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CAN AN INITIAL PUBLIC OFFERING (IPO) BE A SAFE HAVEN FOR SMALL INVESTORS TO PARK THEIR HARD-EARNED SAVINGS? IF SO UNDER WHAT CONDITIONS? OR ARE THEY JUST A MEANS FOR THE PROMOTER TO REALIZE THE FRUITS OF HIS ENDEAVOR? : AN IN DEPTH ANALYSIS

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ABSTRACT

The paper has attempted to understand the nuances that the small investor in India faces, and how to overcome the issue within the parameters of the set norms by various regulators. The widening and deepening of the monetary economy in India has further strengthened the regulatory framework. As the economy is growing at a robust rate of approximately 7% per annum the number of middle-class small investors has increased. It is imperative to safeguard their interest at all points in time.

RESEARCH QUESTION: The paper would explore the reasons why a promoter enters into an IPO. An analysis would be attempted to study the avenues available for a small investor, and whether an investment in an IPO is a risk-averse haven. A study would be attempted to understand the role of stock exchange regulators which in the case of India is the Securities and Exchange Board of India (SEBI), to protect the interests of small investors.

1. INTRODUCTION

The main factor that an investor should keep in mind is time. The qualities that are important to evaluate with respect to the asset are:

- Current and projected profitability
- Asset utilization
- Capital structure

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- Earnings momentum and intrinsic value rather than market value
- Risk tolerance levels

Before one starts investing the important rules that one has to keep in mind are:

- If an individual cannot afford to invest as yet then they should not. It is a fact that if a person starts investing early it would definitely give a longer period for the investment to grow but if it is difficult to spare money given a person's fixed commitments then it is better to wait before entering into the investment market.
- Set investment expectations.
- Understand the investment portfolio.
- Diversify investment decisions.
- Try to have a deep understanding of the portfolio keeping in mind the financial aspects of the areas that one has invested in. Keep an objective view of these investments concerning when to continue and when to exit. An individual should never have an emotional attachment to one's investments.
- The three main goals of an investor are (1) safety, (2) income, and (3) capital gains. The factors that affect investment include goals, age, lifestyle, risk appetite, and returns expected.

Figure 1:

Source: Business Venture

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Another aspect that has to be continuously monitored is an estimate of the money required at the time of retirement. For this, it is necessary to calculate the amount that one has to spend each year in retirement and multiply that figure by 25. The expected age of retirement is anywhere between 60 and 65 and adding 25 years to that would make the period between 75 and 80 years. This is the expected time period of longevity that an individual would live given the environment and the circumstantial conditions.

Figure 2: Different stages of an economy entering into a 'financial bubble'

Source: researchgate.net

The above figure indicates the cyclical impact that stock market returns take over a period of time. The small investor is likely to enter this type of portfolio investment, in the upward stage because the mindset of the investor is to earn quick money. The articles and reports in the newspapers mostly tend to indicate that 'this phase will go on forever'. But there is always a downturn caused by both internal and external factors. It is not easy to predict the timing of the downturn.

The small investor should be extremely cautious in his portfolio choice, and not speculate on extremely risky stocks. Here too he should make a judicious decision to stick to Mutual funds (These funds pool assets from shareholders to invest in securities like stocks, bonds, money market instruments, and other assets) and similar comparatively minimal risk-averse portfolios. This would prevent the complete erosion of the value of the portfolio, when and ever the downturn takes place.

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Most research studies show that portfolio returns of small investors were influenced by behavioral biases and familiarity. Consequently, age and experience play an important role as experience can reduce the biases which may arise in judging the type of portfolio that is chosen. Behavioral biases include:

- Overconfidence
- Regret
- Attention deficit
- Trend chasing
- Anchoring
- Loss Aversion
- Herding

Figure 3: Image depicting behavioral biases

Source: [8 Behavioral Biases That May Hurt Your Investments]

At the time of investment, it is assumed that small investors are risk-averse and that most of them prefer higher returns compared to lower returns for the same level of risk. But this is a strange call as there are several behavioral biases that the investors have to deal with. Behavioral finance (based on the psychological law of attention and perception) is a study that analyzes human behavior in making irrational investment decisions and its impact on the financial markets. Ideally, the investor should make a rational investment decision that would improve the

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efficiency of portfolios and would result in sticking with a plan under any type of condition. The behavioral biases can further be divided into:

1. Cognitive errors

2. Emotional biases

The first is due to the inability to process information correctly and the second is related to feelings and impulses which are extremely difficult to correct compared to the first.

Loss aversion is an emotional bias which means that investors feel more pain when selling an investment at a loss than selling an investment at an equal gain. The reason is that the investor holds on to the investment for a long time in the hope of reducing the loss or coming out even. At times those investors making a gain may sell the stock too early to realize their profits and avoid losses. It is this type of bias that increases the risk and reduces the expected returns. Ideally, a buy or sell decision should be based on expected returns and risks. Investors should co-relate the price of the original asset, the dividend earned on that asset, and the price appreciation. At times being emotionally attached to an asset makes one feel that the asset that they own is worth more than what it actually is, which results in the investor not selling it even though it may be a liability to their portfolio.

The fact that these biases are recognized by the investor impels them to hire financial advisors who can then advise on more rational decisions. Ideally, all financial decisions should be rational ones in an efficient market but it is the influence of psychology in the decision-making process via behavioral finance which leads to irrational decision-making.

This was most apparent when financial theories could not explain economic events like the Housing Bubble (2001-2005) in the United States of America. New home buyers (borrowers of sub-prime mortgage financing) displayed overconfidence bias and a strong expectation that rising house values would persist. Their confidence was boosted by rising prices, low borrowing costs, and aggressive lending. Because of the securitization process, the lenders also had excessive confidence in their lending strategies. Moreover, the financial regulators were overconfident in the rising prices of the US home market. This made them fail to recognize the bubble until it was too late. This goes directly against the Efficient Market Hypothesis Theory (EMH) which states that market bubbles cannot exist, arguing that all prices are perfectly efficient and are not undervalued or overvalued. The presence of these biases also explains why investors behave in markets on the opposite spectrum compared to what the technical market points out. This is the reason why overconfidence, herd mentality, and loss aversion are areas that become more prominent than technical factors.

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2. DEFINITION

It is important to understand the areas that a small investor should park his/her hard-earned savings in. The most important criteria are that they should be risk-averse and should grow above the rate of inflation.

2.1 IPO

To understand the investment in an IPO as a rational decision an analysis of the workings of an IPO is an essential aspect.

Figure 4: What is an IPO?

Source: [What is an IPO (Initial Public Offering)? – Napkin Finance]

An IPO or a stock launch is a public offering in which shares of a company are sold to institutional and normal investors. These are typically underwritten by one or more investment banks who then in turn arrange for these shares to be listed on the stock exchange. It essentially means that a company's ownership is transiting from private ownership to public ownership and very often it is referred to as 'going public'.

In India, an IPO is an offer of shares by a company in exchange for capital. The entire process is regulated by SEBI. The main reason for launching an IPO is to raise funds that could be used for:

- Financing a new project
- Repaying loans
- Expansion of the business
- Giving an exit to early investors

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This occurs because the company has increased in size and it requires money. The company which has decided on the IPO could be a new young company or an old company that has decided that they need to be listed on the stock exchange. This could happen, either by issuing new shares or by shareholders selling their existing shares. If the company is offering its shares to the public, it is not obliged to pay the capital to public investors. In this case, the company is known as an issuer.

An investor can normally subscribe to an IPO, by filling out the application form and paying the initial application money for the number of shares that they want to purchase. An IPO is open only for a limited number of days. Once the IPO closes, the shares are listed on the stock exchange for trading. Buyers then can easily buy or sell on the stock exchange at that price.

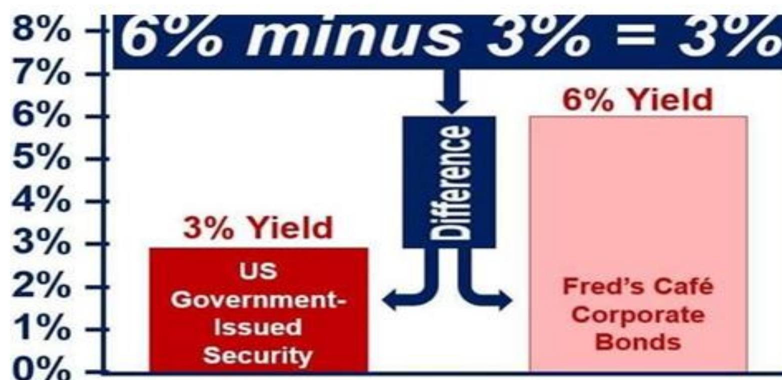
2.2 Risk-Averse Investment

Most investors like returns but do not like risk. But returns cannot be devoid of risks. The returns are directly related to the risk involved. Once the level of risk has been decided, it is possible then to calculate the investment. Most investors have to decide between a risk-return face trade-off.

The return from the investment has two components:

1. Risk-free rate of return: This is the amount that the investment earns which is almost equal to the rate of inflation. This means that such investment maintains its value.
2. Risk Premium: This is the extra interest that the investment earns due to it being risky. The higher the risk the greater the premium.

Figure 5: Depiction of a risk-free vs risk premium investment



Source: Google image.

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2.3 Small Investor

Small investors usually look at three factors while investing:

- Safety
- Income
- Capital Growth

Due to this Mutual Funds become the safest avenue for small investors. They have minimal risk compared to investing in the share market because they are operated by professional money managers. Alternatively, the share market includes IPOs, which may be overvalued with respect to the issue price versus the price that they open at the stock exchange. This price may be greater than or less than the issue price. Thus, there is a greater element of risk that is involved in the case of an IPO.

3. Avenues of Investment Available for the Small Investor

Risk-averse small investors have limited options available for investment in India. These are normally the following:

- Mutual Funds
- Fixed Deposits
- Recurring Deposits
- Public Provident Funds
- Employee Provident Funds
- National Pension Scheme
- SIP (Systematic Investment Plan)

All of the above are extremely safe investments for risk-averse small investors. The aim of these investments primarily is to safeguard the depreciation of money due to inflation reasons.

4. Portfolio Investment with reference to the small investor

Small investor decisions are primarily concerned with choices surrounding the purchase of a small number of securities for self-use. For this choice to be made the information structure of

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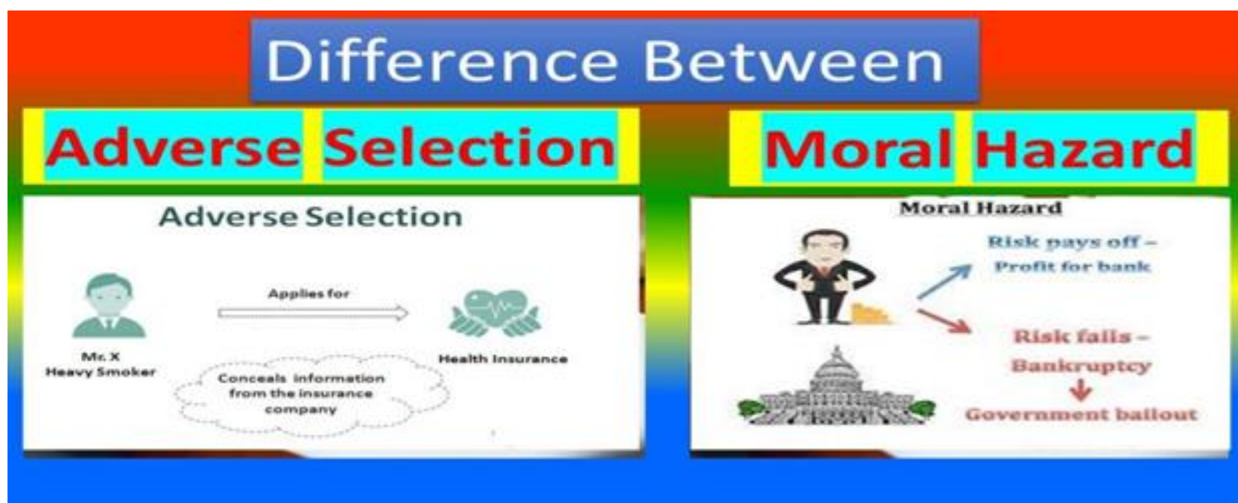
the system needs to be robust. There should be minimal chances for a 'moral hazard' or 'adverse selection' type of situation to set in. An incorrect choice occurs normally when there is asymmetric information before a choice between the buyer and the seller. In this case, if the small investor has scanty information, his/her choice of investment may likely go wrong. It is equally possible that the company or the investment brokers that they are dealing with have not entered into the contract in good faith or they are intentionally hiding some important facts. This in turn leads to a 'moral hazard' type of situation. These terms are commonly encountered in risk management, especially so when the buyer is a small risk-averse investor.

Figure 6: Adverse Selection and Moral Hazard



Source: Google image

The important factors that have to be kept in mind while making investment decisions are:

Patience, returns on investment take a long time to grow to the levels that are anticipated by the small investor.

Time Horizon, is an extremely important milestone that has to be considered. These could be in the form of children's education, buying a home, retirement planning, etc. Under this are various options that could save tax, and provide more efficient tax alternatives.

Compounding, it is an extremely important aspect of wealth creation. Warren Buffet has said, "My wealth has come from a combination of living in America, some lucky genes, and compound interest". Starting early can provide better benefits from compounding. Every time that a market fluctuates, crashes, or surges there lies an opportunity.

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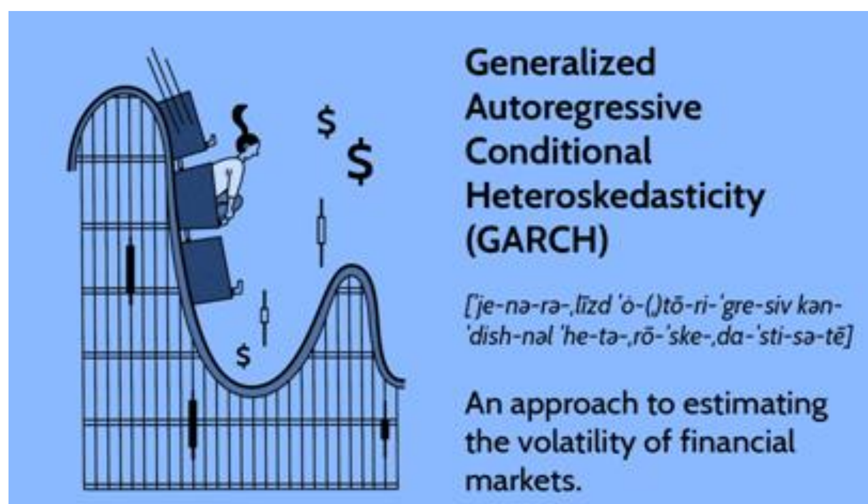
Evaluation of risk-taking capacity involves long-term and short-term investment goals, investment tenure, age, expenses, family status, and current responsibilities before deciding on a portfolio.

Analyzing investment options, for this to be relevant a thorough analysis of market conditions are essential. A Financial advisor's services are important to achieve this goal. The advisor would also be in a position to devise the right investment strategy, which requires a diversified portfolio that minimizes risks and maximizes returns. A lot of research by the advisor goes into studying the diversification of investment. Mutual funds for example research immensely in optimizing portfolios. Also, Detailed documentation is extremely important for auditing reasons.

5. GARCH model as an explanation for small investors

The Generalized Autoregressive Conditional Heteroskedasticity (GARCH) model is one format that could be used to predict the level of volatility in financial markets at a given point in time. It is usually used by financial organizations to determine how volatile returns on stocks, bonds, and market indices will be. It also indicates the proportion of risky versus risk-free assets, which is adjusted on whether the predicted volatility value is higher or lower than the target value. The model assumes homoskedasticity. This means that the model is assuming homogeneity of variances, [an assumption of equal or similar variances in different groups that are being compared]. This is an important assumption for any statistical test as they are sensitive to any dissimilarities. Uneven variances in samples result in biased and skewed test results.

Figure 6: Simple introduction to the GARCH model



Source: investopedia.com

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$$\sigma_t^2 = w + \alpha\varepsilon_{t-1}^2 + \beta\sigma_{t-1}^2$$

The GARCH model is given by the above given equation where σ is the variance. The coefficient α indicates the reaction of volatility to the unexpected return or shocks, whereas, the coefficient β shows the persistence of the volatility, i.e. how long the volatility would take to revert back to long-run volatility {ω / (1 – α – β)}. $\boldsymbol{t}$ stands for the current time period and $\boldsymbol{t-1}$ stands for the previous time period. For this model it is mostly assumed that $(\alpha + \beta) < 1$.

Every stock has distinct risks related to its particular operations or industry, and these risks are reflected in the ups and downs of stock prices. Each stock or asset must be examined using a model that accurately tracks the risks and degree of price variation intrinsic to that specific stock due to the significant risk associated with investing in the stock market. The GARCH model can quantify and anticipate the risk associated with all facets of finance by precisely capturing volatility. The goal of risk management is to reduce the likelihood of poor performance while assisting a portfolio or investment in achieving a particular level of performance.

6. Conclusion and the way ahead

For small investors, savings are their most important invaluable wealth. Most Indians have this fetish to save. But these have to be nurtured in a manner that they grow and are available for all sorts of requirements in the future. Surveys have indicated that the youth, both Indian men and women have an increased capacity to take risks. The whole concept of getting rich ‘fast’ has taken on a great precedent over being cautious. It is in this context that the GARCH model could be applied, indicating that if an investor entered the market during its upturn the tendency to take risks increases. The small investor has to be careful about these bubbles as in most cases a lot of information is asymmetric eventually leading to making adverse selection and resulting in a moral hazard. Globalization and Industrialisation have brought the world closer in every which way, to the extent that there are a large number of Indians who have invested in cryptocurrencies. This requires a lot of courage but as the younger generation is ‘risk loving’, this then becomes a viable option.

It is the older generation, who are very concerned with the valuation of their savings, for whom the Government has put in place an increasing number of options. The size of this portfolio is ever-increasing with the widening and deepening of the money market. The Government of India does not have the bandwidth to provide social security to all its citizens; thus, all its people have to fend for themselves. The Government with its limited resources, and catering to a huge populous economy, has been able to put effective watchdogs in place such that at least the real earnings of the small investor remain intact.

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To prevent unfair advantage to the large middle class of the country, the stock exchanges in India, have the Securities and Exchange Board of India (SEBI), which prevents any bias against the small investor.

In the recent past, it was noticed that the valuation of the IPOs that were being listed was overvalued. This led to an inquiry and resulted in a reworking of the valuation of various firms, and tightening of various financials, making it more secure for the small investor.

Besides this, the Government's thrust on mutual funds, clearly states the advantages and disadvantages of various schemes, which has helped in the growth of these alternative saving methods, which are less risky and ensure the protection of small investors.

Greater efforts on widening and deepening the Indian money market will go a long way in protecting the small investor. Instituting more independent regulators will help in stemming the extent of fraud that attempts to cheat the system. The paramount interest of all stakeholders should be to safeguard the interest of the small investor.

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