Role of Institutional Investors in Indian Stock Market

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Abstract

An important feature of the development of stock market in India in the last *15* years has been *the growing participation of Institutional Investors, both foreign institutional investors and the Indian mutual funds combined together, the total* assets *under their management* amounts *to almost 18% of* the *entire* market *capitalization. This paper* examines *the role of* these *investors in Indian stock* markets *and finds that the market movement can be explained using the direction of the funds flow from* these *investors.*

Key Words : Stock Markets, Clout, Augment, Cumulative, Demat accounts.

The Indian stock market has come of age and has substantially aligned itself with the international order. Over the last fifteen years the following developments have made the Indian stock markets almost on par with the global markets:

- Screen based trading systems replaced the conventional open outcry system of trading and everyone acclaims the contribution of the screen based trading in developing the culture of equity investing.
- The replacement of the fourteen-day account period settlement system give way to rolling settlements on T+2 basis has brought down the settlement risk substantially.
- Dematerialization of securities
- Demutualization of exchanges
- Derivatives trading

Infact, today we have one of the most modern securities

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Market among all the countries in the world. Along with these changes the market has also witnessed a growing trend of 'institutionalization' that may be considered as a consequence of globalization. More precisely the growing might of the institutional investors entities whose primary purpose is to invest their own assets or those entrusted to them by others and the most common among them are the mutual funds and portfolio investors. Today, giant institutions control huge sums of money which they move continuously. In European and Japanese markets, institutions dominate virtually all trading. In the US, retail investors still remain active participants.

An important feature of the development of stock market in India in the last 15 years has been the growing participation of Institutional Investors, both foreign institutional investors and the Indian mutual funds (since the pension funds are still restricted to fully participate in the stock market otherwise pension funds are big investors all world over). With the accelerating trends of reforms Indian stock market will witness more and more of institutionalization and the increasing size of money under the control, this set of investors will play a major role in Indian equity markets. The importance of institutional investors particularly foreign investors is very much evident as one of the routine reasons offered by market Pundits whenever the market rises it is attributed to foreign investors' money, no wonder we see headlines like "FIIs Fuel Rally" etc., in the business press. This is not unusual with India alone as most developed economies of today might have seen a similar trend in the past. The increasing role of institutional investors has brought both quantitative and qualitative developments in the stock market viz., expansion of securities business, increased depth and breadth of the market, and above all their dominant investment philosophy of emphasizing the fundamentals has rendered efficient pricing of the stocks. This paper sets out with the objective of examining whether the institutional investors, with their war chests of money, set the direction to the market. The next section briefly outlines the growth of institutional investors' presence in Indian stock market followed by an explanation of the data and methodology employed by the study and finally we present the results and discussions.

Growing Clout of Institutional Investors on Indian Markets:

Foreign Institutional Investors (FIIs)

A Grave Balance of Payments situation forced the policymakers to take a relook at allowing foreign capital Into the country and the year of 1991 marked the announcement of some fiscal disciplinary measures along with reforms on the external sector made, it possible for the foreign capital to reach the shores of the country. As on 31st March 2005 there were 685 (ISMR 2004-05 NSE, Mumbai) registered foreign institutional investors in the Indian stock market. As on that date the net cumulative investments made by FIIs are around USD 35.9 billion representing around 6.55% of India's market capitalization. Ever since they were permitted to invest in India the investments made by them showed a gradual increase except in the 1998-99. The net inflows averaged around 1.1 bn per year and large net outflows are rare barring the year of 1998-99 where most South Asian countries were out of favour for a while. Foreign portfolio investment carries a sense of notoriety of its own because at the first sign of trouble this flows in reverse direction. The notoriety emanates from the very nature of FII investment - portfolio managers tend to restructure and rebalance their portfolios dynamically across the countries, their primary concern being their portfolio. Owing to their magnitude of flows, the direction of FII investment flows tends to make or break the fortunes of a market. FII flows to India are less

Table I

Year	Net Investments by FIIs (Rs Cr.)
1992-93	4.27
1993-94	5444.60
1994-95	4776.60
1995-96	6720.90
1996-97	7386.20
1997-98	5908.45 -
1998-99	729.11
1999-00	9765.13
2000-01	9682.52
2001-02	8272.90
2002-03	2668.90
2003-04	44000.03
2004-05	41416.45

Since it is not statutorily binding on FIIs to make public, the companies in which they are investing in, there is no publicly available information on this aspect. However, the overall investment that can be made by all FIIs in any company's equity is monitored by Reserve Bank of India, it gives a caution notice, when the overall FII investment level reaches 22 percent in a company. Subsequently, all purchases have to be done by prior approval of Reserve Bank of India. From such monitoring reports it can be gauged that the FIIs are

market or not. Here, one has to note that most stocks that figure in institutional investors' portfolios are more or less those securities that comprise the nifty or sensex indices hence, co-movements between index and the institutional investments is likely. But, when we use Advances and Declines ratio (ADR hereafter) it captures the direction of entire market in unambiguous terms. Generally advances to declines ratio indicate the breadth of the market. Hence, we use ADR instead of Nifty or Sensex returns. In reality, it is not possible to isolate the actions of mutual funds and FIIs on the stock market, since both the category of investors are acting simultaneously hence, the institutional activity is captured by taking the ratio of combined purchases of mutual funds and FI Is to combined sales of mutual funds and FIIs so if the ratio is >1 means institutions have pumped in money i.e., the market witnessed a net inflow of money while a ratio of <1 indicates there is an outflow of money from the market.

Results and Discussions:

Our first question is whether institutional activity has an influence on the market or not and this is examined by running a simple regression with the advances to decline ratio as the dependent variable and the institutional purchases to sales as the independent variable. But, before we attempt to do the regression we have to investigate whether the data is stationary or not and for this we used Augmented Dickey Fuller tests Hamilton, J. (1994). The unit root test results on the individual data series is given below in Table.

Table IV

Variable	**Test** statistic	**P Value**
ADR	14.3039	0.0000
FII	14.2312	0.0000
MF	9.9388	0.0000
INSTI	12.8703	0.0000

McKinnon critical values at 1% level of significance is 3.4385

The inferences about the stationarity of the data series remain unchanged even when we used the Phillips-Perron tests. Since the data series is found to be stationary, the results from the standard OLS regression can not be refuted. Now, we present the results of the linear regression in the following Table.

Table V

Variable	**Coefficien**	**Std error**	t-statistic	**P value**
INSTI	0.925420	0.03056	30.28240	0.0000

We have also conducted another regression with FII and MF as the independent variables separately and the ADR as the dependent variable and the results are similar to the above regression these are presented below:

Table VI

Variable	Coefficient	Std error	t-statistic	P **value**
FII	0.252056	0.031955	7.88774	0.0000
MF	0.753414	0.04279	17.60712	0.0000

So, it is clear that the institutional activity has an influence on the stock market and both mutual funds as well as FIIs actions have significant impact on the market's direction. Does this imply that institutional activity cause the stock market to rise/fall? This question is addressed by using Granger (1969) causality test assuming a one period lag we obtained the following results:

Table VII

Null hypothesis	F-Statistic	**P-value**
INSTI does not Granger Cause ADR	3.15491	0.07595
ADR does not Granger cause INSTI	0.65358	0.41899

The F statistics indicate that the null hypothesis ADR does not Granger Cause INSTI cannot be rejected and the null hypothesis INSTI does not Granger Cause ADR can be rejected. In other words there is statistical evidence that the forecasts about market direction can be improved by using the institutional activity as an independent variable. Then we examined whether the institutional activity is one sided meaning. Whether the FII actions and mutual fund actions are correlated. Since both these type of investors are driven by teams of trained analysts; we can premise that their actions may be positively correlated. The correlation results indicate that there is a weak negative correlation over this period and the correlation coefficient is -0.06439. To further augment our analysis we conducted a Granger Causality test as to whether the direction of FII investments can be predicted using previous day's information on mutual fund activity. The causality test results are shown below:

Table VIII

Null hypothesis	**F-Statistic**	**P-value**
MF does not Granger Cause FII	4.36575	0.03687
FII does not Granger cause MF	0.06531	0.79834

From the above results we can infer that the null hypothesis MF does not Granger cause FII can be rejected but the hypothesis FII does not Granger cause MF cannot be rejected. In other words, the forecasts of FII activity using mutual fund activity can be improved where as the reverse is not possible. This is a little bit surprising as well as interesting to note that the Indian mutual funds are leading the pack and are giving direction to the market and even FIIs are following their direction, probably, because of the larger size of the funds under the management of the mutual funds and hence the statistics are showing accordingly. The growth of institutional investors in the market is having its own advantages as well as its own share of problems on the brighter side almost always purchase stocks on the basis of fundamentals. And this means that it is essential to have information to evaluate, so research becomes important and this leads to increasing demands on companies to become more transparent and more disclosures. This will lead to reduction in information asymmetries that plagued the Indian markets for quite a while. Also, the increasing presence of this class of investors leads to reform of securities trading and transaction systems, nurturing of securities brokers, and liquid markets. On the flip side the increase of foreign investors in particular will brin[g] a very welcome inflow of foreign capital, but there are always some dangers if certain limits are exceeded. Firstly, the foreign capital is free and unpredictable and is always on the look out of profits FIIs frequently move investments, and those swings can be expected to bring severe price fluctuations resulting in increasing volatility. Also, increased investment from overseas may shift control of domestic firms to foreign hands. But, in India there were limits to foreign ownership of shares in firms. If foreign investors reach the ownership limits, shares in those firms are restricted to trading by FI Is.

Conclusion:

The Indian stock markets have really come of age there were so many developments in the last 15 years that make the markets on par with the developed markets. The important feature of developed markets is the growing clout of institutional investors and this paper sets out to find whether our markets have also being dominated by institutional investors. The regression results show that the combined might of the FIIs and mutual funds are a potent force, and they infact direction can forecast market direction using the direction of the flow of funds from FIIs and mutual funds, the Granger causality test has showed that the mutual funds in fact lead the market rise or fall and FIIs follow suit. This may actually raise questions on the market efficiency but on the contrary, markets become more efficient with the growing presence of institutional investors who predominantly go by fundamentals. Noise trading on the part of institutional investors will be less in Indian context since all their trades are delivery based only.

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