Fundamentals to Safeguard Investment in the Capital Market

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Abstract

Capital market is a risk exposed market and at the same time it is also a very attractive field of investment. But lack of prudence of investors in this market sometimes led massive catastrophic effect on the whole economy of any country. Country like Bangladesh is yet to establish a long stable capital market due to lack of some infrastructure and intellectual resources. Capital Market risk arises from various factors. Among the factors, some are fundamental and some are incidental. Both too much bearish and bullish market is not expected in the economy. Before going to invest in capital market and to source capital form capital market, one should have a minimum knowledge about capital market. And regulators, institutions should act proactively in playing their due role.

Below are some basics to know about capital market

On understanding the following, one may easily get the primary concept of the capital market and only then can go to invest in the capital market.

What is the capital Market

In my own perception, Capital market is a place where investors and entrepreneurs have come to benefit by exchanging their respective resources. Here money may be defined as the resource of investor and business idea and intellectuality may be defined as the resource of entrepreneur.

Investors come with their money to invest in a potential, sustainable and well managed business and Entrepreneurs come to invite prospective and intended investors to join them providing necessary fund to launch or run the business that they intend to do.

Capital market also allows subsequent trading of issued shares (which are issued through financing).

Types of Capital Market

The capital markets consist of primary markets and secondary markets.

Primary Market

Newly formed (issued) securities are bought or sold in primary markets.

For example, IPO (Initial Public Offering shares), Private Placement and Promoters' shares. The transactions in primary market exist between investors and public.

Secondary Market

Secondary market allows investors to sell securities that they hold or to buy existing securities. For example: buying 100 shares of a company through stock broker from another party who are not direct investor/promoters in share issuing company.

The transactions in secondary market exist between investors.

Where is the capital market situated?

Like traditional marketplace, capital market is not a land area where products are sold by weighing or counting, rather capital market consists of some institutions, regulators and authority under law of the respective country.

Institutions, regulators and authorities are the infrastructure of the capital market.

What are the products of capital market?

Capital seekers (Entrepreneurs and Business holders) come to the market with different types of instrument to sell for raising their shortage fund. Such instruments may be regarded as the products of capital market. These are :

-Share (the small part of capital)

-Bond (Convertible and Non-convertible)

-Debenture and other similar instruments

Who could be capital market regulators and why?

Nothing could be conducted without proper guidelines, rules and regulations whether the business is intended to make appreciation of money or to make welfare of the community. Likewise capital market needs to be regulated, controlled and ruled for the welfare of investors, entrepreneurs and other related parties. Government should be the firsthand regulator of the capital market with independent body.

What happens if capital market is not regulated properly?

A shattered, fragile and sick capital market is burden for economy and barrier to growth of trade and commerce and overall development of the country.

Non-existence of sound and sustainable capital market will create dearth of sourcing and investing of capital which ultimately will create unemployment and make a slowdown of GDP growth.

What is the difference between money market and capital market?

Basically the difference between the capital markets and money markets is that capital markets are for long term investments, companies are selling stocks and bonds in order to borrow money from their investors to improve their company or to purchase assets. Whereas money markets are more of a short term borrowing or lending market where banks borrow and lend between each other, as well as finance companies and everything that is borrowed is usually paid back within certain period. Another difference between the two markets is what is being used to do the borrowing or lending. In the capital markets the most common thing used is stocks and bonds, whereas with the money markets the most common things used are commercial paper and certificates of deposits.

Following are some fundamental risks factors of capital market

The capital market risk usually defines the risk involved in the investments.

There are two types of capital market –the stock market and the bond market; we may discuss stock market risks.

Factors associated with capital market risks.

Characteristics of Investor

There are some investors who

come in stock market to make profit overnight without any simple understanding of the business fundamentals .They think that this market is only for making profit by buying and selling shares after two or three days .

Though they call themselves investors they do not behave like investors. They behave like vendors.

There is no formal authority to educate investors of capital market in our country.

As we see when share prices significantly fall, investors rally on the street, damage public property and chant slogans against regulatory bodies and government.

But one should ask that when business fails; do real promoters, shareholders or directors come to street to express their anger? Rather they review their activities, decisions and analyze market situation and take decision as to whether they will continue their business or close down.

Instead of reviewing their investment decisions, why investors in capital market (in secondary market) come to the street? Is it not the failure of our regulatory bodies, intermediaries of stock market that they could not educate the investors and direct the market in right track in which investors can trust?

Therefore it is capital market institutions' onus to educate investors and make them understand about capital market risk factors.

The more investors are prudent, the more risk to be mitigated Psychological factors

Research has shown that there are certain psychological factors that shape the stock market prices. Sometimes people tend to see patterns and make 'noise' although no such patterns may exist. Individuals are also victims of group thinking.

Lack of corporate governance in publicly traded company.

Most of the listed companies have no corporate governance practices in conducting their businesses. Regulatory bodies only issue some compliance requirement in the name of ensuring corporate governance. And without some financial institutions, it is rarely found that companies are complying with such requirement.

Existing Companies Act, Bank Company Act and Securities and Exchange Commission Act and Rules are not updated with modern practice of business rules and regulation for which business houses can deal their business as they wish.

Inadequate compliance and governance in the listed companies and weak monitoring by the regulatory bodies expose capital market to risks.

Failure to protect from speculation

Sometimes the market behaves illogically to any economic news. The stock market prices can be diverted in any direction in response to press releases, rumors and mass panic. The stock market prices are also subject to speculation. So, to protect market from any buzz, our regulatory bodies and intermediaries must act proactively so that investors are saved from any kind of wrong doing regarding their investment.

Understanding of Financial Information/Analysis

Any investment decision requires rigorous financial analysis. In our capital market, most of the investors do not calculate their return based on company's dividend payout ratio and earnings per share (EPS). Rather they say 'buy this share and it will go up by Taka 100' or say 'it will go up'. They only consider gain over trading within 3 or 4 days. But how could it be possible? They don't examine. It seems to be ridiculous!

For example, If an investor bought a share of a company at Taka 500.00 from the secondary market having face value of Taka 100 and net assets value of Taka 300.00 and the investee company is paying dividend at 20% p.a. what will be the return on investment of the investor on that particular share ?

In this case, return on investment (20/500)*100=4% (it is assumed

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that the investor holds his share to the record date of dividend entitlement).

But some investors do not know what is dividend; some think they will get dividend on Taka 500 i.e. Taka 100 and some really know their dividend would be Taka 20.

If investing Taka 500 we get Taka 20 annually from the capital market why should we not go to money market where return on investment would be around 10% to12 % and there will be no risk factors of losing capital and income?

The purpose of business is not only making profit but also maximization of wealth by creating net assets value year after year. Investing in the capital market, investors may get chance of making profit and maximization of his wealth value which is not possible in money market.

But should we buy wealth of Taka 300 for Taka 500?. And if we buy, would we be able to get pay back of our investment within 3 or 4 days or even in one year ? If it is not possible by analyzing the growth trend of investee company then question may come why should we buy share with taka 500?

In this case, either we should wait till the value of investment has grown above Taka 500 or we should find another investment opportunity.

So if an investor wants to have a decent return on his investment (expecting dividend) for short term and to maximize the value of his equity then capital market is the perfect place for such investor.

So before coming into capital market, investors' decisions should be taken for long term with a view to maximize the value of their wealth and not for making profit overnight.

Investor in the capital market should also consider the following risks

The market risk defines the overall risk involved in the capital market investments. The stock market rises and falls depending on a number of issues. The collective view of the investors to invest in a particular stock or bond plays a significant role in the stock market rise and fall. Even if the company is going through a bad phase, the stock price may go up due to a rising stock market. While conversely, the stock price may fall because the market is not steady even if the investee company is doing well. Hence, these are the market risks that the stocks investors generally face.

The industry risk affects all the companies of a certain industry. Hence the stocks within an industry fall under the same industry risk.

The regulatory risk may affect the investors if the investee company comes under the obligation of government implemented new regulations and laws.

The business risk may affect the investors if the company goes through some convulsion depending on management, strategies, market share and labor force.

Systematic Risks

The risk inherent to the entire market or entire market segment. Also known as "un-diversifiable risk" or "market risk

Investopedia explains Systematic Risk

Interest rates, recession and wars all represent sources of systematic risk because they affect the entire market and cannot be avoided through diversification. Whereas this type of risk affects a broad range of securities, unsystematic risk affects a very specific group of securities or an ndividual security. Systematic risk can be mitigated only by being hedged.

Even a portfolio of well-diversified assets cannot escape all risks.

Conclusion

It is capital market intermediaries who have to take firsthand responsibility for evolving our capital market. As capital market is one of the important contributors to growth of our GDP, this market should be a place of profitability, sustainability, viability and confidence and trust for investors. Investors' maturity, reaction and prudence are also vital to have sound capital market.

If we consider the above factors of capital market risks before taking investment decision, a chunk amount of risk can be mitigated.

We should bear in mind that this is not the place to rush to make money overnight rather it is the place where slow and steady wins the race.

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