



Foreign Institutional Investments and Stock Markets -An Indian Perspective

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Abstract:

With globalization, foreign investment market has taken the economies into its grip bringing the diversified global market together which made all the developing countries allow Foreign Direct Investment and Foreign Institutional Investments into their national markets. India opened its economy to foreign investors inviting portfolio investment in equities. With liberalization in 1991, India opened its economy to deal with a staggered GDP growth and fall in markets, leading to flexible FDI and FII norms to pave a way and instill confidence in investors. Unregistered FIIs used P-Notes i.e participatory notes also known as offshore derivative instruments to take advantage of tax laws and hedge funds without disclosing their identity and therefore allowed them to register directly and simplified the norms by increasing the ceiling of overall FII investment by 24% of paid-up capital.

FII flows benefit the recipient countries and at the same time, the investors can pull back their portfolio investments at the slight sign of trouble leading to disastrous consequences of the economy. A first sign of economic weakness may lead to large, concentrated withdrawals resulting in economic problems. FII's are usually held for causing contagion i.e., spreading financial crisis in international financial markets.

Therefore, different perspectives evaluating the impact of Foreign Institutional Investments on Stock markets is evaluated and various factors affecting the markets, risk-return and economy are identified and presented.

Key Words: FII, Hot Money, Portfolio, Risk-Return, Volatility

Introduction:

Foreign Institutional Investor (FII) is a term used for an investor, institution or an entity that invests in financial markets of another country different from their origin. The institution can be invited to invest in equities and other securities which include shares, debentures, and warrants etc., listed or to be listed in the exchange or over the counter exchanges traded in both primary and secondary markets. In other words, FIIs are a company registered outside India investing in Indian financial markets.

The FIIs registered with SEBI include FIIs based out of Mauritius and other countries like UAE, Singapore, Japan, Canada, Australia, and Taiwan. Even after Satyam scandal, India is seen as an attractively valued market as evident with FII holdings hitting USD 88 Billion in December 2008 thereby gaining a significant role.

Review of Literature:

With the growing significance for Foreign Institution Investments in India, making it most favoured destination for investment, this area is of study has been of immense focus.

Eun & Rensick (2002) deregulation of financial markets and introduction of new financial avenues like internationally cross listed stocks, country funds and international mutual funds lead to rapid growth in international portfolio investments as investors could diversify their investment internationally with no additional cost.

Trivedi, Pushpa & Nair (2003) duo considered the risk variables. Ex-Ante and unexpected risk are the two factors of realized risk where the relationship is established as negative in case of Ex-Ante return and obscure for unanticipated return.

Kulwant Rai & N R Bhanumurthy (2006) article, determinants of FII in India and the role of risk, return and inflation presents that the understanding the behavior of capital flows is important after liberalization. The study used monthly data from January 1994 to November 2002, wholesale price index of India and producer price index of US is used to compute inflation.

Prasanna, P. K. (2008) analyzed Foreign Institutional Investors and Investment Preferences in India and has presented the significant role of FII in capital markets where the capital availability is dictated by many firm specific factors. Therefore, this paper studied the relationship between FII, and firm specific characteristics chosen like capital structure and performances of company and stock thereby.

Bansal and Pasricha(2009) studied the behavior of stock market to that of the after impact of opening market to FIIs. The change of market return and volatility after the entry of FIIs to Indian capital market is analyzed empirically and no significant change in the Indian stock market average returns is identified leading to a significant reduction in the volatility after India unlocked its stock market to foreign investors.

Dr. Syed Tabassum Sultana, Prof. S Pardhasaradhi(2012) attempted to examine the connection and impact of FDI & FII on Indian stock market. The usage of statistical measures correlation coefficient and multi-regression for the considered eleven years statistics starting from 2001 to 2011.

Anubha Shrivastav (2013) examined similarly and attempted to examine the impact on consumer durable and consumer goods sector.

Objective:

The Objective of this paper is therefore to evaluate different perspectives highlighting the impact of Foreign Institutional Investments on Stock markets and evaluate and various factors affecting the markets, risk-return and economy.

Methodology:

The paper therefore considers **secondary sources** of data collected from journals, magazines, newspapers, websites.

Discussion:

Risk and Inflation: Kulwant Rai & N R Bhanumurthy(2006) studied ex-ante risk and its impact on FII behavior where econometric estimates like GARCH procedure, showed a positive association of FII with return on BSE, inflation in US, being a leading economy and showed a negative association with inflation in India, return on S&P 500, ex-ante risk on BSE and ex-ante risk on S&P 500.

Also, the FII inflows to India remained unaffected by ex-post risk in either economy. The study found any causation between FII inflows and BSE returns and found the impact of news to be more in terms of reaction to bad ones than good news.

Return: Agarwal(1997) and Chakrabarti(2001) et al. established a significant and positive impact of equity return on FII. But given the huge volume of investments, foreign investors would be the market makers who book their profits by buying when the prices decline thereby jacking-up the prices of assets and sell when prices increase leading to bi-directional relationship between FII and the equity returns. The 1998-99 International info-tech bubble burst and Asian crisis led to 61 million dollar worth decline in FII which should have affected equity returns but didn't happen as such marking the shift in the determinants of FIIs. The study postulates that the relationship is quiet opposite when pre and post Asian crisis are compared transforming the positive relationship to reverse relationship.

Financial Variables: Prasanna, P. K. (2008) explains that with liberalization, foreign capital has become significant source of capital and in developing countries like India, it helped in increasing labor productivity and build up foreign reserves. It is observed investors tend to invest more in companies with high general public holdings and identified the relationship between promoters' holdings and foreign investment as inversely related and FIIs choose companies where promoters holdings is not substantial. In terms of firm specific factors, that high Sensex indices and high P/E ratio are two attracting factors for foreign investment. Also share returns and EPS being the significant financial variables influencing investment decisions.

Firm characteristics: Dahlquist (2003) explained that Liquidity drives the firm size making foreign investors inclined towards the large firm with high cash holdings paying low dividends. Foreign listing and export sales are considered for measuring the international presence.

Leuz, Nanda and Wysocki (2003) and Haw, Hu, Hwang and Wu, (2004) explained that the firm specific characteristics may also lead to asymmetric information problem.

Covirg et al. (2007) concluded that domestic fund managers will have more information on domestic stocks than the foreign fund managers.

Ownership and Control: Yin-Hua and Woitke (2005) found that it would be difficult to determine the degree of separation of ownership and management making the investors protection relatively weak when the board members are dominated by a chunk of controlling family group. Also, a negative relationship is found between firm's value to board affiliation in such companies. The same is presented by Choe, Kho, Stulz (2005) from the perspective of US investors. Family managed companies are conducive to expropriation exercising control on insiders there by making availability and access of information limited leading to adverse selection problem and underinvestment. Choe, Kho, Stulz (2005) is in consensus with the above from the perspective of US investors.

Aggarwal, Klapper and Wysocki (2005) found the preference of foreign investors for best governed firms. Li (2005) observed that FDI is preferred more than FII in case of poor governance as they believe FDI could be a safe means.

Cho & Padmanabhan, (2001) established in their literature that firm's performance is influenced by block shareholders and their objective will be quite different if government becomes a block shareholder to that of the one for private investors. Listed companies' governance is an important determinant in FII decisions in general and family businesses in particular.

Douma, Pallathiatta and Kabir (2006) established a positive effect of firm performance and foreign ownership.

Volatile Stock Markets: C. P. Chandrasekhran(2004) mentioned that the volatility has been quiet evident in the medium and long terms. During a Bull Phase, Investing and withdrawing at right time led to high capital gains. FIIs behavior drive the moment of Sensex through substantial investment in equity and thereby increasing the foreign holdings in remarkably performing top companies in India.

Mutual Funds: SSS Kumar(2002) examined the role of these investors and finds and thereby explaining the market movement using the direction of the flow of funds from these investors. The Institutional Investors portfolio usually comprise of stock from nifty or Sensex indices making their co-movement likely. Advance and decline ratio (ADR) is employed and the combined purchases of MF to FII and combined sales of MF to FII are used to capture the institutional activity. The FIIs and mutual funds are a potent force as given by regression results and can forecast market direction using their direction of the flow of funds. Also concluded that the mutual funds lead the market to rise or fall and FIIs follow the same as per Granger causality test.

Fundamentals predominantly drive Institutional investors and their growing presence make markets more efficient reducing noise trading as all their trades are usually delivery based. K.S. Chalapati Rao, K.V.K. Ranganathan and M.R. Murthy also presents that, to widen the investors base in Indian stock markets, foreign private capital flows have been facilitated in the form of portfolio investments. This led to improved trading systems but also pressure on host countries to secure capital gains as well. This paper examines the importance of FPIs to other forms of investments especially MF and analyses the past four-year trends in Indian stock market.

FDI and FII: Dr. Syed Tabassum Sultana, Prof. S Pardhasaradhi (2012) made an attempt to study the impact of FDI & FII on stock market along with their relationship over the past 10 using correlation and multiple regression was presented in this article and was concluded the flow of FDI & FII was moving in tandem with Sensex and Nifty and determines the trend of Indian stock market which is in consensus with Kumar (2002) and Rai and Bhanumurthy (2006).

Kumar investigated the same using monthly data from January 1993 to December 1997 and inferred that fundamentals drive FII investments and short-term changes or technical position of the market do not matter much but the same is contradicted by Morgan and Stanley report which endorses that FII's strongly influences short-term market movement especially during bear market and that the correlation between returns and flows weakens during bull markets and strengthens during bear market as other market participants actively involve to reduce the influence of FIIs.

Kumar concluded that there is causality from FII to Sensex which is contradicted by Rai and Bhanumurthy who did not find any causation using similar data during the period 1994 and 2002 between FII to return in BSE .

Economic growth: Chopra [2002] undertook to study policy reforms impacts on FDI in India for the period 1980-2000 considering policy related variables like debt-service ratio, foreign exchange rate, the degree of openness of the economy and the GDP as the explaining variables of FDI inflows in India. Chopra concluding that GDP is an important factor which drives FDI in the country.

Stanley Morgan [2002] has examined that FIIs contribution is significant in building up India's FOREX Reserves has enabled a host of economic reforms and play an important role in economic growth even in sluggish domestic sentiments.

Conclusion:

Opening of many financial sectors for foreign investment as a part of economic reforms initiated in July 1991 led to a significant impact on Indian stock markets along with improved liquidity as concluded in a study conducted by world bank in 1997.

The relationship of FII to Financial and stock performance and ownership structure of companies in Sensex of BSE to that of the foreign investment and promoter holdings are inversely related. This indicates that the

foreign investors do not show interest to invest in companies were family shareholders who act as promoters with substantial holdings.

Investors allocate a proportionate amount of funds to domestic securities, reflecting home bias despite gaining sizable potential benefits by diversifying internationally. Such bias leads to excessive information, additional transaction costs, legal barriers, discriminatory taxes for foreigners leading to imperfection in international financial markets.

Road Ahead:

FII flows depend on stock market returns, inflation rate and ex-ante risk. the determination of FIIs investment considering real economic and financial factors in a comprehensive manner must be strengthened. Minimizing the ex-ante risk and stabilizing the stock market volatility attract more FII inflow leaving positive impact on the economy. It insists on the need for stabilizing domestic stock market movements and reduce the adverse impact of non-fundamental factors on behavior of FII. SEBI should contain the incidences of secondary market manipulations to benefit the economy in long run since the flow of FIIs determine the trend of Indian stock market and try to maintain steady portfolio flows into developing countries and focus on increasing the pace of reforms in emerging stock markets.

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