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The Study of Capital Markets in Emerging Economies and Role of Indian Stock Market in Managing Risk

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Abstract – Informational contribution was measured by estimating abnormal returns around the release of the recommendation, while the ability to predict investment returns was analysed over a long investment horizon using the event study methodology. The study concludes that analyst recommendations, in aggregate, are useful since they enhance information availability in the market, as well as enable investors to earn abnormal returns, provided that specific trading strategies are employed to use such recommendations. Diversified portfolios formed and periodically rebalanced based on analyst recommendations, when suitably aggregated and ranked, can earn abnormal returns that are not only statistically significant, but also economically significant after reducing transaction costs. Analyst research is, however, also highly biased and can potentially mislead uninformed investors.

Keywords: Indian Stock Market, Economies, Value Investing

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INTRODUCTION

Capital Markets in Emerging Economies

Capital markets assume a significant job in advancing monetary movement worldwide by encouraging and enhancing firms' entrance to back. At the large scale level, extending capital markets, which have plentiful liquidity and created optional markets, are likewise reshaping the creating scene, driving riches creation and the development of incredible territorial exchanging coalitions. In developing and outskirts economies, the advantages that gather to national economies as capital markets development and extend are possibly more noteworthy, yet they are additionally especially delicate to a large group of institutional factors, including rivalry, insurance of minority investors and by and large business efficiency. Along these lines, supporting the improvement of capital markets for the most part includes a wide and yearning project of change. And still, after all that, fruitful market-developers should be aware of signs that markets may exceed the social and administrative capital on which they depend. The requirement for carefulness is particularly incredible on the grounds that, as the emergency of 2008–9 illustrated, markets can proceed to develop and pull in liquidity even as foundations are being disintegrated away from underneath them. Indeed, even before the money related emergency of 2008–09 and the financial downturn that tailed it, the creating scene was developing a lot quicker than created economies. Since the second from last quarter of 2009, the greater part of the world's monetary development has originated from transitional and rising economies (UN 2011). This pattern is embodied by the ascent of the BRIC nations (Brazil, Russia, India, and China), which are all right now positioned among the main ten economies on the planet, and conjecture to rank among the best six by 2020 (CEBR 2011). Since the money related emergency, this significant lopsidedness in future development prospects has fuelled a quick recuperation of both direct and portfolio speculation, frequently to above pre-emergency levels, as progressively remote investors have looked to benefit from development in these markets or essentially to broaden their portfolios from cutting edge economies. While the emergency of 2008–9 imprinted trust in divulgences inside created nations, developing markets have seen discernments gradually recoup and, maybe as significantly, meet. Wilderness markets, then again, are not keeping up, implying that the absolute most encouraging economies on the planet may soon not have the capital markets to coordinate their dynamism. As things stand, the energy for bigger and more profound capital markets in the creating scene is generous however not irreversible. While market capitalization has developed astonishingly and kept pace with levels of development found in

the created world, market liquidity has not. Albeit rising economies are in an ideal situation without the abundance liquidity that the most created capital markets saw paving the way to 2007, it remains the case that markets need to extend further in the event that they are to help fund the quick development expected in these economies

India as a developing market economy

India is probably going to be the third biggest economy with a GDP size of USD 15 trillion by 2030, says Standard Chartered's Super-Cycle Report. China with a GDP of USD 53.8 trillion is anticipated as the greatest economy, trailed by the US at USD 38.5 trillion. Economies with development paces of more than four percent - basically rising economies - presently represent 37 percent of the world GDP, up from 20 percent in 1980. Their offer is set to arrive at 56 percent by 2030, Standard Chartered stated, including that Asia (barring Japan) is probably going to represent two-fifths of worldwide GDP by 2030. Be that as it may, for all the open consideration encompassing India's development rate as of late, confusions stay about what moves it. In the west, many see Indian economy's dynamism as driven by the data innovation (IT) area, when in reality that industry represented just 7.5 percent of India's GDP and utilizes a pitiful 3 million individuals.

While Indian IT was the main business to take off after the progression of the economy in the mid 1990's somewhere in the range of 20 years after the fact, the particular accentuation on IT has turned out to be obsolete. The fervor India's economy has produced of late in huge part is because of changing inward and outside elements. By certain assessments, India's economy will develop from its $1.8 trillion GDP to be the world's third biggest in 2030, with a GDP near $30 trillion. Correspondingly, North America and Western a lot of worldwide GDP is required to recoil from 41 percent to 18 percent, while "creating Asia" will develop from 27 percent to 49 percent. India's fares of merchandise and enterprises have ascended from 8 percent of GDP to 25 percent over the most recent two decades alone. Also, its fares are increasingly expanded - both topographically and as far as the items it sells-than its rivals and neighbors. There is a wide understanding that the worldwide focus of financial action and development is moving to Asia, and investors are progressively seeking India for monetary and exchange openings.

Inside, India's prospect stay brilliant as the white collar class keeps on extending and the advantages of their interest in the economy spread all through the nation - an all the more exceptionally taught working class has supported development in powerful segments of the economy and helped business and utilization. India authoritatively changed its stock market on November 11, 1992, when it first enabled outside investors to put resources into quite a while stock market (see Bekaert and Harvey (2000) and Kim and Singal (2000)). Since the opening up of the Indian value markets to outsiders, remote institutional venture (FII) streams have developed significantly. Its offer in absolute portfolio streams to India has developed to over Rs.1406.2 billion out of 2012-13. During 2012-13, outside direct speculation has expanded to US$ 26953 million. In a similar period, yearly turnover of National Stock Exchange(NSE) and Bombay Stock Exchange (BSE) was expanded to Rs.27082.79 and Rs.5487.74 billion individually and the market capitalization raised to Rs.62390.35 and Rs.63823.11billion disregarded that India is progressively turning into an alluring goal to the worldwide investors. This short introduction of measurable information on India's monetary exhibition consequently builds up that India is currently one of the quickest developing economies on the planet with gigantic development potential. With more than 20 million investors and more than 10,000 recorded organizations in all the stock trades, India has the third biggest speculator base on the planet after United States of America and Japan.

The Indian stock markets are adjusted by 9400 stock specialists roughly. Remote intermediaries represent 29 of these. Any market that has encountered this kind of development has a similarly considerable interest for exceptionally productive settlement methodology. In India 99.9% of the exchanges, as per the National Securities Depository, are settled in dematerialized structure in a T+1 moving settlement the capital market is one condition.

ROLE OF INDIAN STOCK MARKET IN MANAGING RISK

The capital market in India is a market for protections, where organizations and governments can raise long haul reserves. It is a market intended for the selling and purchasing of stocks and securities. Stocks and securities are the two significant approaches to produce capital and long haul reserves. In this manner, the security markets and stock markets are considered as capital markets. The capital markets comprise of the essential market, where new issues are appropriated to investors, and the auxiliary market, where existing protections are exchanged. Furthermore, the Indian Equity Markets and the Indian Debt markets do frame some portion of the Indian Capital market. The Indian Equity Market depends principally on rainstorm, worldwide subsidizes streaming into values and the presentation of different organizations.

The Indian Equity Market is completely commanded by two significant stock trades - National Stock Exchange of India Ltd. (NSE) and The Bombay Stock Exchange (BSE). The benchmark files of the two trades - Nifty of NSE

and SENSEX of BSE are intently observed by the investors. The two trades likewise have a F and O (Futures and choices) portion for exchanging value subordinates including the records. The significant players in the Indian Equity Market are Mutual Funds, Financial Institutions and FIIs speaking to chiefly Venture Capital Funds and Private Equity Funds. The Indian Equity Market at present is a rewarding field for investors. The Indian stocks are gainful for long and medium-term investors, yet in addition for the position brokers, momentary swing dealers and furthermore extremely present moment intra-informal investors and theorists. In India as on November 28 2014, market capitalization (BSE 500) was arrived at Rs. 100.01 lakh crore, coordinating great with other developing economies and chose developed markets. In a creating economy like India, the obligation markets are significant wellsprings of raising capital assets. The obligation markets in India are among the biggest in Asia. Their dealings included government protections, open part endeavors, other government bodies, money related organizations, banks and organizations.

The obligation markets assume a job of expanding assets for usage of government improvement plans. This implies government can raise assets at lower costs by giving government protections. They are exceptionally helpful for the best possible usage of government's money related arrangement. They gave a less dangerous venture condition contrasted with the value markets, empowering generally safe speculations. This prompts remote inflow of assets into the economy. They give high liquidity and appropriate authority over credit. They gave chance to investors to differentiate their venture portfolio in a manner to limit hazard. They advanced stringent divulgence standards and inspecting prerequisites, consequently there was improved straightforwardness and better usage of corporate administration standards. The principles that have been presented during the most recent couple of years to contain market dangers appear to have worked sensibly well. Exacting requirement of these standards is as significant as the guidelines themselves to adequately oversee hazard. In such manner, SEBI should all the more intently review go-betweens and the Stock Exchanges and, if essential, reinforce correctional measures.

SEBI presented a Risk Management System which has taken a few measures to improve the uprightness of the auxiliary market. Administrative and administrative changes have encouraged the corporatization of stockbrokers. Capital ampleness standards have been recommended and are being authorized. An imprint to-market edge and intra-day exchanging farthest point have additionally been forced. Further, the stock trades have set up circuit breakers, which are applied in the midst of over the top unpredictability. The divulgence of short deals and long buys is presently required by the day's end to diminish value instability and further improve the trustworthiness of the auxiliary market. The exploration uncovered that hazard essentially has two segments; vulnerability and presentation. Both these segments are constantly present and should be painstakingly overseen. Dangers are normally characterized by the unfavorable effect they may realize on the benefit of a few unmistakable wellsprings of vulnerability.

Instability in the market Stock costs are changed regular relying on the market. Purchasers and merchants cause the costs to change as they choose how significant each stock may be. Budgetary markets show sensational developments, and stock costs may show up too unpredictable to be in any way advocated by changes in basics. Such noticeable actualities been under investigation throughout the years are as yet being concentrated energetically.

STOCK MARKET CRASH OF 1929

Throughout the 1920s the stock market witnessed a long boom which took stock prices to towering peaks. Stock markets in United States and Europe were earning huge profits since 1920. The Dow Jones Industrial Average (DJIA) rose from 200 in January, 1928 to 381 in September, 1929.

Many investors were convinced that they could get rich by investing in the stock market and thus borrowed heavily to invest in stock market. From 1920 to 1929, stock prices quadrupled. As stocks continued to climb throughout 1920s, many investors came to believe that stocks were a sure way to ensure a secure future for their families However, on October 28, 1929, the Dow Jones Industrial Average (DJIA) dropped 12.82%, losing 38.33 points down to 260.94; then the very next day, on October 29, 1929, it again fell down to 11.73% losing another 30.57 points. As the news spread, more and more investors wanted a way out of the market at whatever price they could get. Even without looking at the price, the investors went crazy to sell off their shares. So began the stock market crash of 1929. The day of 29th October 1929 is remembered as Black Tuesday in the history of stock market crashes. There began the rampant selling of stock on wall street causing values to plummet and paved way to great depression started in 1929 and lasted until the late 1930s and early 1940s.The great depression of 1929 was the most severe trauma the world had experienced. The stock market crashed, banks failed, industrial production was severely curtailed and the unemployment rates escalated ts at macroeconomic level. People went bankrupt overnight and their belief of earning returns through investment in stock market was totally shaken. Before the stock market crash of 1929, the investment in stock market was a disordered and

muddled activity. The investors used to base their investment decisions on insider activities and speculative activities were more in number. Looking at the devastating effects of crash of 1929 and the frequent irrationality of market pricing, Columbia Business School Professors; Benjamin Graham and David Dodd thought of creating sound intellectual framework for stock market investment[1]. There came the origin of the concept of value investing.

ORIGIN OF VALUE INVESTING

In their seminal work entitled "Security Analysis" introduced the concept of value investing and security analysis. Security analysis involves examining a number of securities to identify those securities that currently appear to be mispriced. There are mainly two approaches to security analysis: fundamental analysis and technical analysis. Fundamental analysis involves a detailed study of a company's financial position using financial ratios which help in taking an investment decision for long term. Benjamin Graham's stock selection strategy is based on the fundamental analysis of a company. He introduced a new approach to investing, whereby the securities which are underpriced in relation to their estimated underlying values are bought and sold when the true or actual value of the security is reflected in its market price. This approach of investing is called as value investing. Benjamin Graham, thereafter, was called as father of financial analysis and value investing. He made investment in stock market a profitable venture by devising sound guidelines for analyzing a company's fundamentals and its future prospects.

Meaning of Value Investing

Value investing utilizes a traditional fundamental analysis approach in selecting stocks for investment portfolios (Ahmed, 2008). It consists of buying securities whose shares appear underpriced by some form of fundamental analysis. Such securities trade at discount to book value, have high dividend yields, low price to earnings multiples or low price to book ratios. It can be defined as follows:

The conventional definition: A value investor is one who invests in low price to book value or low price to earnings ratio stocks. *The generic definition*: A value investor is one who pays a price which is less than the value of the assets in place of a firm. Questioned the ability of the firms to sustain same growth in earnings in future, so they hypothesized that firms who have and are currently experiencing high (low) earnings growth are unlikely to able to sustain it to the extent expected by the market e.g. a high price to earnings multiple is indicative of the market's expectation of high future earnings growth. When this earnings growth reverts towards industry/ economy mean, then this will result in the revision of earnings" expectations, a fall in firm's price to earnings multiple and so, a downward correction in its stock price. Therefore, it is prudent to concentrate on securities whose prices are depressed while representing excellent value. These stocks must represent excellent value today in order to create a buffer against future market volatility. Thus, regardless of market volatility, the value of this portfolio remains intact in short term.

Intrinsic Value and Margin of Safety

"The term intrinsic value means the discounted value of the cash that can be taken out of a business during its remaining life. In other words, a company's intrinsic value is equal to the value today of all the money it will deliver in the future" (Boroson, 2001).

Value investors typically calculate intrinsic value by focusing on earnings, cash flow and other indicators of the company's wealth creation potential. The core principle of value investing is to buy companies at a deep discount to their intrinsic value (Graham, 1949). Therefore, the key principle of value investing is to look for a meaningful gap between a company's market valuation and its underlying intrinsic value or worth and is called as margin of safety i.e. value investing: stock intrinsic value-stock market value = margin of safety. Value managers believe in finding the long term true net worth or the intrinsic value of a stock because the stock that is trading well above its long term intrinsic value will eventually decrease to that value and if a stock is undervalued (trading below its intrinsic value), it will presumably migrate back to its long term intrinsic value over time. In both instances, stock is said to be reverting to its mean. The concept of margin of safety is the cornerstone of value investing popularized by Benjamin Graham. It is an important concept for making stock and bond choices. According to Graham, margin of safety is necessary to protect an investor from the price fluctuations. Also, the market price of the stock may not move in line with its intrinsic value. Therefore, the investor must invest in the stocks which have significant gap in its market price and the intrinsic value, so that, the margin of safety can protect him in the event of a huge downturn.

Rules of Stock Selection for Enterprising Investor

The enterprising investor is one who devotes an ample amount of his interest and labor toward getting a better than average investment result. Such investor has greater market understanding and more time for portfolio management. Graham (1949) recommended certain rules of stock selection for enterprising investor.

These rules are:

Financial condition: (a) The ratio of Current assets to current liabilities should be at least 1.5 and (b) the total debt of a company should be lesser than 110% of net current assets. *Earnings stability*: The earnings of the company should be stable in the last five years.

Dividend record: Dividend should be paid by the company in the year preceding portfolio formation.

Earnings growth: The previous year's earnings of a company should be greater than its five year prior earnings.

Price: Current price should be lesser than 120% of net tangible assets.

Based on the fundamental information regarding the company, many investors started investing money in stock markets. The investment managers started developing fundamentals based mutual funds. From 1926 to 1956, Graham Newman Corporation yielded an annual return of 17% during its 30 year period. However, by the early 1970s a consensus had emerged among financial economists suggesting that stock prices could be well approximated by a random walk model and that changes in stock returns were basically unpredictable developed efficient market hypothesis which stated that achieving above average returns on a risk adjusted basis is impossible and a market in which prices always fully reflect available information is called efficient market (Roddenberry and Bacon, 2011). Eugene efficient market hypothesis has become the basis of numerous financial models and forms the foundation of the investment strategies of many individuals and corporations.

GROWTH PHILOSOPHY

Motivated from the concept of strong form of efficient market hypothesis, also emerged simultaneously was growth investing philosophy. While the value investor invests in stocks which are disfavored by the market, hoping the market value of their equity will increase, the subscriber to the growth philosophy invests in stocks which are already popular in the market place, hoping their market value will increase further. It is a strategy of investing in the shares which appear to have substantial growth prospects. Growth shares may appear expensive as their price is high relative to historic performance and a relatively large portion of their value is the expectation of improved return in the future. Growth stocks have been defined as stocks having relatively high prices in relation to fundamental factors like earnings per share, cash flow per share, book value per share and dividends per share. Higher return of value stocks over growth stocks is defined as value premium Growth investors are more apt to subscribe to the "efficient market hypothesis" which maintains that the current market price of the stock reflects all the currently "knowable" information about a company and is therefore the most reasonable price for that stock at that given point in time.

Efficient market hypothesis has been applied extensively to theoretical models and empirical studies of financial securities prices, generating considerable controversy and financial insights into price discovery process Several studies have documented strong evidence of anomalies in the stock market that seems to contradict efficient market hypothesis Thus, a naive view of market efficiency in which price is assumed to be equal to the actual worth of a stock is an inadequate conceptual starting point for market-based research. This view fails to capture the affluence of market pricing dynamics and the complex process of price formation in the stock market (Also, if prices deviate from their fundamental values, research could lead to the exploitation of these opportunities. By doing this, one not only makes money, but the price is also driven back to the true value, given there was mispricing.

Thus, exploring the inefficient form of market, Benjamin Graham in his last years distilled his six decades of experience into ten criteria which investors could use to identify undervalued stocks. The ten criteria are called as value investing rules/ principles of Benjamin Graham.

BENJAMIN GRAHAM'S VALUE INVESTING RULES

Benjamin Graham has given ten rules of stock selection based on value investment strategy, which the investors can use to gain edge over the market. These rules/ principles are as under:

- An earnings to price yield should be at least twice the triple-A bond yield. The earnings yield is the reciprocal of the price to earnings ratio.
- The price to earnings ratio should be lesser than 40% of the highest price to earnings ratio, the stock had over the past five years.
- A dividend yield should be at least two-third of the triple-A bond yield.
- A stock price should be lesser than two-third of tangible book value per share.

- A stock price should be lesser than two-third of net current asset value (current assets less total debt) per share.
- Total debt should be lesser than the book value.
- Current ratio (current assets divided by current liabilities) should be greater than two.
- Total debt should be lesser than twice the net current asset value.
- The earnings of the company should have a compounded annual growth rate of 7% in prior ten years.
- There should be stability of growth in earnings i.e. no more than two declines of five percent or more in year-end earnings (relative to previous year) in the most recent ten years should be there.
- The first five criteria measure reward and are sensitive to price and earnings changes and the second group of five criteria offer a measure of risk and does not change rapidly with changes in price and earnings (Klerck and Maritz, 1997).

The intrinsic value of the stock has been determined through the fundamentals such as earnings yield, dividend yield, tangible book value, net current asset value, total debt, current ratio, earnings growth and earnings stability. Then these measures of intrinsic value have been linked with the market price of the stocks so as to make certain the presence of margin of safety. Thus, stock selection criteria of Graham ensures the sufficient gap between intrinsic value and the market price of the shares in order to guarantee sufficient margin of safety to investors.

ADDING VALUE TO VALUE STOCKS

studied that less than 44 percent of all high book to market firms earned higher returns than the market in the two years following the portfolio formation. Thus, majority of the firms in high book to market portfolio were not showing increment in their value. Consequently, in order to generate value out of value, Piotroski (2000) developed an F-Score model. The model is based on nine fundamental signals which measure three areas of firm's financial condition: profitability, financial leverage along with liquidity and operating effectiveness. The stocks meeting the said condition have been assigned score of one and stocks not meeting the particular condition have been assigned zero score. Based on the historical financial performance of the firm, the model helps to extract true value maximizing securities out of entire value portfolio. The brief discussion of the components of F-Score is as follows:

Return on assets (ROA): This ratio measures the profitability of total assets to investments of a firm and thus establishes the relationship between net profits and assets (Khan and Jain, 1994). It is calculated as:

ROA= Net income before extraordinary items at the end of financial year / Total assets at the beginning of the year. Positive ROA determines the stock's ability to generate funds internally and represents earnings productivity of total assets.

Change in ROA: The firms having current year's ROA greater than the previous year's ROA are given positive score. Piotroski (2000) through this metric made sure that firm has not incurred a loss in prior two years.

Cash flow from operating activities (CFO): Cash flow from operating activities denotes the excess of cash receipts over cash payments, both relating to the company's principal business activities (Parrino et al., 2011). It is calculated as:

CFO= Net cash flow from operating activities at the end of financial year / Total assets at the beginning of the year.

Positive ratio denotes the operating cash flow generation ability of the total assets.

Accrual: Under the cash system of accounting, an organization records and reports financial transactions only when cash has been actually received or expended. However, the system wherein, revenue is recorded when earned and expenses are recorded when incurred, is called as the accrual method of accounting. In other words, revenues and expenses are accrued, when all events have occurred to evidence the obligation, without regard to the time of actual receipt or disbursement of the money (Blazek, 2008). Sloan (1996) found that earnings performance attributable to the accrual component of earnings exhibits lower persistence than earnings performance attributable to the cash flow component of earnings. Thus the accrual ratio receives the negative signal if firm's profits (ROA) are higher than the firm's cash flow from operations (CFO).

Change in leverage: Leverage means the share of average total assets financed by outside funds.

Leverage= Long term debt at fiscal year-end/ Average total assets at fiscal year end. When a company raises debt, it takes on an obligation to considerable predetermined outflows for some time into the future. The company does not have a certain cash inflow over the same period. Indeed the inflow may be most uncertain. A fixed cash outflow combined with an uncertain cash inflow gives rise to financial risk. As a result, a larger

debt is accompanied by larger risk (Walsh, 1993). Thus, the set of companies which have not increased their leverage as compared to previous year's leverage get positive signal.

Change in liquidity: The liquidity position of an enterprise is assessed through its current ratio. The ratio of current assets to current liabilities is called as current ratio. This ratio provides information regarding the current cash position of a company and its capability to stay solvent in the event of adversities. Essentially, it compares short term obligations with the short term resources available to meet these obligations (Van Horne, 1994). Higher the ratio, better the capacity of the company to pay its liabilities. Therefore, higher current ratio as compared to previous year's ratio acknowledges company to get positive signal.

Change in number of shares: Ikenberry et al. (1995) observed that average abnormal return on announcement of share repurchases of value stocks due to undervaluation is 45.3% as compared to glamour stocks where no positive drift in abnormal returns could be observed. Moreover, Loughran and Ritter (1995) found that the companies issuing seasoned equity offering significantly underperform relative to non issuing firms for 5 years after the offering date. Hence, the companies showing an increase in the number of issued shares compared to previous year's shares get negative signal.

Gross margin: This ratio of gross profit to sales is used as the indicator of the efficiency of the production operations (Hampton, 1980). The firm should have a reasonable margin to ensure adequate coverage for operating expenses of the firm and sufficient return to the owners of the business, which is reflected in the net profit margin (Khan and Jain, 1994). A stock gets positive signal if its current year's gross margin is greater than previous year's margin.

Change in asset turnover: It highlights the amount of assets the firm uses to produce its total sales. The ability to produce a large volume of sales on a small asset base is an important part of the firm's profit picture. Idle or improperly used assets increase the firm's need for costly financing and the expenses for maintenance and keep up. By achieving a high asset turnover, a firm reduces costs and increases the eventual profit to its owners (Hampton, 1980). Hence, the firm showing larger asset turnover ratio compared to previous year's ratio, gets positive signal.

The sum of the above mentioned nine signals forms F-Score. Piotroski (2000) observed that if one applies F-Score on the value stocks, high scoring shares will outperform the low scoring firms. Hence, it helps in extraction of real value generating shares out of chaff of value shares.

MAGIC FORMULA INVESTING BY JOEL GREENBLATT

As motivated from the core principle of value investing i.e. buying a dollar for fifty cents, Joel Greenblatt introduced an another approach to value investing which aims at buying stocks of good companies at bargain prices, termed as magic formula investing. It is a two-step formula intended to buy stock in good companies at bargain prices. The magic formula comprises of two factors; return on capital and earnings yield. Return on capital is the performance part of the formula which shows that how much measure of the earnings a company generates from a given level of investment (the growth part of the formula) and the earnings yield is simply P/E ratio turned upside down. This is the value part of the magic formula, which shows that stocks are giving a large share of company's earnings for a small price. The two ratios are:

Return on Capital: It is one of the most important concept in financial management. Every firm has to match each dollar of assets it has by the funds drawn from financial markets. Also, the payment for the funds drawn has to be made at the market rate. This payment comes from the operating surplus resulting from the resourceful employment of assets. Thus, by relating this surplus to the value of underlying assets/ funds, a firm can estimate its return on capital (Walsh, 1993). More specifically, it is measured by calculating the ratio of profits before interest and taxes (PBIT) to tangible capital employed. Therefore, Return on capital= PBIT/ Tangible capital employed (Net Working Capital + Net Fixed Assets.

Earnings Yield: It is the reverse of the most commonly followed valuation metric P/E ratio. It reflects the price currently paid by market for each rupee of currently reported earnings. It therefore measures the investors‟ expectations and the market appraisal of the performance of the firm. Earnings yield is measured by calculating the ratio of pre-tax operating profits (PBIT) to Enterprise value (Market value of equity + Net interest-bearing debt). This ratio helps to make out what a firm earns in relation to its purchase price. Greenblatt reported that a simple stock selection rule based on return on capital (ROC) and the PBIT to Enterprise Value ratio on US securities produced an annualized return.

Greenblatt has used PBIT due to the fact that all companies do not have same level of debt. Also, the companies belonging to different industries can have different tax rates. Therefore, through PBIT, an investor can assess the operating profits of varied companies without the distortions arising from differences in borrowings and taxation rates. Thus, for every company, earnings generated through the operating activities are compared with

the total cost of resources used to generate those earnings. Net working capital plus net fixed assets (or tangible capital employed) is used in place of total assets (used in an ROA calculation), which simply figures out how much capital is required to conduct the company's business (Greenblatt 2006). Overall, the magic formula selects companies that have the best combination of a high return on capital and a high earnings yield.

CONCLUSION

The dependence of examiners on normal stock attributes was likewise tried. Expert suggestions seemed, by all accounts, to be tilted for stocks which had significant expense energy, high profit development, and low advertiser holding. In any case, further tests demonstrated that investigator aptitudes gave gradual prescient capacity, even in the wake of controlling for the normal stock attributes.

The outcomes, showing prescient estimation of expert suggestions, were conflicting with proficient market hypothesis, as per which stock prices completely mirror all accessible data, and in this manner examiner proposals can't industriously give anomalous returns. Be that as it may, the presence of prescient worth was steady with social models of a few creators including Daniel et al. (1998), Barberis et al. (1998), and auxiliary vulnerability model of and parametric vulnerability model of. These models clarify why stocks might be steadily mispriced and why unsurprising return examples, for example, energy in stock prices happen.

Value experts gather data from an assortment of sources, aside from data revealed by firms, or detailed in the media. Further, they apply income anticipating and valuation models officially. This is relied upon to give them relative data advantage over financial specialists, enabling them to include esteem, gave the stocks are mispriced. Therefore, the outcomes can be clarified utilizing social and auxiliary vulnerability hypotheses and the relative data bit of leeway of examiners.

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