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ARTICLES /CASES

1. THE COMPANIES ACT 2013: A GAME CHANGER

The Companies Act, 1956, fashioned after British corporate laws, was the principal edifice of corporate governance in India since 1956. The significant changes in the India financial sector and corporate sector in the wake of liberalization in the early 1990s called for changes in regulation of capital markets and better protection of investors. SEBI was set up in 1992 and the prevailing merit – based capital market was replaced by a disclosure based capital market. The CII released the Code of Corporate Governance in 1996. Following this, SEBI constituted two committees on corporate governance, the Kumaramangalam Birla Committee and the Narayana Murthy Committee. Based on the recommendations of these committees a slew of reform measures were introduced such as

Clause 49 of the Listing Agreement board level reforms, disclosure of related party transactions, inclusion of a "Management and Discussion Analysis" section in the annual report, whistle blowers policy, and the certification of financial statements by the CEO and CFO.

Notwithstanding these reforms, a major corporate accounting scandal occurred at Satyam Computers, a leading IT company. In response, J.J. Irani committee was appointed to review the extant corporate law. The committee submitted its report in 2012. The Companies Act of 2013 was based largely from the proposals made by the J.J. Irani committee. The important changes introduced in the Companies Act 2013 are:

- A stricter definition of "Independent Director' has been provided.
- The Act provides for "limitation of liability" for independent directors.
- It obligates the directors to take a stakeholder approach in their decision- making marking a shift from a shareholder – centric model of corporate law (the anglo – saxon model) to the stakeholder – centric model of corporate law (followed by countries like Germany). But the new act does not accord explicit procedural rights to non shareholders stakeholders.
- It mandates that boards of certain prescribed companies have at least one woman director on their roster.
- It requires that all related party transaction over prescribed thresholds must be approved by the board, audit committee, and shareholders (through special resolution).
- It proscribes grant of stock options to independent directors, but it permits profit – linked commissions to be paid to independent directors besides sitting fees. It also mandates disclosure of ratio of directorial compensation to median employee – pay.
- It mandates rotation of audit firms after two consecutive terms of five years each.
- It allows an Indian company to be merged into a foreign company and allows the foreign company to use India Depository Receipts (IDRs) as a transaction currency for such a merger.
- It permits a merger between a parent and its wholly owned subsidiary without the approval of NCLT.
- It empowers shareholders with class action rights.
- It establishes a new statutory framework by replacing the High Court and the Company Law Board by the National Company Law Tribunal (NCLT) and its appellate authority the National Company Law Appellate Tribunal (NCLAT).
- It creates the Serious Fraud Investigation Office (SFIO) which will have the competence to investigate corporate frauds. The central government has the option of entrusting investigation into the affairs of the company to the SFIO.
- It established the National Financial Reporting Authority (NFRA) which shall make recommendations to the central government on matters relating to accounting and auditing policies and standards. The central government has the discretion of consulting with and examining the recommendations of NFRA, before prescribing the standards recommended by the Institute of Chartered Accountants of India.

The Companies Act, 2013 has been an important landmark in the evolution of corporate governance and investor protection in India. Like all other laws it will certainly undergo changes and revisions over time, but it represents an important step in strengthening corporate governance in India.

2. EQUITY VALUATION: SCIENCE,ART, OR CRAFT

In this research monograph, *Equity Valuation : Science, Art, or Craft* , published by the CFA Institute in 2017, Frank J. Fabozzi et. al investigate how analysts employed by acive investment managers firm their beliefs. For this purpose they interviewed analysts, portfolio managers, directors of research, chief investment officers , and academics at a variety of firms and institutions in Europe and North America.

Here are some important views and insights culled out from those interviews:

- A certain valuation model is useful for one purpose and not for another. For example, Robert Shiller's CAPE (Cyclically Adjusted Price Earnings) ratio is more appropriate for forecasting the long – term aggregate US stock market returns but not for forecasting stock returns in the short term; for explaining cross- sectional price behaviour, or for corporate CEOs focused on the easiest way to enhance the value of their company.
- According to Charles Lee of Stanford Business School, there has been a progressive shift from dividend discount model (DDM) or discounted cash flow (DCF) model to the residual income model (RIM).
- The discount rate is a crucial input. Determining the intrinsic value of a stock requires identifying a natural rate of interest and a natural rate of return. These are related to the macroeconomic situation.
- Laubach – Williams model is among the more popular models for detrmining the natural interest rate. As Thomas Lauubach and John Williams (2015) state: "The natural rate is assumed to depend on the estimated contemporaneous trend growth rate of potential output and a time- varying unobserved component that captures he effects of other unspecified influences on the natural rate."

  In mathematical terms

  $$\gamma_t{*} = g_{\mathrm{t}} + Z_t$$

  where $\gamma_t{*}$ is the natural rate of interest, g_t is the trend growth of the natural rate of output, and Z_t captures other determinants of $\gamma{*}$.
- Corporate buybacks have grown significantly. In the 11 – year perio, 2005 – 2016, U.S. listed companies spent about $6.1 trillion in buying back their own shares.

  Brad Cornell of Caltech says that given corporate buybacks and other innovations, dividend discount models are less useful than they once were.
- According to Philip Straehl and Robert Ibbotson (2015) the shift in corporate payout policy from dividends to buybacks has resulted in a "secular decrease in dividend yields, and an analogous increase in per- share growth." This has led to a structural break in the returm

component of the traditional supply models such as the dividend discount model. So, there is a need for a new supply model of stock returns. They have proposed a "total payout" model of stock returns – the "total payout" is the sum of dividends and cash payouts resulting from buybacks. They argue that their total payout model produces good forecasts of long- term stock returns.

- Asset- based approach and real options approach are more narrowly applicable than the dividend discount model and the discounted cash flow model.
- When a discounted present value approach is deemed difficult or inappropriate, relative valuation methods using market multiples based on heuristics are commonly used.
- Peter Roosenboom (2012) of Rotterdam School of Management found that underwriters typically determine fair – value estimates using three valuaton methods, viz., multiples, dividend discount models and discounted cash flow models. All the three valuation methods have similar accuracy, explainability and bias (positive) with respect to equilibrium market value.
- There is a two- step process in valuing and pricing IPOs. First, the investment banker arrives at a rough idea of value based on fundamentals. Second, the investment banker tests initial investor sentiment which is the key. The price is eventually determined by the information exchange between the underwriter and investors and not much by fundamentals.
- Severin Zorgeibel observed in a working paper of Goethe University in 2016, "Based on the general IPO literature and my research, there are many drivers of IPO valuations, the main drivers being growth expectations, profitability, ownership (venture capitalists with a good reputation, for example), underwriter quality, market timing (IPO bull phases, e.g), industry / technology trends, the number of shares issued, and last but not least, the media coverage (you might call it "hype") before an IPO. It is hard to say which factors are the more important, but I guess it is often a mixture of several. In addition, these driving forces can reinforce themselves and increase or decrease valuatuion levels even further."
- Alok Kumar of University of Miami School of Business Adminstration studied the impact of uncertainty on investor behaviour. In situtations characterised by high uncertainty, people are more likely to use heuristics (rules of thumb), thereby increasing the scope for behavioural biases and investment mistakes. This applies to private equity as well as IPOs.
- Valuation of privately held firms poses two additional challenges: (a) Financial statements are available for few years and are less detailed with more deficiencies. (b) Debt and equity have no assigned market value.
- In the wake of the global financial crisis, central banks have flooded the market with liquidity. Given the artificially low returns on government and other bonds, investors have targeted equities.

- In 2016 Burton Malkiel said that even in emerging markets, which are generally viewed as less efficient than developed markets, passive managers outperform active managers. China was perhaps the lone exception because insider trading there is common.
- Some have suggested that market efficiency is assured, even if active managers account for just 10% of the market.
- Emphasising the important of ESG, Alfred Slager wrote: "By fit- for- purpose, my idea would be – besides the fact that the company is financially viable – that governance is in order, shareholder rights are protected, and especially ESG (environmental, social, and governance) factors have been taken into consideration. All are crucial for long- term risk management. I sort of suspect that ESG is a form of DNA or fingerprint of the organization and that in that sense, might have more predictive value than finacials."

B. SNIPPETS

1. Strategic Asset Allocation, Tactical Asset Allocation, and Security Selection

Strategic asset allocation consists of allocations to asset classes that meet the requirements of investors best, such as 50 percent to stocks, 40 percent to bonds, and 10 percent to cash. Strategic asset allocation may change over time as people's circumstances change.

Tactical asset allocation consists of temporary departures of asset allocations away from strategic allocations, such as decreasing to 40 percent the allocation to stocks and increasing to 50 percent the allocation to bonds. Tactical asset allocation is an attempt to increase portfolio returns beyond the return of strategic asset allocation by exploiting temporary deviations of asset class- values from their values.

Security selection involves selecting particular securities from all securities in an asset class. It seeks to increase portfolio returns beyond the returns of strategic asset allocation by selecting securities are likely to outperform others in their asset class.

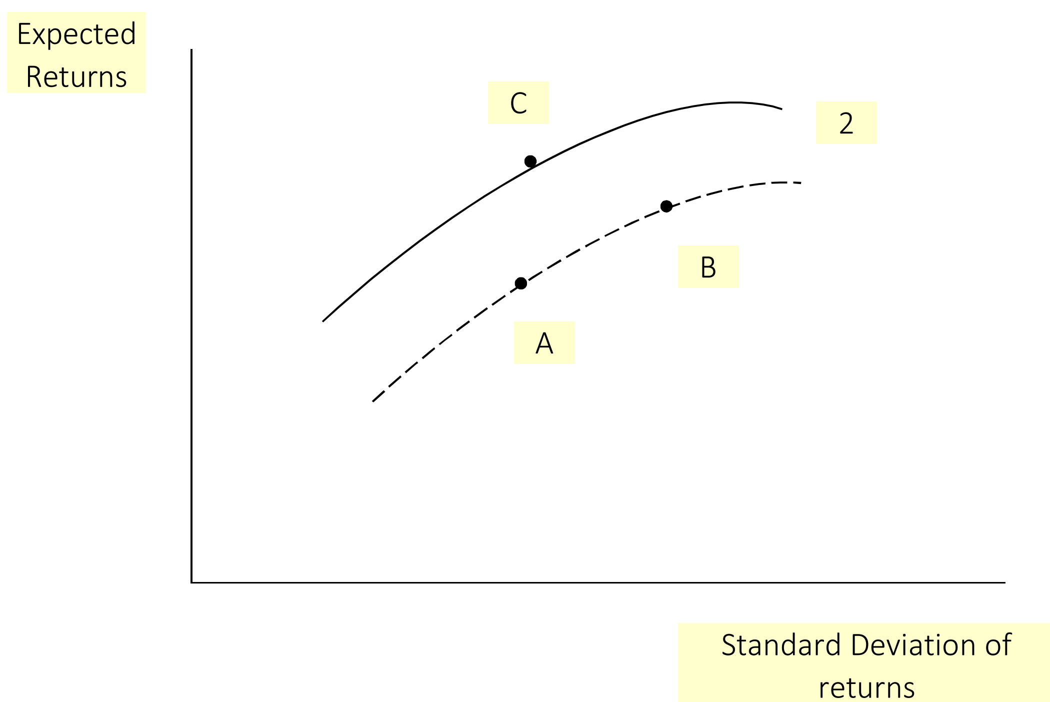
Gary Brinson and his coauthors analysed the performance of 91 large US pension plans and found that variation in strategic asset allocation accounts for an average 93.6 percent variation in the total returns of portfolios, the balance being explained by variation in tactical asset allocation and security selection.

This finding is often interpreted as evidence that strategic asset allocation matters more than tactical asset allocation matters more than tactical asset allocation or security selection. This interpretation is incorrect because explaining the *variation* of returns is quite different from explaining the *magnitude* of returns and their signs, Brinson and his coauthors found that the magnitude of returns in negative 1 percentage points. This means that tactical and security selection *detracted* 1.1 percentage points on average from portfolio returns that would have been produced with strategic allocation alone.

Strategic asset allocation is very important. Tactical asset allocation and security selection can also be potentially important but in different ways. As Meir Statman put it: "Tailoring good strategic allocation and security selection is like tailoring a well- fitting suit. Weaving good tactical asset allocation and security selection is like weaving the suit's fabric at high quality and low cost. But are important but in different ways.

Strategic allocation is part of *management of investors*. It focuses of on the wants, goals, financial resources, risk tolerance, and investment horizon of the investor. It provides guidance for avoiding cognitive and emotional errors on the path of accomplishing wants and associated goals. *Tactical asset allocation and security selection* are parts of *management of investments*. They are concerned with increasing returns without increasing risk. Strategic allocation involves movements on the efficiency frontier, such as from portfolio A to portfolio B on frontier 1.

While strategic asset allocation involves movements on the efficiency frontier, such as from portfolio A to portfolio B on frontier 1 in Exhibit, tactical asset allocation and security selection involve movements of the frontier, like the one from portfolio A on frontiner 1 to portfolio C on the higher frontier 2. Investors engage in tactical asset allocation and security selection seek to move the frontier higher, but all too often they end up moving it lower.



2. Shared Value

Social problems like ecological degradation are enormous. Traditionally, the primary responsibility for solving social problems lay with the government and, to some extent, with the NGOs (non-governmental organisations). The resources of the government and the NGOs, however, are grossly inadequate in relation to the magnitude of the problems. Resources are largely in the hands of the corporations. For example, in the US the resources available with the corporations in the U.S are $20 trillion, whereas the resources with the government are just $3 trillion.

So, corporations must be actively engaged in addressing social problems. They can work out scalable solutions for social problems, provided they can benefit from solving social problems. The conventional wisdom that business profits from *creating* social problems must be replaced by new thinking that business profits from *solving* social problems.

Take the case of pollution. We have learnt that by reducing pollution business can generate profit. Issue by issue it is now being realised that there is no conflict between social progress and economic efficiency in a fundamental sense. Here are some example: Heart Healthy Oils in the U.S has a profitable operation while promoting healthy nutrition. Jain Irrigation in India is helping in saving water with its drip irrigation business which is a profitable activity. The social forestry project of ITC in India is an economically viable operation.

Addressing social issues with a viable business model, that can be scaled up and hence not constrained by resources, leads to creating shared value. Shared value is capitalism of a higher kind:

Shared Value = Social Value + Economic Value

3. In Defence of Passive Investing

Some time back, Fidelity Investments conducted a study in the U.S. to find out what kind of investor accounts enjoyed the best returns. They found that the highest returns were earned by investors who had completely forgotten about their investments for years, even decades- and a good proportion of these investors had died a long time back. The moral of the story is that as far as managing your portfolio is concerned, do exactly what a dead person would do. That is don't do anything.

A conspicuous example of a passive strategy is an American fund named Voya Corporate Leaders Trust Fund, which has not made any changes to its holdings since its beginning. Started in 1935, its initial fund managers selected 30 stocks which in their judgment were the best companies of that time (Corporate Leaders) and invested equal amounts of money in the shares of each.

Barring the changes that have happened automatically on account of mergers and acquisitions, no deliberate change has been made to this mutual fund's portfolio. Over a period of 82 years (1935-2017), the Voya Fund has earned a return of 10.6%, per annum (about 3900 times) when the Dow. Jones Industrial Index earned only 6.7% per annum (about 200 times).

4. India International Exchange (India INX)

India International Exchange (India INX) is a subsidiary of BSE setup in 2017 in International Financial Services Centre (IFSC) in GIFT City, Gandhinagar, Gujarat. The main purpose of setting up the exchange is to bring the large offshore rupee markets back to India, make available a single exchange for global investors to invest in Indian securities without any currency risk, and to provide an easy platform for listing foreign currency securities. The exchange which at present is under the triple regulatory control of RBI, SEBI and IRDA is expected to shortly come under the single regulatory control of International Financial Services Centre Authority set up in 2019 to be the sole regulator for all IFSCs.

The median turnaround time of the exchange is 4 microseconds which reportedly is the fastest in the world. Trading in the exchange takes place for 22 hours a day, in two sessions, to cover all the global time zones. The first session is from 4.30 hours to 17 hours with settlement by 8 hours the next day and the second from 17.01/05 hours to 2.30 hours with settlement the same day by 16.30 hours. All prices and settlements are in US dollars. Any SEBI recognised intermediary permitted to operate in an IFSC can become a member of the exchange and provide services to: persons not resident in India, NRIs and resident Financial Institutions eligible under FEMA to remit funds abroad upto specified limits, or a resident Indian to the extent allowed under Liberalised Remittance Scheme. To make the exchange globally competitive, the charges levied are kept very low and the access formalities very simple. Also, for the trades done in the exchange there is no security transaction tax, commodity transaction tax, capital gains tax or GST.

At present the exchange offers for trade the following contracts: Futures and option contracts on S&P BSE SENSEX, S&P BSE SENSEX 50 (called India 50 Index) and on Indian single stocks. The contract periods are in three monthly cycles of near, next and far months. The products on commodities are futures and option contracts on Brent Crude, gold, silver, aluminium, copper, lead, nickel and zinc. The currency derivatives are futures and options on EUR/USD, GBP/USD, JPY/USD, INR/USD and USD/INR where three serial monthly contracts followed by three quarterly contracts are available. Out of all these contracts, at present, trading is confined to only futures and options on India 50 Index, gold and INR/USD. In the debt segment, Indian and foreign issuers can list bonds in Indian Rupee as well as foreign currency and the bonds will be available for trading through Bloomberg immediately upon listing. Besides foreign currency bonds, exotic bonds like Masala/ Green /Social/Sustainable bonds can also be listed. Some of the issuers of such bonds so far are ADB, Exim Bank, SBI, NTPC, REC, PFC, ONGC, Adani Ports and Yes Bank.

The volume of trading in India 50 Index derivatives is reported to be already comparable to that on the Singapore exchange and that in gold eight times that on the Dubai exchange. Forty seven billion US dollars have already been raised from listings in the exchange so far. The exchange has requested SEBI for permission to deal in REITs, InvITs and GDRs. It has tied up with global exchanges like CME and LME and has ambitious plans to eventually offer products on overseas listed securities, asset backed securities, convertible bonds, depository receipts and derivatives across all commodity classes.

5. **Fund raising by Reliance Jio**

Reliance Industries Limited's net debt stood at Rs.1,61,035 crore as on March 31, 2020, owing mainly to heavy investments in their traditional petrochemical sector and rolling out of new telecom/digital business under the Jio brand. To allay any possible concerns among investors over the rising debt overhang, Mukesh Ambani, the Chairman had stated in the AGM in August 2019 that the company had a very clear roadmap to becoming a zero net debt company within 31st March, 2021. Well before the deadline set, the company was able to become net debt free by stake sale and a rights issue of equity shares. The unprecedented investment blitz saw Reliance Jio alone raising about $20 billion from some global tech giants and financial investors, in just three months, as shown below:

Date of investment/ announcement	Investor	USD (million)	Amount (Rs. In crore)	Percentage stake in Jio
2020 April 22	Facebook	5,700	43,574	9.99
May 4 and June 5	Silver Lake Partners	1,338	10,212	2.08
May 8	Vista Equity Partners	1,500	11,367	2.32
May 17	General Atlantic	873	6,598	1.34
May 22	KKR	1,500	11,367	2.32
June 5	Mubadala	1,200	9,094	1.85
June 7	Abu Dhabi Investment Authority	750	5,684	1.16
June 13	TPG Capital	600	4,547	0.39
June 13	L Catterton	250	1,895	0.39
June 18	Public Investment Fund of Saudi Arabia	1,500	11,367	2.32
July 3	Intel	253	1,894	0.39
July 12	Qualcomm	97	730	0.15
July 15	Google	4,500	33,737	7.73
Total		20,061	152,066	32.43

PART C: WIT AND WIDSOM

1. **HUMOUR**

- A twelve year boy was late in coming to the school one day. The teacher asked him why he was late. The boy said on my way to the school I found a man who had lost his $100 note and searching for it. The teacher asked “Could you help him find his $100 note?”” The boy replied, “No, I was standing on it.”

- A little boy told her mother “Today in the bus, I gave my seat to a lady because dad asked me to do so.”
  The mother said, “I am glad that you showed concern for a lady.”
  The boy replied, “I was sitting on dad’s lap.”

2. **WISE SAWS**

- Flattery is counterfeit money which, but for vanity, would have no circulation. :La Rochefoucald.
- Democracy live like, can survive any attack- save neglect and indifference.