CHAPTER - I

INTRODUCTION

1.1 Background of Study

Nepal is one of the developing country of the world. Nepal's decade-long civil conflict, ongoing political instability, poor governance, and weak structural reforms have retarded economic growth. Per capita GDP has barely increased in the past decade and the country remains one of the poorest in the world with a 2004/05 GDP per capita below US $300. The economy of developing countries is based on agriculture therefore; agriculture is the largest sector and backbone of the Nepalese economy. It is the major source of livelihood for a majority of the country's population. Approximately 80 percent of Nepal's population is tied up with agriculture. Its contribution to the GDP is 39 percent. Nepal Government has given priority to the agriculture because there is less possibility of development in other sectors. So, since 5th economic development plan, Nepal Government has given priority in agriculture but the expected change in this sector is still not achieved.

The economic condition of the country cannot be improved only with the development of agriculture so that, industrial and commercial development is essential. All round development of the country can be possible with the development of industry and business. Unemployment problem can be solved and resources can be utilized properly by the help of industry.

The history of our industrial development is not so long. Nowadays some large scale and medium scale industries are being also established. The contribution of industrial production is about 10 percent in the GDP. There are different types of business organization in the country out of which joint stock companies are largest. They collect necessary capital from the public by selling their shares and debentures. The transaction of share in the market is increasing. Nepal Stock Exchange, in short NEPSE is only authorized institution for share transaction. It works as mediator between the seller and purchaser of shares in the open market. The company can issue the share after registration in the NEPSE. All the interested investors can invest their saving in the share of companies with the help of NEPSE for effective and smooth share transaction. The share transaction is the indicator of the trend of national economy. The investors should analyses the financial position of the company before purchasing their share on the basis of risk and return relationship.

After the adaptation of liberal economic policy many business institutions were established in private and public sectors. In this condition Nepalese security market is also avidly developed which encouraged investors to invest their money in various types of security. When the saving is converted into profitable investment then risk is an associated with the profitability of that investment. Thus, risk and return always is a significant analysis to every investor. “To maximize the share price, the financial manager must learn to assess two key determinants, risk and return. Each financial decision present certain risk and return characteristics and the unique combination of characteristics has an impact on share price” (Gitman, 2001:236). Here, the study is concerned with risk and return associated with common stock investment however there are various types of financial assets to be invested i.e. treasury bill, long term bonds, preferred stock, etc. “Common stock represents commitment on the part of a corporation to pay periodically whatever its board of directors deems appropriate as a cash dividend.” (Shrestha, 1995:1). Investors of common stock are the ultimate owners of the company collectively, they own the company and ultimate risk is associated with ownership. So, the common stock is known as risky security. Thus, before the investment made in common stock, investor must consider the risk associated with their investment and to do so, they need to define the risk properly. “Risk refers to a set of unique outcomes for a given event which can be assigned probabilities, while uncertainty refers to the outcomes of given events which are too unsure to be assigned probabilities” (Khan and Jain, 2007:12.2). In other words “Risk is pornography

Which is hard to define but it will be known if we see it. Investor went to be back higher return to invest in common stock, but their expected return may not be changed in realities. This uncertainty is the major risk to the investor in stock market investment (Van Horn, 2000:89).

The return on investment is usually as dividend plus any change in market price of share and it is usually expressed in percentage. Both dividend and change in market price are uncertain items. So, the actual return on investment in common stock may differ substantially from the expected return. Thus, return from common stock is of two types i.e. dividend received and price appreciation of investment. To invest in common stock the following investment procedure need to be considered (Sharpw, W.F., Alexander, G.J. and Bailey, J.V., 2005:11)

i) Set investment policy

ii) Perform security analysis

iii) Construct a portfolio

iv) Revising the portfolio

v) Evaluate the performance of portfolio

The investment activity must consider the following dimensions:

i) Maximization of expected return for varying levels of risk.

ii) Minimize the risk for varying level of expected return.

In context of Nepal, many investors invest their money on single security without considering the investment process and calculating risk. Though some of the investors invest in two or more it is found that they don't make any analysis of portfolio before selection of such securities of invest. They invest their money in different securities on the basis of expectation and assumptions of individual security rather than analysis of portfolio. So, it is a must to make them well acquainted with these tools along with their practical implication on investment decisions and evaluation.

Generally, investors are risk averse; they are always seeking higher return for more risk as risk premium. So, primary problem in investment is to identify the security which has low risk and high return. However, return cannot increase substantially; risk can reduce by diversification of funds in different stock making a portfolio. Well diversified portfolio can eliminate the unsystematic risk, which is not explained by general market movement. Systematic risk, which is associated with change in return on market as a whole cannot be avoided by, are obviously an important concept in investment and hence to be provided to investors to motivate them to invest rationally.

History of NEPSE

The history of securities market began with the floatation of share by Biratnagar Jute Mile Ltd and Nepal Bank Ltd in 1937. Introduction of company Act in 1964, the first issuance of Government Bond in 1964 and the establishment of Securities Exchange Center Ltd in 1976 were other significant development relating to capital markets.

Securities Exchange Center was established with an objective of facilitating and promoting the growth of capital markets. Before conversion into stock exchange it was the only capital market institution under taking the job brokering underwriting managing public issue, market making for government bonds and other financial services.

Nepal Government, under a program initiated to reform capital markets converted Securities Exchange Center into Nepal Stock Exchange in 1993. Nepal Stock Exchange, in short NEPSE, is a non profit organization, operating under Securities Exchange Act 1983.

The basic objective of NEPSE is to impart free marketability and liquidity to the government and corporate securities by facilitating transaction in its trading floor through member, market intermediaries, such as broker, market markers, etc. NEPSE opened its trading floor on 13thJanuary 1994.

Government of Nepal, Nepal Bank and Nepal Industrial Development Corporation are member and the shareholder of NEPSE (www.nepalstock.com).

Commercial Bank

In general, bank means an institution that accepts deposits in different account and provides loans of different types. Many changes have taken place in the functions of a bank from the initial stages of its development to present day. There are many types of bank which do not accept deposits such as central bank and industrial bank

The modern complex economic system cannot function without bank. The banking system has facilitated the personal transactions such as deposit and remittance of money, and lending and borrowing of money. It has made easier to develop agriculture, industry and trade. At the same time it has helped to accelerate the peace of economic development. The bank helps in mobilization and allocation of scarce resources, which are essential for economic development.

When a bank performs multiple tasks, the efficiency and effectiveness of work become weak. Hence, different bank are established with different purpose and in different categories. Among them commercial bank are only the focus of this study.

The commercial bank is the oldest form of bank. There are various changes in the original concept and functions of commercial bank. In general, banks mean the commercial banks. In other words, The bank that collect deposit, advance loans and provide wide range of financial service are called commercial bank. Commercial banks are established as a joint stock company with a view to earn profit. Thus, banks are regarded as the heart of modern economy. It is because they mobilise resources by collecting deposit and channelize those resources to productive sector by granting loans.

In Nepal, for a very long time the development of bank was affected by the rule of Rana Government and the slowdown in the Nepalese economy. Nepal Bank Limited was established on 30th Kartik 1994 (BS) as the first commercial bank of the country. That time also the banking sector wasn't in growth and progress. Nepal Bank Limited is also going on 30 year without any competitor; Nepal Rastra Bank was established on 14th Baishakh 2013 (BS) as the Central Bank of Nepal. The second commercial bank, Rastriya Banijya Bank was established on 2022 (BS) in order to play major role not only domestic also in foreign trade.

With the initiation of economic liberalization in the country, entry restriction on banking business was lifted. So, the number of private and joint venture bank have been established such as NABIL Bank Ltd (1984), Standard Chartered Bank Ltd (1987), Himalayan Bank Ltd (1993), Nepal Bangaladesh Bank Ltd(1993), Everest Bank Ltd (1994), Bank of Kathmandu (1995), Siddhartha Bank Ltd (2002), Globle Bank Ltd (2007) and many more. The total number of commercial bank in Nepal is 32 out of which 29 commercial banks listed in Nepse. All the detail of commercial bank in Nepal on the basis of name & year established are given below:

S.N.	Name of Commercial Bank	Year of Establishment A.D.
1	Nepal Bank Limited	1957
2	Rastriya Banijya Bank Limited	1966
3	Agricultural Devlopment Bank Ltd.	1968
4	Nabil Bank Limited	1984
5	Nepal Investment Bank Limited	1986
6	Standard Chartered Bank Limited	1987
7	Himalayan Bank Limited	1993
8	Nepal SBI Bank Limited	1993
9	Nepal Bangladesh Bank Limited	1993
10	Everest Bank Limited	1994
11	Bank of Kathmandu Limited	1995
12	Nepal Credit and Commerce Bank Limited	1996
13	Lumbini Bank Limited	1998
14	Nepal Industrial and Commercial Bank Limited	1998
15	Machhapuchre Bank Limited	2000
16	Kumari Bank Limited	2001
17	Laxmi Bank Limited	2002
18	Siddharth Bank Limited	2002
19	Global Bank Limited	2007
20	Citizens Bank International Limited	2007
21	Prime Commercial Bank Limited	2007
22	Bank of Asia Nepal Limited	2007

23	Grand Bank Nepal limited	2008
24	NMB Bank Limited	2009
25	Kist Bank Limited	2009
26	Mega Bank Limited	2009
27	Sunrise bank limited	2009
28	Janata Bank limited	2009
29	Commerz and Trust bank limited	2010
30	Civil Bank limited	2010
31	Century commercial bank limited	2011
32	Sanima Bank limited	2011

1.2 General Information of Selected Sample Banks.

1.2.1 NABIL Bank Limited (NABIL)

NABIL Bank Limited (NABIL) is the first Joint venture commercial bank in Nepal which is the joint venture of Nepali promoters and Emirates Bank International (Dubai) in 1984 under the company act 1996. Now its 50% equity share is hold by Emirates Bank international, 20% equity share hold by Nepali promoters and financial institutions and remaining 30% were issued to general public of Nepal. Market Capitalization of this bank is Rs 47,311,945,530.00 and its total paid up capital is Rs 965,747,000.00 with 9,657,470 numbers of shares.

1.2.2 Himalayan Bank Limited (HBL)

Himalayan Bank Ltd is a joint venture bank with Habib Bank Ltd. of Pakistan established in 1992 under the company act 1964. This is the first joint venture bank managed by Nepali Chief Executive. The operation of the bank started from February 1993. Bank's Market Capitalization is Rs 21,405,384,000.00 and total paid up capital is Rs. 1,216,215,000.00 with 12162150number of shares. The main objectives of the bank is to provide modern banking facilities like tele banking to the businessmen, industrialists, other professional and to provide loans on agriculture and industrial sectors. Now its 20% equity share is hold by Habib Bank and 80% equity share is hold by Nepali promoters, financial institutions, general public and others. Following table 4.7 represents the market price and dividend purchase of HBL for the purpose of risk and return analysis.

1.2.3 Everest Bank Limited (EBL)

Everest Bank Limited (EBL) started its operations in 1994 with a view and objective of extending professionalized and efficient banking services to various segments of the society. Everest bank is joint venture with Punjab National Bank Ltd. India, which holds 20% equity on the bank's share capital. Its head office is located in Lazimpat, Kathmandu. Its present capital structure is as follows: Authorized Equity Capital 2000 million, Issued Equity capital 1391.6 million and Paid up Equity capital 1391.6 million. Equity participation in Punjab National Bank; India is 20%, local promoters is 50% and General public is 30%. The bank is providing customer-friendly services through its Branch Network. All the branches of the bank are connected through Anywhere Branch Banking System (ABBS),The bank has 20 branches, 25 collection counters & 67 ATMs in various parts of the country.

1.2.4 Nepal SBI Bank Ltd.

Nepal SBI Bank Ltd is another joint venture of State Bank of India and Nepali promoters which was registered under the company act 1964 in 1993. The bank is managed by State Bank of India under joint venture and technical services agreement signed between them and Nepali promoters viz, employees provident fund and Agriculture Development Bank Nepal. The main objective of the bank is to carryout modern banking business in the country under commercial bank act 1974. The state bank of India is holding 50.60% equity and 49.40% equity is hold by Nepali promoters, general public investors and others. The bank's Market capitalization is Rs. 16,596,102,900.00 and total paid up capital is Rs. 873,479,100.00 with 8734791 numbers of shares.

1.3 Statement of the Problem

The investment opportunities are shrinking due to the economic recession throughout the country. This may be the major reasons that banks have been found to be unable in utilizing the available fund efficiently. Because of unfavorable present situation, these banks are being compelled to reduce in the interest rate offered to depositors in order to minimize the collection of deposit. In this situation, Nepalese banks were suffering from various problems. Lower per capita income, high population growth rate, lake of inadequate infrastructure and lower economic growth rate are the feature of Nepalese economy. Similarly, lower employment opportunities as well as high unemployment in agriculture sectors are the challenging issues in national economy. All these unfavorable circumstances of economy adversely impact on investment activities on the other hand, due to the lack of knowledge and information about the security market large amount of saving being stay idle. Most of the investors aren't aware of the financial position of the companies in term of their financial indicators, in which they are investing their fund through primary and secondary markets. The market price of common stock does not seem to be in accordance with the financial indicators NWPS, EPS, DPS, ROE, etc.

Instead, in determination of the market price of share, there has been major influence of rumors rather than strength of the companies.

Risk and Return is a new concept in Nepalese financial market and the investors have also little knowledge in risk and return management due to lack of adequate information as well as present unstable political and economic condition the stock price volatility rate is high. Because of that, the investors are losing their confidence toward NEPSE and hesitate to invest in securities, so investors who invest in common stock do not made investment activities rational.

A part from mentioned problem, there are no any separate institution, which provide information required to rational decision that can accelerate the stock investment and market efficiency. Government policy is less encouraging in promoting common stock investment trading volume, absence of professional brokers, early limited information available to investors.

To sum up this study deals with the following issues:

- How much return is provided by the commercial bank to their common stockholder?
- How much risk is associated with common stock investment?
- What kind of relation does exist with risk and return?
- What extent there is systematic risk is related to total risk?
- Does the relation between risk and return support the theory of CAPM?
- Does the portfolio of common stock of commercial bank help to reduce the risk?
- What is effect of portfolio on return?

1.4 Objective of the Study

The key objective of this study is to examine the situation to securities market of Nepal and to evaluate the risk and return associated with common stock investment of selected Joint Venture Commercial Banks.

The specific objectives of this study are as follows:

- To evaluate risk, return and other relevant variables that directly affect the investment in common stock.
- To analyze the correlation among the returns of joint venture banks in Nepal.
- To determine whether stock of joint venture banks in Nepal in terms of overpriced, under priced or equilibrium by analyzing the risk and return of the individual share.
- To analyze comparative risk and return position of these sectors.
- To give suggestion, ideas and materialize recommendation for investors to analysis of data.

1.5 Significance of the Study

The national economy is not at such standard where any one of the Nepalese people can feel proud by heart. As a matter of fact, the recent economic situation of Nepal has been influenced by the economic recession. Nepalese financial institution and capital market are not also able to get ride of such influence. Shrinking investment opportunities due to economic recession has put the Nepalese entrepreneurs in a great trouble. This may be only reason that Nepalese investors are drawing bank their hands from investment sector. The modern complex economic system cannot function without bank. The banking system has facilitated the personal transaction such as deposit and remittance of money and lending and borrowing of money. It has made easier to develop agriculture, industry and trade. At the same time, it has helped to accelerate the pace of economic development. The bank helps in mobilization and allocation of scarce resource, which are essential for economic development. The commercial bank is a great institution that conducts the payment mechanism of a country. The individuals and institutions make payments to each other through the mechanism of commercial bank. The commercial bank plays a leading role in the smooth operation of an economy. It makes available all financial services to individual and institution.

Although the present situation is not fair for investment in economic sector, evaluation of financial institutions, mostly commercial banks are increasing; however, under such circumstance the objective of commercial banks may not be easily fulfilled. It is because these banks not properly mobilize the domestic resources for sustainable economic growth. In this situation most of the Nepalese entrepreneurs are discouraged and they prefer idle stay rather than to invest in common stock. Therefore the study of joint venture commercial banks regarding to risk and return to common stockholder became an indispensable subject matter in today's context.

The study tries to understand how far these institutions are able to provide the satisfactory return with minimum risk in such quite unfavorable situation. Obviously saying, this study is essential to check the investment return to the stockholders their investment. The study detects the inefficiencies of these institutions and helps to explore the appropriate and effective measures for the remedy of investment problem.

Thus, it concludes that the study is matter of crying need to identify the possible return with minimum risk. This study clearly shows identify the investment inefficiency of the Nepalese investors and helps to explore remove such weakness as far as possible and this study will include the history of stock market, five year trend of NEPSE and correlating between rates of return among the securities of four selected Joint Venture Commercial Banks. Therefore this study will be significant to those who want to invest in securities and the future researches of concerned field. The staff and members will be significant as the study provides different guideline, suggestion and recommendations.

1.6 Limitation of the Study

Due to the limitations of the time, cost and other resources, this study has the following limitations:

- This study excludes government securities.
- This study deals with the history and development of securities market of Nepal
- Secondary data provided by SEBON, NEPSE, and other publication related to study have been used in this study as a source of information.
- This study is an analysis of stock market data of the latest five years.
- The effect of inflation which is one of the most important factors for the analysis of economic activities has not been taken into consideration for the purpose of study.
- Only selected joint venture commercial banks have been taken as a sample to draw conclusion.

1.7 Organization of the Study

This research is organised in five chapters which are listed below:

Chapter-I: Introduction

This chapter is introductory and deals with subject matter of the study including general background of the study, statement of the problem, objectives of the study, significance of the study, limitation of the study and organization of the study.

Chapter-II: Review of Literature

This chapter contains the review of available literature related to this stud It is directed towards the review of conceptual framework and review of major related studies. Risk and return, its relationship, determinats, measuring technifues and methods are reviewed from the various available literatures.

Chapter-III Research Methodology

This unit is for the research methodology which is used in the study that includes various tools and techniques for the analysis of data. It consists of research method as library research and field research sources of data, population and sample, research design, methods of data analysis etc.

Chapter-IV Data presentation and analysis

This chapter presents the analysis and presentation of data by using various methods of statistical and financial tools, tables, figures and pie charts, etc. will be used as per necessity.

Chapter-V Summary, Conclusion and Recommendations

This chapter is for summary of main findings, conclusion, recommendation and suggestions for further improvement.

Summary

Risk and Return, a new complex concept, is also foundation of modern investment decision. Here, risk is defined as the variability of the return of a period. The greater the variability of the return the riskier the investment would be whereas an investment involves the sacrifice of current rupees for future rupees or reward that future rupees or reward is called the return. It includes both current income and capital gains or losses that arise due to the increase or decrease on price of the security (common stock). So to maximize the security price, the financial manager must learn to assess two key determinants: risk and return. It becomes easier when there is existence of developed and healthy stock market.

Investors of common stock are ultimate owner of the company, who are ultimately associated with the risk and return. At present, every investment has the risk factor. Investors have to minimize the risk and maximize the return. For this, investors consciously examine and analysis of stock return and ultimate risk associated with it and then invests their fund in efficient portfolio from which they can realize higher return with lower risk.

This study mainly aims to examine the situation of securities market of Nepal and to evaluate the risk and return associated with common stock investment of selected Commercial Banks. The specific objective of this study is to analyze the risk and return associated with the common stock of commercial banks, to analyze and recommend the risk and return behavior within and between commercial banks and to determinate effect of portfolio on risk and return.

Although many studies are already conducted to evaluate the risk and return on common stock investment of some banks, this study is based on 4 selected samples of 32 commercial banks listed in NEPSE. And financial statements are available for at least

5 years of study period the mentioned banks. This research work is based on secondary data provided by SEBON, NEPSE, and other publication related to source of information.

Some relevant and renowned academic books, articles and four published master's thesis were reviewed to have conceptual clarity about risk and return and pragmatic experience to minimize the gap between theory and practices.

For the data analyses major statistical tools as well as financial tools are used to measure risk and return in stock investment for 5 years period were basically analyzed by considering expected rate of return, standard deviation, co-efficient of variation, portfolio risk, portfolio return, beta co-efficient, systematic risk, unsystematic risk, risk minimizing weight are formed on the basis of expected return to examine the relationship between expected return and different measure of risk. Similarly, testing of hypothesis has been tested to analyses the relationship between the average market return of selected sample banks and overall market return of NEPSE.

The values of BPS, MPS, EPS & DPS of sample banks have decreased in the first four years and increased in final year of study period. Risk and Return of the selected commercial banks are not consistence. The expected rate of return, standard deviation and coefficient of variation of NABIL Bank are -16.44%, 47.23% and -2.87 respectively. The expected rate of return, standard deviation and coefficient of variation of HBL are -10.12%, 37.11% and -3.67 respectively. The expected rate of return, standard deviation and coefficient of variation of Nepal SBI bank are -1.79%, 38.67% and -21.60 respectively. The expected rate of return, standard deviation and coefficient of variation of EBL are -9.78%, 34.99% and -3.58 respectively. The average risk of selected commercial banks is 39.50% whereas return is -9.53%. The highest risk is 47.23% of NABIL Bank Ltd whereas lower negative return is -1.79% of Nepal SBI Bank Ltd. The average CV is -7.93 with the lowest negative value -2.87 of NABIL Bank Ltd and the highest negative value -21.60 Nepal SBI Bank Ltd.

For the analysis of portfolio risk and return of 6 combinations are made from the selected sample banks. The result from the analysis provides varying degree of portfolio risk and return in each combination. The average rate of return of the commercial bank combination under portfolio analysis is -6.55%. The combination of NABIL & HBL has found the lowest negative return with the value of -4.24% and the combination of HBL & EBL has highest negative value of -9.83%. The average risk of the commercial bank combination under portfolio analysis is 34.56%. The combination of NABIL & SBI has the highest value of portfolio risk of 37.64% and the SBI & EBL has the lowest value of portfolio standard deviation of value 32.73%. The covariance values of all combinations of the banks are positive. The positive value of covariance between return of two assets indicates that the returns of the assets moves in same direction. Correlation of all combinations of banks is positive which indicates positive correlation between stocks is not so beneficial and all combinations of banks have higher risk and negative return.

The expected market return (i.e. average market rate of return), standard deviation and coefficient of variation of market are -6.85%, 34.89% and -5.09 respectively. All selected commercial banks have less sensitive stock with market with value of beta less than 1. EBL has the highest value of beta (0.96). SBI has the lowest value of beta (0.72). In evaluation of risk involved with in the common stock, NABIL has maximum value of total risk (0.2231) and EBL has minimum value of total risk (0.1224). And proportion of systematic risk of SBI is the lowest (16%) and that of EBL is the highest (30%) as well as proportion of unsystematic risk of NABIL is the highest (48%) and that of EBL is the lowest (4%). In comparison of overall market return of NEPSE and average return of selected Joint Venture Commercial Banks shown that there is no significantly difference.

Conclusion

This present study has been explored some empirical evidences about risk and return behavior in the context of Nepalese commercial banks. BPS, MPS, EPS & DPS of the commercial banks affect the investment on their stock because there is positive relationship between these values and banks transactions. Most of the selected Joint Venture Commercial Bank's BPS, MPS, EPS & DPS have decreased in first four years and increased in last year of the study period.

There is no positive relationship between risk and return. Though investment on banking sectors has more risk, investors are interested to invest their fund in it. Risk and Return of the selected commercial banks are not consistence. The average risk of selected commercial banks is 39.50% whereas return is -9.53%. The highest risk is 47.23% of NABIL Bank Ltd whereas lowest negative return is -1.79% of Nepal SBI Bank Ltd. The expected market return (i.e. average market rate of return), standard deviation and coefficient of variation of market are -6.85%, 34.89% and -5.09 respectively.

The portfolio analysis provides empirical evidence of disparity between risk and return of selected commercial banks. The overall effect of portfolio on risk and return shows high risk and negative return. The portfolio helps to increase the return in some cases but in some cases, it has also decreased the result. The average risk of the commercial bank combination under portfolio analysis is 34.56% but return is -6.55%. The covariance values of all combinations of the banks are positive. The positive value of covariance between return of two assets indicates that the returns of the assets moves in same direction. Correlation of all combinations of banks is positive which indicates positive correlation between stocks is not so beneficial and all combinations of banks have higher risk and lower return.

The return of some of the banks has high degree of positive correlation with the return of other banks. It is no beneficial to make portfolio between such banks because the portfolio between highly positively correlated banks may not be able to reduce the level of risk significantly. The stock of some of the banks is aggressive and these are highly sensitive to market as well as stock of some of the banks is defensive which is not so more sensitive to market. All the selected commercial banks have less sensitive stock with market with value of beta greater than 1. EBL has the highest value of beta (0.96). The average expected rate of return of selected banks and overall market return have positive relationship. In another words, in comparison of overall market return of NEPSE and average return of selected commercial banks shown that there is no significantly difference.