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Impact of FIIs Investment on Volatility of Indian Stock Market: An Analysis

Mr. Prakash D Karigar

Assistant Professor of Commerce, Government First Grade College for Women
Gadag- 582101, Karnataka

ABSTRACT

Foreign Institutional investors (FIIs) are the entities established outside India that are responsible for making investment proposals in India. Foreign Portfolio Investment (FPI) refers to investment made in an economy through the purchase of financial assets, such as bonds, stocks, etc, in a foreign country. The paper focuses on entities that invest in a country's financial market, such as stocks, bonds, and other securities. FIIs can include hedge funds, pension funds, mutual funds, insurance companies, and sovereign wealth funds. Foreign institutional investment is portfolio investment in the stock market by buying shares and debentures in another country by foreign institutions. In India, a particular FII is allowed to invest upto 10% of the paid up capital of a company, which implies that any investment above 10% will be construed as FDI, though officially such a definition did not exist.

Keywords: Investment, Market, Foreign, Institutional, Sensex, Stock, Exchange and portfolio

INTRODUCTION

To invest is to allocate money in the expectation of some benefit in the future. In finance, the benefit from an investment is called a return. The return may consist of a gain (or loss) realized from the sale of a property or an investment, unrealized capital appreciation (or depreciation), or investment income such as dividends, interest, rental income etc., or a combination of capital gain and income. The return may also include currency gains or losses due to changes in the foreign currency exchange rates. Investors generally expect higher returns from riskier investments. When a low risk investment is made, the return is also generally low. Similarly, high risk comes with high returns.

Investors, particularly novices, are often advised to adopt a particular investment strategy and diversify their portfolio. Diversification has the statistical effect of reducing overall risk. Lately, volatility has come to characterize India's stock markets due to portfolio adjustment made by the Foreign Institutional Investors (FIIs), resulting in destabilizing tendencies in the country's system. This volatility has been visible in the medium and long term as well. From a low of 2924 in April 2003, the BSE Sensitive Index (Sensex) had risen to 6194 in January 2004. Only to fall to 4505 in May 2004 and again rise to 6679 in January 2005. While the Sensex crossed 21000 in January 2008, it even witnessed a low of 8000 in September 2008 before climbing to 17000 levels by the end of 2009. These wild fluctuations have meant that for those who bought into the market at the right time and exited at the appropriate moment, the average return earned through capital gains were higher in 2003 than 2004 and 2008-09, despite the extended bull runs in the latter years.

"The market looks expensive given the current fundamentals. Valuations are expensive as profit estimates are being cut. GDP growth for FYF21 will be -8% or even lower and FY22 growth will just about bring the GDP to FY20 levels. The last 1,000-points rally in the Nifty 50 has been quite surprising as the market went up despite significant supply of stock by promoters and companies issuing new equity. While the foreign investors' purchase number looks healthy, a large part of the purchases has been through block deals, offer for sale and QIB placement of shares. Mutual fund flows are also muted – thus a large part of the market optimism is due to an exponential rise in retail trading volumes in the cash equity segment over the past 4 months."(Agarwal, R. N.)

However, the key driver for the market is the global liquidity flood, central bank balance sheet expansion, near-zero interest rates and fiscal stimulus in the developed world. The way markets and all asset classes have moved up in the past 3 months, it needs a continuation of these for the bullishness to sustain – valuations are expensive as corporate profits are under pressure. Overall, the markets will remain volatile due to an interface of two massive forces i.e. the pandemic-linked slowdown and uncertainty on one side and the massive policy actions to keep markets afloat on the other side. The next few months will be interesting to watch Movements in the Sensex during these years have clearly been driven by the behaviour of FIIs. who were responsible for net equity purchases? At one level, this influence of the F113 is puzzling. The cumulative stock of FII investment does not amount much when seen in terms of the percentage of the total market capitalization on the Bombay Stock Exchange. However, FII transactions are significant at the margin. The cumulative turnover by Flls amounted to a substantial per cent of the total volume of turnover whenever the Sensex sees high volatility. Not surprisingly, there has been a substantial increase in the share of foreign stockholding in leading Indian companies, even exceeding 40 per cent of the total free-floating shares in some of the companies.

Such presence of FIIs has given them a considerable role in determining share price movements. Traditionally, Indian stock markets are known to be narrow and shallow in the sense that there are few companies whose shares are actively traded. Thus, though there are nearly 5,000 companies listed on the stock exchange, the BSE Sensex incorporates just 30 companies, trading in whose shares is seen as indicative of market activity. This shallowness also means that the effects of PH activity is exaggerated by the influence their behaviour has on other retail investors, who, in herd-like fashion tend to follow the FIIs when making their investment decisions.

"These features of Indian stock markets induce a high degree of volatility for four reasons. In as much as an increase in investment by FIIs triggers a sharp price increase, it in the first instance encourages further investments so that there is a tendency for any correction of price increases unwarranted by price earnings ratios to be delayed. And when the correction begins, it would have to be led by an FII pull-out and can take the form of an extremely sharp decline in prices" (Banerjee, A., & Sarkar, S)

Secondly, as and when FIIs are attracted to the market by expectations of a price increase that tend to be automatically realized, the inflow of foreign capital can result in an appreciation of the rupee vis-à-vis the dollar. This increases the return earned in foreign exchange, when rupee assets are sold and the revenue converted into dollars. As a result, the investments turn even more attractive, triggering an investment spiral that would imply a sharper fall when any correction begins. Thirdly, the growing realization by the FIIs of the power they wield in what are shallow markets, encourages speculative investment armed at pushing the market up and choosing an appropriate moment to exit. This implicit manipulation of the market, if resorted to often enough, would obviously imply a substantial increase in volatility. Finally, in volatile markets, domestic speculators too attempt to manipulate markets in periods of unusually high prices.

The last few years have been remarkable because, in spite of high volatility, there have been more months when the market has been on the rise rather than on the decline. This clearly means that FIIs have been bullish on India for much of that time. The problem is that such bullishness is often driven by events outside the country, like the performance of other equity markets or developments in non-equity markets elsewhere in the world, it is to be expected that His would seek out the best returns as well as hedge their investments by maintaining a diversified geographical and market portfolio.

However, when they make their portfolio adjustments, which may imply small shifts in favour of or against a country like India. The effects it has on host markets are substantial. Those effects can then trigger a speculative spiral resulting in destabilising tendencies. For example, expectations of an interest rate rise in the US can slow FII investments and thus trigger the end of a bull run. It has very little to do with the performance of the companies listed on the stock exchange.

Further, financial liberalization has meant that developments in equity markets can have major repercussions elsewhere in the system, including banks. Hence, any slump in those markets can affect the functioning of parts of the banking system. The forced closure (through merger with Punjab National Bank) of the Nedungadi Bank is an example of how a bank can suffer losses because of overexposure in the stock market.

"The most important decision is asset allocation. Equity, Fixed Income, Gold, Alternate Investment Funds (AIF), Real Estate should all form part of the investor's portfolio. Equity Funds, AIF are the higher-risk, higher-return part of the portfolio. Gold, Bonds and Commercial Real Estate are the relatively more stable parts. The proportion of these depends on the financial profile and the psychological profile of the investors – these profiles define the risk appetite" (Surbhi Jain)

"Any systematic investment program assumes that the risk-appetite and asset allocation have been analyzed and that the investment pattern is based on such analysis. The asset allocation decision already takes into account the inherent volatility of that class. Thus one should keep investing as per the pre-decided pattern. Strategic decisions should not be changed due to short-term volatility"(Surbhi Jain)

Similarly, if any set of developments encourage an unusually high outflow of PH capital from the market. it can impact adversely on the value of the rupee and set of speculation in the currency that can, in special circumstances, result in a currency crisis. There are now too many instances of such effects worldwide for it to be dismissed on the ground that India's reserves are adequate to manage the situation.

"There's still scope for selective stock-picking. Even within the large-caps, there are many stocks and segments which have lagged, are cheap and may pick up as the growth uncertainty fades away. Some of the themes which have traction are 1) rural economy doing better than urban. This makes the case for segments like paints, FMCG, motorcycles, cement, rural financing etc. 2) Make-in-India theme getting traction due to the China issue and 3) exporters and outward-facing sectors may do better as the recovery in US and Europe may be more immediate compared to India due to the large fiscal measures by these countries. Thus pharmaceuticals, chemicals, IT software, auto-ancillaries may do well" (Surbhi Jain)

"Segments which will remain under stress for a longer time are hotels, restaurants, malls, airlines, multiplexes, highly discretionary spending. If the market stabilizes at these levels and the growth uncertainty reduces, mid and small-caps may outperform as they have lagged significantly over the past two years. However, it needs a continuation of benign monetary and fiscal measures" (Surbhi Jain)

Thus, the volatility being displayed by India's equity markets warrant returning to a set of questions that have been bypassed in the course of nee-liberal reform in India. The most important of those questions is whether India needs FII investment at all. The capital accrued by FII flows does not help finance new investment either, as it is focused on secondary market trading of pre-existing equity. Also, shoring up the Sensex, which is inevitably volatile, merely helps create and destroy paper wealth and generate, in the process, inexplicable bouts of euphoria and anguish in the financial press.

In the circumstances, the best option for the policymakers is to find ways of reducing substantially net flows of FII investments into India's markets. This would help focus attention on the creation of real wealth as well as remove barriers to the creation of such wealth, such as the constant pressure to provide tax concessions that erode the tax base and the persisting obsession with curtailing fiscal deficits, both of which are driven by dependence on finance capital. Measures are needed to prevent the market from being excessively vulnerable to global weaknesses

"The cautiousness stems from the fact that while the stock market has seen a V-shaped recovery, the underlying economy is reacting slower. Sporadic and unpredictable lockdowns in different parts of India and rest of the world are elongating the recovery cycle. Vaccines will take at least a few quarters to be approved and commercialized. Manufacturing vaccines in large quantities will also take time but the good news is that death rates are going down mostly everywhere. Events on the border may create volatility from time to time" (Batra, A.)

Many segments of the economy will be facing reduced demand for quite some time even after normalcy returns. We don't know the secondary and tertiary impact of the lockdown-induced slowdown on small businesses, employment and consumption patterns and change in consumer psychology. Moreover, India has had limited fiscal measures to stimulate growth. While many developed countries have introduced fiscal stimulus of 5-15% of GDP, India has implemented about 1% so far. Even before the pandemic, India had growth issues, so a V-shaped recovery for India is unlikely and getting to a 7+ growth rate on a normalized base will take a couple of years.

CONCLUSION

It should also be noted that global sentiment has turned positive because of massive policy actions by the US Fed, the European Central Bank and Bank of Japan. These have unleashed unprecedented amounts of liquidity into the global financial markets which has lifted all asset prices. The markets need such strong support to continue. Any perception that the central banks are reducing the liquidity spigot can have sharp negative reactions in the market. Indian green bonds not only support sustainability goals but also strengthen the Indian currency by attracting investors and increasing funds within the central bank. The growing demand for socially responsible investments and the limited supply of green bonds can raise their price and yield

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