CAN INVESTMENTS BE FREE OF RISK?

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The logo of the Adani group on the facade of one of its buildings in the outskirts of Ahmedabad. | Photo Credit: REUTERS

Recently, a three-judge Bench of the Supreme Court put forth the idea of setting up an expert committee that could recommend ways to protect common investors from market events. The court's recommendation came soon after the stocks of the companies of the Adani Group crashed following a report by Hindenburg Research, a U.S.-based investment research firm. It is estimated that the fall in the Adani Group's stocks has cost investors over $100 billion. Can investments be free of risk? **Jayati Ghosh** and **Anand Srinivasan** discuss the question in a conversation moderated by **Prashanth Perumal J**. Edited excerpts:

What is the fundamental nature of risk in markets, and why do returns vary based on risk? Why, for instance, does the return on a fixed deposit turn out to be lower than the return on stocks?

Anand Srinivasan: Economists measure risk differently from the way investors measure risk. Economists think volatility is risk, but volatility is not risk. In fact, volatility is an investor's friend and is not to be worried about at all. Volatility refers to the swings in the price of an asset. In the case of fixed deposit, there is no change in the price of the asset, whereas in the case of a bond or a stock, there is a price swing on both sides (up or down). But an investor is worried only about the permanent loss of capital. It is good for an investor when there is volatility because it gives him an opportunity to make profits.

Jayati Ghosh: Typically, in financial markets, investments that are considered risky will require higher returns to attract investors. It holds true for different geographical locations, for example. Investments in some countries in Africa or Asia are considered riskier than investments in the U.S. or Europe. Now, it is true that economists typically look at the variation or change in prices of an asset as an indicator of risk. But that's not the only indicator they look at to measure risk. Investments in particular sectors such as infrastructure are seen as riskier because there's a longer time duration involved and many unexpected forces can come into play.

Do risk-taking investors need to be protected by regulators from losing money in financial markets as suggested by the Supreme Court? Could there be unintended consequences due to such regulations?

Anand Srinivasan: I think there are sufficient laws in place to protect small investors. I don't think we need another committee with a judge sitting on it to tell us what to do. The role of the Supreme Court is not to make laws but enforce them. Had the court enforced existing regulations, this sorry state of affairs wouldn't have come to place. If people are greedy, you cannot protect them. Take the case of cryptocurrencies. China has banned cryptocurrencies because it leads to flight of capital. We should have banned cryptocurrencies a long time ago. The Supreme Court is waiting for the government to respond and the government is waiting for the G-20 to respond. Why is the Supreme Court not talking about this? Genuine investors will feel burdened and leave the country if further regulations are added in the name of protecting investors.

Jayati Ghosh: It's quite interesting that the Supreme Court has chosen to take this up because less than 2% of the Indian population is involved in the stock market in retail. Retail investors are typically those who have wealth to spar and are willing to invest in risky assets and bear that risk. I don't think the Supreme Court should be intervening in these matters. What it should be doing is to ensure that regulatory bodies in finance actually do their job, because it's not so much the retail investors we should worry about; we should be worrying about the LIC, the State Bank of India, and other places that hold the bulk of personal savings in India. These [public] institutions have been investing in a problematic stock, one in which, let's say, a mutual fund would not invest. Why did they keep doing this despite various red flags? There is a broader failure of the public financial institutions which seem to have been too responsive to non-economic considerations, possibly political considerations.

Isn't the capture of regulatory bodies by political interests the norm rather than the exception? If you look at the empirical data, aren't independent regulators few and far between?

Anand Srinivasan: No. Please look at India from 1991 to 2014. The RBI (Reserve Bank of India) was run by economic professionals during that period. This is the first time a non-economic professional has been made RBI Governor. And show me a person from investment banking who has headed SEBI? None so far. The problem at SEBI is institutional capture. You have not had a proper regulator like Raghuram Rajan; instead, you have somebody from the industry. You cannot make a player in the game the referee. If you want to be a player, you should have had a long career in regulation.

Jayati Ghosh: SEBI is actually one of the most empowered regulators in the world. It has got powers of search, seizure, and arrest. It has a surveillance system. It's supposed to catch suspicious trading activity and watch out for price manipulation on a real-time basis. It's beyond comprehension how it could allow this massive increase in the stock price of Adani Enterprises and other stocks for such a long period without noticing it or doing anything about it. And to say now that we've sent some questions to the Adani Group and we are waiting for their response is ridiculous. Furthermore, all the information that Hindenburg Research has released is actually in the public domain. Some of it is even based on written answers in Parliament to Mahua Moitra's questions. So these are all things that SEBI should have been aware of and monitored. It didn't have to take a dramatic collapse of the share prices for SEBI to suddenly sit up and look around. This is an indication of the fact that SEBI has not really been functioning as an independent regulator at all. It is possible that SEBI has instigated various litigations in the past, but it has not taken them forward. So, this is a real comment on the failure of the Indian regulatory process. And even if people in India are scared to speak about all this, foreign investors are noticing that the Indian regulatory system is not really up to the task. This is particularly so in the case of the offshore firms; the regulatory agencies should have been immediately aware of these offshore firms because their purpose is to evade the law.

Should short-selling of stocks be made easier in India, like in the U.S., to keep a check on shady companies?

Anand Srinivasan: Short-selling should be made far easier. The whole Indian system is rigged in favour of those going long; it does not encourage people to go short. Securities are not easily available to borrow and sell short. Even in the case of Hindenburg, what the firm has done is it has used credit default swaps to short the Adani bonds that are listed outside India.

Jayati Ghosh: Short-sellers do play a role in every financial market, because they often either uncover processes that have been opaque or are problematic, or hasten processes which otherwise would take a long time to unfold. Short-selling is operating on the idea that you can get the market to respond to your behaviour, because you create a kind of ‘lemming effect,’ where you have some leaders and then everybody else rushes behind them. This has happened in many sectors. Having said that, they also do generate market instability, and they can often operate on rumour rather than on underlying fundamentals. In the case of Hindenburg, short-selling has actually been good for the Indian financial market because it has forced it to confront the reality that the political economy of the country was not letting it confront. Even now, public financial institutions and regulatory bodies are really trying to evade dealing with the problem and are hoping that things will just quiet down. And unfortunately, the political establishment is also trying to present this as an attack on India rather than a genuine attempt to clean up what is a really murky financial and industrial system. This is not in the interest of the Indian people.

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