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Behavior of Foreign Institutional Investors in India

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***ABSTRACT-* This study aimed to provide a brief introduction to behavioral finance and this essay is motivated by the new tendencies of research in future. It provides good information's to the foreign institutional investor and their role, trading pattern, movements, behavior in Indian stock markets.**

Keywords -: FII; Investments; Behaviour; Activitie

1. INTRODUCTION

The world has increasingly become one big global market. This is reflected in the tremendous amount of flexibility to available to corporations in deciding on the types of securities that they can issue to fund they investments Locations where they can issue they securities, and also type and locations of their own investments. An important attribute of this global financial architecture is the rise of foreign Institutional investors (FIIs) as major players in the financial markets. The period beginning march 2003 till before the sub-prime crisis began to unfold in august-september 2007, India as other emerging economics, has witnessed a renewed romance of FIIs with emerging markets.

There is an unending and inconclusive debate on the role of FIIs in the local equity markets. One view is that foreign investment – both portfolio and direct varieties can supplement domestic savings and argument domestic investment without increasing the foreign debt of the country. It is argued that capital inflows into the equity market lead to higher stock prices, lower cost of equity capital and encourages investment by Indian firms; foreign investors act as catalysts kindling domestic reforms aimed at improving the market design of the securities markets, and help strengthen corporate governance.

On the flip side, arguments are that FII investments in any country are notoriously volatile. A large outflow of funds due to FII activities can leave behind a crisis situation in thedomestic economy, which threatens to spill over to the rest of the world.,

This crisis was what happened in the East Asian crisis of 1997. Before the crisis period, the East Asian economics attracted a large proportion of the total capital inflows to the developing countries. However, this situation changed around 1997-98 when capital flows reversed, and capital started following out of these economics. The crisis which startedin Thailand spread across assai with falling assets prices, capital flight and consequent financial ink stability. The popular view that emerged in analysis of the crisis was that foreign investors destabilize emerging capital markets and in this case, was partly responsible for the collapse of currencies and stock markets. There is a large amount of iterative dwelling on the issue of "herdingbehavior" and "Positive feedback is trading" by FIIs in emerging economies empirically testing if this kind of behavior is attributable to FIIs and if so, is it destabilizing. We shall review this literature, in detail, later in the paper.

2. INDIAN CONTEXT

India's tryst with FIIs began in 1992, when as part of the series of reforms of s\to liberalize the Indian economy>; FIIs where first allowed to invest in all secretes in both primary and secondary markets, and schemes floated by mutual funds within certain limits. Over the years, with gain in experience, the regulatory regime for FIIs has been liberalized along the lines of expansion of categories of eligible FIIs enhanced limits of investments; expansions of eligible instruments for investments and easier and quicker registration process for trading in Indian markets. The figure

3. RECENT CONCERNS OF FII INVESTMENTS

With the advent of FIIs in Indian markets. The advocates of free into developing countries. As soon, India's were forced to improve the quality of their4 trading and settlement procedures and information environment in accordance with the best practices of the world. However, on the negative side, the same concerns engulfing other emerging markets that of FII investments being "hot money" and destabilizi9ng the economy loom large on Indian policy makers as well. It is these concerns which have made the process of evaluation of regulatory regime for FIIs a piecemeal and cautious.

There have been a number of episodes when the stock markets have witnessed large falls. On such occasions, the activity of the FIIs is closely watched to understand, whether, there is a casual relation between FII activity and market movements of these the incidences of May 2004 and may 2006 stand out. In the month of May 2004, following uncertainties on the constitution and policies of the new government that was to take charge at the centre, the benchmark sensex and nifty by 16% in this month. Since the beginning of May, 2004 there was a trend of FIIs being net sellers in the Indian markets after remaining net buyers for the whole of 2003-04 and in the month april, 2004. FIIs sold

a net of Rs. 3247 crores during the month of may 2004. While the FIIs trend net sellers in this month, the domestic mutual funds were net buyers of Rs. 1005 crores equity.

May 2006 also saw unprecedented fall in market indices following fed rate hike, declining metal prices and weak Asian markets. Also, there were rumors of possible tax on business income of FIIs from trading in securities the month saw 15% decline in sensex and nifty. FIIs were net sellers of equity worth Rs.7354 crores on the other hand, domestic mutual funds net bought Rs.7894 crores equity during the month.

Both these episodes point towards FIIs possibly destabilizing the markets and being the first ones to withdraw their investments in case of any negative news about the host economy. However, from another Pont of views, we can refuse this common notion by saying that like any other investor, FIIs are also in the market to make profits and take their investment decisions keeping in view all the attendants risks of investments. Thus it may perhaps be unfair to put the blame solely on FIIs for episodes such as those mentioned above.

4. WHAT THIS PAPER PROPOSES TO DO?

Having put the current scenario in perspective, this paper looks at the dynamics of foreign institutional investments in the country to see the pattern of their investments and possible cause and effect relationship with returns on the domestic markets. While we took at this pattern of FII flows over the period 2003-2008 more specifically. We look at the year 2008 which saw a huge decline in share prices in the country as also witnessed in stock markets all over the world. One world environment has imparted India hug3ely and all theories of decoupling of financial markets have been disproved. What has been the role of foreign institutional investors in transmitting global sentiments to India is in the interesting question to attempt to answer.

To globe able to answer this question, we empirically examine the trading patterns of institutional investors, focusing in particular on the prevalence of positive –feed back trading among FIIs and on the effect of those flows on level of returns in the domestic markets. More specifically, we

i) Test whether FIIs have lead to a broadening of investor base.
ii) Test if the price-pressure hypothesis holds for India
iii) Test whether FIIs indulge in positive feedback trading.

The paper after this introduction section is organized as follow section reviews the literature on this topic. Section 3 presents the data and methodology we employ in the study and the final section 4 lists out the results of our tests and analysis the same.

5. REVIEW OF LITERATURE

As mentioned in the introduction, following the East Asian crisis, one finds sprawling literature examining the possible causal effect of foreign investments on stock markets of emerging economies and looking at various aspects of their investment patterns.

Clark and Berko (1997) test the “base broadening” hypothesis that foreign inflows are because emerging equity priles to rise-using data from Mexico over the period January 1989 to march 1996. They find a positive contemporaneous relation between equity flows and returns. Further, they show that there is no evidence that foreign investors are positive feedback traders. Stulz et al (1999) examine the impact of foreign investment on stock returns in korea from November 30, 1996 to the end of 1997 using trade data. They find strong evidence of positive feedback trading and herding byi foreign investors before the period of Korea’s economic crisis, during the last three months of 1997. The evidence of herding becomes weaker during the cirisis period and positive feedback trading to foreign investors disappears. They find no evidence the trades by foreign investors had a destabilizing effect on korea’s stock market over the sample period. Kim and Klie (2002) also examine the activity of foreign investors in Korea over the period of December 1996 to June 1998. They find that foreign investors show strong tendencies for herding using the measure for herding using the measure for herding as developed by cakonishok et al (1992) froot et.Al. (2001) explore thebehavior of daily, international portfolio flows into and out of 46 countries from 1994 through 1998. They find that flows are strongly influenced by past returns, so that investor trend following is apparent. They further find the sensitivity of local stock prices to foreign inflows to be positive and determining that transitory inflows impact future returns negatively. Griffin at al (2002) use a theoretical model and empirical analysis with data for nine countries (Including India, Korea, Indonesia, Thailand etc., over the period 1996-2001, to show that foreign investors find past stock prices more informative in predicting future domestic return as compared to domestic investors. They find that foreign investors invest more following high returns in a market and that they react quickly often within one calendar day.

Some of the empirical studies done a data from Indian markets are.

Chakrabarti (2001) reports bi-directional Granger-Causality between net FII inflows and returns on the BSE for the period 1993-1999, with monthly data. However, with daily data for the period January 1999 to December 1999, the paper finds causality running from returns to FII flows. He also looks at other determinants of FII flows into the country and finds, that this collection of domestic and international variables likely to affect. FII flows such as return on world index; change in Indian short term interest rate, return on exchange rate etc. fail to diminish importance of contemporaneousreturns in explaining FII chancing trends and adopting positive feedback trading strategies at the aggregate level on a daily basis. However, there is no evidence of positive feed back trading on a monthly basis.

6. CONCLUSIONS

There is a public perception that the investments by the FIIs are driving the market. However, looking of some numbers as quoted in the paper. FIIs do not seem to behaving any large share in the stock market activity in the country. They contribute the only 18% of total turnover on the national stock exchange and the market capitalization of their holds on the exchange is 15% of the total market capitalization.

With out study, we updated the previous studies on FII investment dynamics in the country capturing the latest trends till Dec. 2008, particular emphasis was on getting an insight in the FII activity following the period starting in Nov. 2007. When the sub-prime crisis was seen to be spreading thought the world.

Over the period of our analysis, 2003-2008, we find two way granger causality between FII flows and stock market retuns. However during the period Nov.2007 to Dec.22008. We find the FII flows do not granger because returns on the nifty. Thus when, the markets were generally in the downward trend following the global financial crisis, FIIs did not seem to be the cause for the same. Or results refuge the common myth that periods of crisis are accentuated generally by FII outflows. An analysis of FII flows and stock market returns sing the framework shows that FIII shows that FII flows are predicted by the previous day's stock returns and are also significantly related to their own past years. Impact of FII inflows on returns lasts only up to one or two days beyond which it is statically insignificant.

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