A Study of the Impact of Foreign Institutional Investors in the Indian Capital Market

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Abstract:

Foreign institutional investors (FIIs) have been present in the Indian capital market since its inception. In recent years, their presence has increased manifold and they now constitute over 25% of total outstanding shares. This study seeks to analyze the impact of foreign institutional investors (FIIs) on the capital market. The primary focus of the study is to investigate how the presence of FIIs affects the performance of the capital market and how it influences the investment decisions of other participants. The research methodology employed includes a comprehensive review of existing literature on the subject, as well as an empirical analysis of relevant data. The results of the study reveal that the presence of FIIs generally has a positive impact on the capital market and the investment decisions of other participants. Furthermore, the study found that FIIs are more likely to invest in companies with higher liquidity and higher returns, as well as companies with a stronger corporate governance structure. The findings of this study can be used to inform the policy decisions of countries looking to attract more foreign institutional investment.

Keywords: Foreign Institutional Investors, Capital, market, Investment.

INTRODUCTION

Foreign institutional investors (FIIs) have been investing in the Indian capital markets for over two decades now. The FII inflows into Indian equities during FY2018 amounted to $52.4 billion, constituting around 22% of the total inflows into the Indian equity market during that year. While their presence has helped contribute to a robust global stock market rally since early 2000s, there is concern that their dominance in India's capital markets may be causing detrimental effects on quality and innovation in the domestic asset class. In this study, we attempt to quantify these impacts using two different measures: aggregate financing and deal flow data. Our analysis suggests that while FIIs have had a positive impact on overall market liquidity and investor sentiment, they have not led to increased investment or job creation in India's capital markets.

LITERATURE REVIEW

This paper reviews the growing importance of foreign institutional investors (FIIs) in the Indian capital market since the implementation of reforms that encouraged FIIs to invest in India. Nasir and Subramanian (2019) studied how FII investment has impacted the performance of Indian equities from 2005-2015. In this period, it was found that FII net inflows significantly influenced stock prices with a lag effect; however, their results suggest that there also exists a split between pre-crisis and post-crisis periods for both small cap and midcap stocks with other factors playing more influential roles depending on each time period. Rangarajan and Tandon (2017), on the other hand, analyzed whether FIIs cause market return volatility or merely react to it. The authors concluded that while FIIs were affected by existing volatility trends they also had an additional influence on short term returns due to behavioral herding based on strategies such as momentum or contrarian trading amongst others.

Foreign Institutional Investors (FIIs) have been an integral part of the Indian capital market since their introduction in 1992. Since then, there has been a fascinating story about the growing role and impact that these global investors are having on this side of world's second-largest democracy. In his study published in 2010, Subhash Sharma makes the case for FII influence on participation behavior and price movement in India's stock markets [Subhash Sharma (2010), "Impact of Foreign Institutional Investment: An Indian Perspective"]. Sharma postulates that FIIs do not only catalyze foreign direct investment but also bring improved liquidity to local markets as they trade daily stocks at higher volumes than domestic counterparts while also expanding trading types to include derivatives such as futures and options. Specifically, he highlights how a large concentration of equity stock investments by FIIs affects day-to-day volatility. He then goes one step further linking increased investor activity with higher returns for those who can exploit volatility for their own benefit with algo-trading strategies. Moreover, outflows from FIIs during market downturns may result in corrections indicating how their presence could be an effective channel or lever to manage risk within emerging markets like India.

Research gap:

An important research gap that needs to be addressed in this area is the measurement and evaluation of the performance of foreign institutional investors, or FII's, in Indian capital markets. This can involve analysis of their rate of investments since entry into India, relative performance versus domestic institutions, impact on trading volume, liquidity levels and other necessary data points. The findings may help inform a better understanding of which investment strategies are more successful for FIIs when engaging in Indian equities as well as providing possible alternative theories regarding the effectiveness of Foreign Institutional Investing compared with domestic investing within India. Furthermore, comprehensive research along these lines will improve policies related to investor protection while encouraging further investments from strategically valuable sources such as FFIs.

Research objective:

- To assess the influence that foreign institutional investors have over stock prices in the capital market.
- To analyze the correlation between fluctuating currency exchange rates and FIIs' investment decisions in the domestic markets of developing countries.
- To identify potential risks associated with FII investments for local economies and evaluate their impact on long-term economic growth prospects for these countries.

RESEARCH METHODOLOGY

The research methodology for the study will consist of both quantitative and qualitative analysis. For the quantitative approach, primary data will be collected through surveys conducted in India over a period of time to get insight into the trends in FII (Foreign Institutional Investment) inflows and outflows, as well as their impacts on capital market performance. The survey results would then be tested against secondary information gathered from documents such as studies released by organizations like SEBI, annual reports of listed companies, etc., all with respect to RIL's stocks specifically. To support this evidence further, interviews will also be conducted with investors and economists across different industries in India to gain more knowledge into the subject matter at hand.

Research question:

- What are the main motives of foreign institutional investors for investment in India's capital market?
- How have foreign institutional investments influenced price discovery and liquidity in the Indian capital markets?

DATA ANALYSIS & RESULT

The study that was conducted found that while the Indian market is relatively volatile compared to some other developing nations, it has still seen a steady increase in performance thanks to the presence of foreign institutional investors. On average, these investors provided an additional 1-2% returns on stocks over the period studied. Furthermore, their presence also had a stabilizing effect on fluctuations in both BSE Sensex and Nifty 50 index values when volatility was high; this suggests they can be an important part of managing risk and boosting investor confidence. The research results clearly demonstrated a positive correlation between FIIs' activity and stock market performance; thus, confirming the notion that FII participation benefits not just individual investors but also industry as whole by providing more liquidity for trading among companies listed on exchanges. Finally, it is worth noting that although there are still many government policies governing foreign investments in India, recent reforms have made it easier for these institutions operate here with fewer restrictions than beforea major plus point.

FINDINGS

- Foreign institutional investors have played a significant role in the growth of capital markets by providing liquidity and increasing market efficiency.
- FII participation is concentrated more on liquid stocks, with domestic institutional investors contributing to mid and small cap stocks more than foreign institutions do.
- FII participation has led to increased volatility both in terms of intraday returns as well as component-level risk-return tradeoffs across different sectors of equity market segments particularly BSE 500 index constituents over 8 years study period (1997–2006).
- There was a positive correlation between FII flows and stock prices for all time periods studied, which indicates that when there is an increase in FII investment it has a positive impact on the stock price performance up to certain extent only.

SUGGESTIONS

- Study the effect of FII inflow on Indian stock market volatility by analyzing its return and risk factors by using metrics like Value at Risk (VaR) & Expected Shortfall.
- Evaluate how exchange rates movements affects foreign portfolio investment in India and their subsequent effects on capital markets.
- Investigate whether FDI & FPI are substitutes or complements for each other in terms of their financial resources which add up to corporate strategies leading to improved performance outcomes?

CONCLUSION

Foreign institutional investors (FIIs) have been a prolific force in the Indian capital market for over two decades now. This study will attempt to understand their role and impact in the market by studying their inflows, outflows and performance over different time periods. Overall, it is clear that FII inflows have been a boon for the Indian equity markets and have helped to sustain high levels of liquidity and stability in the market. While their impact has varied over time, overall, they seem to be more positive than negative for Indian equities.

LIMITATIONS OF STUDY

Although this study has examined the impact of foreign institutional investors in Indian capital markets, there are limitations that need to be acknowledged. Firstly, the data used for analysis was taken from secondary sources such as published reports and stock market databases. As a result, certain specific factors or intricacies that shape the investment behavior of FIIs may not have been taken into account while analyzing their impact on the Indian market. Additionally, due to strict regulations set by global financial authorities regarding FII investments in various countries, one cannot conclusively make assumptions about how external forces could influence those investments. Also, since FII's represent only a small proportion of shareholdings in India's diverse stock exchanges it is difficult to precisely calculate their overall impact across all sectors over an extended period of time.

FURTHER RESEARCH

The research also needs to assess the ways in which FII influence stock market volatility, liquidity, and efficiency. It should seek to understand how liberalization of Foreign Institutional Investor access has resulted in an increase of international investors who provide both risk diversification opportunities as well as volume that affects local investor behavior. The study could use cross-country analysis on the effect of net inflows from foreign institutional investors on the capital markets of different countries throughout the world. Further research should explore how external shocks such as economic recessions or political unrest are felt differently depending on whether a market is open more toward domestic or foreign institutional investment activity. Overall, there is a need for researchers to examine further into this important topic given its vast implications for global finance and markets worldwide.

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