

## **CHAPTER 1**

### **INTRODUCTION**

#### **1.1 PROBLEM STATEMENT**

Performance of equities, unit trusts and mutual funds has been an area of frequent research and inquiry since their inception. The development of the Modern Portfolio Theory (MPT) by Markowitz and the basic Capital Asset Pricing Model (CAPM) by Sharpe, Litner, Treynor, Jensen has further intensified work in performance evaluation.

In this study, the quarterly returns and risk from the various sectors in the Main Board of the Bursa Malaysia are measured against the quarterly returns and risk of the Exchange Main Board All Share (EMAS) Index. The sector indices are used as a proxy for sector performance while the EMAS index is used as a proxy for the overall market performance. If a sector performs better than the EMAS index over a given period, it is said to have over performed the benchmark and if it does worse than the EMAS index, it is said to have under performed.

The market capitalisation of the Bursa Malaysia fell by 79.3 % during the crisis. Since the recovery measures were put in place, the market capitalisation had improved almost four fold. Which are the sectors that have over performed and which have underperformed the market? The Malaysian Government had taken steps to promote the growth of the economy. These steps will be discussed in detail later. Had a particular sector of the economy recovered more? If so, how do we rank the sectors from the best performer to the worst? How do we use the Efficient Markets Hypothesis (EMH) and the Inefficient Markets Hypothesis (IMH) to explain these results?

## **1.2 OBJECTIVES OF THE STUDY**

The objectives of the study were :

- i) to identify which sectors have outperformed or underperformed the market during the period of study;
- ii) to rank the sectors in the Bursa Malaysia Main Board from the best to worst performer during the period of study.
- iii) to explain the results with reference to the EMH, IMH and the economic climate.

## **1.3 SIGNIFICANCE OF THE STUDY**

The findings from this study would provide useful information to investors with reliable information on which sectors in the Bursa Malaysia Main Board have outperformed or underperformed the market during the period of study. With this information, investors can evaluate alternative strategies and investment programmes. Investors who want to select a sector or a few sectors for investment, can use this information to assist them in selecting these sectors. The study can also be used to judge the effectiveness of the various measures taken to promote recovery after the recession.

## **1.4 BURSA MALAYSIA**

The first formal organisation in the securities business in Malaysia was the Singapore Stockbrokers' Association, which was formed in 1930. In 1937, the Association was re-registered as the Malayan Stockbrokers' Association.

In 1960, the Malayan Stock Exchange was formed and public trading of shares began on the 9<sup>th</sup> of May that year.

In 1961, the Board system was introduced with two trading rooms, in Singapore and Kuala Lumpur, that were linked by direct telephone lines into a single market with the same stocks and shares listed at a single set of prices on both boards. The Stock Exchange of Malaysia was formed in 1964. With the secession of Singapore from Malaysia in 1965, the common stock exchange continued to function but as the Stock Exchange of Malaysia and Singapore (SEMS).

With the termination of currency interchangeability between Malaysia and Singapore in 1973, the SEMS was separated into The Kuala Lumpur Stock Exchange Bhd. (KLSEB) and The Stock Exchange of Singapore (SES). Malaysian companies continued to be listed on SES and vice-versa.

A new company limited by guarantee, The Kuala Lumpur Stock Exchange (KLSE) took over operations of KLSEB as the stock exchange. In 1994, it was re-named Kuala Lumpur Stock Exchange. In 2004, the Kuala Lumpur Stock Exchange became a demutualised exchange and was re-named Bursa Malaysia.

## **1.5 SECTORS IN THE BURSA MALAYSIA MAIN BOARD**

The stocks listed on the Bursa Malaysia Main Board are categorized under thirteen sectors according to the core business of the listed companies. The sectors are Plantation, Industrial Products, Mining, Technology, Services, Finance, Consumer Products, Construction, Properties, Infrastructure Project Companies, Hotels, Closed-End Funds and Trusts. Due to unavailability of some of the sectoral indices, this study only ranked the performance of seven sectors, which are as follows :

- 1) Plantation,
- 2) Industrial Products,
- 3) Trading / Services,
- 4) Finance,
- 5) Consumer Products,
- 6) Construction and
- 7) Properties

The technology sector was not analysed in this study as movements in the sector may have been affected by global developments in the technology sector following the United States technology crash in 2001. As such, it is not really relevant for this analysis since this study is more concerned with domestic recovery after the East Asian financial crisis.

## **1.6 THE EAST ASIAN FINANCIAL CRISIS**

Financial crises have been a significant feature in the history of the global financial system. The earliest record of a financial crisis dates back to the 17<sup>th</sup> century in the Roman Empire. Since then, financial crisis have been a feature of the global economy, as evidenced by the Dutch tulip mania (1636), the Wall Street Crash of 1929 and the Great Depression, the Organisation of Petroleum Exporting Countries (OPEC) crisis (1973 and 1978), the Exchange Rate Mechanism (ERM) crisis (1993) and the Mexican and Latin American crisis (1982 and 1995).

As the process of globalisation intensifies capital flows across borders in unprecedented volumes and at great speed, financial crisis will become increasingly more frequent. The year 1997 witnessed a new strain of financial crisis – the East Asian financial crisis. Beginning in mid May 1997 with a speculative attack on the Thai baht, the crisis spread across East Asia. Following the depreciation of the Thai baht, the Phillipine peso and the Indonesian rupiah were also forced to float more freely while the Malaysian ringgit and the Singapore dollar came under repeated bouts of selling pressure. The selling pressures on currencies quickly spread outside South-East Asia. The Korean won, Hong Kong dollar and the Taiwan dollar soon came under pressure as well.

The East Asian financial crisis was unlike any crisis in recent history. It was the sharpest financial crisis to hit the developing world since the 1982 Latin American debt crisis. From one of the best performing regions in the world came a crisis of unexpected magnitude, prompting the largest financial rescue in history. The crisis was unique in terms of the severity of the contagion effects and the speed with which the crisis spread across the region. The economies of Indonesia, Thailand and Korea contracted by –13.7 %, -9.4 % and –5.8% respectively in 1998. There was perception

that there existed a common set of high risks in the region. Hence, there was a massive reversal of capital flows from the region. According to an estimate by the International Monetary Fund (IMF), net private capital inflows into Asia in 1997 fell sharply to US\$34.2 billion from US\$101.2 billion in 1996 due mainly to a decline in net portfolio investment and debt related investments.

Malaysia was not spared from the crisis. Following the sharp depreciation of the Thai baht on 2 July 1997, the ringgit began to experience speculative pressure. By the end of August 1998, the ringgit had depreciated by 40 % against the United States dollar relative to its level at the end of June 1997. The ringgit breached a historical intra-day low of US\$1=RM4.8800 on 7 January 1998. The build up of offshore ringgit increased the vulnerability of the ringgit and threatened to further destabilize the economy. The equity market was also severely affected. Bursa Malaysia's Composite Index fell by 79.3 % from a high of 1271.57 points in February 1997 to a low of 262.70 points on 1 September 1998. The full effect of the regional financial crisis was felt in 1998. Real output declined by 7.5 %. Price pressure arising mainly from the depreciation of the ringgit became evident towards the end of 1997. The inflation rate reached a peak of 6.2 % in June 1998. It was evident that Malaysia was facing a recession for the first time in 13 years.

## **1.7 IMPACT OF CRISIS ON MALAYSIAN ECONOMY – BY SECTOR**

The impact of ringgit depreciation on real GDP growth began to be felt since the third quarter of 1997 when GDP growth moderated to 7.7 % from an average of 8.5 % in the first half of 1997. As the crisis deepened, the impact on the economy became more severe with the economy contracting by 3.1 % in the first quarter of 1998 before worsening to –10.9 % and –10.3 % in the third and fourth quarters of 1998 respectively. The impact of the ringgit depreciation on the various sectors of the economy differed and was as follows :

### **1.7.1 Plantation Sector**

The initial impact of ringgit depreciation was on export earnings. The gain was only a windfall gain in terms of higher export receipts in ringgit terms as most commodity prices are quoted in US\$ and Malaysia is a price taker with prices determined by global supply and demand. The direct impact on export volume was negligible as production is price inelastic, constrained more by yields and cultivated acreage rather than prices. The depreciation of the ringgit also had adverse impact on the sector as cost of production rose due to higher ringgit prices for imported inputs such as fertiliser, pesticides and machinery. This affected the sector's competitiveness.

### **1.7.2 Construction Sector**

The output growth had moderated from a peak of 17.5% in the first quarter of 1997 to 7.8 % in the fourth quarter of 1997 as a result of prudential measures introduced prior to the outbreak of the crisis to reduce overheating of the sector. However, following the

Government deferment of the implementation of several projects to reduce pressures on the current account deficit, output contracted significantly by 23% in 1998 and 11.4 % in the first half of 1999.

### **1.7.3 Property Sector**

The commercial property sector was affected by the oversupply situation and measures that were introduced to restrict lending to this sector. Many projects were delayed or postponed. The residential property sector particularly low and medium cost housing was not significantly affected as the underlying demand remained strong and more than 90 % of the inputs were sourced locally. In contrast, the high end housing market underwent a more significant adjustment in terms of prices and take up rates. Many units remained unsold due to the negative wealth effect of the stock market downturn and declining income as retrenchments increased arising from the contraction of the economy. There was also a wait and see attitude on the part of purchasers because of the uncertain employment outlook.

### **1.7.4 Services Sector**

Performance was affected by higher costs of imported inputs, resulting in lower sales and profit margins. For some utilities and transport companies, large external debt exposure resulted in large foreign exchange losses. However, selected companies engaged in international business such as shipping lines benefited from ringgit depreciation in terms of higher receipts in ringgit terms. Intermediate services sub-sector, which form the bulk of the services sector, was most affected by the downturn in economic activity. Overall, the impact of the ringgit depreciation and the



financial crisis on the services sector was relatively less severe than other sectors, with value adding declining by only 0.8 % in 1998.

#### **1.7.5 Financial Sector**

The financial system in Malaysia was not directly affected by the depreciation of the ringgit as the banking system did not rely on foreign funds to finance their activities and hence their exposure to the ringgit depreciation was small. Rather, the currency's impact was transmitted to the financial sector via the contraction in economic activities and decline in the stock market, which in turn affected the banking system asset quality. The deterioration in asset quality and subsequent erosion of the capital base had adversely affected banks' lending activities. As banks focused more on the management of their rising Non-Performing Loans (NPLs), their over-reaction further reinforced the negative impact of the crisis by slowing credit growth, and added greater friction in economic activities. Consequently, the banking system recorded a pre-tax loss of RM 2.3 billion for 1998, and the net NPL/total loans ratio rose to 9 % at the end of 1998.

The near collapse of the Indonesian rupiah saw contagion effects to bring the ringgit to its lowest level of RM 4.88 to the US dollar on 7 January 1998. Inflation had edged upwards. At the same time, loans which were growing very strongly till end 1997, slowed down significantly. The progressive tightening of liquidity in the banking system following the outflow of portfolio funds caused inefficiencies in the intermediation process. As the ringgit continued to depreciate, deposits shifted from small to bigger institutions and, to some extent, from local to foreign banks.

While it was relevant to keep interest rates low given the economic contraction that was emerging, the ringgit was under extreme pressure and there were fears that it could depreciate further. It was assessed that further pressures could precipitate a freefall in the ringgit exchange rate. Further contagion effects from developments in neighbouring countries could not be discounted. Hence, amidst rising inflation and concerns over potential pressures, interest rates were raised to 11 %.

## **1.8 MALAYSIA'S RESPONSE TO THE FINANCIAL CRISIS**

The Government recognized that corporate restructuring and corporate recovery was to be expedited after the crisis. Appropriate efforts had to be directed towards restructuring distressed companies. Immediate measures were taken against the backdrop of the crisis, which subsequently led to economic recovery.

The three immediate measures introduced were to lower statutory reserve ratio to reduce cost of funds and ease lending rates; to peg the Ringgit at USD3.80 and to impose an exit levy on repatriation of capital and profits

The key institutions behind the corporate restructuring were:

- i) Bank Negara Malaysia (BNM)
- ii) Securities Commission (SC)
- iii) Pengurusan Danaharta Nasional (Danaharta)
- iv) Danamodal Nasional (Danamodal)
- v) Corporate Debt Recovery Committee (CDRC)
- vi) National Economic Action Council (NEAC)
- vii) Government of Malaysia (GOM)

The NEAC was established on 7 January 1998 as consultative body to the Government to deal with the economic crisis that had arisen.

The objectives of the NEAC were to prevent economy from going into recession, reduce effect of declining ringgit and share prices on the real economy and formulate a National Economic Recovery Plan

The NEAC announced the National Economic Recovery Plan (NERP) in July 1998. The plan consisted of six objectives for revitalising the economy namely:

- Stabilising the ringgit
- Restoring market confidence
- Maintaining market stability
- Strengthening economic fundamentals
- Furthering the socio-economic agenda and
- Reviving badly affected sectors

The government formulated policy actions in line with these objectives.

In mid 1998, the government accelerated a relaxation of monetary and fiscal policies that had been intended to stabilize the ringgit and impose macroeconomic discipline. Bank Negara Malaysia (BNM) successively reduced the statutory reserve requirement (SRR), the percentage of reserves that banking institutions are required to deposit with BNM, from ten percent to four percent. The base lending rate (BLR) declined from a peak of 12.27 percent in June 1998 to 6.79 percent in June 2000. Additional measures included reducing consumer credit card finance charges, lowering rates on automobile and mortgage loans and increasing funding for small and medium sized enterprises.

Interest rates were eased three times in August to support the economic recovery plan. With the selective exchange controls, interest rates were reduced further. Banks with sufficient capacity were encouraged to achieve a minimum loan growth of 8 % for 1998.

## **1.9 SELECTIVE EXCHANGE CONTROLS**

Since April 1998, banks in offshore markets were offering ringgit deposit rates of more than 30 %. Increasing domestic interest rates, which were at 11% was untenable as the economy was already in recession. Hence on 1 September 1998, the Malaysian authorities decided to impose selective exchange controls to protect its economy from external vulnerabilities and restore financial stability. This was achieved through measures to cease the internationalisation of the ringgit by eliminating the availability of ringgit in offshore markets. These measures were followed by fixing the ringgit exchange rate to the US dollar at RM3.80=US\$1 on 2 September 1998.

The controls were not intended as a substitute for macroeconomic and financial policies. Rather, the selective exchange controls aimed specifically at bringing about stability and to enable monetary policy to be based on domestic conditions. The period of stability would also provide a breathing space for the implementation of macroeconomic measures to support the economic recovery and for the financial restructuring to take place at an accelerated pace. These measures were to expedite corporate and financial restructuring and build the foundations for a speedy economic recovery towards achieving broad based sustainable growth.

## **1.10 PENGURUSAN DANA HARTA NASIONAL BERHAD (DANA HARTA)**

Danaharta was established in June 1998 to purchase NPLs from banking institutions and manage these NPLs in order to maximize their recovery

value. Danaharta, like other asset management companies in the world, was meant to operate within the broad concepts of rehabilitation, restructuring and maximizing the recovery value of the assets. While Danaharta would not purchase the entire NPL portfolio from the banking system, it would ensure that the residual NPLs in the banking sector remains at manageable levels at all times.

Danaharta would also assist in the restructuring of the corporate sector. Once banking institutions have sold their NPLs to Danaharta, Danaharta would be able to impose conditions on the borrowers which may include, amongst other things, the reconstruction or rehabilitation of the underlying assets and identified cash flows. Danaharta was also empowered to appoint Special Administrators for viable companies that faced temporary cash flow problems.

By May 2000, Danaharta had acquired US\$9.63 billion in NPLs, equal to 42 percent of NPLs in the banking system. System-wide, NPLs in April 2000 had declined to 10.8 percent of loans (measured on a three-month basis) or 6.6 percent (six-month basis), down from a peak of 14.9 percent (three-month basis) in November 1998.

#### **1.11 DANAMODAL NASIONAL (DANAMODAL)**

To fully address the issue of improving the balance sheets of the banking institutions, recapitalisation became necessary for certain banks that faced an erosion of their capital base. Recognising the constraint on shareholders to raise capital in the prevailing uncertain environment, Danamodal was established in August 1998 to facilitate the recapitalisation of banking institutions.

Danamodal would only inject capital into viable banking institutions on commercially viable terms and market principles. Once the capital injection was carried out, Danamodal will institute micro reforms through its nominees appointed to the respective Boards of these banking institutions.

Danamodal injected RM 7.1 billion into ten banking institutions when it was set up. By May 2000, the amount of injected capital was reduced to RM 4.9 billion after six banks made partial or full payments. System-wide, the risk weighted capital adequacy ratio of banks was 13 percent as at May 2000, up from 10.5 percent in December 1997.

#### **1.12 CORPORATE DEBT RECOVERY COMMITTEE (CDRC)**

The Corporate Debt Restructuring Committee (CDRC) was set up in July 1998 to deal with the larger corporate sector debts that involved several banking institutions, to ensure that viable corporations continued to receive financing. The CDRC provided a platform for both the borrowers and the creditors to work out feasible debt restructuring schemes without having to resort to legal proceedings. These restructuring efforts would be conducted on a voluntary basis, based on market driven principles to ensure that there would be a win-win situation for both the borrowers and the creditor banking institutions.

#### **1.13 CONSOLIDATION OF FINANCIAL INSTITUTIONS**

In February 2000, BNM gave approval to consolidate Malaysia's 54 domestic financial institutions under ten 'anchor' banks. Financial institutions were required to complete their merger plans by February 2001. The government had originally announced plans to merge financial institutions under six pre-selected 'anchor' banks. It relented and allowed

financial institutions to select their own merger partners following allegations of favouritism and a lack of transparency in the process.

Consolidation of Malaysia's financial sector has been a long-running policy objective to prepare Malaysia's financial sector for increased competition and globalisation. The government also announced plans to consolidate domestic brokerage houses into 15 'universal brokers' as part of a larger government effort to improve the strength and efficiency of Malaysia's capital markets.