.2 above). The relatively greater unfamiliarity of households with mutual funds than with direct shareholding is indicated also by Table 5.3 which depicts how satisfactory or unsatisfactory was the investor's past experience with various investment types. About 30% of respondents answered "can't say / not applicable" in the case of MF equity schemes and MF income schemes, indicating their lack of familiarity. The corresponding figure for direct equity shareholding was less than 10%. Such wide difference is at least partly due to the difference in familiarity with the various types of investment.

What should be done?

5.35 **While there is some recognition in mutual fund circles about the need to educate investors about the advantage**

(or superiority) of mutual fund equity schemes over direct shareholding, the effort has not been commensurate with the need. The approach has not been that of "marketing" which lays emphasis on precisely knowing the customer's needs. The approach being adopted mostly is the "selling" approach, or rather "hard selling" of particular "products".

5.36 **More importantly, the majority of retail investors are not persuaded by the idea of mutual funds because such funds have not so far demonstrated the ability to possess a really superior investment strategy, not attainable by intelligent retail investors.**

The maturing of retail investors

5.37 The bulk of the present generation of retail investors got their exposure to the vicissitudes of the equity market during the last 15 years, specially the 1990s. Their attitudes have considerably matured as a result of lessons derived from boom-bust market cycles and market frauds. They became far more cautious and discerning. They have re-jigged their investment strategy to make it more appropriate to the prevailing Indian environment where market volatility is relatively high and regulation is weak. Their strategy is explained below.

How retail investors "beat" the mutual funds

5.38 The equity investment strategy evolved by the mature and intelligent retail investors has the following broad features:

(a) **They limit the equity share portfolio to a small number of very selected companies, generally not exceeding 10.** This allows better portfolio supervision by knowing the individual companies. The companies are selected strictly on the basis of their long-term potential and not for short-term trading. Our household investors survey of 2004 revealed that about 70% of such investors held shares in not more than 10 companies. Just about 50% of them held shares in 3-10 companies (i.e. narrow diversification). This was broadly true of all income-classes and age-classes of retail investors. [10]

(b) Over the years, they become more familiar with the companies in their portfolio. They wait for the opportunity of buying more shares of the good companies in their portfolio, whenever the market temporarily dips. This reduces their average acquisition cost of the shares without adding to the number of companies in the portfolio but their investment increases. This is a way of **neutralizing the market risk.** It is a well-defined strategy.

[10] For an earlier survey, see L.C. Gupta, C.P. Gupta and Naveen Jain, *Indian Households' Investment preferences* (Society for Capital Market Research and Development, Delhi, 2001), pp. 96-8

(c) This strategy involves no annual management fee to be paid to anybody. This is an important advantage compared to investment through mutual funds which involve annual management and other expenses of about 2.0-2.5% plus entry/exit loads. Many high networth individuals use the services of portfolio managers but such services are costly for retail investors who depend on informal sources of advice.[11]

5.39 **There is theoretical support for the policy of moderate diversification of share portfolios. It has been statistically shown that more than one-half of the investment risk, as measured by standard deviation of individual share returns, is eliminated by portfolios of 5 shares; more than two-thirds of risk is eliminated by portfolios of 10 shares and about four-fifths of risk is eliminated by portfolios of 20 shares. Diversification over 100 shares eliminates 90% of the risk.[12] However, none of this at all provides protection against "market risk" (also known as "systematic risk") whereas the intelligent retail investor's strategy described above provides against market risk by maintaining a long vision and lowering the average cost by taking advantage of market dips.**

[11] For information on sources of investment advice used by retail investors, see *India's Stock Market & Household Investors* (2004), op. cit., pp. 53-55.

[12] See L. C. Gupta, *Rate of Return on Equities: The Indian Experience* (Oxford University Press, 1981), pp. 33-34. 'Market risk' has to be distinguished from the risk of random error or insurable risk. See ibid., pp. 31-32.

5.40 Peter Lynch, a world renowned fund manager, had observed that the herd of fund managers "tend to graze in the same pastures of stocks. They feel comfortable buying the same stocks which other managers are buying and they avoid wandering off into unfamiliar territory. So they miss the exciting prospects that can be found outside the boundaries of the herd".[13] We find, for example, that most of the mutual funds and other institutional investors in India are making the same mistake as pointed out by Lynch: they are investing in the same group of well-known top companies whose share prices are, therefore, often bid up too high.

Final comment

5.41 The Indian mutual fund industry does not seem to be in good shape. There is need for a thorough over-all review of the industry, including its regulation, management structure, investment practices and performance.

[13] See Peter Lynch and John Rothchild, *Learn to Earn* (Fireside New York, 1995), p. 118-19.

Appendix to Chapter 5

Table A5 (1)

ANALYSIS OF HOUSEHOLD INVESTORS ACCORDING TO HOW SATISFACTORY WAS THEIR EXPERIENCE OF INVESTING IN: EQUITY SHARES

Income-classwise Analysis

How satisfactory	***All classes of sample households***	*Household income class (Rs. per month)*				
		Upto 10,000	10,001-15,000	15,001-20,000	20,001-25000	Over 25,000
		Percent of Household Column-wise				
(a) Very satisfactory	**10.88**	13.68	9.09	9.45	8.84	12.50
(b) Satisfactory	**53.59**	50.00	51.82	54.23	55.10	58.00
Sub-total (a+b)	***64.47***	***63.68***	***60.91***	***63.68***	***63.95***	***70.50***
(c) Not satisfactory	**21.96**	18.80	24.09	23.38	26.53	18.50
(d) Extremely unsatisfactory	**4.49**	2.56	5.45	3.98	4.76	6.00
(e) Can't Say/Not applicable	**9.08**	14.96	9.55	8.96	4.76	5.00
Column total	**100.00**	100.00	100.00	100.00	100.00	100.00
No. of Respondents	**1002**	234	220	201	147	200

Table A5 (2)

ANALYSIS OF HOUSEHOLD INVESTORS ACCORDING TO HOW SATISFACTORY WAS THEIR EXPERIENCE OF INVESTING IN: EQUITY SHARES

Age-classwise Analysis

How satisfactory	*All classes of sample households*	*Age of household head(in years)*							
		Upto 25	26-30	31-40	41-50	51-60	61-65	66-70	71 and Above
		Percent of Household Column-wise							
(a) Very satisfactory	**10.88**	9.43	18.81	8.82	9.56	11.49	9.84	12.90	13.16
(b) Satisfactory	**53.59**	66.04	53.47	53.31	51.84	52.87	59.02	48.39	50.00
Sub-total (a+b)	***64.47***	***75.47***	***72.28***	***62.13***	***61.40***	***64.37***	***68.85***	***61.29***	***63.16***
(c) Not satisfactory	**21.96**	15.09	11.88	19.85	26.10	25.29	18.03	29.03	28.95
(d) Extremely unsatisfactory	**4.49**	0.00	3.96	5.51	5.88	3.45	3.28	6.45	0.00
(e) Can't Say/Not applicable	**9.08**	9.43	11.88	12.50	6.62	6.90	9.84	3.23	7.89
Column total	**100.00**	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
No. of Respondents	**1002**	53	101	272	272	174	61	31	38

Table A5 (3)

ANALYSIS OF HOUSEHOLD INVESTORS ACCORDING TO HOW SATISFACTORY WAS INVESTOR'S EXPERIENCE OF INVESTING IN: MUTUAL FUND EQUITY / GROWTH SCHEMES

Income-classwise Analysis

How satisfactory	***All classes of sample households***	*Household income class (Rs. per month)*				
		Upto 10,000	10,001-15,000	15,001-20,000	20,001-25000	Over 25,000
		Percent of Household Column-wise				
(a) Very satisfactory	**6.16**	6.44	4.71	4.62	8.40	7.26
(b) Satisfactory	**31.85**	31.68	32.46	28.32	32.82	34.08
Sub-total (a+b)	***38.01***	***38.12***	***37.17***	***32.95***	***41.22***	***41.34***
(c) Not satisfactory	**23.17**	20.79	19.37	25.43	25.19	26.26
(d) Extremely unsatisfactory	**7.88**	5.94	6.28	8.09	9.16	10.61
(e) Can't Say/Not applicable	**30.94**	35.15	37.17	33.53	24.43	21.79
Column total	**100.00**	100.00	100.00	100.00	100.00	100.00
No. of Respondents	**876**	202	191	173	131	179

Table A5 (4)

ANALYSIS OF HOUSEHOLD INVESTORS ACCORDING TO HOW SATISFACTORY WAS INVESTOR'S EXPERIENCE OF INVESTING IN: MUTUAL FUND EQUITY / GROWTH SCHEMES

Age-classwise Analysis

How satisfactory	***All classes of sample households***	*Age of household head(in years)*							
		Upto 25	26-30	31-40	41-50	51-60	61-65	66-70	71 and Above
		Percent of Household Column-wise							
(a) Very satisfactory	6.16	10.87	8.33	7.38	3.85	4.08	8.62	3.33	9.09
(b) Satisfactory	**31.85**	30.43	34.52	34.43	32.91	27.89	31.03	33.33	18.18
Sub-total (a+b)	**38.01**	**41.30**	**42.86**	**41.80**	**36.75**	**31.97**	**39.66**	**36.67**	**27.27**
(c) Not satisfactory	**23.17**	19.57	19.05	18.44	27.78	27.89	24.14	30.00	12.12
(d) Extremely unsatisfactory	**7.88**	2.17	3.57	6.97	9.83	10.88	3.45	10.00	12.12
(e) Can't Say/Not applicable	**30.94**	36.96	34.52	32.79	25.64	29.25	32.76	23.33	48.48
Column total	**100.00**	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
No. of Respondents	**876**	46	84	244	234	147	58	30	33

Table A 5 (5)

ANALYSIS OF HOUSEHOLD INVESTORS ACCORDING TO HOW SATISFACTORY WAS INVESTOR'S EXPERIENCE OF INVESTING IN: MUTUAL FUND INCOME SCHEMES

Income-classwise Analysis

How satisfactory	***All classes of sample households***	*Household income class (Rs. per month)*				
		Upto 10,000	10,001-15,000	15,001-20,000	20,001-25000	Over 25,000
		Percent of Household Column-wise				
(a) Very satisfactory	**5.06**	4.00	4.17	4.47	5.93	7.10
(b) Satisfactory	**35.77**	38.00	34.90	31.28	38.52	36.61
Sub-total (a+b)	***40.83***	***42.00***	***39.06***	***35.75***	***44.44***	***43.72***
(c) Not satisfactory	**22.38**	19.50	21.88	23.46	22.96	24.59
(d) Extremely unsatisfactory	**6.30**	5.00	3.13	8.38	7.41	8.20
(e) Can't Say/Not applicable	**30.48**	33.50	35.94	32.40	25.19	23.50
Column total	**100.00**	100.00	100.00	100.00	100.00	100.00
No. of Respondents	**889**	200	192	179	135	183

Table A5 (6)

ANALYSIS OF HOUSEHOLD INVESTORS ACCORDING TO HOW SATISFACTORY WAS INVESTOR'S EXPERIENCE OF INVESTING IN:
MUTUAL FUND INCOME SCHEMES

Age-classwise Analysis

How satisfactory	***All classes of sample households***	*Age of household head(in years)*							
		Upto 25	26-30	31-40	41-50	51-60	61-65	66-70	71 and Above
		Percent of Household Column-wise							
(a) Very satisfactory	**5.06**	2.22	4.82	7.53	4.42	1.32	8.62	3.45	8.82
(b) Satisfactory	**35.77**	35.56	30.12	36.40	34.54	42.11	32.76	27.59	38.24
Sub-total (a+b)	***40.83***	***37.78***	***34.94***	***43.93***	***38.96***	***43.42***	***41.38***	***31.03***	***47.06***
(c) Not satisfactory	**22.38**	15.56	26.51	18.83	25.70	23.03	18.97	34.48	14.71
(d) Extremely unsatisfactory	**6.30**	2.22	3.61	5.44	8.43	7.24	1.72	10.34	8.82
(e) Can't Say/Not applicable	**30.48**	44.44	34.94	31.80	26.91	26.32	37.93	24.14	29.41
Column total	**100.00**	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
No. of Respondents	**889**	45	83	239	249	152	58	29	34

Table A5 (7)

ANALYSIS OF HOUSEHOLD INVESTORS ACCORDING TO HOW SATISFACTORY WAS INVESTOR'S EXPERIENCE OF INVESTING IN: NON-GOVT COMPANY BONDS

Income-classwise Analysis

How satisfactory	***All classes of sample households***	*Household income class (Rs. per month)*				
		Upto 10,000	10,001-15,000	15,001-20,000	20,001-25000	Over 25,000
		Percent of Household Column-wise				
(a) Very satisfactory	**1.67**	2.49	2.75	0.59	0.81	1.22
(b) Satisfactory	**17.76**	14.93	15.38	17.75	21.14	21.34
Sub-total (a+b)	***19.43***	***17.41***	***18.13***	***18.34***	***21.95***	***22.56***
(c) Not satisfactory	**18.12**	18.91	17.03	18.34	17.89	18.29
(d) Extremely unsatisfactory	**10.01**	9.45	8.24	11.83	8.94	11.59
(e) Can't Say/Not applicable	**52.44**	54.23	56.59	51.48	51.22	47.56
Column total	**100.00**	100.00	100.00	100.00	100.00	100.00
No. of Respondents	**839**	201	182	169	123	164

Table A5 (8)

ANALYSIS OF HOUSEHOLD INVESTORS ACCORDING TO HOW SATISFACTORY WAS INVESTOR'S EXPERIENCE OF INVESTING IN: NON-GOVT COMPANY BONDS

Age-classwise Analysis

How satisfactory	***All classes of sample households***	*Age of household head(in years)*							
		Upto 25	26-30	31-40	41-50	51-60	61-65	66-70	71 and Above
		Percent of Household Column-wise							
(a) Very satisfactory	**1.67**	0.00	2.44	3.07	1.77	0.00	0.00	0.00	3.03
(b) Satisfactory	**17.82**	15.56	12.20	20.18	18.14	19.01	16.36	10.71	18.18
Sub-total (a+b)	***19.50***	***15.56***	***14.63***	***23.25***	***19.91***	***19.01***	***16.36***	***10.71***	***21.21***
(c) Not satisfactory	**18.06**	13.33	15.85	16.23	19.03	21.83	21.82	28.57	6.06
(d) Extremely unsatisfactory	**10.05**	8.89	10.98	9.21	11.06	11.97	5.45	10.71	6.06
(e) Can't Say/Not applicable	**52.39**	62.22	58.54	51.32	50.00	47.18	56.36	50.00	66.67
Column total	**100.00**	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
No. of Respondents	**839**	45	82	228	226	142	55	28	33

Chapter 6
SHARE PORTFOLIO PRACTICES
OF RETAIL INVESTORS

New light on share portfolio diversification practices

6.1 This chapter presents empirical data about share portfolio diversification practices of retail shareholders in India.

6.2 It is well recognised in portfolio theory that diversification can help to minimize the risk. Diversification may be across individual companies, across industry-groups, or across countries. Retail investors diversify their portfolios among chosen companies usually from different industry groups. Our measure of share portfolio diversification is simply the number of companies represented in the individual investor's share portfolio.

Diversification and "market risk"

6.3 It needs to be noted that such diversification cannot ordinarily reduce "market risk", i.e. the risk due to the whole market going up or down but it can reduce the random type of risk or the so-called "insurable risk". We shall present below the findings on how diversified are share portfolios of retail investors in India. We shall also discuss the implications of such findings. The data was collected directly from the investors in the course of our household investors survey of 2004.[27]

[27] For an earlier survey, see L. C. Gupta, C. P. Gupta and Naveen Jain, *Indian Households' Investment Preferences* (Society for Capital Market Research and Development, Delhi, 2001), pp. 96-8.

6.4 The sample households have been classified by income and age for checking the consistency of findings and also for bringing out significant differences among income-classes and among age-classes.

6.5 The extent of share portfolio diversification varies very widely among our sample households from holding just one company's shares to more than 100 companies' shares. We have identified certain patterns depending on income and age of the investors.

Typical diversification

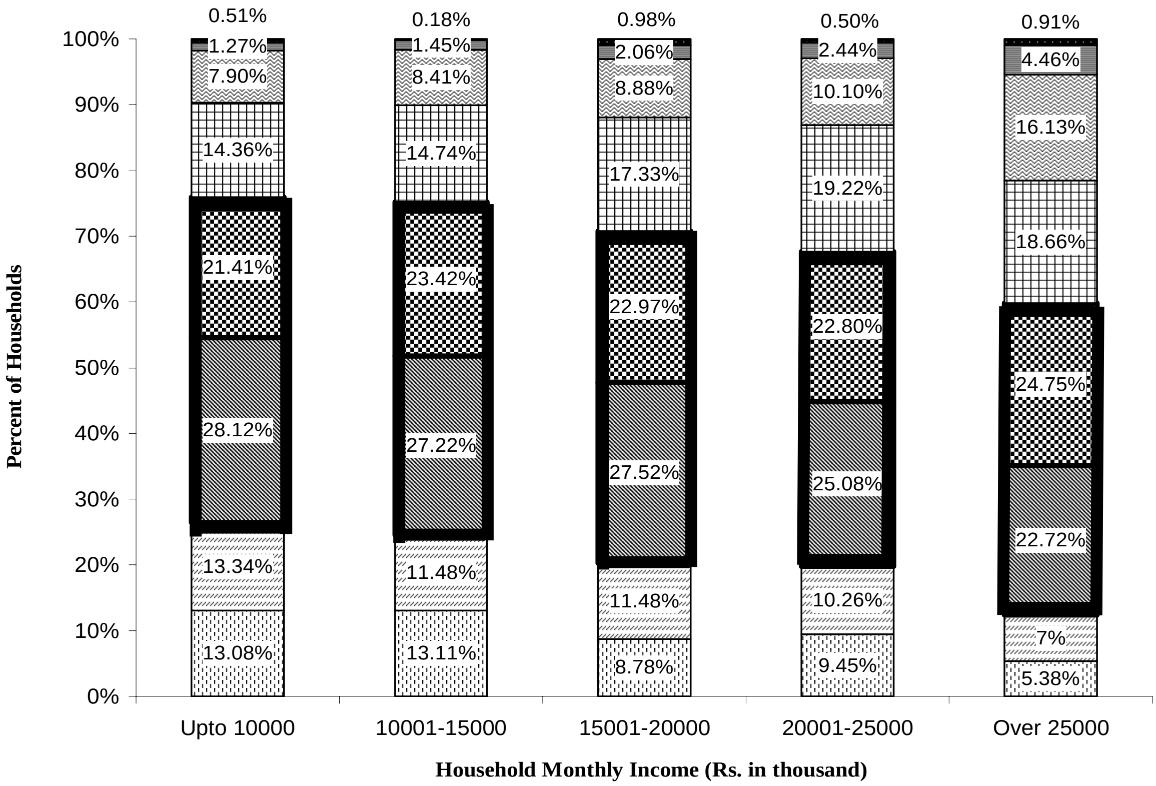
6.6 Interestingly, the **typical extent of diversification lies in the narrow range of 3-10 companies' shares.** Most market professionals will perhaps regard such narrow diversification as very inadequate. However, as we show later, this is "ideal diversification" for the retail investors from the practical viewpoint because of many advantages. Curiously, the typical extent of diversification is broadly the same across all income classes as shown in Chart 6.1 and all age-classes as shown in Chart 6.2. The charts are based on Tables 6.1 and 6.2 given at the end of this chapter. This interesting phenomenon and the reasons underlying it are worth noting, as explained later.

6.7 We shall show that such moderate diversification, which is typical now, seems to work quite well from the viewpoint of investment performance; in fact, it works better than mutual fund equity schemes, so much so that demand for mutual fund equity products has been seriously affected. This is not a known fact so far. The mutual fund industry needs to give serious consideration to it.

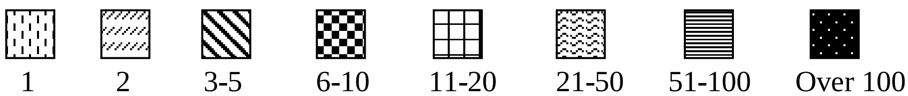
Chart 6.1

PERCENT DISTRIBUTION OF SHARE-OWNING HOUSEHOLDS BY NUMBER OF COMPANIES IN HOUSEHOLDS' SHARE PORTFOLIOS

By Income-class of household head



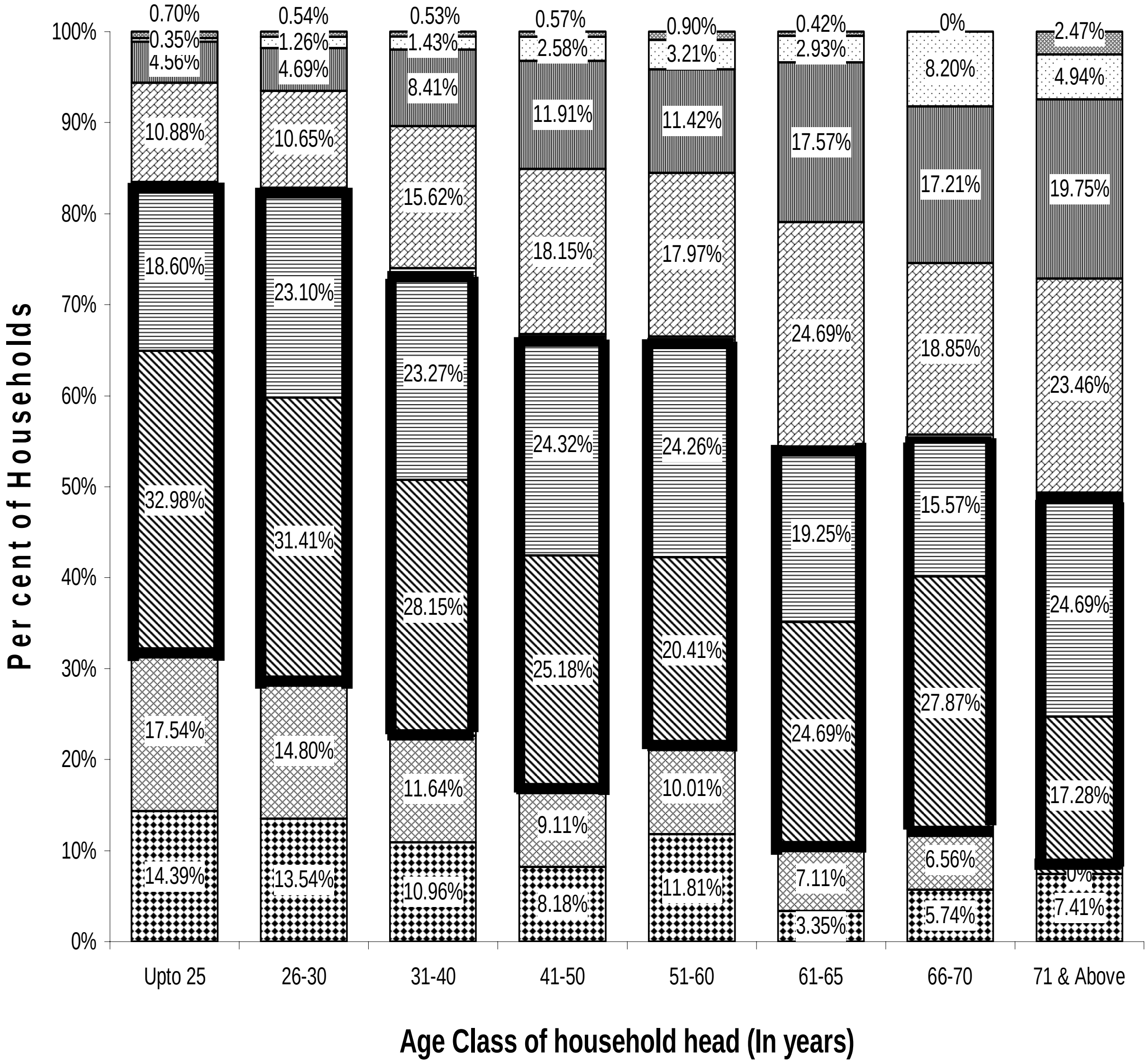
Legend: Number of companies in share portfolio



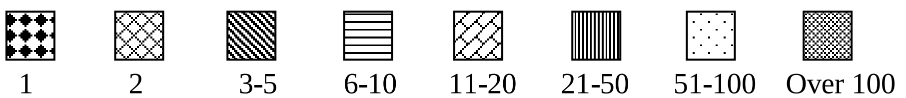
Note: The most typical portfolio size has been highlighted.

Chart 6.2
PERCENT DISTRIBUTION OF SHARE-OWNING HOUSEHOLDS BY NUMBER OF COMPANIES IN HOUSEHOLDS' SHARE PORTFOLIOS

By Age-class of households



Legend: Number of companies in share portfolio



Note: The most typical portfolio size has been highlighted.

6.8 As may be observed from Table 6.1, one-fifth of the sample households had only 1 or 2 companies in their share portfolio. Of course, this can hardly be regarded as diversification. The performance of the shareholding confined to 1 or 2 companies will depend much on chance factor. However, so long as the amount invested is small in relation to the investor's total wealth, the investor may be quite willing to take a chance. Perhaps, he may have subscribed to a glamorous IPO. Such shareholders are 'casual' investors in shares.

6.9 The more serious type of investors will usually have shareholding in several companies. Our analysis shows that about one-half of the total sample households had between 3-10 companies in their share portfolio. Hence, a portfolio of 3-10 companies is the typical diversification of retail share portfolios. Moreover, income-class analysis showed that this much diversification is **typical for every income class and age class.**

6.10 A little above or below 50% of households in all the five income classes held 3-10 companies in their share portfolios. Age-classwise analysis showed a broadly similar pattern. This suggests that the practice of **narrow diversification** (shareholding in 3-10 companies) is the dominant practice among retail shareholders in all income and age classes.

6.11 Higher diversification beyond 10 companies is much less common. About one-sixth of total sample households held shares of 11-20 companies and about one-eighth of the sample held shares in more than 20 companies, as shown by Tables 6.1 and 6.2.

Effect of investor's income and age

6.12 Ordinarily, one would expect households in the higher income classes to have somewhat more diversified portfolios than lower income classes but the **typical diversification does not change much across income classes.** This is visually confirmed by Chart 6.1. The chart shows that, as we move to higher income classes, the percentage of households having shares of **only 1 or 2 companies** (negligible diversification) goes on declining. On the other hand, as may be expected, the percentage of those having shares of **more than 10 companies** (somewhat high diversification) goes on increasing. Thus, the effect of income level on portfolio diversification is perceptible only with regard to extremes of diversification, i.e. in relation to negligible diversification at one end and high diversification beyond 10 companies at the other end. Nevertheless, the typical or dominant extent of diversification (portfolio of 3-10 companies) is not much affected by income level and age level.

Amount invested in portfolio companies

6.13 While the income-class has little effect on the typical extent of diversification, there are reasons to believe that the amount invested in the portfolio companies by wealthier or higher income households would be significantly more than the amount invested by households in lower brackets. For example, the **average invested amount per company** in a portfolio of 10 companies in the case of the richer investors may be, say, Rs. 1,00,000, whereas in the case of less well-to-do investors, such average may be much lower, say, only Rs. 10,000 or Rs. 20,000. It was not possible to collect actual data on the amounts invested by individual households because of extreme reluctance to disclose such personal financial data.[28]

6.14 As regards age-class analysis, one would expect the extent of diversification to increase with age (of household head), as the household goes on accumulating the share portfolio gradually over life time. This is visible in Chart 6.2 in the same way as in Chart 6.1. The percentage of investors having only 1 or 2 companies in their share portfolios goes on declining with increase in age. Exactly the opposite is true about high diversification: the percentage of those having more than 10 companies in the portfolio goes on increasing with the age of the investor. However, this does not affect the typical or dominant extent of diversification which remains the same (3-10 companies) in the case of every age group too, as pointed out earlier.

Advantages of narrow diversification

6.15 Clearly, it is moderate diversification (portfolio comprising 3-10 companies) which is dominant or most popular in all income and age groups. Even though mutual funds offer much greater diversification, most **retail investors find more advantage in direct holding of shares in a few selected companies.** Their approach seems to have a strong rationale, as explained below.

6.16 An important practical reason why moderate diversification is the dominant practice among retail investors is that an average retail

[28] Those who are familiar with such surveys know the difficulties involved. Many households refuse to disclose their monthly income. We included only those who were willing to disclose at least the broad income-class to which they belong. It is known that income is often under-stated because of the apprehension that the information may be leaked to tax authorities, despite our assurance of strict confidentiality.

investor cannot effectively supervise too many companies. It is difficult to keep track of all the events/news and corporate actions if the number of companies is too large. There are several other advantages in adopting this practice.

6.17 The first advantage of direct shareholding vis-à-vis mutual fund equity schemes is that **direct investors do not have to pay the annual management fees and expenses** charged by mutual funds. Such burden usually amounts to around 2.5% per annum of mutual fund portfolio value, in addition to the entry and exit loads. For the direct long-term investor, this makes considerable difference to net annual return from investment. A majority of retail investors are long-term shareholders, as shown by our empirical data about retail investors' investment strategies, according to the household investors survey of 2004.

6.18 A second advantage is that over the years, the direct investor becomes more knowledgeable about the companies and about the share market. The investor begins to understand how to evaluate companies and the market situation. He/she can then differentiate the more promising companies from the less promising ones. He/she also begins to understand when to enter the market and when to quit. Such gain in investment skills is a valuable asset. This enables the retail investor to sharpen the investment strategy. He/she may wait and watch for market dips which provide a good opportunity to buy more shares of the good companies in his/her portfolio, thereby reducing the average acquisition cost. This practical policy is followed by many retail investors. It is not easy to implement a similar policy in the case of mutual funds because NAVs of mutual funds are not available from day-to-day. Individual share prices are available from hour to hour.

Market "risk" turned into market "opportunity"

6.19 We would like to underline that no extent of portfolio diversification can reduce 'market risk', i.e. the whole market going up and down. **Many practising investors regard a temporary fall in market prices, not as a risk, but as an opportunity to buy more shares of the well-performing companies already in their portfolio.**

6.20 Thus, narrow diversification of share portfolios offers solid advantages to retail investors. This may be an important reason why a **majority of respondents in all income and age groups have reported more satisfactory experience from direct shareholding than from mutual fund equity schemes.**

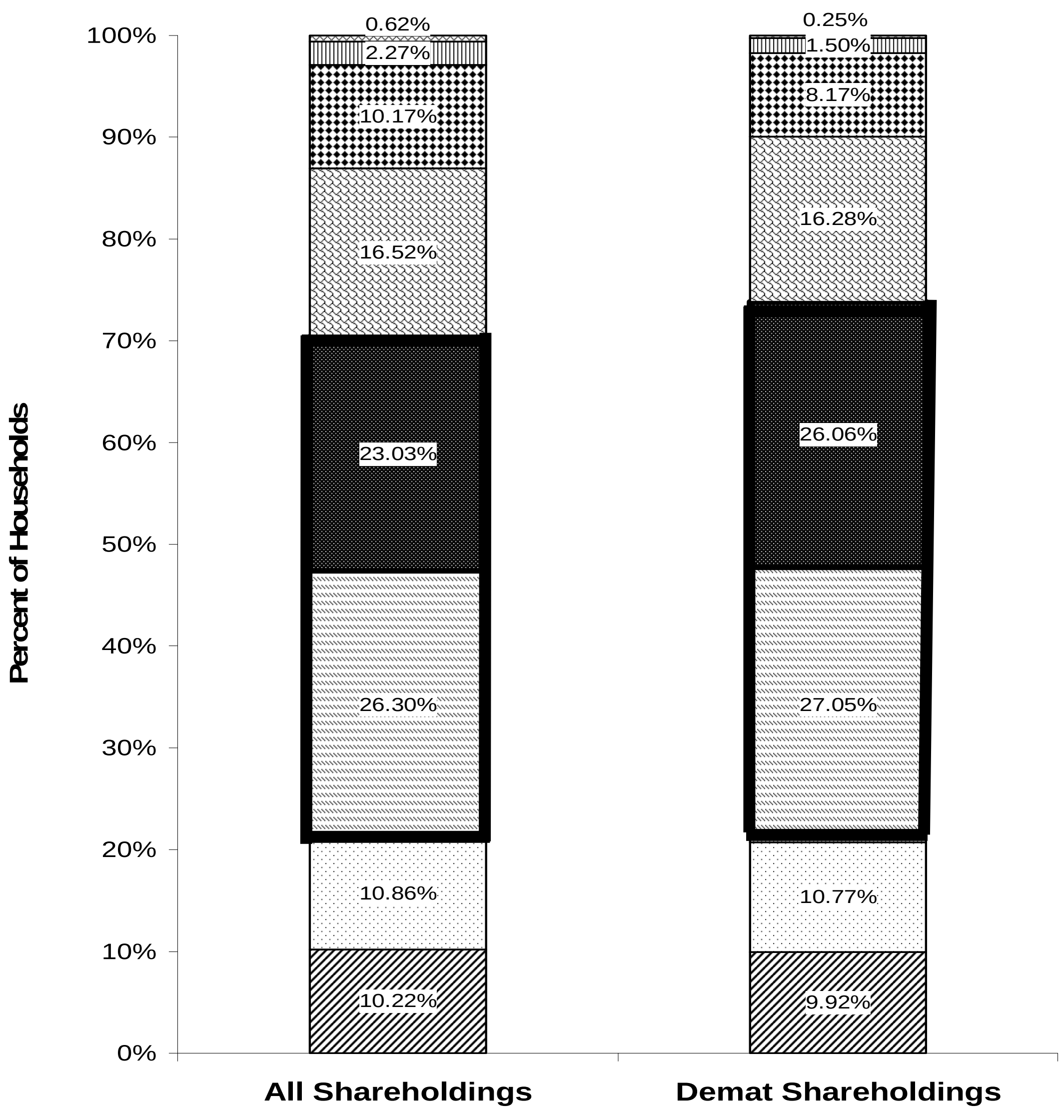
Diversification of demat shareholding

6.21 We undertook a separate analysis of share portfolio diversification for demat shareholders (see Tables 6.3 and 6.4 for data regarding diversification practices of demat shareholders). The analysis showed, more or less, similar pattern for demat shareholders as for all shareholders (see Chart 6.3).

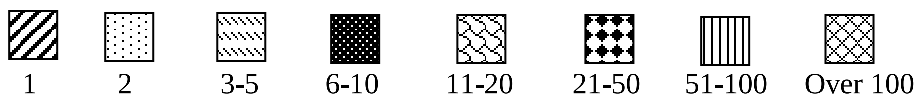
6.22 There is **theoretical support for the policy of moderate diversification** of share portfolios. It has been statistically shown

Chart 6.3

DIVERSIFICATION OF HOUSEHOLDS' SHARE PORTFOLIOS: ALL SHAREHOLDINGS VIS-À-VIS DEMAT SHAREHOLDINGS*



Legend: Number of companies in share portfolio



Note: The most typical portfolio size has been highlighted.

*All shareholdings include both physical and demat shareholdings.

that more than **one-half of the investment risk, as measured by standard deviation of individual share returns, is eliminated by portfolios of 5 shares; and more than two-thirds of risk is eliminated by portfolios of 10 shares.**[29] Hence, diversifying beyond 10 companies can reduce the risk further to a minor extent only. **Such minor reduction in risk through wider diversification does not seem worthwhile as it may be more than offset by the costs and difficulties of supervising and managing the portfolio.**

Length of shareholding period

6.23 We have pointed out above the advantages of maintaining a **long-term but narrowly diversified portfolio** of shares in the case of retail investors. We have also collected empirical data to find out how the investing population is distributed in terms of investment strategies adopted. An important aspect of such strategy is whether it is **short-term oriented or long-term oriented.** We asked respondents to indicate their preferred period of holding shares bought as investment.

6.24 The kind of market participants who dominate a country's stock market determines the market's behaviour and its allocative efficiency. Markets which are excessively dominated by short-term speculators are prone to crises and are characterised by high volatility.[30] Our empirical data throws some interesting light on the holding period length in the case of retail investors, classified

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[29] See L. C. Gupta, *Rates of Return on Equities: The Indian Experience* (Oxford University Press, 1981, pp. 33-34. 'Market risk' has to be distinguished from the risk of random error or insurable risk. See op. cit., pp. 31-32.

[30] There is much theoretical literature by eminent economists on this subject, as indicated in our earlier studies. See, for example, L. C. Gupta, Naveen Jain and Utpal Choudhury, *India's Stock Market and Household Investors 2001-04*, pp. 92-4.

by income-class and age-class (see Charts 6.4 and 6.5 as also the related Tables 6.5 and 6.6 respectively). Some **investors follow a combination of strategies.** They are neither purely short-term oriented nor purely long-term oriented. Despite this problem, a fairly clear broad picture does emerge from our empirical analysis.

Indian middle-class dominantly long-term investors

6.25 The most noteworthy finding is that, contrary to popular belief, the greater part representing **over one-half of our respondents (leaving aside those not interested in shares) stated that they are long-term investors and intend to hold shares for some years.**[31] Less than one-fifth of our respondents, shown against category (a), intended to hold shares for a **few days** only (being traders in shares rather than investors). Their behaviour is governed by transient events and news rather than by fundamental factors. Their activities accentuate the market's volatility as they mostly swim with the current rather than against it, i.e. they sell when prices are declining due to heavy selling in the market, and they buy when prices are rising because of heavy buying in the market.

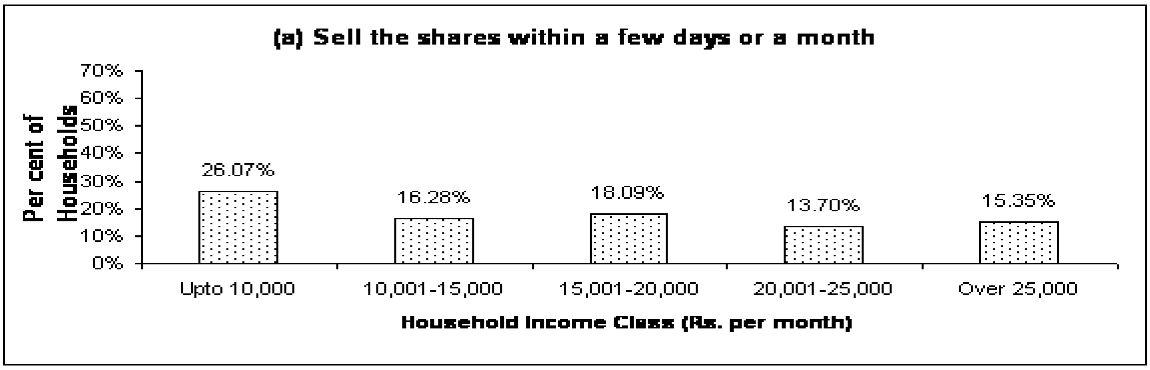
6.26 Somewhat more than one-third of respondents stated that they intended to hold shares for **some months** but not exceeding one year, as shown against category (b). Indian stock market shows very wide fluctuation of prices over a year, as indicated by the ratio of 52-week High/Low prices, published by financial papers along with daily quotations. Such ratio for shares of many

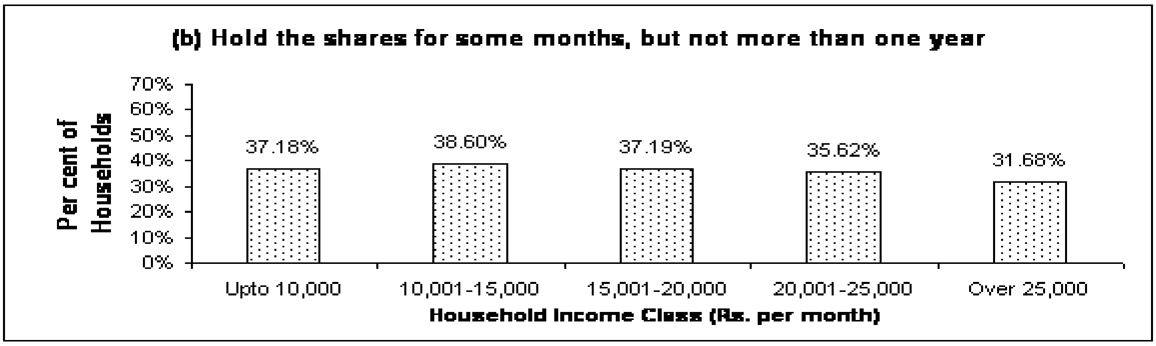
[31] The proportion of long-term oriented retail investors seems to have gone down over the last 3-4 years. This is a matter of concern. For comparative data from the household investors survey of 2002, see ibid., Table 4.3, p. 42. An important reason for the decline of long-term oriented retail investors is that depository charges weigh heavily on the long-term holders as distinguished from frequent traders.

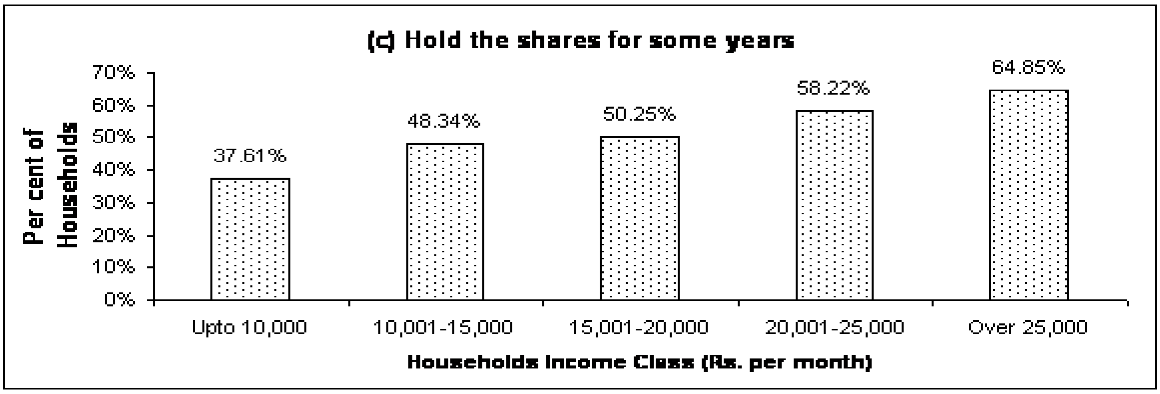
Chart 6.4

RETAIL SHARE INVESTORS' TIME HORIZON

Income-classwise Analysis







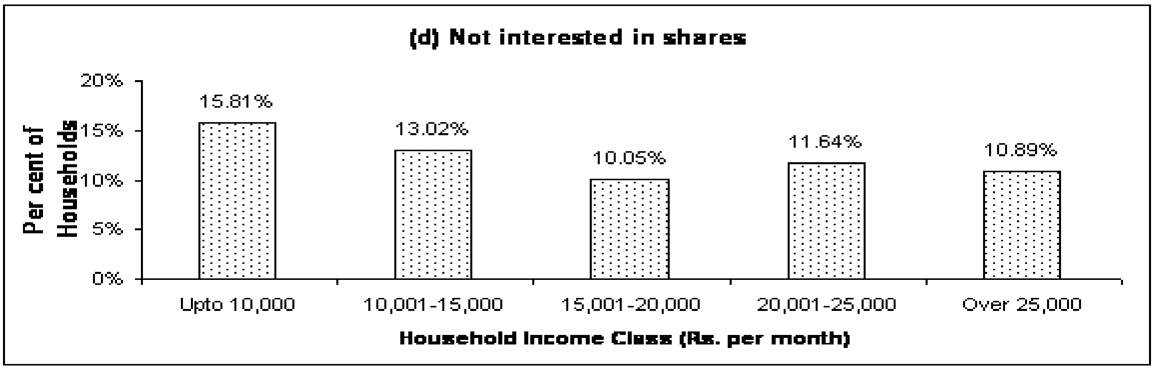
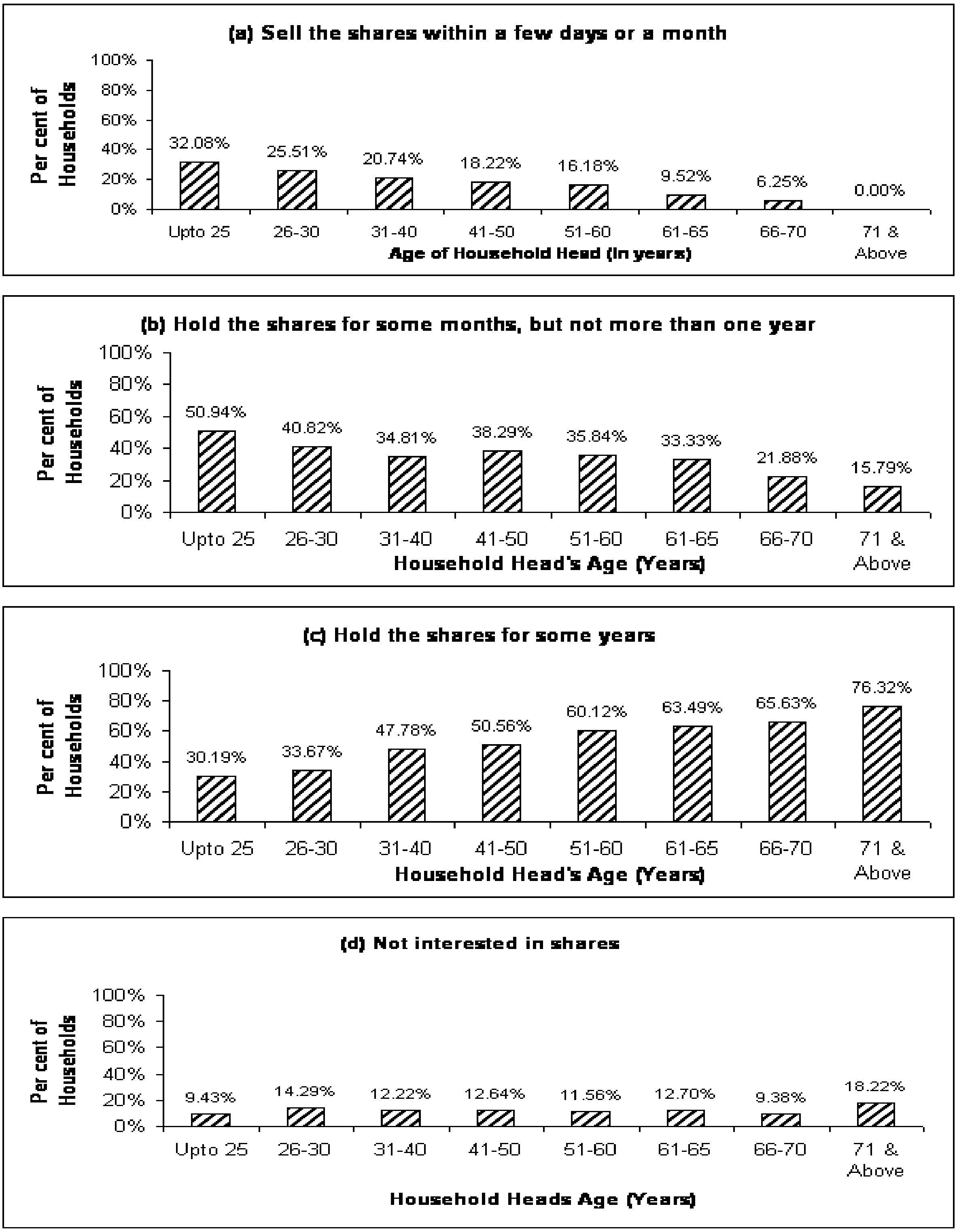


Chart 6.5

RETAIL SHARE INVESTORS' TIME HORIZON

Age-classwise Analysis



leading companies is found to be 2:1 or even more. This provides opportunities for stock picking. Their behaviour can be a stabilizing influence on the market because such behaviour will usually be based on intelligent analysis of certain underlying fundamental factors. For example, it may be the case of a company or industry recovering from sickness or from a recessionary phase or the opposite case of going into a recessionary phase. Such phases may characterise a company or a whole industry at particular times.

6.27 Investors who are able to identify such cases correctly and in time can make very handsome profit within a few months. Such opportunities are more attractive than the usual slow pace of long-term rate of returns on shareholdings. To take advantage of such opportunities requires special ability or contact with insiders.

6.28 The income and age-class analysis shows that the **long-term investors are more predominant in the higher income and higher age-categories,** as may be observed from Tables 6.5 and 6.6 and Charts 6.4 and 6.5.

6.29 **It is noteworthy that category (a), comprising pure short-term speculators, is the smallest so far as ordinary household investors are concerned.** Category (b) is twice more numerous compared to category (a) but much smaller than category (c), shown in Tables 6.5 and 6.6. This is understandable because purely short-term speculation, or satta in popular parlance, is looked down upon by ordinary households who are mostly conservative long-term oriented investors.[32] Our earlier household investors surveys had also brought out that a majority

[32] See L. C. Gupta, Naveen Jain and Utpal Choudhury, *India's Stock Market and Household Investors 2001-04*, SCMRD, 2004), pp. 41-43.

of retail investors are long-term oriented, but there appears to be a tendency for their proportion to decline.

6.30 **Our findings indicate that the middle and the upper middle-class households in India are a relatively conservative lot. On the whole, they do not generate much speculative activity on the stock exchanges. The great bulk of stock market speculation in India is the handiwork of stockbroking firms and professional market operators engaged in day-trading in both cash market and single stock futures market.**

Table 6.1

NUMBER OF COMPANIES REPRESENTED IN INDIVIDUAL HOUSEHOLDS' SHARE PORTFOLIOS [1]

Household Investors Survey - 2004

Income-classwise Analysis

No. of Companies	***All classes of sample households***	*Household income class (Rs. per month)*				
		Upto 10,000	10,001-15,000	15,001-20,000	20,001-25,000	Over 25,000
		Percent distribution of households column-wise				
(a) 1	**10.22**	13.08	13.11	8.78	9.45	5.38
(b) 2	**10.86**	13.34	11.48	11.48	10.26	7.00
(c) **3-5**	**26.30**	**28.12**	**27.22**	**27.52**	**25.08**	**22.72**
(d) **6-10**	**23.03**	**21.41**	**23.42**	**22.97**	**22.80**	**24.75**
(e) 11-20	**16.52**	14.36	14.74	17.33	19.22	18.66
(f) 21-50	**10.17**	7.90	8.41	8.88	10.10	16.13
(g) 51-100	**2.27**	1.27	1.45	2.06	2.44	4.46
(h) Over 100	**0.62**	0.51	0.18	0.98	0.5	0.91
Column total	**100.00**	100.00	100.00	100.00	100.00	100.00
No. of Respondents	**4,806**	1,177	1,106	923	614	986

[1] This Table covers all shareholdings whether held in physical form or demat form.

Table 6.2

NUMBER OF COMPANIES REPRESENTED IN INDIVIDUAL HOUSEHOLDS' SHARE PORTFOLIOS [1]

Household Investors Survey - 2004

Age-classwise Analysis

No. of Companies	***All classes of sample households***	*Age of household head in years*							
		Upto 25	26-30	31-40	41-50	51-60	61-65	66-70	71 and above
		Percent distribution of households column-wise							
(a) 1	**10.22**	14.39	13.54	10.96	8.18	11.81	3.35	5.74	7.41
(b) 2	**10.86**	17.54	14.80	11.64	9.11	10.01	7.11	6.56	0.00
(c) **3-5**	**26.30**	**32.98**	**31.41**	**28.15**	**25.18**	**20.41**	**24.69**	**27.87**	**17.28**
(d) **6-10**	**23.03**	**18.60**	**23.10**	**23.27**	**24.32**	**24.26**	**19.25**	**15.57**	**24.69**
(e) 11-20	**16.52**	10.88	10.65	15.62	18.15	17.97	24.69	18.85	23.46
(f) 21-50	**10.17**	4.56	4.69	8.41	11.91	11.42	17.57	17.21	19.75
(g) 51-100	**2.27**	0.35	1.26	1.43	2.58	3.21	2.93	8.20	4.94
(h) Over 100	**0.62**	0.70	0.54	0.53	0.57	0.90	0.42	0.00	2.47
Column total	**100.00**	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
No. of Respondents	**4,806***	285	554	1,331	1,394	780	239	122	81

See note under Table 6.1

* Out of total sample respondents, a few did not provide information on their age. They have therefore, not been included in the individual age-classes but are included in the total sample.

Table 6.3

NUMBER OF COMPANIES REPRESENTED IN INDIVIDUAL HOUSEHOLDS' SHAREHOLDINGS HELD IN DEMAT FORM [1]

Household Investors Survey – 2004

Income-classwise Analysis

	No. of Companies	*All classes of sample households*	*Household income class (Rs. per month)* Upto 10,000	10,001– 15,000	15,001– 20,000	20,001- 25,000	Over 25,000
			Percent distribution of households column-wise				
(a)	1	**9.92**	10.78	13.15	10.03	9.93	5.56
(b)	2	**10.77**	14.60	9.99	10.49	11.70	6.99
(c)	**3-5**	**27.05**	**28.16**	**31.48**	**27.05**	**24.72**	**22.64**
(d)	**6-10**	**26.06**	**25.61**	**24.15**	**27.20**	**25.39**	**27.94**
(e)	11-20	**16.28**	13.79	14.92	17.02	17.66	19.02
(f)	21-50	**8.17**	6.14	5.44	6.84	8.83	13.97
(g)	51-100	**1.50**	0.93	0.88	0.91	1.32	3.36
(h)	Over 100	**0.25**	0.00	0.00	0.46	0.44	0.52
Column total		**100.00**	100.00	100.00	100.00	100.00	100.00
No. of Respondents		**3538**	863	791	658	453	773

[1] This Table covers shareholdings held in demat form only, i.e. excluding physical form.

Table 6.4

NUMBER OF COMPANIES REPRESENTED IN INDIVIDUAL HOUSEHOLDS' SHAREHOLDINGS HELD IN DEMAT FORM [1]

Household Investors Survey – 2004

Age-classwise Analysis

No. of Companies	***All classes of sample households***	*Age of household head in years*							
		Upto 25	26-30	31-40	41-50	51-60	61-65	66-70	71 and above
		Percent distribution of households column-wise							
(a) 1	**9.92**	16.16	11.40	10.20	9.06	8.74	4.95	11.58	7.81
(b) 2	**10.77**	14.85	14.73	11.01	9.26	10.56	7.69	7.37	4.69
(c) **3-5**	**27.05**	**34.93**	**32.30**	**27.98**	**26.59**	**21.86**	**20.88**	**25.26**	**17.19**
(d) **6-10**	**26.06**	**19.65**	**25.89**	**26.57**	**25.30**	**28.78**	**26.37**	**28.42**	**21.88**
(e) 11-20	**16.28**	9.17	10.21	16.16	18.63	17.85	20.88	11.58	23.44
(f) 21-50	**8.17**	4.37	3.80	6.77	9.36	9.47	17.58	12.63	23.44
(g) 51-100	**1.50**	0.44	1.66	0.91	1.69	2.37	1.65	3.16	0.00
(h) Over 100	**0.25**	0.44	0.00	0.40	0.10	0.36	0.00	0.00	1.56
Column total	**100.00**	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
No. of Respondents	**3538**	229	421	990	1004	549	182	95	64

See note under Table 6.3

* Out of total sample respondents, a few did not provide information on their age. They have therefore, not been included in the individual age-classes but are included in the total sample.

Table 6.5

RETAIL INVESTORS' PREFERRED STRATEGY REGARDING SHARE INVESTMENT IN TERMS OF TIME HORIZON

Household Investors Survey – 2004

Income- classwise Analysis

Time horizon	***All classes of sample households***	*Household income class (Rs. per month)*				
		Upto 10,000	10,001-15,000	15,001-20,000	20,001-25000	Over 25,000
		Percent of Household Column-wise				
(a) Sell the shares within a few days or a month	18.37	26.07	16.28	18.09	13.70	15.35
(b) Hold the shares for some months, but not more than one year	36.14	37.18	38.60	37.19	35.62	31.68
(c) **Hold the shares for some years**	**51.00**	**37.61**	**48.37**	**50.25**	**58.22**	**64.85**
(d) Not interested in shares	12.45	15.81	13.02	10.05	11.64	10.89
No. of Respondents	**996**	234	215	199	146	202

Note: Column totals may add to more than 100 because some investors follow a fixed strategy and have ticked two or three strategies.

Table 6.6

RETAIL INVESTORS' PREFERRED STRATEGY REGARDING SHARE INVESTMENT IN TERMS OF TIME HORIZON

Household Investors Survey – 2004

Age-Classwise Analysis

Time horizon	***All classes of sample households***	*Age of household head (in years)*							
		Upto 25	26-30	31-40	41-50	51-60	61-65	66-70	71 and Above
		Percent of Household Column-wise							
(a) Sell the shares within a few days or a month	18.37	32.08	25.51	20.74	18.22	16.18	9.52	6.25	0.00
(b) Hold the shares for some months, but not more than one year	36.14	50.94	40.82	34.81	38.29	35.84	33.33	21.88	15.79
(c) Hold the shares for some years	**51.00**	**30.19**	**33.67**	**47.78**	**50.56**	**60.12**	**63.49**	**65.63**	**76.32**
(d) Not interested in shares	12.45	9.43	14.29	12.22	12.64	11.56	12.70	9.38	18.42
No. of Respondents	**996**	53	98	270	269	173	63	32	38

Note: Column totals may add to more than 100 because some investors follow a mixed strategy and have ticked two or three strategies.

Chapter 7

THE CHANGING PATTERN OF HOUSEHOLDS' INVESTMENT PREFERENCES

I. Introduction

General

7.1 Investment preferences among household investors have important socio-economic implications. Such preferences influence the direction in which, and the channels through which, household financial savings would flow. A developing economy, like India, needs a growing amount of household savings to flow to corporate enterprises. Such flow can grow on a sustained basis if, and only if, there is an effective system to ensure that the enterprises receiving the flow are sound and will make proper use of the money provided. In the absence of effective checks on mismanagement and misappropriation at the corporate enterprise level, the saver's investment preference is turned away from corporate shares and securities towards other savings instruments.

7.2 Our focus is on the investment preferences of middle class households, more specially on the extent to which they use shares and other non-government capital market instruments as vehicles for accumulating their hard-earned savings.

Historical perspective

7.3 Prior to 1980s, the stock market's role in financing of Indian corporate enterprises was relatively minor. Shareownership was uncommon, except among a small segment of wealthy individuals. Share investment was not regarded highly among

Indian middle-class households and was equated in the public mind with "satta" or speculation.[33]

7.4 Shares were popularised among the middle-class households in India by the so-called FERA issues. Under the Foreign Exchange Regulation Act (FERA) of 1973, foreign companies were required to reduce their shareholding in Indian subsidiaries to the maximum permissible limit of 40 per cent. As a result, share issues had to be made to the public by a large number of well-established highly profitable foreign-controlled Indian companies in order to reduce the foreign holding to the permissible limit.

7.5 The share issue price was fixed by the Controller of Capital Issues according to a conservative formula which invariably resulted in substantial under-pricing. Hence, the subscribers to such issues could earn substantial capital appreciation overnight. Understandably, there was tremendous rush for FERA issues from ordinary investors, many of them putting in multiple applications. Almost every FERA issue was heavily over-subscribed and allotment had to be made by a draw of lots which favoured small applicants. Underpricing due to Capital Issues Control was also a feature of public issues by established domestic companies. The rapid spread of shareownership among middle-class urban households all over the country was aided by an allotment system which favoured small investors in case of over-subscription. It was also promoted by requiring issuing companies to have a large number of collection centres for share applications from all over the country.

[33] See L. C. Gupta, *The Changing Structure of Industrial Finance in India* (London, Claredon Press, 1969), Chapter 9, esp. p. 155. See also L. C. Gupta, P.K. Jain and C.P. Gupta, *Indian Stock Market P/E Ratios* (Society for Capital Market Research & Development, Delhi, 1998), pp. 28-29.

7.6 In fact, equity share ownership had increasingly become a middle class phenomenon in India since around 1980s. Our first household investor survey conducted in 1990 found that the domestic middle-class households had become the backbone of the Indian equity market.

7.7 The abolition of Capital Issues Control and replacing it by a free-pricing system in 1992 removed the safeguard for ordinary investors. However, economic liberalization of 1991 had led to such euphoric conditions that new issues were lapped up avidly and indiscriminately by the investing public. This was so for most part of the period from 1992 to 1994. Because of euphoria, and the lack of proper regulation, this period saw the flotation of a large number of unsound and even fraudulent companies. The widespread bad experiences led to withdrawal of the investors from the stock market for many years after the mid-1990s.

II. Empirical Data on Households' Investment Preferences

Market penetration of investment types

7.8 In our empirical analysis, we shall specially look at the following two aspects of household investors' preferences:

(1) The first aspect relates to examining how the **market penetration** of the various investment types differs among income classes and among age-classes of households. (Market penetration of a 'product', whether financial or other, is measured as the percentage of households possessing or buying the product).

(2) The second aspect relates to the current preferences as reflected in the current choices of **investment type.** This is not readily apparent. This has to be inferred by exploring the investment intentions.

7.9 How the **market penetration,** i.e. the per cent of owners of each type of capital market instrument, varies among income classes is shown in Chart 7.1, and how the penetration varies among age classes is shown in Chart 7.2. Alternatively, for some purposes, these charts may be designed to focus on the patterns **within** each income-class and age-class, as shown in Charts 7.1A and 7.2A. The Charts are based on Tables 7.1 and 7.2 given after the text of this chapter.

7.10 Two features of market penetration stand out:

(a) It is noteworthy that equity shares have achieved a fairly high degree of penetration among the well-to-do middle-class investors. This is indicated by widespread shareownership within each income and age class of households in our sample. Shareowning households were nearly 74% among the sample households in the lowest income class (upto Rs. 10,000 per month), going up to more than 85% in the highest income class (above Rs. 25,000 per month).[34] Age-class variation of sharownership among households had also about the same kind of range. It may be observed from our data that market penetration of equity shares is fairly flat

[34] The percentage figures mentioned above are far higher than the average for the entire population which has a large component of poor and also illiterate households. To place the whole thing in a broad perspective, it may be noted that only 4 -5 percent of all Indian *households* are shareowning households. Shareowning *individuals* hardly constitute 2% of India's total population.

Chart 7.1

PERCENT OF HOUSEHOLDS OWNING PARTICULAR INVESTMENT TYPES, SURVEY 2004

Income-Classwise Analysis ***(1st Method)***

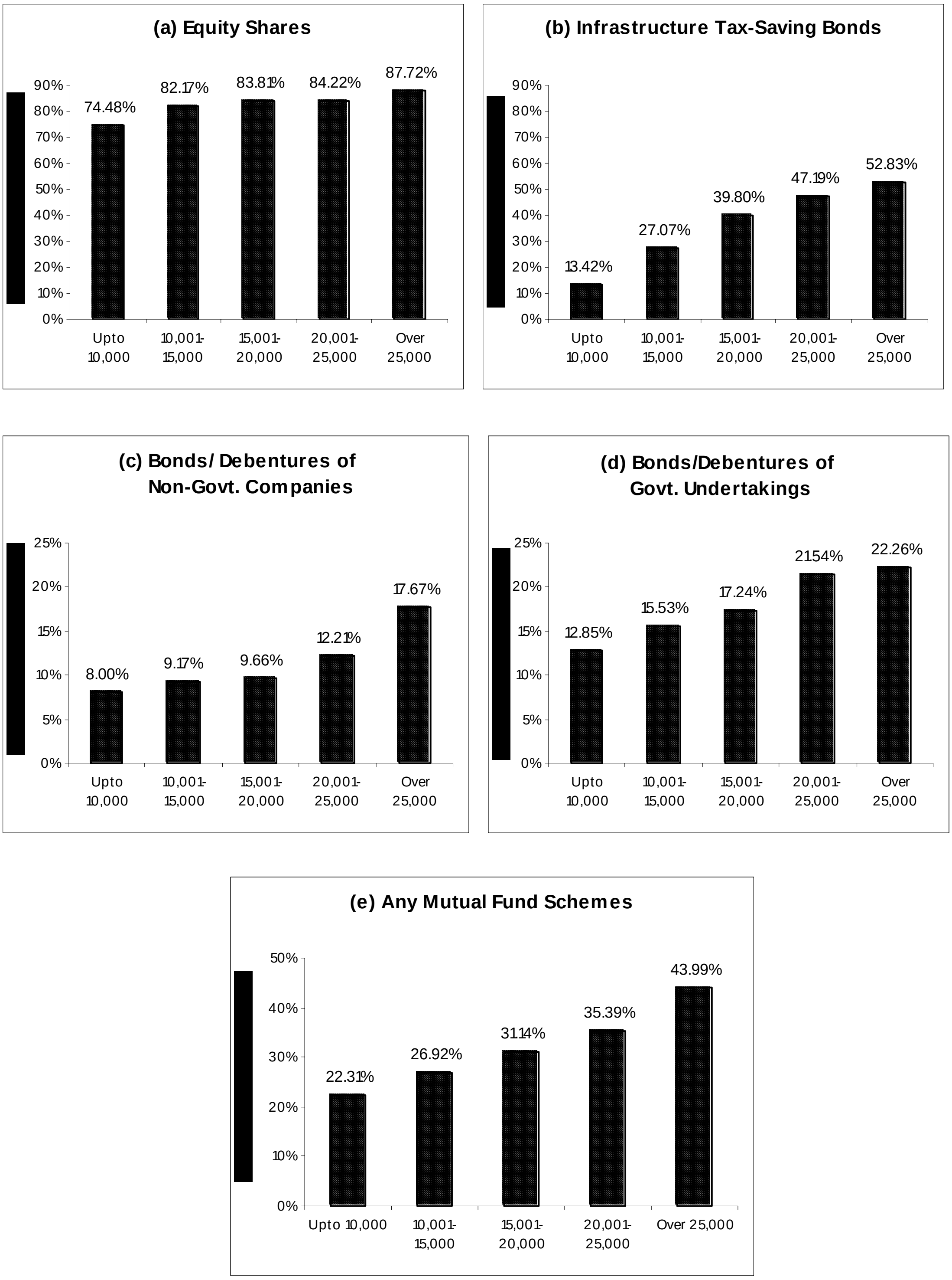


Chart 7.1 A

PERCENTAGE OF HOUSEHOLDS OWNING VARIOUS CAPITAL MARKET INSTRUMENTS, SURVEY-2004

Income Class-wise Analysis (2nd Method)

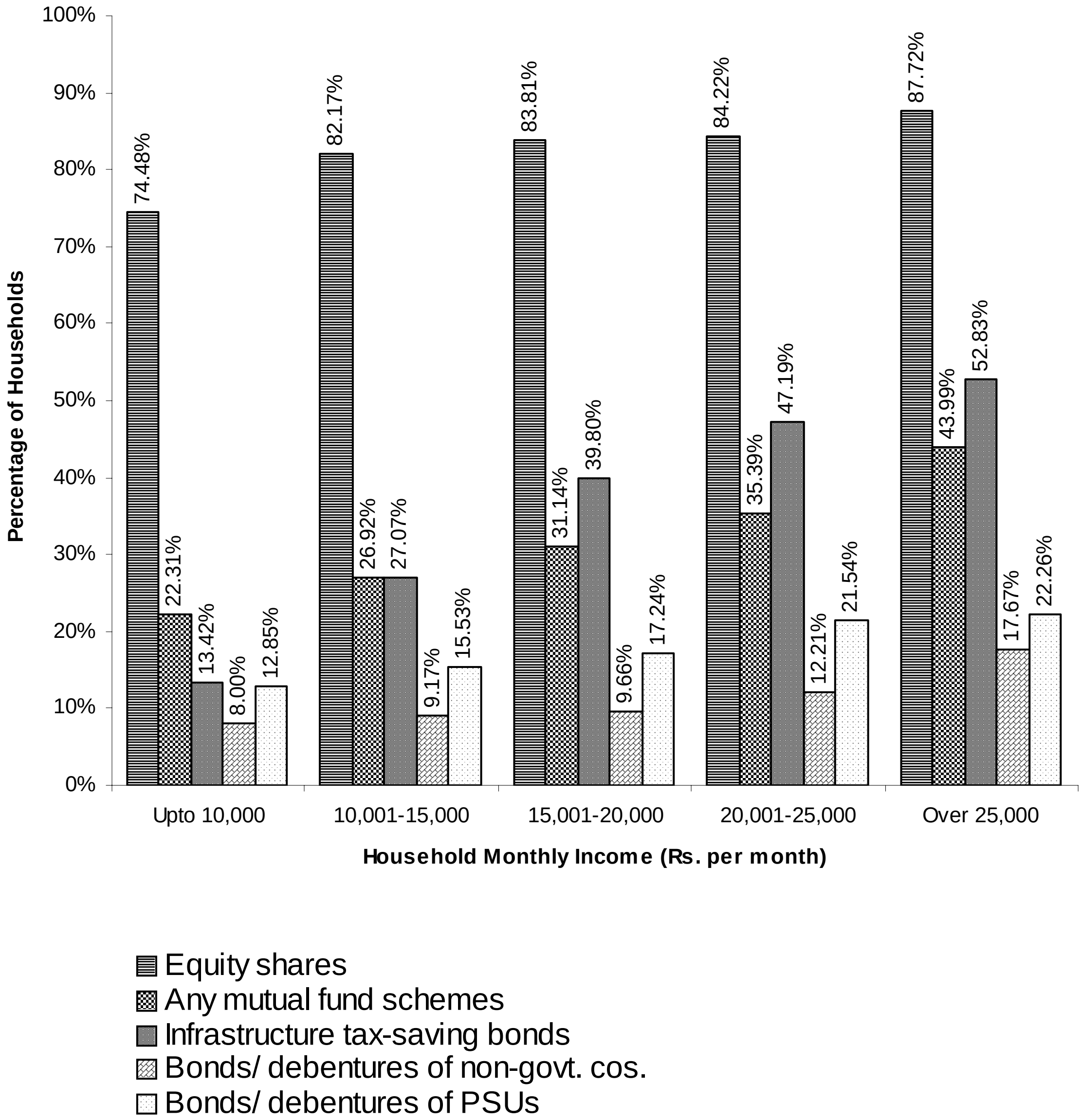
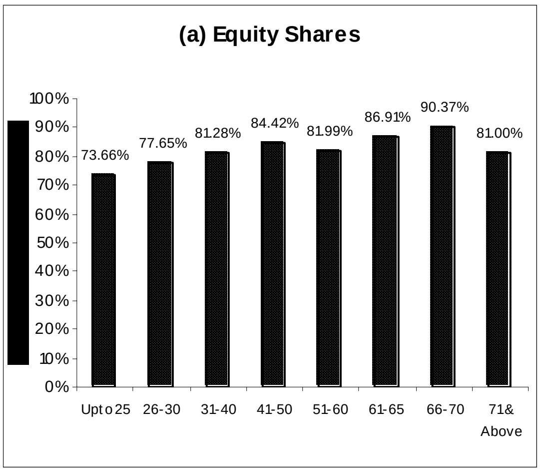
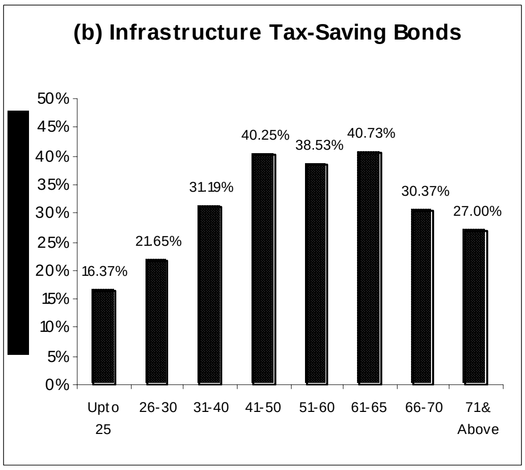


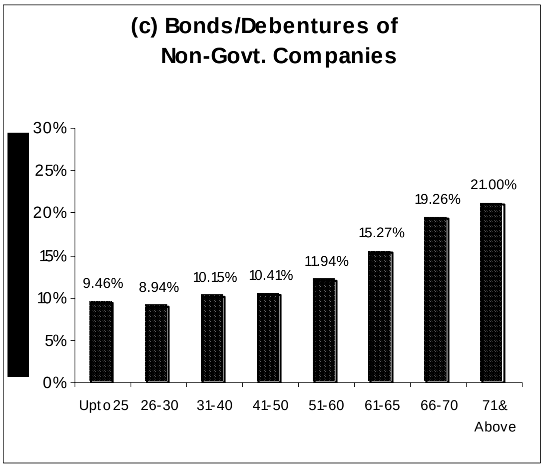
Chart 7.2

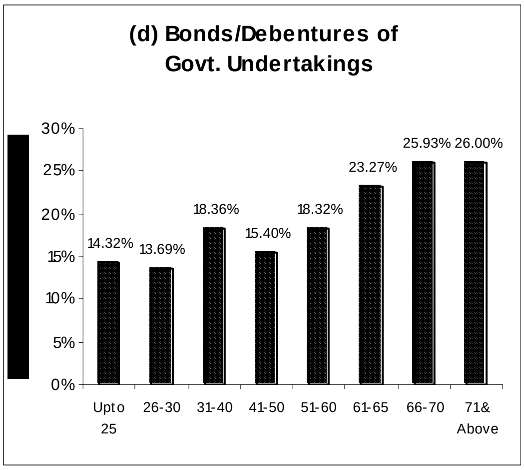
PERCENT OF HOUSEHOLDS OWNING PARTICULAR INVESTMENT TYPES, SURVEY 2004

***Age-Classwise Analysis* (1st Method)**









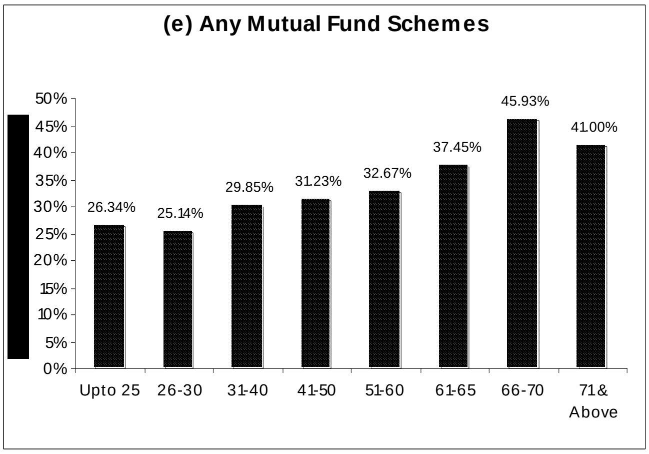
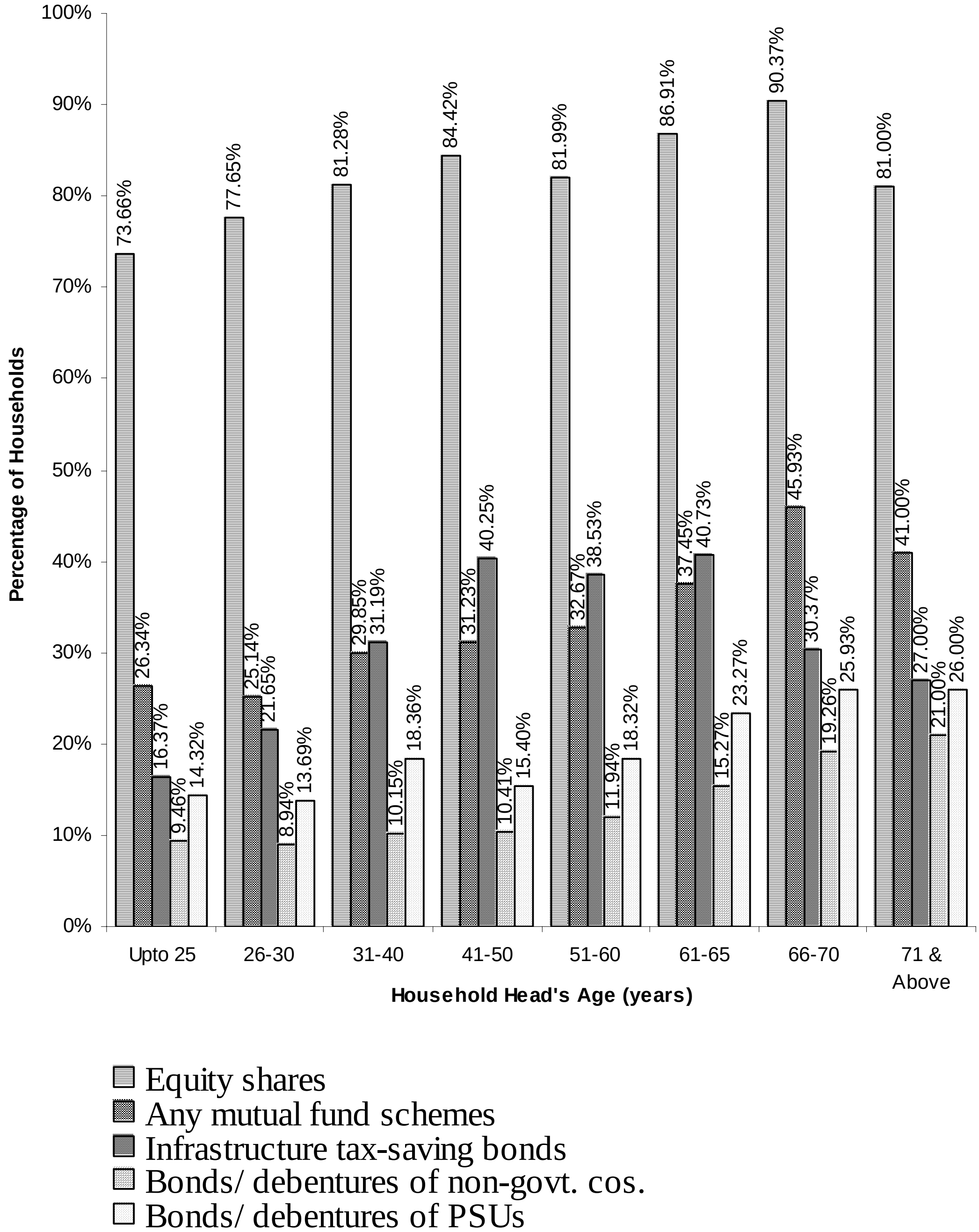


Chart 7.2 A

PERCENTAGE OF HOUSEHOLD OWNINGVARIOUS CAPITAL MARKET INSTRUMENTS, SURVEY - 2004

Age-Classwise Analysis (2nd Method)



across income-classes and also age-classes, showing only a very gradual rise with increase in income and age.

(b) Compared to shares, the other capital market instruments have much lower penetration among household investors. The penetration achieved by mutual funds in the case of every income-class and age-class is only a fraction (one-third to one-half) compared to that of equity shares. Corporate bonds have lower penetration than mutual funds, except in the case of infrastructure tax-saving bonds among the tax-paying classes.

Investment game to identify preferences

7.11 Ownership of particular financial assets (or any durable "product") by households at a point of time is based on purchases made in the past, sometimes many years ago, and may not indicate the current demand or the current pattern of investment preferences. For understanding the current investment preferences, we have used two tools, viz. (1) investment game which was explained in Chapter 5 earlier and (2) asking each household head to indicate what was the likelihood of making 'net addition' over the next one year to the household's investment in selected investment types. Likelihood was distinguished into 'very likely', 'somewhat likely', 'not much likely' and 'not at all likely'.

7.12 The allocations determined from the investment game are based on subjective thinking among the respondents. Nevertheless, as we shall show, the subjective allocational choices clearly reflect the distinct ethos and feelings of the various income-classes and age-classes. This becomes clear from the fact that even though the notional sum to be allocated by every income and age group was exactly the same, a systematic relationship both with income and age is observable from our analysis. Of course, the absolute numbers produced by this game should not be taken at face value[35] but used only for determining the **relative preference** between one investment type and another and also the strength of such relative preference.

7.13 Two aspects of findings of the investment game should be distinguished: (a) The first aspect is the **percent of households** who chose a certain investment type for allocating some money at least. This percentage is comparable to market penetration based on ownership of investment types. All these percentages are not exclusive, i.e. the same household may choose or own several investment types. (b) The second aspect is the **percent of total amount** allocated to a given investment type. The total of allocations cannot exceed 100% of the amount to be allocated because allocation to each investment type is exclusive.

7.14 The investment game shows that the percentage of households choosing to allocate some amount to equity shares is nearly as high in the case of all income groups as the penetration levels of shareownership. The relevant percentages are shown below for ready comparison.

[35] The game permitted allocation within a limited list of investment types whereas the choices available to investors in the real world are unlimited. Hence, the real world pattern of allocations would be different from the pattern observed in our game.

	Method of empirical measure	*Households Monthly Income (Rs.)*					**All Groups**
		Upto 10,000	10,001-15,000	15,001-20,000	20,001-25,000	Over 25,000	
(i)	% of households who owned shares (penetration level)	74.5	82.2	83.8	84.2	87.7	**81.7**
(ii)	% of households who chose to include equity shares in the allocation game	78.5	81.4	77.1	78.4	79.5	**79.0**

(For full details, see Tables 7.1 and 7.3)

Remarkable closeness

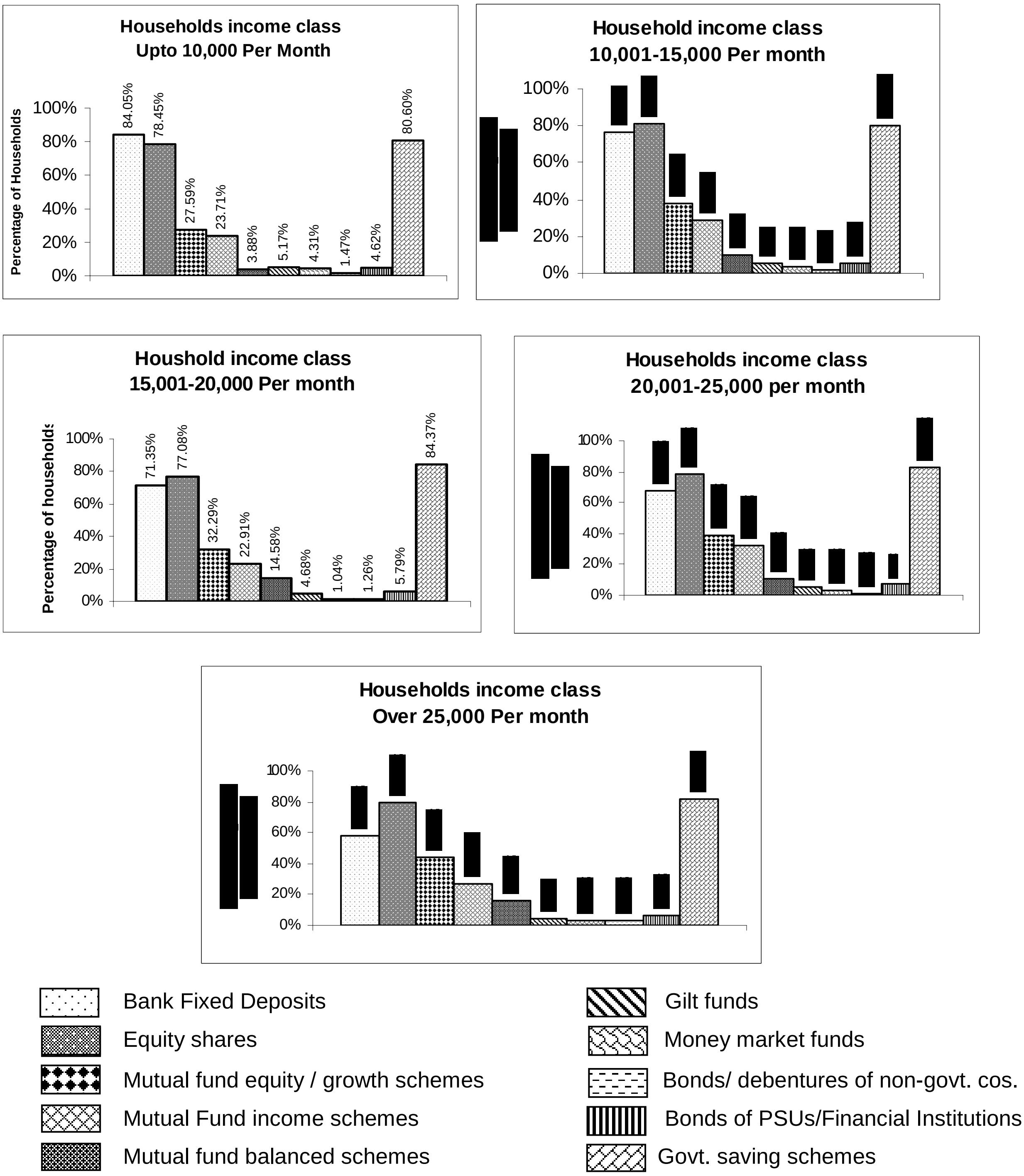
7.15 The closeness of the two sets of percentages given above is really remarkable as the underlying data was collected by different methods at an interval of 2-3 weeks. The shareownership data was collected through personal interviews by field interviewers on the basis of Questionnaire-1. The allocation data was collected through a separate Questionnaire-2 which was directly mailed along with Business Reply Envelope to each interviewee some time after the interview.

7.16 As mentioned a little earlier, the investment game has thrown up two types of data, i.e. the **percentage of households** choosing a particular investment type and the **percentage of money** allocated to that type. The findings on the percentage of households choosing a particular investment type are shown in Chart 7.3 (classified by income class) and in Chart 7.4 (classified by age class). The Charts are derived from Tables 7.3 and 7.4.

Chart 7.3

PER CENT OF HOUSEHOLDS WHO CHOSE PARTICULAR INVESTMENT TYPES WHILE ALLOCATING A SUM RS. 1,00,000

(Income-classwise analysis)

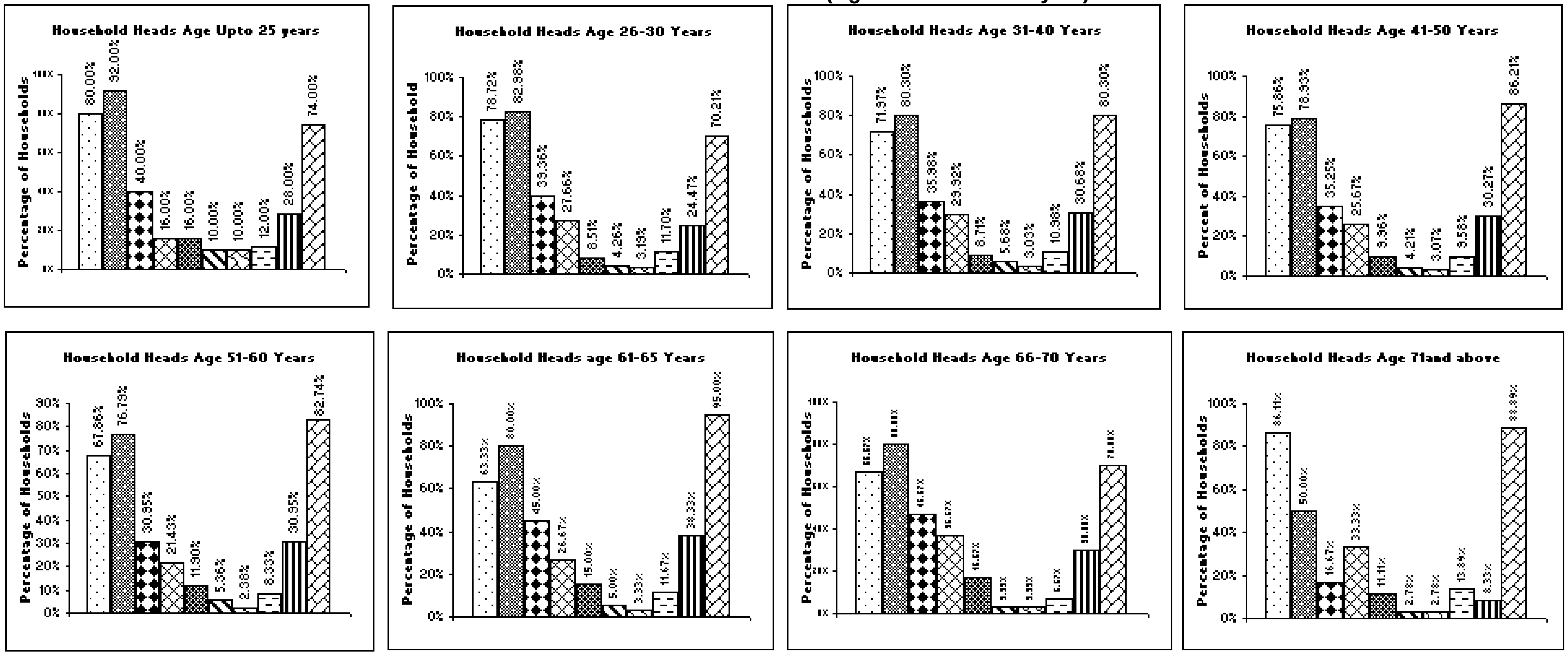


Note: Each respondent was requested to allocate a notional sum of Rs.1,00,000 among not more than 5 of the above-mentioned investment types in the most preferred way in his/her circumstances.

Chart 7.4

PER CENT OF HOUSEHOLDS WHO CHOSE PARTICULAR INVESTMENT TYPES WHILE ALLOCATING A SUM RS. 1,00,000

(Age Class wise analysis)



Bank fixed deposits
Equity shares
Mutual fund equity / growth schemes
Mutual fund income schemes
Mutual fund balanced schemes
Gilt funds
Money market funds
Bonds/debentures of Non-govt. Cos.
Bonds of PSUs/Financial Institutions
Govt. saving schemes

Note: Each respondent was requested to allocate a notional sum of Rs. 1,00,000 among not more than 5 of the above-mentioned investment types in the most preferred way in his/her circumstances

7.17 How the **allocation** of the available fixed amount (notional sum) among investment types varies with income-class and with age-class is shown in Charts 7.5 and 7.6 respectively. They are derived from Tables 7.5 and 7.6. Observe the changes from one income-class to the next and from one age-class to the next in these charts which are self-explanatory. Charts 7.5 and 7.6 may be alternatively presented to focus directly on the sensitiveness of the allocations to change in income and age, as shown in Charts 7.5A and 7.6A.

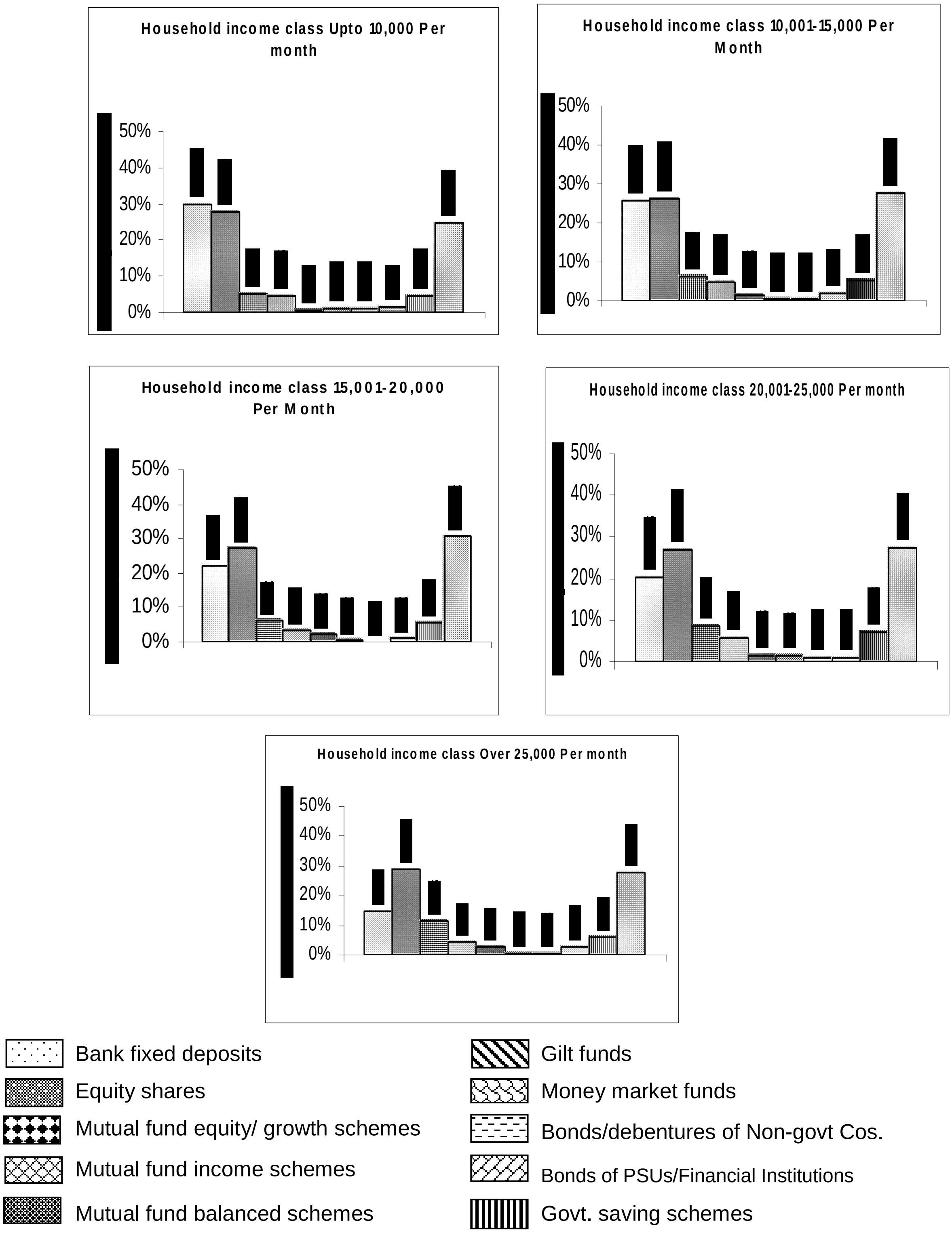
7.18 It may be observed from Charts 7.5A and 7.6A that there is remarkably high orderliness and consistency of findings relating to income-classwise and age-classwise investment preferences, as brought out by the investment game. For example, even though the notional sum to be allocated was the same for all income and age classes, the amount allocated to bank fixed deposits shows a **systematic decline** as we move from lower to higher income classes. This is along expected lines. On the other hand, the amount allocated to mutual fund schemes shows a, more or less, **systematic rise** as we move from lower to higher income classes.

7.19 Government savings schemes are found to enjoy substantial popularity among all income classes. This is mainly because they are the safest instruments, even though not as liquid as bank fixed deposits. Some of the government savings schemes (like public provident fund) offer tax concessions upto a certain limit. They are more attractive to tax payers than to non-tax payers. Since there is also a limit on the allowable tax concession, the amount allocated to savings schemes by the first three income classes at the lower end shows a rising tendency and thereafter a decline (see Chart 7.5A).

Chart 7.5

PER CENT OF A SUM OF RS 1,00,000 ALLOCATED BY HOUSEHOLDS TO VARIOUS INVESTMENT TYPES

Income-Classwise Analysis ***(1st Method)***

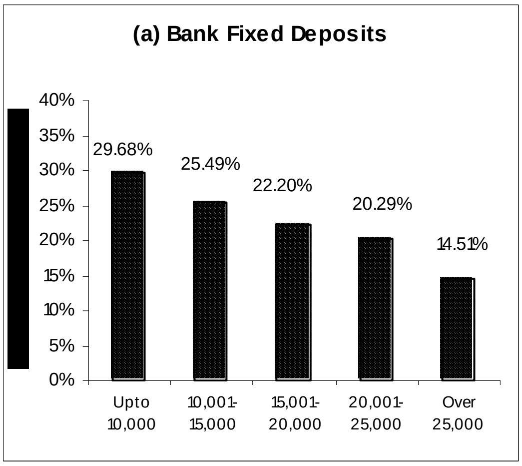


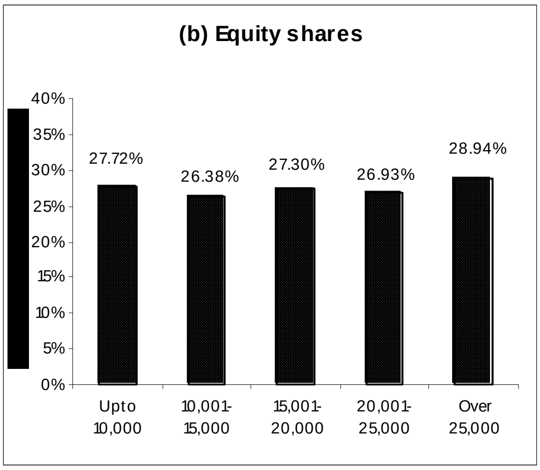
Note: Each respondent was requested to allocate a notional sum of Rs.1,00,000 among not more than 5 of the above-mentioned investment types in the most preferred way in his/her circumstances

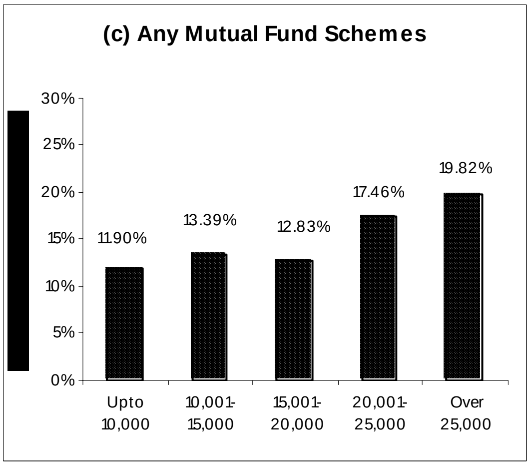
Chart 7.5 A

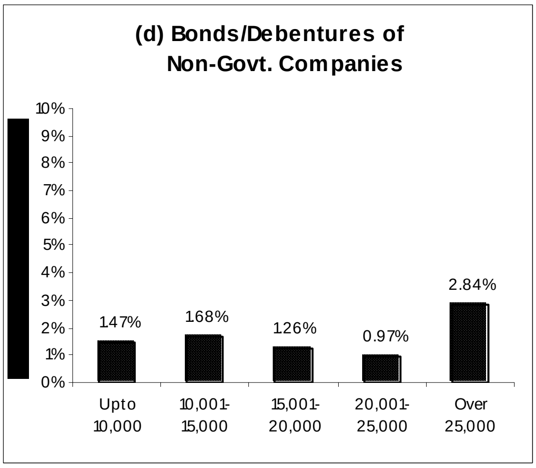
PERCENT OF A NOTIONAL SUM OF RS. 1,00,000 ALLOCATED BY SAMPLE HOUSEHOLD INVESTORS TO VARIOUS INVESTMENT TYPES

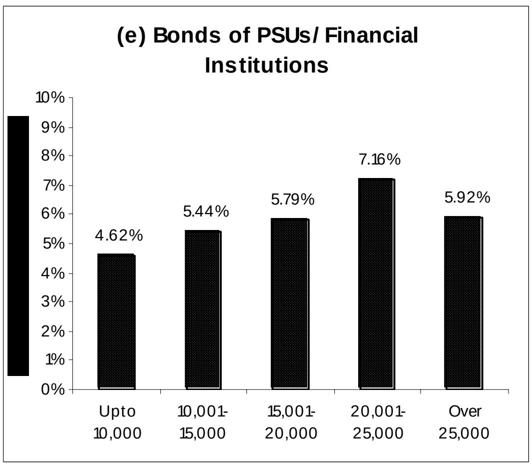
Income-Classwise Analysis ***(2nd Method)***











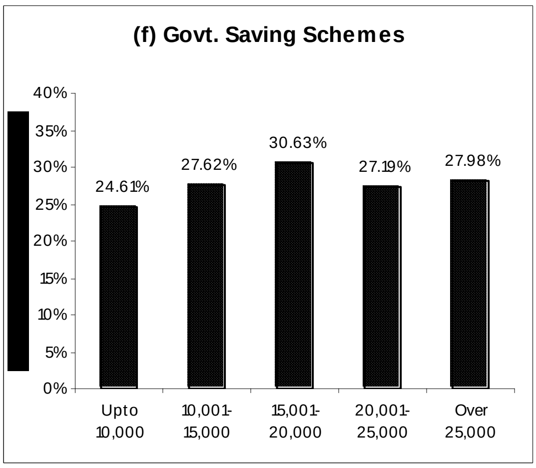
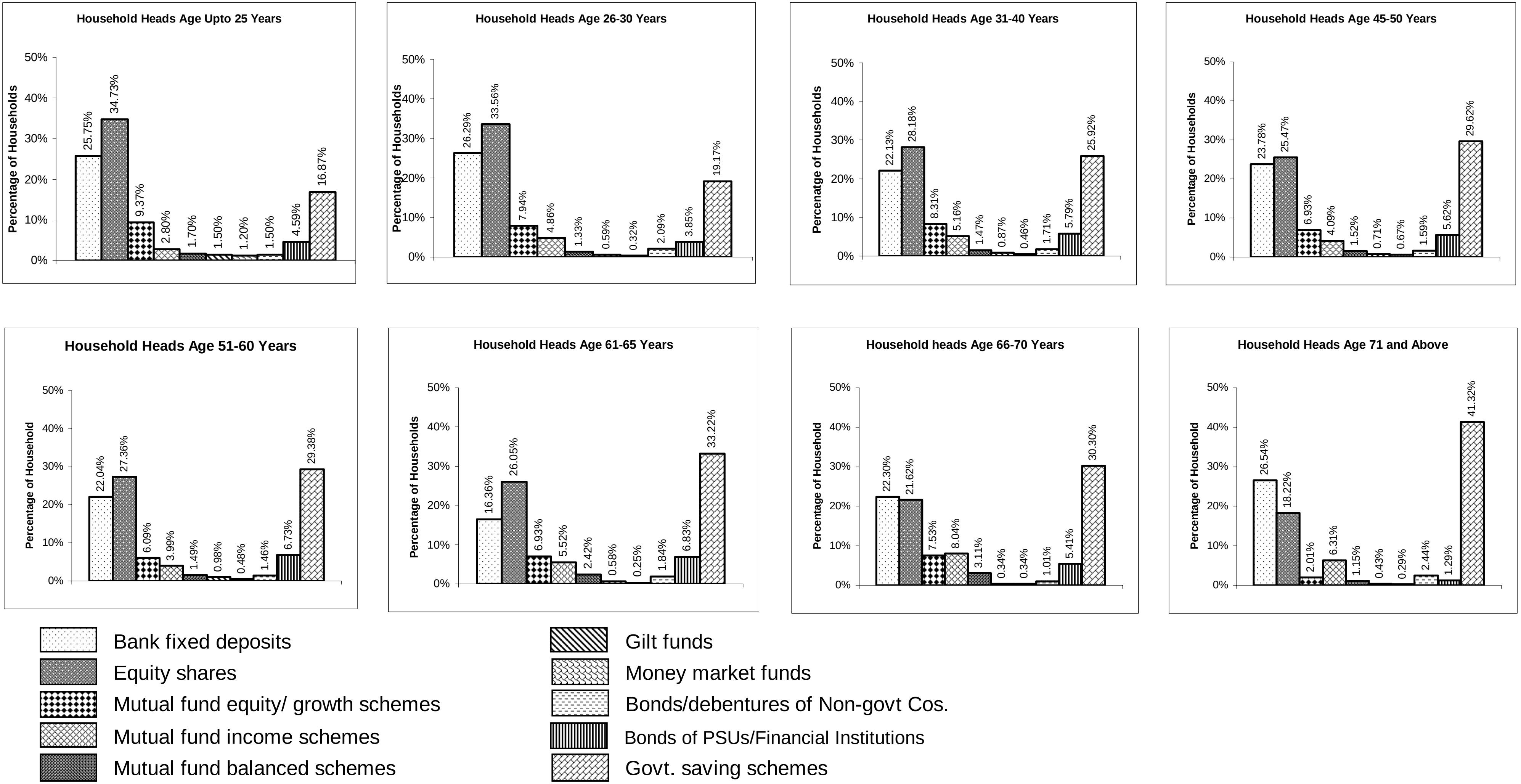


Chart 7.6
PER CENT OF A SUM OF RS 1,00,000 ALLOCATED BY HOUSEHOLDS TO VARIOUS INVESTMENT TYPES
(Age Class wise analysis)

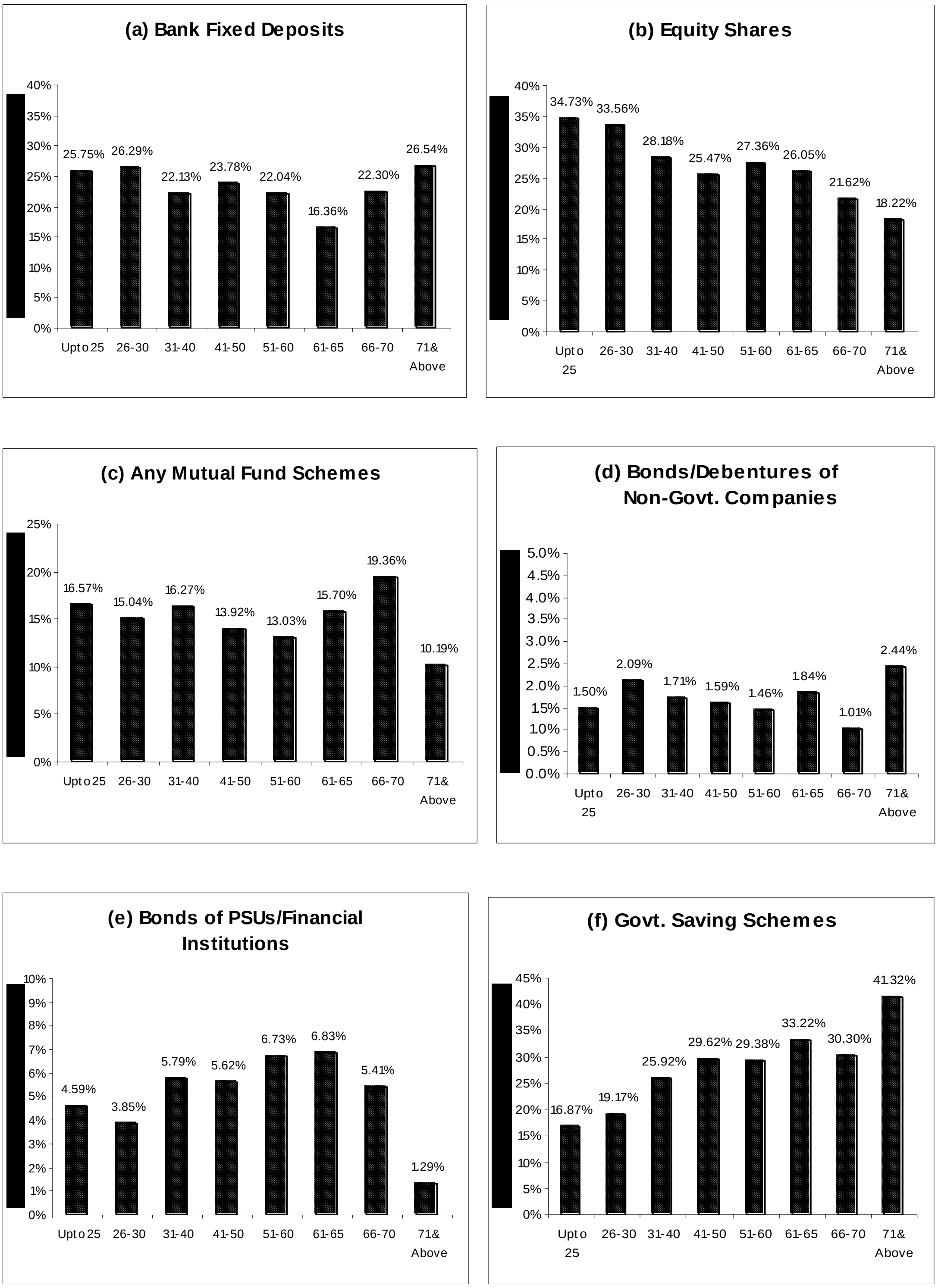


Note: Each respondent was requested to allocate a notional sum of Rs.1,00,000 among not more than 5 of the above-mentioned investment types in the most preferred way in his/her circumstances

Chart 7.6 A

PERCENT OF A NOTIONAL SUM OF RS. 1,00,000 ALLOCATED BY SAMPLE HOUSEHOLD INVESTORS TO VARIOUS INVESTMENT TYPES

Age-Classwise Analysis ***(2nd Method)***



Future intention

7.20 The investment game has provided some useful clues about the retail investors' current preferences among a wide range of financial assets. We separately explored future intentions by a carefully worded question on **likelihood of making 'net addition'[36] over the next one year** to the holding of (1) equity shares, (2) mutual fund equity shares (3) mutual fund income schemes and (4) private sector company bonds. All these are particularly relevant to capital market's development. Likelihood was distinguished into 'very likely', 'somewhat likely', 'not much likely', and 'not at all likely'. For convenience of comparison, we may focus on the combined percentage of 'very likely', and somewhat likely'. The percentages for the four investment types indicated the highest likelihood for equity shares (66.5%), followed, at considerable distance, by mutual fund equity schemes (40.9%) and mutual fund income schemes (34.6%), the least being in the case of private sector company bonds (13.2%). This was largely true of all income classes and age-classes. The detailed Tables are presented in Appendix to this chapter, Tables A 7 (1) to A 7 (8).

Effect of fall in interest rates on attitude towards equity shares

7.21 An interesting aspect covered by our empirical study is the change in the household investors' attitude towards equity shares as a result of fall in interest rates. The interest rates in India have declined substantially over the last few years to touch very low levels. For bank fixed deposits of 1 year or more, the interest rate is now only around 5.0-5.5%. Interest rates on government savings schemes have also been significantly reduced.

[36] The wording of our question allows for the fact that most people cannot be very certain about their future investment intentions but can, at best, given an idea of their general inclination knowledge of inclinations is a useful information. It was explained to the respondents that "net addition means that purchases exceed sales."

This has led to a greater inclination among a majority of household investors towards equity shares, i.e. to accept higher risk in the hope of higher return. This is indicated by the replies to our question whether the fall in interest rates has made share investment more attractive to them. The analysis of replies is presented in Tables 7.7 (for income classes) and 7.8 (for age classes) and also in the form of Charts 7.7 and 7.8. The respondents have been classified by income and age groups in order to ascertain whether there are significant differences among different groups regarding their response to fall in interest rates.

7.22 Table 7.7 shows that slightly over one-half of the total sample households answered 'Yes' and only around 30% answered 'No' to our question whether the fall in interest rates had made equity shares more attractive to them. If we exclude 'can't say' answers (which account for less than 20% of replies), the ratio of 'Yes' to 'No' is 64:36. That is, a little below two-thirds of respondents reported that equity share investment has become more attractive due to fall in interest rates on fixed-income investments. This is, more or less, true for all income-classes with slightly rising proportion of 'Yes' in the higher income classes

7.23 It is noteworthy that age-wise analysis showed a different pattern: the percentage respondents who find equity share investment more attractive due to fall in interest rates is substantially less in the case of higher age groups (over 40 years) than in the case of younger people (upto 30 years).

Effect of holding period on risk and return

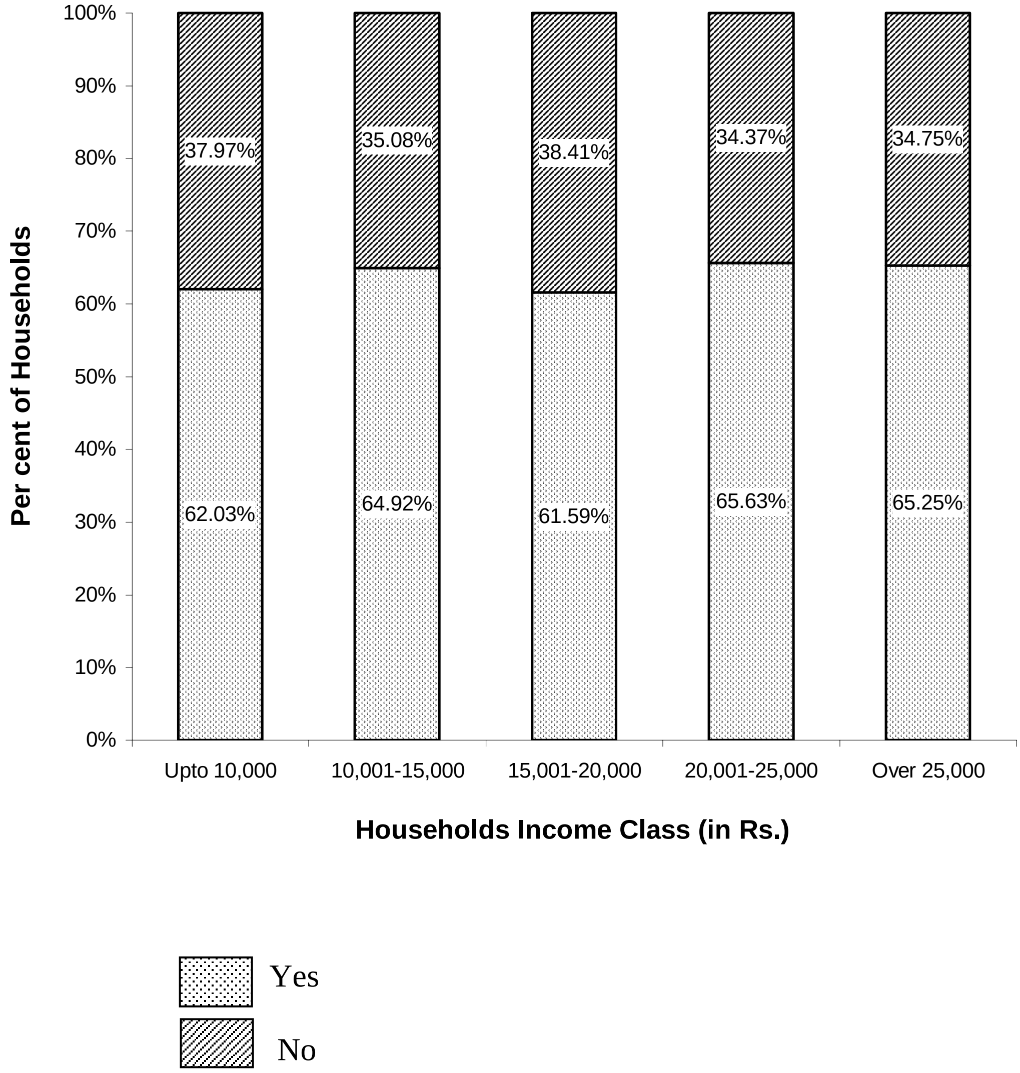
7.24 Equity share investment is quite risky for short holding periods because of wide cyclical swings. At the same time, the total rate of return (including both dividend and capital appreciation) on equity portfolios held for a long-term of 10-15 years has been found to be generally higher than the return on the fixed-income

Chart 7.7

ANSWERS TO QUESTION: HAS FALL IN INTEREST RATE MADE SHARE INVESTMNET MORE ATTRACTIVE TO YOU?

Household Investors Survey – 2004

Income-classwise Analysis ***excluding*** *'can't say' cases*



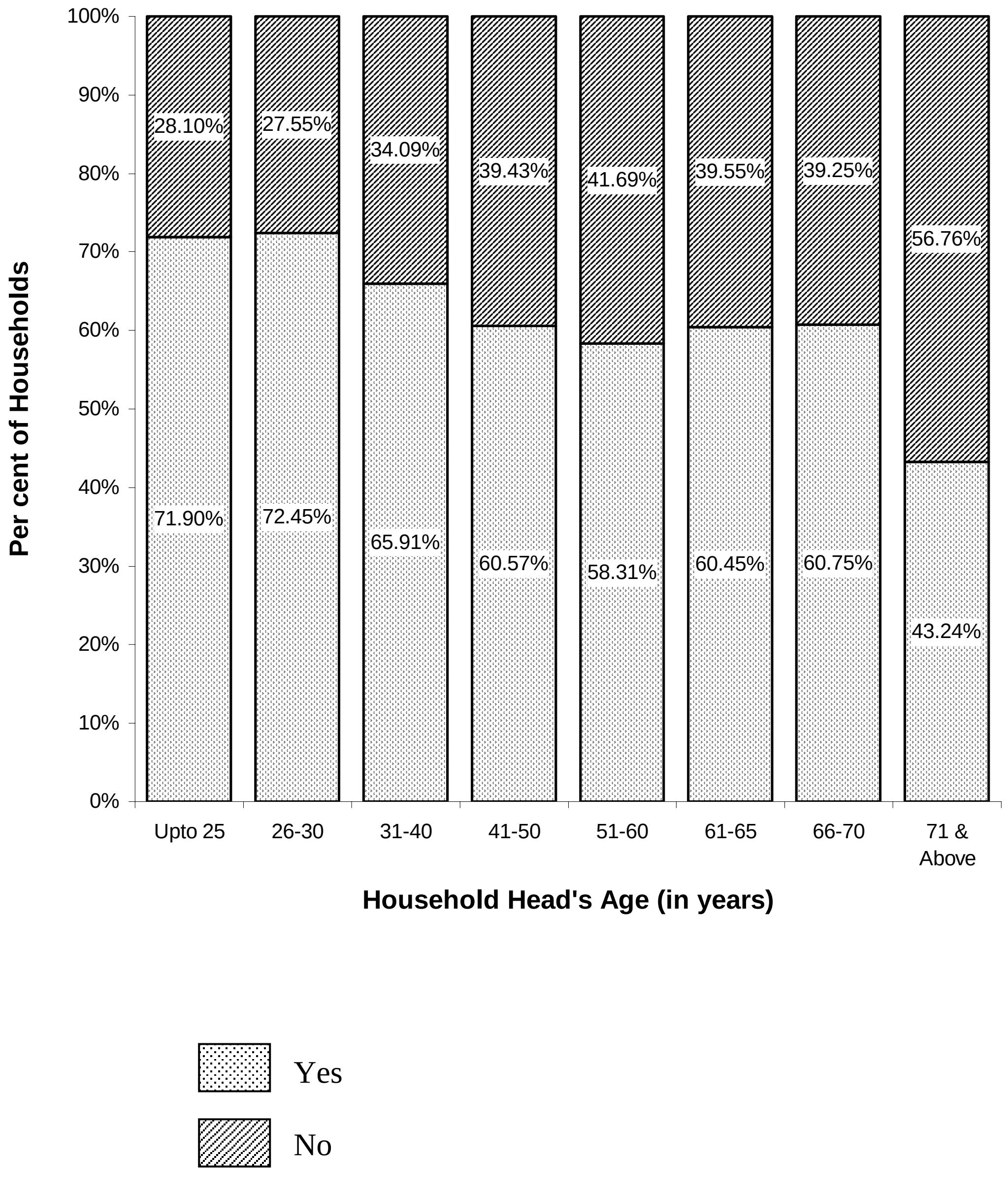
Source: Table 7.7

Chart 7.8

ANSWERS TO QUESTION: HAS FALL IN INTEREST RATE MADE SHARE INVESTMNET MORE ATTRACTIVE TO YOU?

Household Investors Survey - 2004

*Age-classwise Analysis **excluding** 'can't say' cases*



Source: Table 7.8

types of investments. The excess return represents the 'risk premium'. However, over short holding periods, the return on equity shareholding may often be even negative. The shorter the holding period, the more variable is the return from equity investment.[37] For holding periods of less than 5 years, the risk of negative returns is considerably high. This explains why the older people are not attracted towards putting **fresh money** into equity share investment, except holding on to earlier investments.

7.25 Younger people have time on their side. They can afford to take higher risk because they can tide over even a long period of depression by holding on to the share investment and also because, in case of actual loss, they have time to recoup the loss in future.

III. The Maturing of India's Retail Investor Population

Shareowners' age qua shareowners

7.26 What we mean is the number of years since a person became a shareowner for the first time in life. **Maturity in terms of years and also in terms of having been through many market vicissitudes has led to mature behaviour,** as we shall show. Of the sample shareowning households in 2004, about 62% had held shares for 10 years or more (see Tables 7.9 and 7.10, as also Charts 7.9 and 7.10). This is in contrast with the 1990-survey[38] when only 35% households at that point of time were found holding shares for over 10 years. There is wide difference also in per cent of respondents who had shares for less than 5 years. This percentage was much lower at 23% in the 2004-survey compared to much higher figure of 35% in the 1990-survey. Looking at the two extremes (over 10-years and under 5-years of shareholding experience), the present shareowning population is far more mature than was the case in 1990. At the time of survey in 2004, a majority of responding households had the experience of being shareholders of one or

[37] See L. C. Gupta, *Rates of Return on Equities: The Indian Experience* (Oxford University Press, Delhi, 1981), pp. 44-8. See also L.C. Gupta and Utpal K. Choudhury, *Rates of Return on Indian Equity Shares* (Society for Capital Market Research & Development, Delhi, 2000), pp. 103-4.

[38] For 1990 survey, See L. C. Gupta, *Indian Shareowners: A Survey* (Society for Capital Market Research & Development, Delhi, 1991), p. 32.

Chart 7.9

THE YEAR/PERIOD IN WHICH THE SAMPLE HOUSEHOLDS HAD PURCHASED SHARES FIRST TIME IN LIFE

Income-Classwise Analysis

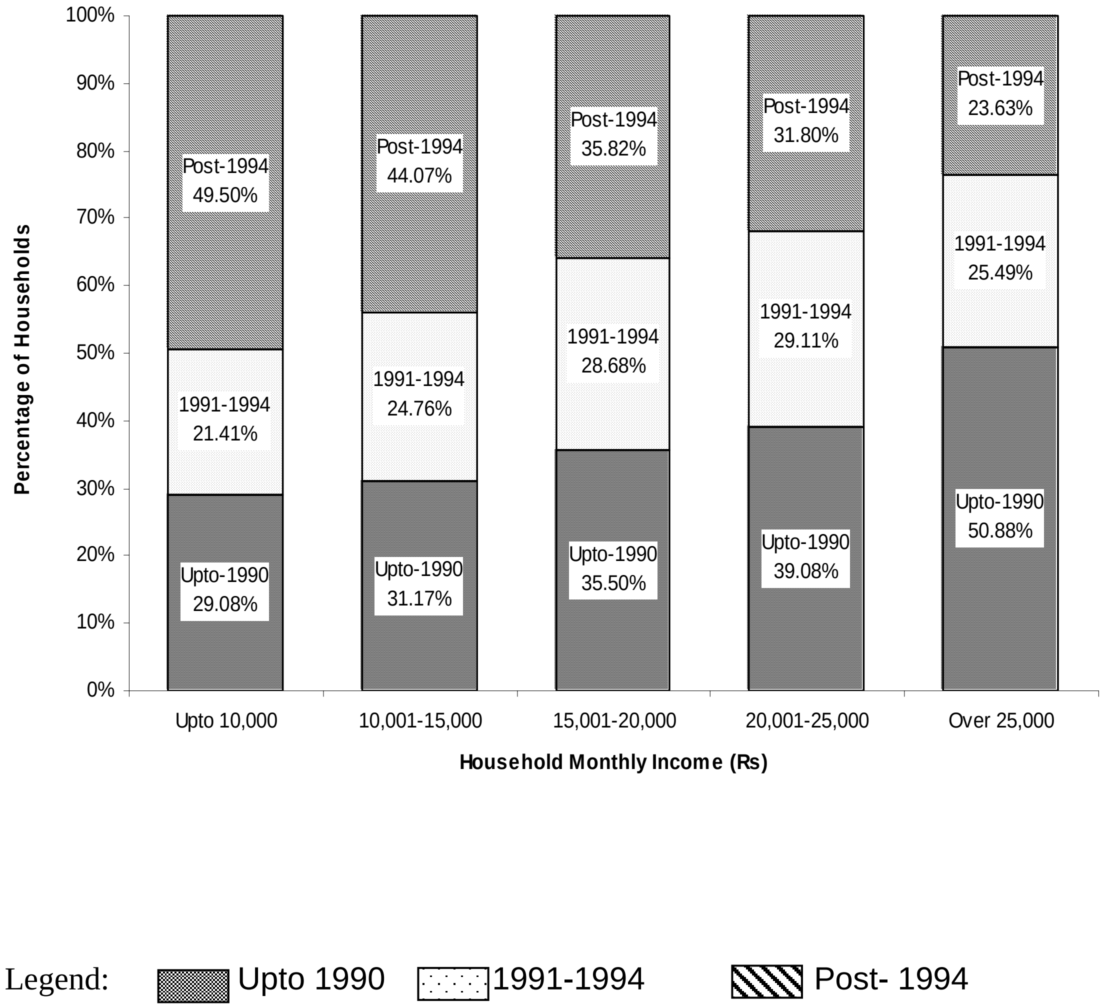
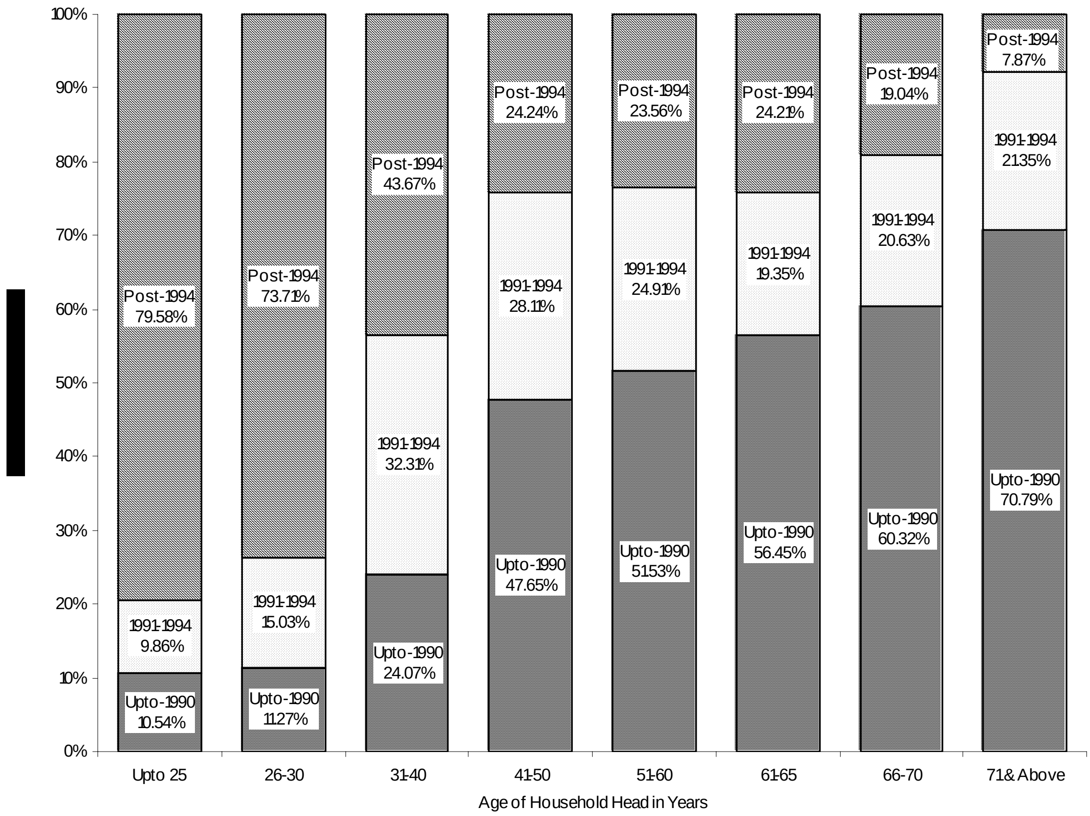


Chart 7.10

THE YEAR/PERIOD IN WHICH THE SAMPLE HOUSEHOLDS HAD PURCHASED SHARES FIRST TIME IN LIFE

Age-Classwise Analysis



Legend: Upto 1990 1991-1994 Post- 1994

more companies for 10 years or longer. They would have acquired good general familiarity with this kind of investment.

Effect of income and age

7.27 Income-classwise analysis showed that 50% of sample households even in the lowest income-class (upto Rs. 10,000 per month) had been shareholders for 10 years or more. The percentage in question goes on rising for the higher income classes and exceeds 75% for the income class above Rs. 25,000 per month. Age-wise analysis revealed that, excepting the first two age-groups (i.e. Upto 30 years), well-over 50% of the shareowning households in all the higher age-groups had been shareowners for 10 years or more. The percentage was around 75% for age-groups between 41-65 years, rising to over 90% in the age-group of 71 years or more. Somewhat over 80% of our sample households fall in the age-groups above 30 years (measured by age of household head). **The shareowning households in our sample are broadly representative of the main stream of the Indian shareowning population.** A good proportion (around 25%) of these households had entered the share market for the first time in the spectacular boom years of 1991-94. Over one-third of our sample households had been shareowners since even before 1990.

Impact on share diversification

7.28 A noteworthy point is that despite being in the share market as shareowners of companies for over a decade or more, a majority of such household investors have adopted the practice of **narrow diversification,** i.e. diversification upto 10 companies. As pointed out in the preceding chapter, the most typical diversification is between 3-10 companies, This is largely true across all income-classes and age-classes.

7.29 This chapter has revealed that majority of retail shareowners in almost all income and age-classes have been shareowners for 10 years or more. When we view this revelation in the light of the preceding chapter's factual analysis, our inference is that the extent of **diversification does not increase beyond 10 companies for most of the mature investors. Only in the highest income-class (above Rs 25,000 per month) and the elderly investors (over 60 years), the most widely adopted diversification of portfolios can be described to lie between 3-20 companies instead of 3-10 companies.**

Emergence of discerning retail investors

7.30 Our data brings out that the bulk of the present generation of Indian retail investors got their exposure to the vicissitudes of the equity market during the last 15 years, specially the 1990s. They have gone through many boom-bust market cycles and also witnessed the many incidents of market frauds and manipulative practices. While some of them became so disgusted that they vowed never to touch the stock market again, most others were less cynical and felt that it was a learning experience. They derived useful lessons and evolved practical approaches to equity investment.

7.31 The retail investors in India have become wiser, more sophisticated and discerning investors. They have begun to understand the amplitude and duration of the Indian Stock market's cyclical ups and downs and also the magnitude of daily gyrations. The popular TV news channels, which now regularly broadcast daily stock market report at prime time, have created greater awareness among ordinary investors about the market's behaviour and parameters.

How maturity has made a difference

7.32 We have carefully observed the important difference made by the maturing of India's domestic retail investor population to the behaviour of the investors and of the stock market. During the height of the 1992-boom as well as the 1994 boom, the average P/E Ratio of both the BSE Sensex and BSE National Index went up to the absurd height of around 40. The retail investors were buying into the share market at the height of the bull market. They were even more eagerly lapping up IPOs of greenfield companies formed by inexperienced and even fly-by-night promoters. New shareowners were entering fast. India's shareowning population went on rising rapidly from year to year upto mid-1990s. At that time, most retail investors had very little understanding about share investment. They seemed to believe that share prices can go only up and up.

7.33 Compare this to the retail investors' behaviour in the recent stock market boom which took off around middle of 2003 and went on for almost the whole of 2004, due mainly to buying of stocks by FIIs (excepting a temporary but sharp break around May 2004 due to political uncertainties arising after the defeat of the BJP-led government at the Centre).

7.34 This recent boom of 2003-04 attracted the retail investors mostly as sellers rather than as buyers. Having become wiser from the mistakes of the past and leant some basics, the retail investors have become less gullible. They have started looking at IPOs with a magnifying glass. Very few IPOs are now able to pass muster. In recent times, a rise in the average P/E ratio of BSE Sensex and NSE Nifty group of companies to touch a level of just 17-18 seems to ring an alarm bell for investors and market authorities.

Table 7.1

PERCENTAGE OF HOUSEHOLDS OWNING VARIOUS CAPITAL MARKET INSTRUMENTS

Household Investors Survey - 2004

Income-classwise Analysis

Capital Market instruments	***All classes of sample households***	*Household income class (Rs. per month)*				
		Upto 10,000	10,001– 15,000	15,001– 20,000	20,001- 25,000	Over 25,000
		Percent of households column-wise				
(a) Equity shares	**81.74**	74.48	82.17	83.84	84.22	87.72
(b) Infrastructure tax-saving bonds	**33.21**	13.42	27.07	39.80	47.19	52.83
(c) Bonds/Debentures of non-govt. companies	**10.95**	8.00	9.17	9.66	12.21	17.67
(d) Bonds/Debentures of govt. undertakings	**17.16**	12.85	15.53	17.24	21.54	22.26
(e) Any mutual fund schemes	**30.79**	22.31	26.92	31.14	35.39	43.99
No. of households	**5,908**	1,587	1,352	1,108	729	1,132

Table 7.2

PERCENTAGE OF HOUSEHOLDS OWNING VARIOUS CAPITAL MARKET INSTRUMENTS

Household Investors Survey - 2004

Age-classwise Analysis

Capital market instruments	***All classes of sample households***	*Household Head's Age (in years)* Upto 25	26-30	31-40	41-50	51-60	61-65	66-70	71 and above
		Percent of households column-wise							
(a) Equity shares	**81.74**	73.66	77.65	81.28	84.42	81.99	86.91	90.37	81.00
(b) Infrastructure tax-saving bonds	**33.21**	16.37	21.65	31.19	40.25	38.53	40.73	30.37	27.00
(c) Bonds/Debentures of non-govt. companies	**10.95**	9.46	8.94	10.15	10.41	11.94	15.27	19.26	21.00
(d) Bonds/Debentures of govt. undertakings	**17.16**	14.32	13.69	18.36	15.40	18.32	23.27	25.93	26.00
(e) Any mutual fund schemes	**30.79**	26.34	25.14	29.85	31.23	32.67	37.45	45.93	41.00
No. of households	**5,908***	391	716	1645	1662	955	275	135	100

* Out of total sample respondents, a few did not provide information on their age. They have therefore, not been included in the individual age-classes but are included in the total sample.

Note: Some respondents ticked more than one capital market instrument.

Table 7.3

PERCENTAGE OF SAMPLE HOUSEHOLD INVESTORS WHO CHOSE PARTICULAR INVESTMENT TYPES FOR ALLOCATING A NOTIONAL SUM OF RS. 100,000

Household Investors Survey – 2004

Income Class-wise Analysis

Investment Types	*All classes of sample households*	*Household income class (Rs. Per month)*				
		Upto 10,000	10,001 -15000	15,001-20000	20,001-25000	Over 25,000
	Percent of Households Column-wise					
(a) Bank Fixed deposits	**72.38**	84.05	76.19	71.35	67.63	58.42
(b) Equity Shares	**79.02**	78.45	81.43	77.08	78.42	79.47
(c) Mutual fund Equity/ Growth schemes	**35.62**	27.59	37.62	32.29	38.85	44.21
(d) Mutual Fund Income Schemes	**26.48**	23.71	28.57	22.92	32.37	26.84
(e) Mutual Fund Balanced Schemes	**10.70**	3.88	9.52	14.58	10.79	16.32
(f) Gilt Funds	**5.09**	5.17	5.71	4.69	5.76	4.21
(g) Money market funds	**3.32**	4.31	3.81	1.04	3.60	3.68
Sub Total (c) to (g)	**81.21**	64.66	85.23	75.52	91.37	95.26
(h) Bonds/Debentures of Non-Govt. Companies	**10.28**	9.48	10.95	9.38	7.19	13.68
(i) Bonds of PSUs/ Financial Institutions	**30.11**	27.16	29.05	33.33	33.81	28.95
(j) Govt. Saving Schemes	**81.93**	80.60	80.48	84.38	82.73	82.11
No. of respondents	**963**	232	210	192	139	190

Explanatory Notes:

(1) Each respondent was requested to allocate a notional sum of Rs. 1,00,000 among not more than 5 of the above mentioned investment types in the most preferred way in his/her circumstances.

(2) The allocations have been worked out in terms of the total amount allocated by all the respondents taken together.

Table 7.4

PERCENTAGE OF SAMPLE HOUSEHOLD INVESTORS WHO CHOSE PARTICULAR INVESTMENT TYPES FOR ALLOCATING A NOTIONAL SUM OF RS. 100,000

Household Investors Survey – 2004

Age-classwise Analysis

Investment Types	***All classes of sample households***	*Age of household head(in years)*							
		Upto 25	26-30	31-40	41-50	51-60	61-65	66-70	71 and above
	Percent of Households Column-wise								
(a) Bank Fixed deposits	**72.38**	80.00	78.72	71.97	75.86	67.86	63.33	66.67	86.11
(b) Equity Shares	**79.02**	92.00	82.98	80.30	78.93	76.79	80.00	80.00	50.00
(c) Mutual fund Equity/ Growth schemes	**35.62**	40.00	39.36	35.98	35.25	30.95	45.00	46.67	16.67
(d) Mutual Fund Income Schemes	**26.48**	16.00	27.66	29.92	25.67	21.43	26.67	36.67	33.33
(e) Mutual Fund Balanced Schemes	**10.70**	16.00	8.51	8.71	9.96	11.90	15.00	16.67	11.11
(f) Gilt Funds	**5.09**	10.00	4.26	5.68	4.21	5.36	5.00	3.33	2.78
(g) Money market funds	**3.32**	10.00	3.19	3.03	3.07	2.38	3.33	3.33	2.78
Sub Total (c) to (g)	**81.21**	92.00	82.98	80.32	78.16	72.02	95.00	106.67	66.67
(h) Bonds/Debentures of Non-Govt. Companies	**10.28**	12.00	11.70	10.98	9.58	8.33	11.67	6.67	13.89
(i) Bonds of Govt. Undertaking/ Financial Institutions	**30.11**	28.00	24.47	30.68	30.27	30.95	38.33	30.00	8.33
(j) Govt. Saving Schemes	**81.93**	74.00	70.21	80.30	86.21	82.74	95.00	70.00	88.89
No. of respondents	**963**	50	94	264	261	168	60	30	36

See explanatory note under Table 7.3

* Out of total sample respondents, a few did not provide information on their age. They have therefore, not been included in the individual age-classes but are included in the total sample.

Table 7.5

PERCENTAGE OF A NOTIONAL SUM OF RS 1,00,000 ALLOCATED BY SAMPLE HOUSEHOLD INVESTORS TO VARIOUS INVESTMENT TYPES

Household Investors Survey – 2004

Income Class-wise Analysis

Investment Types	***All classes of sample households***	*Household income class (Rs. Per month)*				
		Upto 10,000	10,001 -15000	15,001-20000	20,001-25000	Over 25,000
		Percent Allocation of Amount Column-wise				
(a) Bank Fixed deposits	**22.93**	29.68	25.49	22.20	20.29	14.51
(b) Equity Shares	**27.47**	27.72	26.38	27.30	26.93	28.94
(c) Mutual fund Equity/ Growth schemes	**7.22**	5.04	6.10	6.11	8.47	11.31
(d) Mutual Fund Income Schemes	**4.66**	4.70	4.89	3.66	5.67	4.61
(e) Mutual Fund Balanced Schemes	**1.58**	0.52	1.28	2.17	1.37	2.77
(f) Gilt Funds	**0.80**	0.84	0.67	0.73	1.19	0.68
(g) Money market funds	**0.52**	0.80	0.45	0.16	0.76	0.45
Sub Total (c) to (g)	***14.78***	*11.9*	*13.39*	*12.83*	17.46	19.82
(h) Bonds/Debentures of Non-Govt. Companies	**1.67**	1.47	1.68	1.26	0.97	2.84
(i) Bonds of PSUs/ Financial Institutions	**5.65**	4.62	5.44	5.79	7.16	5.92
(j) Govt. Saving Schemes	**27.50**	24.61	27.62	30.63	27.19	27.98
No. of respondents	**963**	232	210	192	139	190

Explanatory Notes:

(1) Each respondent was requested to allocate a notional sum of Rs. 1,00,000 among not more than 5 of the above mentioned investment types in the most preferred way in his/her circumstances.

(2) The allocations have been worked out in terms of the total amount allocated by all the respondents taken together.

Table 7.6

PERCENTAGE OF A NOTIONAL SUM OF RS 1,00,000 ALLOCATED BY SAMPLE HOUSEHOLD INVESTORS TO VARIOUS INVESTMENT TYPES

Household Investors Survey – 2004

Age-classwise Analysis

Investment types	*All classes of sample households*	*Age of household head(in years)*							
		Upto 25	26-30	31-40	41-50	51-60	61-65	66-70	71 and above
		Percent Allocation of Amount Column-wise							
(a) Bank Fixed deposits	**22.93**	25.75	26.29	22.13	23.78	22.04	16.36	22.30	26.54
(b) Equity Shares	**27.47**	34.73	33.56	28.18	25.47	27.36	26.05	21.62	18.22
(c) Mutual fund Equity/ Growth schemes	**7.22**	9.37	7.94	8.31	6.93	6.09	6.93	7.53	2.01
(d) Mutual Fund Income Schemes	**4.66**	2.80	4.86	5.16	4.09	3.99	5.52	8.04	6.31
(e) Mutual Fund Balanced Schemes	**1.58**	1.70	1.33	1.47	1.52	1.49	2.42	3.11	1.15
(f) Gilt Funds	**0.80**	1.50	0.59	0.87	0.71	0.98	0.58	0.34	0.43
(g) Money market funds	**0.52**	1.20	0.32	0.46	0.67	0.48	0.25	0.34	0.29
Sub Total (c) to (g)	***14.78***	16.57	15.04	16.27	13.92	13.03	15.7	19.36	10.19
(h) Bonds/Debentures of Non-Govt. Companies	**1.67**	1.50	2.09	1.71	1.59	1.46	1.84	1.01	2.44
(i) Bonds of PSUs / Financial Institutions	**5.65**	4.59	3.85	5.79	5.62	6.73	6.83	5.41	1.29
(j) Govt. Saving Schemes	**27.50**	16.87	19.17	25.92	29.62	29.38	33.22	30.30	41.32
Column Total	**100.00**	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
No. of respondents	**963**	50	94	264	261	168	60	30	36

See explanatory note under Table 7.5

* Out of total sample respondents, a few did not provide information on their age. They have therefore, not been included in the individual age-classes but are included in the total sample.

Table 7.7

ANSWERS TO QUESTION: HAS FALL IN INTEREST RATE MADE SHARE INVESTMENT MORE ATTRACTIVE TO YOU?

Household Investors Survey – 2004

Income-classwise Analysis

Answer	***Respondents Total***	*Household income class (Rs. per month)* Upto 10,000	10,001–15,000	15,001–20,000	20,001-25,000	Over 25,000
		Percentage of households column-wise				
(a) Yes	**51.54**	49.46	51.68	50.32	52.63	54.76
(b) No	**29.39**	30.27	27.93	31.38	27.56	29.16
(c) Can't Say	**19.07**	20.27	20.39	18.30	19.81	16.01
Column total	**100.00**	100.00	100.00	100.00	100.00	100.00
No. of Respondents	**5,848**	1,569	1,339	1,093	722	1,125
		*Percent of households (**excluding** 'can't say' cases)*				
(a) Yes	**63.68**	62.03	64.92	61.59	65.63	65.25
(b) No	**36.32**	37.97	35.08	38.41	34.37	34.75
Column total	**100.00**	100.00	100.00	100.00	100.00	100.00
No. of Respondents excluding 'can't say' cases	**4,733**	1,251	1,066	893	579	944

Table 7.8

ANSWERS TO QUESTION: HAS FALL IN INTEREST RATE MADE SHARE INVESTMENT MORE ATTRACTIVE TO YOU?

Household Investors Survey - 2004

<u>Age-classwise Analysis</u>

Answer	***Respondents Total***	*Age of household head in years* Upto 25	26-30	31-40	41-50	51-60	61-65	66-70	71 and above
					Percentage of households column-wise				
(a) Yes	**51.62**	57.14	60.34	54.77	48.20	46.77	48.54	48.15	32.32
(b) No	**29.44**	22.34	22.95	28.34	31.38	33.44	31.75	31.11	42.42
(c) Can't Say	**18.94**	20.52	16.71	16.89	20.41	19.79	19.71	20.74	25.25
Column total	**100.00**	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
No. of Respondents	**5,848***	385	706	1,634	1,641	945	274	135	99
					*Percent of households (**excluding** 'can't say' cases)*				
(a) Yes	**63.68**	71.90	72.45	65.91	60.57	58.31	60.45	60.75	43.24
(b) No	**36.32**	28.10	27.55	34.09	39.43	41.69	39.55	39.25	56.76
Column total	**100.00**	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
No. of Respondents *excluding 'can't say' cases*	**4,717***	306	588	1,358	1,306	758	220	107	74

* Out of total sample respondents, a few did not provide information on their age. They have therefore, not been included in the individual age-classes but are included in the total sample.

Table 7.9

INDICATE THE YEAR/PERIOD IN WHICH YOU (i.e. YOUR HOUSEHOLD) PURCHASED SHARES FOR THE *FIRST TIME* IN YOUR LIFE

Household Investors Survey – 2004

Income-classwise Analysis

Year	***All sample households***	Household income class (Rs. per month) Upto 10,000	10,001–15,000	15,001–20,000	20,001 - 25,000	Over 25,000
		Percent of households column-wise				
1. Upto 1990	**36.55**	29.08	31.17	35.50	39.08	50.88
2. 1991 to 994	**25.39**	21.41	24.76	28.68	29.11	25.49
3. 1995 to1998	**11.35**	11.27	13.52	11.45	12.18	8.40
4. 1999 to 2000	**7.83**	11.76	6.85	9.35	5.06	4.49
5. 2001	**5.73**	6.78	7.11	5.99	5.54	2.83
6. 2002	**4.71**	6.86	5.44	3.57	4.11	2.73
7. 2003 to Sept.2004	**8.45**	12.83	11.15	5.46	4.91	5.18
Column total	**100.00**	100.00	100.00	100.00	100.00	100.00
No. of respondents	**4,971**	1,224	1,139	952	632	1,024
Row Total	**100.00**	24.62	22.91	19.15	12.71	20.60

Table 7.10

INDICATE THE YEAR/PERIOD IN WHICH YOU (i.e. YOUR HOUSEHOLD) PURCHASED SHARES FOR THE *FIRST TIME* IN YOUR LIFE

Household Investors Survey – 2004

<u>Age-classwise Analysis</u>

Year	***All sample households***	*Age of household head in years* Upto 25	26-30	31-40	41-50	51-60	61-65	66-70	71 and above
		Percent of households column-wise							
1 Upto 1990	**36.55**	10.54	11.27	24.07	47.65	51.53	56.45	60.32	70.79
2 1991 to 1994	**25.39**	9.86	15.03	32.31	28.11	24.91	19.35	20.63	21.35
3 1995 to 1998	**11.35**	9.52	14.67	13.86	9.88	10.18	10.08	7.14	2.25
4 1999 to 2000	**7.83**	13.61	13.24	9.34	5.25	5.77	5.65	6.35	2.25
5 2001	**5.73**	11.22	13.24	6.71	3.73	2.58	2.02	2.38	1.12
6 2002	**4.71**	11.56	11.27	6.05	2.00	1.84	2.02	0.79	0.00
7 2003 to Sept. 2004	**8.45**	33.67	21.29	7.66	3.38	3.19	4.44	2.38	2.25
Column total	**100.00**	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
No. of respondents	**4,971***	294	559	1,371	1,448	815	248	126	89
Row Total	**100.00**	5.91	11.25	27.58	29.13	16.40	4.99	2.53	1.79

*Out of total sample respondents, a few did not provide information on their age. They have therefore, not been included in the individual age-classes but are included in the total sample.

Appendix to Chapter 7

Table A7 (1)

ANALYSIS OF HOUSEHOLD INVESTORS ACCORDING TO HOW LIKELY THEY ARE TO MAKE NET ADDITION DURING NEXT ONE YEAR TO INVESTMENT IN: *EQUITY SHARES*

Household Investors Survey - 2004

Income-classwise Analysis

How likely	***Respondents Total***	*Household income class (Rs. per month)* Upto 10,000	10,001– 15,000	15,001– 20,000	20,001- 25,000	Over 25,000
		Percentage of households column-wise				
1. Very likely	**41.84**	43.22	42.58	38.84	37.45	44.82
2. Somewhat likely	**24.67**	23.00	25.02	26.43	27.26	23.19
Sub Total (1+2)	***66.51***	*66.22*	*67.60*	*65.27*	*64.71*	*68.01*
3. Not much likely	**13.36**	12.48	13.52	14.69	14.63	12.28
4. Not at all likely	**20.12**	21.30	18.88	20.04	20.66	19.71
Column total	**100.00**	100.00	100.00	100.00	100.00	100.00
No. of Respondents	**5,597**	1,474	1,287	1,048	697	1,091

Table A7 (2)

ANALYSIS OF HOUSEHOLD INVESTORS ACCORDING TO HOW LIKELY THEY ARE TO MAKE NET ADDITION DURING NEXT ONE YEAR TO INVESTMENT IN: *EQUITY SHARES*

Household Investors Survey - 2004

Age-classwise Analysis

	How likely	***Respondents Total***	*Age of household head in years*							
			Upto 25	26-30	31-40	41-50	51-60	61-65	66-70	71 and above
			Percentage of households column-wise							
1	Very likely	**41.84**	49.45	50.45	46.89	38.27	35.05	35.96	26.98	30.85
2	Somewhat likely	**24.67**	24.73	24.40	23.38	25.72	26.04	27.72	23.02	12.77
	Sub Total (1+2)	***66.51***	*74.18*	*74.85*	*70.27*	*63.99*	*61.09*	63.68	50.00	43.62
3	Not much likely	**13.36**	12.36	10.27	12.50	14.24	14.51	14.61	20.63	17.02
4	Not at all likely	**20.12**	13.46	14.88	17.23	21.77	24.40	21.72	29.37	39.36
	Column total	**100.00**	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
	No. of Respondents	**5,597***	364	672	1,544	1,594	910	267	126	94

*Out of total sample respondents, a few did not provide information on their age. They have therefore, not been included in the individual age-classes but are included in the total sample.

Table A7 (3)

ANALYSIS OF HOUSEHOLD INVESTORS ACCORDING TO HOW LIKELY THEY ARE TO MAKE NET ADDITION DURING NEXT ONE YEAR TO INVESTMENT IN: *MUTUAL FUND EQUITY / GROWTH SCHEMES*

Household Investors Survey - 2004

Income-classwise Analysis

	How likely	***Respondents Total***	*Household income class (Rs. per month)*				
			Upto 10,000	10,001– 15,000	15,001– 20,000	20,001- 25,000	Over 25,000
			Percentage of households column-wise				
1.	Very likely	**16.23**	12.94	15.46	16.19	15.71	21.80
2.	Somewhat likely	**24.68**	22.49	25.50	25.06	27.40	24.48
	Sub Total (1+2)	***40.91***	*35.43*	*40.96*	*41.25*	*43.11*	*46.28*
3.	Not much likely	**17.71**	15.63	17.54	19.84	19.23	17.67
4.	Not at all likely	**41.38**	48.93	41.50	38.91	37.66	36.05
	Column total	**100.00**	100.00	100.00	100.00	100.00	100.00
	No. of Respondents	**4,867**	1,267	1,106	902	624	968

Table A7 (4)

ANALYSIS OF HOUSEHOLD INVESTORS ACCORDING TO HOW LIKELY THEY ARE TO MAKE NET ADDITION DURING NEXT ONE YEAR TO INVESTMENT IN: *MUTUAL FUND EQUITY / GROWTH SCHEMES*

Household Investors Survey - 2004

Age-classwise Analysis

	How likely	***Respondents Total***	*Age of household head in years*							
			Upto 25	26-30	31-40	41-50	51-60	61-65	66-70	71 and above
			Percentage of households column-wise							
1	Very likely	**16.23**	21.04	19.10	19.56	13.56	13.36	14.72	11.30	6.02
2	Somewhat likely	**24.68**	26.86	30.29	26.62	22.73	22.85	22.08	16.52	15.66
	Sub Total (1+2)	***40.91***	*47.90*	*49.39*	*46.18*	*36.29*	*36.21*	36.80	27.52	21.68
3	Not much likely	**17.71**	19.42	17.21	17.21	17.45	17.98	22.08	17.39	14.46
4	Not at all likely	**41.38**	32.69	33.39	36.62	46.26	45.82	41.13	54.78	63.86
	Column total	**100.00**	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
	No. of Respondents	**4,867***	309	581	1,360	1,364	801	231	115	83

*Out of total sample respondents, a few did not provide information on their age. They have therefore, not been included in the individual age-classes but are included in the total sample.

Table A7 (5)

ANALYSIS OF HOUSEHOLD INVESTORS ACCORDING TO HOW LIKELY THEY ARE TO MAKE NET ADDITION DURING NEXT ONE YEAR TO INVESTMENT IN: *MUTUAL FUND INCOME SCHEMES*

Household Investors Survey – 2004

Income-classwise Analysis

	How likely	***Respondents Total***	*Household income class (Rs. per month)*				
			Upto 10,000	10,001–15,000	15,001–20,000	20,001-25,000	Over 25,000
			Percentage of households column-wise				
1.	Very likely	**13.09**	12.60	13.33	12.75	13.08	13.81
2.	Somewhat likely	**21.52**	19.18	22.10	23.25	22.52	21.68
	Sub Total (1+2)	***34.61***	*31.78*	*35.43*	*36.00*	*35.60*	*34.49*
3.	Not much likely	**19.10**	16.45	18.36	20.77	21.52	20.39
4.	Not at all likely	**46.28**	51.77	46.21	43.23	42.88	44.12
	Column total	**100.00**	100.00	100.00	100.00	100.00	100.00
	No. of Respondents	**4,758**	1,246	1,095	886	604	927

Table A7 (6)

ANALYSIS OF HOUSEHOLD INVESTORS ACCORDING TO HOW LIKELY THEY ARE TO MAKE NET ADDITION DURING NEXT ONE YEAR TO INVESTMENT IN: *MUTUAL FUND INCOME SCHEMES*

Household Investors Survey – 2004

Age-classwise Analysis

	How likely	***Respondents Total***	*Age of household head in years* Upto 25	26-30	31-40	41-50	51-60	61-65	66-70	71 and above
			Percentage of households column-wise							
1	Very likely	**13.09**	18.57	14.11	1.51	11.22	11.10	16.16	10.08	6.02
2	Somewhat likely	**21.52**	21.17	21.96	22.64	21.46	20.55	19.21	24.37	15.66
	Sub Total (1+2)	***34.61***	*39.74*	*36.07*	*37.15*	*32.68*	*31.65*	*35.37*	*34.45*	*21.68*
3	Not much likely	**19.10**	22.15	23.21	19.07	17.02	19.92	20.52	10.08	13.25
4	Not at all likely	**46.28**	38.11	40.71	43.77	50.30	48.42	44.10	55.46	65.06
	Column total	**100.00**	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
	No. of Respondents	**4,758***	307	560	1,316	1,328	793	229	119	83

*Out of total sample respondents, a few did not provide information on their age. They have therefore, not been included in the individual age-classes but are included in the total sample.

Table A7 (7)

ANALYSIS OF HOUSEHOLD INVESTORS ACCORDING TO HOW LIKELY THEY ARE TO MAKE NET ADDITION DURING NEXT ONE YEAR TO INVESTMENT IN: *PRIVATE SECTOR COMPANY BONDS*

Household Investors Survey - 2004

Income-classwise Analysis

How likely	*Respondents Total*	*Household income class (Rs. per month)*				
		Upto 10,000	10,001–15,000	15,001–20,000	20,001-25,000	Over 25,000
		Percentage of households column-wise				
1. Very likely	**4.76**	4.75	4.20	5.23	4.95	4.84
2. Somewhat likely	**8.43**	6.31	8.40	9.77	8.87	9.78
Sub Total (1+2)	**13.19**	11.07	12.60	15.00	13.82	14.62
3. Not much likely	**15.10**	11.64	15.74	15.70	16.38	17.58
4. Not at all likely	**71.71**	77.30	71.66	69.30	69.80	67.80
Column total	**100.00**	100.00	100.00	100.00	100.00	100.00
No. of Respondents	**4,624**	1220	1048	860	586	910

Table A7 (8)

ANALYSIS OF HOUSEHOLD INVESTORS ACCORDING TO HOW LIKELY THEY ARE TO MAKE NET ADDITION DURING NEXT ONE YEAR TO INVESTMENT IN: *PRIVATE SECTOR COMPANY BONDS*

Household Investors Survey - 2004

Age-classwise Analysis

	How likely	*Respondents Total*	*Age of household head in years*							
			Upto 25	26-30	31-40	41-50	51-60	61-65	66-70	71 and above
			Percentage of households column-wise							
1	Very likely	**4.76**	6.83	5.15	4.69	4.99	3.79	3.62	5.36	3.66
2	Somewhat likely	**8.43**	10.58	10.48	8.67	8.14	7.44	6.33	8.04	4.88
	Sub Total (1+2)	**13.19**	17.41	15.63	13.36	13.13	11.23	9.95	13.39	8.54
3	Not much likely	**15.10**	20.14	15.81	17.03	11.75	14.10	17.19	14.29	15.85
4	Not at all likely	**71.71**	62.46	68.57	69.61	75.12	74.67	72.85	72.32	75.61
	Column total	**100.00**	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
	No. of Respondents	**4,624***	293	544	1280	1302	766	221	112	82

*Out of total sample respondents, a few did not provide information on their age. They have therefore, not been included in the individual age-classes but are included in the total sample.

Chapter 8

SMALL INVESTORS' PROBLEMS WITH DEMAT SYSTEM

Small long-term investors bear the brunt

8.1 Retail investors have been encountering serious problems with the demat system. This has happened because the SEBI, in a hurry, made demat compulsory without giving due consideration to the realities of our socio-economic situation. The result is that India's demat system has not evolved as a voluntary business service, priced attractively for the mass of investors. It is heavily tilted in favour of speculators and large market participants but against the retail investors. Its effect has been to gradually push out the retail investors from the equity market. The demat system was never promoted by compulsion in the U.S. or U.K. It grew there gradually as investors became familiar with it and found it beneficial and economical to them.

The original purpose

8.2 The report of the Working Group, set up in 1994, on the legal framework of a depository system for India,[39] had envisaged that "it would be optional for an investor to hold and transfer the securities through or outside the depository", although, in long run, the Group expected that the bulk of the securities would be held in depository form. The Group also recognised that "in many cases, investors would be residing at a place where no

[39] The members of the SEBI Working Group on Framework for Depository System were : Mr. C. Achuthan, Dr. L.C. Gupta, Mr. S. Murthy and Ms. D.N. Raval. See Report of the Working Group (August 1994, unpublished), specially para 11.4.

depository facilities are available and a small investor might find it costly to transfer the shares through depository."

8.3 The original objective of introducing the depository system was to eliminate the many irritating problems and costs (like back-and-forth transmission of millions of physical share certificates, bad deliveries, shares lost or stolen in transit, delay in share transfer registration, etc.). It has undoubtedly solved these problems but, at the same time, the structure of demat charges has played mischief due to being highly biased against small investors. It has hurt them so much that they are tending to quit the equity market.[2] This could not have been the SEBI's intention.

8.4 Around the time when the Depositories Act was enacted in 1996 to enable the creation of a depository system, the official expectation from the new system of dematerialisation of securities was expressed by SEBI in the following words:

> "It is expected that as the network of depository participants expands, and the proportion of securities dematerialized in the depository increases, **the benefits of reduced risk and lower transaction costs will extend to the vast majority of market participants** and lead to improved investor protection and service."[3] (Emphasis added.)

The truth is that the "vast majority of market participants" have been disappointed by the depository system mainly because of its structure and the use of compulsion leaving no option to the

[2] For more detailed discussion, see L. C. Gupta and Naveen Jain, *Economic and Political Weekly*, May 17, 2003, pp. 1969-74. See also by same authors, "Small Investors at the Receiving End" in *The Economic Times*, 25 January, 2003.

[3] See SEBI *Annual Report*, 1996-97, p. 20. In May 1996, SEBI also notified SEBI (Depositories and Participants) Regulations. Following the notification, National Securities Depository Limited (NSDL) was sponsored by IDBI, UTI and NSE. The NSDL began its operations in November 1996.

investor. There is an inherent monopoly element in such a system.

Problem recognized but action awaited

8.5 Belatedly in February 2004, the SEBI recognised the problem of high demat charges in the case of small investors and constituted a Group on Reduction of Demat Charges. The Report of the Group observed:

> Ever since Depositories changed the method of charging depository participants on transactions, from the *earlier method of ad valorem to flat fee structure (FFS),* there has been a perception in certain quarters that small investors are overcharged. Further, it has been felt that the charges are beyond the bearable capacity sometimes for certain class of investors and thus it was reported that small investors have been driven away from the Indian equity market . . . .
>
> Considering the role of small investors in Indian capital market, we need to have a cost effective system which will address many of the issues concerning small investors. . . .
>
> The depositories started charging DPs on FFS basis since May, 2002 and DPs in turn started charging on FFS basis to investors. This system is tilted in favour of high networth and institutional investors who trade in large quantities. The long-term small investors who trade less frequently feel the unwanted burden of heavy outgo on account of FFS.[4]

[4] See SEBI's website: www.sebi.gov.in

8.6 The Group recommended that the small investors should be charged on the basis of ad valorem only and that the charges, like account maintenance and demat charges, should not be levied on small investors at all by DPs. The Group also recognised that the companies have really been the main beneficiaries of the depository system which has saved them huge cost incurred earlier on registration of share transfers. It recommended that all companies should pay a one-time fee to the Depository at 0.1% of their market capitalisation. The suggestions of the Group have yet to be implemented.

How the depository system works

8.7 For a proper understanding of the retail investors' problems with the demat system, the following historical background should be kept in view. The securities depository system was introduced in India towards the end of 1996 with the creation of the National Securities Depository Limited (NSDL) under the sponsorship of IDBI, UTI and NSE. Subsequently, in February 1999, a second depository, called Central Depository Services Limited (CDSL), was sponsored by the Bombay Stock Exchange. The First Working Group (1994) on the Depository System had envisaged a competitive system of multiple depositories. The Group thought that it would be too risky to have a single depository in the initial stages (Para 10 of Group's Report). The Depositories Act recognised the competitive principle by keeping the door open for multiple depositories.

8.8 However, initially the depository system came to be entirely controlled by a single depository, viz. NSDL, Well before the second depository could come up, SEBI had already made trading through depository compulsory. This gave NSDL enormous monopoly power by placing the later entrant, CDSL, at enormous disadvantage. The CDSL could garner only the 'left over' depository business because switching from one depository to another was not workable in practice. The NSDL took full advantage of its monopoly power.

8.9 The depositories levy certain fees from Depository Participants (DPs), who are like agencies for providing depository services to investors. The investors have direct contact with the DPs only and no contact at all with the depositories.

8.10 DPs are completely free to decide in what manner and how much they will charge to the investors for the depository services. Most DPs charge for account opening, account maintenance, custody, transaction settlement, pledge creation and closure, etc. The DPs have to charge to investors substantially more in total because DPs have to recover their own operational expenses, besides the fee they pay to the depositories. Many DPs levy several miscellaneous types of charges too, such as courier charges, penalties, interest-free deposit with the DP, etc.

How competition is obstructed

8.11 The system of DPs' charges to the investors is a virtual jungle and obstructs competition. The charges differ a great deal with respect to the heads under which they are made and also with respect to the level of each type of charge. For this reason, the investors have great difficulty in comparing the charges of various DPs and determining the cheapest. This makes the whole system very opaque.

8.12 The NSDL has argued that because of the existence of several hundred DPs in the country and two competing depositories, there is sufficient competition in the Indian depository system. This argument is fallacious. An examination of ground realities shows that competition does not seem to work in the depository system. The reasons are: an opaque and confusing system of charges at the DP level; substantial costs and hassles for the investor if he wants to change his DP and a heavy annual flat fee payable by every DP with the result that many small places have no DP and some places have only one DP.

Most retail investors remain outside the demat system

8.13 *A stark reality is that despite the existence of the depository system in India for nearly eight years and despite demat form being made compulsory by SEBI for trading on stock exchanges, most of the small investors, who constitute the majority of shareholding population in India, have remained outside the share depository system.* This is true of many companies which have lakhs of shareholders and very active trading in their shares.

8.14 This was confirmed by the data collected by us directly from 130 individual companies in 2003, as summarised in Tables 8.1 and 8.2.[5] Table 8.1 classifies the companies into five size-groups by market capitalisation. The analysis shows that a *majority of shareholders in every size-class were holding physical shares*.

[5] See. L.C. Gupta, Naveen Jain and Utpal Choudhury, *India's Stock Market and Household Investors 2001-04* (SCMRD, 2004), p. 40.

8.15 Table 8.2 specially looks at 20 individual companies which had the largest number of shareholders in our sample. (Names of individual companies have been kept confidential). Table 8.2 shows that, in the case of six companies having over 5 lakh shareholders each, over three-fourths (78-84%) of their shareholders held physical shares. Each of the 20 companies covered by Table 8.2 had over 1,50,000 shareholders. The percentage of shareholders having physical certificates varied among the companies but in as many as 16 out of 20 companies, more than 50% of shareholders held physical shares. The data on which Tables 8.1 and 8.2 are based relates mostly to August-September 2003. The number of depository accounts have been gradually increasing but it has not so far altered the over-all picture presented by us. It is known that the total number of demat accounts is still much below 50% of India's shareowning population.

Table 8.1

PER CENT OF PHYSICAL SHAREHOLDERS IN A SAMPLE OF 130 COMPANIES CLASSIFIED BY MARKET CAPITALISATION

Around Aug – Sep. 2003

	Market capitalization Size Group (Rs. Cr.)	*Total Market Capitalisation (Rs. Cr.)*	*Total No. of Shareholders*	*% physical shareholders to total number of shareholders*
1.	Upto 200	2,239	5,35,129	53.84
2.	201-500	8,257	17,18,444	51.91
3.	501-2000	29,940	22,90,940	62.20
4.	2001-5000	37,543	16,95,769	61.91
5.	5000 & above	1,54,297	33,74,364	51.31
	All-groups	2,32,276	96,14,646	54.02

Table 8.2

PER CENT OF PHYSICAL SHAREHOLDERS IN MAJOR INDIAN COMPANIES

Around Aug – Sep 2003

S. No.	*Total no. of equity shareholders**	*Percent of shareholders holding physical shares*
1	830,760	84.28
2	737,792	78.02
3	682,680	13.97
4	646,689	79.18
5	646,159	65.53
6	558,793	82.69
7	444,406	55.26
8	369,578	80.75
9	325,756	61.74
10	250,438	0.00
11	248,466	53.60
12	230,978	83.70
13	225,000	65.78
14	222,425	67.82
15	218,993	55.15
16	178,325	52.94
17	170,506	3.79
18	168,984	52.77
19	156,171	59.29
20	153,474	47.90

* In descending order of total No. of Shareholders

Note: Names of individual companies have been kept confidential as the data was collected by giving such assurance.

8.16 The number of shareholders having a depository account at the end of December 2004 is only a little over 70 lakh, whereas the total shareowning individuals in India, as per independent estimates provided by the Society for Capital Market Research and Development and by SEBI-NCAER survey, is around 2 crore.[6] Even if we allow for some consolidation of shareholding by various members of the same family for economising demat cost, it is reasonable to infer that a majority of individual shareowners of individual companies have not joined the depository system.

8.17 The Indian market regulatory authorities seem to have played down the fact about majority of retail investors remaining outside the depository system. **No official agency has even tried to compile and provide company-wise official data on the percentage of the number of investors who continue to hold shares in the form of paper certificates and of those who hold in demat form.** The only figures being officially provided relate to the **amount** of equity share capital held in demat form and traded in demat form. The retail investors' problem has thus been swept under the carpet.

8.18 If we look only at the amount of capital, it should be noted in this context that the top 10 shareholders of most of the listed Indian companies hold over 60% of the share capital. At the other end are thousands or even lakhs of small shareholders who account for only about 10-20% of a company's amount of share capital. It may well be that the bulk (80-90%) of the total share capital is held in demat form and yet a majority (50-60%) of retail investors remain outside the depository system. The focus of our analysis is on this huge mass of small investors, most of whom, as we have shown, *have remained outside the share depository system.*

[6] See SEBI-NCAER *Survey of Indian Investors* (published by SEBI, June 2000). See also L.C. Gupta, C.P. Gupta and Naveen Jain, *Households' Investment Preferences : The 3rd all-India Investors' Survey* (SCMRD, 2001), specially pp. 110-21.

8.19 Our surveys have shown that:

(a) a little less than one-fourth of the total number of shareowners in our sample had **all** their shareholdings in demat form only;

(b) about one-third had paper certificates only without having any demat account; and

(c) two-fifths had paper certificates for some scrips and demat account for the other scrips.

8.20 The third category mentioned above is the result of a strategy of some shareowners to demat those shares in which they would like to trade frequently, but not demat the other shareholdings. This explains why nearly three-fourths of retail shareowners in India continue to hold paper certificates for some shareholdings.

Demat in the context of investors' strategies

8.21 We had enquired from our sample of households why they had not converted some or all shareholdings into demat form. We discovered that the individual investor's attitude to demat form was closely related to their investment strategy in terms of whether the investor bought shares for long-term investment extending over some years or for short-term speculation.[7] A significant fact revealed by our analysis is that, contrary to popular belief, **a majority of household investors are long-term oriented. The proportion of such investors tends to rise**

[7] In real life, the dividing line is not clear. Some respondents explicitly mentioned that they followed a mixed strategy (i.e. *indulging in both short-term speculation and long-term investment),* taking into account the market conditions.

with income and age (see Tables 6.6 and 6.7 in the preceding chapter).

8.22 Buying shares for long-term holding implies that the buyer is basically guided by economic and corporate fundamentals. Hence, the predominance of long-term oriented investors enhances market efficiency, as also the flow of savings into corporate enterprises. Such investors need to be encouraged.

Retail investors' specific complaints

8.23 We asked respondents to our survey why they have not converted all or some of their shareholdings into demat form. Tables 8.3 and 8.4 presents an analysis of the replies by income-class and age-class. The following points are noteworthy:

(a) As our analysis shows, the single most important complaint of household investors about demat system is that **demat charges are too high**. One out of every five respondents mentioned this complaint. Households in all income and age-classes have this complaint. Notably, the proportion of complainants is distinctly higher, being 24-25%, among the elderly shareowners aged above 65 years compared to 16-17% among the young shareholders aged 30 years or below.

(b) A related point made by a little over 10% of respondents was that they are long-term shareholders and **don't need the demat system.** The demat system penalizes the small long-term shareholder. The demat is a requirement when a person wants to sell and not during holding period. For holding shares, one needs only safe custody which should be cheaply provided. Notably, the percentage of respondents making this point is distinctly higher among those above 40 years than among the younger investors. This may be observed from Table 8.4.

(c) The complaint that companies concerned have not joined the depository system has been voiced by about one-sixth of total respondents but this proportion is distinctly higher among those above 40 years than among the younger groups. While the number of listed companies is reported to be over 9000, the number of companies which have joined the demat system is 5216 according to the *SEBI Annual Report 2003-04.* However, the report says nothing about how the regulatory authorities propose to protect the shareholders of over 4000 listed companies which have not joined the depository system.[8]

(d) A significant percentage of respondents stated that they are unable to understand the demat system or that they find the procedure too complicated (see Tables 8.3 and 8.4). Their problems deserve sympathetic consideration by simplifying the procedures.

(e) The complaint of some respondents is that depository service was not available in the town. As per *SEBI Annual Report 2003-04,* NSDL covers, through its Depository Participants (DPs), 242 locations (i.e. cities/towns) and CDSL 108 locations. Many of the locations would be common between NSDL and CDSL. Together they may be covering only around 250 locations in the whole country. One-third of locations are reported to have only one DP who

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[8] As per *SEBI Annual Report 2001-02,* India had 9644 listed companies. Its subsequent annual reports do not provide any information on the number of listed companies.

is free to fix its own charges. The depository system does not cover all class-1 towns, i.e. places having more than one lakh population. In the light of this fact, it is unreasonable to make the demat system compulsory for all shareholders wherever located. The compulsory requirement is preventing the spread of shareownership to smaller towns and thus restraining the growth of shareowning population.

8.24 The annual custody and account maintenance charges penalise the small long-term holders of shares.[9] They have the effect of squeezing them out from the equity market. This is already happening to some extent.

8.25 The small investors are faced with a serious dilemma. On the one hand, if they demat the holding, they find that long-term holding of shares in demat form is often uneconomical due to annual account maintenance and custody charges. Both these charges have to be paid annually even when the return from holdings is negative or negligible. On the other hand, if they continue to hold paper certificates, they will have difficulty in selling their holding as and when they want because trading arrangements for paper certificates have been dismantled in haste without creating an alternative reasonably economical trading system. Hence, **long-term small investors are gradually quitting the equity market by becoming mostly sellers when market conditions become bullish, as in 2003 and 2004.**

Concluding comments

8.26 The over-all effect of the demat system has not been to attract a greater number of domestic retail investors into shareowners but

[9] The demat system has a 'penalising' effect on small investors ever since the basis of charge was changed from *ad velorem* system into flat rate system.

the opposite. **The demat system has been very attractive to the speculators and frequent traders.** For this and other reasons, the speculative trading volumes have grown enormously but the percentage of annual households' financial saving flowing into direct shareholding and mutual fund schemes has fallen to a negligible level.

8.27 What has fundamentally gone wrong with the depository system is that it is designed to cater mainly to frequent traders, speculators and large investors rather than to provide **an economical paperless system for long-term holding of securities by the huge number of small investors.**[10] The needs of large investors are well taken care of by the present flat fee system of depository charges. If the recommendation of the SEBI Group (2004) to charge small investors on *ad valorem* basis is implemented, it will largely alleviate the problem being faced by small investors.

8.28 According to our analysis, the demat system, because of the design of its charges, has led to compression of the size of shareowning population in India instead of expanding it. We need a demat system with which the retail investors can feel secure, comfortable and happy. This is not so with the present system.

[10] It is interesting to note that the Depository Trust & Clearing Corporation (DTCC) of the U.S. provides for the safe-keeping of securities for customers. See *News and Information for DTC customers*, October 2002, page 11, attached to its *Annual Report, 2001*.

Table 8.3

REASONS GIVEN BY HOUSEHOLD SHAREOWNERS FOR NOT CONVERTING THEIR SHAREHOLDINGS INTO DEMAT FORM
Household Investors Survey - 2004

Income-classwise Analysis

	Reasons	***All classes of sample households***	*Household income class (Rs. per month)* Upto 10,000	10,001–15,000	15,001–20,000	20,001-25,000	Over 25,000
			Percent of Shareowning households column-wise				
(a)	High demat charges	**19.89**	21.33	21.34	19.18	20.36	16.94
(b)	No depository service available in my city/town	**3.62**	3.82	4.88	3.47	2.77	2.64
(c)	Complicated procedure for joining depository	**6.39**	5.86	5.33	7.04	7.33	7.00
(d)	Companies concerned have not joined the depository	**16.87**	14.44	15.82	15.06	22.48	19.17
(e)	I don't fully understand demat system	**9.63**	9.69	9.86	9.86	7.65	10.34
(f)	I am long-term shareholder and don't need demat	**11.07**	8.92	10.58	13.65	11.73	11.36
(g)	Any other reasons or problems	**13.15**	12.32	11.30	14.63	16.45	12.78
	Total Sample of shareowning Households	**4,806**	1,177	1,106	923	614	986

Note: Some respondents have ticked more than one reason.

Table 8.4

REASONS GIVEN BY HOUSEHOLD SHAREOWNERS FOR NOT CONVERTING THEIR SHAREHOLDINGS INTO DEMAT FORM

Household Investors Survey - 2004

Age-classwise Analysis

	Reasons	*All classes of sample households*	*Age of household head(in years)* Upto 25	26-30	31-40	41-50	51-60	61-65	66-70	71 and above
			Percent of Shareowning households column-wise							
(a)	High demat charges	**19.89**	17.19	16.25	18.32	20.59	22.34	23.01	24.59	24.69
(b)	No depository service available in my city/town	**3.62**	4.91	4.51	4.65	2.80	2.31	3.35	4.92	1.23
(c)	Complicated procedure for joining depository	**6.39**	6.67	4.87	5.71	5.67	7.83	9.62	11.48	9.88
(d)	Companies concerned have not joined the depository	**16.87**	7.72	8.48	13.96	20.37	20.92	24.69	22.13	23.46
(e)	I don't fully understand demat system	**9.63**	9.12	9.93	9.31	8.97	11.94	7.95	9.84	9.88
(f)	I am long-term shareholder and don't need demat	**11.07**	4.56	9.03	9.83	13.13	12.32	10.88	13.11	14.81
(g)	Any other reasons or problems	**13.15**	6.32	7.04	10.96	14.85	14.76	25.10	22.95	20.99
	Total Sample of Shareowning Households	**4,806***	285	554	1,332	1,394	779	239	122	81

***** Out of total sample respondents, a few did not provide information on their age. They have therefore, not been included in the individual age-classes but are included in the total sample.

Note: Some respondents ticked more than one reason.

Chapter 9
INVESTOR EDUCATION

The need

9.1 The Indian stock market has witnessed impressive technological progress in the last decade regarding the trading system. However, unless the retail investors are educated enough to understand the basics of the stock market's behaviour and stock selection criteria, most of them would be unable to benefit from the market's technical progress. There are many cases of stock market investors losing the bulk of the money invested due to their own lack of understanding, as well as their greed and gullibility. Financial markets abound with people who are looking for easy preys, i.e. ignorant investors.

9.2 The Ministry of Company Affairs has recognised this problem. It administers a special fund, known as Investor Education and Protection Fund (IEPF). It is a laudable idea but it is just a beginning. There is need for vastly greater efforts in the direction of promoting investor education and for giving more thought to both the content and the delivery mechanism for investor education on countrywide basis**.**

Implications of socio-economic changes

9.3 The fast socio-economic changes in India, as in other countries, are increasingly forcing people to provide for their own retirement during their working life.[40] While some of this

[40] See article on 'Global Aging", based on P. Engardio, and C. Matlack Report, *The Economic Times*, 30 January 2005, p.7

provision is to be through public or private pension funds, a good part should preferably be through self-managed investments. How well one manages own investments will determine the retirement income. The investors should be equipped with knowledge to undertake this task. Such knowledge should be imparted in a systematic way. The affluent people can hire portfolio management services but the ordinary people will find these too costly.

9.4 Understandably, the first investments by a young person usually take the form of life insurance and bank fixed deposits. In the case of shares, some learning is necessary for successful investing. Hence, the need for suitable educational programmes for investors.

Delivery mechanism and method

9.5 What should be the delivery mechanism and method for investor education programmes is an important problem in a vast and diverse country like India with many regional languages.

9.6 Most of even the educated English-knowing middle-class people are familiar only with simple forms of investments, like fixed deposits and government savings schemes. Their understanding about the share market and mutual funds is mostly poor. Hence, **investment education programmes are needed for large numbers of retail investors across the country.**

Investor education: U.S. practices

9.7 In the U.S., the Securities and Exchange Commission (SEC) has what it calls the Office of Investor Education and Assistance. It organises **investors' "Town Meetings" in cities throughout the**

country to help the people learn how to save and invest wisely and prepare for retirement and achieve financial security. It also publishes free brochures and other educational materials on numerous investment topics.[41]

9.8 It is also reported that **schools throughout the U.S. have brought fantasy stock-picking into the classroom, with The Stock Market Game, sponsored and distributed by The Securities Industry Foundation for Economic Education.**[42] Lakhs of students play the game every year. The game is played over 10 weeks from start to finish. The students are divided into teams which compete among themselves for selecting the best performing stocks. **School teams compete at the local, provincial and regional levels, just like tennis, volleyball, hockey, etc., tournaments.**

9.9 The investment game is both fun and education. The players learn the basics of investing through the game. Of course, 10 weeks, or even a year, is too short a period for true test of the winning stocks over the long-term in real life.

Importance of starting early

9.10 A large number of **people lose money by investing in shares because they start investing before they have learnt the basics of share investment.** They may be investing at the wrong time, like the peak of a bull market, or their stock selection may not be based on sound criteria. They may lack a historical perspective about the stock market's boom-bust characteristic and inherent volatility. Such perspective will guard the investors against being

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[41] See SEC's website: www.sec.gov

[42] See Peter Lynch, *Learn to Earn* (Fireside, New York 1995), p. 128.

over-optimistic and will help them in evolving a sound long-term investment strategy.

Evolving a systematic training methodology

9.11 There is a definite **need for some formal and systematic training for investors during their working life even if they may not be investing significantly in shares at that time.** Just as they go through training for a vocation or occupation to earn a living, every earner should ordinarily save and invest a part of the earnings to provide for old age, children's education, etc. **Learning to invest should be regarded as a preparation for adult life. Education programmes to facilitate this process should be made easily accessible on a countrywide basis. The internet is a potent tool for making this possible.**

Investment games as training tools

9.12 The training of investors can take many forms, including exciting investment portfolio games. We have used some investment games in the course of earlier household investor surveys to create awareness among investors about how much, or how little, they know. There is scope for devising varied investment games which can be used as pedagogical tool. There could be a formal training "school" catering to investors spread across the country, based on today's e-business model.

9.13 **At younger age, the potential investors can be encouraged to experiment for a while taking small bets with share investment.** The young people have a long future before them. They will learn from mistakes. By the time, they have grown and have substantial money to invest, they would be much better prepared for investing skilfully.

Behaviour of returns from share investment

9.14 Most of the ordinary investors are familiar with simple investments, like bank fixed deposits and government savings schemes. **Share investment is a more complex type of investment. It can be more exciting because it can earn a far higher return than fixed-income types but it has to be learnt. Serious share investment is methodological and not just a lottery.** One should understand the various investment strategies, methods of risk control, the importance of timing and how the share market as a whole and the individual shares behave and what the underlining factors are.

Emphasize the key factors

9.15 Such training should particularly drive home the point that shares which do well in the long run belong to companies which do well in the long run and hence the key to successful investing is to buy shares of successful companies, or potentially successful companies.[43] This is well conveyed by the principle advocated by Warrren Buffett that when you buy any shares, think as if you are buying a part of the business. Investors must also ensure at the same time that they are not paying too much for the same. They must know that a share is a good buy only if the buying price is "good" (i.e. advantageous for the buyer). Buying a good company's share at too high a price is a bad investment. This aspect also needs to be driven home. The factors which determine the risks and returns should be understood.

[43] Peter Lynch, op. cit.

9.16 Depending entirely on tips can be very risky. If one has learnt share investing, one would also be able to evaluate a tip. One should be clear about the type of information on which the investor should focus. The investor should understand the basic elements of both market behaviour and company financial performance.

Investors' suggestions

9.17 The investors themselves are feeling the need for education programmes. Suggestions received by us from respondents in the course of the recent household investors survey indicate the need for improving the investor education programmes being offered. The suggestions make a long list of what they want to learn – from the evaluation of a company's performance and prospects to the evaluation of the market conditions, procedures of buying and selling, how to devise a good investment portfolio suited to one's own circumstances, how to choose mutual funds, how the changes in interest rate affect the value of investments, how to interpret stock indices, etc.

9.18 Our feedback from the sample households indicated that 68 per cent of them have neither watched the T.V. programmes on investor education nor attended any investor education seminar. More effective ways and alternative delivery channels have to be devised. Educating the ordinary investors should be an important mission for the benefit of the mass of ordinary investors.

Topics for education programmes

9.19 We are giving in the Appendix to this chapter an edited and selected version of the respondent's suggestions on topics for investor education programmes. Going through the list of topics can be educative for the organisers of such programmes.

Annexure to Chapter 9

Classified List of Topics for Investor Education Programmes

1. Stock Market

a. Fundamentals of stock market
b. Functioning of the stock market
c. How investment in shares helps the industry and the economy.
d. How a small investor can benefit by investing in the stock market.
e. Difference between Indian stock market and international stock markets.
f. Technical analysis: Is it useful?

2. Investment types and selection of right investment

a. Basic types of investments.
b. Selection of right investment.
c. Comparison of returns among various instruments.
d. Categories of investment.
e. Benefits of investment: Short-term vs. long-term
f. Difference between speculation and investment.

3. Investment Risks and Returns

a. How to analyse risk factors regarding various investment types.
b. Safety of investments in Govt and non-govt. schemes.
c. Return maximization strategies.
d. De-risking through diversification.
e. Highlight the risks involved in equity investments.
f. How to calculate risk.
g. Precautions to be taken while investing in equity market.
h. How to protect against market volatility

4. Company Analysis

a. How to find out real worthiness of a company.
b. Choosing the right stock.
c. How to know whether a company is good or not from investment purposes.
d. How to study a Balance Sheet.
e. Z-category companies.
f. How to evaluate a company's performance.
g. How to recognize fraudulent companies.

5. Book Building Procedures and Mechanisms

a. Information about book-building.
b. Various aspects of book building and dangers to public.

6. Bonds

a. Difference between private and govt. bonds.
b. Interest rate risk
c. Credit rating
d. Evaluating bond investment
e. Role of Trustees

7. Mutual Funds

a. Functioning of mutual funds.
b. Types of schemes
c. Sources of grievance redressal of small investors with regard to mutual fund schemes.
d. Difference between mutual funds and shares.
e. Assured/guaranteed returns.
f. Risks associated with MFs.

8. Grievance Redressal Mechanisms

a. Sources where to file grievances in case of non-payment of bonds/debentures. as per terms of bonds/debentures.
b. Types of Investor Grievances in the case of bonds
c. Protection to Investors under SCRA and SEBI Act.
d. Investor Grievance laws.

9. Demat Procedures

a. NSDL, CDSL and DPs.
b. Depository services.
c. How to open demat account
d. Share Transfer.
e. Benefits of demat.
f. Cost of demat services

10. Hedging and derivatives

a. What are Derivatives
b. What are futures
c. What are options
d. Different types of options
e. Different types of futures
f. Trading of futures and options
g. What is Hedging
h. Mark-to-market margins

11. Delisted Companies

a. Why are companies delisted?
b. Sources from where to get information regarding shares which are no longer traded at certain stock exchanges.
c. Remedies against delisted companies

12. Understanding of Investment related Tools

a. Ratio’s
b. B/S analysis
c. Investment related terms
d. Financial analysis of securities
e. Risk Management Analysis
f. P/E Ratio
g. EPS
h. Dividend Yield
i. Circuit Breakers

13. Net Trading

a. How to trade on net

14. Market's Behaviour

a. How to determine optimum time of buying and selling
b. Market fluctuations
c. Analysis of price movement
d. When to exit and when to enter the stock market
e. Warning signals to investors in case of a volatile market

15. Insider Trading

a. How to be aware of insider trading

16. T+1

a. What is T+1

17. Buyback

a. What is share buyback

18. Portfolio management

a. Principles of diversification
b. How should retail investors go about portfolio management

Chapter 10
WRAP-UP OF STUDY

10.1 The study is based on a massive amount of primary data specially collected for the purpose of creating a deeper understanding of the household investors' problems, needs and changing investment preferences, specially with regard to capital market instruments.

10.2 The major strands of our analysis may now be brought together in order to derive a broad picture about the emerging situation and its implications for policymaking and regulation.

10.3 Special attention has been given to bring out the concerns of investors by using a variety of questions. The three most important and persistent worries of household investors have been identified as (a) too much volatility of stock market prices, (b) too much price manipulation and (c) deficient corporate governance.

10.4 Our analysis suggests that measures adopted often tend to be inadequate, specially because no long-term view is taken or the attempt is simply to prevent an immediate market crisis. Averting a crisis is, of course, important but market crisis is an extreme event. It is rare in well-developed markets but was recurrent in India and made the Indian market notorious.

10.5 From investor protection viewpoint, we need to progress towards a more positive approach than mere crisis prevention. The **aim should be to ensure greater orderliness in the working of the stock market and to assure all investors at all times that they shall get a fair deal and shall be protected against**

malpractices and frauds. Only then they can be expected to invest more of their saving in capital market instruments.

10.6 An example of a serious unfair practice, which borders on fraud and has adversely affected lakhs of retail investors, is the delisting of companies without ensuring the protection of interests of the outside shareholders vis-à-vis the company managements. By first allowing a company to be listed, it was enabled to collect money from many outside investors. Delisting means that the management can almost walk away with that money or fritter it away with no checks. Since the persons responsible for creating a situation leading to delisting are hardly ever punished, there has been no effective deterrent.

10.7 It seems to us that **limiting the regulatory objective to the prevention of market crisis is not enough for ensuring proper investor protection. Such protection has been recognized as a very important objective in itself.** More active and direct pursuit of investor protection objective is necessary. Of course, protection of investors can be only against market malpractices and fraud, not against loss due to for investors' own miscalculation and greed, or the market's ups and downs due to economic reasons.

10.8 The respondents' feed-back to our questions on corporate governance indicates that their trust in corporate managements and auditors is quite weak. This is also indicated by the negligible percentage of the households' annual financial savings going into shares and bonds, as per RBI data.

10.9 Corporate governance of the family-controlled listed companies is a thorny problem. The top management of a company, which has no controlling group, can be dismissed and replaced if a dominant group of outside shareholders (such as institutional shareholders) so demand. In contrast, even the combined might of institutional shareholders cannot dislodge a controlling group, so long as the group holds majority of voting power.

10.10 In this context, we should remember that the institutional shareholders are trustees for millions of small investors who need to be protected. For furthering such protection, the institutions should be enabled to play a countervailing role to check self-serving practices of controlling groups. There is no doubt that **corporate governance standard need to be considerably raised in most of the listed companies. The need is recognised but a practical or workable remedy is yet to be found. Although a code of corporate governance has been prescribed by SEBI, tangible results from the investor's viewpoint have yet to be achieved.**

10.11 According the OECD's *White Paper on Corporate Governance in Asia,* the **non-controlling shareholders need to be protected from exploitation by the controlling shareholders.** The paper identified this problem "as the most serious corporate-governance challenge" in the Asian region, which includes India.

10.12 We suggest the adoption of a formal device in the form of an *Institutional Shareholders Council*. If business houses have associations / federations to represent their interests, the **institutional shareholders, in their capacity as shareholders of companies and as trustees for millions of small shareholders, should also establish a consultative mechanism for jointly evolving the institutional shareholders' policies in cases of companies having governance problems.** Such a Council can be a channel of communication between institutional shareholders, businessmen's federations and governmental authorities on matters affecting institutional shareholders. It will help to crystallise thinking on corporate governance reform in the specific Indian context.

10.13 Examination of the household's investment preferences is a major part of this study. Much of our analysis has been devoted to a comparison between shares vs mutual fund products. Investment in mutual fund products was found to enjoy a relatively low preference compared to direct share investment. The result is a stunted growth of the mutual fund industry in India. A comprehensive review of all aspects of the mutual fund industry, including its management structure, practices and regulation, is needed in order to work out a long-term role and perspective for this industry.

10.14 A significant finding of this study is that, contrary to popular belief, **a majority of household investors in the stock market are long-term oriented investors rather than short-term speculators.** This is clearly indicated by our examination of the investment strategies being followed at the individual investor-level. This is a very healthy feature and should be encouraged by the policymakers and regulators.

10.15 While top-level economic policies (like exemption to long-term capital gains) are intended to promote long-term shareholding, some of the operational systems of the stock market, such as the system of depository charges, have the effect of discouraging small long-term shareholders. The data collected by us revealed that **a majority of shareholders of many leading companies in India have remained outside the depository system** because of high burden of depository charges on small long-term shareholders. The total number of depository accounts at the end of December 2004 was only around 70 lakh. This is less than one-half of the estimated total number of shareholders in India. This shows that the depository system in India has failed to cater to the needs of a majority of small investors. Some attempt is being made to rectify the situation but the results are not yet clear.

10.16 The demat system has undoubtedly helped immensely in solving certain irritating problems, such as shares stolen or lost in transit and delays in registering share transfers. However, making it compulsory in haste without fully taking into account the problems of small long-term shareholders, specially those in mofussit places, has adversely affected the growth of shareowning population.

10.17 **The demat system, despite its technical virtuosity, has not at all helped in stimulating the growth of shareowning population.** On the contrary, it has reduced the size of shareowning population by squeezing out the small long-term shareholders from the equity market. The demat system is extremely attractive to speculators, frequent traders and large investors but very burdensome and uneconomical for small long-term investors, who have been complaining about this.

10.18 For the first time in India, detailed data has been collected from household investors about their share portfolio practices. The study has thrown up are many interesting findings in this regard. It was found that the most typical extent of share portfolio diversification by retail investors was “narrow diversification” in the range of portfolios of 3-10 companies. Nearly 50% of households in almost all income-classes and age-classes had such narrow diversification. The study draws attention to certain important practical advantages of such narrow diversification. This strategy is worth popularizing.

10.19 The study draws attention to the emerging phenomenon of what we call "maturing of retail investors" in India. The bulk of the present generation of Indian retail investors got their exposure to the vicissitudes of the equity market during the last 15 years, specially the 1990s. They have gone through many boom-bust market cycles and also witnessed the many incidents of market frauds and manipulative practices. While some of them became so disgusted that they vowed never to touch the stock market again, most others were less cynical and felt that it was a learning experience. They became wiser, more sophisticated and discerning investors. Interestingly, as brought out by our data, **the bulk of the present shareowning population** in India has been shareowners for 10 years or more.

10.20 There has been a great improvement recently in the general public perception about capital market regulation in India. This is clearly reflected in the responses to our questionnaire. The findings are presented in Table 10.1. The market's regulation was regarded as good or excellent by 57% of the total sample of respondents. About one-third of the respondents rated the regulator as poor or very poor.

10.21 Table 10.1 also shows analysis by income and age classes. The results of income class analysis are in line with the over-all results.

10.22 Analysis by age-classes revealed an interesting difference between the young and the old. It showed that somewhat over 60 % of the younger respondents upto 30 years of age regarded capital market regulator as good or excellent but the percentage was only a little above 50% in the case of older generation of respondents above 60 years of age. This may be because of earlier bad experiences, almost throughout the 1990s and upto 2001 which witnessed the Ketan Parekh - led stock market scam, the crisis in the UTI's US-64 Scheme and the appointment of the Joint Parliamentary Committee (II) to investigate the market irregularities. The market's regulatory system has been considerably streamlined since then. Those entering the stock market in recent years seem to be fairly satisfied.

10.23 At the same time, it is also true that shareowning households in India are no more than 4-5 percent of total households. This percentage has been stagnant for nearly a decade. Strengthening of investor protection can help to stimulate the savings flow to the capital market. Share trading volumes have been booming in India but very negligible proportion of household financial saving is flowing into share investment. There is much to be done to increase this flow in order to facilitate more rapid and broad-based growth of corporate enterprises in India.

Table 10.1

HOUSEHOLD INVESTORS' OVERALL PERCEPTIONS ABOUT REGULATION OF CAPITAL MARKET IN INDIA

Household Investors Survey - 2004

A. Income-classwise Analysis

	Opinion	*All classes of sample households*	Household income class (Rs. per month) Upto 10,000	10,001– 15,000	15,001– 20,000	20,001- 25,000	Over 25,000
			Percent of households column-wise				
1.	Excellent	**3.14**	4.30	3.05	3.17	2.34	2.13
2.	Good	**54.22**	51.83	56.80	55.84	53.99	53.07
3.	Poor	**28.85**	26.99	26.91	28.96	29.89	32.98
4.	Very poor	**5.49**	5.63	5.43	5.34	4.82	5.96
5.	Can't say	**8.30**	11.25	7.81	6.70	8.95	5.87
	Column total	**100.00**	100.00	100.00	100.00	100.00	100.00
No. of respondents		**5,883**	1,582	1,345	1,105	726	1,125

B. Age-classwise Analysis

	Opinion	*All classes of sample households*	Age of household head in years Upto 25	26-30	31-40	41-50	51-60	61-65	66-70	71 and above
			Percent of households column-wise							
1	Excellent	**3.14**	3.60	4.06	3.24	3.02	2.84	1.82	3.73	2.02
2	Good	**54.22**	60.15	57.62	55.50	52.63	52.63	49.45	49.25	48.48
3	Poor	**28.85**	21.08	25.87	28.00	30.45	30.57	33.82	33.58	30.30
4	Very poor	**5.49**	3.86	4.48	4.65	7.31	5.78	4.36	3.73	7.07
5	Can't say	**8.30**	11.31	7.97	8.62	6.59	8.19	10.55	9.70	12.12
	Column total	**100.00**	100.0	100.00	100.00	100.00	100.00	100.00	100.00	100.00
No. of respondents		**5,883***	389	715	1,636	1,655	952	275	134	99

*Out of total sample respondents, a few did not provide information on their age. They have therefore, not been included in the individual age-classes but are included in the total sample.