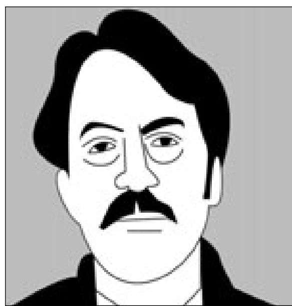
My crystal ball says...

it's a hopeless future for Indian brokerages as investors wake up to the reality that equities are only for a limited few and aren't the best long-term investment



BY INVITATION

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THE Indian stockbroking industry is blessed with a colourful past, a confused present and a hopeless future.

Broking, at its heart, is a pure commodity business, with little scope for differentiation. The current situation reflects precisely that very characteristic of this business; almost zero entry barriers coupled with a vanilla services portfolio.

The situation in retail broking was nearly always bad, even in the best of times. No retail investor pays a premium commission rate for so-called superior service or even for superior advice. It was only the phenomenon of margin financing that kept this game alive for a few years. But with the broadening of the derivative segment, the margin funding business began to suffer, given its higher cost structures.

The institutional broking segment remained the cosy preserve of just a few firms for several years, and hence remained relatively in better shape. But growth was hard to come as two major changes took place: hedge funds shrivelled in the post-2007 crash and large parts of FII inflows started to come in through very low-cost ETFs. A third factor also chipped in — the abolition of selling incentives on domestic mutual funds and a crimp on ulips further drove commission-paying volumes down in the institutional segment.

The favourite Indian refrain of "it's the government's fault" is being played out across dealing rooms. But is that really the case? The answer is a bit complex.

At the heart lies the core issue — is the promise of equities, i.e., "higher returns over the long run", just plain wrong? My answer is, yes.

Equities simply don't give you adequate risk-adjusted returns over the long run. They do this only over the short run, i.e., six months to two or three years. Between 1992 and 2003, Indian market went nowhere. Then they exploded to give 55 per cent compounded returns between 2003 and 2007. And then, nothing...

So equities have been sold on the wrong premise. They are not for the long-term, generally speaking. Which then, automatically, rules it out for the Indian middle class, which prefers long-term investments without volatility in return. In short, Indians generally prefer investments that give return of capital rather than return on capital. Any portfolio manager would tell you that Indian investors don't mind low returns as long as they are positive returns. They just don't like to see the minus number at the end of the year.

Think about it. Fidelity has propounded the theory of long-term investing all over the world. It comes to India, sets up its mutual fund, and shuts it and goes within five years! Why no application of its "invest for the long term" in its own capital investment decisions? How then can funds expect investors to have infinite patience to get some sort of return?

As a result of this false selling premise, investors have largely left the market or are in the process of leaving it, evidenced by the large-scale fund redemptions.

But before we get too despondent, allow me to inform readers that equities are a dying investment option worldwide. After decades of fraudulent mis-selling by Wall Street majors, now investors are waking up to the reality that equities are for a very, very limited few. Hence, stock market turnovers are declining in most markets across the world; across Bric nations, retail investors are leaving the equity fold; across Europe, things are even worse. The number of listed companies in the US has halved in 12 years. I have no doubt that India will see the same as promoters realise that there is little sense in remaining listed.

So what does my crystal ball show for players in the equities game?

I suspect the Cobrapost expose of our three most respected private sector banks indulging in large-scale, nationwide money laundering would have planted the seeds of the future growth direction of the stock broking business in the minds of intrepid Indian brokers. After all, if these venerable banks are fuelling deposits, insurance and mutual funds through laundered money, why should brokers be left behind?

I also suspect that sections of the stock-broking community may already be doing large-scale laundering. If banks aren't following KYC norms, why expect poor brokers to be so compliant? Get ready for a rush for bank licences by brokers. Now that the RBI deputy governor has given a lightning-fast clean chit to the Big 3, brokers will be comforted with this knowledge that the central bank will look the other way when they are caught in the act. The Indian broking community has hardly been the model of good governance over the years, and desperate times require desperate solutions.

I also see a sharp rise in pump-and-dump schemes. I know many stock-broking companies, which manage excellent revenues based on pump-and-dump schemes. If you meet their owners, you would be pardoned for asking if they can walk and chew paan at the same time. But they will tell you reassuringly, "If you have any proposals for ramping up and placement with major institutions, just let us know." Well, the government does precisely that in its divestments, so why blame these poor brokers?

My crystal ball shows large amounts of corruption seeping into the institutional broking business, as fund managers realise that their jobs aren't going to last very long, and like about-to-retire-honest bureaucrats, they turn to bolstering their personal retirement funds. Many brokers I know are focusing on this and reaping rich rewards. The ones who are not are just plain poor business strategists.

I see a spurt in fraudulent IPOs, which are primary market variants of the pump-and-dump schemes. The cost of doing an IPO is about 30 per cent to 80 per cent as per my market intelligence. A few deals per year, get your numbers up, and then possibly, sell out to a bank wanting to set up an investment banking business. Ask for cash only. Never take stock. Bank stocks have been looking very, very shaky lately.

I also see regulated brokers getting into the 'dabba' trading business (shadow stock exchanges). If they can be legally run in the UK as CFDs, why not in India? As I am given to understand, margins in the dabba broking business are hefty: for example, Rs 50 per option lot versus Rs 5 per lot in the regulated options market.

So what am I seeing in my crystal ball, in essence? That there is no honest way left to earn a living in this equities business? Sorry folks, that ended many years back. And it's never coming back.

Ask Wall Street.

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