INTRODUCTION TO EQUITIES

Equity is a share in the ownership of a company. It represents a claim on the company's assets and earnings. As you acquire more equity, your ownership stake in the company becomes greater. Whether you say shares, equity, or stock, it all means the same thing. There are two main types of stock: common stock and preferred stock.

Common stock is, as the name suggests, common. When people talk about stocks in general they are most likely referring to this type. Common shares represent ownership in a company and a claim (dividends) on a portion of profits. Investors get one vote per share to elect the board members, who oversee the major decisions made by management. Over the long term, common stock, by means of capital growth, yields higher returns than almost every other investment. The higher return comes at a cost since common stocks entail the most risk. If a company goes bankrupt and liquidates, the common shareholders will not receive money until the creditors, bondholders, and preferred shareholders are paid.

Preferred stock represents some degree of ownership in a company but usually does not come with the same voting rights (This may vary depending on the company). With preferred shares, investors are usually guaranteed a fixed dividend forever. This is different than common stock which has variable dividends that are never guaranteed. Another advantage is that in the event of liquidation preferred shareholders are paid off before the common shareholder (but still after debt holders). Preferred stock may also be callable and/or convertible, meaning that the company has the option to purchase the shares from shareholders at anytime for any reason (usually for a premium) or that the shares can be converted into common stock after a certain time period.

Characteristics of an efficient stock market:

- Timely and accurate information on the price and volume of past transactions and on prevailing supply and demand.
- Liquidity, meaning that an asset can be sold or bought quickly at a price close to the price of the previous transaction assuming no new information has been received.
- Low transaction cost, meaning that all aspects of the transaction entail low cost, including the cost of reaching the market, the actual brokerage cost involved in the transaction and cost of transferring the security.
- Quick adjustment of prices of securities to new information.

Most stocks are traded on exchanges which are places where buyers and sellers meet and decide on a price. Some exchanges are physical locations where transactions are carried out on a trading floor. The other type of exchange is a virtual kind, composed of a network of computers where trades are made electronically. The purpose of a stock market is to facilitate the exchange of securities between buyers and sellers, thus reducing the risks of investing.

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Classification of Different Equity Markets:

Primary Market

- Covers new public issues of all categories of securities, including Government securities (G-sec), bonds, debentures, equity and preference capital by GOI, PSUs, banks & financial institutions (FIs).
- It is also called the market for public issues.
- This market refers to the raising of new capital (debt and equity shares through initial public offer – IPO, follow-on public offer, rights issue), preference shares, and debentures by corporations.
- Newly floated companies or existing companies may tap the equity market by offering public issues.
- Primary issuance can be through exchanges or private placement route (E.g. private placement of corporate bonds)

Secondary Market

- This market deals with securities of all types that have already been issued.
- Transactions in the secondary market are carried out through one of the authorized stock exchanges, where the traded security is listed.
- Transactions can also be private between interested sellers and buyers.
- The main function of the secondary market is to provide liquidity to the listed securities by enabling a holder to easily convert securities into cash through the stock exchanges.
- The secondary market also acts as an important indicator of the investment climate in the economy.
- It also assists in price discovery & assessing investor's sentiments.

Types of Issues

Primary market Issues can be classified into four types.

- Initial Public Offer
- Follow on Offer
- Rights Issue
- Preferential Issue

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Initial Public Offer (IPO)

An Initial Public Offering (IPO) is the first sale of stock by a private company to the public. When an unlisted company makes either a fresh issue of securities or an offer for sale of its existing securities or both, for the first time to the public, the issue is called as an Initial Public Offer. IPOs are often issued by smaller, younger companies seeking capital to expand, but can also be done by large privately-owned companies looking to become publicly traded.

Follow on Public Offer (FPO)

It is an offering of additional shares after a company has had an initial public offering. When a company which is already listed makes either a fresh issue of securities to the public or an offer for sale of existing shares to the public, through an offer document, it is referred to as FPO.

Rights Issue

A company implementing a rights issue is offering additional and/or new shares but only to already existing shareholders. The existing shareholders are given the right to purchase or receive these shares before they are offered to the public. A rights issue regularly takes place in the form of a stock split, and can indicate that existing shareholders are being offered a chance to take advantage of a promising new development.

Preferential issue

Preferential issue is an issue of fresh shares or convertible debentures allotted to a select set of people, whether promoters, their relatives, or institutional investors. One could call it a wholesale equity market since the retail investors or shareholders are not invited to participate. The issue is currently governed under Section 81 of the Companies Act, 1956, that is neither a rights issue nor a public issue.

The National Stock Exchange of India Limited

The National Stock Exchange of India Limited (NSE) was created as a result of the report of the High Powered Study Group on Establishment of New Stock Exchanges, which recommended promotion of a National Stock Exchange by financial institutions (FIs) to provide access to investors from all across the country on an equal footing. Based on the recommendations, NSE was promoted by leading Financial Institutions at the behest of the Government of India and was incorporated in November 1992 as a tax-paying company unlike other stock exchanges in the country. The market capitalization of the capital markets (equities) segment of the NSE as of March 31, 2006 was approximately Rs. 28.13 trillion or approximately $632 billion. NSE manages 99% of all equity futures and options investments. The clearing and settlement operation of the NSE is managed by its wholly-owned subsidiary, the National Securities Clearing Corporation Limited. Funds settlement takes place through designated clearing banks. The National Securities Clearing Corporation Limited interfaces with the depositaries on one hand and the clearing banks on the other to provide delivery versus payment settlement for depositary-enabled trades.

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Bombay Stock Exchange Limited:

Bombay Stock Exchange Limited (BSE) is the oldest stock exchange in Asia with a rich heritage. It was established as "The Native Share & Stock Brokers Association" in 1875. It is the first stock exchange in the country to obtain permanent recognition in 1956 from the Government of India under the Securities Contracts (Regulation) Act, 1956. The estimated aggregate market capitalization of stocks trading on the BSE as of March 31, 2006 was approximately Rs. 30.22 trillion or approximately $679 billion. The BSE began allowing online trading in May 1995. As of March 31, 2006, BSE had 874 members, comprising of 180 individual members, 675 Indian companies and 19 foreign institutional investors.

Trading on both the NSE and the BSE occurs Monday through Friday, between 9:55 a.m. and 3:30 p.m. (Indian Standard Time).

Regulatory Body

The Securities and Exchange Board of India (SEBI) is an autonomous and statutory body that acts as a market regulator and market developer. It regulates and controls the Indian capital market. SEBI was formed with the prime objective of protecting the interests of investors in securities, promoting the development of, and regulating, the securities market and for matters connected therewith or incidental thereto.

SEBI's function is to ensure that:

- Capital markets function efficiently, transparently and economically in the better interests of both the issuers and the investors.
- Promoters should be able to raise funds at a relatively low cost.
- Investors must be protected from unethical practices and their rights must be safeguarded.
- There is a steady flow of savings into the market.
- There is proper regulation, code of conduct and fair practice by intermediaries to make them competitive and professional.

SEBI initiatives:

- Introducing exchange traded interest rate derivatives.
- Promoting an index to comprehensively reflect the level of corporate governance.
- Setting up a central listing authority to dynamise listing requirements.
- Facilitating demutualization of stock exchanges.
- Building a cadre of securities market professionals through training and certification.
- Constructing a central registry of securities market participants and professionals.
- Rationalizing margin trading, securities lending and short selling.
- Promoting secondary market for corporate debt securities.

Determinants of Stock Price

At the most fundamental level, supply and demand in the market determines stock price. Price times the number of shares outstanding (market capitalization) is the value of a company; however, comparing just the share price of two companies is meaningless. Theoretically, earnings are what affect investors' valuation of a company, but there are other indicators that investors use to predict stock price (Remember, it is investors' sentiments, attitudes, and expectations that ultimately affect stock prices). There are many theories that try to explain the way stock prices move the way they do but, unfortunately, there is no one theory that can explain everything. Technical analysis and fundamental analysis are just two of the ways that people use to predict price movements, and they are further explained in our research section separately.

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Stock Split

Companies often split their stock when they believe the price of their stock exceeds the amount smaller individual investors would be willing to pay for that stock. By reducing the price of the stock, companies try to make their stock more affordable to these investors. As the name implies, a stock split divides each of the outstanding shares of a company, thereby lowering the price per share - the market will adjust the price on the day the action is implemented. A stock split, however, is a non-event, meaning that it does not affect a company's equity, or its market capitalization. As only the number of shares outstanding change; thus, a stock split does not directly change the value or net assets of a company.

A company announcing a 2-for-1 (2:1) stock split, for example, will distribute an additional share for every one outstanding share, so the total shares outstanding will double. If the company had 50 shares outstanding, it will have 100 (50*2/1) after the stock split. At the same time, because the value of the company and its shares did not change, the price per share will drop by half. So if the pre-split price was 100 per share, the new price will be 50 (100*1/2) per share.

The result of the 2-for-1 stock split is two-fold: (1) the drop in share price will make the stock more attractive to a wider pool of investors, and (2) the increase in available shares outstanding on the stock exchange will make the stock more available to interested buyers.

Example
The face value of a company XYZ's shares may be Rs.100. The company may want to change the face value. So it will take one share of Rs 100 and make it two (2:1 split). So now, the face value of each share is Rs.50. If you owned one share, you will now own two. So, basically, the numbers of shares have increased. But the number of shareholders is the same.

Ratios of 2-for-1, 3-for-1, and 3-for-2 splits are the most common, but any ratio is possible. Splits of 4-for-3, 5-for-2, and 5-for-4 are used, though less frequently. 3-for-2 stock split entitles to receive one additional share for every two shares held on that date. (If due to the stock split there are additional shares in decimals, then those shares can be cash settled by the company)

Example
Suppose you own 100 shares of XYZ prior to the split with a market price of 45 per share, for a total value of 4,500. As a result of the 3-for-2 stock split, you would receive an additional 50 shares (one share for every two shares held). So, after the split, you would own 150 shares. The total value of the company does not change Therefore, the post-split value of XYZ would adjust and become 30/share instead of 45/share.

Reverse Stock Splits
A reverse stock split reduces the number of shares and increases the share price proportionately. For example, if you own 10,000 shares of a company and it declares a one for ten reverse split, you will own a total of 1,000 shares after the split. A reverse stock split has no affect on the value of what shareholders own. Companies often reverse split their stock when they believe the price of their stock is too low to attract investors to buy their stock. Some reverse stock splits cause small shareholders to be "cashed out" so that they no longer own the company's shares.

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Allotment of the additional shares
The company announces the split ratio on a particular date called the record date. All shareholders whose names appear on the company's records as on the record date will be eligible for the additional shares.

Difference between Stock Split and Bonus
A stock split is somewhat like a bonus - in that when a Rs 10 stock is split into two Rs 5 shares, the number of shares you hold doubles at no cost to you. But that is where the similarity ends as a bonus is a free additional share. A stock split is the same share split into two. In a stock split, the number of shares increases but the face value drops. The face value never changes for a bonus shares. So a stock split is just a technical change in the face value of the stock. There is no other change in the company.

Example
Bonus shares are issued in a certain proportion to the existing holding. So, a 2 for 1 bonus would mean you get two additional shares free of cost for the one share you hold in the company. If you hold 100 shares of a company and a 2:1 bonus offer is declared, you get 200 shares free. That means your total holding of shares in that company will now be 300 instead of 100 at no cost to you.

Dividends

There are two types of dividends a company can issue: **cash** and **stock dividends**. Typically only one or the other is issued at a specific period of time (either quarterly, bi-annually or yearly) but both may occur simultaneously. When a dividend is declared and issued, the equity of a company is affected because the distributable equity (retained earnings and/or paid-in capital) is reduced. A cash dividend is straightforward. For each share owned, a certain amount of money is distributed to each shareholder. Thus, if an investor owns 100 shares and the cash dividend is 0.50 per share, the owner will receive 50 in total. A stock dividend also comes from distributable equity but in the form of stock instead of cash. A stock dividend of 10%, for example, means that for every 10 shares owned, the shareholder receives an additional share.

Market capitalization

It refers to the value of a company, that is, the market value of its outstanding shares. This figure is found by taking the stock price and multiplying it by the total number of shares outstanding. For example, if XYZ was trading at Rs.20 per share and had 1 million shares outstanding, then the market capitalization would be Rs.20 million (Rs.20 x 1 million shares).

- **Mega cap:** This group includes companies that have a market cap of $200 billion and greater. They are the largest publicly traded companies and include names such as Google, Microsoft, Wal-Mart, and General Electric. Not many companies will fit in this category, and those that do are typically the leaders of their industry.
- **Big/large cap*:*** These companies have a market cap between $10-$200 billion. Many well-known companies fall into this category, which includes names like Yahoo, IBM, Infosys, L&T and Citigroup. Typically, large-cap stocks are considered to be relatively stable and secure. Both mega and large cap stocks are often referred to as blue chips.
- **Mid cap*:*** Ranging from $2 billion to $10 billion, this group of companies is considered to be more volatile than the large and mega-cap companies such as Zee news, Power finance cooperation, Cairn energy etc. Growth stocks represent a significant portion of the mid caps. Some of the companies might not be industry leaders, but they are well on their way to becoming one.
- **Small cap*:*** Typically new or relatively young companies, small caps have a market cap between $300 million to $2 billion such as Arvind mills, Bellary steel, Nagarjuna fertilizer, Auto lite, etc. Although their track records won't be as lengthy as that of the mid to mega caps, small caps do present the possibility of greater capital appreciation - but at the cost of greater risk.
- **Micro cap*:*** Mainly consisting of penny stocks, this category denotes market capitalizations between $50 million to $300 million fall into this category, example: Silver line, IQMS software, etc. The upward potential of these companies is similar to the downside potential, so they do not offer the safest investment, and a great deal of research should be done before entering into such a position.

Index

An index is a statistical measure of the changes in a portfolio of stocks representing a portion of the overall market. An Index is a number used to represent the changes in a set of values between a base time period and another time period. Stock index represents a change in the value of a set of stocks, which constitute the index, over a base year. Any index is an average of its constituents. For example, the BSE Sensex is a weighted average of prices of 30 select stocks and S&P CNX Nifty is a weighted average of prices of 50 select stocks, where the weight is the market capitalization of individual stocks.

Popular Indian Stock Indices:

BSE SENSEX (also known as the BSE 30 index) is a value-weighted index composed of thirty stocks. The set of companies which make up the index has been changed only a few times in the last twenty years. These companies account for around one-fifth of the market capitalization of the BSE.

S&P CNX Nifty (nicknamed **Nifty 50** or simply **Nifty**) is the leading index for large companies on the National Stock Exchange of India. S&P CNX Nifty is a well diversified 50 stock index accounting for 22 sectors of the economy. It is used for a variety of purposes such as benchmarking fund portfolios, index based derivatives and index funds.

CNX Nifty Junior is an index for companies on the National Stock Exchange of India. It consists of 50 companies representing approximately 10% of the traded value of all stocks on the National Stock Exchange of India. The CNX Nifty Junior is owned and operated by India Index Services and Products Ltd. It is quoted using the symbol **NSMIDCP**

Other Indices:

The Dow Jones Industrial Average (DJIA) contains 30 of the largest and most influential companies in the U.S. It is the most recognized index in the world, and the one that is frequently referred to as "the market". The original DJIA was simply an average of stock prices. Today it uses a price-weighted system. For example, Citigroup's stock is worth approximately 3% of the DJIA.

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The Standard & Poor's 500 Index (S&P 500) improves on the main drawback of the DJIA which is that it only contains 30 companies. By including 500 companies, it is increasingly seen as the benchmark of the U.S. stock market. In fact, the performance of most equity managers is pegged against the S&P 500. The S&P 500 is a market capitalization-weighted index. This means every stock in the index is represented in proportion to its market capitalization. The S&P 500 is one of the best benchmarks in the world for large cap stocks. By including 500 companies, it offers great diversification and accounts for approximately 70% of the U.S. market.

The Nasdaq Composite Index represents all the stocks that trade on the Nasdaq stock market. The recent surge in popularity of technological stocks has launched the Nasdaq into the spotlight. Consequently, the composite index has become one of the premier indices in the world. The Nasdaq Composite Index contains over 4,000 stocks. The Nasdaq Composite is a capitalization-weighted index, with each company weighting being proportionate to its market value. It is heavily weighted in technology and internet stocks. Usually, the companies listed in the Composite are considered to have high growth potential.

The Wilshire 5000 Total Market Index contains over 6,500 stocks that trade in the U.S. Investors often refer to the Wilshire as the "total market index" because it covers such a wide variety of shares. The Wilshire 5000 is market-capitalization weighted. Easily the most diversified index in the world, it covers virtually all of the public companies in the U.S.

The Russell 2000 Index measures the performance of small cap stocks (small caps) that are often excluded from the big indices. The average market capitalization in the Russell 2000 is approximately $530 million. To put that into perspective, Microsoft alone has a market capitalization of more than $300 billion at the time of writing. The Russell 2000 is weighted on market capitalization. It is a well-diversified index for smaller companies with great growth potential.

Uses of Stock Indices:

- It acts as a barometer for market behavior.
- It is used to benchmark portfolio performance.
- It is used in derivative instruments like index futures.
- It can be used for passive fund management as in the case of index funds.

Conclusion

India is believed to be a good investment despite political uncertainty, bureaucratic hassles, shortages of power and infrastructural deficiencies. It presents a vast potential for overseas investment and is actively encouraging the entrance of foreign players into the market. The Indian stock markets have been booming. The quality of investors has also been changing as far as FII investment is concerned. There are investors from pension funds and from countries that have never invested in India. Japan, Korea, Taiwan and Germany have all come here to invest. The number of registered investors has also increased. This ensures a steady inflow as every new investor invests a base amount after registration.

The year 2006 has been another great year for the Indian equity markets, with a gain of over 40% for the benchmark BSE Sensex. The Sensex breezed past several thousand-point levels; took out 10,000 with ease and even traded above 14,000 levels in December 2006. This has beaten the expectations of most market experts. The calendar year, 2007 is likely to see the largest amount of capital being raised by corporations. In the first six months of 2007, the corporate sector has raised equity of over Rs. 600 billion, which is higher than any of the previous six years. The investor response has been buoyant as the issues witnessed an average oversubscription of 15.6 times, reflecting sustained confidence in Indian equities and encouraging more corporations to raise money in primary markets.

Despite this boom, only 2% of Indians and a pitiful 3% of Indian households invest in the capital markets (September 2007 figures.) The main reason is lack of awareness.