fin-sight

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"As part of our ongoing initiative to share knowledge on the Indian financial services sector, Motilal Oswal Investor Relations presents its article series – Fin Sight. In each issue, we discuss a topic impacting this sector. We draw upon the Group's learning, experience and current thinking to develop these insights. We look forward to your questions and feedback to help us provide you a better perspective of this sector…"

Sameer Kamath, Chief Financial Officer

Retail participation in Indian cash equities – Is the stage set for a sustained trend reversal?

Recent developments in retail participation – From years of drought to initial signs of a revival this year…

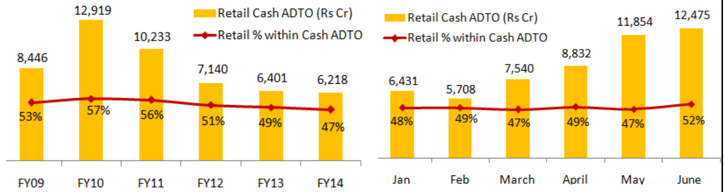
Retail cash volumes were sluggish in the last few years due to low returns, high volatility and pessimism over the economic outlook and corporate earnings. However, some retail interest seems to be reviving with the recent uptick, backed by optimism over the long-term outlook (given the majority numbers of the new govt.), real interest rates turning positive and returns picking up. Some are using this uptick to book profits after sitting on losses. But it has also been an opportune time for new investors to enter.

Trading velocity in the retail cash segment has doubled recently between Feb and May 2014. However, the overall cash velocity is yet to see a sustained uptick, due to declines in FII and Prop cash velocity in Feb, Apr and Jun 2014. DII cash velocity has also remained largely sluggish.

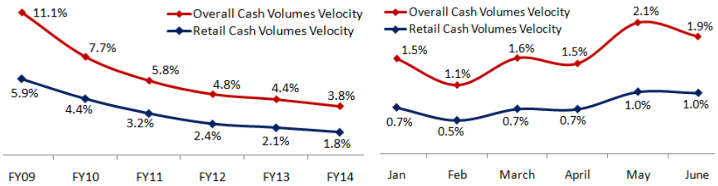
Given redemption pressures, equity funds saw net outflows of ~Rs 29,000 cr over 9 consecutive quarters till Mar 2014. Even in 2014, redemptions continued unabated as investors utilized the uptick to book profits and exit, as evidenced by dip in equity folio count. But, higher levels of gross sales since Mar pushed net inflows northwards & indicate a revival of retail interest in equity funds. Q1FY15 saw the highest quarterly net inflows in the last ~5 years.

So where did retail savings go? Most retail investors chose fixed income and physical assets. Physical savings as a proportion of GDP and household savings picked up during recent years, as did the proportion of bank deposits within household financial savings. Conversely, the share of equities in household financial assets dipped as interest in equities was plagued by volatility and sluggish returns.

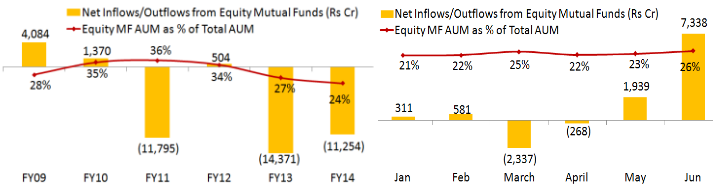
Retail volume trends since the last 6 years, and in the immediate past 6 months



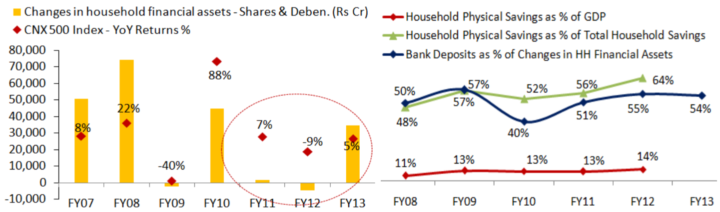
Trading velocity picked up slightly in recent months, but not yet in sustained manner



Net inflows into equity mutual funds seeing some initial signs of reversal this year



Retail savings went into fixed income, physical assets in recent years, over equities



Why is it imperative to deepen retail interest in equities?

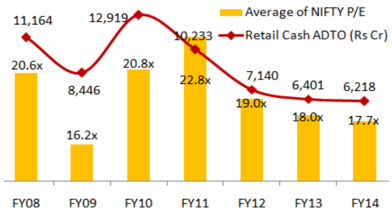
(a) Enhance liquidity and avoid over-dependence on FIIs: Domestic flows help liquidity by providing adequate counterparties to FIIs, directly and indirectly through funds. Over-dependence on FIIs can be detrimental. FII flows can be volatile owing to changes in the monetary/economic situations in their home countries, and it is not possible to control their allocation. As monetary policy in those countries tightens, their yield differential with India would reduce, further impacting liquidity. Most domestic investors are currently underweight in equities. **(b) Deepen interest in SME stocks:** Anecdotal evidence suggests most FII interest is in large-caps/larger mid-caps due to liquidity risk of smaller stocks. But domestic investors often go for the smaller stocks as well. For a developing nation like India, higher investor interest in SME stocks would help SMEs raise equity capital and expand their operations. **(c) Helps raise more debt:** Raising equity capital is imperative for companies beyond a point, as only then can they leverage further with more debt to maintain acceptable debt-equity ratios. Equity and debt capital complement each other. **(d) From the investors' perspective**, equities have generated better returns over the long-term over most other asset classes. Hence, they help in long-term wealth creation.

What is required to ensure this initial trend-reversal sustains?

1. Retail needs to time-it-right: Retail are typically laggards and act opposite to the logic of buy low/sell high. They buy when markets are near peaks. Retail cash volumes were high when market valuations reached the upper-end, while it is low when valuations were lower. Even equity funds saw high net inflows when valuations were higher. This impacted their ability to make profits in line with institutions, and built pessimism in terms of future participation.

Despite valuations being lower than 5-Year historical averages during the entire previous fiscal, retail participation picked up only from Apr onwards when valuations moved from 19x to 21x. However, investors should evaluate if the fundamentals are changing during periods of market rise. Only if valuations have outpaced fundamentals, that should be the sole reason to sell.

Retail volumes higher when valuations peaked



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Business Updates:

- MOSL awarded the Best Performing National Financial Advisor – Equity Broker at the UTI-CNBC TV18 Financial Advisor Awards for the 4th year in a row
- MOAMC launched the Focus-35 Fund, whose mandate is to invest across sectors and the market capitalization spectrum. The company has also complied with SEBI's minimum requirement for net worth of Rs 50 cr
- Motilal Oswal Private Equity made the second close of its 2nd real estate fund – India Realty Excellence Fund II (IREF II), raising total commitments of Rs 292 cr till-date
- Aspire Housing Finance received its Certificate of Registration from NHB to commence the business

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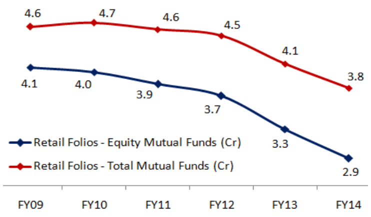
2. Entry of long-term Pension funds: Recently, some global pension funds have made direct investments into Indian equities, rather than just being Limited Partners in PE funds, prominent being Canada's CPPIB, CDPQ, PSP, OTRS. They help add credibility to the long-term India story, which can encourage more retail investors to enter from the long-term perspective. EPFR suggests some India-focused US/Europe funds saw net outflows from India recently, despite FIIs net buying record amounts. Some of those exiting were active-managed long-term funds. In contrast, some of those buying were believed to be shorter-term, tactical funds who wanted to take advantage of the pre-election rally. This might make Indian markets skewed towards the volatilities of short-term money, and pension funds help tilt the scale towards long-term stable money. They also help add counterparties in front of exiting funds, which helps to stabilize the markets. Further long-term money would come when there is an improvement in the fundamentals and RoE in the markets. Even within India, increasing the equity allocation of the EPFO corpus would also help divert long-term money towards equities and add depth.

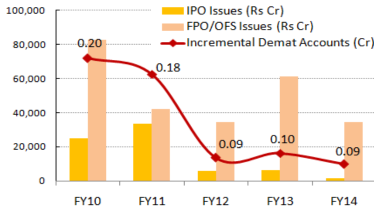
3. Put faith in fund manager's call: This uptick is a time to buy selectively into attractively-valued stocks, and investors should heed to their fund managers' calls. An ironical feature of retail investors has been their reluctance to heed the advice of fund managers, who are qualified professionals, and instead relying on their own judgment. Through the downturn, most fund managers have stressed the need to remain invested in quality stocks. However, many retail equity investors redeemed. Investors should divide their portfolios into trading and investment purposes, and set internal benchmarks for both which should help manage their objectives better.

Retail folios in equity MFs declined sharply



4. Uptick in primary markets: Primary issues have been a popular entry point for retail investors. But the lackluster performance of most issues in recent years dampened interest in future issues. One reason was that many past issues were over-priced, and the recent downturn impacted the performance, and prices, of companies post-listing. Recent news suggests the investors are becoming more choosy and selective when it comes to new issues, having burnt their fingers in the past by going for every issue that hit the market. They are now looking at valuations closely in terms of fair-pricing and stock quality. Companies selling few shares at high prices are finding few takers, and many issues got held up recently due to valuation mismatches.

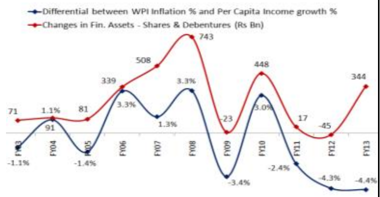
New demat accounts fell as issues sried up



It is good that retail investors are now looking at public issues with more scrutiny. Going forward, if reforms initiation, faster decision-making and policy clarity can spurt capex plans and equity capital raising, that might give an impetus to new retail investors to enter. There are companies who raised debt in recent years when equity markets dried up. They might now opt for public issues to deleverage their balance sheets. Companies in demand would be those who had raised debt to invest into productive real assets, rather than just to fund losses.

5. Turnaround in industry drivers: A sustained pick-up in India's economic performance should bode well for fuelling retail equity investing. Historically, GDP growth helped boost gross savings and household financial savings, which increased at a faster pace during years of high GDP growth. Ability to save is impacted by the differential between inflation and personal income growth. Investments into India's supply-side deficiencies should help inflation move south-wards, thus expanding the differential between inflation and per capita income.

Equity allocation rises with real income

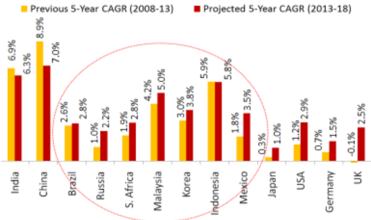


Such periods of high positive differential coincide with an increase in the allocation towards equities. The share of retail participation within financial savings would rise once inflation decreases and disposable incomes increase. Such periods could be the starting point for many new investors into equities, helping deepen participation.

With India's projected GDP growth likely to outpace most large emerging markets, this should bode well for further growth in savings and discretionary allocation to equities.

In terms of further allocations to physical savings: Gold prices were impacted due to import curbs to control the INR. Real estate would remain favorite, though increasing property prices going beyond the reach of investors might be a boon for equities.

Higher projected GDP bodes well for India



6. Making education more niche and action-focused: Specific awareness efforts to stress on merits of direct vs. indirect equity investing, giving precedence to stocks' quality, stock timing, sectors that would benefit from reforms and managing valuation of portfolio vs. market valuation. Eventually, firms have to measure the ROI of their education efforts. For this purpose, simulations, games and challenges can be useful to entice investors to actively participate in the markets. Such active, intuitive and interactive education modes can benefit the firms much more through conversions, as compared to passive training sessions.

Initiatives taken by leading stock exchanges

BSE EXPERIENCE THE NEW presents DSIJ's STOCK MARKET CHALLENGE Where the Best Investors Compete

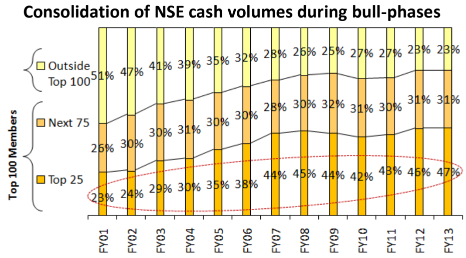
NSE पाठशाला

7. Addressing liquidity challenges: This is a major concern impacting participation. The proportion of genuine long-term investors in India is still small, and enhancing liquidity might induce more participation. Lowering of STT would help make the cost of transaction more attractive inducing future participation and liquidity. While the recent Budget has not addressed this, it remains a area of advocacy by brokers.

How will the larger brokers gain?

NSE cash volumes trends shows large brokers actually increased their share of volumes during bull-periods, unlike popular belief that consolidation occurs during downturns. Large brokers are better equipped to handle higher volumes of trades, without compromising on quality. New participants entering at these times benefit from the advisory that large brokers provide. They can handhold novice investors and help them avoid misinformed decisions. Incremental equity allocation from retail investors during the current market up-cycle should benefit the larger brokers. Reactivation of inactive clients would also help large brokers increase throughput at lower acquisition cost.

Consolidation of NSE cash volumes during bull-phases



Conclusion

While retail interest is showing initial signs of revival, a lot is needed to sustain their interest. Overdependence on FIIs would be a challenge to market stability if monetary policies of those countries reverse. Ultimately, every country needs equity to complement debt capital and support its economic growth. For this, sustaining retail equity interest would be imperative.

It is imperative that retail investors take educated decisions and keep a long-term mentality, and ensure that the current optimism does not run into any irrational exuberance

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