Market wisdom INVESTOR EMPOWERMENT SERIES
LESSON NO. 26 FROM THE HOUSE OF ASIT C. MEHTA INVESTMENTS

Budget 2007

The fall in markets after the Budget needs to be understood in line with Expectations vs actual announcements by the Finance Minister. There was a general expectation for reduction in surcharge and taxes in view of huge collections that have happened during this year. It was expected that the anomaly in definition of short term, long term and speculation profits be removed. None of this happened. The reduction in index that we saw over the last week also goes on to show that the budget was going to announce certain measures that not market friendly and hampering corporate earnings. This is one more example of "market always knows" in advance. Budget cannot be said as leaked but the market is smart to pick up signals of impending Boom or gloom.

The negative items that we saw in the budget are, increase in dividend tax from 12.5 % to 15%. Dividend tax is a tax that a company pays when giving dividend to shareholders. Dividend tax is double taxation. The FM had removed tax on dividend some time back because of this reason. Dividend is paid on income after payment of tax. Hence the income is already taxed and again paying tax on distribution is twice the payment of tax on same income. Increase in this tax amounts to lesser retained earnings for company. Increase in education cess from 2% to 3%. This increase is not substantial but attached to this there is distrust in minds of citizens that the money collected is not well spent. There is also an increase in tax on income from money market mutual funds. There is a general feeling amongst the regulators that money market mutual funds which have approximately 2,00,000 crore invested in them by way of gsecs and liquid funds are used by corporates to avoid taxes and there is no major retail participation. Hence a steep increase in income distribution taxes.

Two more issues are also relevant to markets is permitting institutions to short sale provided they have shares with them. What this means is the institution will sell in the market and not give delivery of shares. The delivery stock is borrowed through the lending and borrowing mechanism if either the stock exchange or clearing corporation. A small charge is paid to the lender of the stocks. The seller prefers to pay this charge rather then give delivery of the shares since he does not want to book profits or losses on the shares which he is originally holding. The owner expects a short term fall in prices which it wants to capture and turn it into a profit situation.

This is not something new that the Finance Minister is introducing. Several concept papers have been introduced by SEBI on this issue. The talk to introduce short selling has been on for last 6 years since banning of Badla in 2001. There are changes required in Income tax law to permit this activity. The lender of stocks should not be charged capital gain but taxed only for the charge that he receives for lending the share. There is no mention of this in the budget speech. Further there is always a fear that permitting short selling will lead to large sales being made since the markets are overheated. In fact permitting short selling brings more stability to the markets since there is less volatility. In absence of short sell the markets go only one way, there is no opportunity for persons to sell without stock. The proposal made now also requires that there should stock in possession of the seller. Hence we do not know how much impact this provision will have on markets and whether it will be actually implemented. Allowing short selling is not enough, just as markets can be overheated then can be under priced also. Hence there should be a robust margin trading facility in place to permit investors to buy and leverage when the prices are unusually low.

Another important concept that was talked about was Self Regulatory Organizations (SRO). The government wants to encourage such institutions in capital markets. Hence brokers will have an SRO, which will inspect the brokers and ensure that they comply with law, similar is the case of mutual fund managers, the merchant bankers, registrars, debenture trustees etc. Today in case of brokers the exchanges as well as SEBI inspects the brokers besides auditors who also conduct specific internal and statutory inspections. It is important that Stock exchanges and SEBI should delegate some of these inspections powers, which are routine in nature and retain only investigative powers in exceptional circumstances. However it is doubtful whether these agencies will give up the powers. Today also inspections are done by stock exchanges as well as SEBI on same compliance issues. There is every likelihood that RO will be the third agency to carry out inspection. The cost of compliance is very high and ultimately investors will pay the same in one form or the other.

There are several positive things in the budget also which is in giving general direction to the country's economic and social progress. Lot of emphasis has has been laid on education, agricultural infrastructure development, development of agri based industries. Again the apprehension is how much it will reach the ultimate beneficiaries. We need to strengthen delivery mechanisms whereby the recipient of the government largeness is the ultimate farmer and not intermediaries be it beaureaucrats or politicians or any other middle man.

There is a lot one can write on the budget. I have however tried to talk only about the direct tax impact on capital markets, introduce two new concepts being short selling and self regulatory organizations. However the bigger issue that I wish to bring to your notice is the volatility at such times. Markets fell initially by almost 600 points and then recovered to better levels. The initial reaction was not based on reading of the fine print of the budget. Slowly the television guests also started talking positive on various subjects, how much was genuine praise and how much was to be in good books of the Government remains to be seen. What is important to you is nothing stays down forever; panicking at such times is detrimental to your wealth. As the light of knowledge dawns on various announcements, things are clearer and actual impact known, after all the Finance Minister also cares that your wealth is not eroded.

Company performances will be a key driver for the future course that the market will take. If companies maintain the growth momentum there is little that can keep the sensex in dumps for long.

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