



# Fundamental Determinants of Equity Investments among Infrequent Small Scale Investors

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## Abstract

*Investment in equity needs a detailed study of various factors of a company before investing. The institutional investors are usually well versed with analysis of fundamental factors before investing in equities. Now, the small investors have also started considering different factors those influence the likely performance of the company due to changing scenario of stock broking business and mandatory provisions of regulatory bodies. This study is an attempt to identify the factors, which infrequent small investors consider substantially while investing in any equity. The factors, which were analyzed, are: financial performance and policy, quality of management, dissemination of information and governance and ethical practices. With the help of this study it was found that majority of infrequent small scale investors appraise fundamental factors of a company. However, their analysis is limited to financial performance and policy and information dissemination. The other variables like governance and ethical practice of the company are considered at lower degrees of consideration.*

**Keywords:** Infrequent investors, Small scale investors, Equity investment determinants, JEL Classification: G-02, G-11, G-12

## Introduction

Investment in equity needs a detailed study of various factors of a company before investing in it. The institutional investors analyze the various factors which are to be studied before investing in equities but the small investors traditionally, with their less resources and knowledge, do not appraise the company before investing in shares. However, with rising degree of awareness and several investor awareness programmes conducted by different broking houses as a part of their investor friendly image building strategy and sometimes to comply with the mandatory provisions of regulatory bodies, even small scale and infrequent investors have started considering different factors those influence the likely performance of the company they are investing in.

This study is an attempt to find how the infrequent small investors consider the different fundamental determinants while making equity investment decisions. The factors have been categorized in four categories based on their basic relevance substantially while investing in any equity.

**Financial Performance and Policy:** Cash Flow pattern of the company; Trend in Profits of any company; Level of gearing of the company; Dividend policy of the company; Reports of the financial statements and annual reports of the company; and Financial results i.e. liquidity, profitability, solvency.

**Quality of Management:** Quality of management discussions; Quality and experience of executive directors; Quality, qualification, experience and independence of non-executive directors; Extent to which the non-executive directors are seen

to influence company policy; Quality, qualification, experience independent directors; and Separated roles of chairman and MD/CEO.

**Information Dissemination:** Extent and Quality of disclosure in the company's financial statements; Quality of disclosure in the company's annual report; Level of disclosure regarding the company's strategies and initiatives; Level of disclosure regarding business costs of the company; Frequency with which information is disseminated to shareholders of the company; Prompt release of information about significant transactions that affect minority shareholders, by the company; Frequency and nature of communication with investors; Frequency and availability of other information about the company, which is publicly available; and Frequency and nature of public and press comment about company.

**Governance and Ethical Practices:** Corporate governance practices; Extent and clarity of related party transactions; Existence of corporate governance codes and business ethics; Existences of other transparency mechanisms that help ensure fair treatment to all shareholders in any company; Level of disclosure of corporate governance practices; Existence of an internal audit department; Quality of external auditors of the company; and Existence of remuneration committee in the company.

**Literature Review:** The fundamental determinants of equity prices have attracted many scholars from different countries to find the determinants of equity share prices. Amarjit Gill, Nahum Biger, Neil Mathur (2012), attempted to find variables that explain the variance of equity share prices in America by

taking a sample of 333 American firms listed on New York Stock and found that book value per share, earnings per share, dividend per share, price-earnings ratio, the CEO duality, and the internationality of the firm explain the variance of equity share prices in America<sup>1</sup>.

Nirmala P.S., Sanju P.S., Ramachandran M., identified the determinants of share prices in the Indian market using panel data pertaining to three sectors viz., auto, healthcare and public sector undertakings over the period 2000-2009 concluded that the variables dividend, price-earnings ratio and leverage are significant determinants of share prices for all the sectors under consideration<sup>2</sup>. Sharma, S., in his study to examine the empirical relationship between equity share prices and explanatory variables such as: book value per share, dividend per share, earning per share, price earnings ratio, dividend yield, dividend pay-out, size in terms of sale and net worth for the period 1993-94 to 2008-09 found that earning per share, dividend per share and book value per share has significant impact on the market price of share<sup>3</sup>. The study also indicated that the study of financial factors prove to be beneficial for the investor in the India, as these factors possess strong explanatory power.

Sharma and Singh used data from 160 Indian firms and found that earnings per share, price-earnings ratio, dividend per share, dividend coverage, dividend pay-out, book value per share are important determinants of share prices<sup>4</sup>. Gill and Mathur used a data from 91 firms listed on Toronto Stock Exchange from 2008 to 2010 and found that the CEO duality has a positive impact on the market value of manufacturing firms in Canada<sup>5</sup>.

The majority of researches have emphasised on the fundamental and other determinants of equity prices in different sectors or countries. The present study also emphasises on fundamental determinants, however, it is an attempt to analyse how infrequent and small scale investors consider these determinants in the decision process of equity investment.

**Objectives of the Study:** The above literature review helped in identifying the following research gaps: i. Identifying and confirmation of determinants being considered among infrequent small scale investors, ii. Examination of the extent to which the category of investors studied tend to be influenced by the factors identified; and iii Understanding the behaviour of the studied category investors which may further help to understand the market microstructure better and emphasise balanced approach rather than institution-centric approach.

The present study is based on the following formal research objectives in order to fill the gaps identified from the detailed literature review: i. To identify the determinants those determine the infrequent small scale investors' investments decision behaviour, ii. To confirm the presence of these determinants in understanding of the small size individual investors; and iii. To examine the extent to which these determinants are responsible for individual investment decision.

## Methodology

This study is an attempt to identify the factors, which infrequent small investors consider while investing in any equity. The study is based on one hundred sixty seven infrequent small scale investors selected based on the judgment of the researcher. The infrequent small scale investors who understand the fundamental determinants of investments were only selected as a constituent of sample. Two hundred questionnaires were circulated out of which one hundred seventy six were received back within the stipulated time for the purpose. Nine questionnaires were later rejected due to multiplicity of ratings for one question and other reasons that made them unsuitable for including in the study.

The investors who invest in equity not more than twice a year were considered to be infrequent investors. Similarly, the investors with investable funds not more than one hundred thousand at once were considered to be small scale investors. The data were collected during the second half of 2012 in the Rajasthan state of India. The respondents were requested to fill in the questionnaire designed to collect the desired information. They were asked to tick the appropriate one option only that best represents their opinion with a view to maintain the exclusivity of their consideration to specific factor.

In order to quantify the extent to which these factors influenced their investment decision respondents were asked to assess the relative importance of each factor. A rating of five denotes the strongest influences, a rating of one denotes the weakest influence and a rating of zero denotes no influence. The ratings were subsequently averaged to calculate mean scores for each factor. Each question's individual average rating has been evaluated to understand the importance of specific factor that affects the equity investment decisions of investors.

**Hypothesis:** The hypothesis is that the infrequent small scale investors do not consider the fundamental determinants of equity investment in any company due to their smaller funds and infrequent investments. The findings have been tested for test scale of 'very important' as the variables studied carry great importance in quality investments.

*Null Hypothesis (H<sub>0</sub>):* The mean scale is equal to 4 (Very Important) i.e., infrequent small scale investors consider the studied variable to be very important in equity investment.

**Testing of Hypothesis:** Computed 'Z' score was used to ascertain the probability using normal distribution (z), which was compared with the comfortable error level i.e., 5% (A=0.05)

## Results and Discussion

The responses on different fundamental determinants included in questionnaire have been summarized in the following table. The mean scale has also been computed for further testing of hypothesis.

**Table-1**  
**Findings on consideration of different variables**

Variable Code	Variable	Vital (5)	Very Important (4)	Important (3)	Considerable (2)	Ignorable (1)	Mean Scale
<b>I. Financial Performance and Policy</b>							
VAR – 1	Cash Flow pattern of the company	114	43	8	0	0	4.64
VAR – 2	Trend in Profits of the company	150	15	0	0	0	4.91
VAR – 3	Level of gearing of the company	77	45	29	14	0	3.95
VAR – 4	Dividend policy of the company	98	67	0	0	0	4.59
VAR – 5	Reports of the financial statements and annual reports of the company	162	3	0	0	0	4.98
VAR – 6	financial results and solvency	155	10	0	0	0	4.94
VAR – 7	Trend in EPS of the company	109	39	17	0	0	4.56
<b>II. Quality of Management</b>							
VAR – 8	Quality of management discussions and analysis of the year's results and financial position of the company	85	54	21	5	0	4.27
VAR – 9	Quality and experience of executive directors	77	43	26	13	6	3.88
VAR – 10	Quality, qualification, experience and independence of non-executive directors	74	35	27	22	7	3.62
VAR – 11	Extent to which the non-executive directors are seen to influence company policy	65	36	23	21	20	3.38
VAR – 12	Quality, qualification, experience of independent directors	55	31	19	29	31	2.95
VAR – 13	Whether roles of chairman and MD/CEO are separated or not	52	46	24	24	19	3.24
<b>III. Information Dissemination</b>							
VAR – 14	Extent and Quality of disclosure in the company's financial statement	93	54	18	0	0	4.45
VAR – 15	Quality of disclosure in the company's annual report	95	53	17	0	0	4.47
VAR – 16	Level of disclosure regarding the company's strategies and initiatives	61	45	23	21	15	3.45
VAR – 17	Level of disclosure regarding business costs of the company	76	43	29	14	3	3.89
VAR – 18	Frequency with which information is disseminated to shareholders of the company	76	42	24	16	7	3.80
VAR – 19	Prompt release of information about significant transactions that affect minority shareholders, by the company	54	36	23	24	28	3.10
VAR – 20	Frequency and nature of communication with investors	68	41	21	21	14	3.52
VAR – 21	Frequency and availability of other information about the company, which is publicly available	32	43	24	36	30	2.63
VAR – 22	frequency and nature of public and press comment about the company	35	41	23	32	34	2.68

IV. Governance and Ethical Practices							
VAR – 23	Corporate governance practices	65	54	31	12	3	3.86
VAR – 24	Extent and clarity of related party transactions	61	52	29	16	7	3.68
VAR – 25	Existence of corporate governance codes and business ethics	87	56	21	1	0	4.38
VAR – 26	Existence of other transparency mechanisms that help ensure fair treatment to all shareholders in the company	71	41	27	21	5	3.67
VAR – 27	Level of disclosure of corporate governance practices	69	40	24	25	7	3.54
VAR – 28	Existence of an internal audit department	82	49	26	8	0	4.15
VAR – 29	External auditors of the company	78	43	31	12	1	3.98
VAR – 30	Company has an remuneration committee	49	34	29	27	26	2.99

The findings have been tested for test scale ‘very important’ (4). Computed ‘Z’ score was used to ascertain the probability (P) using normal distribution (z), which was compared with the comfortable error level i.e., 5% (A=0.05).

**Table-2**  
**Test for Variables under Financial Performance and Policy One-Sample Statistics**

Variable Code	N	Mean	Std. Deviation	Std. Error Mean
VAR – 1	165	4.6424	.57330	.04463
VAR – 2	165	4.9091	.28835	.02245
VAR – 3	165	4.1212	.98642	.07679
VAR – 4	165	4.5939	.49259	.03835
VAR – 5	165	4.9818	.13402	.01043
VAR – 6	165	4.9394	.23933	.01863
VAR – 7	165	4.5576	.67491	.05254

**One-Sample Test**

Variable Code	Test Value = 4					
	T	Df	Sig. (2-tailed)	Mean Difference	95% Confidence Interval of the Difference	
					Lower	Upper
VAR - 1	14.394	164	.000	.64242	.5543	.7306
VAR - 2	40.497	164	.000	.90909	.8648	.9534
VAR - 3	1.578	164	.116	.12121	-.0304	.2728
VAR - 4	15.488	164	.000	.59394	.5182	.6697
VAR - 5	94.106	164	.000	.98182	.9612	1.0024
VAR - 6	50.418	164	.000	.93939	.9026	.9762
VAR - 7	10.612	164	.000	.55758	.4538	.6613

**Table-3**  
**Test for Variables under Quality of Management One-Sample Statistics**

Variable Code	N	Mean	Std. Deviation	Std. Error Mean
VAR - 8	165	4.3273	.81273	.06327
VAR - 9	165	4.0424	1.12809	.08782
VAR - 10	165	3.8909	1.23475	.09613
VAR - 11	165	3.6364	1.41891	.11046
VAR - 12	165	3.3030	1.53981	.11987
VAR - 13	165	3.5333	1.36834	.10653

**One-Sample Test**

Variable Code	Test Value = 4					
	T	Df	Sig. (2-tailed)	Mean Difference	95% Confidence Interval of the Difference	
					Lower	Upper
VAR - 8	5.173	164	.000	.32727	.2023	.4522
VAR - 9	.483	164	.630	.04242	-.1310	.2158
VAR - 10	-1.135	164	.258	-.10909	-.2989	.0807
VAR - 11	-3.292	164	.001	-.36364	-.5817	-.1455
VAR - 12	-5.814	164	.000	-.69697	-.9337	-.4603
VAR - 13	-4.381	164	.000	-.46667	-.6770	-.2563

**Table-4**  
 Test for Variables under Information Dissemination One-Sample Statistics

Variable Code	N	Mean	Std. Deviation	Std. Error Mean
VAR - 14	165	4.4545	.68480	.05331
VAR - 15	165	4.4727	.67683	.05269
VAR - 16	165	3.6970	1.33629	.10403
VAR - 17	165	4.0606	1.06895	.08322
VAR - 18	165	3.9939	1.17648	.09159
VAR - 19	165	3.3879	1.48812	.11585
VAR - 20	165	3.7636	1.33841	.10420
VAR - 21	165	3.0667	1.41047	.10981
VAR - 22	165	3.0667	1.45725	.11345

**One-Sample Test**

Variable Code	Test Value = 4					
	T	df	Sig. (2-tailed)	Mean Difference	95% Confidence Interval of the Difference	
					Lower	Upper
VAR - 14	8.526	164	.000	.45455	.3493	.5598
VAR - 15	8.972	164	.000	.47273	.3687	.5768
VAR - 16	-2.913	164	.004	-.30303	-.5084	-.0976
VAR - 17	.728	164	.467	.06061	-.1037	.2249
VAR - 18	-.066	164	.947	-.00606	-.1869	.1748
VAR - 19	-5.284	164	.000	-.61212	-.8409	-.3834
VAR - 20	-2.268	164	.025	-.23636	-.4421	-.0306
VAR - 21	-8.500	164	.000	-.93333	-1.1501	-.7165
VAR - 22	-8.227	164	.000	-.93333	-1.1573	-.7093

**Table-5**  
 Test for Variables under Governance and Ethical Practices One-Sample Statistics

Variable Code	N	Mean	Std. Deviation	Std. Error Mean
VAR - 23	165	4.0061	1.02110	.07949
VAR - 24	165	3.8727	1.14319	.08900
VAR - 25	165	4.3879	.72908	.05676
VAR - 26	165	3.9212	1.17384	.09138
VAR - 27	165	3.8424	1.23935	.09648
VAR - 28	165	4.2424	.89136	.06939
VAR - 29	165	4.1212	.99871	.07775
VAR - 30	165	3.3212	1.44824	.11275

**One-Sample Test**

Variable Code	Test Value = 4					
	T	df	Sig. (2-tailed)	Mean Difference	95% Confidence Interval of the Difference	
					Lower	Upper
VAR - 23	.076	164	.939	.00606	-.1509	.1630
VAR - 24	-1.430	164	.155	-.12727	-.3030	.0485
VAR - 25	6.834	164	.000	.38788	.2758	.5000
VAR - 26	-.862	164	.390	-.07879	-.2592	.1017
VAR - 27	-1.633	164	.104	-.15758	-.3481	.0329
VAR - 28	3.494	164	.001	.24242	.1054	.3794
VAR - 29	1.559	164	.121	.12121	-.0323	.2747
VAR - 30	-6.021	164	.000	-.67879	-.9014	-.4562

**Conclusion**

The findings reveal that all factors, except level of gearing of company, under financial performance and policy satisfies the null hypothesis which means that all the factors other than gearing of a company are considered to be very important by the infrequent small scale investor. Quality and experience of executive directors and independence of non-executive directors are the factors which have not been considered very important in decision making by the studied group of investors. It is probably because their voting power in selection of directors is negligible.

Information dissemination is one of the factors which influence the investment decisions largely. Level of disclosure regarding business costs of company and the frequency with which information is disseminated to shareholders of the company were found to be the factors which are not assigned greater importance by the studied category of investors. The forth section of determinants i.e. governance and ethical practices was found to be the least considered by the small size investors. Corporate governance practices, extent and clarity of related party transactions, existence of other transparency mechanisms that help in ensuring fair treatment to all shareholders in any company, level of disclosure of corporate governance practices and external auditors of the company were the variables which got lower consideration as compared to mean scale assigned.

The findings conclude that the infrequent small scale investors do consider the fundamental determinants of a company before investments but their considerations are limited to easily understandable financial performance variables, generally needed and available information regarding company operations, fundamental reputation of company management and mere existence of corporate governance practices in the company.

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