[Academic Script]

Secondary Market in India Part -1

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Academic Script

1. Introduction

Capital market comprises of two markets namely Primary Market and Secondary market. Primary Market is a market for new issues of long term securities where companies raise long term funds by issuing securities like shares, debentures, bonds etc. Secondary market is the place for sale and purchase of existing securities. It helps the investors to sale their existing securities for cash to meet liquidity needs and also enables the buyer to park his liquid money to take the benefit of tradable securities. In this session we are going to discuss secondary market in India.

Let us start our discussion with market design of Stock Exchanges in India

The stock exchanges are the exclusive centres for trading of securities. The regulatory framework favours them by almost banning trading of securities outside exchanges. Earlier, they enjoyed territorial monopoly. Listing of companies on the local exchange is mandatory to provide an opportunity to investors to invest in the securities of local companies. The companies wishing to list their securities must get listed on the regional (state/union territory) stock exchange nearest to their registered office. Earlier the area of operation of the exchange was specified at the time of its recognition but then later with advancement and competition all exchanges were allowed to set up trading terminals across the country.

The first organized stock exchange in India was started in Bombay in 1875 with the formation of the 'Native Share and Stock Broker's Association'. In all 4 national and 19 Regional stock exchanges were there. With the passage of time due to the problem of low volume though the exchanges were demutualized started closing and at present only 7 stock exchanges are there in the country. Rest all exchanges are granted exit by SEBI.

The **National Stock Exchange of India Limited** (**NSE**) is the leading stock exchange of India, located in Mumbai. NSE was established in 1992 as the first demutualized electronic exchange in the country. NSE was the first exchange in the country to provide a modern, fully automated screen-based electronic trading system which offered easy trading facility to the investors spread across the length and breadth of the country.

BSE has initiated BOLT (BSE online Trading) and NSE had started NEAT (National Exchange Automated Trading) as fully automated screen-based electronic trading systems.

Now let us discuss International Stock Exchanges

The names of major international stock exchanges are New York Stock Exchange, NASDAQ in New York, USA; London Stock Exchange in London; Japan Exchange in Tokyo, Japan; Shanghai Stock Exchange in Shanghai, China; Toronto Stock Exchange in Toronto, Canada; Hong Kong Stock Exchange in Hong Kong; Australian Securities Exchange in Sydney, Australia; etc.

2. What is Demutualization of Exchanges?

Do you know what Demutualization of Exchanges is? Demutualization is the process through which a member-owned company becomes shareholder-owned company. In other words,

transforming the legal structure of an exchange from a mutual form to a business corporation form.
In January 2002, SEBI directed all the recognizes stock exchanges to suitably amend their rules within a period of 2 months from the date of the order to provide that no broker member of the stock exchanges shall be an office bearer of an exchange i.e. hold the position of President, Vice President, Treasurer, etc. This would give effect to the decision taken by SEBI and the policy decision of government in regard to demutualization/corporatization of the exchanges by which ownership, management and trading membership would be segregated from each other.

It is interesting to know whether Indian companies are allowed to raise funds from International capital Markets

Yes, Indian companies are permitted to raise funds from foreign capital market as a part of liberalization process initiated in India since 1992. Indian companies can raise funds in foreign currency resources through two main sources:
a) Issue of Foreign Currency Convertible Bonds (FCCBs) –
b) Issue of ordinary equity shares through depository receipts, namely, Global Depository Receipts (GDRs)/American Depository Receipts (ADRs) to foreign investors i.e. institutional investors or individuals (including NRIs) residing abroad. These issues are more commonly known as 'Euro Issues'.
A depository receipt (DR) is any negotiable instrument in the form of a certificate denominated in US dollars. The certificates are issued by an overseas depository bank against certain underlying share/stocks. The shares are deposited by the issuing company with the depository bank. The depository bank in turn

gives DRs to the investors. A DR is a non-voting Equity holding. DRs facilitate cross border trading and settlement, minimize transaction costs and broaden the potential base, especially among institutional investors.

An American Depository Receipt (ADR) is a negotiable U.S. certificate representing ownership of shares in a non-U.S. corporation. ADRs are quoted and traded in U.S. dollars in the U.S. securities market.

Global Depository Receipts (GDRs) may be defined as a global finance vehicle that allows an issue to raise capital simultaneously in two of more markets through a global offering. GDRs may be used in either the public or private markets inside or outside the U.S. GDR, a negotiable certificate usually represents a company's publicly traded equity or debt.

ADRs and GDRs are identical from a legal, operational, technical and administrative standpoint.

The FCCBs/GDRs/ADRs issued by Indian Companies to non-residents have free convertibility outside India. In India, GDRs/ADRs are reckoned as part of foreign direct investment and hence need to conform to the existing FDI policy.

3. Which is Indian Stock exchanges and their Indices?

Now let us move on to next topic which is Indian Stock exchanges and their Indices

Bombay Stock Exchange and National Stock Exchange are the major two stock exchanges in India.

Bombay Stock Exchange

The Bombay Stock Exchange was established in 1875 as 'The Native Share and Stock Brokers Association'. It is the oldest one in Asia, even older than the Tokyo stock Exchange, which was established in 1878. It was initially started as an AOP (Association of Person), but then it was demutualized as per the norms of SEBI. The Bombay Stock Exchange's main index was BSE 30 (SENSEX), it was also named as sensitive Index. The Sensex includes top 30 stocks (securities) as per the capitalization.

Sensex (BSE 30), BSE MIDCAP – it includes shares/securities of Mid-size i.e. as per capitalization, BSE IT – includes shares/securities of IT companies, BSE Pharma includes shares/securities of Pharma companies, BSE Top 200 are some of the indices of Bombay Stock Exchange.

National Stock Exchange

The National Stock Exchange (NSE) is India's leading stock exchange covering various cities and towns across the country. NSE was set up by leading institutions to provide a modern, fully automated screen-based trading with national reach. NSE commenced operations in the Wholesale Debt Market (WDM) segment in June 1994. The Capital Market (Equities) segment commenced operation in November 1994 and operations in Derivative segment commenced in June 2000.

NIFTY (NSE 50), NSE MIDCAP it includes shares/securities of Mid-size i.e. as per capitalization, NSE IT – includes shares/securities of IT companies, NSE Pharmaceutical includes shares/securities of Pharmaceutical companies, NIFTY is the main index and it included the TOP 50 stocks as per the market capitalization.

The CNX Nifty is the flagship index on the National Stock Exchange of India Ltd. (NSE). The Index tracks the behavior of a portfolio of blue chip companies, the largest and most liquid Indian securities. It includes 50 of the approximately 1600 companies listed on the NSE, captures approximately 65% of its float-adjusted market capitalization and is a true reflection of the Indian stock market. The CNX Nifty covers 21 sectors of the Indian economy and offers investment managers exposure to the Indian market in one efficient portfolio. The Index has been trading since April 1996 and is well suited for benchmarking, index funds and index-based derivatives. The CNX Nifty is owned and managed by India Index Services and Products Ltd. (IISL). IISL is India's first specialized company focused on an index as a core product.

Construction of NSE

The CNX Nifty is computed using a float-adjusted, market capitalization weighted methodology. Beginning June 26, 2009, the CNX Nifty is being computed using float-adjusted market capitalization weighted method, wherein the level of index reflects the float-adjusted market capitalization of all stocks in the Index relative to a particular base period. The methodology also takes into account constituent changes in the index and corporate actions such as stock splits, rights issuance, etc., without affecting the index value.

Now let us discuss Free Vs. Full Float Methodology

Full-market capitalization' methodology, the total market capitalization of a company, irrespective of who is holding the shares, is taken into consideration for computation of an index. However, if instead of taking the total market capitalization, only the Free-float market capitalization of a company is considered for index calculation, it is called the Free-float methodology.

Free-float market capitalization is defined as that proportion of total shares issued by the company which are readily available for trading in the market. It generally excludes promoters' holding, government holding, strategic holding and other locked-in shares, which will not come to the market for trading in the normal course. Thus, the market capitalization of each company in a Free-float index is reduced to the extent of its Free-float available in the market.

Now let us discuss the Impact of Corporate Actions like Right Issue, Bonus Issue and Stock Split on the Index

1) Right Issue – Right issue is the one when additional requirement of funds by the company is fulfilled through the existing share holders.
2) Bonus issue – the bonus issue is the one which is made out of free reserves built out of the genuine profits or share premiums collected in cash only.
3) Stock Split - A stock split is a decision by the company's board of directors to increase the number of shares that are outstanding by issuing more shares to current shareholders.

All this corporate actions leads to the valuation of financial assets for the buy sell or hold decision. The underlying force behind the valuation is the information.

The information can be past, present and expected (future). The information such as declaration of dividend, stock split, mergers and acquisition, increase or decrease in the profitability of the company react to the price in the current stage. Although studies (researchers) have found that future or insider information has a very strong impact, but as such norms prohibit the companies to use that information and conduct insider trading. It is only when the information is disseminated in the market and officially investors react to it. Past information has very low impact as the probable effect of it may not be the same as earlier due to the changes in the market.

4. What does bulls and bears mean in stock market?

Now let us see what does bulls and bears mean in stock market

Bull Market

In a bull market, there is an assumption that stocks will continue to rise in price. Ideally, you'd like to buy the stock in the lower range and collect on earnings as the stock continues to soar. Any losses are viewed as minimal or temporary within a bull market. For example, if a stock's price rises five days in a row and drops on the sixth day, it is assumed to rise again on the seventh day. Within a bull market investors tend to take more risks with their finances in the hopes of securing more reward. In a bull market, investors might feel bullish towards all stocks or an individual stock

Bear Market

In a bear market, there is an assumption that stocks will fall in price. Stock prices are assumed to be continually falling. Losses are considered to be substantial. Any gains are considered to be minimal or temporary. Similar to the bull market scenario, the stock can do something in days one through five, something different in day six, but then revert back to the pattern in day seven. In a bear market it is never a good idea to put more money at risk in the same manner you would in a bull market.

In a bear market investors might feel bearish towards all stocks or an individual stock.

Now let us see what are the factors influencing the movement of stock markets

Economic, Industry and Company (EIC) analysis

We are going to talk about the fundamental factors that affect the security prices in the market. And this particular system is known as economic analysis - is a part of broad analysis called economic industry and company analysis. Before we talk about they how the stock price will be there, how the valuation of a particular stock is going to be there. We should be aware of the things, that are happening across the industry in that particular company belongs to, as well as the overall economy that the industry belongs to.

Fundamental analysis

For estimating the price of a stock, the security analyst must forecast the earnings and cash flows that can be expected from the firm. This is primarily known as fundamental analysis.

Fundamental analysis also comprises of EIC analysis – comprises of

Economic analysis

Industry analysis

Company analysis

Coming to the **economic analysis:** Any fluctuation in security market that happens, it will be related to the expectation in the aggregate economy. And obviously, the company's impact and performance is tied to the economic performance - and the economic performance of particular country is also tied to the broader international economic condition.

And it is quite possible that in some cases, the macroeconomic factors may influence the company's performance more than the companies its own performance relative to the particular other firm performance in that particular sector.

Now let us see which Securities are Available for Trading in stock exchange

The Capital Market (Equities) segment of NSE facilitates trading in the following instruments:

1) Shares
a. Equity Shares
b. Preference Shares
2) Debentures
a. Partly Convertible Debentures
b. Fully Convertible Debentures
c. Non Convertible Debentures
3) Warrants / Coupons / Secured Premium Notes/ other Hybrids
4) Bonds
5) Units of Mutual Funds

Now let us see what are the myths attached to investing in Stock markets

Many investors wonder whether or not investing in stocks is worth all the hassle. At the same time, however, it's important to keep a realistic view of the stock market. Regardless of the real problems, common myths about the stock market often arise. Here we go over these myths in order to bust them.

1) **Investing in stocks is just like gambling.**

This reasoning causes many people to stay away from the stock market. To understand why investing in stocks is inherently different from gambling, we need to review what it means to buy stocks. A share of common stock is ownership in a company. It entitles the holder to a claim on assets as well as a fraction of the profits that the company generates. Too often, investors think of shares as simply a trading vehicle, and they forget that stock represents the ownership of a company.

In the stock market, investors are constantly trying to assess the profit that will be left over for shareholders. This is why stock prices fluctuate. The outlook for business conditions is always changing, and so are the future earnings of a company.

Gambling, on the contrary, is a zero-sum game. It merely takes money from a loser and gives it to a winner. No value is ever created. By investing, we increase the overall wealth of an economy. As companies compete, they increase productivity and develop products that can make our lives better. Don't confuse investing and creating wealth with gambling's zero-sum game.

2) The stock market is an exclusive club in which only brokers and rich people make money.

Many market advisors claim to be able to call the markets' every turn. The fact is that almost every study done on this topic has proven that these claims are false. Most market prognosticators are notoriously inaccurate; furthermore, the advent of the internet has made the market much more open to the public than ever before. All the data and research tools previously available only to brokerages are now there for individuals to use. Actually, individuals have an advantage over institutional investors because individuals can afford to be long-term oriented. The big money managers are under extreme pressure to get high returns every quarter. Their performance is often so scrutinized that they can't invest in opportunities that take some time to develop. Individuals have the ability to look beyond temporary downturns in favor of a long-term outlook.

3) Fallen angels will all go back up, eventually.

Whatever the reason for this myth's appeal, nothing is more destructive to amateur investors than thinking that a stock trading near a 52-week low is a good buy. Think of this in terms of the old Wall Street adage, "Those who try to catch a falling knife only get hurt."

Suppose you are looking at two stocks:

- XYZ made an all time high last year around Rs. 50 but has since fallen to Rs. 10 per share.
- ABC is a smaller company but has recently gone from Rs. 5 to Rs. 10 per share.

Which stock would you buy? Believe it or not, all things being equal, a majority of investors choose the stock that has fallen from Rs. 50 because they believe that it will eventually make it back up to those levels again. Thinking this way is a cardinal sin in investing! Price is only one part of the investing equation (which is different from trading, which uses technical analysis). The goal is to buy good companies at a reasonable price. Buying companies solely because their market price has fallen will get you nowhere. Make sure you don't confuse this practice with value investing, which is buying high-quality companies that are undervalued by the market.

4) Stocks that go up must come down.

The laws of physics do not apply in the stock market. There is no gravitational force that pulls stocks back to even. Over ten years ago, Berkshire Hathaway's stock price went from Rs. 6,000 to Rs. 10,000 per share in a little more than a year. Had you thought that this stock was going to return to its lower initial position, you would have missed out on the subsequent rise to Rs. 70,000 per share over the following six years.

5) Having just a little knowledge, because it is better than none, is enough to invest in the stock market.

Knowing something is generally better than nothing, but it is crucial in the stock market that individual investors have a clear understanding of what they are doing with their money. It's those investors who really do their homework that succeed.

Don't forget, if you don't have the time to fully understand what to do with your money, then having an advisor is not a bad thing. The cost of investing in something that you do not fully understand far outweighs the cost of using an investment advisor.

5. Summary

Secondary market is a place where existing shares are being bought and sold. It is a place where buyer and seller meet. Earlier (traditionally) the secondary market was an open outcry market where buyers and sellers have to practically visit the exchanges for buy/sell. Then New system was introduced SBTS – Screen Based Trading System under which NSE launched NEAT and BSE launched BOLT. Also the new system was stretched to Internet/WAP through which the prospective buyer and seller can trade online from anywhere in the world. The secondary market facilitated the to create market transparent and a better capital market in the country