The Speculative Nature of Stock Market

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ABSTRACT

This paper focuses on the speculative nature of the stock market in Romania, emphasizing the basic rules and risks associated with stock transactions. On the one hand, the speculative nature may be considered as a mandatory feature of the stock market, for the purposes of supporting a fair and efficient functioning stock system. On the other hand, the term "speculative" can be also interpreted in a negative direction, i.e. in combination with market manipulation or market abuse. Related to this latter interpretation, the study refers to European legislation on market abuse, accepted market practices and those that constitute market manipulation.

KEYWORDS: *capital market, market abuse, market manipulation, risk, speculation, stock market.*

JEL CLASSIFICATION: *K22*

INTRODUCTION

Capital market consists of two major components: the primary market and the secondary market. In the following we will focus on secondary market, which is a market for previously issued securities, namely those issued and put into circulation on the primary market. The secondary market consists also of two parts - the stock market and over-the-counter market, giving securities holders the possibility of their recovery before producing income (dividends or interest) and also the possibility of negotiation and conversion into cash, depending on supply and demand, thereby certifying that those securities have a certain value. This can be considered an absolute market, if we relate to the supply and demand free adjustment mode, reflecting both the need for capital and the state economy. Thereby, this market ensures the capital mobility and the negotiability of the securities passed through the primary market. The main objective is to obtain a higher profit in a short time. The instrument that maintains this profit is the stock exchange price, which represents the price of securities determined after negotiation and has the role to maximize the profitability of shares and bonds, having also a specific role in decreasing the risk of any securities. Both trends relate to dividends or interest at the end of the financial year. The fundamental problem of secondary capital market activity is, therefore, price formation (rate) of the securities as a result of negotiations, that can be very different from the nominal value. The level and rate evolution depend on many factors that influence the relationship between the demand and supply of securities, including: dynamics of prices (inflation phenomenon), the average interest rate on money market, economic and financial results, issuer's economic prospects, national and international economic conjuncture and

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also psychological behavior of participants. One of the secondary capital market segments is the stock market, which is becoming the key to success for most investors, which are attracted by the speculative nature of transactions in this market. This quality of stock exchange trades, which for the less informed investors could be a real disadvantage, may result in some significant gains from exchange differences of securities, or contrary to substantial losses. By its nature, the stock market has already earned a good economic reputation, considering the results obtained through induced effects in the economy (economic growth), representing an opportunity which deserves to be exploited.

1. THE PURPOSE OF STOCK EXCHANGE TRADES. SPECULATION ROLE

The main operations performed on the stock market have a predominantly speculative nature and are classified in two groups: spot trading and forward trading.

Spot transactions, which are also known as "cash transactions", consist in the exchange of securities for certain sums of money at the existing stock exchange price in the day of the transaction, accepted by participants at the time (Botezatu, 2008). These transactions are characterized by the fact that the person who put the purchase or sale order undertakes to immediately (or during normal liquidation) provide the other partner the sold securities or the amount of money representing the transaction price. Thus, an investor can buy securities, if he can pay the same day (or days) their full value. A customer who sells "cash" must deliver the contracted securities at same time, receiving their value in his account open at the stock company (entity broker). Usually, these operations are carried out with the intent to change the portfolio structure or for processing the financial assets held in cash. Also, it can have speculative purposes when multiple transactions are performed on various markets, where securities are quoted differently, resulting in a gain from the price difference for the benefit of operators (spreading operations).

Forward trading, or transactions known as "futures", are characterized by the fact that the participants undertake to meet their obligations over a certain period from the date of the transaction, but the price is determined when the transaction is completed. Forward transactions are essentially speculative, as the main objective of operators is not the actual receipt or delivery of securities, but obtaining a profit through a favorable course difference, between the day of its conclusion and the one of its maturity (Anghelache, 2009).

As a tool for seizing investment opportunities, speculation plays a crucial role in achieving a balance between financial market actors. Hedge funds are designed to seize market imbalances, to adjust interest rates or exchange rates. The stock market recognizes speculation as a prerequisite for proper functioning. The ultimate goal is placement of stock exchange trades in securities, divided into four categories: simple investments, securities arbitrage, hedging transactions (hedging) and stock exchange speculations.

Simple investments means the investing of available capital (of individuals or firms) on stock markets, by purchasing or selling securities. These securities are represented by variable-income securities (shares), fixed income securities (bonds) and other stock products. Such investments are made in order to get income in the form of dividends or interest, or in the form of capital gains. An investor who places available capital on stock markets, is expecting to better exploit this capital, but at the same time he knows that these investments are subject to a specific risk, which is usually greater the more profitable the investment is. The main way to reduce that risk is diversification. Therefore, a balanced investor will place his funds in more securities, not just one, thus compensating the losses caused by certain securities with income derived from others. Therefore, the investor will build an effective and balanced portfolio of securities, in compliance with certain basic principles, among which we mention the detailed analysis of the securities portfolio, the constant surveillance and a better information on stock market development (George, 1989).

The securities arbitration aims achieving gains through a series of investments, namely through a purchase of securities in a market where the stock rate is lower, followed by simultaneous or immediate sale in another market where the value higher. Arbitration is considered to be without risk, so investors may be satisfied with minor gains. Unlike speculation, arbitration is based on stock rates of already known securities and not on estimates, so it may not be completed otherwise than with a profit. Arbitration should not only be confined to obtaining positive differences for the same securities at a time, but it must pursue the gains also from different securities arbitration and for longer periods. For example, if you notice that the overall situation of an economy tends to deteriorate, it will arbitrate shares for bonds (indexed, if we are to do with inflation). Subsequently, if the situation starts to recover, it will arbitrate shares for bonds (Angas, 1970). It is good to point that arbitration is not accessible to anyone, being intended especially for specialists in stock exchange trades or for those within the stock exchange system, who have access to informational leverages and are always kept abreast of changes in stock rates, while trading on multiple markets.

Hedging operations are those operations by which the initiator intended to cover himself from the risks of securities stock rates changes. In practice, hedging is the protection of the investor's securities in volatile market conditions and not for profit. Thus, through these hedging operations the losses are avoided, but also are the chances of obtaining a profit. Even if the hedge's purpose differs from that of the speculators, the technique is the same as in the case of speculation, where one of the partners involved in the transaction will win and the other one will lose, resulting a case where both loss and gain are transferred. In this case, at the same time with the stock sale operations at risk, the one who wants to cover speculative stock will begin trading under the same conditions, but in a reverse way. Therefore, the buyer of certain securities will become also a speculator seller for the same securities and the seller will become a speculator buyer.

Stock speculations are successive selling - buying securities operations, aiming for profit from stock exchange rates differences. The underlying principle is that of any stock speculation business: buy low and sell high. What characterizes stock speculations are the profits seeked by the speculator and the risk he assumes knowingly. This risk derives from the fact that currency evolution can not be predicted with certainty by the speculator (Popa, 1993).

In many cases, differentiation between simple investments and speculation is difficult, although the objectives are different. By simple investments we seek obtaining income and investment security. However, a simple investment, by which were purchased securities to be stored, will become a speculation if these securities are quickly sold for profit. The same happens in the reverse case, as stated George Soros - the great speculator and financial expert: "an unsuccessful speculation becomes an investment." Several types of speculators are encountered: those who speculate rate fluctuations towards the average rate for a certain period, those who speculate rate changes from one day to another, long-term speculators, who aim the rate changes recorded for longer periods of time (months, years) permanent speculators (Dragoescu, 1995). The objective of any speculator is to maximize profit on the stock exchange of any completed transaction, knowing and expecting for this to happen as a result of the risk he assumes. From this point of view, the speculator will be ready at any time to "get rid" of any securities that he personally has no confidence, seeking to place them to less savvy investors.

In practice, there are two main types of speculation, depending on the stock rate evolution:

- Speculation “on drop” - the case of a speculator who suppose the stock rate will decrease and therefore will give an order to sell “futures”. If its predictions are confirmed (the rate will drop), till the maturity of the contract he will acquire securities through a spot operation (in the due date) and will give it to the buyer. In this way, the speculator earns the difference between the two stock rates (he sold high and bought low) and is considered a speculator “á la baisse”;
- Speculation “on growth” – the case of speculator who suppose the stock rate wil increase and therefore will give an order to buy “futures”. In the event that rate will grow, till the maturity of the contract he will acquire securities at the previously established rate and will make a spot sale in (in the due date). Thus, the speculator will earn the price difference, and because he bought low and sold high, is considered a speculator “á la hausse”.

As a conclusion, the one that has the ability to predict the evolution of stock exchange rate will win, while the other will lose. The existence of well informed speculators is a benefit for stock markets, as their operations attenuate stock exchange oscillations and therefore the investors who are interested in investments or sales are more easily able to find a counterparty. It is a fact that stock market speculation is necessary and, contrary to appearances, it does not violate ethical rules as long as the speculator profits is not free, but is the result of the risks which he has assumed. Most times there is wrongly made a confusion between the concepts “speculator” and “gambler”. In general, the speculator is a prudent person, well informed, with a rich portfolio of knowledge in stock markets area, being centered on rational forecasts, while the "gambler" relies much on luck. By comparison, an experienced investor will use in appropriate and effective manner both elements of rational economic analysis and understanding of his behavior and of others. In this way, he will be able to affect the performance of its portfolio less than would do an inexperienced investor, who is easily influenced by recent developments in its portfolio or on the market (Obreja Braşoveanu, 2011).

In another train of thoughts, it must be also mentioned the implications of certain transactions that are intended to artificially increase or decrease rates by spreading false rumors regarding the situation of certain companies, practices which are called agiotage. This is an operation that contravenes the rules of fair practice in the stock markets. Those making use of agiotage artificially influence the rate on decrease and when it reaches the desired level low enough, they will buy and then will sell at a higher price, after they artificially raise the rate.

2. ROMANIAN STOCK MARKET

Romanian capital market is currently in a continuous growth, gradually managing to overcome the negative model of south-eastern Europe stock exchanges, which basically remain underdeveloped, with weak capitalization and limited liquidity. With such limited liquidity, market brokerage viability is problematic and market capitalization data are likely to mislead. It must be noted that stock exchanges in the Balkan area were created as privatization devices and the initial transaction was aimed to property redistribution. They remain mostly secondary markets, dedicated to these functions. In some stock exchanges, most transactions are still made in large amounts. The underdevelopment of capital markets in the countries of south-eastern Europe is mainly determined by supply problems, as the stock exchanges lack large companies with substantial free-floating. In some cases, the listed securities, resulted from privatization programs at a lower price (discount privatization), are actually residual government securities of unattractive companies. On these markets there are very few new investors, and securities are traded primarily between existing participants, which is why the stock exchanges in question are often described as the only indoor games between brokers.

Currently, the Romanian capital market has succeeded to distinguish in a positive way from the Balkan model, given the recent quality of European Union member state. However, the influence of the Balkan model over the Romanian market is still very important. As a consequence, inside such a market, stock market speculations in the classical sense has been and still are difficult, because of the lack of sufficient stock liquidity. Also, the weak development of forward market transactions and also of short-selling type did not allow the growth of this segment. Therefore, the notion of speculation has tended to receive a negative connotation and is often associated with market abuse or market manipulation. Until a few years ago, the most common stock market speculation had its source in the foundation of Romanian securities market establishment, namely the privatization process. On an inefficient market, where companies are rarely listed at their true value, those who have accumulated stocks of capital markets and managed to take or to impose their control in various listed companies, may be considered market speculators. The cornerstone of the establishment of capital market was the Mass Privatization Program, which was a way of accelerating the transfer of state property to private property.

In the last years, the Romanian capital market managed to grow and reach a sufficient size to allow the emergence of other speculative activities. On the background of macroeconomic stability and growth-oriented, which was shaded only by the international financial crisis (beginning with 2007-2008) that occurred gradually in Romania, indicators and indexes have seen major increases and have confirmed the strategic objectives of the Bucharest Stock Exchange. Firstly, the Romanian market has started to develop in correlation with the other markets in the central European region, which created the possibility of obtaining immediate profit by looking at developments in emerging markets with attractive liquidity. This type of speculation is mainly intended for institutional investors, those who have the resources and opportunity to study the development of these markets. As the market trend in the region tends to a synchronized one, those who speculate the inertia correlations of the stock exchanges indices can often record significant profits.

For small and medium investors appeared new possibilities of speculation, along with the increase of stock market liquidity. Among the most common speculation opportunities are companies corporate operations, announcement of financial results and especially the new listings on the exchange rate. The main issue raised by speculative operations is related to assessing the true value of a stock asset and because of that speculation often require rapid decisions under conditions of significant change to the information from a financial standpoint. In this context, recent decades have strengthened several models of stock price valuation, which are vital for making the investment decision. In this direction, we can identify issuers, such as some major companies, for which can be verified the hypothesis of a market with greater efficiency compared with the other firms in that market. Such companies have large and good profitability, strong reputation and market position, being always in the attention of analysts, investors and speculators.

Choosing a type of investment from the multitude of options is related to the estimation of return and risk associated with that asset, and investment decision is a direct result of these estimates. In terms of investment objectives, we are dealing with two distinct models of groups, namely investors and speculators. The first have a medium term investment horizon and start from the idea that on the market can be found undervalued securities, but with high attractivity (can generate constant and consistent income), while speculators rather seek a short term retention rather, followed by trading in order to make a profit.

Related to potential risks, in any stock market we can find two main types of risk: systematic risk and individual risk (unsystematic). Systematic risk or market risk covers the entire capital market and is linked with economic and political influences which have an objective influence within an economy. The changes in the economy, inflation, monetary and fiscal reforms are systematic factors affecting the overall market. In this category we have different types of risk – political risk, currency risk and double taxation risk.

Individually or unsystematic risk is specific to particular areas of activity. This risk is specific for each placement, the more for each share, bond or option. Individual risk can be reduced by making different investments.

3. MARKET ABUSE AND MARKET MANIPULATION

With regard to European regulation of these concepts, the Committee of European Securities Regulators (CESR) issued a first guide: Market Abuse Directive Level 3 **-** second set of CESR Guidance and information on the common operation of the Directive to the market. This guide concerns the accepted market practices laid down in Directive 2003/6/EC (hereinafter called "Directive"), in relation to market manipulation and the indications about what CESR members consider to be market manipulation and reporting guidelines for suspicious transactions to a common format. Currently, investors confidence towards the Romanian stock market is still reduced and untrusted markets are destined to fail. This is because, in many cases, under the speculation concept were hidden operations at the limit of legality, aimed at attracting investors to invest too risky and that ultimately proved unfavorable. Based on accumulated rich experience in the field, developed markets issued a set of rules for listed issuers management, providing a solid coverage against speculative activities that could mislead investors, thereby protecting their funds and keeping a positive nature of these speculative operations. Therefore, the idea of market abuse is still actual for the development of Romanian market, especially when viewed in terms of European Union membership, whose law and experience in the field of economics could be of great benefit to Romanian capital market.

Preamble 20 of the Directive states that " a person who enters into transactions or issues orders to trade which are constitutive of market manipulation may be able to establish that his reasons for entering into such transactions or issuing orders to trade were legitimate and that the transactions and orders to trade were in conformity with accepted practice on the regulated market concerned.

Article 1 (5) of the Directive defines market practices as "practices that are reasonably expected in one or more financial markets and are accepted by the competent authority in accordance with guidelines adopted by the Commission..." It should be noted that accepted market practices are not safe practices similar to those provided in art. 7 and 8 of the Directive, which deal with shares in “buy-back” programmes and stabilisation of financial instrument. The purpose of introducing "the concept of accepted market practices' is to avoid penalizing operations which would constitute market manipulation, under the definition of article 1.2 (a) of the Directive, taking into account that in certain conditions such operations may be justified. To qualify for this provision, in addition to the transaction / order to trade must be in accordance with accepted market practices, the person who started the transaction or issued the order to trade must prove that the reasons for so doing are legitimate. In the absence of a legitimate aim, accepted market practice is not valid. According to Directive 2003/6/EC, market manipulation can be translated into: false or misleading transactions, artificial price manipulation and the use of fictitious transactions. The normal functioning of the capital market and especially of the stock exchanges, as well as avoiding market abuse (whatever form it might have), constitute great problems for the actors of this market and for the enterprises/companies behind financial transactions, as it influences the real economy with chain reactions, having all kinds of negative and positive effects.

CONCLUSIONS

Having as example the experience of more developed European markets, and at the same time a clear growth potential of active investors and number of listed issuers, the Romanian capital market can hope to fulfill the main desire, namely to reach a reference market in the central and eastern European region.

With the acquirement of new status member of European Union, this goal seems to be strengthened through the establishment of the real growth bases. Although still present on some segments, a gap sometimes obvious to the markets of the central European region, the Romanian market begins to attract attention by sustained growth rates and the extraordinary latent potential that is hidden.

In this process it was observed the existence of a possibility to achieve speculations that have systematically developed, so that they now constitute a growing segment in the capital market transactions. As a result, the interest that any trader awards speculation activities is becoming increasingly higher, if we have in mind that the existence of stock speculation, a constituent part of any stock market, is vital to maintain the market efficiency and proper functioning. Although the importance of the speculative nature of the stock market cannot be disputed, there is still more critical perspectives on the more or less ethical purpose of speculation, which for some represent a firmly rooted normality and for others a departure from the real economy and social/moral values (enrichment without reason), as they are known at the conceptual level. However, speculation must be a supported and regulated activity, so that long-term effects of this kind of operations do not affect the integrity of the market and carrying out its functions.

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