# Something's Not Right Somewhere

STOCK markets are unpredictable and that is why they are interesting. Behavioural finance is one angle to consider when analysing stock markets. It is the only explanation for a several otherwise inexplicable anomalies such as 'predictable surprises'. A heavy smoker is bound to face lung problems, while a habitual drinker is prone to liver cirrhosis. Potential consequences are known, but no action is taken because of the inability to take tough decisions. Behavioural science has a term for it — Decision Paralysis. If it ain't broken, don't fix it.

Today, India can boast of having the finest and efficient stock market systems in place with the right checks and balances, thanks to an efficient regulator. Even a transfer of one share from a husband to a wife needs to be reported through the stock exchanges. This provides the right transparency. Even mutual funds transferring from one scheme to other have to report the transactions through the stock markets.

However, according to reports in **The Economic Times** and **The Times of India** over the past fortnight, almost one-third of the trading volume in the Indian stock exchanges is outside the purview of the stock market regulator. This is made possible by the existence of participatory notes (P-notes) issued by certain foreign institutional investors (FII) registered with the Securities and Exchange Board of India (Sebi). In effect, there is a parallel stock market, which is more than one-third of the Indian stock market by volume. Most of the FIIs issuing P-notes also offer over the counter (OTC) derivative products to their clients.

P-notes could probably explain the seemingly strange behaviour of the stock market of late. The market is showing huge volatility and even on days when declines exceed advances by a big margin, the indices show an upward movement. To manipulate an index, all you need to do is to push up a few heavyweight stocks. P-notes make it possible.

Let's understand what's wrong with P-notes. Firstly, they enable FIIs to circumvent all regulatory hurdles faced by Indian institutions and mutual funds.

**Human beings have a typical inability to take tough decisions. This leads to 'Predictable Surprises'. So, are P-notes next in the queue, asks Parag Parikh**

Thus, we are not providing a level playing field to Indian entities. India has equally smart and qualified fund managers who, given an opportunity, can provide products to the foreign investors. The exchequer loses revenue by way of security transaction tax and other taxes for inter clients transfers. Finally, we don't know either the behaviour or the identity of such investments. They have to be speculative, especially when derivative products are issued. Derivatives are weapons of mass destruction, so says Warren Buffet. The recent downfall of Amaranth Advisors, a leading US hedge fund that wiped out half of its net worth in one month, should be an eye opener. How many such funds are dealing in the Indian market outside the purview of our regulator?

Globalisation is here to stay and we need to understand the effect such global funds flow will have on the stock market. Such huge transactions outside the purview of our Indian regulator will only increase the volatility. This would drive out the Indian investor from the market as powerful global firms with deep pockets start dominating it. A good healthy market is necessarily not one which goes up everyday, but one where there is resemblance of sanity and less volatility. What will happen when this money becomes shy? It's a Predictable Surprise. But when it happens it will be painful. These are the pangs of globalisation.

Why do we behave in ways when we know that we will be hurt? At this stage the stock market is cruising high and overconfidence and over-enthusiasm reigns supreme. No one is interested in upsetting the apple cart. If any decision on P-notes is taken we could have a big reaction in the market. So, we are struck by decision paralysis and think it safe to maintain the status quo. However, it is evident that something is not right somewhere and the sooner it is corrected the better.

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