Growing Retail Investor Base in India- Opportunities & Challenges

Shachindra Nath
Group CEO
Religare Enterprises Ltd.

Indian capital markets have attracted a lot of attention across the globe. Besides the growth witnessed by the market over the last decade, returns generated have attracted huge inflows of capital both domestic and foreign. While this has facilitated depth in the market it has also made it vulnerable to global dynamics. One key participant in this growth story has been the active membership by India's retail investors. Retail investor appetite for investment in market directly or indirectly has grown rapidly over the last few years. Even in the 2008-09, which was the year of anomalies, household allocation of their financial savings to direct equity remained the same as in 2007-08, that is showed no decline relative to the year that observed the peak in the markets. Interestingly, it was mutual funds that experienced a withdrawal effect to the tune of Rs 10,478 cr approx in the same time period. However, in spite of a growing appetite a lot has been left wanting of retail investors. Retail investor penetration in India is still very low compared to any developed or developing markets. This fact holds special importance when seen in the light of the fact that less than 1% of India's population invests in equities. More so, less than 3% of total household savings makes it to equities & debentures.

Besides limited retail penetration the markets currently seem to be suffering from waning retail interest and engagement. This has sparked various rounds of discussions in multiple forums, with all trying to ascertain the next logical step to address this problem. Retail participation is an important excerpt in the story of India's growth and now would be the right time to expand access and insert confidence to get the masses rolling once more and this time in larger droves.

Sleeping Giant – Retail capital opportunity waiting to be tapped

Today, India has one of the highest savings rate in the world. In 2008, India household's net savings as a percentage of personal disposable income was ~32% compared to China's 22%, 12% in France, 11% in Germany and 2% in USA & UK. However, as per a recent McKinsey analysis, total equities investments by households in India as on 2008 (based on stock analysis) was approx. 19% compared to 47% in US, 37% in UK and 30% in Brazil.

In the last five years, Rs. 978 bn has been mobilized for IPO's with FY 08 recording the peak at Rs 425 bn. Retail participation hovers at the 50% mark, making that Rs 212.5 bn at peak, which amounted to only 6% of the total Household savings lying in deposits in FY 08 (Rs. 3,740 bn). Net investment by FII's in the same time period was Rs. 661 bn. For FY09 which was an anomaly, the net FII outflow was Rs 458 bn while household deposits for the same time period were Rs. 4,367 bn. The numbers while a little overwhelming, indicate clearly our over-reliance on foreign capital flows and the systemic risk they pose towards capital markets price movements. The real opportunity for India lies in the mobilizing retail investors towards shifting the flows out of deposits into the capital markets to ensure sufficient liquidity and mitigate risk of foreign outflows, each time a foreign country faces turbulence. This is likely to further facilitate reverse capital flows as India emerges as a safer bet rather than always suffering from the liquidity withdrawal syndrome. Markets suffer from the theory of self fulfilling prophecy and India's large underutilized deposits offer a tremendous opportunity to take control of our domestic capital flows and ensure that their introduction in the capital markets can provide stability and reduced dependence on foreign capital

Before we address the possible solutions it would be imperative to examine the reasons around the absence or rather hesitance of the retail investor that pose significant challenge.

Lower risk appetite & guaranteed returns- Much of the slim participation of retail investors can be attributed to the traditional mindset of investors where one would take minimum risks and secure guaranteed decent returns. ~78% of the Household financial savings in FY09 was allocated towards Deposits & Insurance (Deposit- 58% and Insurance 20%). This share has only been increasing over the last 3 years with 61% in FY06; 66% in FY07 and 69% in FY08. In FY09, with the onset of the economic crisis, there was a massive redemption in the retail AuM to the tune of Rs 10,478 cr, while the direct equity investments were positive by Rs 32,119 cr.

Lack of distribution reach in the smaller cities- Retail equity turnover dominates the total equity trading turnover, contributing nearly 55% of the total turnover. However, if we look at the city-wise contribution, four cities, Mumbai, Delhi, Ahmadabad and Kolkata, account for 85% of the cash trading (as reported by NSE for Cash Turnover Data). Considering the limited contribution of the other 350 urban locations that itself presents a huge opportunity to deepen the investor base in India.

Limited Investment Products- Indian bond market penetration remains very low and the market is dominated

by government bonds. In the absence of any liquid bond trading market, the retail participation is close to negligible. Further absence of a well developed structured product & non- equity based derivative market limits the investment options for retail investors.

Low Awareness & Confidence- As per data released by IIMS Data works, the low take up of retail mutual fund investment opportunities in India has as much and more to do with low awareness levels among smaller retail investors as it does issues of risk appetites. Further, if we look at the contribution of Tier II & III cities in the mutual funds, it is close to ~20%.

Short Term Horizon - Also, the investment patterns of retail investors seem to be oriented towards the short term rather than the longer term and a drift in these patterns can also be an opportunity in disguise. In a recent publication by AMFI, it claimed that number of retail investors holding equity mutual funds for more than 24 months witnessed substantial improvement. Of the total retail investors, 62.5 per cent preferred to hold on to their MF investment for a longer period in stark contrast to 46 per cent reported in March 2009. However, this was on account of the fall in churn ratio, following the ban on entry load coupled with the timing of most of the investments to be around the peak in 2007, with investors holding out waiting for recovery or higher returns. This is further validated by the number of account closures. In the last one year MF investors closed 775,980 folios (accounts), of this retail investors accounted for 612,694 folios. According to the March report, retail investors folios stood at 40,293,410 compared with 40,906,104 folios reported in March 2009.

Regulatory Conflicts- The recent regulatory conflicts between the regulators on different issues (for e.g. Ulips) have further created confusion in the mind of retail investors and has further reduced the appetite to make fresh investments in those products

In light of these issues we need a two pronged approach to improve both the levels of penetration and participation. The suggested two pronged approach can be split into building 'Access' and improving 'Confidence'.

ACCESS

Introducing newer products & services

Currently the products available are plain vanilla with limited breadth on factors such as risk and return. In most developed countries products such **ETF's** have garnered sufficient interest among the retail community. US ETF market is the largest in the world with 721 products and $631 billion of assets, although Europe has a greater breadth of products with 783 products totalling $ 204 billion in assets. Commodity based ETF's enjoy considerable popularity in this category. In India however, Gold ETF's account for only 1% of the total (physical & ETFs) gold volumes traded and ETF's are not allowed under any other commodity. Expanding the range of ETF led products and perhaps launch of Exchange-traded interest rates and currency futures could also be of possible interest.

Reducing the lot size of **derivatives contracts** on S&P CNX Nifty & other stock futures to attract greater participation from retail investors could also be an interesting route.

Further, globally, there are over 1.5 million individual **structured product offerings** listed from over 1,200 companies, dating back to 1995. These products in total represent sales of over $1.6 trillion. In India the structured products market is simple and often limited to nifty linked debentures. Encouraging development of a structured product market to offer customized products to retail customers can be another access point.

Developing a **REIT market** to allow retail investors to take indirect exposure in the real estate market can provide a limited risk option. Till now in India, only venture funds have been offering real estate funds available largely to high net worth individuals and institutional and global investors due to the minimum investment size restriction.

Indian public has always had an interesting fascination for PSU's. These companies have always been viewed to be strategically positioned and largely safe bets. This is evident by the number of PSU schemes launched in recent months by AMC's and the response received. Some of the key PSU fund schemes launched in the last 18 months include big names such as SBI PSU Fund (Targeting ~Rs 1000cr), Sundaram BNP Paribas PSU Opportunities Fund (Rs ~310cr), Religare PSU Fund (Rs 230cr). Debt funds too joined the fray with the Baroda Pioneer PSU Bond and the ICICI Prudential Banking and PSU Debt fund raked in an additional Rs.39.28 cr. Expediting the **PSU divestment plan** coupled with offering retail investment products to take exposure in this plan will provide a tremendous opportunity for expanding both access and confidence. The Govt. is looking at raising Rs. 450-657 billion from the divestment plans in more than 30 PSUs over the next few years. The pipeline includes prestigious projects such as ONGC, MMTC, SAIL etc.

Building a vibrant secondary debt market-

India's value of outstanding corporate bonds as a percentage of GDP was 1.4% in 2009 compared to 99% in France, 45% in Spain, 20% in USA and 7% in China. This is indicative of the limited dependence of Indian corporate on the bond market as a source of debt capital. Most of the bonds issuances are carried out by the Government and both Government and Corporate issuances are subscribed largely by Institutions through private placements (*Total Debt private placement to Institutions in FY09 at $36 bn only with approx. 1000 issuances*), hence retail Investors have not been able to contribute in this area. Further, lack of any developed bond trading market (*Average Monthly trading of Indian bonds in NSE at ~$7 bn only*) restricts the ability of retail investors to participate in the Indian debt capital market. There is strong room for retail investors to participate in this space, if the regulators can focus on debt market reforms and promote a bond exchange in India

Focus towards regulatory reforms-

Encouraging Application supported by blocked amount (ASBA) introduced as a payment mode for retail investors, so that they can participate in the capital markets without any process inefficiency

Encourage retail participation in the Private Equity/ Venture Capital space by reducing the minimum ticket size to enter this market (Currently No venture capital fund can accept any investment from any investor which is less than five lakh rupees)

Building stronger online & mobile technology to expand distribution-

Increasing Internet penetration in India has resulted in significant growth in online turnover for both Cash and F&O Markets and increasing share of online trading to nearly 20% of total trading in 2009. However this is still considerably lower than markets like the Philippines where 55-60% of retail trades are done online.

There is an urgent need of building stronger online & mobile technology platforms to expand distribution reach in Tier II & III cities, where bulk of retail investors reside and have limited access to financial services offering

A reduction in the complexity and cost of opening dematerialised accounts to encourage people beyond the top-10 centres to invest directly in equities will also encourage greater participation from the retail investors

CONFIDENCE

"Financial Stability" in the market can be facilitated by encouraging Institutional players such as Insurance, Pension Funds, and Sovereign Funds to be long term investors in the markets.

In 2008 only 2% of Indian pension-fund assets were in equities, versus 40% in developed markets and 20%plus in emerging markets

Currently 80-90% of the total Domestic Institutional Investments in India are channelized through Insurance Cos and Pension Funds. However, regulations restricts these Institutions to take any significant exposure in the equity market (Regulations restricts Capital Markets exposure of Insurance Cos at ~20% of the controlled fund; Non Govt. provident funds guidelines allow investments of 5% in equities and another 10% in equity linked mutual funds, which is very low**).** There is a need to possibly re-visit some of these regulations and find ways to build financial stability in the market through greater exposure by these Institutions

Allowing effective allocation of cash flows from the **PSU Treasury in the equity markets.** Most of the leading Public Sector Undertakings are carrying substantial reserves in their balance sheet, which has been kept utilized. Regulatory reforms could allow channelizing of these funds into the Indian capital markets and create further stability and long term prospect for the investors

Setting up a **Sovereign Wealth Fund for India could be an important channel to invest in the local market to bring financial stability.** As on date, India doesn't have a SWF unlike most of the emerging economies. SWFs are only one of the many channels through which government deploy their financial assets. The funding of SWFs comes from various sources, which varies from current account surpluses from export of oil and other commodities or manufactured goods, fiscal surpluses, public savings, privatization receipts or pension reserves. Around 45% of SWFs came from oil rich countries in the Middle East while, Asia followed with a third of the total with most funds there originating from excess of official foreign exchange reserves. 70-75% of the total SWF assets ($3.8 trillion as on 2009) are held by funds in Middle East & Asia.

Reducing the market volatility by restricting the role of FIIs in the market, who have the ability to create turbulence in a downturn. FIIs are important sources of foreign capital with net investments in FY10 (April-Jan'10) at $22 billion. 85-90% of their investments are in equities. Significant chunk of their investments are speculative in nature and termed as "hot money", which can exit the market in downturn situation leading to high market volatility

Building "Investor awareness & confidence" Increased investor education and awareness in semi-urban centers, e.g., investor camps in key centers, nation-wide programs with a focus on ethical selling practices by financial services companies. According to a financial industry survey, Indian consumers show some weakness in the level of knowledge of financial products. 90 per cent of working Indians with cash incomes were unaware of a mutual fund as a vehicle of investment and less than 5 per cent could give an accurate description of the mutual fund concept. Just 59% of the population is estimated to have a deposit account, whereas more than 80 percent of the agricultural workforce is still unbanked. 91% of insurance customers only have a traditional life insurance endowment plan.

Faster resolution of **investor grievances.** No. of Investor Grievances by retail investors at NSE increased by 14% in FY10 to 5919. However, 20% of the complaints are still pending with Exchange/Arbitrators, hence calls for corrective actions by the Regulator

And last but not the least **reducing regulatory conflicts** can prevent systemic confusion in markets and uncertainty marked by weak investor sentiment.

To reiterate the retail investor will play an important part in the India's growth story. The retail sentiment over the last couple of months has been weak and it will be a challenge to restore it if we were to continue to function as is. With rising global uncertainty and the world looking to India and China as the two most promising states, which are likely to pull the global economy up, retail engagement in capital markets needs to be a crucial item on both the government and private sector's list of things to do. A collaborative approach will be an ideal thrust to tap the untapped savings of the household sector and put them to more productive uses such as capital formation facilitated through the financial markets.