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Can the markets be recast for small players?

By CKG Nair & MS Sahoo, Last Updated: Jul 24, 2007, 08:00:00 AM IST

Synopsis
Every market tries hard to allure the small ones and has catchy, nice messages for them, extolling the advantages of joining the bandwagon.

Political affinity to the 'small' man and the consequent love for the 'children of God' by the state is understandable. In statecraft he is quite useful as he has one vote which he generally exercises. But in markets, which believe in survival of the fittest, he is really small in terms of resources (finance and knowledge). With the basic credo of efficiency and quest for low transaction costs, public display of affection for the small man by the markets is a bit of contradiction. Excepting that these small men provide livelihood for many 'big' men. The latter need the former mostly to promote their commercial interests and at times for strategic reasons. They also entertain the former as a condition of business imposed on them in public interest.

Take the case of financial markets. Each segment of the market strives to service the 'bottom of the pyramid' . The securities markets hypnotise small investors to enter the market in droves; the commodity derivatives markets cajole the small farmers to hedge their risks; the insurance segment wheedles the fragile men to insure against the uncertainties of life, property and crops; the banking segment flatters small customers with dedicated products.

Every market tries hard to allure the small ones and has catchy, nice messages for them, extolling the advantages of joining the bandwagon. The state quite often mandates a minimum service, generally in the form of reservation, to small ones. The general presumption is that small ones need special attention and protection; otherwise they would be deprived of a fair share in the competitive markets and benefits from the growth story.

Come to the securities markets; the main craft of capitalism. There is no pretension of minimum allotment to small men in the US which excels in securities markets as well as in capitalism. Indian securities markets, however, reserve a certain percentage of public issue for retail individual investors (RIIs), who apply for securities for a value not exceeding Rs 1 lakh.

The big fishes masquerade as RIIs by applying under the RII category to garner the benefits of reservation. To increase the probability of allotment, they make multiple applications from benami/fictitious accounts and, thereby, edge RIIs out of the markets. The associated generation of numerous fictitious DP accounts and hiring of PANs are now legends.

Let us look at, very liberally, the economics of a small investor who has, say, Rs 10,000 for investing through IPOs. Since most of the issues get oversubscribed (a few of them as high as 500 times), the probability of getting allotment, ignoring proportionate allotment for a moment, may not exceed 0.05. Assuming receipt of refund takes not more than 18 days from the date of subscription; the same money can be rechannelled for 20 issues in a year. This makes the probability of allotment at best 1 in a year.

A 20% return, which may not always be the case, will get him an absolute amount of Rs 2,000 minus the transactions costs of making subscriptions 20 times and the interest cost on Rs 10,000 for a year. The net gain to investor will not be much different from the return on a risk free product such as fixed deposit, PPF. The net gain to the system would be still less. In contrast, the economics works out in favour of an institutional investor who does not part with the subscription money except for the margin of 10%, incurs relatively low transaction costs as a percentage of the value of transaction and does not need intensive state care.

Now, come to the commodity derivatives market. The ostensible objective of opening up all agri-commodities for futures trading is to provide market-based risk management tools to farmers, particularly the small ones, to facilitate hedge their growing risk in the liberalised , globalised era. But is commodity futures market accessible to the small farmers? The skill base, the knowledge and financial requirement and the milieu are too farfetched for most farmers to enter. Nor the small farmer has a hedging need that can be satisfied by the exchanges trading in contract sizes much larger than his annual production. Interestingly, for many farmers without marketable surplus there is no price risk.

In order for a farmer to benefit from the futures market directly he needs to have a reasonable quantity of marketable surplus. This could be at least a truck load of the commodity in question that can be economically taken to a warehouse for storing and, if need be, pledged with a bank for interim financing needs.

The moral is that transactions in the markets involve costs. The technology enables an intermediary to charge a flat fee for a transaction irrespective of its value. Depending on the degree of imperfection of the market-information asymmetry , externalities and agency problems, the small value transactions invite disproportionate costs. Further, logistical advantages make large transactions less expensive.

The fact, therefore, is that markets are by nature biased against small transactions and hence against small players. The endeavour to marry socialism and markets on this front is at least a contradiction. Little realising the caricature of such a marriage as “post office socialism” by John Kenneth Galbraith, post office has been increasingly sought after as the focal point of action for capturing the small players! That too when the complex big players operating in trillions at lightning speed cater to the sophisticated requirements of their big clients in globalised financial markets.

Contrary to the neo-classical and neo-liberal assertion, many markets, particularly financial markets, are characterised by substantial degree of information asymmetry and the consequent high transaction cost. Hence the need for institutions designed to reduce information asymmetry and the costs attached. Institutions for regulation, legal systems capable of defining property rights unambiguously, etc are mechanisms for reducing asymmetries but cannot fully wash away all of them. Limits of law and institutions are a reality. No institutional arrangement could bring down transaction cost to the Coasean wonder world where seamless transactions can take place at zero cost. Markets seldom reach such state of bliss.

As long as transaction costs are positive, markets would be innately biased in favour of the big players. That is why companies and fund managers love HNIs, PEs, QIBs and MFs rather than the millions of scattered retail investors. If that were the case inducing the small players to enter such market is against their interest. Rather they should be advised to come forward only if they are above a critical threshold ; both in terms of money and knowledge. Unless, of course, one wants them to be the counter-parties to the enormous risk appetite of the big players and bear the burden of providing liquidity and stability to the market!

(Authors are civil servants. Views are personal)