

Understanding Stock Market

We will start with the meaning of term shares, taking further to share trading, stock market, derivatives etc

Brief Working of Stock Market

"A" is running a sole proprietorship firm by the name "A & sons". It is into manufacturing of garments. He started the business at a very small level and gradually expanded the business. Now he plans to involve a friend of his, "B", in the business so as to have more money in the form of capital being pumped into the business. They both formed a Private Limited Company with equal shareholding. "A & sons" is rechristened "AB Pvt Ltd". It becomes a Private Limited company having a separate legal identity. Now they plan of expanding the business further. To do this they need to sell some shares of their company to the public and raise requisite money. In order to sell the shares of the company to the public, it has to be first listed on any of the recognized stock exchanges of the country. "AB Pvt Ltd" gets listed on National Stock Exchange and becomes "AB Ltd". Now it has become a public limited company and can issue shares to the public through Initial Public Offering (IPO). "AB Ltd" had a share capital of Rs 100 lacs. The same is divided into one lac shares of Rs 100 each. They sell 49K shares to the public at Rs 120 each (i.e. at a premium of Rs 20 per share) and keep balance 51K shares with them. This way, "AB Ltd" pumps in money in the business. This process of capital pumping in business is called raising money through an IPO and the market is called primary market. The business is earning good profit margins and the price of the share in the market is ranging in between Rs 140-150 per share. 49K shares sold in the market are now traded on the stock exchange between the buyers who make money out of it. This is called trading in secondary market. "AB Ltd" decides to raise the share capital further to Rs 500 lacs. The company now comes out with Follow on Public Offer (FPO) of 4 lac shares of Rs 100 each. The company has 4.49 lac shares being traded in the market. These are called free float shares. Some portion of the profit earned by the company is distributed amongst the shareholders as dividend.

Let's now understand the concept of shares and their trading in details:

- Shares are defined as 'Total capital of the company divided into units of small denomination'. Shares can be Equity Shares or Preference Shares. An Equity Shareholder has right to vote and control affairs of the company, whereas a Preference Shareholder gets certain preferential rights. It is customary to prefix rate of dividend with preference share capital. Shares are traded on stock exchange.
- Stock Exchange is a government recognized place where buying and selling of shares takes place. In India, presently we have 23 regional stock exchanges two national exchanges namely, The National Stock Exchange (NSE) and Over the Counter Exchange of India (OTC). Bombay Stock Exchange is the largest Stock Exchange in India where maximum number of transactions takes place.
- A company which intends to issue shares to the public has to get its shares listed on any of the stock exchanges. Listing means, the shares can be bought and sold on the stock exchange. Listed shares are categorized under Group A or Group B (Group A are rated higher than Group B) depending on the capital of the company and trading volume of the shares of the company.
- **Trading of shares** - Earlier share trading was done by exchange of physical share instruments between buyer and seller through an intermediary called registered share broker, transfer agent etc. Share certificate gets endorsed in favor of

transferee by the authorized representative of the company on payment of some stamp duty. Stamp duty is payable by the transferee. Trading was done on trading floors of stock exchanges through open outcry system (Open outcry is a method of communication between professionals on a stock exchange which involves shouting and the use of hand signals to transfer information primarily about buy and sell orders), which was later on modified to screen based trading. It is a system whereby distant participants can trade with each other through computer network of the brokers either by placing the orders or by inputting the quotes. In both the above methods of share transfer by endorsement, the company reserves the right to reject the share transfer on account of certain deficiencies in the transaction.

- **Understanding Demat:**

- It is the latest & current technology of share trading. Dematerialization (Demat) of share certificates is the process of converting physical instruments in electronic form. A demat account is opened with a Depository Participant (DP). A depository participant is an agent of depository and a depository is a place where stocks of investors are held in electronic form. Depository is the head office where all technology rests and details of all accounts are maintained. Whereas, DPs are branches that cater to the individuals who wish to open demat account. There are only two depositories in India- National Security Depository Ltd (NSDL) and the Central Depository Services Ltd (CDSL). There are over 100 DPs. A demat account holder gets periodic statement of holdings and transactions. Conversion of physical holdings in electronic form is mandatory for doing any transaction. Benefit of electronic form over physical form lies not only in the speed but also more transparency and safety, investor can do the transaction himself without involvement of an intermediary, no rejection of transfer by the company, no stamp duty being charged from transferor, no paper work etc. Existing shares are surrendered to the DP and are sent to the respective companies for cancellation after "Dematerialization". After this, depository account with the DP is credited with the shares. The securities on Demat appear as balances in depository account. These balances are transferable like physical shares. If required, these "demat" securities can be converted back into paper certificates.
- A broker should not be mistaken to be a DP and visa versa. A broker is member of the stock exchange, who buys and sells shares on behalf of his clients and for himself. A depository participant on the other hand provides an account to hold these shares. An investor's DP can be separate from that of his broker. For providing the services, the DP charges some fees for account opening, annual maintenance and transaction charges. DP provides a unique BO ID (Beneficial Owner Identification) Number which has to be quoted for all future-transactions.
- Some investors do the trading by involving the brokers. They open demat account with the DP and use trading account of their broker for executing the transaction. While selling the shares, order is placed with the broker and delivery instruction is given to the DP. Demat account is debited by DP by the number of shares sold and payment is received from the broker. While buying the shares, depository account number is informed to the broker for crediting the shares in the account. In such cases, certain amount is set aside with the broker by the investor for doing the purchase transactions. Amount of money to be kept with the broker depends from broker to broker. This is called Offline Share Trading.

- However, if the investor is doing trading himself, without involvement of broker, he needs to open three accounts:

- Saving Bank Account- used for setting aside money for the sale/purchase transaction
- Demat Account- used for holding the securities
- Share Trading Account-used for sale/purchase of equity shares through the broker.

All these accounts are linked and self trading can be done without involving the broker in between. Such kind of hassle free facilities are offered by brokers like, ICICI direct, HDFC Securities, India Infoline, Reliance Money etc. This is called *Online Share Trading*.

- **After understanding share trading, let us now understand, function and purpose of stock market:**

Stock Market is one of the most important sources for companies to raise money. This allows businesses to go public and raise additional capital for expansion. On the other hand, the liquidity provided by the exchange allows investors to make quick money by buying and selling shares. If securities are held for a longer duration, say a year or more, the holder is entitled to earn dividend declared by the company out of its profits. So it is a win-win situation for both the corporate and the investor. However, this win-win situation may turn sour when the market index falls and share prices dip leading to loss of the holder of securities and even the company whose share price falls. Stock Market is affected by the dynamics of the economic/political activities in the country & rest of the world.

- **What is Market Index and how is it determined?**

In India, there are two major Stock Exchanges, National Stock Exchange (NSE) and Bombay Stock Exchange (BSE). Index of NSE is called Nifty and Index of BSE is called Sensex. Index is a statistical measure of change in an economy or a securities market. In case of financial markets, an index is essentially an imaginary portfolio of securities representing a particular market or portion of it. It gives a general idea about whether most of the stocks have gone up or down. Each index has its own calculation methodology and is usually expressed in terms of a change from a base value. Hence, a change in index is more meaningful if expressed in percentage terms rather than absolute terms. Let's understand calculation of Sensex. Sensex is calculated taking into consideration stock prices of 30 different BSE listed companies. The base value of the Sensex is 100 as on Apr'79. At irregular intervals, the Bombay Stock Exchange (BSE) authorities review and modify its composition to make sure it reflects current market conditions. Sensex is calculated using free-float market capitalization method (Worth of the company in terms of its shares is called Market Capitalization and worth of the shares of the company which are available for trade on the stock exchange is called free float market capitalization). Under this method, market cap of these 30 companies (used as sample for the entire universe, considered based on certain criterions) is calculated for those shares which are freely available in the market for trade. This figure is then prorated for the entire universe to calculate sensex.

- **Let us now go to the terminologies used in Share Market and Share Trading:**

- **Open:** Opening price of the share in the morning.

- **High:** Highest price of the share during the day.
- **Low:** Lowest price of the share during the day.
- **Close:** Closing price of the share at day end.
- **Volume:** Quantity.
- **Bid Price:** Buying price.
- **Offer Price:** Selling price.
- **Bid Quantity:** Total number of shares available for buying.
- **Offer Quantity:** Total number of shares available for selling.
- **Buying and Selling of Shares:** Buying is also called as demand or bid and selling is also called as supply or offer.
- **Shorting of Shares or Short Sell:** First selling and then buying (this only happens in day trading) is called as shorting of shares or short sell.
- **Share Trading:** Buying and selling of shares is called share trading.
- **Day Trading:** Buying and selling of shares on daily basis is called day trading or intra day trading. Squaring off is done on the same day.
- **Delivery Trading:** In such type of trading, delivery of securities purchased is to be taken in the demat account. For entering into this transaction, requisite money needs to be there in the account. Once, the shares are purchased, they would be deposited in the demat account in T+2 days. These shares can be retained for as much time as the investor feels. In case of delivery trading, first purchase is done then only sale can be done, unlike day trading.
- **T+2:** Trading day plus 2 days.
- **Transaction:** One complete cycle of buying and selling of shares.
- **Squaring Off:** This term is used to complete one transaction. For every purchase a corresponding sale is required and vice versa.
- **Limit Order:** In limit order the buying or selling price has to be mentioned and when the share price comes to that price, then the order will get executed with the price mentioned at the time of placing order.
- **Market Order:** The market order gets immediately executed at the current available price.
- **Stop Loss Order:** They are limits set by traders at which they will automatically enter or exit trades. An order to buy or sell is placed in the market if price reaches a specified limit. A stop loss order is set to limit a trader's potential loss. The stop loss is placed below the current price (to protect a long position i.e. when share is to be purchased) or above the current price (to protect a short position i.e. when a security is to be sold). Limit Order and Stop Loss Order are used together.
- **Fundamental Analysis in Indian Share Market:** It is a method of analysis of shares of a company for long term investments based on organization's plans, results, collaborations with foreign counter parts etc.
- **Technical Analysis in Indian Share Market:** It is method used by day traders and short term investors by studying the price movement charts, quantity traded charts, support and resistance levels, technical indicators etc.

- **Insider Trading:** It is trading of a corporation's stock or other securities by the corporate insiders such as officers, key employees, directors, or holders of more than 10% of the firm's shares. It is buying or selling of a security by someone who has access to material, nonpublic information about the security. Insider trading may be legal or illegal. Insider trading is legal once the material information has been made public, at which time the insider has no direct advantage over other investors. Illegal insider trading occurs when privileged, non-public information is used to trade on corporation's stock or other securities. It may include the purchase or sale of shares prior to the disclosure of a corporate news release or the purchase or sale of shares on the basis of information that would never be disclosed to shareholders.

After being through with normal share trading, let's move to derivatives and their trading:

- The term derivative has its origin in the word "Derived". It refers to an asset which has no independent value of its own but is derived from the value of underlying asset. It therefore means a forward, future, option or any other hybrid contract of pre determined fixed duration, linked for the purpose of contract fulfillment to the value of as specified real or financial asset or to an index of securities.
- Derivative trading in India takes place either on a separate and independent Derivative Exchange or on a separate segment (index) of an existing Stock Exchange. Derivative Exchange/Segment function is a Self-Regulatory Organization (SRO) and SEBI acts as the oversight regulator.
- **Forwards Contract:** It is one to one bi partite contract, to be performed at a future date and specified price. It offers lot of flexibility to the parties to design the contract and suffers from poor liquidity and default risk.
- Futures & Options are forms of exchange regulated forward trading in which a transaction is entered into today, and settlement of the same will happen at a future date.
- **Futures Contract:** It is an agreement between two parties to sell and purchase a specified asset at a specified future date and price. The actual transaction will not be executed till the arrival of specified date and it is mandatory on part of both the parties to honor the transaction. It is a structured/regulated form of forwards contract.
- **Options Contract:** It is a refined form of futures. In this type of transaction, premium is paid by buyer of the option to the seller of the option at the time of entering into the contract. By paying this premium, buyer of the option purchases the rights from the seller. This premium gives the buyer of the option the right without the obligation to buy/sell the underlying asset on a specified date and at a specified price. Buyer is also called holder of the option and seller is also called writer of the option. *Hence, option in securities means a contract for the purchase or sale of a right to buy or/and sell securities in future.*
 - An option to buy is called Call option
 - An option to sell is called Put option.

- An option exercisable on or before expiry date is called American Option.
 - An option exercisable only on expiry date is called European Option.
 - Price at which option is to be exercised is called Strike Price/Exercise Price.
 - Date of execution of option is called Expiry Date.
- Both futures and options can be settled either by cash settlement or by delivery. Cash settlement is a method used in certain future and option contracts whereby, upon expiry or exercise of the contract, the seller of the financial instrument does not deliver the actual possession (delivery) of the underlying asset but cash is exchanged between the seller and the buyer, being the difference between spot price and futures price. Payment of cash depends on the contract terms.
 - Futures and Options based on stock index are called index futures and index options. Here the underlying asset is index. Index, derives its value from the prices of securities that constitute the index. Such contracts cannot be delivered, hence are cash settled on expiry.
 - **Type of derivative market traders:**
 - **Hedgers:** A hedger makes an investment in a way to reduce the risk of adverse price movements in the underlying assets by use of futures.
 - **Speculators:** A speculator selects investments with higher risk in order to earn profit from an anticipated price movement. More sophisticated investors will also use a hedging strategy in combination with their speculative investment in order to limit potential losses.
 - **Arbitrators:** An arbitrator purchases an underlying asset in one market and sells in another, thereby taking advantage of price discrepancy in two markets and making profits out of it.