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INTRODUCTION TO STOCK MARKETS AND FACTORS INFLUENCING RISK AND RETURNS OF AN INVESTMENT

Parviz Hajizadeh — *Faculty member of Payamenoor University, Iran*

Azra Hajizadeh — *Research Scholar, Department of Commerce, University of Mysore, Mysore, Karnataka, India*

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ABSTRACT

Investment in stock markets is lucrative as well as risky. Investors investing money into unstable, unpredictable, and uncontrollable dimensions can be exceedingly risky. There are many who have lost huge amounts of money employing poor investment decisions and showing haste in getting huge profits on their investment. The main aim of this paper is to first understand the stock market in general. The paper also desires to investigate possible investment opportunities that prove beneficial to the investors, help them weigh their respective risks and returns relating to the investment, and end up making educated investment decisions. The idea is that a detailed investigation of the opportunities and risks for high returns in each investment will immensely help in the future selection and implementation of smart investments. This shall aid in developing strategies for intelligent investments and how to play safe in most unstable markets. This is hoped to facilitate methods of identification and possible anticipation of present and future market trends which will acutely influence future investment decisions and help avoid the risk factors for the investor.

INTRODUCTION

A stock market is the secondary market where stocks are bought and sold by the prospective buyers. It is also known as an equity market or share market. Ownership interests of stocks in companies of the prospective buyers are represented by these stock markets. The main aim of the stock market is to facilitate the buyers' transactions.

The stocks are traded in the market as large companies list them on a stock exchange because it makes their shares more liquid which means it becomes easy to buy and sell. More liquidity through selling of shares attracts international investors and it in turn boosts the growth of the economy. The London Stock Exchange is an example of a share market. In India, the shares are traded both on National Stock Exchange (NSE) and the Bombay Stock Exchange (BSE).

It is noteworthy that the stock market rather than in physical form, exists in electronic form. The stocks of companies may include publicly or privately traded securities. The investors who desire to buy stocks can electronically access the market from their device (provided it is connected to the internet) and go ahead with their transactions, whether selling or buying of shares. The stock market can be accessed via a registered stock broker who acts as an intermediary between the investor and the stock market.

With the introduction of globalization and liberalization in the economy, the dependence of people on various stock markets has increased. When stocks are traded in the market, the buyers get returns on their investment. The returns could be in the form of Dividend paid by the company or the amount got by selling the stocks at the price prevalent in the secondary market.

Investing in well run companies that yield profitable returns in the long term must be invested in after a series of analysis of the company's history and operations. The returns that are generated over a long term period are called long term capital gains and the returns generated over a short term period are called short term capital gains. The long term period means investments held for more than a period of 365 days and short term period means investments held for less than a period of 365 days.

Thousands of transactions happen on a daily basis in the stock markets where the investors are buying and selling the stocks. To check the security and safety of every transaction and proper compliance of the rules, the stock markets need a regulatory authority which can ensure that the investors, companies, brokers, etc adhere to the regulations framed and comply with the rules.

REGULATORY AUTHORITY

To regulate the investment and finance markets in India, the Securities and Exchange Board of India (SEBI) is the designated regulatory body for stock markets. SEBI was established by the Government of India. The SEBI was established in 1988 and on April 12, 1992, it was provided with regulatory powers only, through the Securities and Exchange Board of India Act, 1992.

Headquarters of SEBI is located at the Bandra Kurla Complex Business District in Mumbai. It has its regional offices in the northern, southern, eastern, and western regions of the country. The SEBI attempts at maintaining a secure and an efficient environment for the smooth conduct of trading activities in the market. SEBI formulates and enforces regulations in the financial marketplace on the investors to make them comply with the market regulations.

The main purpose of SEBI is to promote the advancement of stock exchanges, retail investors' interests, and to regulate and control the activities that the financial intermediaries and market participants are involved in. Commonly, SEBI ensures

1. Stock brokers and sub brokers conduct business in a fair and just manner.
2. The stock exchanges (BSE and NSE) conduct business in a fair and just manner.
3. Participants do not get involved in unfair practices and non-compliance of rules and regulations.
4. Interest of retail investors are protected at all times.
5. Corporates do not misuse the markets and take undue advantage of the circumstances, as the case in Satyam Computers.
6. Overall and large scale development of the market.
7. Large investors with huge cash pile should not manipulate the markets.

SEBI cannot have regulation over all the factors above. Hence, entities are formed and SEBI has prescribed a separate set of rules and regulation to all the entities. The entity should operate within the legal framework of SEBI's prescription. The specific rules prescribed to different entities are made available on the website of SEBI published under the 'Legal Framework' section of SEBI's site.

TRADING MECHANISM

Trading at the exchanges takes place through an electronic limit order book. Earlier to 1996, the shares were bought and sold in the physical format. After the Depository Act of 1996 was introduced, the shares were dematerialized from its physical form and the shares since then have been traded in dematerialized form. Here the order matching process is performed by the trading computer. The entire order matching process is purely driven by the orders placed. It means that the orders placed in the market are matched automatically with the best limit orders. Hence, the obscurity of both the buyers and sellers is retained. The advantage of this process is that it ensures transparency, as all that is bought and sold in the market is recorded and displayed in the database. The only factor is that there is no surety that the orders will be executed.

It is mandatory that all orders in the trading system should be placed through brokers. Online trading facility is provided to both industries and retail customers by the brokers. This process is also called as Direct Market Access (DMA). Here, the trading terminals are facilitated by the brokers for the purpose of directly placing orders into the trading system of stock markets. Institutional investors can also take advantages of the Direct Market Access (DMA) option.

SETTLEMENT CYCLE AND TRADING HOURS

Settlement cycle means the time by which a transaction gets settles in the stock market. There are two types of market – Spot market and Forward market. Spot market is where the securities are delivered on the spot, whereas in forward market, the securities are delivered at a future determined date as per the customer's demand. As far as the Equity spot markets are concerned, they follow a (T+2) rolling settlement. In Indian stock exchanges, trading takes place between 9:55 am and 3:30 pm on a daily basis, Indian Standard Time (+ 5.5 hours GMT). The trade takes place from Monday to Friday. The markets are closed on Saturday and Sunday. According to the (T+2) rolling settlement, a trade taking place on Monday gets settled by Wednesday. The Delivery of shares must be made in dematerialized form. Each exchange has its own clearing house and by serving as a central counterparty, it assumes all settlement risks to be prevalent.

STOCK MARKET PARTICIPANTS AND THEIR REGULATION

The stock market attracts corporations and individuals from different backgrounds. Anyone who carries out transaction in the stock market is known as a market participant. The market participant can be segregated into several categories. Some of the categories of market participants are as follows:

1. **Domestic Institutions** – These include large corporate entities that are based in India. For example, the LIC of India.
2. **Domestic Retail Participants** – These are people like you and me transacting in markets.
3. **NRIs and OCI** – People here are of Indian origin but are based outside India.
4. **Foreign Institutional Investors** – They are basically non Indian corporate entities. These could be hedge funds, foreign asset management companies, and other investors.
5. **Domestic Asset Management Companies (AMC)** – In this category, the participants would be companies dealing with mutual funds like the DSP Black Rock, SBI Mutual Fund, HDFC AMC and Fidelity Investments.

The main aim of these stock market participants and the stock investors is to make profitable transactions. When money is involved, the stock investors may fall prey to unfair practices, those of which are being practiced in the market. In India, Harshad Mehta was involved in unfair practices and conducted dubious transactions.

In accordance to this, there is a requirement that the stock markets need to be regulated and compliance with the rules must be ensured. It must also be ensured that people adhere to these compliance and regulations making the markets a safe place for every investor.

THE STOCK BROKER

The stock broker is one of the most important financial intermediaries in the financial markets. A stock broker is a corporate entity who is registered as a trading member with the stock exchange and obtains a stock broking license from the regulating body. The brokers operate under the guidelines prescribed by SEBI.

A stock broker is the gateway to all transactions in stock exchanges. To start with a 'Trading Account' must be opened with a broker who meets the investor's requirement. It is imperative that a broker can be identified who is capable of providing the investors a single platform to transact across multiple exchanges across the world at the same time.

A trading account helps in carrying out financial transactions in the markets. A trading account is an account registered with the broker which makes the investors eligible to buy/sell securities in the securities market. Therefore, an interaction with the broker is mandatory if the investors wish to buy or sell securities.

The brokers provide various services to the investors. The basic services include-

1. Giving the investors an access to the markets and allow them to transact.
2. Giving trading margins
3. Facilitating the transfer of funds between the investor's trading and bank account
4. A contract note is a written confirmation detailing the transactions that have been carried out during the day. The brokers issue contract notes with respect to the investor's transactions.
5. Provide support with respect to trading. Also they provide software supports if issues related to trading terminal are faced.
6. Providing investors with a back office login for the purpose of seeing the summary of the investor's account
7. The broker charges a 'brokerage charge' or brokerage for the services he has provided. The brokerage rates vary from one another depending upon the services provided.

ISSUE OF SHARES

Share capital is one of the main sources of fund or finance for further operations for a company. Shares are issued in the stock market only when the shares are listed on the respective stock exchanges. When a private company decides to approach public and issue shares, it is required to choose an exchange where it desires to be listed. To get a company listed on a stock exchange, it is mandatory that the company meets the listing requirements of the exchange. The company is also mandated to pay both entry and yearly listing fees. Listing requirements vary from one exchange to the other. The exchanges in order to list a company include details of a minimum share price, minimum stockholder's equity, and a minimum number of shareholders. The purpose of having strict listing requirements is to assure that only securities of high quality are traded on the exchanges and the exchange's reputation should be upheld among investors. However, a company decides the number of shares it wants to raise as capital.

To issue shares, the company must decide on the face value at which each share shall be offered. The face value of a share is nothing but, the par value of the share. Face value is also known as the Nominal denomination or value of a share. To issue shares, a company must comply with the rules and procedure formulated and regulated by the Companies Act (1956 or 2013) and Securities Exchange Board of India (SEBI).

There are different ways in which the shares are issued. They are:

- For consideration other than cash
- For cash.

ISSUE OF SHARES FOR CONSIDERATION OTHER THAN CASH

Sometimes shares are issued to the promoters of the company (Individuals, corporate entities, firms) in lieu of the services provided by them towards the company's operations. They are not required to pay the amount for the shares offered to them and this is called shares issued for a consideration other than cash.

ISSUE OF SHARES FOR CASH

In general, shares are issued for cash which means a value must be paid for the shares purchased by the investors. It is the company's wish to call for the share money either in one installment or in two or more installments. But, it is imperative to note that the payment by investors is always collected through its bankers.

INITIAL PUBLIC OFFERING (IPO)

A stock market launch or an initial public offering (IPO) is a type of public offering made for the first time on a securities exchange where the shares of stock in a firm are sold to the general public. This is used by firms by possibly monetizing investments of private investors, to raise expansion capital, and to become publicly traded companies. Through this process is which a private company becomes a public company. After the IPO, when free trade of shares happens in the open market, the money obtained passes between the public investors. IPO provides many advantages, alongside significant disadvantages. The most important among these are the requirement to disclose certain information and the costs that are associated with the process.

FOLLOW-ON PUBLIC OFFER (FPO)

A follow-on public offer (FPO) is the shares that are issued to the investors by companies that are currently or already listed on a stock market exchange. An FPO is a process of issuing additional shares of the company. FPO involves trading of already publicly listed shares and shares of companies those who have undergone the IPO process. FPOs are more popular and familiar methods for the companies to raise additional equity capital in the capital markets through stock issuances.

PROSPECTUS

Details of the proposed offering by the firms are provided to potential investors in the form of a document known as a prospectus.

The prospectus must contain adequate and material information on:

- the firm's assets, liabilities, profit or loss and financial position,
- the firm's future prospects and vision,
- the rights attached to the securities being offered for sale and other factors causing a material impact on the securities' value, and
- the risks that may affect the financial position, firm's operations, and performance or the value of the security.

UNDERWRITER

Most of the firms offering an IPO take the assistance of an investment banking firm which acts in the capacity of an underwriter. An underwriter is a party that assumes and evaluates another party's risk for a fee that is charged, for example as a premium, commission, interest or a spread. The underwriters provide valuable services, which helps the firms

in accurately assessing the share price, and establishing an initial sale or a public market for shares.

INVESTMENT DECISIONS

It is important to know if managerial investment decisions affect the liquidity of a firm's stock.

In any organization, the manager decides on the optimal allocation of cash between payment of dividends and investment in the growth option. A more productive growth towards expansion of business option implies more investment by way of purchasing more machinery or raw materials for production, investment in Research and Development for further improvement in the running of the business. A firm's investment may be limited if it is financially constrained and does not allocate optimal funds for the investment.

Also, a relation between asset liquidity and stock liquidity must be studied. It has always shown that relation is more positive (or less negative) in firms with less growth opportunities. In firms that have less growth opportunities, more cash is allocated on the balance sheet towards paying dividends to the investors and less towards investments in new projects and expansion of business.

Also it is important to know how the relation between stock liquidity and asset liquidity is affected by financial constraints. In the markets, it is seen that the relation in financially constrained firms is expected to be more positive because such firms like these usually limit their investments and conserve more cash on their balance sheet rather than investing in operations for diversification.

In the markets, generally stock liquidity is ascertained on a daily basis. Hence for analysis and report generation, annual averages of the stock liquidity are determined to measure stock liquidity. After this analysis, it is determined how stock liquidity has its affects on managerial decisions and smooth conduct of business. It is always proved that managerial investment decisions are fundamental drivers of uncertainty and result in stock liquidity. On the other hand, to measure asset liquidity, the firm's assets based on their liquidity are sorted and liquidity scores between zero and one are assigned to each asset class. Then a weighted liquidity score for the respective firm deploying the book value or market value of the different assets are calculated. Therefore, it is certain that the relation between stock liquidity and asset liquidity depends importantly on investment opportunities.

IDENTIFYING STOCK PRICE MOVEMENTS

In the stock exchanges, charting applies statistical techniques to record and retrieve historical stock prices and volumes to identify the future stock price movements. This does not consider the basic characteristics of the stock, economic environment, and the nature of business, as the impact of these factors is deemed to reflect in the stock price. Technical analysis assumes the prices taken randomly and investors can judge future price movements based on the past trends of the Company's operations. Hence, it helps investors to make optimum decisions related to their investments.

Technical analysis has two methods –

- Based on intuition and interpretation, and
- Based on analysis of data.

Under the first method, analysts read and interpret the price charts depending on the pattern of double-bottoms, movement - head-and-shoulders patterns, pennants and flags, etc. To predict the share price movements, these patterns are used by analysts.

In case of the second method, complex calculations of numbers are relied upon by the analysts by ascertaining raw price and volume data. After this process of analysis, the secondary indicators, i.e., moving averages, oscillators, etc, are ascertained and used to buying on the spot or selling the securities. Analysts also use complex equations, scientific methods, software, and complex mathematical formulas to derive indicators that influence the analysis of stock price movements.

RISKS AND RETURNS

Risk means the possibility of losing some or all of the original investment made by the investor in the stock markets. The magnitude of risk or uncertainty depends on the magnitude of investment. Low potential returns are obtained from low levels of uncertainty (low risk). High potential returns are obtained from high levels of uncertainty (high risk). Investment risks are divided into two categories: Systematic and unsystematic.

Systematic Risk:

Systematic risk is also known as "un-diversifiable risk" or "market risk". It is the uncertainty that is inherent to the entire market or its segment. It is also referred to as volatility. Systematic risk is fluctuations that happen on a day-to-day basis in the prices of stocks. An important measure of risk is volatility as it refers to the "temperament" or behavior of the investment rather than ascertaining the reason for such behavior. The agile movement of the markets is the reason why people make money from investing in stocks. Hence, volatility is essential for the level of high or low returns. Therefore, the more unstable the investment is, the more there is a chance for an experience of a dramatic change in direction of investments. These risks cannot be reduced through diversification.

Factors like recession, interest rates, wars, etc are causes of systematic risk as they affect the entire market. These risks are beyond control and cannot be avoided in any circumstances. The only way that a systematic risk can be mitigated is by being hedged or using hedging.

Unsystematic Risk:

Unsystematic risk is also known as "diversifiable risk", "specific risk" or "residual risk". Unsystematic risk only is discovered from the side of the company or industry in which the investors make their investment. These types of risk can only be reduced through diversification. For instance, Investors who have shares in a company where a sudden strike by the workers or employees is declared, it is considered as an unsystematic risk.

CONCLUSIONS

In the present times of Liberalization, Privatization and Globalization (LPG), diversification of portfolio by making international investments is important because the stock markets are highly volatile now and higher arbitrage can be obtained. Focus on emerging economies has increased. Emerging markets are an attractive place for investments because of introduction of open market system and liberal guidelines towards Foreign Institutional Investment and Foreign Direct Investment. According to a report by MorganStanley, Indian markets are about three times more volatile as compared to other emerging markets and almost

five times more than the volatility in developed markets. After the introduction of LPG at a global level, the interdependence of various stock markets on one another has increased.

To invest in the right market or markets, at a national level or an international level, market efficiency is very important because the investor's investment decisions are largely influenced by market efficiency. Hence the effect of market efficiency at different levels is listed below:

- If market is weak-form efficient, excess returns cannot be obtained if the investors depend on the factor of past prices. Hence, this hypothesis assumes that the rates of return in the market should be independent. Past rates should not have any effect on the future rates and returns.
- If market is semi-strong efficient, excess returns cannot be received by considering the study of available public information. This hypothesis assumes that stocks quickly adjust to absorb new information that is available from any source. Hence, new information can't produce returns than expected compared to risk involved.
- If market is strong-efficient, prices are adjusted even after secret or privately held information is released. All the information about stock prices are available from the stock markets. Hence, no excess return can be expected and obtained even by insider trading.

When the stock volatility is considered, there is a positive contemporaneous relationship between the volume of investment and the volatility of returns. It is imperative to note that there is a significant effect of the previous day trading volume on the current return on the investment returns. Therefore, having clarity as to where an investor must invest unburdens the investor) from thinking about the risk of losing the amount of original investment and not gaining anything. Careful investment helps the investors to maintain consistent profitability. Despite the volatility of the stocks and market, trading in stock markets can be a very rewarding investment opportunity.

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