Original Paper
ISSN: 2321-1520

Cost Factor in Stock Market Investment

Gurudutta P. Japee*

Associate Professor, SD School of Commerce, Gujarat University, Ahmedabad
*Corresponding Author

Received Date: 17-4-2017
Published Date: 15-9-2017

Abstract

After witnessing the rise in the prices of stocks over the years, despite large number of corporate frauds and crisis, it is now commonly accepted that the stock market is the best place to enable one's financial growth. There are many misconceptions about the stock market and there are many people refrain from investing in stock market just because of the jargons and lack of information they have about it. The paper is written for those who are novice in the field of stock market and want to explore more about investing in stocks. The paper is limited to the cost involved in buying and selling the stocks which will certainly help investors to know about the cost involved in stock market.

Keywords: GST Explicit cost, Implicit cost, Transection cost, STT, Impact cost.

Introduction

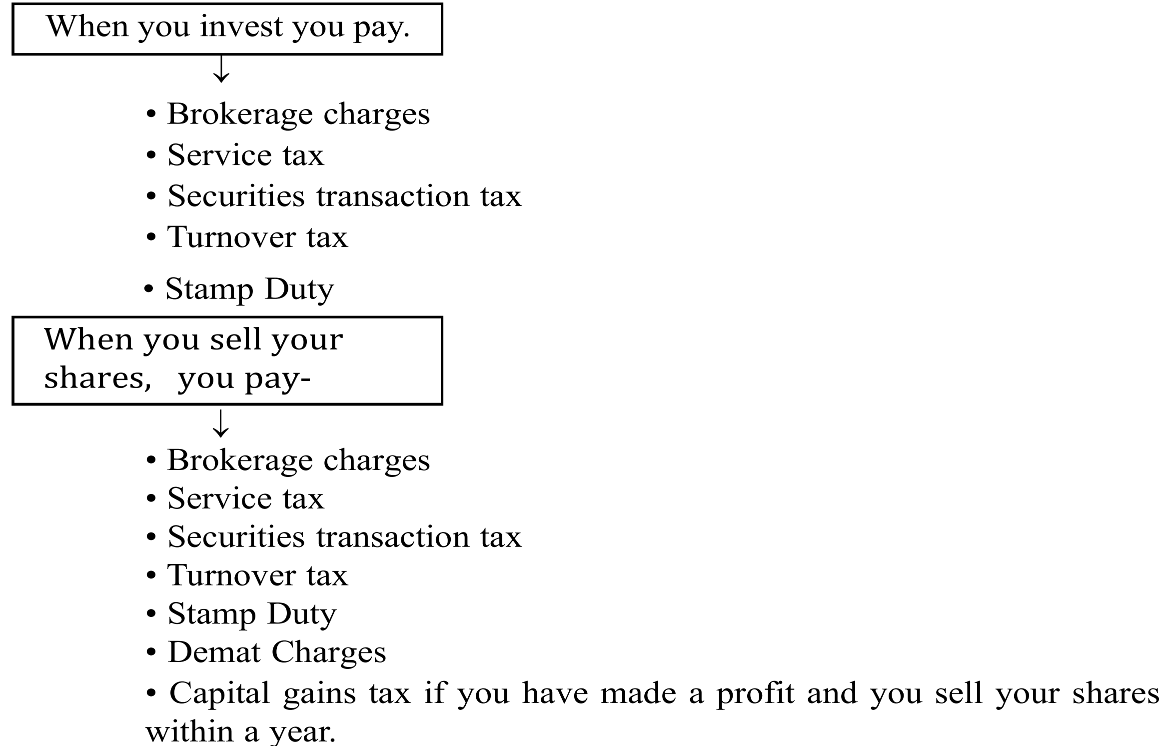
Having understood the many facets of equity investments, we now come to the important question: How are these on the wallet?

Transaction charges in equity investments vary from broker to broker. Brokers offer various schemes for different types of investors/traders. Frequent and high value investors/traders may offer lower rates.

Further, it must be borne in mind that these are transaction charges and are levied when you buy or sell and not taxes which you have to pay when you earn a profit. Hence, even in the event of losses, you will have to pay these charges which effectively increase your losses. There are two stages where costs are involved, one at the time when investor invests and other when investor sells. This can be

clear from the following flow chart.

Cost of Equity Investments



What are 'Transaction Costs?'

Transaction costs are expenses incurred while buying or selling a good or service. Transaction costs represent the labor required to bring a good or service to market, giving rise to entire industries dedicated to facilitating exchanges. In a financial sense, transaction costs include brokers' commissions and spreads, which are the differences between the price the dealer paid for a security and the price the buyer pays.

Transection cost can be classified in two categories depicted in table 1.

(Table 1: Types of transection cost)

Stamp Duty:

Stamp duty on broker contract notes is levied at 0.01 percent of the transaction value. It is levied on purchase as well as on sale transactions.

Brokerage and Commission:

Your broker charges a commission based fee for all transactions of purchase as well as sale of shares. Increased competition has drastically reduced brokerage fees over the years. Typically, retail customers incur a brokerage of 0.25 per cent to0.50 percent of the transaction value. Hence, if you ask your broker to

Explicit cost	Implicit cost
Explicit costs are tangible and observable. They can be easily measurable and are borne by investors These indirect explicit transection cost encompass on capital costs related to operational and credit risks.	**Implicit costs are intangible in nature. These cost cannot be known in advance because they are included in the trade price. These Implicit costs are related to components, spread and market impact.**
Explicit cost are ❖ **Stamp duty** ❖ **Brokerage and Commission** ❖ **Service tax** ❖ **Custody charges**	**Implicit costs are** ❖ **Bid ask spreads** ❖ **Realized spreads** ❖ **Opportunity cost on delayed execution**

purchase 100 shares of Reliance Industries @ Rs 2000/ share and your brokerage charge is 0.50 per cent, then the brokerage cost will be Rs 10 per share (0.50 per cent of Rs 2000) and your cost of shares would increase from Rs 2000 to Rs 2010 per share (other charges explained below are not considered).

Brokerage rates could be lower if you do not buy and sell for delivery and square off the transaction on the same day (intra-day), For instance, if you buy 100 shares of Reliance Industries and sell them on the same day itself, then you may incur a brokerage of 0.03 per cent to 0.05 per cent. Continuing the above example of 100 shares of Reliance bought at Rs 1700 per share and assuming intra-day brokerage of 0.05 per cent, the brokerage at the time of purchase could be Rs 0.85 per share (0.05 per cent of Rs 1700). Similarly, 0.05% could be payable on the sale price when you sell the shares on the same day.

Service Tax:

Brokerage commission is now subject to service tax which a broker will charge you and pay to the government. The current service tax rate (exclusive of surcharge and education cess) is 10 per cent which is charged on the brokerage (not on the transaction amount).

Demat Account:

Like different brokers have different brokerage structures, different Depository Participants (DPs) charge different fees for rendering depository services. You should thoroughly understand the charge structure and confirm the same with your DP before signing the agreement for opening a Demat account. There are no account opening charges (except statutory charges). No Demat charges are levied for

purchase (credit) of shares. The Demat charges generally charged by the DPs to the investors are for yearly account maintenance, Demat of physical share certificates and transaction charges for sale (debit).

Securities Transaction Tax (STT):

Buying and selling of shares is also subjected to Securities Transaction Tax (STT). SIT would be applicable whenever a buy or sell transaction is executed on a recognized stock exchange, like NSE or BSE. Hence, off market transactions such as "Open Offers': "Buy back of shares'; etc. are exempt from STT.

STT was introduced in 2004 as against the then prevailing higher capital gains taxes (explained later). While capital gains are levied on gains, STT is a transaction based charge which is levied on the transaction value, whether it converts into a profit or loss.

Individuals, whose income from share transactions is treated as business income (i.e., traders, as opposed to investors) can claim a rebate for the STT paid by them on such share transactions. The condition is that the total STT amount refundable should not exceed the tax payable amount on earnings out of share transactions.

The rate at which STT is presently levied on different transactions is depicted in the table2 below:

Product	**Transaction**	**STT Rate**	**Charged on**
Equity-Delivery	Purchase	0.125%	Turnover
	Sell	0.125%	Turnover
Equity-Intraday	Purchase	-	-
	Sell	0.025%	Turnover
Future	Purchase	-	-
	Sell	0.017%	Turnover
Option	Purchase	0.125%	Settlement price, on exerci se
	Sell	0.17%	Premium

(Table 2: STT rate on different transection)

STT of 0.25% is charged by the AMC at redemption of units to the seller of the units only on equity schemes.

Turnover Tax:

At present, the turnover tax on cash market transactions is0.0042 percent of the transaction value. It is levied on purchase and sale transactions. On futures and options transactions the rate is 0.0052 percent.

Capital Gains:

Gains from shares held for more than one year and on which SIT is paid on sale are considered Long-term capital gains and completely exempted from tax. Gains from shares held for less than one year and on which STT is paid on sale are considered Short -term capital gains and taxed @ 15 per cent (plus surcharge and education cess).

Impact Cost:

It is the cost that a buyer or seller of stocks incurs while executing a transaction due to the prevailing liquidity condition on the counter. In other words, it represents the cost of executing a transaction of a given security, with a specific predefined order size, at any given point in time.

It is a realistic measure of liquidity of the stock or security and is deemed to be closer to the true cost of execution faced by a trader in comparison to the bid-ask spread (difference between the best buy and the best sell orders). It is the percentage markup observed while buying or selling a desired quantity of shares with reference to its ideal price.

The ideal price can be illustrated by an example.

Suppose a buyer wants to purchase 300 shares of, say, AAA. If the best buy order for 100 shares is placed at Rs 237 and the best sell order for 150 shares is placed at Rs 239, the ideal price for the deal should be:

(239+237)/2 = Rs 238

At this price, one can expect the buyer to ideally get the desired quantity of AAA shares.

But suppose that the buyer was able to buy 300AAA shares at an average cost of Rs 239.67

Average cost: [(150x 239) + (100 x 240) + (50 x 241)]/300

Or (35850+ 24000+ 12050)/300 = 239.67

The impact cost, therefore, would be 0.70 per cent. To find the impact cost, the formula is:

(Actual cost - ideal cost)/ideal cost*100 (#)

In our example, the ideal price is Rs 238, but the average acquisition price for that buyer is Rs 239.67.

By formula (#), the impact cost should thus be:

(239.67 - 238)/239.67*100 = 0.70

This is a cost that the buyers incur due to lack of market liquidity. The importance of impact cost can be judged from the fact that it is one of the criteria to select a stock for inclusion in the NSE's benchmark index Nifty50.

For a stock to qualify for possible inclusion into Nifty50, it has to have traded at an average impact cost of 0.50 per cent or less during the last six months for 90 per cent of the observations for a basket size of Rs 2 crore.

It must be noted that impact cost does vary for different transaction sizes. It is dynamic in nature and depends on the outstanding orders. Lastly, a penal impact cost is applicable if a stock is not sufficiently liquid.

Hedge Fund:

Hedge fund is a private investment partnership and funds pool that uses varied and complex proprietary strategies and invests or trades in complex products, including listed and unlisted derivatives. Put simply, a hedge fund is a pool of money that takes both short and long positions, buys and sells equities, initiates arbitrage, and trades bonds, currencies, convertible securities, commodities and derivative products to generate returns at reduced risk. As the name suggests, the fund tries to hedge risks to investor's capital against market volatility by employing alternative investment approaches. Description: Hedge fund investors typically include high net worth individuals (HNIs) and families, endowments and pension funds, insurance companies, and banks. These funds work either as private investment partnerships or offshore investment corporations. They are not required to be registered with the securities markets regulator and are not subject to the reporting requirements, including periodic disclosure of NAVs. There are many strategies a hedge fund may use to generate returns. One such strategy is global macros, where the fund takes long and short positions in large financial markets based on the views influenced by economic trends. Then there are funds that work on market-neutral strategies. Here, the goal of the fund manager is to minimize market risks by investing in long/short equity funds, convertible bonds, arbitrage funds, and fixed income products. Another type includes event-driven funds that invest in stocks to take advantage of price movements generated by corporate events. Merger arbitrage funds and distressed asset funds fall into this category. As of June 30, 2014, there were 158 alternative investment funds (pooled-in investment vehicles for private equity, real estate, and hedge funds). Some examples of hedge funds include names like Munoth Hedge Fund, Forefront Alternative Investment Trust, Quant First Alternative Investment Trust and IIFL Opportunities Fund. There are others such as Singlar India Opportunities Trust, Motilal Oswal's offshore hedge fund and India Zen Fund. The minimum ticket size for investors putting money in

these hedge funds is Rs. 1 crore. According to Eureka hedge India Hedge Fund Index, which tracks hedge funds in India, the category generated 5.07 per cent return in 2015 compared to 38.84 per cent logged in 2014.

Implied Volatility:

In the world of option trading, implied volatility signals the expected gyrations in an options contract over its lifetime. Investors and traders use it to determine option pricing. Many experts in derivatives trading look at this indicator as a more important tool than time value of an option for pricing a contract. Implied volatility alerts an investor of the possibility of uneven changes in the price of the underlying security, as it is dependent on demand and supply of a particular option contract as well as expectation of the direction of share price. Description: Implied volatility helps investors gauge future market volatility. It has a positive correlation with the expectation of stock price and is one of the six parameters used to determine the price of an option. If investors believe the price of a stock will rise in the future, then implied volatility will rise, whereas if they expect the price to fall, then implied volatility will decline. How does implied volatility affect the price of an option? Lower implied volatility means the price of an option will fall. The time value of an option, talked about earlier, hence becomes cheaper or expensive depending on the fall or rise in implied volatility. The formula for the calculation of Implied Volatility is as follow: s˜2pT---v.C/S wherein,

s= Implied volatility

T= Duration of the option contract

C= Call price of the option contract

S= Strike price of the contract

The term is of great importance to traders and investors, as the success of their trade can be greatly increased depending on whether they are on the right side of the volatility. Short-dated options have lower sensitivity to implied volatility whereas long-dated options have higher sensitivity to it as the time value is priced into such option in a higher quantity.

To Sum-up

- The transaction rate of investing in equities varies from one brokerage house to another.
- High-volume traders and high net worth individuals may get lower rates.
- Transaction charges are irrespective of the taxes paid on making a profit. They are charged even in case of a loss.
- Retail customers incur a brokerage of 0.25% to 0.50% of the transaction value.

- Brokerage rates could be lower if you do not buy and sell for delivery and square off the transaction on the same day.
- Brokerage commission is subject to a service tax of 10% (plus surcharge and education cess) which is charged on the brokerage amount.
- Securities Transaction Tax is applicable on every transaction made on the stock exchange.
- Different Depository Participants charge different fees for opening and operating Demat accounts. The Demat charges are for yearly account maintenance, Demat of physical share certificates and transaction
- Charges for sale (debit).
- The turnover tax on cash market transactions is 0.0042% of the transaction value
- Stamp duty on broker contract notes is levied at 0.01% of the transaction value
- If gains accrue from shares held for less than a year and you pay STT on the sale, the gains are considered short-term capital gains and taxed at a 15% rate (plus surcharge and education cess).

Reference

Kanan (2011), Stock Market Investing Network 18 publication.

Modigliani, F.; Miller, M. (1958). "The Cost of Capital, Corporation Finance and the Theory of Investment". American Economic Review. American Economic Association.

Rosenbaum, Joshua; Joshua Pearl (2009). Investment Banking: Valuation, Leveraged Buyouts, and Mergers & Acquisitions. Hoboken, NJ: John Wiley & Sons.

Yee, Kenton K. (2000). "Aggregation, Dividend Irrelevancy, and Earnings-Value Relations". Contemporary Accounting Research

www.Algotradingindia.in

http://economictimes.indiatimes.com

www.sebi.gov.in

www.investopedia.in