

CHAPTER-I

INTRODUCTION

1.1 General Background of the Study

A dollar in hand today is worth more than a dollar to be received next year. It is because, if you had it now, you could invest it, and end up next year with more than one dollar. Investment, in its simplest form, means employing money to generate more money in future. It is the sacrifice of current dollars for future dollars.

Investment is the investors' decision to channelize the saving into a venture with the expectation of some extra return in the future. Investors sacrifice the present consumptions for saving and invest with the desire to get larger sum in the expected future (Francis, 1995:p1).

An investment is a commitment of funds made in the expectation of some positive rate of return. If the investment is properly undertaken, the return will be commensurate with the risk the investors assume (Fischer & Jordan, 2000:p21).

Investment generally involves two attributes: time and risk. The sacrifice takes place in the present and is certain. The reward comes later and the magnitude is generally uncertain. In some cases, the element of time predominates (for example, government bonds). In other cases, risk is the dominant attribute (for example, call option on common stocks). In yet others, both time and risk are important (for example, shares of common stock) (Alexander, 2003:p3).

One of the basic elements in achieving a self-reliant growth of the economy and for sustaining the desired level of economic development is because of accelerated rate of

investment in the economy. Investment both reflects and influences the health of the economy. Investment environment directly affects the investment decision of the investors. The major factors that may affect the investment decisions are investment objectives, the expected rate of return, the expected risk, taxes, the investment horizon, and investment strategy.

Investment in securities in the capital market is a key factor in the U.S. economy. If economic environment is ripe and corporate management expectations are optimistic, a firm normally wishes to expand. This expansion can take the form of an enlarged physical facility, an increased sales force, or any one of number of such factor. If conditions are appropriate, all this will eventually lead to higher earnings and higher prices for the firm's outstanding securities. Financing this expansion often comes about by gaining access to the capital markets- namely through the sale of stocks and bonds (Fischer & Jordan, 2000:p3). The globalization of investment business has become a recurring theme in recent years. The U.S. economy is now much more integrated with the rest of the world than it was several decades ago. Similarly, U.S. financial markets are now much more sensitive to events abroad than they were previously. The growth in foreign security markets has significantly increase international opportunities for U.S. investors. However, in the growing investment scenario in Nepal, investors are the background of the capital market and they expect return by sacrificing their income to generate more return in future but this is what the management of the companies is not realizing (Shrestha, 2003:p2).

1.1.1 Financial Instruments/Securities

A wide range of investment alternatives is available to individual investors in the investment environment. Buying common stocks, bonds of a company, depositing

money into bank account, buying a piece of land, gold or silver are examples of investment. Basically investment alternatives can be categorized into two groups as:

-) Real assets of Non-financial assets
-) Financial assets/Financial instruments

Real Assets

Real Assets can be tangible or intangible. Plant, machinery, office, factory, furniture and building, precious metals are example of tangible assets while technical know-how, technological collaborations, patents and copyrights are intangible assets. The firm requires a number of real assets to carry on its business. Real assets are generally less liquid than financial assets. Returns on real assets are frequently more difficult to measure accurately.

Financial Assets or Instruments

Financial Assets or Instruments are pieces of paper representing an indirect claim to real assets held by someone else. These pieces of paper represent debt or equity commitments in the form of IOUs (written document providing evidence of debt) or stock certificates (Thapa, 2003:p3).

In general, only a piece a paper represents the investor's right to certain prospects of property and the conditions under which he or she may exercise those rights. This piece of paper, serving as evidence of property rights, is called a financial instrument. It may be transferred to another investor, and with it will go all its right and conditions. Thus, it is a legal representation of the right to receive prospective future benefits under stated conditions (Alexander, et al., 2003:pp2-3). Some of the

examples of financial instruments are common stocks, preferred stocks, bonds, convertibles, warrant, options, rights and futures.

Government and private firms issue financial instruments. Government issue financial instruments to finance deficits in their budgets when revenues fall short of expenditures. Government instruments are almost invariably bond issues of various types. These bonds are issued by governments at all levels: federal, state and municipality. Because the federal government can print money, its instruments are not subject to default. The instrument of the state and municipal governments, however are only as sound as the abilities of these governments to raise revenue through taxation and other means. Private firms issue a wide variety of different types of financial instruments from bonds to common stocks. The quality of these issues is based on the quality of the earning power of the firms issuing them (Haugen, 1997:p7).

Securities Exchange Act 2040 explains that "Securities means shares, stock, bond, debenture, debenture stock issued by a corporate body or a certificate relating to unit swing scheme or group saving scheme issued by any corporate body in accordance with a prevailing laws or negotiable certificate of deposits or treasury bills issue by Nepal Government and it includes the securities issued under full guarantee of Nepal Government by a notification published in the Nepal Gazette or receipts relating to deposits of securities as well as rights and interest relating to securities."

1.1.2 Financial Markets

Financial market is the market where money itself is traded – loaned or borrowed – in terms of different financial assets or instruments like stocks and bonds (Ritter and

Silber, 1993:pp25-26), i.e. financial instruments are traded in financial market. Financial market can be defined as a mechanism for bringing together buyers and sellers of financial assets in order to facilitate trading. It plays a significant role in bridging the gap between the deficit and surplus unit of society. Buy and sell orders that flow from investors' demand and supply pattern determines the prices of financial instruments, which in turn will ultimately influence the allocation of resources throughout the economy.

A healthy economy is dependent on efficient transfers of funds from people who are net savers to firms and individuals who need capital- that is, the economy depends on efficient financial markets. Without efficient transfers of funds, the level of employment and productivity, and hence our standard of living, would be much lower. So it is absolutely essential that our financial markets function efficiently (Weston & Brigham, 9th ed., pp73-74).

Globalization of economies and market has been one of the major instruments of change. Due to globalization, every sort of change occurring in one sector of the world affects the other. With the result of dynamic global changes and development, financial markets are rapidly responding. Therefore, now-a-days financial market has become global phenomena and a basic concern of financial and economic condition of any nation.

Financial market can be classified in various ways. The most common classification is:

) Primary market and Secondary market

) Money market and Capital market

Primary Market and Secondary Market

The term "market" can have many different meanings. One usage of the term denotes the primary market and the secondary market. These two markets distinguish between the market where securities are created and the market where they are traded among investors. Their function is key in understanding how stocks trade.

Primary Market

Primary Market is that financial market in which corporations raise funds by issuing new securities. The primary market itself can be sub-divided into seasoned and unseasoned new issues. A seasoned new issue refers to the offering of an additional amount of an already existing security, whereas an unseasoned new issue involves the new offerings of a security to the public. Unseasoned new equity issues are often referred to as initial public offering or IPO'S (Alexander, 1998:p4).

Investment banking firms are important institutions in the primary market. They stand between corporation and its potential security holders and provided the corporation with a number of important services in marketing its securities. They have knowledge of the current state of the market, and they provide the firm with information about how much money can be currently raised and what types of securities would be most effective in raising it (Haugen, 1997:p24).

Secondary Market

Secondary Market is that market in which corporations and public agencies trade securities among investors after they have been issued. The majority of all capital market transactions occur in the secondary market. The function of secondary market

is to provide liquidity for securities purchased in the primary market. Once investors have purchased securities in the primary market, they need a place to sell those securities. Without the liquidity of the secondary market, firms would have difficulty raising funds for productive purposes in the primary market. The secondary market comprises the organized securities exchanges and the Over-the-Counter (OTC) markets (Cheney & Moses, 10th ed., p72). Organized security exchanges are centralized auction-type markets, while OTC market is an intricate network of security dealers that take position in various securities and buy and sell them from their own portfolios (Haugen, 1997:p25). Nepal Stock Exchange (NEPSE) is the only organized exchange to carry out the secondary market operation of corporate securities in Nepal. The secondary market can be further broken down into two specialized categories: auction-market and dealer-market.

In the auction market, all individuals and institutions wishing to trade securities will congregate into one area and announce the prices at which they are willing to buy and sell (bid and ask offers). The idea is that an efficient market should prevail by bringing together all parties and having them publicly declares their prices. Thus, theoretically, the best price of a good need not be searched for because the convergence of buyers and sellers will cause mutually agreeable prices to emerge. The best example of an auction market is the largest stock exchange in the world, the NYSE.

In contrast, a sealer market does not require parties to converge. Individuals or institutions will specialize in specific securities or commodities and then buy and sell according to the demand of the market. These dealers then earn profits through differences in the posted bidding and asking prices for their specific securities.

The rationale behind a dealer market is convenience: investors aren't required to wait for other participants before a transaction can occur. Thus, many over-the-counter markets are classified as dealer markets since the demand and supply for particular stocks is not always enough to meet the requirements of different investors, allowing the specialist to intervene by buying and selling out of personal inventories. Most bonds are traded in dealer markets.

Money Market and Capital Market

Money Market

Money Market is that financial market where funds are borrowed or loaned for short periods –usually less than a year. The main function of money market is to provide short-term loans to business, government and household. Money market activities include primary and secondary market activities in short-term negotiable instruments such as treasury bills, inter-bank deposits, commercial paper, certificates of deposit, banker's acceptance, repurchase agreements, and short-term municipal securities issued by non-financial corporations. The treasury bills, which are government deficits and can also, support monetary policy implementation. Other money market instruments are used to facilitate the supply of credit to larger corporations and to ease inter-bank financing.

Capital Market

Capital Market is concerned with long-term finance. In the capital market, financial instruments with an original maturity of more than one year are traded. Equities or stocks (ownership instruments), bonds, debentures, collateralized mortgage

obligations, and derivatives are all capital market instruments. It consists of a series of channels through which the savings of the community are made available for industrial and commercial enterprises, and public authorities. It is concerned with those private savings, individuals as well as corporate, that are turned into investments, through new capital issues and also new public loans floated by government and semi-government bodies (Kuchhal,1976:p283).

Capital market is the most important part of any financial market. An efficient capital market is an essential per-requisite of economic development and the development of capital market in a country is dependent upon the availability of savings, proper organization of intermediary institution to bring the investors and business ability together for mutual interests, regulation of investment, etc. with the rise of joint stock organization of production and distribution, the importance of capital market as a liaison between the investor and the entrepreneur has become paramount.

Capital market plays a significant role in mobilizing constant flow of saving and unutilized financial resources for expanding productive capacity of the countries. It provides the best investment opportunity to the investors. The major role of the capital market is to provide buying and selling opportunities of financial assets at competitive prices for the investors. In the capital market, demand comes from agriculture, industry, trade and government while supply comes from the individuals or corporate savings, institutional investors and the surplus of governments. The saving institutions like saving banks, investment trusts or investment companies, specialized financial corporations and stock exchanges are some of the important constituents of capital market (Kuchhal, 1976:p283).

In theory, money market is different from the capital market. In practice, however, in most countries with efficient financial market (that is, the money market and the capital market combined), the merchant banks are active in both. This is a simple function of the fact that a negotiable money market instrument for all practical purposes is simply a shorter-term capital market instrument. Therefore, the techniques and facilities needed to operate in the money market are essentially the same as those needed to operate in the capital market.

Sidney Martin Robbins, in his article 'security' has pasteurized the brief history of the development of security market. It seems that the Stock Exchanges have got very old history for which we have to turn towards 12th century.

"Traders I European fairs in the middle age found it convenient to use credit, which required the supporting documents of drafts, notes and bills of exchange. The French stock exchange may be traced as far back as the 12th century, when trading occurs in commercial bills of exchange. To regulate these incipient markets, Philip the Fair (1268-1314) created the profession of courratier de change, the forerunner of the modern French stockbroker, or agent de change. From similar roots in trade and commerce, the institutional beginnings of stock exchanges appeared during the 16th and 17th centuries in other great trading centers throughout the world – Amsterdam, Great Britain, Denmark, Germany.

By the early 1600s, shares of the Dutch East India Company were being traded in Amsterdam; in 1773, London stock dealers who had previously been meeting in

coffeehouses moved into their own building; and by the 19th century, trading in securities on a formal basis was common in the industrialized nations.

The evaluation of stock exchanges continued. In Great Britain, progress has for the most part been internal and voluntary; the London Stock Exchange has regulated its own activities. The French stock exchanges, in contrast, are directly subject to law, and the operations of the agents de change have been affected by national decrees. Securities markets in the United States begin with speculative trading in issues of the new government. In 1791, the country's first stock exchange was established in Philadelphia, then the leading city in domestic and foreign trade (Robbins, 2003)."

1.1.3 Overview of Nepalese Financial Market

1.1.3.1 Brief History

The issuance of corporate and government securities has not made a long history in Nepal. In the corporate sector, it began with the floatation of shares to the general public by Biratnager Jute Mills Ltd. 1936 AD. It issued 8,000 ordinary shares of Rs. 100 each. Ordinary shares were quite popular in early forties due to very high dividend (i.e. 110%) declared by the Mill. But very few companies were able to follow it. It even led to the cases of over-subscription by three to four times in some companies. Not only for common stocks, Biratnagar Jute Mills is the pioneer for issuance of debentures also. It introduced the use of debentures as early as 1936. it issued 1,600 debentures of Rs. 500 each. But afterwards, its use has remained infrequent (Shrestha, et al., 2003:27-28). In Nepal, the Treasury Bills were first issued by the government sector in year 1962 AD and similarly. Government Bonds in 1964 AD.

Before the establishment of Security Exchange Centre (SEC), there were no institutional arrangements to undertake and to manage the new issues of securities. Initial public offerings (IPO's) have to make as per the provisions of the then company Acts. But, the provisions made in the company Acts were not adequate and relevant. The company Act 1936 had not even included preference share as a corporate securities. It was embodied as corporate security only by Company Act 1964. The growth of issue of securities was not well documented till last seventies. Data on issue of securities are available since last seventies when SEC assumed the role of issue manager.

1.1.3.2 Legal Arrangements of Financial Market in Nepal

A number of institutional arrangements, legal reforms and policy stance are required to make the market allocationally and operationally efficient. Government felt that one separate body should be established to give a systematic figure to the financial market of Nepal. Securities Exchange Center 1976 was an outcome of the realization. It was established with an objective of facilitating and promoting the growth of capital markets. At that time, due to very few issues of corporate securities, Centre confined its activities in trading government securities only. It manages 26 issues between 1978 and 1992 until it was converted into Nepal Stock Exchange in 1993. Since then, financial institutions are managing primary issues, particularly by finance companies. In Nepal, the concept of well-structured secondary market has not evolved till 1983. No separate regulations were there to regulate trading of securities. It was 1983, when the first Security Exchange Act 1983 got enactment. The act prohibited the exchange of unlisted securities. It entrusted the SEC with multiple role of stock exchange-an operator in the stock exchange and regulator of the stock market. Since November 1984, SEC operated the stock exchanges by listing the corporate securities. SEC was

the only capital market institution undertaking the job of brokering, underwriting, managing public issue, market making for government bonds and other financial services. These multiple roles were difficult and self-contradictory. As a result, it necessitated massive reforms in Securities Act 1983.

Accordingly, Securities Act (first amendment) 1992 was enacted in 1992, which came into force since 1993. SEBO started to register securities and grant approval for issuing securities to the public in 1993. The first amendment in the Act also led to conversion of SEC into Nepal Stock Exchange Limited (NEPSE) in 1993 with objective of operating and managing secondary transactions of securities. Accordingly, it has made Membership and Transaction Bylaws 1998 (by replacing the earlier bylaw of 1993) and Securities Listing Bylaws 1996. The initial efforts led to the opening of a full-fledged stock exchange in January 13, 1997.

The second amendment in Securities Exchange Act, 1983 was made in 1997 with the objective of upgrading the securities upgrading system. Similarly the third amendment made in 2006 to make the stock more transparent. The mandatory provisions for the listed companies to submit annual and semi-annual reports to SEBO. This amendment also requires securities businesspersons to submit annual reports incorporating the securities transactions carried out by them to SEBO.

SEBO is empowered to issue guidelines and directives to stock exchanges, corporate bodies issuing securities to general public and securities businesspersons. Accordingly, the Board has issued Guidelines for regulations and issue approval of securities, 1995 to regularize the issue of securities by companies. Similarly, the board also issued the Directives to Share Allocation 1994 and Issuance of Securities and Sales Management Directives 1997 Other important improvement includes,

Government Securities by law, 2005, Security board regulation 2007, Security business person (stock broker, dealer & market Maker), Regulation 2007, Security business person regulation, 2007, stock exchange licensing regulation 2007.

The main objective of SEBO is to regulate and promote the securities market and protect investors' interests. The Securities Exchange Act and regulation defines the following as the major functions of SEBO.

-) To develop and implement policies and programs for the development of securities market and advice Nepal Government in this regard.
-) To register securities and grant issue approval.
-) To provide license to corporate bodies to operate stock exchange business.
-) To provide license to operate securities businesses.
-) To supervise and monitor stock exchange and securities businesspersons.
-) To conduct research, study and awareness programs regarding securities market.

In this way, finally capital market has got a structured shape and institutional arrangements. Further changes are taking place in improving the acts, bylaws and guidelines to regulate capital market. SEBO forwarded initial draft of New Securities Act, 1999 to Nepal Government. Disclosure formats were developed in 2000 and implemented in stock exchange and to stockbrokers in 2001. Bonus share issue guidelines 2001 were made effective for operation in 2002.

Presently, there are 24 stockbrokers, two securities dealers, nine issue managers and one stock exchange 146 listed companies in the Nepalese securities market.

1.2 Statement of the Problem

Numbers of investment alternatives are available to individual investors in the market. Investors have the freedom of choice over the selection of different investment alternatives. They should know which financial instrument best fits their expectations and which are most suitable for them to invest in. Given the various investment alternatives, every investor has a target to increase gain from investment in kinds of securities depending on their perception and choice of the particular securities. However, many investors in Nepal consider investment as a jackpot to gain equivalent to gambling. This is the reason why investors fail because their investment alternative selection is providing weak and a without proper judgment and analysis. This is also remark of NEPSE given in the guideline of investment on remorse without adequate information about a particular security chosen for investment.

Nepalese capital market has been passing through the transactional phase over the past few decades. There are various inconsistencies and hindrances existed on the way of smoothing function of market. Not only institutional bottlenecks are hampering the growth of capita, but also all times the existing imperfect national characteristic phenomenon deeply noted proper trading in security market. The arbitrarily quoting for the stock price without fundamental and technical justification made securities market not to look after the protection (Shrestha, 2002:p2).

The Nepalese capital market is very lean to provide investment alternatives to the investors. Among various alternatives available in the world of financial market, very of few, alternatives like common stock, preferred stock, corporate bonds and government bonds are available for Nepalese investors. Out of the total alternatives available, preferred stock and corporate bonds are very limited and the total market is

dominated by common stocks. (Bhattarai, 2003:p50) Likewise, the use of derivatives is almost nil and the use of municipal bonds was often heard but that had not been materialized yet.

Although Nepalese regulated capital market has crossed the history of around two decades (since 1984), it seems that the ordinary shares are the only instruments through which company can go to public for capital. The use of common stocks alone covers 76.06% of total issues. It reveals, nobody has even thought about other types of instruments. Nobody has made researches to see what the investors really think about other types of instruments; are other instruments really ineffective to be ignores totally, then why our market is unable to welcome other securities. It seems that market is not conducive to the knowledgeable investors also.

If we see the scenario of government securities in Nepal, bonds are used in greater extant than treasury bills. Commercial banks are the major subscribers of treasury bills, which is the money market instrument of government. Similarly, government bonds are not trading in the secondary market i.e., NEPSE. It shows that there is no freedom to the investor to buy and sell the government securities in the secondary market and it has made the investment market again limited.

On the background, some of the main problems identified in the Nepalese capital market are:

-)] What are the investment alternatives available in the Nepalese capital market?
-)] How the investment alternatives are developing in Nepal?
-)] What is the current status of investment alternatives?

Poudel (2002), "Investing in Shares of Commercial Banks in Nepal", have pointed out that among the shares traded in Nepal, commercial banks' shares are the most preferred one.

"It is noteworthy to point out those commercial banks to total annual turnover stood at 82 percent by the end of the fiscal year 2000/01 with those shares accounting for 62.4 percent of the total market capitalization during the 2000/01 fiscal year. These indicators reveal that the shares of commercial banks have a dominant role in determining the key indicators of the Nepalese stock exchange. It is thus unsurprising that commercial banks' shares have continued to appear as the most attractive investment alternatives since the opening of the floor in January 1994."

The Nepalese capital market is totally dominated by banking sector and NEPSE index is pushed up or down by changes in the price of bank share. These commercial banks' shares play key role in determining the stock exchange indicators. Why only commercial banks' shares stand as the most preferred instruments; why securities of other sectors are not preferred to this extent by the investors; this is also one problem, which necessitates the study.

Another problem regarding Nepalese capital market is the performance of investors in the market. Nepalese investors are not well informed and aware of features of different financial instruments. They lack proper knowledge and confidentiality because of which they are losing their hard earnings. Institutional investors seem very passive in Nepalese capital market. The restrictions made on investors, especially institutional investors, by several directives are also preventing them from

freely playing in the market with different instruments. On the other hand, participation of individuals of government securities is also not as expected.

Due to a strong control and monitoring mechanism created by NRB, banks and finance companies are required to publish their periodic financial statements every quarter or every six months. Such periodic statements help the investors to ascertain stock prices of the companies. But such a strong control mechanism does not exist for other companies like manufacturing, trading, insurance, hotel and other sectors. Therefore, many other companies do not publish their periodic financial reports to inform the prospective investors.

The Nepalese stock market is primarily guided by whims and not by new information. Investors are pouring their funds into the share market due to rumors rather than due to change in fundamentals. Any type of technical analysis is not being carried out in Nepalese capital market. This is a sign of market inefficiency. The cause of inefficiencies is due to lack of professional analysis and consultants. The government of Nepal has not launched any effective program to develop investors' knowledge (Tuladhar, 1996; Poudel, 2001; Subedi, 2003). Although the amount of money involved for each investor may be modest, it is vital that investors understand their options and match these to their own needs (Cowdell, 2002:8). The effectiveness of capital market, the success of issues of the firm and performance of the company in the primary and secondary market depends upon this match.

1.3 Objectives of the Study

The main objective of this study is to provide details about development of financial instruments in Nepalese capital market. The specific objectives of the study are:

-) To identify the different investment alternatives available in the Nepalese capital market.
-) To analyze the development of different investment alternatives in the Nepalese capital market.
-) To explore the current status of available investment alternatives.
-) To provide suggestions and recommendations to the concerned for the further improvement.

1.4 Rational of the Study

A well-developed capital market presumes the existence of not only the investors-individual and institutional-but more significantly the existence of a network of specialized institutions and agencies that are always on the look out for investment in new ventures. This study provides guidelines to those agencies, which are looking for investment in new venture. It helps them to take correct investment decisions.

This study has highlighted the several kinds of financial instruments that are widely used in Nepalese business sphere. How these financial instruments play a vital role in Nepalese capital market is also a major concern of this study. This study aims to see how the governments as well as private securities are able to protect investors' interest and what type of benefits it provided to the investors regarding decision making. Basically, the companies issue the common stocks and these stocks are transacted regularly in the NEPSE. Why Nepalese companies do not issue the debentures and preferred stocks in the Nepalese Capital market is also the prime focus of the study.

This study has addressed those problems and issues, which are prevailing in Nepalese capital market. These problems and issues will surely act as an effective guideline to the new issuer to reach the potential investors. This study will also help prospective investors, financial intermediaries, investment bankers, and other researchers in future giving them information about the Nepalese capital market and financial instruments available over there.

1.5 Limitation of the Study

This study has got certain limitations. Time is a major limitation of this study. As this study is conducted for the partial fulfillment for the degree of Masters of Business Studies (MBS), there is very limited time for this study. Also, study is conducted within the Kathmandu valley only. So, the study area is also one of the limitations of this study.

The scope of study is limited within the framework of financial instruments only, which are used in Nepalese financial markets. Study has not considered other investment alternatives prevailing in the investment environment.

Study deals more with capital market instruments than money market instruments. This study confines only the listed company's securities and partly government securities. So, it may not represent the population thought.

In terms of investors, the study has focused on general investors (individual investors) rather than institutional investors due to limitation of time. Since the institutional investors are mostly guided by directives and mostly kept in legal boundaries, what matters more is directives rather than their independent thoughts. So, the study has

focused more on general investors. The study highly depends on primary data collected from the individual investors selected randomly.

The study highly based on primary data collection method. So, the reliability of data will heavily depend upon the responses of the respondents. Also the relevancy of the secondary data relies on published financial documents, annual reports, other related journals, magazines and books of NEPSE, SEBO/N and NRB. So far as analytical tools are concerned, the limitations of analytical tools may creep in along with themselves.

1.6 Organization of the Study

This study has been divided into five parts. They are:

Chapter I: Introduction

This is the first part of the study that starts with general background of the study followed by overview of financial markets and financial instruments of Nepal. Statement of the problem, Objectives of the study, Rationale of the study and Limitations of the study are also the contents of this segment.

Literature Review

Second part of the study is literature review. Different related books, journals, articles, periodicals, reports, and other publication has been studied and reviewed in this part. This chapter is classified into three sections as (i) conceptual/theoretical review, (ii) articles review, and (iii) review of related studies. Conceptual reviews are made to present the prevailing scenarios. Article review includes review of several related articles to present the glimpse of nature of Nepalese financial market and instruments being used over there and different other related studies are reviewed to find out what

types of studies were made previously in this field and what results were generated by prior researcher.

Chapter III: Research Methodology

This part of the study is employed to attain the objectives of the research. It consists of research design, population and sample, source of data, data collection techniques, data processing and data analysis tools.

Chapter IV: Data Presentation and Analysis

In this part of the study, results are found out using several analytical tools. The tabulated data, figures, charts and other analyzed results are presented in this part along with the interpretations and findings.

Chapter V: Summary, Conclusion and Recommendations

The whole study is summarized and concluded in this chapter. A list of suggestions and recommendations are also provided in this part of the study.

A list of bibliography and appendices are also presented after the end of the chapter five.

CHAPTER - II

LITERATURE REVIEW

2.1 Conceptual Review

2.1.1 Defining your investment Objectives

Investing wisely is a function of your needs and goals. Each investor has different objectives that need to be met depending on age, income, planned activities, and attitude about risk. How can you work with your investment advisor to best determine

which investments are right for you? Among the important factors to consider are personal status, plans and constraints.

Investors, as buyers of financial products, expect to obtain three characteristics from the financial instruments. They are the expected return, security and liquidity (Blake, 2000:p57). The principal objective in making investments is to earn a return that compensates investor for the risk of the investment. Some of the issues that you and your advisor should consider in defining the objectives that are right for you are listed below:

1. Goals and Needs
2. Income
3. Taxes
4. Safety
5. Time Horizon
6. Tolerance of Risk
7. Liquidity

1. Goals and Needs: You may have specific goals and requirements that you want your investment portfolio to fulfill. For example, you may be funding college for children, business expansion, travel plans or retirement needs. You should identify these goals and needs clearly with your investment advisor so that his or her recommendations for your portfolio can assist you in meeting them.

2. Income: Both your absolute income level and your income requirements influence your investment objectives in several ways. First, income, like age, influences the choice between dividend-paying or interest-paying investments, and those whose primary return is in the form of capital gains. You may prefer income-producing

investments if you need to supplement or replace earned income. Your income level also affects your investment choices because it determines your tax rate. Low-tax-bracket investors - generally those whose income is lower - will be more likely to prefer income-producing investments. High-tax-rate investors are more likely to choose tax-deferred or tax-sheltered assets.

Income also may influence risk preferences. High-income investors may be more willing to choose higher risk investments since they can more easily contribute additional investment capital. The need of regular varies greatly, depending upon such factors as the age, wealth, and non-investment income of the investor. Bonds, preferred stocks, and other investments with high current yields are traditional income investments (Stevenson and Jennings, 1984:p4).

3. Taxes: Your after-tax return is the return that matters. You should fully inform your investment advisor about your tax rate and any special tax circumstances that might apply to you. This will determine whether you should seek tax exempt or tax-sheltered securities as apart of your portfolio. The appropriateness of income or capital gains should be discussed in the context of your personal situation, so you may want your investment advisor to consult with your accountant. If you have tax-qualified or tax-deferred asset, you should hold these as separate portfolios, which will likely carry different investment objectives.

4. Safety: Many investors equate the objective of safety of principal with the purchase of high-quality investment instruments. Savings accounts, certificates of deposit, and savings bonds all have a virtually guaranteed return of principal. While these types of investments may help keep the amount of the portfolio reasonably constant, inflation may reduce its purchasing power. Hence, investors often seek to

keep the portfolio safe in terms of purchasing power by seeking enough growth to offset changes in the cost of living.

For the pension funds, investment on safety instruments is more desirable. The safe investment made by Mexican companies - 90% of their pension funds' money is invested in government bonds - has made Mexico's future pensioners more fortunate. But in Britain and America, pension funds are suffering from chronic shortfalls, for them 90% investment on government bonds is too high (The Economist, April 26th 2003;p77).

5. Time Horizon: an important consideration in setting investment objectives is time horizon. When do you expect to liquidate a portfolio? Should you choose assets of short or long maturity? Do you have time to recover from a declining market, or is capital preservation important to meet an immediate financial need?

6. Tolerance of Risk: Your tolerance for risk is a very personal decision, and a question that is difficult for many investors to answer. In general, markets tend to provide higher returns in exchange for bearing higher risks. Often you will find that the investments with the highest long-term returns are very volatile in the short run. It is important to be honest with yourself in assessing whether you are comfortable with market volatility, and the level you can tolerate. While it is easy in hindsight to wish you had invested in a risky segment of the market that has performed well recently, a more realistic view is to look forward at the risk that might occur in the future.

7. Liquidity: Liquidity is the ease with which you can convert your assets to cash at fair market value. It is essential that you recognize the need to convert your assets into cash at the appropriate times. Do you require a portfolio that can be liquidated easily,

or can you afford to wait? Since greater liquidity generally results in lower return, it is necessary to give serious consideration to the inherent tradeoffs.

Define your objective before Buying Stocks

People invest in the share market for different purposes. If someone is not clear about his/her purpose, the strategy followed can be wrong and the benefits not satisfactory, or there s/he may even incur a loss. So, one should first define his/her objectives and then only start "playing with market. Some possible objectives would be to maximize dividend income, to maximize capital gain in the short run, to maximize total gain and to minimize risk. A proper setting of objectives helps identify the category of shares that help to accomplish the set objectives. If we observe stock market regularly, we find various patterns of movement in different stocks. Thus setting clearly defined objectives will help to gain from such movements.

The Bank of Kathmandu (BOK) Limited and International Leasing and Finance Company (ILFC) Limited both paid 10 percent cash dividend to the shareholders for the F/Y 2003/04. The shares of BOK were currently trading in a range of Rs. 450 - Rs. 460 and the shares of ILFC were trading in a range of Rs. 120 - Rs. 130. Investors who want to maximize their dividend income would do better by investing in ILFC than in BOK. With a same amount of investment one could purchase more shares at a less amount of commission in the ILFC as compared to BOK. But for those investors who want to maximize their return by capital gain in the short run, it is better to avoid investing in shares of finance and insurance companies because their share price is found to fluctuate less as compared to the banks. In case of stocks that do not fluctuate much, it will be difficult to cover the transaction costs. Capturing a capital gain in a

short run requires a selection of highly fluctuating companies or newly listed companies.

The next fundamental objective of buying security is for the purpose of borrowing. Investors can borrow money by using the shares as collateral. Banks and finance companies provide loan up to 50 percent of the market price of the shares. To borrow in this way, you should have those securities that promise more certain return as well as growth. Therefore, it is better to buy these high priced stocks if you intend to borrow by pledging them. Such borrowing can be used to buy more stocks and the selection of such stocks will again depend on the purpose for which you want to buy them. If the objective is to minimize the risk, investors require selecting stocks that remain less fluctuating in the market (Bhattacharai, 2005:p65).

2.1.2 Institutional Investors and Changing Markets

The growth in size and activity of institutional investors has produced increasing pressures on the security markets. The commission structure, membership requirements, and auction process of the organized exchanges have shown great incompatibility with the nature and needs of institutional investors.

The growing size and needs of institutional investors have increasingly come up against exchange rules, regulations and other rigidities (Fisher and Jordan, 2000:p51). Since the late 1960s there have been a number of changes in the operation of the securities markets. These changes have been the result of competition within the securities industry and the result of external pressure from the Securities and Exchange Commission and Congress. The broad classification of secondary securities market is occasionally divided into four categories of secondary markets. The first market represents the exchanges; second market represents over-the-counter trading; the third market represents the over-the-counter trading of shares that are listed on an exchange; and the fourth market represents direct trading between two investors (typically large institutional investors) without the brokerage firm acting as an intermediary (Fuller and Farrell, 1987:p34).

2.1.2.1 Efficient Financial Market

Fama defined efficient markets in terms of a "fair game" where security prices "fully reflect" the information available. That is, if markets are efficient, securities are priced to provide a normal return for their level of risk.

An efficient financial market exists security price reflect all available public information about the economy, about financial markets, and about the specific

company involved. The implication is that market prices of individual securities adjust very rapidly to new information. As a result, security prices are said to fluctuate randomly about their "intrinsic" values. Expressed more formally, market efficiency means that the unanticipated portion of the return earned on a security is unpredictable and, over a sufficient number of observations, does not differ systematically from zero. The unanticipated portion is simply the actual return less than which was expected based on some fundamental analysis (e.g., its intrinsic value). Put differently, it is the surprise element.

Forms of the efficient market hypothesis

Fama suggested that the efficient market hypothesis (EMH) could be divided into three categories: the "weak" form, the "semi-strong" form, and the "strong" form. In the weak-form EMH, the type of information being considered is restricted to only historical prices. Investors should not be able to consistently earn abnormal profits by simply observing the historical prices of securities.

The semi-strong form EMH asserts that security prices adjust rapidly (and correctly) to the release of all publicly available information. Thus, under this form, current prices fully reflect not only all past price data but also such information as earnings reports, dividend announcements, annual and quarterly reports, and news items in the financial press.

The strong form EMH represents the most extreme case of market efficiency possible. Under this form it is argued that security prices fully reflect all information, including both public and private (monopolistic) information (Fuller and Farrell, 1987: pp49-99).

2.1.2.2 Efficient Market Theory

a) Random Walk Model

The random walk theory assumes that all future streams of income from the equity investment are independent of proceeding incomes. So, the future prices of common stock cannot be forecasted on the basis of past price behavior.

Random model says that previous price changes or changes in the price are useless in predicting future prices or return changes. It means if we attempt to predict future price in absolute term using only historical price change information, we will not be successful successive price changes are independent. This independence implies that prices at any time will on the average reflect the intrinsic value because among other things, different investors evaluate the available information differently or have different insights into future prospects of firm, professional investors and astute non professional will seize upon the short-term or random deviations from the intrinsic value and through their active buying and selling of the stock in question will force the price back to its equilibrium position. Finally, the efficient market theory holds that since price reflects all available information and since information arrives in a random fashion, there is little to be gained by any type of analysis whether fundamental or technical. It assumes that every piece of information has been collected and processed by thousands of investor and this information (both old and new) is correctly reflected in the price. Returns cannot be increased by studying historical data, either fundamental or technical, since past data will have no effect on future prices (Fisher and Jordan, 2000:p553).

b) Technical Analysis

Technical analysis dates back to the 1800's. It attempts to resolve the investment timing issue by gaining insight into market behavior through analysis of historical price and volume data. Technical analysis comprises many different subjective approaches, but all have one thing in common - a belief that these past movements are very useful in predicting future movements (Fisher and Jordan, 2000:p539). Technical approaches analyze market prices, breadth of the market, general investor sentiment (both institutional and individual investors), and the price behavior of individual securities.

Technical analysts maintain that the price of a share at any time (present price) is the balance struck by buyers and sellers at a point in time. Price movements take place on account of diverse internal and external factors (profits, political environment, predictions and the like). Prices stabilize when equilibrium between buyers and sellers is achieved. They believe that a record of price movements over a period of time in the past. As a whole theory is based on the assumptions that history repeats itself. That human nature does not change and that is likely to repeat his patterns of past movements will repeat themselves in the future (Raghu Palat, 1991:p172).

Technical analysis has become much more complex in recent years due to advances in communication technology and data processing. These technological developments allow technicians to obtain data almost instantaneously and to use a variety of procedures to analyze the data (Cheney and Moses, 1999:p205).

c) Fundamental Analysis

Fundamental analysis developed after the passage of the Securities Act of 1933 and the Securities Exchange Act of 1934. When detailed financial information became available, the techniques and procedures of fundamental analysis began to emerge. Benjamin Graham is recognized as the father of fundamental analysis (Cheney and Moses, 1999:p205). According to fundamental approach, the security analyst or prospective investor is primarily interested in analyzing factors such as economic influences, industry factors, and pertinent company information such as product demand, earnings, dividends, and management, in order to calculate an intrinsic value for the firm's securities. This intrinsic value is the true economic work of financial assets. He reaches an investment decision by comparing this value with the current market price of the security (Fisher and Jordan, 2000:p538). The fundamentalists maintain that any points of time every stock has an intrinsic value, which should in principle be equal to the present value of the future stream of income from that stock discounted at an appropriate risk related rate of interest (Bhalla, 1999: p283).

2.1.3 Financial Markets and Instruments

Financial markets are conduit through which those who do not spend all their income can make their excess funds available to those who want to spend more than their income (Ritter and Silber, 1993:p26). In response to the need for vast amounts of funds for capital investment, the corporation emerged as a form of business organization in which the ownership could be shared by a number of shareholders. Corporations raise funds for capital investment by selling securities directly to savers (Richards et al., 1984:p368). Participants in the financial market commonly distinguish between the "capital market" and the "money market" former referring to

borrowing and lending for long-term investment purposes, and the latter term generally referring to borrowing and lending for a periods of a year or less (Vishwanath, 2000:p322). Accordingly, a country's money market is often referred as its "market for short term funds", and its capital market, the "market for long term funds" (Kent, 1972:p243).

2.1.3.1 Money Market Instruments

Highly liquid debt securities that have short terms (meaning, arbitrarily, one year or less) until they mature and involve little or no risk of default are called money market instruments (Francis, 1991:p32). They are less risky, easily marketable and carry low rates of return. Money market instruments / short-term debt securities play a major role in the investment and borrowing activities of both financial and non-financial corporations. Individual investors with substantial funds may invest in such money market instruments directly or indirectly. Some money market instruments are negotiable and are traded in active secondary dealer markets; others are not. Some may be purchased by anyone with adequate funds; others only by particular type of institutions (Alexander, et al., 2003:p343).

Money market instruments are frequently issued instead of longer-term debt securities in order to avoid costly administrative process. These instruments pay continuously fluctuating rates of interest that exceed the rate of inflation only slightly. It pays interest to their investors by selling at a discount from their face or maturity values (Francis, 1991:p32).

Money market instruments possess certain type of characteristics like:

They are all debt obligations; they have maturities ranging from one day to a full year

They exhibit typically a high degree of safety of principal (they are subject to negligible interest rate risk, and issued by generally high credit standing borrowers like Central Bank), and They have high degree of liquidity (Santomero and Babel, 1997: pp242-244).

Some of the types of money market instruments are:

- a. Treasury Bills
- b. Commercial paper
- c. Certificates of Deposit
- d. Banker's Acceptances
- e. Eurodollars
- f. Repurchase Agreement
- g. Short-term Municipal Securities
- h. Other Instruments

a. Treasury Bills

Treasury Bills are short term debt of the government which has maturity period of 91 day 182 days or 364 days. These securities are issued in denominations of Rs. 1000 and sold on discount basis. The size of discount is determined in an auction, which will depend on the term of the bill and the prevailing market conditions. Treasury bills are issued in book-entries form; the buyer receives a receipt at a time of purchase and the bill's face value at maturity. They do not carry coupon or stated interest. So, they are called zero coupon bonds or debenture discount bonds. The yield on Treasury bill

is the difference between redemption value and purchase value. Treasury bills are considered as risk-free assets so that they have low yield to maturity and this yield is treated as interest income for tax purposes (Alexander, et al., 2003:p348 & Shrestha, et al., 2003:p72).

In US Security market, US Treasury issues Treasury bill. The treasury sells bills at regularly scheduled auctions to refinance maturing issues and to help finance current federal deficits have resulted in rapid growth in Treasury also sells bills in recent year. Congress first authorized them in 1929 (Cook, 1998:p75). The Federal Reserve Bank of New York, acting on behalf of the U.S. Treasury, auctions each new bill issue to dealers and other investors. The bills go to the bidders offering the highest price, thereby resulting in the lowest implied interest cost to the treasury. Because of the low risk and short maturity of these instruments, treasury bills are attractive investments for many financial market participants. Individual: co operations, state and local governments and money market mutual funds have large holdings. To individual and commercial investors, treasury bills constitute approximately one fourth of the total of all U.S. government marketable debts (Santomero and Babbel, 1997: pp244-245).

In Nepal, NRB issues treasury bills on behalf of the government to meet funding gap of the government to support various development programmes. Treasury bills with different levels of maturities (28 days, 91 days, 182 days and 364 days) will be open for outright purchase and sale in the secondary market. However, priority will be given to the issue of short-term TBs so as to influence the overnight inter-bank rate and make the secondary market operations more effective.

In the first three months of this year, TBs of 91 days were auctioned 13 times. The highest average discount rate of the 91 days TBs was recorded at 39188 on the first week of the first month of stood the lowest at 20882 on the third week of the second month. The total amount offered stood at Rs. 5.37 billion (all were renewals) and the bid amount stood at Rs. 15.0 billion (Main Economic Indicator of NRB 2005).

Table 2.1

Ownership Pattern of Treasury Bills

(Rs. in Million)

Particular	Outstanding as at Mid-July					
	2005		2006		2007	
	Amount	Percent	Amount	Percent	Amount	Percent
NRB	10923.8	21.26	9029.3	14.34	13768.8	18.50
Commercial Banks	39501.6	76.88	51645.8	82.01	58611.5	78.73
Others	957.7	1.86	2115.2	3.65	2065.0	2.77
Total Debt.	51383.1	100.00	62970.3	100.00	74445.3	100.00

Source: NRB Quarterly Economic, Bulletin mid- Oct. 2007

b. Commercial Paper

Commercial paper is an unsecured short-term promissory note. Both financial and non-financial companies issue this type of instruments. The dollar amount of commercial paper financial companies issue this type of instruments. The dollar amount of commercial paper outstanding exceeds the amount of any other type of money market instrument except for treasury bills, with the majority being issued by financial companies such as bank holding companies as well as companies involved in sales and personal finance, insurance and leasing. Such notes are often issued by large firms that have unused line of credit at banks, making it highly likely that the loan will be paid off when it become due (Alexander, et al., 2003:p343). These firms

issue commercial paper only because that type of credit is quicker and easier to obtain than bank loans. The credit ratings of most commercial paper issuers are so high that the so-called prime (that is, highest-quality credit rating) commercial paper interest rate is essentially a riskless rate of interest matching the yields on negotiable Certificate of Deposits and Bankers' Acceptances (Francis, 1991:p33).

Commercial paper has a maturity period of up to 270 days. It is sold at discount basis and repaid at par. It means that the commercial paper issuing firms receive less than the par value and then pays the investors the par value at maturity. It represents an attractive financing source for large, financially strong firms (Shrestha, et. al., 2003:p72). The quality of commercial paper can be variable and depends on the quality of the issuing firms and their access to other forms of credit. Commercial paper can be placed through the market or through dealers. In the case of dealer place paper, the dealer sets the rate and stands behind the payment (Haugen, 1997:p13). Because of the advantages of commercial paper for both investors and issuers, commercial paper has become one of America's most important debt markets. It is the second largest money market instruments, in terms of outstanding debt, behind treasury bills. Money market funds are the largest investors in commercial paper. Insurers, banks, thrifts, non-official corporations, and state and local government bodies are also important investors in this instrument (Santomero and Babbel, 1997: pp 253-255).

In Nepal, no company has issued commercial paper so far. The company culture of efficiency' is missing linkage to provide strong base for issue of commercial papers in

Nepal. In other words, public confidence does not exist in Nepal to accept commercial paper (Shrestha, et al., 2003: pp 72-73).

c. Certificate of Deposit (CD)

A certificate of deposit is a document evidencing a time deposit placed with a depository institution. The certificate states the amount of the deposit, the date on which it matures the interest rate, and the method under which the interest is calculated. A CD can be legally negotiable or non-negotiable, depending on certain legal specifications of the CD. City bank of New York originated Negotiable CDs in 1961. A negotiable CD is a receipt from a commercial bank that can be sold by one investor to other investors who can in turn resell them. Negotiable CDs can therefore be easily traded in active secondary market. The depositor generally must hold Non-negotiable CDs until maturity. Most CDs feature a fixed interest rate to maturity; however some CDs have variable interest rates. CDs are issued both in bearer and registered form. A bank tries to sell as many CDs as possible directly to investors. Because banks have limited capability to sell all their CDs directly to investors, however, they often sell some of their CDs to dealers who resell them to investors. In general, smaller banks and foreign banks make the greatest use of dealers when selling their CDs. Banks also frequently sell those CDs to dealers that are hard to sell directly to investors, such as longer-term CDs and variable-rate CDs (Morris and Walter, 1998).

Like treasury bills, CDs are also sold at discount basis and repaid at par value. The difference between redemption value and purchase value amount is the holding period return. CDs are highly liquid, almost risk-free and yield higher return than treasury

bills, so they are popular, form of short-term investment for companies and individual investors. In "Nepal, only a few commercial banks issue CDs as capital market is not proving efficient and government regulations proved to be restrictive than liberal in facilitating commercial banks to play active role in capital market (Shrestha, 2003: p 72).

d. Banker's Acceptances (BA)

Banker's acceptances are securities that are written when a bank inserts itself between the borrower and the investor and accepts the responsibility for paying the loan; this shields the investors from the risk of default. BAs are often preceded by a written promise from the lending bank that it will make the loan - such letters are called letters of credit. The lender bank does not actually "accept" the BA until the borrower takes down the loan. Later, if the lending bank wants to withdraw the money it has invested in the loan before the loan expires the bank can sell the BA to another investors. BAs may be resold to any number of the investors before the loan is repaid; there is an active secondary market in these debts. An investor who buys a BA can collect the loan on the date it is scheduled to be repaid.

BAs are one of the oldest money market securities. Historically, BAs were created to finance goods in transit; currently, they are typically used to expedite foreign trade by financing account receivables between a buyer and seller from different countries. For a fee plus the interest on the loan, large international banks create BAs (Francis, 1991: p 33).

BAs have very active secondary market in America. The yields of BAs are slightly lower than those on commercial paper because BAs are less risky due to borrower's

pledge to pay, the collateral of goods and the guarantee of the accepting bank. Over the past seventy years, BA investors have not suffered any losses of principal. BAs are very popular in export - import business. Acceptances arising from imports into the United States accounted for 28 percent, those arising from exports from the United States accounted for 24 percent, and those arising from the storage of goods in or shipment of goods between foreign countries accounted for 38 percent (Santomero and Babbel, 1997: p 256).

e. Eurodollars

In the world of international finance, large short-term CDs denominated in dollars and issued by banks outside the United States (most often in London) are known as Eurodollar CDs (or simply Euro CDs). Also available for investment are dollar-denominated time deposits in banks outside the United States, known as Eurodollar deposits. A key distinction between Euro CDs and Eurodollar deposits is that Euro CDs are negotiable, meaning that they can be traded, whereas Eurodollar deposits are non-negotiable, meaning that they cannot be traded.

The demand and supply conditions for such instruments may differ from the conditions for other U.S. money market instruments, owing to restrictions imposed (or likely to be imposed) by the United States and other governments. However, enough commonality exists to keep interest rates from diverging too much from rates available on domestic alternatives. One difference from CDs issued by U.S. banks is that the Euro CDs do not have federal deposit insurance (Alexander, et al., 2003:p345). Large corporations with international access invest on Eurodollars (Shrestha, et al., 2003: p 73).

f. Repurchase Agreement (REPO)

Repurchase Agreement, the REPO is an agreement between two parties whereby one party (mostly the dealer of the government securities) sells securities to another party and agrees to buy the same securities at agreed higher prices at later date (Shrestha, 2003: p73).

Repurchase Agreements are instruments used by securities dealers to help finance part of their multi-million-dollar inventories of marketable securities for one or a few days. For instance, if a security dealer ends a day of trading with an increase of \$40 million in its inventory of marketable securities, a REPO may be sold to finance the \$40 million inventory overnight. The securities dealer pays a REPO broker a finder's fee (or broker's commission) to find an investor with \$40million of unused cash that needs to be invested overnight, while agreeing to repurchase these securities the next day at a slightly higher price. This slightly higher price represents the interest income for the overnight investor who purchases the REPO. The investor is essentially making a short-term loan to the securities dealer with the securities dealer's inventory serving as collateral.

REPOs that last longer than overnight, called term REPOs can span 30 days or even longer. Term RHPOs are marketable securities, actively traded between the money market trading desks of large banks and brokerage houses (Francis, 1991:p34). Investors such as banks, money market funds, and other non-financial firms who have funds to invest for short periods of lime, take it as an attractive alternative to the zero return received from idle balances in a checking account (Santomero and Babbel,1997: pp 256-257).

Securities issued by the U.S. government are traded by calls between Treasury bond dealers, the Treasury bond trading desks of brokerage houses, just as money market securities are traded.

g. Short-term Municipal Securities

Local governments or municipal governments often have temporary needs for cash to finance their own expenditures, to provide tax to some tax-exempt entities such as colleges and non-profit hospitals, and, to a limited degree, to provide funds to private firms and individuals. To meet such needs, they often issue short-term municipal securities. These securities are issued in two forms: interest bearing notes and discount notes. The interests earning and capital gains in the case of municipal securities are generally exempted from the taxes, provided that the investor is a resident of the state or city that issues the debt instruments. Individuals, mutual funds, banks and other corporations are the major types of investors in municipal securities (Santomero and Babbel, 1997: pp 248-250).

h. Other Instruments

There are different other types of money market instruments used in different other countries. If we see the American money market, besides above discussed, federal funds, federal agency discount notes are very popular money market instruments.

Table 2.2
Money Market Instruments - at a glance

Characteristics of Money Market Instruments (International Perspective)

Money Market Instruments	Principal Borrowers	Principal Investors	Duration (Common Maturities)	Credit Risk	Liquidity	Timing of Payment Risk
Treasury Bills	Government	Individuals, non- financial and financial corporations, money market funds, etc.	91,92 & 364 days	Assumed to be none	Very active secondary market	Known
Commercial paper	Financial and non-financial corporations	non-financial corporations, money market funds	20-45 days	Medium to very low, rated by credit agencies	Limited secondary market	Known
Certificates of Deposits	Large banks and thrifts	non-financial corporations, money market funds	1,2,3 & 6 months	Low to high; not guarantee against default	Active secondary market	Known
Banker's Acceptances	Financial and non-financial corporations	non-financial corporations, money market funds, Governments	1-9 months	Very low, major banks are guarantor	Active secondary market	Known
Repurchase Agreements	Banks, Securities dealers, other owner of government securities	non-financial corporations & financial institutions	1 day, 1 week, 3 – 6 months, flexible term	Low risk, collateralized by treasury securities, collateral price risk	High liquidity but no secondary market	Known
Short-term municipal securities	State local government	Insurance companies and individuals	1-12 months	Rated credit agencies	Moderately active secondary market for large issues	Known

Source: Santomero and Babbel, 1997: pp 258-259

2.13.2 Capital Market Instruments

The capital market is defined as a place where finance is raised by companies for meeting their requirement of funds for new projects, modernization and expansion programs, long-term working capital needs and for various other purposes. The capital market mobilizes savings of individuals as investment in shares, debentures, unit of mutual funds and other like financial instruments, which are ultimately deployed for productive purposes in various sectors of the economy.

The capital market is concerned with long-term finance. In the widest sense, it consists of a series of channels through which the savings of the community are made, available for industrial and commercial enterprises, and public authorities. In the capital market, demand comes from agriculture, industry, trade and government while supply comes from the Individual or corporate savings, International investors and the surplus of governments. It comprises the savers - individuals and institutions - and bodies through which these savings are mobilized. The savings institutions like savings banks, investment trusts or investment companies, specialized financial corporations and stock exchanges are some of the important constituents of capital market (Kuchhal, 1976: p 283).

Financial instruments in capital market have original maturities of more than one year. The principal suppliers and demanders of funds in the capital market are more varied than in the money market. Trading of funds in the capital market makes possible the construction of huge establishments like factories, schools and highways (Rose, 2000).

The first step in studying capital market is to develop an understanding of the different classes of financial instruments. Some of the popular financial instruments that are traded in the capital market are:

- a. Equity or Stock (ownership instruments)
- b. Bond (Debt instruments)
- c. Derivative Securities

a. Equity/Stock

Equity is the major instrument of financial market. Equity represents ownership shares in a corporation (Fisher and Jordan, 2000: p 327). By law, the only class of capital a company must. Have is ordinary shares. These are more commonly called 'equities' (Cowdell, 2002). Equities or stocks are basically the contracts that establish an on-going relationship between "borrower" and "lender" and almost always bundling some combination of "control rights" and rights to be a "residual claimant". In the establishment of corporations of small and medium sizes, stock sales to the incorporators are usually the principal source of cash and other assets (Kent, 1972:p264). Investment on equities is also known as investment by way of proprietary interest. Such investment gives the investor a status of proprietor. He may be a sole proprietor, a partner, or a member of a joint stock company (Whyte, 1951:p78), Holding a stock certificate means that the holder owns the part of the corporations. Thus there are only corporate stocks, no government or a state and local government stock, since individual cannot own governments (at least not legally) (Ritter & Silber, 1993: p 29).

Equity market has shown impressive recovery from the sharp fall in 1994 with the lag effect elongated till late 1998. At present, it has been performing more strongly than

in the earlier years. The improvement in the equity market has been attributed to various factors including good prospect of corporate earnings and broader household participation in the stock market. Investors not only rely on the statement of the brokers, but they also have a concern over the financial information of the concerned company. Therefore the shares of companies with better prospects of dividend, capital increment and growth have normally higher prices in the stock market. Recent rise in equity prices can also be attributed to the gradual fall in the bank deposit interest rates causing excess liquidity in the market. Investors without any credible investment opportunity have diverted their resources towards the stock market. At present, the stock market in Nepal has witnessed its strength surprisingly, and this has raised hopes for sustained growth of corporate undertakings (Timilsina, 2000: p 4).

There are two main types of equity ownership prevalent in the market. They are -

i) Common Stock

Common stock is the first security of the corporation to be issued and, in the event of bankruptcy, the last to be retired. Common stock represents an ownership share in the firm; it has the lowest-priority claim on earnings and assets of all securities issued. It is the residual claimant to the earnings of the firm. The chance of a common stockholder getting anything back from a bankrupt firm is minimal. They receive whatever is left after all the other claimholders have taken their rightful share. But, common stock has an unlimited potential for dividend payments and price appreciation. Payment of common dividend is purely discretionary on the part of the management. If the earnings are retained rather than distributed, stockholders do benefit in the sense that if the retained earnings are invested profitably, the firm will grow in size, and the stockholders will eventually capture the growth.

Thus, stockholders can expect to receive their income in the form of capital gains as well as dividends. Management controls the distribution of income between dividends and capital gains through its control over the fraction of earnings distributed as dividends. Firms that pay out a smaller fraction of their earnings as dividends can be expected to grow at a faster rate than firms that pay out a larger fraction.

The investor's risk is higher with common stock than with any other security a firm might issue. As a result of this risk, investors refuse to invest in common stocks unless they offer a rate of return sufficiently high to induce the investors to assume the possible losses.

When investors buy common stock, they can obtain certificates as a proof of their part as owners of the firm if they so desire. A stock certificates state the number of shares purchased, their par value (if any), and the number of shares bought are noted in the stock record book of the transfer agent. As a result, there is little reason for most investors to have stock certificates prepared. The registrar checks to verify that the transfer agent made no errors.

Common stockholders elect the board of directors and vote on major issues that affect the corporation because they are the owners of the corporation. But most stockholders are not interested in the voting power they possess and simply sign and return the proxies mailed to them by the company. A proxy allows a named person, usually a member of corporate management, to vote the shares of the proxy signer at the

stockholders' meeting. The use of proxies usually allows management, which seldom owns a majority of votes, to vote its decisions into effect.

Many corporate charters allow for cumulative voting. This permits a stockholder to have as many votes as he or she has shares of stock times the number of directors being elected. The stockowner may cast all these cumulative votes for only one director or divide them among several. This provision allows stockholders with a significant minority of shares to gain representation on the board of directors.

The preemptive right allows existing stockholders the right to subscribe to any new issue of stock so that they can maintain their previous fraction of total outstanding shares. The preemptive right, if exercised, prevents dilution of ownership control inherent in additional stock issues. Not all issues of stock have the preemptive right (Francis, 1991: pp 50-51 & Haugen, 1997: p 15).

As opposed to fixed-income securities, common stock is often viewed as a homogeneous type of security. Despite the homogeneous nature, it is important to realize that the risk-return characteristics of stocks can vary significantly. Indeed, stocks are often classified on the basis of these characteristics.

) Stocks of very large firmly established corporations are often referred to as blue-chip stocks. Because of their dominant industry positions, strong balance sheets, and size, these stocks are often viewed as conservative instruments.

) Stocks that observe significant increase in earning per share (EPS) that result from an increase in financial leverage is called growth stock.

-) Stocks that have a long-term record of stable cash dividends are often referred to as income stocks.
-) Most stocks are influenced by economic and industry cycles. For e.g. Companies in the homebuilding and machine-tool manufacturing industries are affected by recessions and periods of economic growth and are therefore known as cyclical stocks. Other types of industries and companies that appear to be less susceptible to economic cycles are known
-) The classification of a stock as speculative or investment quality depends on the way the investor feels about risk.
-) Corporations have authorized, issued, outstanding and treasury stock. If a corporation decides to buy back its own stock, the acquired stock is called treasury stock and appears as a reduction in stockholders' equity on the balance sheet.
-) Investment organizations assign quality ratings to common stocks that reflect the number of classifications discussed above. The ratings are similar to bond ratings and are designated as A+, A, A-, B+ and so on.

ii) Preferred Stock

A term "Preferred Share" is a relatively recent Canadian phenomenon. The phrase is used to describe a particular type of share that has many of the characteristics of debt. A term preferred share pays dividend and is preferred over the common shares as to assets but often has additional features (Hatch, 1983: p 209). Preferred stock is a hybrid of sorts between a fixed and a variable income security. It is occasionally referred to as a hybrid security since its characteristics lie somewhere between those of common stock and bond. Its claim isn't really fixed and definite in the sense that

can force the firm into bankruptcy if it isn't paid in full. On the other hand, its claim limited in size to a specified amount. In general, the only leverage a preferred stockholder has over the firm is that no dividend can be paid on the common stock until the specified dividends have been paid on the preferred stock. Preferred stocks are usually perpetual securities having no maturity date, although there are expectations to this general rule. Preferred stocks are commonly callable, however (Haugen, 1997: pp 14 -15). Preferred stock dividends are treated the same as common stock dividends for tax purposes. From the viewpoint of the investors preferred dividends are treated as dividend income, subject to the same dividend-exclusion provisions as are common dividends. From the viewpoint of the firm, preferred dividends, like common dividends, are not a tax-deductible expense, whereas interest payments on bonds are a deductible expense (Fuller and Farrell, 1987: p 15).

Preferred stockholder have a legal priority (or seniority) over common stockholders with respect to earnings and also with respect to assets in the event of liquidation. But,-preferred stockholders are in a more risky (or junior) position relative to the corporate bondholders. Preferred stockholders generally receive a greater rate of return on their investment than bondholders in compensation for the greater risk they bear. However, they generally receive a lesser rate of return than the common stockholder because they assume less risk. In terms of control, the preferred stockholder usually is in a better position than the bondholder -assuming that the preferred stock holder has voting rights (Francis, 1991: p 55).

Preferred stock is suitable for investors who require fixed return on their investment. It is traded in organized exchanges as well as over-the-counter market. The use of preferred stock is gradually growing in Nepal. Some companies like Necon Air, Birat

Shoe Factory, Everest Bank, Jyoti Spinning Mills, etc. have issued preferred stock as a source of financing (Shrestha, et. al., 2003: p 6).

There are two basic types of preferred stocks, Cumulative and Non-cumulative

-) In the case of a cumulative preferred, if the firm skips its dividend in any given year, no dividend can be paid on the common stock until that dividend and any other arrear dividends on the preferred have been paid in full.
-) In the case of a non-cumulative preferred, if the firm skips the dividend on the preferred in any given year, it can pay dividends on the common as long as it pays the dividends on the preferred in the same year. A non-cumulative preferred has a very weak claim on the earnings of the firm (Haugen, 1997: p 15).

Probably 90 percent of all stock outstanding today is common stock since it has a broader appeal to investors than preferred stock. Since the yield is fixed, the price of preferred stock generally will not increase as the company becomes more profitable and successful. Thus, the typical preferred stock holder does not benefit from price appreciation as would a common stock holder; instead, the price of preferred stock is based on prevailing interest rates (Carman et al., 1985: pp 492-494).

Is a shareholder personally liable for Company Debts?

A shareholder is a member, or part owner, of a limited company. Legally, a shareholder is a separate legal entity from his company and owners of fully paid shares do not have any legal responsibility for the company's debts. Obviously, shareholders may undertake such liability if they sign a guarantee, but mere ownership of fully paid shares in itself cannot make the shareholders personally liable. With partly paid share the position is different, because in the event of liquidation the shareholder could be liable for the amount of uncalled capital on his shares. This payment would be required only if the company's fund were insufficient to meet its external liabilities.

Finally, a holder of partly paid shares could still find himself personally liable for the debt of his company even if he had sold the shares prior to his liquidation. A liquidator will call upon the registered owners of partly paid shares at the time of the liquidation, if he needs the uncalled capital, If it proves impossible to obtain the money from this source, the liquidator has the right to claim from any previous owner of the partly paid shares who had sold the shares within 12 months of liquidation. This liability on the part of the partly paid shareholders explains why banks are reluctant to take a full legal mortgage of such shares as security. Legal mortgagers of shares are the registered shareholders, and as such could become liable in the event of liquidation.

Most quoted shares are fully paid, apart from a few that have only just been issued and on which the various calls are not yet due.

b. Bond

A bond is a type of fixed income security by a borrowing entity in which the amount to be paid to the investors is specified in the investment contract or indenture. The inclusion of provision specifying the amount of income is a major distinguishing characteristic of bonds. In contrast, the Board of Directors determines the income from common stock-cash dividend. Periodically - A trustee (usually a large commercial bank) is appointed when the bond is issued to represent the collective interests of the investors (Cheney & Moses: p314).

A bond is a legal document containing an acknowledgment of indebtedness by a company. It contains a promise to pay a stated rate of interest for a defined period and then to repay the principal at a given date of maturity. In short, a bond is a formal legal evidence of debt and is termed as the senior securities of a company (Bhalla, 1999). Since a bond is a liability of the issuer, the bondholders receive priority over common stockholders in two important ways. First, they have priority in receiving interest income each period; the issuer has a contractual obligation to make these distributions, even if the issuer's income is not adequate for the period. Second, the bondholders have priority in the event the issuer's assets are liquidated; since bonds are liabilities, funds from liquidation must be used to pay these claims before any distribution can be made to preferred or common stock investors.

These two priorities (income and liquidation) mean that bonds, as a general class of security, are less risky than common stocks. Less risky in this sense refers to the greater likelihood of receiving income (interest or dividends) and repayment of principal. It should be noted, however, that when bonds and stocks of different

corporations are compared, some individual bonds might have greater risk than some stocks (Cheney & Moses: p314). In the stringent money market conditions, companies find it difficult to attract equity capital or even preference capital. Since banks generally advance only on the securities of floating assets, issue of bond is regarded as the only other suitable alternate for raising capital (Bhalla, 1999).

The economic environment of the late 1970's and early 1980's resulted in some dramatic changes in the bond market and, consequently investors' attitudes towards bonds. Historically, investing in bonds was characterized as simply "buy and hold" or "clipping coupons" - a passive investment strategy that lacked the glamour of investing in other type of securities. Since the early 1980's, however, double-digit inflation, monetary and fiscal policies, and international events have produced not only extremely high nominal interest rates but also considerable volatility in interest rates, which has resulted in fluctuating bond prices.

Predictably, there is a considerable debate about the future bond environment. On the one hand, some analysts view 1970s and 1980s as simply another page in history that will be remembered as unusual but not predictive; they believe the future will see a return to more passive bond portfolio management. On the other hand, some analysts believe the period was a good indication of future; they think that financial markets will continue to be volatile and that more active bond portfolio management strategies will be appropriate. Volatile markets encourage active management and call buy and hold strategies into question (Cheney & Moses: pp 316-319).

Types of bonds

There are different types of bonds such as:

i. Corporate Bond

Corporate bond is a long-term promissory note issued by a business organization. Corporate bond has more default risk than government and municipal bonds and hence offer higher return too. They are traded in organized exchanges as well as over-the-counter market. Corporate bonds have not yet been popular investment alternative in Nepal. The only outstanding bond listed in NEPSE is the bond of Himalayan Bank Ltd (Thapa, 2002: p 256; ' Shrestha, et al, 2003: p 8).

When corporate bonds are issued, they are backed by an indenture in which the firm promises to the bond trustee that it will comply with certain provisions. Among these are the payment of the scheduled interest and principal. There may also be restrictions on the amounts of dividends that can be paid to stockholders. There may be restrictions on the use of the proceeds of the bond issue, guarantees on the acquisition of insurance and restrictions on investments by the firm in the capital market (Haugen, 1997: p 13). A corporate bond comes in a wide variety of forms.

) Mortgage Bonds represent debt that is secured by a pledge of specific property. In the event of default, the bondholders are entitled to obtain the property in question and to sell it to satisfy their claims on the firm. In addition to the property itself, the holders of mortgage bonds have an unsecured claim on the corporations. Mortgage bondholders are usually protected by terms included in the bond indenture.

- J Collateral Trust Bonds are backed by other securities that are usually held by the trustee. A common situation of this sort arises when a security of a subsidiary firm are pledge as collateral by the parent firm.
- J Equipment Obligations, also known as equipment trust certificates are backed by specific pieces of equipment like railroad cars and commercial aircrafts. If necessary, the equipment can be readily sold and delivered to a newer owner. The legal arrangement used to facilitate the issuance of such bond can be very complex. The most popular procedure uses the "Philadelphia Plan" in which the trustee initially holds the equipment and issues obligations and then leases the equipment to a corporation. Money received from a lessee is subsequently used to make interest and principal payments to the holders of the obligations. Ultimately, if all payments are made on schedule, the leasing corporation takes title to the equipment.
- J Debentures are general obligations of the issuing corporations and thus represent unsecured credit. To protect the holders of such bonds, the indenture will usually limit the future issuance of secured debt as well as any additional unsecured debt.
- J When more than one issue of debenture is outstanding, a hierarchy may be specified. For example, subordinated debentures are junior to unsubordinated debentures, meaning that in the event of bankruptcy, junior claims are to be considered only after senior claims have been fully satisfied (Alexander, et al., 2003: p 368).

ii. **Municipal Bond**

States, cities, towns, villages and any special tax districts such as toll bridge authorities, college dormitory authorities, and sewer districts are all municipalities. The bonds issued by municipalities to finance their public works projects are called municipal bonds, or simply municipals. All municipal securities are bonds because municipalities are not authorized to sell equity securities to finance community projects. More generally, "munis" included debt obligations of state and local commissions, agencies and authorities as well as state and community colleges. Municipal bond interest is exempt from income taxes but the income price change is not tax exempt. Municipal bond is of two types.

-) General obligation bonds: This type of municipal bond is backed by the general or total taxing power of the municipality. They are also called full-faith-and-credit bonds because all the taxing authority and tax revenues of the issuer can be used to satisfy the interest and principal payments.
-) Limited obligation bonds: The term limited obligation bond is applied when the bond issuer is in some way restricted in raising revenues used to pay its debts. Revenue bonds are the most popular form of limited obligation bond. The distinguishing aspect of such bond is that they are only entitled to the revenue generated from the specific property they financed. These bonds are widely used to finance one specific municipally owned utility such as water works, electrical facility, gas facility, sewage disposal systems, or a public convenience like a swimming pool or toll bridge.

iii. Zero Coupon Bond

A zero coupon bond is a bond that does not make interim interest payment and is sold with a large discount. Zero coupon bonds pay no interest but are offered at a substantial discount below their par values and hence provide capital appreciation rather than interest income. The advantages to the issuer are that no cash outlays are required until maturity, and these bonds often have a lower required rate of return than coupon bonds. The advantages for investors are that there is a little danger of a call, and zeros guarantee a "true" yield to maturity since there is no reinvestment rate risk.

iv. Foreign Bond

A bond held by a resident of one country denominated in the currency of another country. In issuing foreign bond, the issuer must abide by the rules and regulations imposed by the government of the country in which the bonds are issued. This may be relatively easy or difficult, depending on the country involved.

One of the major advantages of purchasing foreign bond is the opportunity to obtain international diversification of the default risk of a bond portfolio while not having to be concerned about foreign exchange fluctuations.

v. Eurobond

A bond that is offered outside of the country of the borrower and usually outside of the country in whose currency the security is denominated.

Bond issued by U.S. Corporation that is denominated in Japanese yen (or U.S. dollars) and sold in Germany would be referred to as a Eurobond. As the Eurobond

market is neither regulated nor taxed, it offers substantial advantages for many issuers and buyers of bonds (Thapa, 2002: p 256-259; Cheney & Moses: p 325-326).

Other types of bonds

-) Income bonds are more like preferred stock than bonds. Payment of interest in full and on the schedule is not absolutely required, and failure to do so need not send the corporation into bankruptcy.
-) Guaranteed bonds are issued by one corporation but backed in some way by another.
-) Participating bonds require stated interest payments and provide additional amounts if earnings exceed some stated level.
-) Voting bonds give the holders some voice in management.
-) Corporation for equipment financing sometimes uses serial bonds, with different portions of the issue maturing at different dates.
-) Convertible bonds give their holders the option of exchanging their bonds for the common stock of the firm.
-) Putable bonds also give the holders an option, but this time it is to exchange their bonds for cash equal to the bond's face value (Alexander et al., 2003: p 369 & Haugen, 1997: p 13).

Development bonds of Nepal Government will be issued in the primary market through a auction process and the secondary market transactions will be allowed through a NEPSE. These development bonds will be issued as coupon bonds and an arrangement will be made to issue these bonds on a uniform price through price auction. Though these bonds will be opened through the Stock Exchange in the secondary market, an arrangement will be made to accept these bonds as collateral for

repo transaction and to providing standing liquidity facility to the commercial banks (Economic Survey, 2004/05).

Bond Ratings

The rating reflects the likelihood that the issuer will default on the payments of interest and/or principal. Assigning a rating to a particular bond is an art rather than a science. Standard & Poor's and Moody's are the two principal rating agencies. These firms employ professional analysts who evaluate the bond, using fairly standard financial analysis techniques. As per standard & Poor's, bonds are rated as AAA (highest grade), BBB (Medium grade), CCC (very speculative bonds) and likewise. Similarly, criteria for each rating category used by Moody's are Aaa (best quality), Baa (medium grade obligations), Caa (poor standings) and likewise (Richards, et al., 1984: p 376; Cheney & Moses: p337).

Characteristics of Common Stocks, Preferred Stocks and Bonds

	Common Stocks	Preferred Stocks	Bonds
Claim on income: Priority amount	Last residual	Second Fixed	First fixed
Claim on assets: Priority Amount	Last residual	Second fixed	First Fixed
Mandatory or discretionary clam	Discretionary	Discretionary	Mandatory
Maturity	Perpetual	Perpetual	Fixed

Table 2.3
Comparison of Common Stocks, Preferred Stocks and Bonds

	Common	Preferred	Bonds
Cannot force firm into bankruptcy for failure to pay dividends			
Provides dividends			
Permanent source of financing, with no maturity date			
Dividends are partially tax-exempt to corporate investors			
Have a par value			
No participation in firm profits beyond stated dividend or contractual interest			
No voting rights			
May be convertible			
May have a sinking fund			
May have a call feature at per or slight premium above par value			
Cumulative dividend provision			
Provides interest			
Payments by issuer are tax-deductible expenses			

Source: Santomero and Babbel, 1997: p 347

c. Derivative Securities

Derivatives are financial contracts whose price relates to the price of a particular asset. It means the value of derivative securities, if not all; a part of their value is derived from the value of another security. For example, the value of a call option is derived from the value of the common stock against which the call option is written; the value of a commodity futures contract is derived from the value of a commodity, which must be delivered in the future. There are wide ranges of derivatives, which are used mainly for managing financial risk. (Fuller and Farrell, 1987:p16). Derivative securities are important investment alternatives in developed market, but they are not

available in Nepal. A few important derivative securities from the point of view of investors-are:

J **Option**

In the world of investments, an option is a type of contract between two people wherein one person grants the other person the right to buy a specific asset at a specific price within a specific time period. Alternatively, the contract may grant the other person the right to sell a specific asset at a specific price within a specific time period. The person who has received the right, and thus has a decision to make, is known as the option buyer because he or she must pay for this right. The person who has sold the right, and thus must respond to the buyer's decision, is known as the option writer (Alexander et al., 2003: p 601).

An option falls under the category of security because it also has the value as the shares or bonds have and can be traded in the registered exchanges or in the over the counter market. But options are called the derivative securities because they derive their value from the underlying assets. The underlying assets may be common stock, Treasury bills, Treasury notes, Treasury bonds, future contracts, commodities, stock indexes, interest rates, etc.

Some options are traded in the organized exchanges and are known as 'exchange traded options'. Others are traded in OTC market and are known as 'OTC options' or 'off exchange options'. An OTC option is the result of private negotiations of two parties whereas exchange traded options are initiated and further traded on organized exchanges. Exchange traded options are standardized as to the amount and price of

the underlying assets. Organized exchanges began trading options on equities in 1973, whereas exchange-traded debt options did not appear until 1982.

Greeks are said to be the first users of the options. The history of option dates back to 550 B.C. Thales, the ancient Greek philosopher, mathematician, and astronomer is believed to be the first person to use options (Gautam and Thapa, 2061: p 71).

The two most basic types of option contracts are known as calls and puts. Call option is the most prominent type of option contract for stock. It gives the buyer the right to buy ("call away") a specific number of shares of a specific company from the option writer at a specific price at any time up to and including a specific date. A second type of option contract for stocks is then option. It gives the buyer the right to sell ("to put away") a specific number of shares of a specific company to the option writer at a specific selling price at any time up to and including a specific date (Alexander et. al., 2003: p 604). Put and call options are examples of secondary securities. The firms do not issue them, and the net supply of these securities is zero. Options are written and sold by individual investors.

Russell Sage, who is said to be the grandfather of modern option trading, organized the system of trading put and call options on an OTC market in the USA in the late 19th century. He has developed a famous theory on option pricing called 'put-call parity theorem'. In the USA, Chicago Board of Option Exchange (CBOE) is the first stock exchange that started option trading with 16 call options in April 1973, followed by the introduction of put option trading in June 1977. It is still the largest organized exchange for options trading in the USA. In Canada, call option trading began in mid-

September 1975 and put option trading was added in 1978 (Gautam and Thapa, 2061: p 7.1 & Hatch, 1983: p 402).

Cap, Floors and Collars

A cap is a call option on interest rates, often with multiple exercise dates. A floor is a put option on interest rates, often with multiple exercise dates. Collar is a position taken simultaneously in a cap and a floor (Saunders, 1997: p 546).

) Warrants, Rights and Convertibles

Warrants: A warrant is a primary security, historically been issued mainly by small, growing companies. It is in all other respect, identical to a call option, although warrants usually have longer lives than call options. Warrants in a particular company give the holder the right to subscribe for ordinary shares in that company on the terms set out in the articles of association. Holders of warrant are not entitled to any dividend/or voting rights, and if the subscription has not been exercised by the expiry date, the warrant becomes valueless. Warrants are often given to the executives as a part of their compensation. They are also frequently attached securities, such as bonds and preferred stock offerings. Warrants are dealt with on the Stock Exchanges in exactly the same way as any other quoted security. The holder will receive a certificate that usually sets out the number of warrants held, and the terms on which ordinary shares can be purchased (Cowdell, 2002; Haugen, 1997: p 20 & Hatch, 1983: p 427).

Rights: Rights, also known as subscriptions warrants, are issued to give existing shareholders their preemptive right to subscribe to a new issue of common stock

before the general public is given an opportunity. Each share of stock receives one right. A stated number of rights plus cash equal to a specified subscription price are required in order to obtain one new share. Setting the subscription price below the stock's market price at the time the rights are issued ensures the sale of the new stock. New subscriptions do not get a bargain, however; they must pay old stockholders for the required number of rights, which become valuable as a result.

Rights generally have short lives (a few weeks) and may be freely traded before exercise. Up to a specified date, old shares of the stock trade cum rights, meaning that the buyer of the stock is entitled to receive the rights when issued. Afterwards the stock trades ex rights at a correspondingly lower price. Rights for popular issues of stocks are sometimes traded on exchanges; others are available in the OTC market. Often trading begins before actual availability with the rights sold for delivery on a When-issued basis (Alexander et al., 2003: p 646).

A distinction between right and a warrant is that rights are issued as a pre-emptive right to current stockholders where warrants are issued attached to other securities. Some of these warrants are detachable and some are not; a trading market exists for detachable warrants (Carman, 1985: p 621).

Convertibles: A particularly popular financial instruments is a security that can be converted into another security of the same firm that has different rights and privileges under certain conditions. A convertible security is usually a bond or a preferred stock that can be converted into shares of the firm's common stock, with the stated number of shares received for each bond or share of preferred stock. If it is a

bond, the convertible security provides the investor: with a fixed interest payment, and if it is a preferred stock, with a stipulated dividend. Usually no cash is involved: the old security is simply traded in, and the appropriate number of new securities is issued in return. Convertible preferred stocks are issued from time to time, but tax effects make them, like other preferred stock, attractive primarily to corporate investors. For other investors, issues of convertible bonds are more attractive (Alexander et al., 2003: p 647 & Francis, 1991:p58).

Convertible securities are considered an alternative investment. Although they are not as popular as traditional investments in straight (non-convertible) bonds and common stocks, their unique features may make them attractive alternatives in an active investment strategy. The volatility of bond and stock markets during the 1980s and early 1990s has increased investor interest in convertibles. In late 1989, the total market value, of all outstanding convertibles was around \$50~\$60 billion (Cheney and Moses, 1999: p 530).

As a rule, convertible securities are callable. The purpose of the call provision is not to redeem the convertible bonds or preferred stock but to force conversion of the issue when the conversion value of the security is well above the call price. In practice, few convertibles are ever redeemed.

) Forward and Futures Contracts

A forward & future contract is a firm legal arrangement between a potential buyer (long) and a potential seller (short) of a commodity. It obligates you to buy and sell a particular commodity at a particular price on a particular day. If you buy a forward or future contract, you have obligated yourself to buy a commodity at a stated price. On

the other hand, if you sell such a contract, you have obligated yourself to sell the commodity at a stated price. These are to be distinguished from options in that they don't give you the right to buy or sell; they obligate you to buy or sell.

Investors can profit from increases or decreases in the prices of various commodities by purchasing and selling forward and future contracts. Forward contract can do something none do the contracts can. Their values can become negative! If you have obligated yourself to buy a commodity at a price of \$100 and a commodity is currently selling at a price of \$70, the value of your forward contract to buy is negative.

When originated, the contracted price you must later buy or sell for is set such that the buyer and a seller will exchange the contract with no associated cash payment. That is, the forward or future price is set to make the current market value of the contract equal to zero. The market value of a forward contract is allowed to subsequently become positive or negative as a commodity price goes up or down. In the case of a future contract, however, one aspect of the contract is changed each day to keep the market value of the contract at zero. The aspect of the contract that is revised is the future price, in a process called marking to market. The process of marking to market is an important feature that differentiates a future from a forward contract.

Futures are written on commodities such as gold, silver and agricultural products as well as on various financial contracts such as treasury bills, treasury bonds, pass-through and even stocks. The market for financial futures is currently exploding in terms of types of contracts traded, volume of trading, and investor interest (Haugen, 1997: pp 20-22).

J Swaps

Consider a situation in which a portfolio manager wants to make major changes in the proportions of funds that are invested in different assets classes. He or she recognizes that substantial transaction costs will be incurred if the transactional method of selling certain securities and replacing them with others is used to make the changes. Indeed, these costs can be so large that most of the changes, if conducted in this manner, should not be made. One relatively new method that has become very popular in allowing such changes to be made at relatively low transaction costs involves the use of swaps.

Although the unique features of swaps can become complicated, their general nature is quite simple. Such swaps are contracts that typically involve two parties, known as counter parties, exchanging sets of cash flows over a predetermined period of time (Alexander et al 2003: p 807). Swaps are more recent addition to the financial markets than the contingent claim discussed so far. The swap market has been in existence since the early 1980's. Currency and interest rate swaps are the most common type in the market. A currency swap transfers the obligation for payment in one currency to another party who, in turn, undertakes an obligation for payment in another currency. The difference between the two types of swaps is that an interest rate swap only involves the exchange of interest payments, while the principal remain the obligation of the initial borrower. Therefore the riskiness of the loan is still associated with the writer of the debt, and not transferred. Swaps are conducted through an intermediary, usually a market-maker, or a swap bank (usually a commercial or investment bank), which accept the default risk, and earn a fee from both participants dependent on the

level of that 'risk. Swap prices are negotiated by auction, usually conducted on the telephone, and are very much under the control of the market-maker (Piesse et al., 1995: pp 197-198).

) Financial Spread Betting

"A spread bet is a short term equity derivative and should only be used if you are confident something is either going up or down" says David Buik at Cantor Index, whose clients have profited from down bets on banking, insurance and pharmaceutical shares. Under financial spread betting investors do not buy the assets itself; they simply bet on how far its price will move, staking an amount per point of variation from a price quoted by spread betting companies. In UK we can find the spread betting companies like IG Index, Financial Spread Cantor Index, and City Index. Spread betting firms quote on UK and overseas shares and stock market indices, as well as bonds, interest rates, currencies and commodities. Daily cash bets are popular with experienced speculators who trade rapidly in and out to exploit the greater volatility of indices compared to shares (Accounting and Business, June 2003: pp 41-42).

2.1.3.3 Securities Innovation

One of the chief characteristics of financial markets is their ability to develop innovative financial instruments. The last two decades have witnessed unprecedented innovation in the range of and manner in which firms issue securities. Just as engineers apply scientific principles to design new products and services, financial engineers apply principles of financial economics for the purpose of structuring, pricing and managing the risk of financial contracts. Financial engineering involves

the design development and implementation of innovative financial instruments and processes, and the formulation of creative solutions to problems in corporate finance. Innovative instruments make financial markets more complete and efficient. For instance, greater efficiency could be achieved by reducing transaction costs. Financial markets can be made more complete by designing a new security whose contingent after-tax returns cannot be replicated by any combination of existing securities. Financial engineering involves three type of activities - design of new financial instruments development of new financial processes, and providing creative solutions to problems it corporate finance. Index linked bonds, on-line trading of securities and project finance are I examples of the three activities respectively (Vishwanath, 2000: p 319).

What drives Financial Innovation?

Firms issue innovative securities for many reasons, but two of the most important are to escape the bite of taxes and regulation. Tax and regulatory friction are the basic motivators for financial innovations (Grinblatt and Titman, 2003: p 51). Some academics consider financial innovations 'unpredictable improvements' that come into being as a result of regulatory and tax impulses (and not because of MBAs from A-rated business school), while other consider innovative instruments and processes as attempts by companies to lessen the financial constraints they face.

The major factors that are responsible for financial innovations are:

- Transaction Costs
- Taxation
- Agency costs

- Risk - opportunities to reduce some forms of risk or to reallocate risk from one market participant to another whose either less risk averse or else willing to bear the risk at a lower cost.
 - Opportunities to increase an asset's liquidity
 - Regulatory and Legislative changes
 - Level and volatility of prices and interest rates
 - New financial theories and similar other technological factors
- (Vishwanath, 2000: pp 319-320).

Recent innovations include the creation of asset-backed securities, which are securities that are collateralized by cash flows from assets, like mortgages and account receivable. In March 1994, for example, Northwest Airlines brought the first airline industry asset-backed certificates to the market. They were backed by Northwest's accounts receivable - their ticket payments.

Occasionally, conditions that influence the macro economy, such as inflation lead to innovative debt securities. For example, during the 1989 Kuwait crisis, the crude oil prices skyrocketed. At that time, their investment banks convinced several firms that it was a good time to issue oil-linked bonds. They were characterized by lower than normal coupon rates and to compensate investors for low rate, the principal was to be paid either four times the per-barrel price of oil or \$100 at maturity, whichever was larger. The emerging and growing capital markets are more able to welcome the financial innovations, as was seen in Russia in 1994 (Grinblatt and Titman, 2003: pp 52-53).

Likewise, Indian capital market has also witnessed a few innovative debt instruments in the recent past. Some of these innovative instruments are deep discount bonds, capital indexed bonds, secured premium notes, etc. A deep discount bond is issued at 'deep discount' to the face value of the instruments. The bond appreciates to its face value till maturity. The investor does not receive any interest during the life of the instruments. The capital indexed bonds were designed to eliminate the purchasing power risk. The bond is issued with an initial principal of Rs. 100 and a real yield determined through the auction process. Over time, the principal adjusts according to changes in the price index from the time the bond is issued. Secured premium note is a debt security with a warrant attached to it. They have a face value of Rs. 300, no interest is paid during the first three years, and subsequently they will be redeemed in four equal installments of Rs. 75 each beginning from 4th year. In addition, the company pays Rs. 75 each year to the investors. The warrant gives the investors an option to buy one share at Rs. 100. Dual currency bonds are also one example of innovated securities. These bonds are offered in one currency while the interest payments and redemptions are made in another currency. The issuer offers to make interest and principal payments in some specified list of currencies. The investor has the option to choose the currency (Vishwanath, 2000: pp 320-322).

The pace of financial innovation has been remarkable, given that new security designs cannot be patented, are easily copied, and once copied, their probability to the inventor drops dramatically. To encourage such a rapid pace of innovation, successful security designs have to be phenomenally profitable to the inventor for that brief period of time before competitors introduce imitations (Grinblatt and Titman, 2003:p320). Financial engineering can be used not only in reducing financing costs

and creating customized financial instruments but also in advancing a company's strategic goals (Vishwanath, 2000: p 320).

2.2 Review of Related Studies

2.2.1 International Journals

Garside, R.R (1998) conducted a research that in his project report, Garside have described - "At one level, capital markets are simple enough. The primary market is where companies raise capital by issuing securities, basically either shares or bonds. The secondary market is where those same securities are traded. Those definitions are simple and there is nothing very complex about the mechanisms for issuing, trading or setting. Sometimes, the term capital market is extended to cover long-term bank loans to companies. But at another level, the capital markets are mere complex because when they function properly, they are the very hubs of a free market economy. In them, all economic currents and forces meet and interact.

A healthy capital market is democratic and egalitarian. It shows no respect for class or caste. It does not acknowledge hierarchy. When the price of share falls, it falls for all those who hold it. Financial analyst may have decorated in math but some of the best traders of equities, future and options have been near a university."

Grinblatt and Keloharju (2004) have conducted a study to monitor buys, sells and holds of individuals and institutions in the Finish Stock Market on a daily basis. They have tried to explore the motivations for trade. With the variety of tests, the study lists several factors like: past returns, reference price effects, volatility, life cycle, size of holding period capital gain or loss, and tax effects which motivate the individual and

institutional investors to decide on buying and selling. These all are determinants of investment decisions.

Past returns are the most important factor for less sophisticated investors - households, general government and non-profit institutions; they are more predisposed to sell than to buy stocks with large past returns. Such investors tend to be contrarians and foreign investors are opposite, they show momentum behavior.

Life cycle consideration also account for investment decisions. Investors tend to sell (primarily inherited stock) early in life, purchase stock in the prime earning years of middle age, and then sell stocks in old age. The youngest investors buy more. Investors begin net sales of stocks at an old age that is later in life. So far as volatility is concerned, high volatility increases the propensity of households to buy rather than sell a stock.

Luis M. Viceira (2004) has made a study in relation to portfolio choices and income. The paper examines how risky labor income and retirement affect optimal portfolio choices.

"With idiosyncratic labor income risk, the optimal allocation of stocks is ambiguously larger for employed investors than for retired investors, consistent with the typical recommendations of investment advisors. Increasing idiosyncratic labor income risk raises investors' willingness to save and reduces their stock portfolio allocation towards the level of retired investors. With time variation in investment opportunities, retirement and death play an instrumental role as events that exogenously fix the

individual's investment horizon. When future level income is certain, it is optimal for employed investors to hold proportionally more stocks in their portfolio than it is for retired investors" (Viceira, 2001: p 433).

This paper shows, employed investors have an additional source of income, they can afford more aggressive portfolio than retired investors. Financial advisors typically recommend that their customers invest more in stocks than in safe assets when they are working, and shift their investment towards safe assets when they are retired.

Rashes Micheal (2004) had conducted a study to find out how the confusion of investors affects the stock market. As per the confusion of investors, three possibilities are identified - incorrect order entry; failure to utilize all available information and ticker symbol confusion. This paper basically focuses on the ticker symbol confusion of MCI Communication (MCIC) and Mass-mutual Corporate investors (MCI). Here, Rashes have illustrated that as many as one percent of the MCIC trades those investors intend to make incorrectly result in MCI transactions. This happened due to the investors' confusion between a well-known stock and a lesser-known one that have little in common besides their similar ticker symbols.

This paper examines the noise traders, who actively trade on the basis of incomplete or premature information. Some investors are also found failed to condition their portfolio decisions and the complete information set. This paper finds that genuine shifts in sentiments due to misunderstanding of information about a single stock can lead to deviations of security prices from fundamental values.

Vayanos Dimitri (2004) has illustrated strategic trading of strategic traders in a noisy market. Large traders, such as dealer, mutual funds and pension funds, play an important role in financial market. He assumes, trading motives for large traders are generally of two types - informational and allocational. Informational motives arise from private information about asset payoffs and allocational motives are risk sharing, portfolio rebalancing and liquidity. Large traders or investors are assumed to be risk averter instead of risk neutral. This paper reveals that the strategic traders like large traders often play with their stocks, termed as market manipulation. They go on changing their holdings as per the inside information. Likewise they sell the stocks with the inside information that price will fall because of negative earnings announcements and they will again repurchase the stock when the price falls. These are also known as 'round trip transactions'.

A study made by Daniel, Hirshleifer and Subrahmanyam have concluded that securities market under overreactions based on two well known psychological biases - investor over confidence about the precision on private information and biased self attribution, which cause asymmetric shifts in investor's confidence as a function to their investment outcome.

According to them, over confidence implies negative long-term auto correlation, excess volatility and when managerial actions are correlated with stock miss pricing, public ever based return predictability. Biased self attribution add positive short lag auto correlation momentum', short run earning 'drift' but negative correlation between future returns are long-term past stock market and accounting performance.

2.2.2 Review of Related Articles

Nepalese capital market got a proper structure only in the year 1993. Stock market has in the past decade but not an extent desired. It is still in an early age and has to grow significantly to play a more meaningful role in the banking dominated financial system. Kettel, D.R., a chairman of SEBO/N has a view that there should be concerned efforts to improve market size, liquidity, concentration and volatility in order to gain a status-of a credible market. It ahs become more relevant to focus on developing a credible market when banking sector is its way of meaningful reform and pressure for integration to the world and the regional markets are mounting. We probably do not have any other better choice than keeping in rhythm with regional prosperity through more investment and service linkages.

Organized stock exchange in Nepal had made a history of ten years. Although it is not sufficient to make a history, NEPSE had faced all types of happenings. The big bullish period, the long bearish period, the unprecedented market capitalization, the quite fair market driven by innocent and honest market intermediaries, the quite unfair market driven by unfair practices, the rumor driven market, the big changes in ownership of joint venture banks, the addition and subtraction in the listed companies, etc are some key events in the history of Nepalese capital market. Though, the concept of secondary market was developed especially for the promotion of portfolio management of big business houses and big investors, the concept has failed in our country due to restrictions on their participation in the market (Agrawal, 2004: pp 68-69). In this regard, Mr. Jagdish Agrawal, FCA has remarked –

"...If we talk about the size of the market we can compare it with a person suffering from a disease, due to which his height has stopped increasing but he is gaining in weight (Agrawal,- 2000)"

One serious weakness facing Nepal's stock market is the low participation of investors in securities transaction. Majority of the investors participating in the exchange are from Kathmandu valley. Since there is only one stock exchange in the country and it is located in the capital, and there is no other alternative available, participation of the investors from outside the valley is very low. A ray of hope has been aroused by the Tenth Five-year Plan that targets to increase the investor participation in the securities transaction and to have a minimum of 3% of total population investing in the share capital of the organized sector enterprises. For this the government has brought out the concept of regional exchange. But it is worth nothing than the concept of regional exchange that was introduced in the Ninth Plan also. As nothing noticeable was done towards this direction during the Ninth Plan period, doubts are raised also at the possibility of implementing the program in the Tenth Plan period. For investors, who want to invest through the primary market, it is not so great a problem even if they are living far away from the stock exchange as they can easily apply for the shares through different financial institutions which have their offices scattered around the country. But, in the real sense, this is not enough for the involvement of the people in the securities transaction and investment in share capital of the organized sector enterprises. It is important to facilitate the participation of such people in the secondary market as well (Bhattarai, 2005).

If we see the scenario of instruments, equity issuance formed a significant portion of total issue in the capital market since 1993/94. The issuance of such securities is

viable opportunity for risk-bearing investors who wish to take greater risk for higher return. The risk-averse investors on the other hand would seek to invest on securities like bonds issued by corporations and government, debentures, preference share etc. which would provide them fixed return over a period of time with very little on their investment. The corporate bonds/debentures of only five institutions namely Sri Ram Sugar Mills Ltd., Bottlers Nepal Ltd., Himalayan Bank Ltd., Nepal Investment Bank Ltd. and Everest Bank Ltd. have been issued in the capital market till date. Of these debentures, those of Bottlers "Nepal and Sri Ram Sugar Mills have already matured. This speaks for the need of increase the issuance of more viable risk-averse investment opportunities to cater for that category of investors (Vaidya and Parajuli, 2006).

In one of his article - "Debentures are welcome" Bhattarai (2005) discusses the future prosperity of debentures. He recognized that debentures have good future market potentiality, though it's market size is small in the present context. Though the government bonds are not available in the stock exchange floor, corporate bonds are being made available. The issuance of the 8.5% Himalayan Bank Ltd. 2009 bond and it's listing in the secondary market with separate trading system became a milestone in his regard. Thus, he concludes that debentures have good future prospects.

When we see the trend of share market, more than 90% of the transactions that take place in the share market relate to the securities of the financial institutions. We can count the active industrial and trading sector units on finger. This shows that the securities market in Nepal is essentially the financial securities market. This also implies that the financial transformed itself into the most dynamic and also the most

attractive sector of investment in Nepal. So, credit of current position of public interest in share investment actually goes to banks and Financial sectors (Shrestha, 2004). It is obvious that investors or general savers are main wheels of securities market to run. Both individual and institutional investors mean a lot to security market. But, in our context, we lack the active institutional investors. Despite the lack of institutional investors, the stock market in Nepal has good confidence of the general investors. This is proved by the response that the public offering by some companies received during the recent past. The public has the interest and capacity to subscribe the shares in primary market. Shree Investment Finance Company Ltd., Janaki Finance Company Ltd., Gorkha Finance Company Ltd., Sri-Lanka Merchant Finance Company Ltd., SB1 (right shares) Himalayan Bank (debentures), Everest Bank (preference share) etc. were offered to the public and all of them were oversubscribed (Ghimire, 2004).

In one of his article, Mr. Nabaraj Adhikari, an officer of SEBO/N had remarked that though the institutional development of securities market in Nepal started in 1976, it is still at an underdeveloped stage, characterized by legal inadequacy, low resource availability to the regulator, low liquidity, double taxation on dividend and capital gain tax, poor corporate governance practices, low involvement of institutional investors, poor disclosure practices, high cost of public issue, and high transaction cost.

The present status of securities market could be improved and developed as an important source of long-term financing by finalizing the legislative process of the proposed Securities Ordinance and Proposed Companies Ordinance and implementing

them effectively taking regulatory measures that mandates investment of a certain percentage of funds in securities market by institutional investors i.e., Employee Provident Fund and Citizen Investment Trust, enhancing the pace of privatization by sale of shares, promoting privatization bonds, development bonds, municipal bonds and securitisation activities in the market, following one window policy in public issue process, establishing automated trading system, OTC market and Central Depository of Securities (CDS), provisioning increased resources to the regulator, improving the taxation policy to avoid double taxation of dividend, rationalizing the present capital gain tax provision, and by the implementation of accounting and auditing standards developed by Institution-of Chartered Accountants of Nepal.

2.2.3 Review of Unpublished Masters' Degree Thesis

Bhatta (2004) conducted a study on the topic "Dynamic of Stock Market in Nepal". The main objectives of the study are to analyze the trend of Nepalese stock market. His study found out that investors are interested to invest their resources in the shares of corporate sector. Hence it is necessary to develop the entrepreneurship and encourage the entrepreneurs to start the productive venture as soon as possible. Management capability of the entrepreneurs is a key for better performance of the firms. Government should launch programs to enhance management capability of the entrepreneurs, which may contribute to raise the return from the investment.

Development of manufacturing sector is the backbone of an economy, which in turn assists to foster banking, finance and insurance sectors. Unfortunately, the manufacturing sector does not have a good performance in Nepalese economy. Almost all firms in this sector have sustained a loss. The secondary aspect of the stock

market is also not functioning well in Nepal. There is almost no liquidity in the stock market for shares except that of banking and some finance and insurance sectors. Although it has become late to take steps to overcome such problems of the Nepalese stock market in order to make it active and supportive, the stock market has good prospect for the resources mobilization to finance the productive enterprises in Nepalese economy.

Koirala (2004) made a study regarding government securities as internal debt of Nepal. For meeting the ever-widening budgetary deficit, government has to resort to internal borrowing. Internal public debt has been playing a significant role in the formation of financial resource for development expenditure as well as in the growth of money and capital market. It can be in the form of real and unreal borrowing. The unreal borrowing includes the government bonds and treasury bills held by Rastra Bank and commercial banks. The real borrowing includes the bonds and the treasury bills held by individual, groups and other institutions, and this can decrease the inflation since it reduces the purchasing power of the investors. Koirala states that the internal debt increased with an average annual growth rate of 13.3%.

The investors' interests were found to be affected by their occupation. The businessman, students and the retired persons are less interested to purchase the government securities but the civil servant and permanent employee of organized bodies are more interested to purchase the government securities. On the contrary, level of education found to be irrelevant factor. It does not affect to the interest towards the government securities. It means all level of people from the viewpoint of education is equally interested to purchase government securities. But, the

background of education seems as an important factor. Those people whose academic background is economics, finance, management and commerce are more aware than the people with other background. Koirala, in his study states that higher income group people are less interested to purchase the government securities. The test regarding awareness resulted that the people from urban area are more aware than the people from rural area regarding government securities.

Koirala declares that the bonds and securities must be of different types so that they may suit the preference of people from the different segment of society, either rich or poor. Bonds can be varied in terms of interest rates, maturity and denominations. To attract people towards the government bonds, it is essential that some special bonds might be issued for development work with a particular locality. This will motivate other localities also. Maturities of bonds are recommended not to exceed 7 years, due to declining real value of assets because of increasing rate of inflation.

Pandey (2005) had conducted research on the topic of "Legal and Institutional Arrangements for investors' Protection in Capital Market of Nepal". His study concluded that the existing legal provisions and regulations were insufficient for protecting investors' interest. Provisions were insufficient especially in case of timely disclosure of price sensitive information and insider trading. The study found that there was duplication and redundancy of regulation in between ROC and SEBO/N. Both the institutions were doing some of the tasks under the regulations. Collective performances of regulations like SEBO/N, ROC, NEPSE, NRB and company board were found to be less effective and unsuccessful. No proper coordination among regulatory was found. He also added that insider-trading practice is existed in

Nepalese securities market. Sufficient legal provisions to check insider trading did not exist. Regulatory authority like SEBO/N had no appropriate and adequate power to make investigations and take decisions.

Paudel (2005) studied about the "Government Securities Practices in Nepal". It finds out that the interest of investors on government security and their educational background is completely independent both the educated and uneducated people are equally interested on government securities. The study also draws the conclusion - both poor and rich people are interested to Government securities. Those who are unable and unskilled to exploit market and start their own enterprises are investing in government securities; those who have studied the business related subjects are more aware of various categories of government securities; and people in rural area are less aware of the government securities.

In addition, Paudel states that T-bills are most welcomed security in comparison to other government securities. His study (found that 50% of the respondents were aware of the government securities since few years ago only. 59.1% respondent told that they prefer government securities due to tax freeness and risk freeness. Large investors thought to invest idle cash in government securities and only few of them used loan in order to purchase the government securities.

Pahari (2006) had conducted a study about the debt market in Nepal. He points out the fact that the government securities in terms of bonds and corporate securities in terms of equity are issuing and growing regularly since 1993. However other types of securities like preference shares and debentures are not growing properly. His study

also looks towards inflation – the relationship between inflation rates with government borrowing is positive. Positive relationship was also found between government securities (national saving certificates and government bonds) and market interest rate. But market interest rate is adversely influence by T-bill rates.

Survey of investors made by Pahari shows that majority of respondent preferred common stocks for the investment. Government securities got the second priority and corporate debt securities got the third, whereas majority of respondent companies gave the first priority to the government debts. Majority of respondents were found willing to invest in banking sector debt securities. Pahari also found that majority of investors felt that the government securities should also be traded on NEPSE floor. Study finds that the government securities market is unsystematic. Nepalese investors were found to believe that "common stocks are marketable than debentures' as a motive of issuing common stock in place of debentures, yet they also pointed that 'default in payment of interest and principal' also makes the debentures unattractive. Regarding foreign investors, Pahari asserts that the majority of respondents were in favor of welcoming the foreign investors. Respondents also agreed that the Nepalese debt securities market lacks adequate infrastructures and facilities; infrastructure indicates trading mechanism, rules and regulations, and credit rating agencies.

Subedi (2006) studied about the "Investors Awareness in the Securities Market in Nepal." His study aimed 10 find out whether the investors are aware or not in the stock market. Nepal being a developing country, where security market has just began to grow, how the investor's are reacting towards investment in securities and their knowledge towards securities market is the main focus of the study. He had attempted to dig-out the major factors that affect the investors' decisions.

Subedi indicated that significant portion of investors (24.54%) responded that there are better opportunities for investors in non-securities sector, however majority group (75.46%) believe that securities sector provide better opportunities. Among those investors, who chose securities market as better sector responded that the banking, finance, insurance, manufacturing, hotel, trading and other sectors are suitable in ranking. Those who chose non-securities sector responded the bank's fixed deposits, fixed assets, business ventures and other sectors as suitable alternatives. Investors feel that investment in common stock is popular since it provides sufficient return in comparison to other field of investment.

Study made by Subedi also explored that majority of investors are dissatisfied with security market. 81.95% were dissatisfied with the availability of information, 87.5% were dissatisfied with the grievance handling, and 76.39% found dissatisfied with the present level of return from the stock investment. This study also found that majority of investors does not think regulatory measures are adequate. This study also states that dividend and capital appreciation were the most inspiring factor to attract the investors. Most of the investors responded that their level of awareness is at low and moderate level while only few others responded that their level of awareness is at very low and very high level.

Investors are found very highly affected by whim and rumor related to share price. No one bothers to analyze before they invest in shares. They just follow the trend, and buy the shares of the company whose demand is high. This is because of lack of awareness and educational and technical qualifications. Programs to educate

investors, to intensify public awareness, to train market professionals need to be increased.

Upadhyaya (2007) conducted research to examine and analyze the preferences of the Nepalese investors in selecting financial instruments. The survey made by him resulted that the majority of the Nepalese investors (55.8% of respondents) preferred the equity share for investment they preferred government securities after common stocks (by 28.8% respondents). The preferred stocks and debentures were least preferred (by 7.7% respondents for each). Majority of investors (53.6%) preferred banking sector for the investment. 69.2% agreed that they prefer common stock rather than other instruments due to the dividends. Those who prefer government securities agreed that risk free return is the main attraction behind this alternative. Among the options of profit, marketability, social status; majority of investors (73.1%) vote for profit. When investors were asked whether they were satisfied with the return from the investments, 57.7% of them replied that they are not. 55.8% of respondents agreed that investors lack awareness regarding security market. Likewise, 69.9% stated that they are not getting the sufficient and timely information regarding the investment from the companies. Upadhyaya (2007) have also explored about the opinion of investors regarding their protection, in which 80.8% stated the existing rules and regulations of the government are not sufficient and effective. Market capitalization of the different financial securities showed the common stock had the largest chunk of trading in the market. Among the common stocks, the stock of banking sectors has the largest chunk of trading in the market.

Study recommends, as there are no professional firms providing the financial assistance and advice to the existing as well as prospective investors, the government should arrange for creating such environment for the development of financial professionalism. Similarly, the concerned authorities should take measures to disseminate the required information to the general public through appropriate means. Market makers, brokers, concerned public limited companies, and other concerned bodies should launch programs to increase Investors' awareness regarding security market.

2.3 Research Gap

Many studies have been reviewed in the previous section but no researches have made study about the development of financial instruments in the Nepalese capital market. Bharat Prasad Bhatta (2004) made a research about dynamics of stock market in Nepal, S. 1C. Koirala (2004), about government securities as internal debt, Meg Nath Pandey (2005) about legal and institutional arrangement.- for investors' protection in capital market, Ram Prasad Poudel (2005) about government securities practices in Nepal, Ishwor Pahari (2006) about Nepalese debt market, Badri Subedi about (2006) about investors awareness in the Nepalese securities market, and Santosh Upadhyaya (2007) about preferences of Nepalese Investors in selecting financial instruments.

All these materials found in different studies are of fragmented nature. Some of them are related to the investor's behavior, some with their psychology and some with their decisions. However, none of the study is directly related with the development of financial instruments in the Nepalese capital market. This shows a clear research gap about the study.

CHAPTER -III

RESEARCH METHODOLOGY

Research Methodology is the method used to test the hypotheses set by the researchers. It is the mechanism by the application of which the objectives of the study are empirically tested and some kind of inference is drawn. Due to such implications, the research methodology should always be in a broader perspective - includes the design of the research, population and sample, nature and sources of data and collection, procedures, data analysis techniques and statistical tools used.

3.1 Research Design

Research Design is a plan, structure and strategy of investigation conceived so to obtain answer to research question and to control variances. It is a definite procedure and technique which guides to study and provide ways for research viability. This study describes and explores the development of financial instruments in Nepalese capital market. The current status of financial instruments in well explained with the proper analysis of past data. Therefore this is historical type of research design.

3.2 Populations and Sample

The entire number of financial instruments available in the Nepalese capital market and the investors of such instruments are the population for the research study. Survey is conducted on different places like NEPSF- floor, broker's offices, and several other places. Six year data from the period of 1999/2000 - 2006/07 (2056/57 - 2063/64) of six commercial banks and finance companies were taken a as a sample for the study

of secondary data. Name of sampled companies selected for the study are listed in table below:

Table 3.1

Name of the Companies Taken as a Sample

S.No.	Sectors	Name of sampled companies
1.	Commercial Banks	Nepal SBI Bank Ltd.
		Nepal Investment Bank Ltd.
		NABIL Bank Ltd.
		Standard Chartered Bank Nepal Ltd.
		Himalayan Bank
		Nepal Bangladesh Bank
2.	Finance Companies	Ace Finance Company
		Goodwill Finance Company
		International Leasing and Finance Company
		Nepal Merchant Banking and Finance Company
		Kathamndu Finance Company
		People's Finance Company

The amount of investments made on government securities and corporate securities are also considered during the study. In terms of financial instruments, issuance of corporate securities and government securities from the F/Y 1995/96 to 2006/07 are taken for the study. To study the IPO subscriptions, the issuance of securities made since 1995/96 till 2006/07 are taken. Six years data in terms of sector-wise traded amounts are taken to study the sector-wise trading volumes.

3.3 Sources of Data

This research is based upon the secondary data for the historical performance assessment and the primary data for the qualitative assessment of information. The required data are collected from various secondary sources like SEBO/N reports, NEPSE reports, and annual reports of selected listed companies, economic survey

published by Ministry of Finance and economic indicator published by NRB. Apart from this, primary data collection methods are used to know about the development of financial instruments in Nepalese capital market. Thus, both primary and secondary sources are used for the data collection. The study heavily depends upon the secondary sources of data.

3.4. Data Collection Techniques

To collect the primary data, questionnaire survey has been done along with some interviews and observations. Structured questionnaires are used in this regard and some unstructured interviews are also taken as per necessity. The queries related to the failure and success of securities market, weaknesses existed in the primary and secondary markets have been asked. Questionnaires were distributed to those individuals who have a knowledge and experience about capital market. A survey was conducted on the floor of different commercial banks and broker's offices within a period of three days (06-04-2008 to 08-04-2008). For this two commercial banks namely - Nepal Investment Bank Ltd. and Nepal Arab Bank Ltd. were considered. Participants of the questionnaire survey are the staffs and clients of the banks who were available during survey period. Similarly, discussions, interviews and informal talks were also held with investors, brokers and analysts to know much about their psychology,

As for secondary data collection, different reports, bulletins, journals, articles and other .f-publications published by relevant sources like NRB, NEPSE, SEBQ/N etc. are used along with the annual reports of sampled institutes.

3.5 Data Processing and Analysis Techniques

Analysis is the systematic and careful examination of available fact so that certain conclusions can be drawn and inferences are made. For the purpose of processing and analysis of the data, different relevant statistical tools are used. Several hypotheses are also formulated during the course of the study and analysis. The study has used the mix of statistical tools from simple percentage analysis to the hypothesis testing tools as per the requirements and their suitability. The statistical tools that are applied in this study are:

3.5.1 Non-parametric Statistical Tools

a. Median Analysis

Median is the middlemost item in the set of numbers. It divides the total observation into two halves. One half comprising all the values greater and other half comprising all the values smaller than median. This tool has been selected to find the number of investment alternative in the Nepalese capital market. Median has been calculated on the basis of rank-sums. So those observations that have rank-sums more than median are the preferred one and vice versa. Median has the desirable property of being insensitive to extreme scores. In the distribution of scores, median distribution would remain exactly the same if the lowest score is simply 1. Formula to calculate median is given below:

$$\text{Median} = \text{Value } \left(\frac{N+1}{2} \right)^{\text{th}} \text{ item}$$

Where,

N = Number of items

b. Percentage Analysis

The percentage analysis is done to compare the two or more data from general information. It is use as a method to divide the opinions of related sectors into two or more sectors.

c. Chi-square test 2

Chi-square has been used to check whether there is any association between two independent variables as well as to check the uniform distribution of variables. It is calculated as:

$$\chi^2 = \sum_{i=1}^r \sum_{j=1}^c \frac{(O_{ij} - E_{ij})^2}{E_{ij}}$$

Where,

χ^2 = chi-square statistic

r = Number of rows

c = number of columns

O_{ij} = Observed number of cases categorized in the i^{th} row of the j^{th} column

E_{ij} = Number of case expected in the i^{th} row of the j^{th} column = $E_{ij} = \frac{R_i C_j}{N}$

N = Total of cases

d.f. = (r - 1) (c - 1)

d. Coefficient of contingency C

Coefficient of contingency has been used as a supplement to chi-square to test what is the degree of agreement or association between the two variables. Coefficient of contingency can be calculated by given formula. Higher C represents the greater degree of association.

$$C = \frac{\sqrt{\chi^2}}{N + \chi^2}$$

Where,

χ^2 = Chi-square

N = Total number of observations

e. Cramer Coefficient C

Cramer coefficient C has been used as the supplement to chi-square test. It has been used to test how significant relation is there between two attributes. There is not any tabulated value to test Cramer's C. Its difference from C represents the association in variables. Higher the difference better is the association.

$$C = \frac{\sqrt{\chi^2}}{N(L-1)}$$

Where,

χ^2 = Chi-square

N = Number of observations

L = Minimum of the number of rows or columns in contingency table.

f. Friedman Two-way analysis of variance by Ranks χ^2

During the analysis, the objects are ranked as per their rank-sum. Those with highest rank-sum are given the first rank to denote the best one. To test the ranks assigned to them, Friedman chi-square has been calculated. Hypothesis is tested on the basis of comparison of calculated and tabulated value on the desired level of significance and

required degree of freedom. Null hypothesis is accepted if the calculated value is less than tabulated value. Its formula is presented below:

$$\chi^2 = n(t-1) \text{ SS condition}$$

$$\text{SS}_{\text{condition}} = \frac{\sum T^2}{n} - \frac{G^2}{tn}$$

$$\text{SS}_{\text{people}} = \sum X^2 - \frac{G^2}{tn}$$

Where,

χ^2 = Friedman's Chi-square

$\sum X^2$ = Summation of squares of rank

n = No. of subjects

t = No. of conditions

G = T

T = Total rank / rank sum

g. Kendall Coefficient of Concordance W

During the course of analysis, different types of financial instruments available in the Nepalese capital market and the preference of. Investors towards different investment alternatives are analyzed. To check whether there is any agreement or similarity between the .1 preferences of different groups of investors towards different types of financial instruments, Kendall's W has been calculated. It gives us the degree of agreement among the judges who ranks the objects. Value of W ranges from 0 to 1, higher W range the higher agreement.

$$W = \frac{12 \sum R_j^2 - 3k^2 N(N+1)^2}{K^2 N(N+1)}$$

Where,

W = Kendall coefficient of Concordance

R = Sum of the ranks

k = Number of cases who ranks

N = Number of conditions or objects being ranked

Test null hypothesis is rejected if calculated value is greater than critical value.

h. Kruskal - Wallis Test (Non Parametric ANOVA) H

Kruskal - Wallis test helps us to test the hypothesis whether the responses of two categories of subjects are significantly different or not. To test if there is any difference in the choice of different investors towards different financial instruments available, this Kurskal-Wallis H has been calculated. The formula for H is given below:

$$H = \frac{12}{N(N+1)} \left[\sum_{j=1}^k \frac{R_j^2}{n_j} \right] - 3(N+1)$$

Where,

k = Number of samples

n_j = Number of cases in j^{th} sample

N = $n_{j,}$, the number of cases in all samples combined

R_j = Sum of ranks in the j^{th} sample

Test if the calculated value is greater than the tabulated value null hypothesis is rejected.

3.5.2 Parametric Statistical Tools

a. T-Test

T-test is used to see whether there is any difference in the average investments made in government securities and common stocks by commercial banks and finance companies.

$$\text{Formula for } t \text{ is: } t = \frac{\bar{X}_1 - \bar{X}_2}{S \sqrt{\frac{1}{n_1} + \frac{1}{n_2}}}$$

Where,

\bar{X}_1 = Arithmetic mean of first sample

\bar{X}_2 = Arithmetic mean of second sample

n_1 = First sample size

n_2 = Second sample size

$$\text{Standard error} = \frac{1}{S \sqrt{n_1}} + \frac{1}{n_2}$$

$$\text{Where } S = \frac{\sum(X_1 - \bar{X}_1)^2 + \sum(X_2 - \bar{X}_2)^2}{n_1 + n_2 - 2}$$

Test: If calculated /-stat is greater than the critical value H0 is rejected.

b. F-Test

The Fisher's 'f-distribution' is defined as a distribution of the ratio of two independent chi-square variables each divided by the corresponding degrees of freedom. It is clear that the f-distribution have a single mode. Not that the shape of f-distribution depends o the value degrees of freedom and value of 'f' lies between zero to infinity. The f-test sometime called variance ratio test, is based on f-distribution. In order to test goodness of fit of the regression model, f-test is use.

3.5.3 Financial Tools

a. Subscription Ratio

Subscription ratio is calculated to see the subscription scenario in the primary issues.

Basically, this tool has been used to see sector-wise subscriptions to find out which sector has better subscription.

$$\text{Subscription ratio} = \frac{\text{Number of shares applied}}{\text{Number of shares issued}}$$

b. Growth Rates

Growth rates are used to see how the investment on government securities and common stocks are growing in commercial banks and finance companies. This helps to reflect the investments made on different financial instruments available in the Nepalese capital market.

$$\text{Growth rates} = \frac{V_1 - V_0}{V_0} \times 100$$

Where,

V1 = Value of new year

V0 = Value of previous year

c. Coefficient of Correlation

The coefficient of correlation, symbolically denoted by 'r' is one of the important measures to describe how well one variable is explained by another. It measures the degree of relation between the two casually related variables. The value of this coefficient can never be more than +1 or -1. Thus, +1 and -1 are the limits of this coefficient. A value of +1 represents perfect positive correlation and a value of -1 represent perfect negative correlation. In practical life, the possibility of obtaining

either a perfect positive or perfect negative correlation is very remote. If a coefficient of correlation has a zero value, then it means that there exists no correlation between the variable under study.

Karl Pearson's correlation coefficient method is one of the most widely used methods of measuring the relation between two variables. it can be worked out as under.

$$\text{Karl Pearson's Correlation Coefficient (r)} = \frac{\sum XY - n\bar{X}\bar{Y}}{\sqrt{\sum X^2 - n\bar{X}^2} \sqrt{\sum Y^2 - n\bar{Y}^2}}$$

d. Coefficient of Determination

The coefficient of determination (symbolically represented as R²) is a measure of the degree of linear association or correlation between two variables, say X and Y, one of which happens to be independent variable and the other being dependent variable. The coefficient of determination can have a value ranging from zero to one.

3.5.4. Graphs

Pie charts are used to show the sector wise converge in total trading volumes.

Line chart are used to show the trend of issues of instruments.

CHAPTER-IV

DATA PRESENTATION AND ANALYSIS

This chapter puts forward the analysis of secondary and primary data along with their results and interpretations. The chapter starts with the analysis of secondary data concerned with the issuance of financial instruments, subscription ratios, trading volume, NEPSE Index, citizen investment scheme, and the institutional investors, followed by the analysis of primary data collected through questionnaire survey. Several relevant, tools and tests have been used for analysis of primary data.

4.1 Development of Nepalese Capital Market

Although, the history of financial instruments in Nepal begins with the issue made by Biratnagar Jute Mills, it got further developments only after the restoration of democracy and liberalization policy. Between 1984 and 1990/42 companies were listed, out of which more than 25 companies had some form of government ownership. Government's privatization policy also enabled new industrial companies to enter the stock market. Of the total public issues approved in (994 and 1995, 28.4% was issues of privatized companies. The growth of the stock market has mainly "been due to the liberalization ant the resulting growth of the result growth of the financial sector (commercial banks and finance companies) rather than that of the industrial sector.

Stock market in Nepal has been growing gradually both in terms of turnover as well as the-capital investment. In the F/Y 2003/04, 26 companies have listed their securities amounting to Rs. 3428.30 million in NEPSE. The securities listed consist of

ordinary shares, right shares, bonus shares, and debentures. Of the 26 companies listing securities in NEPSE, 12 are new companies. As at the end of this F/Y, number of listed companies in NEPSE reached 135.

Table 4.1
Listed Companies by the end of the F/Y 2006/07

S. No.	Sector	No. of listed company	paid up value (Rs. in million)	Trading (Rs. in million)	Market capitalization value (Rs. in million)
1.	Commercial Banks	15	9281.9	5563.5	135588.4
2.	Development Banks	16	1630.9	577.5	6010.6
3.	Finance Company	53	3100.2	713.6	9889.3
4.	Insurance Company	16	1286.7	205.0	8059.8
5.	Hotels	4	1552.9	7.0	3261.1
6.	Manufacturing and processing Companies	21	2602.3	24.3	6200.0
7.	Trading Companies	5	62.2	10.4	796.4
8.	Other Companies	5	2281.7	1258.8	16495.7
	Total	135	21798.8	8360.1	186301.3

Source: SEBO Annual Report, 2006/07

Out of 135 listed companies, NEPSE classified 66 companies consisting of 12 commercial banks, 4 development banks, 37 finance companies 11 insurance companies and 1 manufacturing and processing company and one other company under group "A" and the rest under group "B", as per the provision of "Securities Listing Bye-laws, 1996". As per the provision of this bye- laws those listed companies which have profit track record for the last three years, book value higher than paid value, submitted its financial statement to NEPSE' within six months after the expiry of F/Y, paid up capital exceeding Rs. 20 million, have at least 1000 general

shareholders falls on category "A". The current figures, as per the SEBO Annual Report 2006/07, show that the total amount of securities traded in this F/Y is Rs. 8360.1 million and the total paid up value of the listed securities reached Rs. 21798.8 at the end of this F/Y. In the last F/Y, total amount of securities traded was Rs. 3451.43 million and the paid up value of the listed securities was 20008.55 million. By the end of this F/Y, the market capitalization value of the listed securities reached to Rs. 186301.3 million. In the last F/Y, this value was Rs. 96763.74 million. During this year, the highest value of market capitalization was Rs. 16301.3 million and the lowest was Rs. 89020.1 million. The percentage contribution of market capitalization on GDP is estimated to be 27.78%.

NEPSE Index

By the end of the fiscal year 2006/07, the NEPSE index of the listed securities (Price Index) remained at 683.95 points, which is 297.12 points higher than that of the last fiscal year end index of 386.83points. The highest index during the fiscal year 2006/07 was recorded at 683.95 points on July 16, 2007 and the lowest index was 355.60 points on August 03, 2006 the detail of NEPSE index in presented in table 4.2. and figure 4.1.

Table 4.2

NEPSE Index for the F/Y 2006/07

Month	Aug	Sept	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	July
NEPSE	390.	382.	398	447.	508.	537.	523.	494.0	494.	513.4	575.	683.9
Index	86	56	.44	43	58	09	94	6	59	5	04	5

Sources: SEBO Annual Report

Figure 4.1

Trend Line Showing NEPSE Index in F/Y 2006/07



The total number of listed companies at the end of first nine months of FY 2006/07 stood at 131 as against 135 in the preceding fiscal year, owing to delisting of 12 existing companies and additional listing of 8 new companies in the Stock market. In this review period, institutional debentures of 3 companies are also registered. At the end of first nine months of FY 2006/07 market capitalization value reached to Rs. 133398.8 million owing to 67.85 percent increment in Rs. 7947.3 of the same period of preceding year. In the first 9 months of FY 2006/07, there was increase of 161.49 percent in the share transaction amounting to Rs. 5534.2 million with the transaction of 11.08 million shares as compared to transaction held in the same period of the last fiscal year. In the first 9 months of FY 2005/06, the total transaction of 6593830 shares has fetched Rs. 2116.4 million. In the first 9 months of FY 2006/07, number of transaction increased by 26.83 percent resulting to total transaction of 91036 as compared to 71777 transactions in the preceding fiscal year. At the end of first 9 months of 2006/07 NEPSE index rose by 159.82 points to the total point of 494.59 which was 334.77 during the same period of last year.

4.2. Scenario of Nepalese Financial Market

4.2.1. Primary Market Scenario

Table 4.3

Trend of Primary Market

(Rs. in Million)

Description		Fiscal Year						First 9 months	
		2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2005/06	2006/07
1	Capital Realization	493.40	1579.90	696.60	1090.40	1672.30	2443.30	1499.40	702.90
a	Ordinary Share	278.70	319.50	394.30	657.50	377.50	579.80	490.90	177.90
b	Rights Share	131.80	621.90	162.20	70.00	949.30	1013.50	75.50	525.00
c	Preference Share	–	140.00	–	–	–	–	–	–
d	Debentures	–	360.00	–	300.00	300.00	850.00	200.00	–
e	Mutual Fund	–	–	100.00	–	–	–	–	–
f	Citizens Unit Plan	82.90	138.50	40.10	62.90	455.00	142.90	140.00	37.40
2	No. of Capital realizing companies	90.00	120.00	180.00	140.00	140.00	340.00	180.00	140.00

Sources: Economic Survey 2006/07

The government and public limited companies issue securities. General public, for profit and non-profit organizations are the buyers/investors of securities and finance companies, licensed to carry out merchant banking activities in Nepal. Development of primary market in Nepal started after the establishment of Securities Exchange Center in 1976. Despite some positive indications, the primary market is still in infancy state. The type of securities issued, and the volume of issue is still insignificant (Shrestha et al., 2003:pp29-30).

In the first nine months of FY 2006/07, 14 corporate entities have been authorized to mobilize capital from the primary stock market for a total amount of Rs700.29 million

by issuing stock of ordinary and rights share. Such authorized amount was lower by 51.50 percent compared to the same period of FY 2005/06. In the same period of previous fiscal year, there were, 18 such entities authorized to mobilize capital of Rs. 1449.4 million through ordinary and preferential shares and mutual fund.

4.2.2. Secondary Market Scenario

Table No. 4.4

Trends of Secondary market

(Rs In Million)

Items	Fiscal Year						First 9 months	
	2002/01	2001/02	2002/03	2003/04	2004/05	2005/06	2005/06	2006/07
Share Transaction Value	2344.2	1540.6	575.8	2144.3	4507.7	3451.4	2116.4	5534.2
No. of Shares Transaction'000'	49890.0	60050.0	24280.0	64680.0	184340.0	122219.3	65938.3	110800.0
Transaction (no)	460950.0	420280.0	691630.0	855330.0	1062460.0	973740.3	717770.0	910360.0
Market Capitalization value	46349.4	34703.8	35240.4	41424.8	61365.9	96813.7	79471.3	133398.8
percent of transaction in market capitalization in market capitalization value	50.6	44.4	16.3	51.8	73.4	35.6	26.6	41.5
Market capitalization value as percent of GPD	105.0	75.5	71.6	77.2	104.1	149.8#	–	–
Paid up capital value of listed shares	8165.2	9685.0	12560.0	13404.2	16771.90	20008.6	18643.0	23963.0
No. of listed companies	1150.0	960.0*	1080.0	1140.0	1250.0	1350.0	1280.0	1310.0
No. of companies under transaction	670.0	690.0	810.0	920.0	1020.0	1100.0	830.0	1110.0
NEPSE Index (in point)	3484.0	2275.0	2048.6	2220.40	2866.7	3868.6	3347.7	4945.9

* 25 companies eliminated from the list

based on estimated GDP (at producer price)

Source: Economic Survey, 2006/07

The role of secondary market is more in focus than that of primary market in securities market. It is mainly due to the fact that secondary market provides liquidity to the securities and ensures continuous price formation. The continuous price formation process reduces sudden jump in the price of the securities in the market. NEPSE is the only organized exchange to carry out secondary market operation of corporate securities in Nepal (Shrestha et al., 2003:pp30-31).

4.2.3. Corporate Securities

Table 4.5

Issues of Corporate Securities

(Rs. In Million)

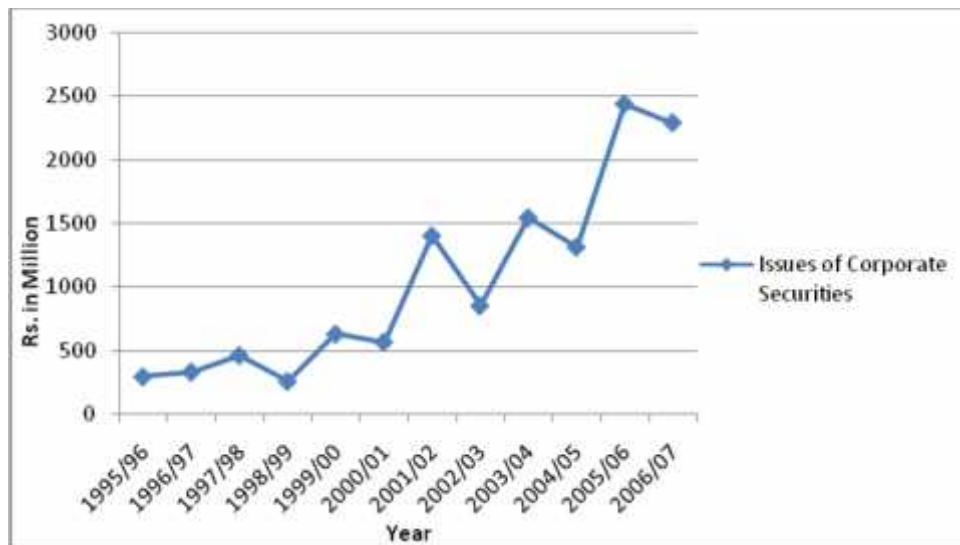
Fiscal Year	Ordinary Shares	Right Shares	Common Stock*	Preference Shares	Debentures	Mutual Fund / Unit Scheme	Total
1995/96	224.74	69	293.74	0	0	0	293.74
1996/97	57	275.2	332.2	0	0	0	332.2
1997/98	119.4	249.96	369.36	0	93	0	462.36
1998/99	148	30	178	80	0	0	258
1999/00	412.46	124.6	537.06	0	0	93.25	630.31
2000/01	118.5	365.79	484.29	0	0	82.91	567.2
2001/02	378.76	387.87	766.63	140	360	138.48	1405.11
2002/03	551.5	162.24	713.74	0	0	140.09	853.83
2003/04	755	429.96	1184.92	0	300	62.28	1547.2
2004/05	300.89	669.42	970.31	0	300	45.49	1315.8
2005/06	579.83	1013.45	1611.28	0	850	0	2443.28
2006/07	380.30	1265.30	1645.60	400	250	0	2295.6
Total	4026.38	5043.75	9087.13	620	2153	562.5	12404.63
Percentage	32.46%	40.66%	73.25%	5%	17.36%	4.53%	100%
Rank			1	3	2	4	

**It includes both ordinary shares and right shares.*

Sources: SEBON Annual report 2006/07

The table 4.5 shows the amount of different corporate securities that are issued in different time periods (from fiscal year 1995/96 to 2006/07 in Nepalese capital market. The total amount figures to Rs. 12404.63 millions during this time period of 12 years. It shows that the ordinary shares dominate the total market. Ordinary shares have the largest share in the total market i.e. 40%, and then come right shares, debentures, mutual funds and preference shares. These instruments are ranked in terms of their coverage in total amount. The rank shows that common stock is in first rank with 73.25% coverage in total amount of public issue. The above trend shows that the issue of •debentures and mutual funds slowly emerge from 1999/2000 in the market but preference share is still not that very popular in the Nepalese capital market.

Figure 4.2
Trend of Corporate Issues



The above line chart shows the trends of issues of corporate securities in the capital market of Nepal since 1095/96. Only a line representing common stock follows an increasing trend, whereas others have very ups and downs as well as frequently reach the zero limits.

On this basis, we can conclude that common stocks are the most widely used corporate security. Similarly, preference share is a least used financial instrument in the Nepalese financial market. It means that capital market of Nepal is heavily dependent upon the equity instruments. Financing from other instruments is still very small compared to equity instruments. Issuance of just four types of securities reveals that our capital market is really very poor on the matter of varieties of corporate securities. Nepalese capital market is fully dependent upon these traditional types of securities. Financial or securities innovation is lacking in Nepal's capital market.

4.2.4 Government Securities

Table 4.6
Issue of Government Securities

(Rs. in Million)

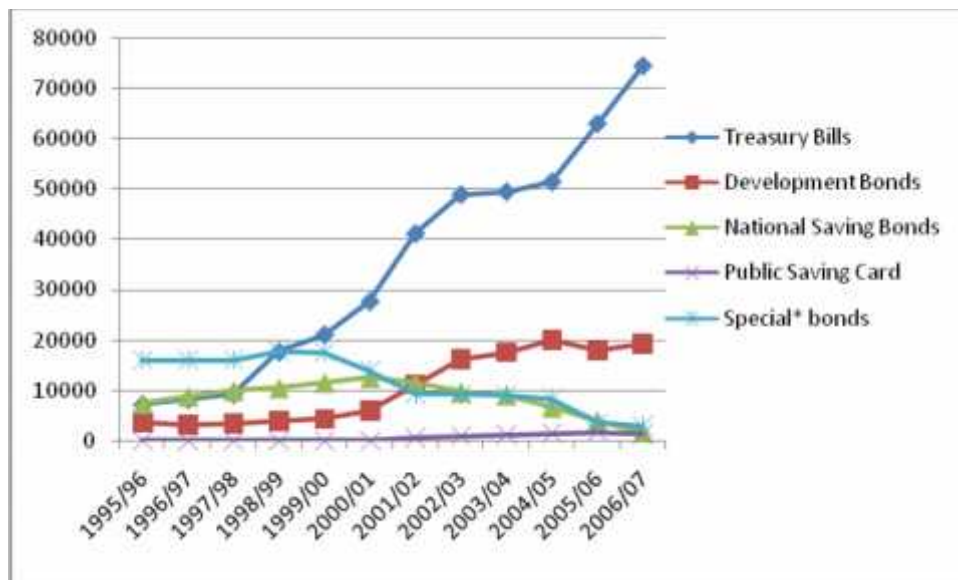
Fiscal Year	Treasury Bills	Development Bonds	National Saving Bonds	Public Saving Card	Special* bonds	Total
1995/96	7142.50	3672.20	7376.50	0.00	16050.60	34241.80
1996/97	8092.50	3042.20	8736.50	0.00	16019.60	35890.80
1997/98	9182.5	3302.20	9886.40	0.00	16035.50	38406.60
1998/99	17568.90	3872.20	10426.40	0.00	17784.20	49651.70
1999/00	21026.90	4262.20	11526.50	0.00	17541.40	54357
2000/01	27610.80	5962.30	12476.40	0.00	13994.30	60043.80
2001/02	41106.50	11090.70	11536.10	628.10	9259.30	73620.70
2002/03	48860.70	16059.20	9629.80	931.10	9164.50	84645.30
2003/04	49429.60	17549.20	9029.80	1178.90	8946.20	86133.70
2004/05	51383.10	19999.20	6576.80	1428.90	8176.30	87564.30
2005/06	62970.3	17959.2	3876.8	1678.9	3469.8	89955
2006/07#	74445.3	19177.1	1516.9	1391.0	2773.5	99303.8
Total	418819.6	125947.9	102594.9	7236.9	139215.2	793814.5
Percentage	52.76%	15.87%	12.92%	0.91%	17.54%	100%
Rank	1	3	4	5	2	

Source: NRB Quarterly Economic Bulletin, Mid July 2007 and Economic Survey, 2006/07 # First eight months.

If we see the scenario of government securities, treasury bills are widely issued during the period of last twelve years with the coverage of 52.76% out of total government securities issued. Similarly, special bonds, national saving bonds and development bonds are also issued to some extent by the government which covers 17.54%, 12.92% and 15.87%. The table shows that public saving cards were issued for the first time in 2002. Though its contribution in total amount is very little ie. 0.91% its use is increasing tremendously.

Figure 4.3

Trend of Government Issues



The above line chart displays the trends of issuance of various government securities. In the figure, we can see that the Treasury bill is the only instrument which follows the rapid increasing trend. Development bonds are also growing, but in a very slow pace. Special bonds and national saving bonds start following decreasing trend since 1999/2000 and 2000/01. Public saving card's line is in very low level. From the above figure, we can conclude that Treasury bills are most widely used government

securities and the public saving cards are newly introduced instruments. T-bills are mostly used by institutional investors as it helps them to increase their liquidity.

4.2.5 Collective Investment Scheme

4.2.5.1 Citizen Unit scheme

SEBO had permitted Citizen Investment trust (CIT) to operate the Citizen Unit Scheme in the F/Y 1994/95. The objective of the scheme is to collect capital from the small and medium savers to make investment in a professional and efficient way and distribute the returns earned thereon. This is an open-ended scheme with the face value of Rs. 100 per unit. CIT itself has been performing the function of selling and repurchasing the unit of the scheme. It has been regularly reporting SEBO on the performance of the scheme. The performance of Citizen Unit scheme in a last six years is shown in a table below:

Table 4.7
Performance of Citizen Unit Scheme

(Rs in Million)

S.N.	Particulars	Fiscal Years					
		2001/02	2002/03	2003/04	2004/05	2005/06	2006/07*
1	Total amount of units sold	645.26	837.5	1003.9	1215.6	1486.3	1702.3
2.	Total amount of units repurchased	280.62	432.2	536.9	702.5	829.0	1004.1
3.	Investment	371.50	414.4	417.0	567.6	657.5	707.8
	a. Government Bond	119.50	188.0	182.0	184.6	173.9	92.9
	b. Bank Deposit (Fixed)	130.00	96.5	92.0	100.0	317.5	441.0
	c. Share / Debenture	10.50	15.4	26.5	22.8	26.5	34.3
	d. Loan & Advances	111.50	114.5	116.5	260.2	139.6	139.6
4.	Net Income	35.26	37.4	36.3	41.9	50.4	48.8
5.	Dividends (%)	8.5	8.0	7.0	7.0	7.0	6.25
6.	No. of unit holder	8299	9087	9871	2651	2840	2795

Source: SEBO Annual Report Unaudited figure

As reported by CIT, by the end of the F/Y 2006/07; it sold units amounting to Rs. 1702.32 million and repurchased the units amounting to Rs. 1401.01 million. By the end of this F/Y, its total investment is Rs. 707.77 million and the profit of the scheme in this F/Y is Rs. 48.8 million. This profit decreases-at the rate of 3.17% in compare to last fiscal year. The total number of participants of the scheme reached to 2795, which decreases by 1.58% from last year. It distributed 6.25% dividend to its unit holders during this period.

4.2.5.2 N.C.M Mutual Fund, 2059

SEDO approved for the operation of NCM Mutual Fund, 2002 in the F/Y 2002/03. The total amount of the mutual fund is Rs. 100.00 million. It is an close ended fund and its maturity period is 10 years. Each units of the fund has a par value of Rs. 10. the scheme is listed in the NCPSC. NIDC Capita) Markets Ltd. is the fund manager of this scheme and Nepal Industrial Development Corporation is the trustee.

As reported by the NIDC Capital Markets - the fund manager, total investment fund reached to Rs. 393.4 million by the end of this F/Y and the net assets value reached to 314 million. The performance of the fund in the last four years is given in the table below:

Table 4.8**Performance of the NCM Mutual Fund**

(Rs. in Million)

S.N.	Particular	Fiscal Year			
		2003/04	2004/05	2005/06	2006/07*
1.	Investment	123.41	157.74	210.71	393.4
	shares and debenture	95.88	126.21	183.53	279.4
	Government bonds	10.00	10.00	10.00	10.0
	Bank Deposit	8.83	16.54	13.68	93.3
2.	Net Income	9.50	11.47	13.89	23.2
	Dividend in Shares	2.16	1.90	2.82	3.5
	Interest in Government Bonds and Debentures	0.77	0.81	0.81	0.8
	bank Interest	0.61	0.35	0.54	3.9
	Income from sales of shares	5.96	8.42	9.71	14.9
3.	Net Assets Value	118.20	144.93	189.14	314.0
4.	Outstanding units (in '000)	10000	10000	10000	1000
5.	Net Assets value per units (Rs.)	11.80	14.49	18.91	31.40
6.	number of unit holder	2882	2559	2481	2417
	Institutional	19	20	20	20
	Individual	2863	2539	2461	2397
7.	Dividend (%)	5	5	5	10

* Provisional

Source: Annual Report of SEBO.

4.3 Primary Subscription of Securities

As per the provision of securities legislation, a company should issue its securities to the public within two months after getting issue approval from SEBO. During the period of last twelve years (1997/98 to 2006/07), total 147 companies issue their securities to the public amounting to Rs. 1004.4145 million, among which 69 are finance companies and 29 are commercial banks (Details are presented in Appendix no. 1).

From the analysis, it is found that the number of issuing finance companies is greater than the issuing commercial banks. But, the issues 'made by commercial banks are highly oversubscribed in the primary market. This shows that investors want to make investment in commercial banks rather than finance companies. Most of the securities issued by manufacturing and processing companies are found to be under-subscribed.

In this F/Y 2006/07, 17 companies consisting of 2 commercial banks 11 development banks and 4 finance companies issue their securities to the public amounting to Rs. 1030.3 million. In the last F/Y18 companies had issued securities amounting to Rs. 1429.3 million. This shows that the issue of securities to the public follows the increasing trend. Total amounts of securities issued to the public in a last 12 years are shown in a table below:

Table 4.9

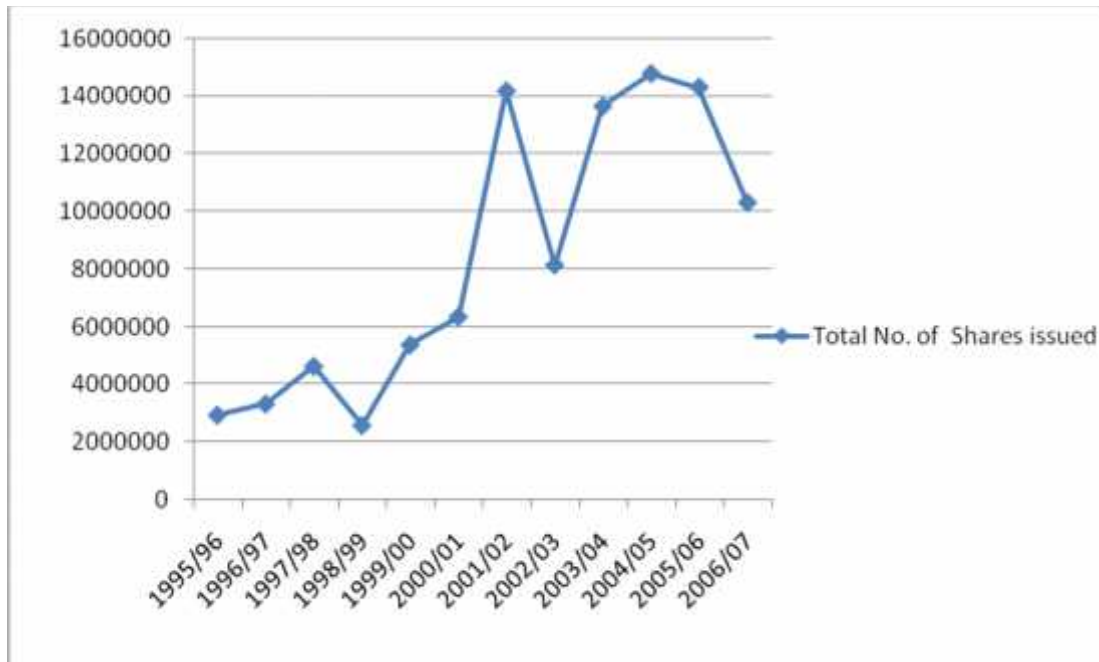
Issue of Securities to the public

Year	Total No. of Shares issued	Total amount of shares issued (Rs. In Million)
1995/96	2937400	293.74
1996/97	3322000	332.20
1997/98	4623600	462.36
1998/99	2580000	258.00
1999/00	5370600	537.06
2000/01	6342900	634.39
2001/02	14166500	1416.65
2002/03	8137400	813.74
2003/04	13634245	1363.4245
2004/05	14768200	1476.82
2005/06	14298300	1429.83
2006/07	10303000	1030.30
Total	100484145	10048.4145

The above table can be clearly explained with the help of trend line below. It shows that the issue of securities to the public follows the increasing trend except in the I-VY 1998/99 and 2002/03. This depicts that public are slowly being attracted towards the securities, and due to the changing scenario of the economy, there is still a hope of increasing this trend. But in this F/Y it is quite decreasing.

Figure 4.4

Securities issued to the public in a last twelve years



4.4 Trading Volumes

During the course of our study, we have also analyzed the sector-wise trading volumes of different financial instruments in the NEPSE floor. The trading volumes of different securities by the different investment sectors are presented in the table below:

Table 4.10

Trading Volume of Securities on the basis of Investment sectors

Shares turnover (in units)									
Year	Commercial Banks	Development Banks	Insurance	Finance	Mfg. & Processing	Hotels	Trading	Others	Total
2001/02	1219.59	0.00			5282.16	181.25	11.12	279.93	6974.05
2002/03	1623.12	0.00	143.29	976.79	1786.29	142.13	7.15	310.38	4989.15
2003/04	1935.55	139.08	101.72	637.39	1833.09	1316.9	4.35	36.35	6004.48
2004/05	858.98	163.64	391.63	804.34	48.00	121.29	22.42	17.59	2427.89
2005/06	2737.52	212.80	256.37	1202.27	1977.82	61.04	8.64	11.72	6468.18
2006/07	6416.57	135.62	328.13	1443.34	7602.89	98.17	10.41	2398.4	18433.55
Total	14791.30	651.14	1221.14	5064.13	18530.30	1920.8	64.09	3054.3	
Amount of trading volumes									
2001/02	877.65	0.00	82.22	60.95	73.83s	26.72	12.20	23.21	1166.71}
2002/03	1922.28	0.00	38.64	254.61	67.19	22.34	4.46	26.39	2335.91
2003/04	1151.35	23.54	28.45	170.60	21.44	138.44	4.25	2.56	1540.63
2004/05	332.51	25.90	64.59	129.69	4.00	6.80	11.84	0.66	575.9!)
2005/06	863.4 1	32.33	36.86	165.09	1031.62	2.84	11.83	0.29	2144.2,'
2006/07	4021.83	22.01	67.62	216.37	114.90	4.48	7.99	52.48	4507.68
Total	9169.03	103.78	318.38	997.31	1312.98	201.62	52.57	105.59	
Percentage (amount)									
2001/02	75.87	0.00	7.11	5.27	6.38	2.31	1.05	2.01	100.01
2002/03	82.29	0.00	1.65	10.90	2.88	0.96	0.19	1.13	100.00
2003/04	74.73	1.53	1.85	11.07	1.39	8.99	0.28	0.17	100.01
2004/05	57.73	4.50	11.21	22.52	0.69	1.18	2.06	0.1 1	100.00
2005/06	40.20	1.50	1.70	7.70	48.10	0.10	0.50	0.00	99.80
2006/07	89.20	0.40	1.50	4.80	2.30	0.20	0.10	1.10	99.60
Total	420.02	7.93	17.91	62.26	61.74	13.74	4.18	4.52	

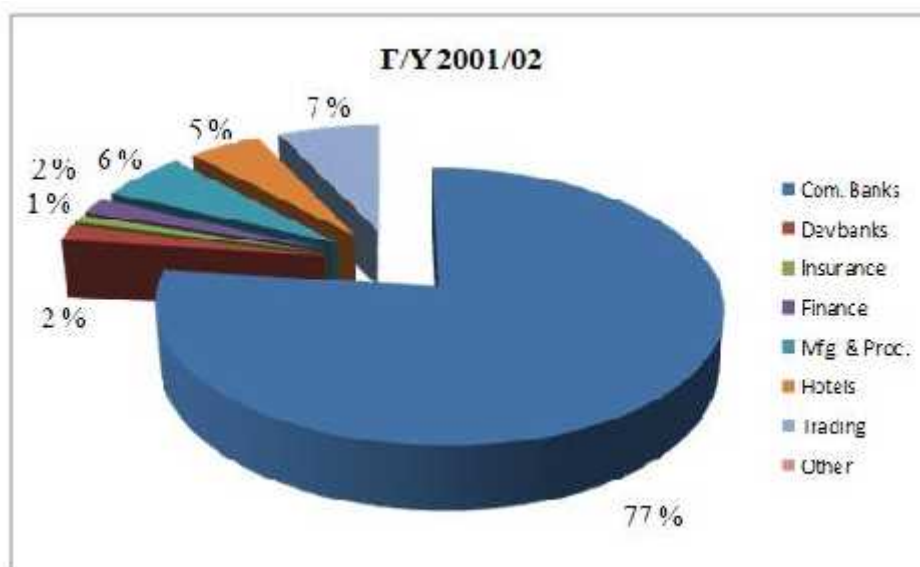
Table No. 4.10 depicts that the commercial banks covers the greater percentage of trading activities than other sectors. During a period of last six years, commercial bank alone makes a transaction amounting to Rs. 9169.03 million. Coverage of

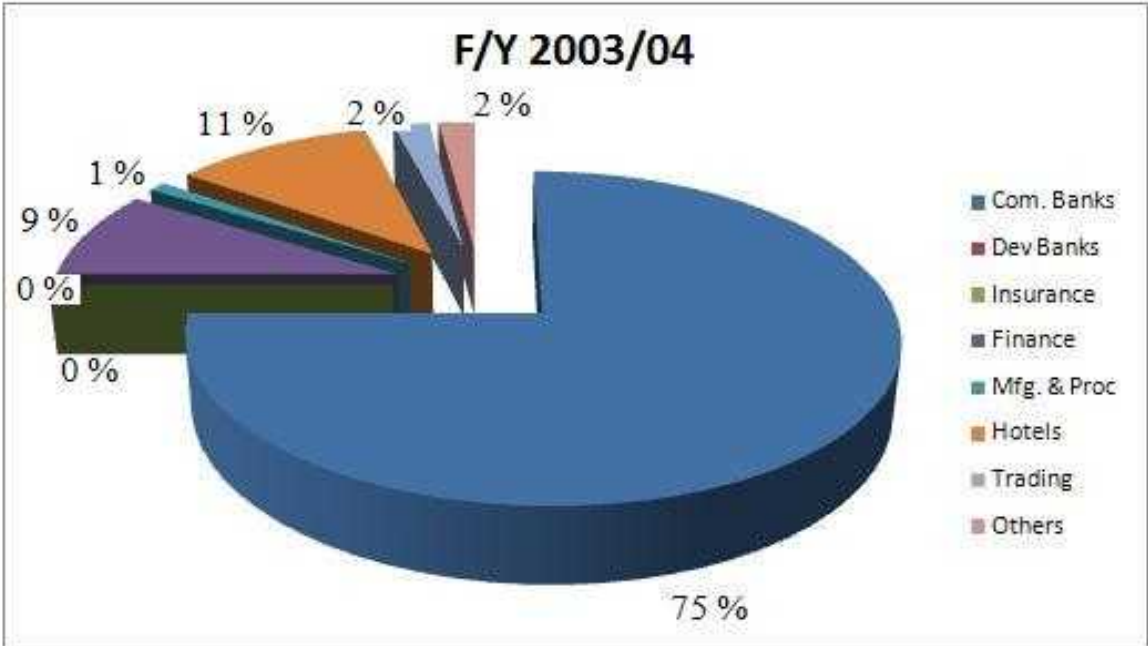
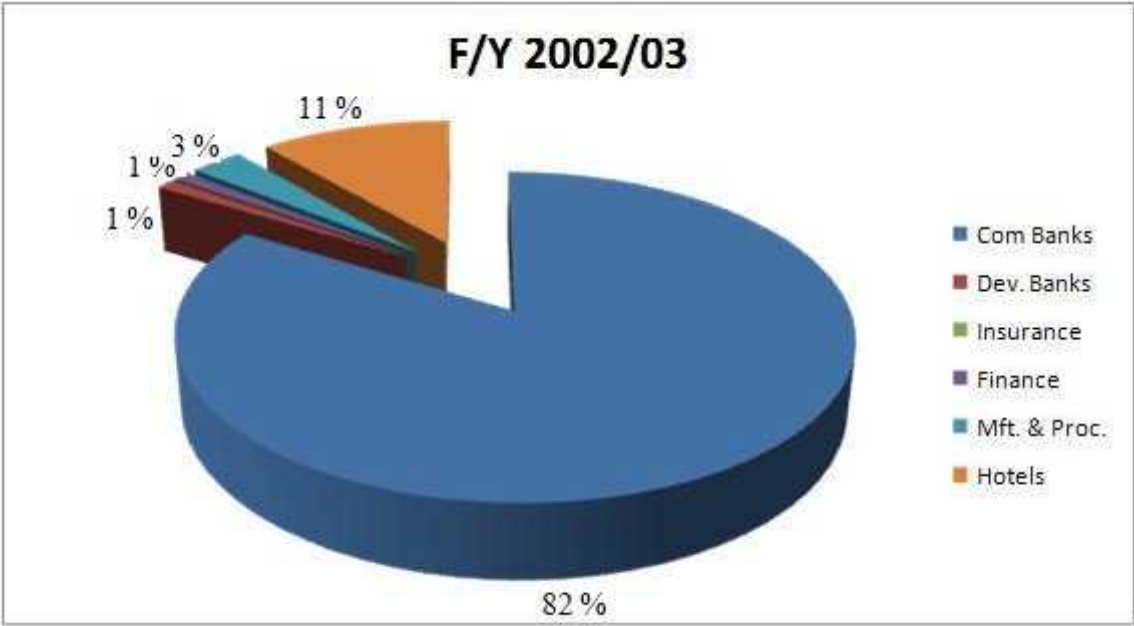
commercial bank is always more than 40% in total trading volumes. Due to sudden increase in the trading volume of manufacturing and processing company in a F/Y 2005/06, it takes place a second position. In this period, it covered around 48% of total volume. A year ago it was just 0.69%, but with a gradual increment, it reached to 48%. The trading of financial companies was also used to be good till 2004/05 with 22.52% of total trading volume in that period. But, from the F/Y 2005/06 onwards, the trading volume of finance companies and insurance companies had fallen down tremendously. Development bank as a separate sector has got its existence only from F/Y 2003/04 and its trading volume is growing in a good pace The trading of hotels has trembled very much in a last year. Manufacturing and processing companies are also not doing well; their share in total trading volume is reducing.

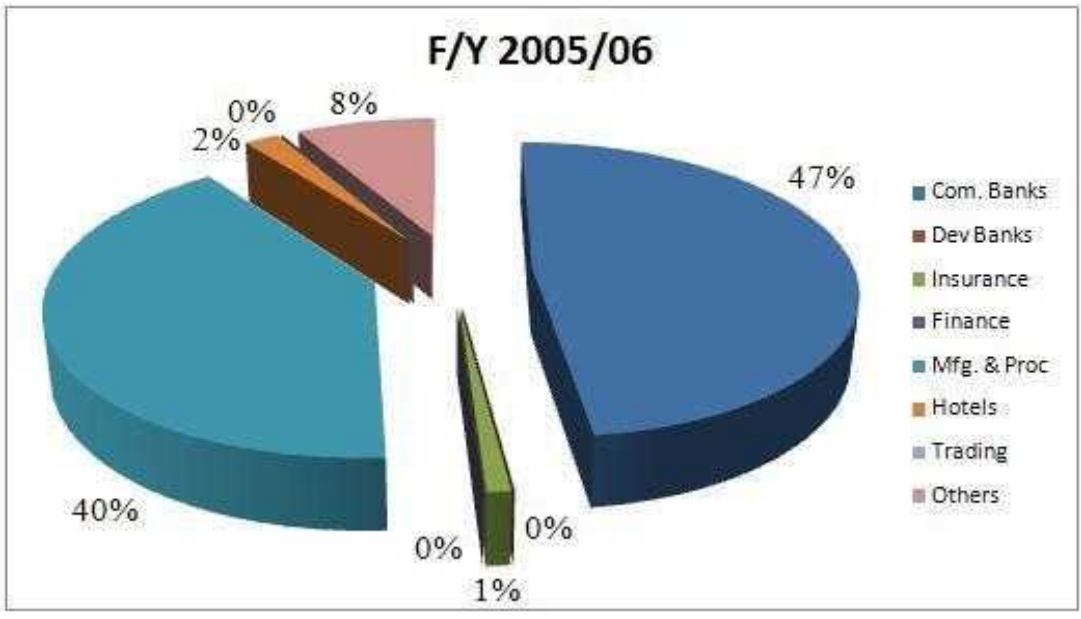
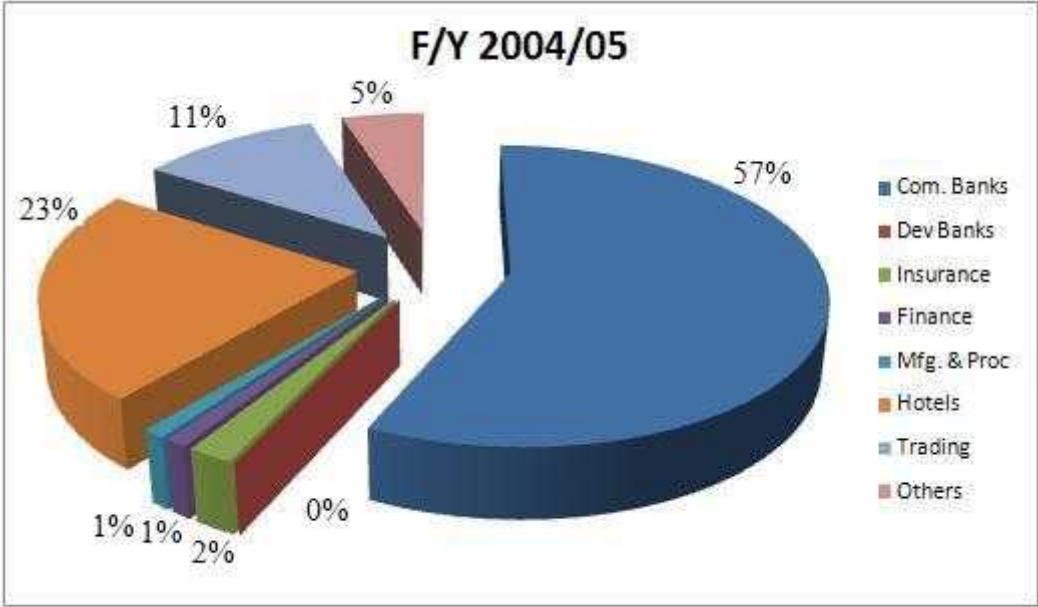
The trading volume of securities made by different investment sectors in each individual year (2001/02 to 2006/07) is shown in a pie chart below.

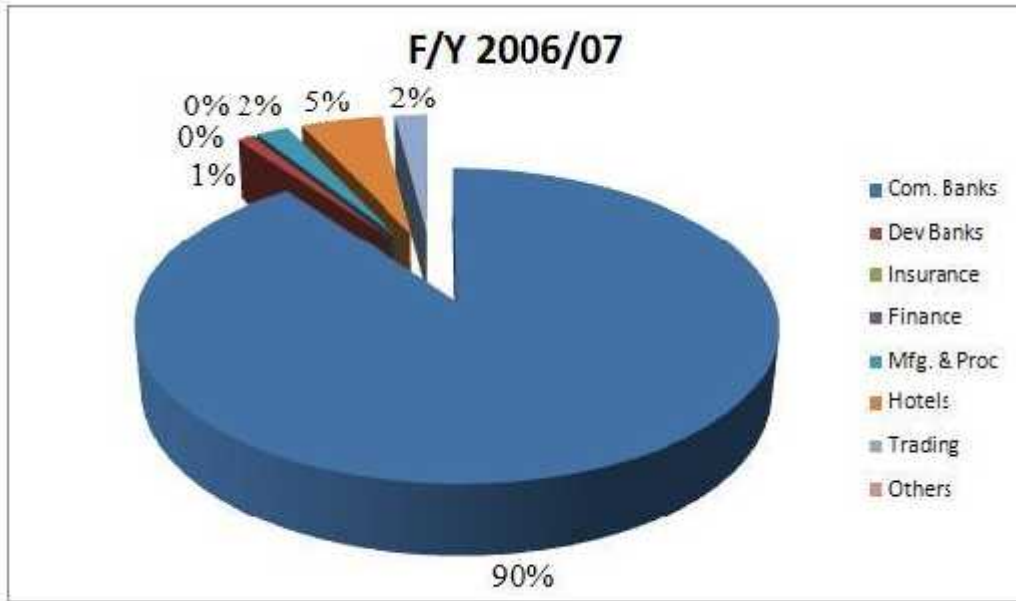
Figure4.5

Pie charts showing sector-wise trading volumes









4.5 Investment made by different Financial Institutions

Study has explored the institutional investment made by different commercial banks and finance companies towards corporate securities and government securities.

4.5.1 Investment of Commercial Banks in Government and Corporate Securities

Table 4.11

Table showing total investment of commercial Bank

(Rs. in Million)

	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	Average Growth
Investment in Government Securities							
Nepal SBI Rank Ltd.	192.85	364.69	503.17	1189.39	1871.46	2588.14	71.82%
Nepal Investment	0.00	300.00	224.40	400.00	2001.10	1948.50	113.47%
NABIL Bank Ltd.	1233.82	2732.96	4120.29	3588.77	3672.63	2413.94	25.49%
Standard Chartered	3338.67	4811.01	5784.72	6722.83	7948.22	7203.07	17.88%
Himalayan Bank	2112.88	222 '3	3047.75	3998.87	3431./J	5i6y 73	2J.74%
Nepal Bangladesh	-14155	262.56	891.Q4	2040.45	2578.86	2212.54	67.95%
Total	7321.77	10695,52	14571.37	17940.31	21504	21835.92	15644.82
Average	1220.30	1782.59	2428.56	2990.05	3584.00	3639.32	2607.47
Growth Rate		46.08%	36.24%	23.12%	19.86%	1.54%	25.37%
Investment in Corporate Securities							
Nepal SRI Hank Ltd.	8.94	8.94	17.89	17.89	17.89	19.54	21.87%
Nepal Investment	12.69	12.69	13.89	13.89	13.89	17.74	7.44%
NABIL Bank Ltd.	16.12	18.82	22.22	22.22	22.22	440.28	383.36%
Standard Chartered	11.19	11.19	11.19	11.19	11.19	13.35	3.86%
Himalayan Bank	9.49	1069	34.27	34.27	34.27	39.01	49.93%
Nepal Bangladesh	60.00	15.00	38.41	38.41	38.41	62.77	28.89%
Total	1 18.43	77.33	137.87	137.87	137.87	593.59	200.49
Average	19.74	12.89	22.98	22.98	22.98	98.93	33.42
Growth Rate		-34.70%	78.28%	0%	0%	330.51%	74.82%

Source: Annual Reports of respective banks and information provided by SEBO/N

Table No. 4.11 depicts the total investments made by different commercial banks (samples taken) in government securities and corporate securities, average of them, growth rates along with the average growth rates of individual banks during a period of 2001/02 to 2006/07. During this period, average amount of investments made on government securities is Rs. 2607.47 million whereas average investment made in corporate securities is Rs. 33.42 million. This obviously shows that huge amount of investment is made towards government securities than corporate securities. But, considering (he growth rate, average growth rate of investment in corporate securities (74.82%) is higher than that of investment in government securities (25.37%). This may be because of tremendous increase in investment towards corporate securities during this particular fiscal year, 2006/07. In this fiscal year, investment in corporate securities is haphazardly increases by 330.51%. This shows that banking sectors are increasing their investment towards corporate securities.

If we see individually, average growth rate of investment in government securities is greater than investment in corporate securities in case of four sample banks (Nepal SBI Bank, Nepal Investment Bank, Standard Chartered Bank, and Nepal Bangladesh Bank). But, incase of NABIL Bank and Himalayan Bunk average growth rate of investment in corporate securities is greater that in Government securities (Details of calculation are presented in Appendix No. 2)

4.5.2 Investment of Finance Companies in Government and Corporate Securities

Table 4.12

Table showing total investment of Finance Companies

(Rs. In Million)

	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	Average Growth rate
Investment in Government Securities							
Ace Finance co. Ltd.	122.60	122.50	183.30	202.00	128.03	128.77	4.74%
Goodwill Finance Co. Ltd.	27.64	37.70	41.82	46.5	25.95	35.48	10.21%
International Leasing and Finance Co. Ltd.	85.50	90.50	150.00	157.50	117.05	167.83	18.86%
Nepal Merchant Banking and Finance co. Ltd.	208.39	208.39	320.19	449.3	724.15	487.88	24.50%
Kathmandu Finance Co.	4.90	4.90	1.75	1.75	1.75	0.00	-32.86% -
People's Finance Co. Ltd.	9.00	9.00	9.00	5.00	0.00	0.00	-28.89%
Total	458.03	472.99	706.06	862.05	996.93	819.96	719.34
Average	76.34	78.83	117.68	143.68	166.16	136.66	119.89
Growth Rate		3.27%	49.28%	22.09%	15.65%	-17.75%	14.51%
Investment in Corporate Securities							
Ace Finance co. Ltd.	41.18	35.45	33.05	33.20	33.20	30.43	-5.71%
Goodwill Finance Co. Ltd.	13.25	24.45	23.93	22.04	11.86	7.39	-1.87%
International Leasing & Finance Co. Ltd.	0.14	0.13	4.68	4.68	4.70	4.70	698.66%
Nepal Merchant Banking and Finance co. Ltd.	2.59	1.74	19.14	17.39	17.79	6.19	179.03%
Kathmandu Finance Co. Ltd.	1.59	4.24	4.00	4.00	4.98	1.72	23.72%
People's Finance Co. Ltd.	2.00	2.00	2.00	11.12	11.14	3.09	76.78%
Total	60.75	68.01	87.76	93.37	83.67	53.52	74.51
Average	10.13	11.34	14.63	15.56	13.95	8.92	12.42
Growth Rate		11.95%	29.04%	6.39%	-10.39%	-36.03%	0.19%

Source: Annual Reports of respective banks and information provided by SEBO/N.

As previous, the above table shows the scenario of finance companies (sample companies) towards investment in government securities and corporate securities. Table depicts that average amount of investment made towards government securities (Rs. 119.89 million) is higher than corporate securities (Rs. 12.42 million). Hence, we can conclude that both sectors, commercial banks and finance companies, make huge amount of investment towards government securities.

In case of finance companies, total average growth rate towards government securities is 14.51%, which is higher than that of corporate securities (0.19%). But, if we consider the individual samples, all samples' except that of Ace Finance and Goodwill Finance; average growth rate of investment in corporate securities is more than investment in government securities. Ace Finance Company decreases its investment towards corporate securities from the F/Y 2001/02 whereas Goodwill Finance Co. follows this decreasing trend from F/Y 2003 (Calculation details are presented in Appendix No. 3). Finally, we can conclude that finance companies are increasing their investment towards corporate securities.

4.6 Assessment of Disclosure Standards in Nepalese Stock Market

The tenth plan document (2002-2007)-of Nepal Government has clearly stated that the government is committed to create opportunity for number of people to reap benefits from the return obtained by directing investment in income generating portfolio of assets. This objective can be fulfilled only by the rational and accountable behavior focused towards the compliance of the disclosure standards by the key players in the capital market. Disclosure standard implies to any kind of reliable information disclosed, to-the users of information especially to shareholders and other

interested investors. This helps to understand the performance of companies that affect the capital market as a result of primary and secondary market activities. The act of disclosing helps the public to have rational judgment through the process of analysis and evaluation of performance necessary for making decisions.

Whatever the fund raised from the public needs to be expended in accordance with legitimate authority. If not, any illegality and inadequacies in system of management and accounting disclosure standards can undermine the public confidence that ultimately affects the stock market in one way or the other. In our country, despite continuous efforts to improve the quality and contents of disclosure standards, many inconsistencies still exist due to restraint and reluctant attitude of management towards adequate disclosure of information to the public. The presentation, quality and contents of the disclosure are still not proving satisfactory to win the confidence of investing public.

Table 4.13**Table showing compliance of Disclosures**

Fiscal Year	Listed	Companies Submitting Annual	Disclosure Status (%)
1995/96	89	59	66.29
1996/97	95	56	58.94
1997/98	101	58	57.43
1998/99	107	68	63.55
1999/00	110	61	55.46
2000/01	115	67	58.26
2001/02	96	68	70.83
2002/03	108	66	•61.1!
2003/04	114	71	62.28
2004/05	125	86	68.80
2005/06	135	85	62.96%
2006/07	135	82	60.74%

Source: SEBON Annual Report (For the period of 1995/96 to 2006/07)

The twelve years data reveals that the listed companies increased from 89 in 1995/96 to 135 during 2006/07 but due to de-listing it decreased to 96 in 2001/02. The compliance of disclosure is 70.83 % of listed companies and in some years it had dropped to 55.46 %. For the F/Y 2006/07, 82 companies out of 135 submitted their annual reports to the board. These companies consist of 11 commercial banks, 8 development banks, 37 finance companies, 10 insurance companies, 3 hotels, 6 manufacturing and processing companies, 2 trading companies and 4 other company. However, taking disclosure status of the listed companies finance companies top the list since more than 93% of finance companies submit the annual report timely to the concerned authorities, then followed by commercial banks providing disclosure varying from 83% to 90%. Insurance companies come under third ranking of the

disclosure status from 72% to 82%. Hotels and others provide disclosure from 50% to 80% and among all trading sector has the lowest disclosure status from 18% to 30%.

Empirical Analysis of Disclosures

The empirical analysis of data is based on six years data from 1996 July to 2001 July. The performance of corporate disclosure on NEPSE index, trading turnover and market capitalization is given below:

Table 4.14
Empirical Analysts of Disclosure

Fiscal Year	Corporate Disclosure (%)	NEPSE Index	Trading Turnover (Rs. in Million)	Market Capitalization (Rs. in Million)
1995/96	73	185.6	209.9	12295.0
1996/97	72.6	1763	416.2	12698.0
1997/98	54.7	163.4	202.6	14289.0
1998/99	58.2	216.9	73.8	23508.0
1999/00	57.3	360.7	283.7	43123.3
2000/01	70.8	348.4	128.0	46349.0

Source: SEUO .Journal, Volume II

NEPSE Index and Corporate Disclosure

Considering the NEPSE index as dependent variable, it shows NEPSE Index is positively con-elated to the corporate disclosure. The coefficient of correlation is 0.070 but the coefficient of determination R² is 0.005. This gives the indicative signal of positive relation of dependant variable (NEPSE Index) over the independent variable (Corporate Disclosure). However, there is no denying the fact that NEPSE Index is the key determinant variable in the secondary securities market. The positive coefficient of correlation between corporate disclosure and NEPSE Index indicates

that investors are gradually getting aware with the importance of fundamentally backed financial information to ignore the risk factors. Similarly, observing the test of confirmation of the results by the use of F-test ratio, it is found that the tested value is less than the tabulated value at 5% level of significance and this gives a clear cut message that the coefficient of correlation is significant.

Trading Turnover and Corporate Disclosure

In the above-presented table, it is clear that the trading turnover is dependent variable while the corporate disclosure is the independent variable. Trading turnover is positively correlated with the corporate disclosure. The coefficient of correlation is 0.301 but the coefficient of determination R^2 is 0.090. This shows a positive relation of dependant variable (Trading turnover) over the independent variable (Corporate Disclosure). Trading turnover is a good surrogate to measure the performance of the stock market in general. The positive coefficient of correlation between corporate disclosure and trading turnover provides a good message to the investor's confidence of buying and selling securities. This also shows the fact that investors are gradually getting conscious to invest in shares of listed companies. However, observing the test of confirmation of the results by the use of f-test ratio, it is found that the tested value is less than the tabulated value at 5% level of significance and this shows that the coefficient of correlation is significant.

Market Capitalization and Corporate Disclosure

In the above-presented table, it is clear that the market capitalization is dependent variable while the corporate disclosure is the independent variable. Market capitalization is positively correlated with the corporate disclosure. The coefficient of

correlation is 0.134 but the coefficient of determination R is 0.018. This clearly exhibits a positive relation of dependant variable (Market Capitalization) over the independent variable (Corporate Disclosure). Market capitalization is the message of the market to see how the stock is really performing. It is the technical yardstick to measure the performance of the stock market in general. The positive coefficient of correlation between corporate disclosure and market capitalization provides an appreciation in shareholders' value in terms of wealth maximization generated from capital gain from stock transaction. But the rational behavior of the investors is still missing linkage in the slowly growing securities market of Nepal. While observing the test of confirmation of result using f-test ratio, It is found that the tested value is less than the tabulated value at 5% level of significance and this shows that the coefficient of correlation is significant.

On the overall observation, it is quiet evident from the supporting data that corporate disclosure is significantly related with movements in NEPSE Index, Trading Turnover and Market Capitalization. The favorable the corporate disclosure, the greater is the response in rise of NEPSP Index, Trading Turnover and Market Capitalization.

4.7 Primary Data Analysis

In order to find out the present status of financial instruments in Nepalese capital market, questionnaire survey was made with investors of different nature randomly, "including male, female, less informed, well informed, employed, unemployed investors and so on. 117 investors were taken as subject for the study. They were asked with several questions like which are their choice of investment alternatives? In which financial instruments they want to make investment? And so on. (Details of descriptive statistics are shown in Appendix no. 4).

- **Gentler and Age.**

Among 117 selected investors, 66.67% of investors were male investors and 33.33% were female investors. As per the age, 30.77% were below 30 and rest were 30 and above.

- **Education**

On the basis of education, investors are categorized into three groups – undergraduate, graduate and postgraduate and above. Among them, majority of investors - 50.43% were graduate, 35.89% of respondent were postgraduate and above and remaining 13.68% were undergraduate.

- **Employment Status**

Considering employment status, majority of investors were found to be jobholders (61.54%). it mean that they are regular earners. 24.79% of respondents were found to be self-employed. they were also the regular earners. Around 11.11% were unemployed which means that they do not have regular source of income and very few were found to be retired. They do not have current regular income source except pensions and provident funds.

- **Category**

Regarding the question asked to the investors about category, 39.32% replied that they are less informed investors. Likewise, 9.40% of respondents answered that they are well informed. 7.69% were found to be analyst or professional investors and rest belong to informed category. During the survey, it was found that most of investors who were found in NEPSE floor and broker's offices were well informed and professional.

For the collection of primary data, it is done on the basis of major investment alternatives, available financial instruments, and investors' attitude towards awareness, whim, risk and return and so on.

4.7.1 Major Investment alternatives available in the capital market

For this study, corporate securities, government securities, real estate and bullion are taken as a major investment alternative that is prevailing in the Nepalese investment environment.

Ranks are assigned to the investment alternatives as per respondent's view, details of which are shown in appendix no. 4. Table below shows the total of ranks (rank sum) and ranks assigned.

Table 4.15

Ranks of Investment Alternatives

Alternatives	Rank Sum	Rank Assigned
Corporate Securities	345	1 st
Government Securities	322	2 nd
Real Estate	270	3 rd
Bullion	233	4 th

Source: Questionnaire Survey, Details in Appendix No.: 5

$$\text{Median} = \text{value of } \frac{(N+1)}{2}^{\text{th}} \text{ item}$$

$$= \text{value of } 2.5^{\text{th}} \text{ item}$$

$$= \frac{322 + 270}{2}$$

$$= 296$$

As per the median analysis the alternatives that have the rank sum of more than 296 are major investment alternatives. On this basis, we can say that corporate securities and government securities are major investment alternatives where as real estate and bullion is not a major one. As per the rank assigned, corporate securities are widely used than government securities.

Rank Test

Taking responses of total 117 cases, the available investment alternatives are ranked as per their rank sum. Ranks given in the above table are valid only if the difference of rank sums is statistically significant. A suitable test that can establish the significance of the differences of the rank sums is the Friedman test. It consists of computing a test statistic called Friedman Chi-square. Before computing the test statistic, we have to assume that each investment alternative is considered as a major alternative in the Nepalese capital market. They are ranked only because of restriction imposed on them to select best one. The hypothesis to be tested is that all alternatives are major one, against the alternative that any one of them is major whereas remaining is not that important.

Null Hypothesis (H_0) = Corporate securities, government securities, real estate and bullion all are major investment alternatives.

Alternative Hypothesis (H_1) = Corporate securities, government securities, real estate and bullion all are not a major investment alternatives. Any one of them is more preferable than others.

Table 4.16

Calculation of Friedman test-statistic

	Corporate Securities	Government Securities	Real Estate	Bullion	Total
T	345	322	270	233	1,170
T²	1,19,025	1,03,684	72,900	54,289	3,49,898
X²	1,133	1,010	756	611	3,510

	Sum of Squares	Degree of Freedom (d.f.)
Between Alternatives	$SS_{\text{alternatives}} = \frac{\sum T^2}{n} - \frac{(\sum T)^2}{tn}$ $= \frac{34898}{117} - \frac{(1170)^2}{4 \times 117}$ $= 65.58$	d.f. = t-1 = 4 - 1
Within Subjects	$SS_{\text{people}} = X^2 - \frac{G^2}{tn}$ $= 3510 - 2925$ $= 585$	d.f. = n(t-1) = 117 (4-1) = 351
Residual	$SS_{\text{residual}} = SS_{\text{people}} - SS_{\text{alternative}}$ $= 585 - 65.58$ $= 519.42$	d.f. = (n-1) (t-1) = (117-1) (4-1) = 348

Now,

$$X^2 = \frac{n(t-1) SS_{\text{Alternative}}}{SS_{\text{People}}}$$

$$= \frac{351 \times 65.58}{585}$$

$$= 39.35$$

Tabulated value of chi-square at 0.05 level of significance (3 d.f) is 7.82. Since the calculated value of chi-square (39.35) exceeds the tabulated value (7.82), the null hypothesis is rejected. So, we can say that every investment alternatives available in

the capital market is not a major one. The new ranks given to the alternatives are valid. The corporate securities are major alternatives whereas bullion is least preferred one. The corporate securities is widely used in the Nepalese capital market because of the reasons also like bank interest rates are going down, government bonds are rarely available, there is persistent slump in real estate business and the bullion market is not systematically organized.

4.7.1.1 Investment made by different types of Investors in the Capital Market

To test whether ranking of different types of investors in the Nepalese capital market are similar or not, investors were categorized as less informed, informed, well informed and analyst/professional. The details of ranking made by different categories of investors were shown in Appendix No. 6.

Table 4.17

Ranks given by different type of Investors

Type of Investors	Corporate Securities	Government Securities	Real Estate	Bullion
Less Informed	4	2	3	1
Informed	3	4	2	1
Well Informed	4	3	1	2
Analysts / Professionals	4	3	2	1
R	15	12	8	5
Mean (R)	3.75	3	2	1.25
R²	225	144	64	25

Source: Questionnaire Survey

Table No. 4.17 summarizes the ranks given by different types of investors to the investment alternatives available in the Nepalese capital market. Greater rank means

better. From this table, it can be seen that informed investors would like to invest in government securities (with rank 4), whereas other type of investors likes to invest in corporate securities. Less informed investors invest in real estate rather than government securities. Lack of awareness of capital market might have resulted this. They don't know how the capital market works, which securities are highly liquid and profitable, how one can earn easily and quickly from the effective play in the market and so on. That's why they think that they can invest their savings in real estate.

To test whether there is some agreement between these four categories of investors, or it is the result just of some chance; a test statistics Kendall's W has been used. Kendall's W shows the agreement between these four categories of investors. In this regard the hypotheses are:

Null Hypothesis (H_0) = the ranking made by less informed, informed, well-informed and professional investors are completely independent.

Alternative Hypothesis (H_1) = the ranking made by these 4 sets of investors are not independent.

Now,

$$W = \frac{12\sum R^2 - 3k^2 N(N+1)^2}{K^2 N(N^2+1)}$$

$$W = \frac{2 \times 458 - 3(4)^2 4(4+1)^2}{(4)^2 4(4^2 - 1)}$$

$$= \frac{5496 - 4800}{960} = 0.725$$

Calculated Kendall's W for the above case is 0.725. This represents the degree of agreement among the four types of investors in ranking the four investment alternatives. To test its significance, at $\alpha = 0.05$ level, tabulated value of W can be referred, which equals 0.619 at $k = N - 4$. This means that calculated concordance is significant; the match is not just because of some chance. In this case we reject the null hypothesis and conclude that four sets of investors do not have independent responses. Their ranking highly matches with each other, in other words there is similarity in the ranking made by four categories of investors.

4.7.1.2 Investment Decision as per Employment Status

On the basis of employment status, investors are separated into four categories - unemployed, jobholder, self-employed and retired. From this, jobholders and self-employed were taken as employed whereas unemployed and retired were taken as unemployed investors. Employment directly affects the earnings of the investors, and earnings have impact over investment decisions. Hypotheses to be tested in this regard are:

Null Hypothesis (H_0) = there is no significance difference between the ranks given by unemployed and employed investors.

Alternate Hypothesis (H_1) = there is significance difference between the ranks given by unemployed investors and employed investors.

Kruskal Wallis one-way non-parametric ANOVA by ranks has been used to test the difference in two groups.

Table 4.18

Calculation of Kurskal Wall is statistic

		Rank Sum	Rank (R)
Unemployed Investors	Corporate Securities	39	3
	Government Securities	37	1
	Real Estate	45	4
	Bullion	39	2
Rank Total			10

		Rank Sum	Rank (R)
Employed Investors	Corporate Securities	303	8
	Government Securities	287	7
	Real Estate	226	6
	Bullion	194	5
Rank Total			26

Source: Questionnaire Survey, Details in Appendix No.: 7

	Unemployed	Employed
Corporate Securities	3	8
Government Securities	1	7
Real Estate	4	6
Bullion	2	5
R	10	26
R²	100	676

$$\text{We have, } H = \frac{12}{N(N+1)} \left[\sum_{j=1}^k \frac{R_j^2}{n_j} \right] - 3(N+1)$$

Now,

$$H = \frac{12}{8(8+1)} \left[\frac{776}{4} \right] - 3(8+1) = 32.33 - 27 = 5.33$$

Tabulated value of chi-square at 0.05 level of significance with 1 d.f. is 3.841. Since the calculate value (5.33) is greater than the tabulated value, null hypothesis is rejected. So, it can be concluded that person holding a job and a person without a job make investment towards different investment alternatives. In this case, those who have jobs and have regular source of income make investment in corporate securities and government securities over real estate and bullion whereas the unemployed investors invests in real estate and corporate securities over government securities and bullion.

Result was quite surprising, employed investors should make investment towards instruments like government securities so as to get the safe regular return. This might have caused because of lack of awareness. Besides, an altitude towards the real estate just for the possession was found; they think that after saving some, they should put their money on real estate. So, they were just planning to possess land and buildings. That's why result was opposite to the theoretical belief.

4.7.2 Major Financial Instruments in the Nepalese Capital Market

Previously we have seen the investment made by different investors towards major investment alternatives. Now we have dropped the alternatives like real estate and bullion and focused only on the financial instruments. Study had considered common stock, preference shares, government bonds, debentures, mutual funds and treasury bills as the major financial instruments, since these are the major instruments that prevail in the Nepalese financial market. Among the survey made with 117 investors, their preferences towards different financial instruments were shown in Appendix No. 8.

Table 4.19

Ranking of Financial Instruments

Financial Instruments	Rank Sum	Rank Assigned
Common Stocks	270	1 st
Government Bonds	168	2 nd
Preference Shares	110	3 rd
Debentures	56	4 th
Mutual Funds	55	5 th
T-bills	43	6 th

Source: Questionnaire Survey, Details in Appendix No.: 9

$$\text{Median} = \text{value of } \left(\frac{N+1}{2}\right)^{\text{th}} \text{ item}$$

$$= \text{value of } 3.5^{\text{th}} \text{ item}$$

$$= \frac{110+56}{2} = 83$$

The above table lists down these financial instruments, as well as it presents the rank sums and ranks. Here, we can see common stocks have the highest rank sum and T-bills have got the lowest rank sum. Median value has been calculated on the basis of rank sums. As per the median analysis, the securities have a rank sum of more than 83 are major financial instruments. Hence, common stock is major securities since it has a highest rank sum and T-bills are least tradable securities since it has a lowest rank sum. Common stock, government bonds and preference shares are more tradable in the capital market in compare to debentures, mutual funds and T-bills.

Rank Test

On the basis of rank sum, ranks were distributed to the financial instruments. To test the statistical validity of those ranks, Friedman test is used. Hypothesis to be tested in this regard is:

Null Hypothesis (M_0) = Common stocks, government bonds, preference shares, debentures, mutual funds and T-bills, all are major financial instruments in the Nepalese capital market. Alternate Hypothesis (H_1) = All these financial instruments are not a major one. Some of them are more preferable than others.

Table 4.20

Calculation of Friedman test statistics

	common Stock	Government Bonds	Preference Shares	Debentures	Mutual Funds	T- Bills	Total
Frequency (r)	106	79	63	41	36	26	
T	270	168	110	56	55	43	702
T²	72906	28224	12100	3136	3025	1849	121234
X²	742	410	222	90	95	79	1638

	Sum of Squares	Degree of Freedom (d.f.)
Between Instruments	$SS_{\text{instruments}} = \frac{\sum T^2}{n} - \frac{G^2}{tn}$ $= \frac{121234}{117} - \frac{(702)^2}{6 \times 117}$ $= 334.19$	$d.f. = t - 1$ $= 6 - 1$ $= 5$
Within Subjects	$SS_{\text{people}} = \sum X^2 - \frac{G^2}{tn}$ $= 1638 - 702$ $= 936$	$d.f. = n(t - 1)$ $= 117(6 - 1)$ $= 585$
Residual	$SS_{\text{residual}} = SS_{\text{people}} - SS_{\text{instruments}}$ $= 936 - 334.19 = 601.81$	$d.f. = (n - 1)(t - 1)$ $= (117 - 1)(6 - 1)$ $= 580$

Now,

$$r^2 = \frac{n(t-1)SS \text{ instruments}}{SS \text{ people}}$$

$$= \frac{585 \times 334.19}{936} = 208.87$$

Tabulated critical value of chi-square at 0.05 level of significance (5 d.f.) is 11.07. Since the calculated value of chi-square (208.87) exceeds the tabulated value, the null hypothesis is rejected. So, we can conclude that every financial instrument available in the Nepalese capital market is not a major one. They are not equally tradable the market. Some of them are highly tradable whereas some are less. Hence the ranks assigned to the instruments are statistically valid. Common stock is the most popular financial instruments in the market whereas responses towards T-bills were found to be very low. It may also because of lack of access of general investors to the T-bills.

4.7.2.1 Ranks given to the financial instruments by different types of investors.

Table below summarizes the ranking made by different type of investors to the six different types of financial instruments available in the capital market.

Table 4.21

Ranks of Financial Instruments given by different Investors

Type of Investors	Common Stock	Government Bonds	Preference Shares	Debentures	Mutual Funds	T-bills
Less Informed	6	5	4	3	2	1
Informed	6	5	4	3	2	1
Well Informed	6	5	4	3	2	1
Analysts / Professionals	6	4	5	3	2	1
R	24	19	17	9	9	6
Mean (R)	6	4.75	4.25	2.25	2.25	1.5
R²	576	361	289	81	81	36

Source: Questionnaire Survey, Details in Appendix No. 10

Common stock appears as the most preferred instruments for all types of investors in the capital market since it has got highest rank from all categories of investors. Kendall coefficient of concordance W has been calculated to test whether the ranking of these financial instruments are independent or not. Hypotheses in this case are formulated as:

Null Hypothesis (H_0) = the ranking made by four types of investors are independent, and there is not any agreement between them.

Alternate Hypothesis (H_1) = the ranking made by four different types of investors are not independent. They are similar in nature.

We have,

$$\begin{aligned} W &= \frac{12\sum Ri^2 - 3k^2N(N+1)^2}{K^2N(N^2-1)} \\ &= \frac{12 \times 1424 - 3(4)^2 6(6+1)^2}{(4)^2 6(6^2-1)} \\ &= \frac{17088 - 48(294)}{16 \times 210} = 0.886 \end{aligned}$$

The tabulated value of W at 5% level of significance with $k = 4$ and $N = 6$ is 0.512, whereas calculated Kendall's W for this case is 0.886. Since the calculated value is greater than critical value, null hypothesis is rejected. It means that the ranking of all six types of financial instruments by different types of investors are similar in nature.

Although, all kinds of investors in the capital market prefer to invest in same financial instruments, common stock appeared to be the most popular instruments to

all of them. Common stocks are highly traded in market, and its market mechanism is also relatively better. Government bonds are very rarely available to the public and investors are not very much aware of it. Similarly, we can see that ranking of preference shares and debentures are in third and fourth rank respectively, which is not that bad. But their level of issuance is really very poor which have pulled the investors to invest towards common stock.

4.7.3 Selection of Investment Sector

SEBO and NEPSE have categorized the listed companies in 8 sectors as - commercial banks, development banks, finance companies, insurance companies, hotels, manufacturing and processing companies, trading companies and others. For this study also, same sectors of investments are considered to see which sector have more transaction of securities. Among the survey made with 117 investors, details of selection of their investment sector are shown in Appendix no. 11.

Table below lists the investment sectors of "Nepalese financial system and summarizes the ranking made by investors.

Table 4.22

Ranking of Investment Sectors

Investment Sectors	Rank Sum	Rank Assigned
Commercial Banks	350	1 st
Finance Companies	175	2 nd
Insurance Companies	101	3 rd
Development Banks	56	4 th
manufacturing Processing Companies	8	5 th
Trading Companies	7	6 th
Hotels	5	7 th

Source: Questionnaire Survey; Details in Appendix No. 12

$$\begin{aligned}\text{Median} &= \text{value of } \left(\frac{N+1}{2}\right)^{\text{th}} \text{ item} \\ &= \text{value of } 4^{\text{th}} \text{ item} \\ &= 56\end{aligned}$$

As per the median calculated, the sectors that have the rank sum of more than 56 are investible sectors and the sectors that have a rank sum of less than 56 are non-investible sectors. According to this, commercial banks, finance companies, insurance companies are found to be suitable sectors for investment whereas manufacturing and processing companies, trading companies and hotels are not a suitable one. Among them also, commercial banks are most suitable for investment.

Rank Test

To check the statistical validity of the ranking, Friedman chi-square has been calculated. Here, we have to accept the assumption that each individual respondent wants to invest in all sectors. The hypothesis to be tested is that all sectors are investible one against the alternative. Null Hypothesis (H_0) = all seven sectors are equally investible sectors to make investment. Alternate Hypothesis (H_1) = all seven sectors are not equally investible one. Some of them are better than other sectors.

Table 4.23
Calculation of Friedman Test Statistics

	Commercial banks	Finance Companies	Insurance Companies	Development Banks	Manufacturing & processing Companies	Trading Companies	Hotels	Total
Freq ⁿ (r)	121	102	76	40	5	4	3	351
T	350	175	101	56	6	7	5	702
T ²	122500	30625	10201	3136	64	49	25	166600
X ²	1028	329	155	88	14	15	9	1638

	Sum of Squares	Degree of Freedom (d.f.)
Between Instruments	$SS_{\text{instruments}} = \frac{\sum F^2}{n} - \frac{G^2}{m}$ $= \frac{166600}{117} - \frac{(702)^2}{7 \times 117} = 822.22$	d.f. = t - 1 = 7 - 1 = 6
Within Subjects	$SS_{\text{people}} = \sum X^2 - \frac{G^2}{m}$ $= 1638 - 601.71 = 1036.29$	d.f. = n (t - 1) = 117 (7 - 1) = 702
Residual	$SS_{\text{residual}} = SS_{\text{people}} - SS_{\text{instruments}}$ $= 1036.29 - 822.22$ $= 214.07$	d.f. = (n - 1) (t - 1) = (117 - 1) (7 - 1) = 696

Now,

$$\chi^2 = \frac{n(t-1)SS_{sectors}}{SS_{people}} = \frac{702 \times 822.22}{1036.27} = 556.99$$

In this case, we get $\chi^2 = 556.99$ whereas tabulated value of χ^2 at 0.05 level of significance is 12.591. Since the calculated value of chi-square exceeds the tabulated value, the null hypothesis is rejected. That is, all sectors are not equally investible. The new ranks assigned to the sectors are significantly valid. Commercial banks are most investible sectors whereas manufacturing and processing companies, trading companies and hotels are not profitable sectors.

4.7.4 Awareness of Financial Instruments

Among the 117 randomly selected general investors, only 7.69% were found to be professional investors who are really informed and aware as well as they do the analysis while making investments. 9.40% said that they are well informed about financial market. Around 46 (39.32%) of investors said that they are less informed type of investors. A large segment of investors (43.59%) said that they are neither less informed nor well informed. They are: informed just to a satisfactory level. It shows how much Nepalese investor are aware of financial instruments. Only 20 among 117 said that they are really much informed. This scenario depicts that majority of investors are not well informed and much aware of financial instruments (details in appendix no.4).

4.7.4.1 Education and Market Information

In the samples taken, majority of investors were found informed but not well informed and also significant portion said that they are less informed. A test has been

made to see if the awareness of market information varies with the level of education. Theoretically, it can be said that highly educated person has much knowledge of market. To test it chi-square test has been made for the variables like education and categories of investors.

Null Hypothesis (H_0) = the variables, level of education and market information has no association.

Alternate Hypothesis (H_1) = the two variables have significant association.

Table 4.24

Level of education and Market information

Type of Investors					
Level of Education	Less Informed	Informed	Well Informed	Analysts / Professional	Total
Undergraduate	5	6	3	2	16
Graduate	25	28	4	2	59
Post graduate	16	17	4	5	42
Total	46	15	11	9	

Source: Questionnaire Survey

As per the calculation made in Appendix No. 13,

Tabulated value of chi-square (χ^2) at 5% level of significance for 6 d.f. is 12.59

Calculated value of chi-square (χ^2) at 5% level of significance for 6 d.f. is 5.6574

Since the table value exceeds the calculated value, null hypothesis is accepted. It means that there is not any association between level of education and market information.

Similarly, contingency coefficient is 0.2148 also shows that those two variables have very low relation. Only to be highly educated can't make a person well informed investors.

4.7.4.2 Awareness of Financial Derivatives

Table 4.25

Knowledge and attitude towards financial derivatives

	Do you know about financial derivatives?			
Yes	49	41.88%	If yes which one do you know	
			Derivatives	Frequency
			Future	15
			Options	23
			Warrants	24
			Convertibles	35
			Do you want to invest on them	Yes
			37	12
No	68	58.12%		
Total	117	100%		

Source: Questionnaire survey

As shown in the above table, majority of investors (58.12%) were found to be unaware of financial derivatives. Only 41.88% of investors were found to be aware of financial derivatives. Among them, most of them know about convertibles (since it has got the largest frequency of 35), options and warrants are found to be almost equally popular. Only few investors (i.e. 15) know about future. Among those who know about financial derivatives were asked whether they want to invest on them if they get opportunity. For this question, among 49 investors, 37 of them said that they will where as remaining 12 said that they just know about derivative but don't want to invest on them.

Education and knowledge of financial derivatives

Since 58.12% of investors were unaware of financial derivatives, whether the education of investors affects the knowledge of derivatives or not has also been explored on the basis of chi-square test.

Null Hypothesis (H_0) = There is no relation between the level of education and knowledge of derivatives.

Alternate Hypothesis (H_1) Relationship exist between the level of education and knowledge of derivatives

Table 4.26

Education and knowledge of financial derivatives

Level of Education	Know about derivatives?		
	Yes	No	Total
Undergraduate	2	14	16
Graduate	18	41	59
Post-graduate and others	33	9	42
Total	49	68	117

Source: Questionnaire survey

Tabulated value of chi-square at 5% level of significance for 2d.f. is 5.991. As per the calculation made on Appendix no. 14, calculated value of chi-square is 32.035. Since calculated value exceeds the table value, null hypothesis is rejected. It means that there is association between level of education and knowledge of derivatives. To see how significant relation is mere between these two attributes, Cramer's coefficient (C) has been calculated, which is equal to 0.5234 (Details on Appendix No. 14). It shows

that those two variables have a significant association (since C is significantly different from zero). Now, we can conclude that the knowledge of derivatives varies with the level of education. Most of the investors with high level of education were aware of derivatives.

4.7.5 Attitude towards government securities

Survey made with 117 investors shows the following result towards investment on government securities.

Table 4.27

Investment on Government Securities

	Frequency	Percentage
Investors who have invested in government securities	82	70.09%
Investors who have not invested in government securities	35	29.91%
Total	117	100%
For those who have invested in government securities, what factors made them invest on in		
Marketability / Liquidity	8	9.76%
No risk / Safety	69	84.15%
NRB	3	3.66%
Friends and relatives	2	2.44%
Whim and rumor	0	0
Total	82	100

Source: Questionnaire Survey

A result shows that 70.09% of investors have invested in government securities. 84.15% of them have invested on government securities because of safety or no risk and 9.76% have invested because of the liquidity. Only few investors have invested

on government securities just by studying the NRB notices (3.66%) and through friends and relatives (2.44%). However, nobody said that they were affected by the whim and rumor.

4.7.6 Consideration for Investment Decisions

As per the survey made with the investors, different factors were considered while making an investment decisions. Different factors and their frequencies were shown in the table below

Table 4.28

Consideration for investment decisions

	Frequency
Company's track record / goodwill	101
Forecasted profit	92
Management team and promoters	83
Environment factors	42
Expected risk level	43
Taxation	6
Inflation	4
Liquidity and maturity	32

Source: Questionnaire Survey

Studying the frequency, we can say that company's track record is that factor which majority of investors consider while making investment decision. Then comes forecasted profit as second major consideration and the factors like management team and promoters comes in third place of consideration.

All above-mentioned factors are very crucial factors while making decision of investment. So, good investors must consider all these factors before making investment.

4.7.7 Attitude towards re-investment

Table 4.29

Attitude towards Re-investment

		Frequency	Percentage
Re-investment	Purchase more securities of more kind	34	29.06%
	Purchase some other kind of securities	49	41.88%
	Total	83	70.94%
No re-investment	Spend on durables	16	13.68%
	Save it safely	18	15.38%
	Total	34	29.06%

Source: Questionnaire survey

The above table depicts majority of investors i.e. 70.94% want to re-invest their return, whereas 29.06% of investors just want to save the return safely or spend the returns to buy some durables.

Among those who want to re-invest, 49 investors (59.04% of re-investors) want to purchase some other type of securities. However 34 investors (40.96% of re-investors) want to purchase the same kind of securities from which they have gained. It means that most of the investors want to diversify their portfolio by selecting some other investment instruments. But during the survey, most of the investors said that the decision to select the instruments frilly depends upon the market scenario.

4.8 Major Findings

Some of the summarized major findings of the study are:

1. Financial Instruments in Nepal

The issuance of corporate securities made since 1995/96 shows that 76.06% of total issues is covered by common stock. Since it has highest coverage in total corporate issues, it means common stock is the most widely used corporate security. Whereas preference shares and debentures are in low limits. In comparison to them, mutual fund and unit schemes are used significantly.

Government issues shows that T-bills are the mostly used government security which covers around 46.55% of total issues. It is the money market instruments and is not targeted for individual investors. Special bonds have also significant coverage in total issues of 21.99%. Public saving card has appeared as a new concept and is growing in a good phase.

2. Major Investment alternatives in the Nepalese capital market

While conducting survey with 117 randomly selected investors, corporate securities, government securities, real estate and bullion are considered as major investment alternatives available in the Nepalese capital market. Among them, corporate securities are found to be widely used alternatives. Similarly, government securities also have good scope in the Nepalese capital market. But the alternatives like real estate and bullion are not that much preferred by Nepalese investors. In terms of different categories of investors (less informed, informed, well-informed, analyst/professional), their rankings towards different investment alternatives were also found similar. Similarly, both the employed and unemployed investors like to invest their savings in corporate securities, but the unemployed investors give more preference towards real estate than corporate securities. Those who are less informed, unemployed and uneducated, are found to be unaware of financial market so, they

were found quite reluctant towards heavy investments on financial instruments. They want to invest small portion of their savings in financial instruments and planning to possess some land and buildings.

3. Selection of investment sector

Results showed that investors want to invest most of their savings on banking and financial sectors in comparison to other sectors like: manufacturing and processing, trading, hotel and others. Commercial banks, finance companies, and insurance companies were found to be the most profitable and safe sectors.

Analysis of subscription ratios has also showed that the issues of financial institutes are highly over-subscribed. On the contrary, issues made by manufacturing and processing companies suffer from under-subscription. It depicts that in the primary market also, most of the savings were invested in the banking and financial sectors. Likewise, the trading volume of secondary market also shows that banking sector takes an important place than other sectors.

4. Major Financial Instruments in Nepalese capital market

To focus more on financial instruments only, the alternatives like real estate and bullion were dropped and different financial instruments that are prevailing in the Nepalese capital market were presented in the study. To see which financial instrument is widely popular in the "Nepalese capital market, statistical tool called Friedman chi-square is used. Here, common stock appeared as the most popular financial instruments. Responses towards T-bills were found very low. However, government bonds appeared as the second most popular financial instruments. As per

the issuance also, Nepalese capital market heavily depends upon common stock. The issuance of other instruments in comparison to common stock is very poor. It means that the capital market of Nepal lacks the choices. Financial innovation is really lacking in Nepalese financial market.

5. Awareness of financial instruments

Nepalese financial market is lacking well-informed and professional investors. Most of the investors are educated but education has not to do much with the knowledge of capital market and financial securities. They do not conduct detail analysis before making investment on financial instruments. While interviewing, investors said that before investing, they should consider several important factors like companies' track record, promoters of the company, forecasted profit, environmental factors and others. But in practice, our market is totally guided by whim and rumor. So, at the time of making decision, whim and rumor affects much.

Awareness towards the derivatives is found to be very poor in the Nepalese capital market. 58.12% of respondents said that they have not ever heard about derivatives. Only some educated and professional investors were found to be aware of derivatives. Most of them know about convertibles and only few investors know about future. 24.49% of investors said that also they have an idea about derivatives; they do not want to take risk by investing on them.

Around 71% of investors said that they re-invest the returns they gain. But remaining 29% will consider either buying some durables or saving the return safely if they gain from investment.

CHAPTER-V

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Summary

The history of securities market begins with the flotation of shares to the general public by Biratnagar Jute Mills Ltd. in 1936. However, the development of securities market could not be a national policy for a long time. The then industrial policy of Nepal led to the development of securities markets with the establishment of Securities Marketing Centre (SMC) in 1976. Before the establishment of SMC, there were no institutional arrangements to undertake and to manage the new issues of securities. IPO's had to be made as per the provision of Companies Act, 1936, which were not adequate and relevant. The Act had not even included preference share as corporate security. Only Companies Act, 1964, recognized it as corporate security.

SMC started secondary trading of securities in 1981, which was restricted to government bonds. Till 1983, the concept of well-structured secondary market had not evolved in Nepal. No separate Act existed to regulate the trading of securities. The Securities Exchange Act, 1983 was enacted in 1983. The Act restricted the exchange of unlisted shares. The SMC was renamed Securities Exchange Centre (SEC) in 1984. The SEC was the only institution at that time managing and operating primary and secondary markets of long-term government and corporate securities.

A need to develop different institutional mechanisms relating to securities market was strongly felt to avoid potential conflict of interest between the services provided. The first amendment in the Securities Exchange Act, 1983 in 1993 paved the way for the

restructuring of securities market in Nepal, which led to the establishment of Securities Board of Nepal (SEBO) in 1993 with a mandate to regulate and develop the securities market. SEBO started to register securities and grant approval for issuing securities to the public in 1993. The first amendment in the Act also led to conversion of SEC into Nepal Stock Exchange (NEPSE) in 1993 with the objective of operating and managing secondary transactions of securities. The initial efforts led to the opening of full-fledge stock exchange in January 13, 1994.

The second amendment Securities Exchange Act 1983 was made in 1997. This amendment made provision for registering securities businesspersons in SEBO. As per the provision of second amendment SEBO provide the license to the securities businesspersons in 1997. The amendment made mandatory provisions for the listed companies to submit annual and semi-annual reports to the SEBO. This amendment also required securities businesspersons to submit annual reports incorporating the securities transactions carried out by them to SEBO.

Currently, there are 24 stockbrokers, 2 securities dealers, 9 issue managers. 1 stock exchange and 146 listed companies in the Nepalese securities market. Till now, the companies like banks, finance, insurance, hotels, manufacturing, trading, aviation etc have entered into security market but the companies from construction, information technology, etc have not entered yet. Ordinary shares, right shares, preference shares, debentures, and mutual funds are the major corporate securities of Nepalese capital market. Common stock appears as the most widely used corporate securities. To turn towards the government securities, there are T-bills, and bonds of several types like - development bonds, national saving bonds, special bonds and IMF promissory notes.

The participation of mutual fund in the securities market institutional investors is limited to only two - Citizen Investment Scheme (operated form 1994/95) and NCM Mutual Fund (operated from 2002/03).

Looking towards the public issue, during the period of last twelve years (1995/96 to 2006/07), total 112 companies issue their securities to the public among which most are finance companies. But the issues made by commercial banks are highly oversubscribed in the primary market. Most of the securities issued by manufacturing and processing companies are found to be under-subscribed. This indicates that investors want to hold the securities of commercial bank than companies from other sectors.

Nepalese financial market consists of varied types of investors, those who are completely unaware of market and those who are professional players of security market. However, the institutional investor seems very much passive in secondary market though their participation in IPO's are very significant. In such scenario, this study was conducted with an objective to explore the developmental position of different financial installments in the Nepalese capital market. Specifically, the objectives of the study are set as: to identify the different investment alternatives available in the Nepalese capital market, to analyze the development of different investment alternatives in the Nepalese capital market, and to find out the current status of .available investment alternatives. Responses of 117 randomly selected investors are taken for the study. The time period for this study is from 2001/2002 to 2006/2007.

5.2 Conclusion

Capital plays a vital role in the economic development of a country. Nepal being one of the least developed countries in the world has to make every possible endeavor to efficiently mobilize the available capital. The need for securities market development in Nepal has been an accepted reality; however it is still at a nascent stage. The economic liberalization, which really started to gain momentum after the establishment of several joint venture commercial banks in the mid-eighties, ushered to establish full-fledge NEPSE and SEBO to trade and regulate securities respectively in the Nepalese capital market. Despite revisions in the securities law and the its underlying regulations to make the capital market more vibrant and dynamic, the effort have not yielded the desired results. With the current stock-trading turnover of about Rs. 4507.68 million, market representation severely tilted towards the banking sectors (around 89%), almost non-existence institutional investors, undeveloped bond and derivative markets coupled with serious governance issues, our market is far from appealing to potential investors.

History of securities market shows that only four types of securities (Common stock, preference shares, debentures, mutual funds) were being issued in Nepal at varying period of time. Nepalese security market is completely dominated by equity shares. Investors do not have many choices, so they are pouring their investments on those equity investments. There are very less number of professional investors, whom we can count easily. The awareness level of those professional investors is really good, but those investors who do not have much information about the market, makes investment just because of influence of friends and relatives. They even don't know how the transfer of share ownership takes place and what its process is. The

awareness level of general investors is really poor. They just follow the whim of the market. Those who do not know about the financial market and investment scenario prefer real estate and bullion where their capital gets stuck for the long time in a hope of rise in their price. Such investment will not help in the capital mobilization of the economy.

Institutional investors are also very passive in Nepal. Commercial banks, finance companies, insurance companies, pension funds, investment trusts etc. are the major institutional investors of any economy. But, in our country, all of these are not actively taking part in the capital market, especially in secondary market. Institutional investor such as CIT has very low participation in Nepalese security market and Employee Provident Fund has no participation at all. The participation of mutual fund in the securities market as institutional investors is limited to only two - NCM Mutual Fund and Citizen Investment Scheme. Similarly, listed companies as institutional investors have stake in an average below one percent in the primary market. It seems stock market liquidity needs improved seriously. The market will have better liquidity if the securities are available to the price takers and the price reflects all relevant information. Nepalese security market is performing poorly in both these aspects. The consequence is very low market participation.

The efficient services of market intermediaries, awareness campaigns for investors, conductive and realistic policies of regulating authorities, legal inadequacy, double taxation on dividend and capital gain tax, poor corporate governance practices, poor disclosure practices, high cost of public issue, high transaction cost and so on are the major felt need in this regard.

5.3. Recommendations

With the study of findings of research and the literatures reviewed, finally some suggestive measures can be forwarded to the concerned parties.

) Investors tend to avoid securities market because they do not have options to invest in securities according to their risk-return preference (K.C., 2006). The diversity in more developed securities market installments attracts the investors of various risk-return preferences thereby promoting the size of market and liquidity. Ordinary share is a risky instrument whereas preference share, mutual fund and debentures are low risk instruments. In the context of Nepalese market, there is less opportunity for risk averter and risk neutral investor as the market is dominated by ordinary share, which is most risky instruments. Market is not conducive to knowledgeable investors as there are no derivative instruments like warrants, options, future, swaps, etc. to match with their preferences and expectations. Government securities (bond) market is unsystematic as the buying and selling of government securities is not based on demand and supply. Corporate bond market is also in the initial stage of development. Thus, the market is not encouraging to attract the large number of potential investors.

) Systematizing the government securities market and attracting institutional investors in the market could partly solve the problem of low diversity in securities market instruments. The systematic market for government securities also provides benchmark in setting interest rate for corporate debentures. To systematize government securities market, government securities should be transacted through the NEPSE. Privatization bond, development bond, municipal bond and securitization activities should be

promoted to increase the market for fixed income instruments. Institutional investors should be encouraged to enter into the market with suitable fiscal and other incentives as they could stimulate demand for debentures. Incentives should also be provided to the companies raising funds by issuing derivatives.

) Institutional investors are more informed than individual investors and have more incentive to monitor performance and keep management up to the mark. Institutional investors help stabilize price of securities and maintain confidence of retail investors in the market. But, the involvement of institutional investors is very low in Nepal. To address this problem, government should take initiative in establishing a clear regulatory provision that requires the Employee Provident Fund and Citizen Investment Trust investing certain portion of funds in the securities market along with some provisions of fiscal and other incentives. Some flexibility in the directives should be brought to attract the institutional investors in the market of financial instruments.

) The securities market provides liquidity to the issued securities. The BAFIO, 2006 requires every financial institution to offer at least 30% share of issued capital to the general public. Similarly, Insurance Board also requires every insurance company with its registered office in Nepal to offer at least 20% of its issued capital to general public. However, in case of companies from other sectors, there is no mandatory provision for the issuance of securities.

) The liquidity in the market can be promoted by increasing public flotation of shares. Amending the legal provisions governing financial institutions and insurance companies that require the increase percentage of public flotation

could do this. In addition, mandatory provision should be made for the companies from other sectors to float certain percent of their shares to the public. The government should also be committed to achieve its goal set in the tenth plan to increase the public ownership in the corporate bodies. The pace of privatization of public corporations should also be increase by making use of the securities markets mechanism in the process.

-) Study shows that large portion of investors is unaware of market mechanism. Due to this they are investing their big chunk of capital towards unproductive alternatives like real estate and bullion. If awareness level of investors can be improved, more savings can be pulled towards financial instruments. Awareness programs and campaigns should be launched for this. This will also help to increase the number of smart investors who will not just gamble on the basis of rumor and whim.
-) A separate body that effectively council and give investment related information to the current as well as prospective investors should be formed. Specialized firms, consultancy or forum to provide financial assistance and advices to the investors are really needed for the betterment of the investor's investment decision.
-) Regulating authorities like SRBO should work for the well being of the investors with the pro-investors policies. They should not be simply watching the malpractices of listed companies. Investors are the main pillars of the capital market. Without the trust of investors, no capital market can sustain. So, to win the trust of investors, regulating authorities should act on the best interest of investors.

-) The regulating authorities should try to bring the investors in the main streamline so as to increase their trust and participation in financial system. Representatives from the investors in regulating mechanism can be one strong move in this regard. Regulating authorities should act as the facilitators rather than the interveners.
-) Dividend is the most inspiring aspects for the investment on the ordinary shares of the companies. Stocks with larger ratio of dividend per share to book value per share have higher liquidity, lower leverage, higher earnings, higher assets turnover and higher interest coverage (Pradhan & Adhikari, 2006). Nepalese shareholders are not indifferent towards payment or non-payment of dividends as dividend payout affects the price of a common stock. Despite the important aspect of dividend to encourage the investment in the security market, it is taxed twice. First it is taxed at the corporate level and when it comes to the hands of the investors then also it is taxed. This discourages the investment in ordinary share. In view of present level of securities market development, there should not be double taxation on dividend.
-) Capital gain tax can divert securities market investment to the commodity and bullion markets. In the provision of present capital gain tax, tax is imposed on capital gains from the trading of securities but there is no clarity regarding the write off of capital losses incurred and there is also a problem of establishing net gains in the trading of securities. So the provision of capital gain tax should be rationalized in view of present initial stage of securities market development.

-) Generally, companies with the poor governance practices hesitate to issue securities. Issuing companies with poor corporate governance practices from manufacturing and processing, trading and hotel sectors, which issued securities in the past had very poor performance and could not provide any returns to the investors. As a result, investors hesitate to subscribe public issues from manufacturing and processing, trading and hotel sectors and due to this the companies from these sectors face difficulties in raising fund from the market. Hence, concerned authorities must be aware to improve corporate governance practices in the country and rehabilitate the companies from manufacturing and processing, and trading sectors. For this, regulator should prescribe codes on corporate governance and should make mandatory provisions to follow.
-) A good disclosure practice is essential to bring transparency in the securities market. Inadequate disclosure practices and poor transparency discourage potential investors from investing in the security market. In order to secure investors' confidence and commitments, a flow of information is a must as investors can make informed decisions in securities market only with adequate information. Informed decisions of investors not only help to stabilize price of securities but also help to attract additional investors in the market. So, to curb the problem of poor disclosure practice, regulatory provisions relating to securities market should be strengthened, as present securities laws do not provide sufficient power to the regulators to enforce better disclosure practice of the listed companies.
-) Cost of public issue (i.e. underwriting cost, advertising, printing and other expenses, collection and refund charges, and issue management commission)

is relatively high in Nepal compared to neighboring countries. Among the cost components, collection and refund charges is highest due to over-subscription of issue. Hence, public issue process should be made simple by adopting one window policy that ultimately reduces cost of public issue.

) Cost relating to secondary trading of securities is taken here as transaction cost. Lower the transaction cost higher the return to the investors on securities trading and vice versa. Competitive transaction cost is an incentive to increase volume of share trading. Low transaction cost helps to stabilize securities market by reducing volatility I pricing thereby provide investors a safer place to invest.

) The securities market in Nepal is underdeveloped where procedural or opportunity cost is significantly higher that explicit cost. To reduce the cost, the present 'open-out-cry' trading system should be replaced with 'automated trading system'. This will reduce transaction time and increase the ease of trade execution. Further development of on-line trading system of securities will provide trading facility to greater number of investors who have access to web. The reduction in transaction time and increasing ease of trade execution should lead to higher volume of securities trading and lower transaction cost.