A STUDY OF FACTORS AFFECTING STOCK PRICE VOLATILITY: PERCEPTION OF STOCK BROKERS

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ABSTRACT
Since the economic liberalization there has been a substantial growth in the volume of trade in stock exchanges which is evident in the rise in the stock indices. The growth in stock market operations has been largely on account of an increase in number of investment avenues available for retail investors matching to their risk appetite and thereby increased participation of investors in stock market operations. The primary objective of investors is to earn optimum returns out of their investments however, expected rate of return differs depending on the market knowledge, risk perception of different factors and the risk taking ability of the individual investor. The present paper attempts to study the perception of brokers regarding factors effecting stock prices in India and thereby influencing their investment decisions. The study has used factor analysis to categorize the major influencers of investment decisions of the stock brokers and has indentified seven factors guiding their investment decisions.

Key Words: Investment decision, Investors optimism, Risk appetite, Investor’s behavior, Investment benefits, Liquidity, Profitability

INTRODUCTION
Over past two decades, the robust growth rates, increasing income levels and booming stock markets have led to more and more numbers of high net worth investors (HNIs) in India. It has reflected in involvement of higher number of investors in sock markets. However, the investment behavior of all the investors has not been guided by same set of rational assumptions. The investors with higher risk appetite want to experiment and try new and exotic products in the name of diversification while small investors have been more inclined towards less risky investments which are consistent in returns. The investment decision of investors is guided by expected returns and their perception of risk associated with the investment options.

Economic theory on investment decisions explains the investment decision of the individual in terms of macroeconomic aggregate. According to the intertemporal utility theory individuals maximize their utility based on classic wealth criteria making a choice between consumption and investment through time. However, some empirical studies conducted in the 1970s focused on the individuals rather than aggregate investor profiles. During the same period, the discipline of behavioral finance focused on investigating investment choices under conditions of uncertainty. Research in Behavioral finance revealed six primary theoretical streams, namely Prospect Theory, Regret Aversion, Self Control, Emotions, Social Interaction and Overconfidence. Each of these research streams captured and analyzed behavioral attributes of individual investors.

The stream of behavioral finance assumes that information structure and the characteristics of market participants systematically influence individuals’ investment decisions as well as market outcomes. According to it investor market behavior derives from psychological principles of decision making to explain why people buy or sell stocks. In this context the present study aims at identifying the leading factors determining the perception of stock prices and thereby influencing investment behavior of stock brokers.
LITERATURE REVIEW
It is assumed that individuals behave rationally in the matters involving money. However, the return on trade and investments made in stock markets are found to be beyond the usual frame of rationality. The economists, statisticians, and teachers of finance have been interested in developing and testing models (Fama, 1965) which would explain changes in stock prices. The relationship of stock returns and fundamental variables has been extensively studied through decades. There is a large amount of evidence that short and long-horizon stock price changes, and so returns, are dependent on fundamental variables such as dividend yields. Other studies have found that stock returns are predictable from a whole set of economical variables such as monetary and fiscal policies, interest rates, inflation, the economic and external events, business cycles, technical factors, etc.

Forecasting of share prices is a difficult task because of uncertainty regarding prevailing conditions in the market and varied expectations of the persons dealing in the market. The conditions prevailing and investor expectations have a direct relationship with factors responsible for such fluctuations in share prices. Market performances are only driven by data; but they are also a trade-off between producer and consumer (Scott, 2006). Markets are influenced by various factors like rising investor confidence, further simulated by soaring corporate profits and fresh market opportunities, further made possible by Global perspective and the advent of internet, due to which major stock markets have seen unprecedented growth (Kollmeyer, 2001). As per Bouchaud and Cont, 1998, fluctuations in stock markets exhibit diverse statistical peculiarities which require proper interpretations.

Various studies have focused on different factors that effect price volatility in stock markets. Some studies have found that stock market fluctuations majorly depend on the economic data and daily news items which directly or indirectly effects the economy. A survey on UK market conducted by Lee et. al., 2002, has shown a potential correlation between economic news and the stock market Paulo and Pensiri (2002) studied economic news and market correlation and found that stock market has been influenced by entirety of factors, which roughly could be divided into various groups such as macroeconomic variables as foreign direct investment, state budget revenue and expenditure, gross domestic product, price index of consumer goods and services, money in a broad sense, average profitability of governmental bonds and inflation. Similarly, Reilly and Brown (2003) found that stock prices reflect expectations of earnings, dividends, and interest rates. As investors attempt to estimate these future variables, their stock price decisions reflect expectations for future economic activity, not current activity.

Numerous studies have analyzed existence of the relationship between money supply and stock price changes. Special attention was paid to determination of whether changes in money supply precede changes in stock prices. Results of such researches tend to change from time to time Reilly and Brown, (2003). Various studies supported the view that there is a strong leading relationship between changes in money supply and stock prices. Such results implied that changes in the growth rate of the money supply could serve as a leading indicator of stock price changes (Reilly and Brown, 2003).

Cleary (2001) found that the two most important tools of fiscal policy namely, levels of government expenditures and taxation had a simulative effect on the economy generally or specific segments of it and share prices; while a cutback in spending has the opposite effect. Conversely, tax increases dampen consumer spending and business profitability, while tax cuts spur the economy and boost profits and common share prices. Downs and Hendershot (1987) analyze impact of the Tax Reform Act of 1986 on stock prices. This act cuts the corporate tax rate, eliminates the investment tax credit and lengthens tax depreciation on structures. Authors find that, these changes should raise equity
values by 10 to 13 percent. The rise in stock prices follows from the heavier taxation of new capital and the resulting rise in returns on existing capital. (Downs et al., 1987).

Darrat (1990) considers the possibility of changes in fiscal policy (government debt) to exert important effect on stock market and equity returns. In his survey Darrat measures fiscal policy by the real market value of privately held federal debt scaled by potential GNP. His empirical results indicate that fiscal policy plays an important role in determining stock prices in the United States. Specifically, the results show, that changes in the stance of fiscal policy have significant effect on changes in aggregate stock prices during the estimation period. He claims that the stock market can be seen as an important channel “transmitting the influence of fiscal policy to the real side of the economy”.

As reflected in the major averages it is apparent that the general market, impacts more than half of a stock’s price, while earnings account for most of the rest (Andrews, 2004). Keeping this in the mind, it is cheaper for companies to finance projects and operations that are funded through borrowing as stock prices should rise with falling interest rates because it becomes cheaper. The perceived value of a stock increases when lower borrowing costs allow higher earnings. Stocks, commodities and existing bond prices tend to rise in a falling interest rate environment. Relationship between interest rates and bond prices is inverse, i.e., an increase in interest rates will cause a decline in bond prices and a decline in interest rates will raise bond prices.

Many authors accentuate the depressing effect of inflation on stock prices (Cleary, 2001), as inflationary price pressures create widespread uncertainty and lack of confidence in the future. These factors tend to lower corporate profits. Consequently, lower corporate profitability as a result of inflation makes common shares less attractive to investors. As in the case of stocks, inflation causes bond markets to perform poorly. Inflation causes growth of interest rates, and hence bond prices fall. Anticipated rise in interest rates in an inflationary environment result in the fall of both stock and bond prices (Andrews, 2004).

Notably, the actual relationship between inflation, interest rates, and stock prices is an empirical question and the effect varies over time. Therefore, although there has generally been a significant negative relationship between inflation, interest rates, and the returns on stock, this is not always true. In addition, even when it is true for the most of the market, certain industries may have earnings, cash flows, and dividends that react positively to inflation and interest rate changes. In such an instance, their stock prices would be positively correlated with inflation and interest rates (Reilly and Brown, 2003). The health of the economy has a fundamental influence on share prices because it is ultimately responsible for driving company profits. Broadly speaking, if the economy is growing, company profits improve and shares will become more highly valued. If the economy is weakening, company profits will fall and share prices will go down (London Stock Exchange, 2005).

Not much work on impact of macro economic factors influencing price volatility of stock market has been done in the Indian context. The post liberalization era of the Indian economy has seen a lot of price volatility and price sensitivity. Subsequent to the economic reforms of July 1991, Indian stock markets have been progressively integrated with the other developed markets across the world. Due to foreign institutional intervention and investing pattern in the domestic market since 1993, India has now become vulnerable to the fluctuations happening at the global level. In order to meet the dynamic demands of modern day finance the Indian stock market has revamped and had undergone sea changes like developing a full-fledged derivatives market for futures and options. Indian stock markets, particularly the BSE, have observed many booms and busts and battered several crises during the last decade. (BSE30) which is considered to be the indicator of the Indian economy has
exhibited relatively higher volatility during the post reforms period. In the past decade Indian stock market had witnessed two major scams leaving an adverse impact on the market; sensex has also witnessed reoccurrence of financial irregularities.

A major institutional development has been the setting up of the National Stock Exchange (NSE). Shah and Thomas (2001) summarize that, “NSE seems to have generated a dynamic process of change in the securities industry. It directly spawned new institutions (the Clearing Corporation and depository) and played a vital role in injecting new ideas into the securities markets (such as derivatives trading). Through competitive pressure, and by being a role model, it indirectly helped accelerate the process of change in other exchanges in the country. Thus NSE’s overall importance in the reforms process on the equity market has been quite considerable.” The increased exposure to foreign investors and foreign stock markets has greatly increased the price volatility in Indian markets. Price volatility is a rate at which the price of a security increases or decreases for a given set of returns. It therefore, becomes important to study the possible factors that influence stock prices in the Indian context. The present paper is an attempt to identify the factors that affect price volatility in the Indian stock market by studying the perception of stock brokers.

METHOD

The study

The present study is an empirical investigation and aims to determine broker’s perception about the factors that influence their decision of investment in various stocks. The research is descriptive in nature.

The sample

The target population was share brokers in the Indian stock market. The brokers were residents of M.P. The sample consisted of 70 stock brokers. 100 brokers were personally contacted during the research however the complete data could be obtained only from 70 brokers.

The tools

For Data Collection: A self developed questionnaire was used for the purpose of the study. The questionnaire consisted of a five point likert scale which comprised of 40 items. For Data Analysis: For ensuring the validity of the scale and reliability of the scale item to total correlation and factor analysis was used. Item to total correlation saw 24 items to be significantly correlated at 0.05 level of significance and 16 items were dropped. This finally left 26 items in the scale which was administered to the sample. For further analyzing the data factor analysis was used. Varimax Rotated factor matrix with principal component method was used. The data was analyzed using the 14.0 version of SPSS

RESULTS

There are seven factors, which have been identified; which affect fluctuation in stock prices -

FACTOR 1: Economic Environment: Its factor load is 8.4. The factor includes variables like Increase in demand and supply of products and services with a load of 0.90, Increase in supply of products and services with a factor load of 0.90, robust financial system with a factor load of 0.90, PE Ratio of the company with a factor load of 0.78, Time of harvest with load of 0.77, Natural calamities abroad with a factor load of 0.71, EPS of the company with a factor load of 0.68, Natural calamity in India with a factor load of 0.64, Market capitalization with a factor load of 0.59, Post - Announcement of budget with a factor load of 0.56, fluctuation of foreign share market with a factor load of 0.49 and
pre announcement of budget with a factor load of 0.48. The factor accounted for 29.2 percent of the total variance.

FACTOR 2: GDP and Government policies: The factor has a load of 2.52. The variables in this factor are growth in GDP with a load of 0.79; Inflation with a load of .63 government polices with a load of 0.56 and Liquidity in economy with load of 0.54 and accounts for 13.3 percent of the total variance.

FACTOR 3: Foreign trade and Investments is the next set of predictors, which are affecting the share market. The factor has a load of 2.21. It includes Balance of payments with a load of 0.88; profitability of investment avenues with a load of 0.79 and policies of SEBI with a load of 0.54. The factor covers 9.7 percent of the total variance.

FACTOR 4: Disclosures is the fourth factor which has a load of 1.07. It includes variables such as Transparency in system with a load of 0.54 and Disinvestments of PSU with a load of 0.53. The factor covers 8.1 percent of the total variance.

FACTOR 5: Seasonal Effect is fifth factor with a load of 0.59 and includes the variable of Effect of monsoon with a load of 0.59. The factor accounts for 6.9 percent of the total variance.

FACTOR 6: Asymmetry in Information is the sixth factor with factor load of 0.56 having a single variable namely Insider trading it accounts for 5.6 percent of variance.

FACTOR 7: Liberalization is the last factor revealed by the study which consists of Current account convertibility with a load of 0.45 and accounts for 4.78 percent of the variance. (See Table 1)

DISCUSSION
The results show that one of the predominant factors affecting stock prices is economic environment. These results are logical as an increase in economic development will lead to an increase in demand for goods and services which will lead to higher profits for companies, better price earning ratios which investors will discount into stock prices. This will increase investor expectation and perception of company’s performance which in turn will be reflected in higher share prices. Similar, empirical analysis of Lithuanian stock market, concentrated on the impact of country’s economical development on stock prices of Lithuanian companies proved the existence of relationship between stock prices, represented by OMX Vilnius Stock Index (OMXV), and economic activity. The study also highlighted the influencing macroeconomic variables to be: foreign direct investment, state budget revenue, state budget expenditure, gross domestic product, price index of consumer goods and services, money supply, average profitability of governmental bonds and inflation (Manuela and Michailova, 2006).

Similar studies have also shown that stock prices reflect expectations of earnings, dividends, and interest rates. As investors attempt to estimate these future variables, their stock price decisions reflect expectations for future economic activity (Reilly, Brown, 2003). The price earning of a company was also seen to directly affect the stock prices. This is supported by the Efficient Market Hypothesis (EMH) which is based on assumption that large numbers of rational, profit-seeking investors in the marketplace which react quickly to the release of new information. As new information about stocks appears, investors reassess the intrinsic value of stock and adjust the price accordingly. Therefore, at...
any point in time a stock price is an unbiased reflection of all available information and represents the best estimate of the stock’s true value (Cleary, 2001).

Reilly and Brown, (2003) have also shown that the economy and the stock market have a strong, consistent relationship. For many years economists, statisticians, and teachers of finance have been interested in developing and testing models (Fama, 1965) which would explain changes in stock prices. There is a large amount of evidence that short and long-horizon stock price changes, and so returns, are dependent on fundamental variables such as dividend yields. Other studies have found that stock returns are predictable from a whole set of economical variables such as monetary and fiscal policies, interest rates, inflation, the economic and external events, business cycles, technical factors, etc.

Zuckerman (1999) studied market efficiency to examine the response of stock prices to fiscal and monetary policy pronouncements, changes in industrial policy, changes in administered price policy, and changes in exchange rate policies of a particular industry or a group of firms, such as export-oriented firms and FERA companies. Concerned with the fiscal and monetary policy pronouncements, it has been found that Union budgets were associated with increases in volatility, whereas half-yearly credit policy announcements had no impact on the market movements.

Chaturvedi (2000) worked on the share price behavior in relation to P/E ratios in the pre- and post-announcement period of 90 stocks listed on the Bombay Stock Exchange (BSE). It has also been observed that two-third of the post-announcement cumulative abnormal returns were observed to occur in the control period +21 days to 40 days, implying that stock prices do not adjust rapidly to the P/E information. Gupta and Yuan (2003) studied the market efficiency to examine the semi-strong form of efficient market hypothesis with the help of selected accounting variables and macroeconomic variables. It was observed that the dividend per share was positively and significantly related to the share prices. However, the return on equity did not show a significant influence but the growth in price-earning ratio showed little evidence. Likewise, the growth in earning per share and leverage had negligible influence in explaining the share prices.

The second factor found to influence stock prices as perceived by stock brokers was GDP and Government policies. These findings are supported by Darrat, 1990 (1960to 1987). He considers the possibility of changes in fiscal policy (government debt) to exert important effect on stock market and equity returns. In his survey he measured fiscal policy by the real market value of privately held federal debt scaled by potential GNP. His empirical results indicate that fiscal policy plays an important role in determining stock prices in the United States. Specifically the results show, that changes in the stance of fiscal policy have significant effect on changes in aggregate stock prices during the estimation period (Darrat, 1990) (1961 to 1987).

Other important factor is economic stability, expansion of economy will create new demands for financial services, and such increase in demand will exert pressure for establishing larger and more sophisticated financial intention to satisfy the new demand for these services.

In the context of share market development, financial and economic policies seems to be an important factor, which comes under regulatory framework, Levine and Zervous (1998) found stock market become larger, more liquid and more internationally integrated following liberalization of restrictions on capital and dividends flow. Thus, liquidity directly affects stock process.
The third factor affecting stock price volatility was foreign trade and investment. This is supported by a study of the Kuwait market which saw that. During 2005 Kuwait stock exchange for the surge of the regional stock markets. The most important is the region’s strong economic performance fueled by higher oil prices, lower interest rates and general decline in regional uncertainty following the end of the war on Iraq. In addition, strong oil revenues in Kuwait usually lead to a rise in the level of regional liquidity, through higher remittances, better export opportunities to the GCC markets and a surge in direct investment flows to the non-oil Arab countries.

On the regulatory front, the need for Securities Commission supervising the Kuwait stock exchange led the way on regulatory development of the capital markets in the region, Kuwait had developed a niche market Islamic products and services. The volatility of stock market returns was high in Kuwait stock exchange relative to developed markets. The study further found that the variance of stock market excess returns varied with time was mildly persistent, leptokurtosis and influenced by exogenous variables representing government market support and liberalization policies. The fourth factor revealed by the study was Disclosures. The transparency of the system was found to affect the price volatility. In a study titled motives for disclosure and non-disclosure: a framework and review of the evidence. By; Russell et al (2006); posit that the primary goal of voluntary disclosure is reduction of information asymmetry (between managers and investors) and thereby cost of capital. The researchers assume basic or frictionless market where firms choose to disclose all news except worst possible outcomes. They find that market price volatility is influenced by disclosures. Another study by added Aktas, and Semra (2006) found that unexpected events can put more stress on the financial market, and market participants may lose their ability to assess rationally the valuation implications of event. On March 1, 2003 Turkish parliament rejected the highly controversial bill that allows the deployment of U.S Troops in Turkey. This paper investigates the pricing behavior of the Turkish stock market in case of a major political event that had strong economic implication for market participants. In response to unfavorable political events, stock prices are expected to behave differently in the efficient market since new information will have different economic impact on individual firms.

The fifth factor effecting stock price volatility was found to be seasonal variations specially monsoon. As the Indian economy depends on agriculture to upto 24% of the GDP, poor monsoons have a direct impact on stock prices. The market has a tendency to be weak between June and September when the monsoon has a say on the Indian economy. Nathan (2003) reported the effect of a drought would directly reflects on company earnings which may adversely affect stock prices. The sixth factor identified in the study was asymmetry in information. Informational efficiency of the market has always been an area of vital interest for financial economists. The efficient market hypothesis is based on the preposition that available information is reflected by stock prices and no investor is able to beat the market to attain abnormal returns. The time consumed by the market to get it adjusted to new information is the most crucial factor. If the markets respond instantaneously, accurately, and in an unbiased manner, it is assumed to be more efficient. Ball and Brown (1968) and Fama et al. (1969) were first to notice that there is a delay in the stock market’s response to the events that contain relevant information. Consequently, Fama (1991) defined sub-efficient markets where prices may fail to fully reflect all relevant information because of existence of time lag between the announcement of an event and its incorporation into share prices.

The seventh factor found to affect stock volatility was liberalization policies. This finding is supported by Biswas, 2005 who evaluated the development and efficiency of the Indian stock market in the post liberalization period. The researcher found that with the implementation of financial liberalization in
the securities market during the last decade, Indian stock market had graduated to a better position vis-à-vis the stock markets in developed and emerging market in terms of a number of parameters. On the domestic count also Indian stock market responded favourly with the stock market liberalization policies. The Indian market, however, plagued by high volatility, price manipulations and price rigging in the post-liberalization period. Having discussed one of the reasons of asset price fluctuations, this study concluded with some suggestions to arrest the volatility in the Indian stock market.

In a study conducted for 16 countries Levine and Zervos (1998b) found that stock markets become more liquid following stock market liberalizations. In a study on ADRs it was reviewed that ADRs a rich option for investment liberalization which lead to reduced costs of capital. Karolyi (1998), A study conducted by Chari and Henry (2004) exhibited that individual firms experience reductions in the costs of capital post-equity market liberalization. Lins et al. (2005) illustrate that firms from rising markets listing in the United States are able to relax financing restraints. Galindo et al. (2001) explained that financial liberalization improves the effectiveness of capital allocation for firms in number of developing countries. Gupta and Yuan (2003) confirms that industries depending more on external finance experience considerably elevated growth following liberalization and nurture faster through the design of new plants (as a replacement for of investing in existing ones). Thus all these studies highlight that liberalization reduces cost of capital which leads to increased returns which in turn leads to higher stock prices.

CONCLUSION

The study revealed seven external factors primarily influencing the investment decision of the brokers. Post liberalization the Indian stock market has been plagued by high volatility. The result suggests that economic environment, GDP and government policies, foreign trade and investments, disclosure, seasonal effect, asymmetry of information and liberalization policies of the government are major factors effecting stock prices. As growing economy and a booming stock market has become extremely attractive for small investors. The findings of the study can be a useful guide to understand factors contributing to stock market volatility. As brokers have their hand on the pulse of the market, the perception of stock brokers regarding contributors to price changes are most pertinent. The Indian government needs to look at various policies and measures it needs to adopt to enhance market efficiency.

REFERENCES


Table 1: Factors Affecting Volatility of Stock Prices

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<tr>
<th>Factor Description</th>
<th>Variable load</th>
<th>Total factor load</th>
<th>Variance(%)</th>
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<td>Increase in demand of products and services</td>
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<td>Increase in supply of products and services</td>
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<td>Robust financial system</td>
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<td>Time of harvest</td>
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<td>Natural Calamity – Other than India</td>
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