Understanding Capital Markets

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Market Efficiency

- We always mean informational efficiency i.e., how well the prices reflect available information
- In other words …
- The idea is that intense competition in the capital market leads to fair pricing of debt and equity securities

Technical Analysis

- Forecast stock prices based on watching the fluctuations in historical prices
- They look for trends and cycles and make profits from them

Technical Analysis

Kilburn Chemical, listed in BSE, 13 years price chart, monthly data with 23 months moving average

Select chart or study
Enter parameters

Moving Average
28
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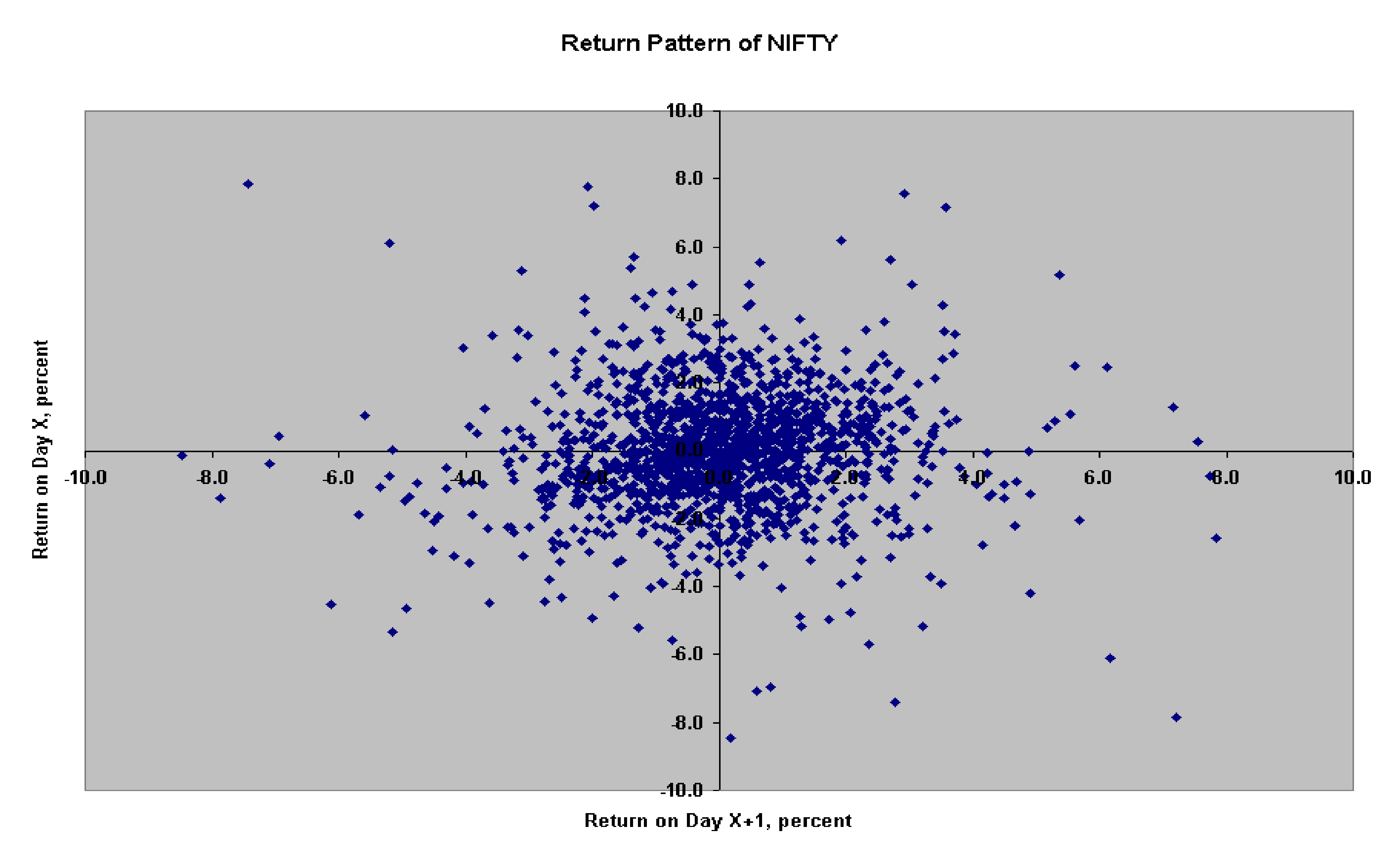
Random Walk Theory

- The movement of stock prices from day to day DO NOT reflect any pattern
- Statistically speaking, the movement of stock prices is random
- If there is a pattern, then investors would be able to earn huge profits by exploiting the pattern

Random Walk Theory



Efficient Market Theory

- Weak Form Efficiency

→ Market prices reflect all historical information

- Semi-Strong Form Efficiency

→ Market prices reflect all publicly available information

- Strong Form Efficiency

→ Market prices reflect all information, both public and private

Implications of Efficient Market

- Using this information cannot generate above normal profits in the long run
- Weak Form Efficiency

→ Technical analysis fails

- Semi-Strong Form Efficiency

→ Fundamental analysis fails

- Strong Form Efficiency

→ Insider info also do not give any profits

Implications of Efficient Market

- But if prices always fully reflect that information, investors have no incentive to incur the cost of analysis.

→ Limits of market efficiency are set by the cost of obtaining information

- Similarly in technical analysis – cycles and trends will self destruct as soon as investors recognize them

Efficient Market Theory

- So, if there is a takeover attempt for Hero Honda then what happens ...

→ It would be fully reflected in the stock price on the announcement day.

- What happens to the mutual funds ...
- Will they underperform or overperform the market ...
- They will underperform in approximately half the years

Efficient Market Theory

- So, what happens to the markets when there is a global financial crisis …
- There will be a change in growth perception which will change the index value dramatically
- So, what happens to the markets when Satyam & Raju's revealed their true colors
- Stock and Index crashed …

Lessons from Market Efficiency

- Markets have no memory
- Trust market prices
- In other words, it is very difficult to outguess the market, as the security prices are fair

Indian Capital Markets …

- Are they efficient … if so to what level?
- Are there any measures comparing Indian capital markets with some international capital markets

Indian Capital Markets …

- If that is the case then why do scams take place …
- Because of systemic errors … failures
- Harshad Mehta Scam
- Ketan Parekh Scam

International Comparison

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International Comparison: End Dec. 2005								
Particulars	USA	UK	Japan	Germany	Singapore	Hongkong	China	India
No. of listed companies	5143	2759	3279	648	557	1126	1387	4763
Market Capitalization ($ bn)	16998	3058	4737	1221	208	1006	781	553
Market Capitalization Ratio (%)	140	152	100	48	198	548	40	82
Turnover ($ bn)	2150	4167	4997	1763	120	460	586	443
Turnover Ratio (%)	129	142	119	146	63	49	83	94
Source: S&P Emerging Stock Market Factbook, 2006								

Fundamental Analysis

- Research the value of securities using various valuation methods and uncover the value of stock
- Keep track of all possible (usually public) information/events/news about the company (incl. its industry, relevant economy, etc.)