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Suneel Maheshwari * and Deepak Raghava Naik

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Article

From FII Dependence to DII Dominance: Behavioral Dynamics and Minskyan Risk in India's Stock Market

Suneel Maheshwari [1,*] and Deepak Raghava Naik

[1] Department of Accounting and Information Systems, Indiana University of Pennsylvania, Indiana, PA

[2] Department of Management Studies, Ramaiah Institute of Technology, Bangalore, India

* Correspondence: Suneel@iup.edu

Abstract

This study examines how market leadership in Indian equities has structurally shifted away from Foreign Institutional Investors (FIIs) toward Domestic Institutional Investors (DIIs) and Mutual Funds (MFs), and evaluates the systemic risks created by this rebalancing. Using monthly transaction data from April 2007 to January 2026, we analyze evolving investment patterns among FIIs, DIIs, and MFs through trend analysis, Pearson and Spearman correlations, and phase decomposition. Since 2021, FIIs have recorded cumulative net outflows exceeding ₹8.68 lakh crore (US$ 95.36 billion), while DIIs—led by Mutual Funds financed largely through Systematic Investment Plans (SIPs)—have made net purchases of over ₹19.37 lakh crore (US $212.67 billion) , effectively absorbing FII selling and helping to maintain elevated index levels. The SENSEX remained above 80,000 points through 2025 despite persistent FII disengagement. We find that DII flows are positively and significantly correlated with SENSEX levels ($r = 0.686$, $p < 0.001$), whereas FII flows are significantly negatively correlated ($r = -0.365$, $p < 0.001$). The DII share of total market purchases increased from roughly 39% in 2017 to more than 54% by January 2026, highlighting a growing structural reliance of Indian equity markets on domestic liquidity. Drawing on Minsky's financial instability hypothesis and behavioral finance perspectives, we argue that prolonged, sentiment-driven domestic absorption of FII exits, in the absence of corresponding gains in corporate fundamentals or earnings, represents an emerging source of systemic vulnerability, with important implications for retail investors, fund managers, and regulators.

Keywords: foreign institutional investors; domestic institutional investors; mutual funds; Indian stock market; BSE SENSEX; bubble risk; SIP; minsky hypothesis; market stability

1. Introduction

The Indian capital market has undergone a profound structural transformation over the past two decades (Chakrabarti, R., 2001; Mukherjee & Coondoo, D., 2002; Patel, S., & Vaidya, R., 2018). From a market historically sensitive to the fluctuations in Foreign Institutional Investors (FIIs) now formally reclassified as Foreign Portfolio Investors (FPIs), the Indian equity market has evolved into one predominantly influenced by domestic institutional investors (DIIs), primarily mutual funds (MFs) and insurance companies (Dhingra et.al., 2016; G., Suresh & Kok Loang, Ooi., 2024; Malik et.al., 2025; Rao, K. S., & Mishra, P., 2019). While this shift reflects greater market depth and financial inclusion, it introduces latent risks that have received insufficient attention in the academic literature (Kok Loang, Ooi., 2024; Mahapatra, M. S., & Mishra, R., 2020). A growing body of popular commentary and practitioner analysis has observed that FIIs have been systematically divesting Indian equities since 2021, yet the SENSEX—India's flagship equity benchmark has continued to hover near historic highs. The year 2022 saw FII net outflows of approximately ₹2.78 lakh crore (US $ 30.54 billion), followed by ₹3.04 lakh crore (US $ 33.40 billion) in 2024 and ₹3.06 lakh crore (US $

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33.60 billion) in 2025. Paradoxically, the SENSEX crossed 85,000 points in November 2025. This apparent contradiction, we argue, is the product of sustained and accelerating DII and Mutual Fund inflows, increasingly funded by the retail investor ecosystem through the SIP mechanism(Ki-Hong & Seong-Min., 2020; Babajide, & Adetiloye., 2012; Eric et.al., 1999;).

The scale of this substitution is striking. For the period 2021 to January 2026, FII net outflows amounted to approximately ₹10.38 lakh crore (US $ 113.96 billion), while DII net inflows stood at ₹19.37 lakh crore (US $ 212.67 billion) and Mutual Fund equity net inflows aggregated ₹13.55 lakh crore (US $ 148.77 billion). In essence, domestic institutions have not merely offset FII selling; they have exceeded it by a ratio of nearly 1.9:1, actively inflating valuations beyond what cross-border capital alone might justify.

This paper investigates whether the structural reliance on domestic liquidity particularly retail-driven SIP inflows to sustain elevated market valuations constitutes an emerging asset price bubble. We draw on Minsky's (1978; 1986; 1992) financial instability hypothesis, which posits that prolonged periods of stability and rising asset prices generate the very conditions for financial fragility, and on behavioral finance literature on herding and sentiment-driven investment(Pertiwi, T et.al., 2019; Lu & Li., 2023; Hwang, S., & Salmon, M., 2004; Gavrilakis, N., & Floros, C., 2021). Our analysis utilizes monthly data from April 2007 to January 2026, including the Global Financial Crisis (GFC) of 2008, the COVID-19 shock of 2020, and the post-COVID taper tantrum of 2021–2022.

The remainder of the paper is structured as follows: Section 2 reviews the relevant literature; Section 3 describes the data and methodology; Section 4 presents empirical findings; Section 5 discusses implications and risks; and Section 6 concludes with policy recommendations.

2. Literature Review

The relationship between foreign institutional flows and equity market performance in emerging economies has been extensively studied (Feng et.al., 2020). Bae, Chan, and Ng (2004) demonstrate that foreign investors tend to be momentum traders, buying into rising markets and exiting during corrections, amplifying volatility in host markets. In the Indian context, Gordon and Gupta (2003) established that FII inflows are significant positive predictors of SENSEX returns, a finding corroborated by Mukherjee, Bose, and Coondoo (2002) who employed Granger causality analysis to show bidirectional causality between FII flows and equity indices.

Chakrabarti (2001) noted that FII flows are primarily return-chasing rather than fundamentals-driven in India, making domestic markets vulnerable to abrupt reversals. More recent work by Dhingra, Gandhi, and Bulsara (2016) confirms that while FII flows are positively correlated with market returns over shorter horizons, they introduce significant tail risk during global risk-off episodes. The growing literature on DII countercyclicality—wherein domestic institutions absorb FII selling—has been documented by Patel and Vaidya (2018), who find that DII purchases systematically increase when FII net selling intensifies, suggesting a stabilising role.

The democratisation of Indian equity investing through the Systematic Investment Plan (SIP) mechanism represents one of the most significant structural shifts in the market's history. AMFI data indicate that monthly SIP contributions crossed ₹25,000 crore (US $ 2.75 billion) in 2024–25, with over 90 million active SIP accounts. Rao and Mishra (2019) find that SIP-driven inflows exhibit lower sensitivity to short-term market volatility compared to lump-sum equity investments, creating a relatively stable, recurring demand for equity assets.

However, this stability may carry a Minsky-type paradox. As Kindleberger and Aliber (2005) elaborated upon Minsky's framework, the more stable a market appears—supported by steady inflows—the more investors and institutions take on risk, amplifying potential future instability. The SIP narrative, reinforced by distributor networks and favourable regulatory messaging, may be creating a 'new normal' expectation among retail investors that equity markets offer risk-adjusted returns superior to other asset classes, irrespective of valuation levels.

The theoretical foundation for identifying asset price bubbles rests on the divergence between intrinsic value and market price. Shiller (2000) advanced the concept of irrational exuberance, noting

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that sustained price appreciation unsupported by earnings growth creates conditions for eventual violent mean reversion. In the Indian context, the cyclically adjusted price-to-earnings (CAPE) ratio and the market capitalisation-to-GDP ratio (Buffett Indicator) have been frequently cited by analysts to argue that Indian equities are structurally overvalued.

Brunnermeier (2008) notes that bubbles are characterised by three features: unsustainable price trajectories, concentration of leverage or liquidity risk in particular agent types, and narrative-driven investor behaviour. In the current Indian context, all three elements are present to varying degrees. The SENSEX has more than doubled since 2020 lows without commensurate earnings growth (Da et.al., 2015). Domestic retail investors are increasingly leveraged via derivatives and margin financing and the narrative that mutual funds are right investment has become deeply embedded in investor consciousness(Dantas & Oliveira., 2018; Goodell., 2020; Urquhart & Mcgroarty ., 2016).

The BSE Low Volatility Index, which tracks stocks with the lowest price volatility, offers an additional lens for understanding market risk perception. Ang, Hodrick, Xing, and Zhang (2006) document the low volatility anomaly, wherein low-volatility stocks outperform high-volatility ones on a risk-adjusted basis. However, Baker, Bradley, and Wurgler (2011) caution that this anomaly can be attributed to benchmark constraints and investor sentiment, and may reverse sharply during liquidity crises. The convergence of low-volatility index performance with SENSEX performance (correlation = 0.993 in our sample) may signal that market-wide volatility suppression—potentially engineered by sustained DII buying—is masking underlying fundamental risk.

3. DATA AND METHODOLOGY

3.1 Data Sources and Description

This study utilizes monthly data from April 2007 to January 2026, comprising 226 observations across five datasets obtained from the Securities and Exchange Board of India (SEBI), BSE India, and the Association of Mutual Funds in India (AMFI).

The datasets include:

- (i) FII/FPI transaction data: Gross purchases, gross sales, and net purchases/sales in Indian equity markets (in ₹ crore).
- (ii) DII transaction data: Corresponding metrics for gross purchases, gross sales, and net purchases/sales.
- (iii) Mutual fund investments in equity and debt: MF-specific equity and debt transactions, available from November 2001 for extended historical context.
- (iv) BSE SENSEX monthly OHLC data: From January 2007 to February 2026.
- (v) BSE Low Volatility Index monthly closing values: From December 2015 to January 2026 (123 observations).

3.2. Analytical Framework

We employ a multi-method approach encompassing: (a) Descriptive trend analysis with phase decomposition; (b) Pearson and Spearman rank correlation to assess the relationship between institutional flows and market levels; (c) Structural shift analysis demarcating key inflection points in FII–DII flow dynamics; (d) Crisis episode analysis examining four distinct stress periods; and (e) Risk identification through Minsky-framework overlay.

3.2.1. Trend Analysis and Phase Decomposition

A linear time-trend regression is estimated for the SENSEX closing index to characterise the long-run appreciation trajectory:

$$S_t = \alpha + \beta t + \varepsilon_t \text{ ----------(1)}$$

where S_t denotes the SENSEX closing value in month t, t is a time index (t = 1, 2, …, T), α is the intercept, β is the estimated monthly appreciation (slope), and ε_t is the error term. The coefficient β is

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estimated by Ordinary Least Squares (OLS). The coefficient of determination R^2 is reported to assess the explanatory power of the linear trend.

The full sample is subsequently partitioned into five phases based on structural breaks in net FII flow direction, DII dominance emergence, and macroeconomic context:

The full analytical period (April 2007–January 2026) is subdivided into five distinct phases based on dominant flow characteristics: Phase I (2007–2012): FII dominance with cyclical DII support; Phase II (2013–2016): FII recovery and early SIP mobilisation; Phase III (2017–2020): FII outflow onset and DII countercyclicality emergence; Phase IV (2021–2023): Accelerated FII exit and DII structural absorption; Phase V (2024–January 2026): DII hegemony and bubble risk crystallisation.

3.2.2. Pearson Correlation Analysis

To assess the linear co-movement between institutional net flows and SENSEX levels, the Pearson product-moment correlation coefficient is estimated for each institutional category k (FII, DII, MF Equity) as:

$$r_{k,S} = \Sigma_{t=1}^{T} (F_{k,t} - F_k)(S_t - S) / \sqrt{[\Sigma_{t=1}^{T}(F_{k,t} - F_k)^2 \cdot \Sigma_{t=1}^{T}(S_t - S)^2]} \text{---------- (2)}$$

where $F_{k,t}$ is the net flow of institutional category k in month t, S_t is the SENSEX closing value in month t, and F_k and S are their respective sample means. Statistical significance is evaluated using the t-statistic:

$$t = r_{k,S} \sqrt{(T-2)} / \sqrt{(1 - r_{k,S}^2)} \quad \sim t_{(T-2)} \text{ ----------(3)}$$

All correlations are tested at the 1% significance level ($\alpha = 0.01$). Given the possibility of non-normality in monthly flow distributions—due to large episodic transactions and fat tails—Spearman rank correlations are computed as a robustness check.

3.2.3. Spearman Rank Correlation

The Spearman rank correlation coefficient provides a non-parametric alternative that is robust to outliers and distributional assumptions:

$$\rho_{k,S} = 1 - [6 \Sigma_{t=1}^{T} d_t^2] / [T(T^2 - 1)] \text{ ----------(4)}$$

where $d_t = \text{rank}(F_{k,t}) - \text{rank}(S_t)$ is the difference in ranks of observation t for flows and SENSEX levels respectively. Under H_0: $\varrho = 0$, the test statistic is approximately t-distributed with $(T - 2)$ degrees of freedom for large T.

Bivariate Pearson correlations are computed between FII net flows, DII net flows, MF equity net flows, and SENSEX closing values. Given potential non-normality in monthly flow data, Spearman rank correlations serve as robustness checks. All correlations are tested for statistical significance at the 1% level. A DII-to-FII absorption ratio is constructed as the ratio of absolute DII net inflows to absolute FII net outflows in each calendar year to quantify the degree of domestic substitution. The share of DII gross purchases in total institutional gross purchases is computed annually to assess structural dominance trends.

3.2.4. DII Absorption Ratio

To quantify the degree to which domestic institutions offset FII selling in a given year y, we define the DII Absorption Ratio (DAR) as:

$$DAR_y = |DII\ Net\ Inflow_y| / |FII\ Net\ Outflow_y| \text{ ---------- (5)}$$

A DAR > 1 indicates that DII inflows exceeded FII outflows in absolute terms—i.e., domestic institutions more than fully offset foreign selling and injected net additional capital into the market. A DAR < 1 indicates partial absorption. When FII flows are net positive in a given year, DAR is not

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computed for that year. For the period 2021–2025, DAR is further decomposed into a MF-specific Mutual Fund Absorption Ratio (MFAR):

$$MFAR_y = |MF\ Equity\ Net\ Inflow_y| / |FII\ Net\ Outflow_y| \quad (6)$$

3.2.5. Institutional Dominance Share

The structural shift in market composition is captured through the DII Dominance Share (DDS), defined as the proportion of total gross institutional purchases attributable to DIIs in year y:

$$DDS_y = DII\ Gross\ Purchase_y / (FII\ Gross\ Purchase_y + DII\ Gross\ Purchase_y) \times 100 \quad (7)$$

DDS captures the compositional weight of domestic capital in total market activity and is distinct from net flows, as it reflects the volume of market participation regardless of the direction of net investment. A rising DDS trend indicates increasing domestic structural control over price discovery.

3.2.6. Cumulative Flow Divergence Index

To visualise the growing structural imbalance between FII outflows and DII inflows, a Cumulative Flow Divergence Index (CFDI) is constructed for the Phase IV–V period (January 2021 onwards):

$$CFDI_t = \Sigma_{\tau=1}^{t}\ DII\ Net_\tau + \Sigma_{\tau=1}^{t}\ FII\ Net_\tau \quad (8)$$

where $\tau = 1$ corresponds to January 2021. When FII net flows are negative, their contribution to CFDI is negative, amplifying the divergence signal when DII net flows are simultaneously positive. A rising CFDI signals accelerating domestic liquidity injection; a persistently high CFDI in the context of flat or declining earnings growth is treated as a bubble risk indicator consistent with Minsky's instability hypothesis.

3.2.7. Return and Volatility Analysis: SENSEX vs. BSE Low Volatility Index

For the overlapping sample period (December 2015–January 2026), monthly log-returns are computed for both indices:

$$R_{i,t} = ln(P_{i,t}) - ln(P_{i,t-1}) \quad (9)$$

where $P_{i,t}$ is the closing value of index $i \in$ {SENSEX, Low Volatility} in month t. Annualised volatility is estimated as:

$$\sigma_i^{ann} = \sigma_i^{monthly} \times \sqrt{12} \quad (10)$$

The convergence of SENSEX and Low Volatility Index return trajectories alongside suppressed volatility in the latter is interpreted through the lens of the low-volatility anomaly literature (Ang et al., 2006; Baker et al., 2011) as a signal of artificially compressed market-wide risk perception driven by sustained DII buying activity.

3.2.8. Minsky Risk Overlay

While formal bubble detection tests (e.g., Phillips-Shi-Yu BSADF) are beyond the scope of this study, a qualitative Minsky Risk Score (MRS) is constructed for each phase using three binary criteria:

$$MRS_{phase} = C_1 + C_2 + C_3 \quad (11)$$

where: $C_1 = 1$ if DAR > 1 (domestic flows exceeding FII outflows); $C_2 = 1$ if SENSEX CAGR exceeds estimated nominal GDP growth in the same period; $C_3 = 1$ if DDS > 45% (structural domestic dominance). MRS $\in$ {0, 1, 2, 3}, with MRS = 3 signalling the highest level of Minsky-type fragility. This criterion-based approach draws on Kindleberger and Aliber's (2005) checklist methodology for

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bubble identification. Thus, each method used in the analysis and the appropriateness of the functionality and usage of data used is reflected in Table 1.

Table 1. Statistical tests used and data considered.

sl	Method	Equation(s)	Purpose	Data Used
1	Linear Trend Regression (OLS)	(1)	Characterise SENSEX long-run trajectory	SENSEX monthly close
2	Pearson Correlation	(2), (3)	Linear co-movement of flows with SENSEX	FII/DII/MF net flows, SENSEX
3	Spearman Rank Correlation	(4)	Non-parametric robustness check	FII/DII/MF net flows, SENSEX
4	DII Absorption Ratio (DAR, MFAR)	(5), (6)	Quantify domestic offset of FII exit	Annual net flows by category
5	DII Dominance Share (DDS)	(7)	Structural market composition shift	Gross purchases: FII & DII
6	Cumulative Flow Divergence Index	(8)	Measure of growing liquidity imbalance	Monthly net flows post-2021
7	Log-Return & Volatility Analysis	(9), (10)	Index risk suppression assessment	SENSEX, BSE LowVol Index
8	Minsky Risk Score (MRS)	(11)	Phase-wise systemic fragility indicator	DAR, CAGR, DDS per phase

Note: All monetary values are in Indian Rupees (₹ crore). Statistical tests employ a two-tailed 1% significance threshold.

4. Empirical Findings

4.1. Long-Run Trend Analysis

As observed in Table 2, over the full sample period, cumulative FII net flows aggregate to approximately ₹8.68 lakh crore (US $ 95.30 billion) of net outflows, while DII net inflows total approximately ₹22.23 lakh crore (US $ 244.07 billion), and MF equity net inflows aggregate to ₹16.69 lakh crore (US $ 183.24 billion). The divergence is remarkable: a market that was effectively FII-net-positive until 2016 has been DII-net-positive in every year from 2017 onwards, with the gap accelerating sharply from 2022.

The SENSEX rose from approximately 13,000 in April 2007 to over 85,700 in November 2025, representing a compound annual growth rate (CAGR) of approximately 10.6% over 18 years. However, this growth masks significant compositional heterogeneity: the period 2007–2017 was characterised by episodic FII-led rallies and corrections, whereas 2017–2026 increasingly reflects DII-sustained appreciation. The linear trend regression of SENSEX on time yields a slope of approximately 299 index points per month (R^2 = 0.86), indicating a remarkably steady upward trajectory that is inconsistent with normal cyclical market behaviour in an environment of rising global interest rates.

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Table 2. Annual Institutional Net Flows and SENSEX Performance (₹ Crore = USD 109.79 million).

Year	FII Net (₹ Cr)	DII Net (₹ Cr)	MF Equity Net (₹ Cr)	SENSEX Close (approx.)	
2008	-1,01,803	+72,967	+11,753	~9,648	
2012	+1,01,166	-55,800	-20,947	~19,427	
2015	-20,374	+67,587	+71,000	~26,118	
2017	-44,109	+90,738	+1,17,044	~34,057	
2018	-73,212	+1,09,662	+1,13,333	~35,527	
2020	+65,246	-35,663	-59,833	~47,751	
2021	-91,626	+94,846	+44,780	~58,254	
2022	-2,78,429	+2,75,726	+1,67,932	~60,840	
2023	-16,325	+1,81,482	+1,68,555	~72,241	
2024	-3,04,217	+5,27,438	+4,37,237	~78,140	
2025	-3,06,419	+7,88,184	+4,93,875	~85,221	

Source: SEBI, BSE India. Compiled by authors.

4.2. Correlation Analysis

Table 3 presents the Pearson and Spearman rank correlations between institutional net flows and SENSEX closing levels over the full sample period. The results are statistically significant at the 1% level for all pairs and reveal a striking bifurcation.

Table 3. Pearson and Spearman Correlations of Institutional Flows with SENSEX.

Variable Pair	Pearson r	p-value	Spearman ϱ	p-value
FII Net vs. SENSEX	−0.365	< 0.001	−0.208	0.002
DII Net vs. SENSEX	+0.686	< 0.001	+0.486	< 0.001
MF Equity Net vs. SENSEX	+0.705	< 0.001	+0.613	< 0.001

Source: Authors'.

The negative and significant correlation between FII net flows and SENSEX ($r = -0.365$) indicates that higher SENSEX levels are associated with net FII selling—suggesting that FIIs systematically use elevated market levels to book profits and repatriate capital. Conversely, the strong positive correlation of DII ($r = +0.686$) and MF flows ($r = +0.705$) with SENSEX confirms that DII buying intensifies as markets rise—a pro-cyclical pattern that is consistent with SIP-driven automatic monthly accumulation regardless of valuation. The Spearman correlations, being rank-based and robust to outliers, confirm the directional relationships, albeit at lower magnitudes, underscoring the non-linear nature of these dynamics.

4.3. Phase Analysis and Structural Shifts

Our five-phase decomposition reveals a structural evolution with profound risk implications.

Phase I (2007–2012) was characterised by high FII volatility—the GFC of 2008 triggered FII outflows of ₹1.02 lakh crore (US $ 11.20 billion), the largest single-year outflow at that time—partially absorbed by DII purchases of ₹72,967 crore (US $ 8.01 billion). MF equity flows were relatively modest. Crucially, the SENSEX corrected from ~21,000 to ~8,000, demonstrating that DII flows at their then-level were insufficient to prevent sharp market corrections.

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Phase II (2013–2016) saw FII recovery (cumulative net inflow of ₹2.17 lakh crore) alongside the emergence of SIP culture. The launch of 'Mutual Fund Sahi Hai' campaign in 2017 and regulatory emphasis on financial inclusion through MFs catalysed structural changes in savings behaviour.

Phase III (2017–2020) marked the inflection. FII flows turned persistently negative from 2017 (₹44,109 crore (US $ 4.84 billion) outflow) and 2018 (₹73,212 crore (US $ 8.04 billion) outflow), while MF equity net inflows in 2017 exceeded ₹1.17 lakh crore (US $ 12.85 billion)—the first year MF flows decisively overwhelmed FII outflows. The COVID year 2020 is an exception: FII returned briefly on account of global quantitative easing, while DIIs and MFs absorbed pandemic-related redemptions.

Phase IV (2021–2023) represents the critical transition to structural DII dominance. The cumulative FII net outflow over this period was ₹3.86 lakh crore (US $ 42.38 billion), while DII and MF equity collectively absorbed ₹5.52 lakh crore (US $ 60.60 billion), driving the SENSEX from ~47,000 to ~72,000. This phase coincides with aggressive US Federal Reserve rate hikes (2022–2023), which historically triggered large-scale EM outflows but were significantly cushioned by domestic flows in India.

Phase V (2024–January 2026) represents what we term DII hegemony. In 2024 alone, FII net outflows of ₹3.04 lakh crore were offset by DII net inflows of ₹5.27 lakh crore (US $ 57.86 billion) and MF equity net inflows of ₹4.37 lakh crore (US $ 47.98 billion). The DII absorption ratio—DII net inflows as a multiple of FII net outflows—reached 1.73 in 2024 and 2.57 in 2025. The DII share of total gross institutional purchases crossed 54% in 2025–26, compared to approximately 39% in 2017, as shown in Table 4.

Table 4. DII Share in Total Institutional Gross Purchases (%).

Year	DII Share (%)	Year	DII Share (%)	
2017	39.7	2022	45.4	
2018	42.7	2023	42.8	
2019	40.4	2024	45.4	
2020	38.7	2025	52.1	
2021	41.1	Jan-26	54.8	

Source: Authors.

4.4. Crisis Episode Analysis

Four stress periods are examined to assess whether domestic flows successfully supported markets and at what cost:

(1) GFC 2008–09: FII outflows of ₹1.10 lakh crore (US $ 12.08 billion); DII inflows of ₹83,411 crore (US $ 9.16 billion); SENSEX fell ~55%. Domestic absorption was insufficient. (2) COVID-19 (H1 2020): FII outflows of ₹69,662 crore (US $ 7.65 billion); DII inflows of ₹88,212 crore (US $ 9.68 billion); SENSEX fell 38% initially before recovering rapidly, aided by fiscal and monetary stimulus. (3) Post-COVID Taper 2021–22: FII outflows of ₹3.79 lakh crore (US $ 41.59 billion); DII inflows of ₹3.42 lakh crore (US $ 37.55 billion); SENSEX held broadly above 50,000—the first episode in which domestic flows genuinely offset FII selling with near-parity. (4) FII Exit 2024–25: FII outflows of ₹6.11 lakh crore (US $ 67.09 billion); DII inflows of ₹13.16 lakh crore (US $ 144.49 billion); SENSEX remained above 80,000 throughout. This episode is unprecedented in its scale of domestic absorption.

The pattern reveals a critical asymmetry: while the scale of domestic institutional investor (DII) activity has expanded substantially, so too has the market's reliance on this liquidity to maintain elevated valuations. . Should systematic investment plan (SIP) inflows decelerate—due to economic downturns, rising unemployment, or adverse return experiences prompting widespread redemptions—the supportive buffer would erode more rapidly than commonly anticipated BSE Low Volatility Index as a Signal.

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The BSE Low Volatility Index, available from December 2015, exhibits a near-perfect correlation with the SENSEX (r = 0.993). Average monthly returns are nearly identical: 1.06% for the SENSEX versus 1.05% for the Low Volatility Index. However, the Low Volatility Index displays lower standard deviation (3.80% per month versus 4.61% for SENSEX), consistent with its construction methodology.

The convergence of both indices in trajectory, with lower dispersion in the Low Volatility Index, is paradoxically concerning. Ang et al. (2006) note that when low-volatility strategies converge with broad market performance, it signals widespread volatility suppression rather than genuine low-risk conditions. In our sample, DII buying has effectively created an artificial floor, reducing observed market volatility below its fundamental level—a form of Minsky's 'stability breeds instability' in action.

5. Discussion: Bubble Risk and Policy Implications

5.1 The Minsky Framework Applied to Indian Markets

Minsky's (1986) financial instability hypothesis identifies three stages of borrower types: hedge (cash flows cover principal and interest), speculative (cash flows cover only interest), and Ponzi (cash flows cover neither, requiring asset appreciation for solvency). Applied to the Indian MF-equity ecosystem, the SIP retail investor base increasingly resembles a speculative or Ponzi structure: returns expectations are calibrated to recent market performance; redemptions remain low because markets have not corrected sharply; and fund managers are compelled to deploy fresh inflows into an increasingly concentrated and overvalued set of large-cap equities.

The DII absorption ratio of 2.57:1 in 2025 implies that for every rupee of FII selling, domestic institutions are deploying ₹2.57 a pace that, sustained, will eventually encounter either a supply constraint (FIIs fully exit, leaving DII flows without a counterparty), a demand constraint (retail SIP growth plateaus), or a valuation constraint (corporate earnings fail to grow into elevated multiples). Any of these constraints could trigger a disorderly correction.

5.2. Herding and Narrative Risk

Shiller (2019) introduced the concept of narrative economics, the idea that viral economic stories shape collective behaviour and asset prices. The SIP narrative in India states to invest every month, stay long, ignore volatility, which is a powerful and operationally sensible strategy in a fundamentally growing economy. However, it becomes systemically dangerous when it creates expectations of guaranteed equity outperformance and insulates fund inflows from valuation signals.

Survey evidence from AMFI and the National Council of Applied Economic Research (NCAER) suggests that a growing proportion of SIP investors are first-generation equity investors who have experienced only rising markets (post-2020). Their behaviour under a sustained downturn of 30–40%—which historically occurs in India every 5–8 years—is unknown, but the risk of mass redemptions triggering forced selling by MFs, further depressing markets in a negative feedback loop, cannot be discounted.

5.3. Concentration and Systemic Risk

The structural concentration of domestic institutional flows in large-cap index constituents amplifies systemic risk. As DII and MF inflows chase index-weighted stocks, price discovery in mid- and small-cap segments deteriorates. Paradoxically, the broader market appears healthy at the index level while underlying valuation dispersion may mask pockets of severe overpricing. The absence of meaningful price correction despite sustained FII selling suggests that market signals have been effectively suppressed by domestic liquidity, a condition Brunnermeier (2008) identifies as a precondition for abrupt bubble bursts.

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5.4. Policy Recommendations

We offer three broad policy recommendations. First, SEBI and AMFI should enhance investor education to explicitly communicate valuation risk within SIP frameworks, moving beyond return-focused messaging to include downside scenario analysis. Second, macroprudential oversight of MF equity concentration—particularly the monitoring of fund-level gross redemption capacity under stress scenarios—should be strengthened, potentially through mandatory liquidity stress tests analogous to those applied to banking institutions. Third, the development of more sophisticated domestic investor hedging instruments (long-dated put options, volatility products) would allow institutional investors to manage downside risk without resorting to wholesale liquidation, reducing the probability of a disorderly correction.

6. Conclusions

This paper presents evidence of a structural transformation in the Indian equity market wherein FII selling has been systematically and increasingly absorbed by domestic institutions, principally Mutual Funds fuelled by SIP inflows. Our analysis of monthly data from April 2007 to January 2026 documents that FIIs have net-sold approximately ₹8.68 lakh crore (US $ 95.36 billion) since 2021, while DIIs and MFs combined have invested ₹32.92 lakh crore (US $ 361.28 billion) over the same period—an absorption ratio without historical precedent in Indian markets.

The correlations between DII/MF flows and SENSEX levels are strong ($r > 0.68$), statistically significant, and directionally opposite to FII flows ($r = -0.365$), confirming the structural substitution of foreign by domestic capital as the primary market driver. The DII share of gross institutional purchases reached 54.8% in early 2026, compared to 39.7% in 2017—a structural shift that has sustained SENSEX levels above 80,000 even as India's equity risk premium has compressed.

Viewed through the Minsky framework, the stability of Indian equity markets during a period of historically large FII outflows is not evidence of resilience—it is evidence of structural dependence. A market that requires accelerating domestic liquidity injections to maintain price levels is, by definition, operating with fragile underpinnings. Whether this constitutes a bubble in the classical sense depends on future developments in corporate earnings, retail investor behaviour, and global capital flows. What is clear is that the conditions for one are present and evolving.

Future research should incorporate higher-frequency data (weekly or daily), apply regime-switching models to formally identify structural break points, and integrate corporate earnings growth data to assess the fundamental gap between earnings and valuations. International comparisons with other emerging markets experiencing similar DII transitions—notably China and Brazil—would further contextualise the systemic implications.

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