CHAPTER 1

INTRODUCTION

The concept of relationship between risk and expected rate of return has become widely accepted by both theorists and practitioners in the field of financial portfolio management and investment analysis. This relationship has been extensively studied and documented in the past for well-developed and mature markets like the New York Stock Exchange(NYSE) and London Stock Exchange. For relatively small, but fast developing markets, like the Kuala Lumpur Stock Exchange(KLSE) and Singapore Stock Exchange(SSE), there have been few detailed studies aimed at the determination of actual relationship between risk and expected rate of return. These studies include those conducted by Kok and Goh(1992), and Tang(1974) and Dawson(1984). Kok and Goh found that beta coefficients(risks) have significant correlations with returns without exogeneous shocks such as the Gulf crisis. Tang and Dawson found that betas of portfolios of securities were better predictors of future returns than those of individual securities.

1.1 Objective of the study

This study is an update to a study conducted by Kok and Goh and used updated stock data, that is, from 1991 to 1995 and involved seventy-one stocks listed in the

KLSE. The main objectives of this study are to explore the extent to which beta coefficients are useful for predicting the future returns and to determine the usefulness of beta coefficients in securities portfolio analysis and investment strategy.

1.2 The Kuala Lumpur Stock Exchange (KLSE)

The Kuala Lumpur Stock Exchange (KLSE) is the only stock exchange in Malaysia. KLSE plays a pivotal role in the economic development of the country. Its importance has been acknowledged by the Government with the establishment of the Securities Commission to oversee the sound development of the securities industry in Malaysia.

Due to its rapid expansion in recent years, the KLSE has outgrown the notion that capital markets in developing countries are thin and fragmented. Market capitalisation stood at RM806.77 billion as at 31 December 1996. The number of listed stocks has increased from 336 as at 31 December 1991 to 889 as at 31 December 1996. Of these 889 stocks, 621 stocks are listed on the Main Board and 208 stocks listed on the Second Board. The spectrum of securities listed on KLSE's Main Board is fairly well diversified, comprising 58 Consumer Products stocks, 86 Industrial Products stocks, 68 Trading and Services stocks, 62 Finance stocks, 6 Hotel stocks, 64 Properties stocks, 40 Plantation stocks and the rest are Mining, and Trusts stocks.

The privatisation policy of the Government has contributed, to a large extent, to the rapid growth of the stock market. The two largest capitalised stocks, Telekom and Tenaga Nasional were the result of Government privatisation policy. Together they constitute about 10 percent of the total market capitalisation. The implementation of the privatisation policy is envisaged to provide a significant source of new listings and, more importantly, to further promote the development of the securities market.

In its effort to increase efficiency, the Central Depository System (CDS) was implemented in November 1992 and this marks the initialisation of the KLSE scripless trading system. Trading on all counters on the KLSE was fully automated in 1992 under SCORE(System on Computerised Order Routing and Execution) trading system. Trading information is disseminated on real-time basis using the MASA system.

1.3 Stock market Index

A stock market index is often constructed to measure the performance of the overall stock market or a sector of the market. In Malaysia, a number of organisations have constructed stock indices. The KLSE itself has constructed the widely followed Composite Index, the all-share Emas Index, the various sectorial indices for the industrial, finance, properties, tin, hotel and plantation sectors and the Second Board Index. The New Straits Times has the NST Industrial Index and other sectorial indices while the Business Times also publishes its Composite Index, Ordinaries Index and the various sectorial indices.

1.4 Organization of the study

This empirical study is reported in five chapters. Chapter One briefly describes the purpose of the study and the KLSE. Chapter Two presents a summary of the theoretical background with respect to risks and expected rate of returns in capital market. This chapter also reviews the findings of some of the most relevant past theoretical and empirical studies carried out by both local and overseas researchers.

Chapter Three presents the methodology employed in the study. This chapter gives a description of the data used, the sample and its size, the time period covered, method of analysis, the validity of assumptions used and the general limitations of the study.

Chapter Four presents the results of analysis and the findings of the study. This chapter presents the summaries of the findings in the form of tables and graph, while the detail of the findings will be in the Appendix.

Chapter Five presents the summary and conclusion which comments on inferences, implications and possible explanations of the findings.