CHAPTER 1

INTRODUCTION

1.1 Overview

Sustaining a comparative advantage involves implementing strategies that not merely generate profit above norm, but also insure its persistence. Rates of return incommensurate with the risk associated with the activities the firm undertakes will disappear if a firm fails to manage the competitive forces. Limiting forces that drive profits back to competitive levels are vital to achieve superior business performance. In a competitive market, this abnormal profit is a disequilibrium phenomenon due to innovation, shocks in supply or demand, or changes in tastes.

In capitalist economies, the profit rate indicates the economic vitality of firms and industries, which determines the speed of capital expansion through the processes of production and exchange. The critical role of profit rate within the economy includes regulating a number of processes that structure competition and economic change. First, movements and variations in the profit rate affect the volume of investment funds' flow among economic sectors. Marxist, neoclassical, and Keynesian economists developed various equilibrium models, agreed that capital tends to flow from less to more profitable activities (Boris and Stein (1964), Kaldor (1961), Roemer (1981)). Second, the profit rate exerts a significant influence on the speed and direction of technological progress: governing the necessity of firms to adopt new techniques (Farjoun and Machover (1983), Rigby (1990)); affecting the ability of firms to finance technical change (Grabowski and Mueller (1978)); varying

the range of technologies that are economically viable (Binswanger and Ruttan (1978)); and structuring the timing of innovation by controlling anticipated returns (Baldwin and Scott (1987)). Third, the profit rate could determine the turning points of long waves of economic activity and the attendant rounds of growth, recession, and restructuring that they entail (Mandel (1981)). Broad shifts in economic climate and sudden reversals in industrial and regional fortunes are directed by patterns of profitability, investment and divestment (Aglietta (1979), Massey (1978), Webber (1982)).

Generally, profitability signals the direction resources should flow to satisfy customer demand. The adjustment of resources and output into areas earning excess profits and away from areas earning below average profits will, in time, bring profits back to competitive levels. If this adjustment does not occur, or is slow, it is evident to the ability of management to insulate the firm from competitive forces. However, this insulation from competitive forces is not riskless. The sluggishness of the convergence process would benefit successful firms to earn profits above norm for a longer period of time. Consequently, it also renders profits below norm for unsuccessful firms in longer term.

In other words, successful firms that earn profits above norm are expected to take measures to maintain their advantages in the future. In contrast, success in the present is expected to attract imitation from competitors or entrants, which may have adverse consequences for the future profitability of the current successful firms. These linkages between current and future profitability induced a need to study profits using a dynamic and evolutionary framework.

These principles have given rise to substantial empirical research, referred to as the 'persistence of profit' literature. This strand of literature applied time series models to company profit data, and to use the fitted coefficients of these models to draw inferences about the nature of the competitive process. The development of this literature will be presented in Chapter 2 of this study.

1.2 Objective Of The Study

The task of this study is to analyse the persistence of profitability of firms listed within each sector of the Main Board of Kuala Lumpur Stock Exchange (KLSE). Comparison for persistence of profitability is made amongst the different sectors within the Main Board.

The objective of this study is to identify whether each firm (incumbent) could maintain their profit above norm in the long run despite competition from entrants, particularly those from the KLSE Second Board as well as other unlisted firms (local and foreign).

The motivation of this study is to identify firms with persistent high returns. The outcome could be used as an additional tool for decision making to the fundamental analysis and technical analysis. The tool in this study can be used as a preliminary analysis prior to the both fundamental analysis and technical analysis. The process can be conducted as follows. Initially, by applying the tool in this analysis, we will be able to identify the firm as well as sector with persistent profitability and high long-run equilibrium profitability. Nevertheless, this can be used in conjunction with the fundamental analysis to verify the findings by evaluating

firm's value for stock selection process. Subsequently, the technical analysis can be applied to determine the entry-exit price level for selected stocks.

1.3 Framework Of The Study

The study is structured as follows. Chapter 1 provides an overview of the study. Chapter 2 provides a detailed literature review. Chapter 3 describes the methodology and data set used in this study. Chapter 4 describes the analyses and results. Chapter 5 concludes the study with a summary of main findings and implications of the result.