Attitude of Investors about Investment Avenues in Equity and Debt, Derivatives- a study

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Abstract

This paper aims to identify the factors influencing the investor's attitude towards investment in equity, debt, derivatives. The Indian stock market is one of the oldest and largest in the world. The rapid industrialization in the country since independence has given vitality to the stock market. Stock market helps to channelize household savings to the corporate sector which in turn facilitates the development of industrial and service sectors. An equity share is a part of the ownership capital of the company eligible to share many benefits from the company. When one invests in shares, he keeps it for some time depending upon the stock price. When the rates of shares increase, he sells the securities to another party. Investment is generally done by people in order to meet their future needs and also to protect them from the impact of inflation. Investment in shares will fetch better returns compared to any other form of investment. Whenever the inflation rate is high, the stock market has given higher rates of return to the investors. Share trading helps the corporate to raise additional funds for expansion by creating demand for the securities Primary data is collected through questionnaire.

The average value of the top five highly influential factors according to the investors' were what the company does , valuation of the company's Stock , company's 10-Q annual reports , Price to earnings ratio , Is the company profitable. The five factors which were given lowest priority or which had low influence on the attitude of the retail investors investing in equity stocks were Revenue/ profit patterns of the company was considered to be the lowest influencing factors among the five, customer/ client reviews about the company , vision and mission of the company , risk factors involved in the nature of business, debt-to-equity ratio. The liquidity that an exchange provides gives the investors the ability to quick and easy selling of securities. This is an attractive feature of the stock market investment. Investors can select the suitable avenue according to their desired level of risk, return and liquidity. Investment in securities of capital market can be made through primary or secondary market. In the primary market corporate entities offer new securities directly to the investors and mobilize the funds needed for their development. The secondary market provides continuous liquidity to the securities by trading them in the stock exchanges.

Keywords: Investors, Investment, Influencing factors, trading, exchanges.

Introduction

In India, the investors have the dual advantages of free enterprises and government control. Freedom and growth are ensured from the competitive forces of private enterprise. On the other hand, being a fixed economy, government control exerts discipline and curtails some elements of freedom. A public sector left free to operate hope to achieve the benefits derived from both socialistic and capitalist forms of government. But such an independent public sector brings in disadvantages also. In India, the political climate is conducive to investment as government controls lends stability to the capital markets. The success of every investment decision has become increasingly important in recent times. Making sound investment decisions require both knowledge and skill. Skill is needed to evaluate the risk and return associated with and investment decision. Knowledge is required to analyse the complex investment alternatives available in the economic environment. The main aim

of investors is to get capital appreciation and regular returns. The capital appreciation occurs when an investment is sold out at a higher price as compared to the original purchase price of an investment. The regular return from investment is derived in the form of interest or dividend. An investor means a person who invests his savings. Investment is an activity, which is different from savings. Savings are generated when a person abstains from present consumption for a future use. Savings keep the cash idle and do not earn anything. Hence the saver has to find a temporary repository for his savings until they are required for his future. This results in investment. Increase in investments is because of hike in working population, enhanced family incomes and consequent savings, availability of large and attractive investment alternatives and increase in investment related publicity.

Investment has become a household word and is very popular with the people at large. But to-day, the equity investment has become a household word and even middle class people also actively involved in equity investment operations with the results that the total investments on equity in various companies in India had increased tremendously. The investment made with the help of rumours and tips may erode off the amount invested. As there is a general attitude prevailing that making out of the stock market is easy, many enter the stock market without prior knowledge and get their fingers burnt. In Indian stock market, the majority of the investors are investing their money in shares based on their own assumptions and others' decision. In buying a share number of factors are to be considered like the standing of the company, political and economical environments, condition of the financial, market and psychological factors. These considerations help to purchase the shares with least cost and selling them at high price. It is better to invest after careful study and a systematic evaluation in the form of fundamental and technical analysis. Many investors neglect this evaluation due to inefficiency or lack of knowledge of the importance of such an analysis.

Objective:

This paper intends to explore Investors Attitude towards Stock Market in general and equity , debt, hedge funds, derivatives in particular

Investment in equity, mutual funds and debt across India

Hisar, Bathinda or Dharamsala are not what comes to one's mind when one thinks of investors having more inclination towards equity mutual funds. But, it seems, investors, especially in the tier-III cities of the northern region, are fickle-minded and impatient, as 70-75% of the total amount is invested in equity mutual funds by the investors of these cities.

The investment in equity and debt funds is in the ratio of 50:50, especially in big cities and across the country, according to wealth advisers. Equity mutual funds invest primarily in stock markets with an aim to generate higher returns, while debt funds invest in fixed income securities such as bonds and treasury bills.

Over the past few years, there has been a drastic shift in investors' attitude towards equity mutual funds in small cities such as Mandi, Pathankot, Yamunanagar, Ambala, Ferozepur, Hamirpur and Sangrur.

"More investors are inclined towards equity mutual funds, especially in small cities. This is due to ignorance among the investors and scarcity of certified wealth advisers in smaller cities of the northern region as compared to the western and southern region," said SBI Mutual Fund MD Ashwani Bhatia.

The total assets under management (AUM) in the region, comprising Haryana, Punjab, Chandigarh, Himachal Pradesh and Jammu & Kashmir, is Rs 52,258 crore, excluding SBI Mutual fund. Out of this, equity mutual funds account for Rs 35,004 crore and debt funds Rs 17,254 crore. The total AUM of SBI Mutual Fund is around Rs 6,307 crore.

According to DP Singh, Executive Director, SBI Mutual Fund, the investor's portfolio should be a right mix for balanced growth. "Though in big cities, the ratio of equity and debt funds is similar, it is more skewed towards equity funds in the North," he said.

Debt funds are considered less risky when it comes to investing in a product which can give decent inflation-beating returns along with tax benefit. So, debt funds are preferred by individuals who are not willing to invest in a highly volatile equity market. A debt fund provides a steady but low income as compared to equity fund.

According to the wealth advisers, when the stock market is witnessing a bull run, people invest more in equity funds. However, the fascination lasts as long as the market is heading towards north. "If the market witnesses successive falls and panic starts creeping in among the investors, they not only lose money but it is also deterrent to the industry. The portfolio must be a mix of equity and debt mutual funds," said a Chandigarh-based wealth adviser.

According to rough estimates, the northern region comprising Delhi, UP, Uttarakhand, Rajasthan, Haryana, Chandigarh, Punjab, HP and J&K, contributes 15-20% to the total monthly inflow to the MF industry. Hedge funds are alternative investments that use market opportunities to their advantage. These funds require a larger initial investment than others, and generally are accessible only to accredited investors. That's because hedge funds require far less regulation from the Securities and Exchange Commission (SEC) than others like mutual funds. Most hedge funds are illiquid, meaning investors need to keep their money invested for longer periods of time, and withdrawals tend to to happen only at certain periods of time.

As such, they use different strategies so their investors can earn active returns. But potential hedge fund investors need to understand how these funds make money and how much risk they take on when they buy into this financial product. While no two hedge funds are identical, most generate their returns using one or more of several specific strategies that we've outlined below.

Key Takeaways

- Hedge funds are versatile investment vehicles that can use leverage, derivatives, and take short positions in stocks.
- Because of this, hedge funds employ various strategies to try to generate active returns for their investors.
- Hedge fund strategies range from long/short equity to market neutral.
- Merger arbitrage is a kind of event-driven strategy, which can also involve distressed companies.

Long/Short Equity

The first hedge fund used a long/short equity strategy. Launched by Alfred W. Jones in 1949, this strategy is still in use on the lion's share of equity hedge fund assets today. The concept is simple: Investment research turns up expected winners and losers, so why not bet on both? Take long positions in the winners as collateral to finance short positions in the losers. The combined portfolio creates more opportunities for idiosyncratic (i.e. stock-specific) gains, reducing market risk with the shorts offsetting long market exposure.

Long/short equity is basically an extension of pairs trading, in which investors go long and short on two competing companies in the same industry based on their relative valuations. It is a relatively low-risk leveraged bet on the manager's stock-picking skill.

For example, if General Motors (GM) looks cheap relative to Ford, a pairs trader might buy $100,000 worth of GM and short an equal value of Ford shares. The net market exposure is zero, but if GM does outperform Ford, the investor will make money no matter what happens to the overall market.

Let's suppose Ford rises 20% and GM rises 27%. The trader sells GM for $127,000, covers the Ford short for $120,000 and pockets $7,000. If Ford falls 30% and GM falls 23%, he sells GM for $77,000, covers the Ford short for $70,000, and still pockets $7,000. If the trader is wrong and Ford outperforms GM, however, he will lose money.

Long/short equity hedge funds typically have net long market exposure, because most managers do not hedge their entire long market value with short positions. The portfolio's unhedged portion may fluctuate, introducing an element of market timing to the overall return. By contrast, market-neutral hedge funds target zero net-market exposure, or shorts and longs have an equal market value. This means managers generate their entire return from stock selection. This strategy has a lower risk than a long-biased strategy—but the expected returns are lower, too.

Long/short and market-neutral hedge funds struggled for several years after the 2007 financial crisis. Investor attitudes were often binary—risk-on (bullish) or risk-off (bearish). Besides, when stocks go up or down in unison, strategies that depend on stock selection don't work. In addition, record-low interest rates eliminated earnings from the stock loan rebate or interest earned on cash collateral posted against borrowed stock sold short. The cash is lent out overnight, and the lending broker keeps a proportion.

This typically amounts to 20% of the interest as a fee for arranging the stock loan, while "rebating" the remaining interest to the borrower. If overnight interest rates are 4% and a market-neutral fund earns the typical 80% rebate, it will earn 3.2% per annum (0.04 x 0.8) before fees, even if the portfolio is flat. But when rates are near zero, so is the rebate.

Merger Arbitrage

A riskier version of market neutral, merger arbitrage derives its returns from takeover activity. That's why it's often considered one kind of event-driven strategy. After a share-exchange transaction is announced, the hedge fund manager may buy shares in the target company and short sell the buying company's shares at the ratio prescribed by the merger agreement. The deal is subject to certain conditions:

- Regulatory approval
- A favorable vote by the target company's shareholders
- No material adverse change in the target's business or financial position

The target company's shares trade for less than the merger consideration's per-share value—a spread that compensates the investor for the risk of the transaction not closing, as well as for the time value of money until closing.

In cash transactions, target company shares trade at a discount to the cash payable at closing, so the manager does not need to hedge. In either case, the spread delivers a return when the deal goes through, no matter what happens to the market. The catch? The buyer often pays a large premium over the pre-deal stock price, so investors face large losses when transactions fall apart.

Because merger arbitrage comes with uncertainty, hedge fund managers must fully evaluate these deals and accept the risks that come with this kind of strategy.

There is, of course, significant risk that comes with this kind of strategy. The merger may not go ahead as planned because of conditional requirements from one or both companies, or regulations may eventually prohibit the merger. Those who take part in this kind of strategy must, therefore, be fully knowledgeable about all the risks involved as well as the potential rewards.

Convertible Arbitrage

Convertibles are hybrid securities that combine a straight bond with an equity option. A convertible arbitrage hedge fund is typically long on convertible bonds and short on a proportion of the shares into which they convert. Managers try to maintain a delta-neutral position, in which the bond and stock positions offset each other as the market fluctuates. To preserve delta-neutrality, traders must increase their hedge, or sell more shares short if the price goes up and buy shares back to reduce the hedge if the price goes down. This forces them to buy low and sell high.

Convertible arbitrage thrives on volatility. The more the shares bounce around, the more opportunities arise to adjust the delta-neutral hedge and book trading profits. Funds thrive when volatility is high or declining, but struggle when volatility spikes—as it always does in times of market stress. Convertible arbitrage faces event risk as well. If an issuer becomes a takeover target, the conversion premium collapses before the manager can adjust the hedge, resulting in a significant loss. On the border between equity and fixed income lie event-driven strategies. This kind of strategy works well during periods of economic strength when corporate activity tends to be high. With an event-driven strategy, hedge funds buy the debt of companies that are in financial distress or have already filed for bankruptcy. Managers often focus on senior debt, which is most likely to be repaid at par or with the smallest haircut in any reorganization plan.

If the company has not yet filed for bankruptcy, the manager may sell short equity, betting that the shares will fall either when it does file or when a negotiated equity-for-debt swap forestalls bankruptcy. If the company is already in bankruptcy, a junior class of debt entitled to a lower recovery upon reorganization may constitute a better hedge.

Investors in event-driven funds need to be able to take on some risk and also be patient. Corporate reorganizations don't always happen the way managers plan, and, in some cases, the may play out over months or even years, during which the troubled company’s operations may deteriorate. Changing financial-market conditions can also affect the outcome – for better or for worse.

Credit

Capital structure arbitrage, similar to event-driven trades, also underlies most hedge fund credit strategies. Managers look for a relative value between the senior and junior securities of the same corporate issuer. They also trade securities of equivalent credit quality from different corporate issuers, or different tranches, in the complex capital of structured debt

vehicles like mortgage-backed securities (MBSs) or collateralized loan obligations (CLOs). Credit hedge funds focus on credit rather than interest rates. Indeed, many managers sell short interest rate futures or Treasury bonds to hedge their rate exposure.

Some hedge funds analyze how macroeconomic trends will affect interest rates, currencies, commodities, or equities around the world, and take long or short positions in whichever asset class is most sensitive to their views. Although global macro funds can trade almost anything, managers usually prefer highly liquid instruments such as futures and currency forwards.

Macro funds don't always hedge, but managers often take big directional bets—some never pan out. As a result, returns are among the most volatile of any hedge fund strategy.The ultimate directional traders are short-only hedge funds—the professional pessimists who devote their energy to finding overvalued stocks. They scour financial statement footnotes and talk to suppliers or competitors to unearth any signs of trouble possibly ignored by investors. Hedge fund managers occasionally score a home run when they uncover accounting fraud or some other malfeasance.

Short-only funds can provide a portfolio hedge against bear markets, but they are not for the faint of heart. Managers face a permanent handicap: They must overcome the long-term upward bias in the equity market.Investors should conduct extensive due diligence before they commit money to any hedge fund. Understanding which strategies the fund uses, as well as its risk profile, is an essential first step.

Conclusion

Credit funds tend to prosper when credit spreads narrow during robust economic growth periods. But they may suffer losses when the economy slows and spreads blow out.Hedge funds that engage in fixed-income arbitrage eke out returns from risk-free government bonds, eliminating credit risk. Remember, investors who use arbitrage to buy assets or securities on one market, then sell them on a different market. Any profit investors make is a result of a discrepancy in price between the purchase and sale prices. Managers, therefore, make leveraged bets on how the shape of the yield curve will change. For example, if they expect long rates to rise relative to short rates, they will sell short long-dated bonds or bond futures and buy short-dated securities or interest rate futures.

These funds typically use high leverage to boost what would otherwise be modest returns. By definition, leverage increases the risk of loss when the manager is wrong. The irrational investors enter the market and buy the shares as per their own wish and pleasure. They do not mind whether it is worthy to invest or not in the particular company's share. As a result the market loses its stability, when a large number of irrational investors play in the stock market. Ultimately when the stock markets lose the stability, the flow of funds in to capital market slows down and affects the economic growth of the country.

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