

CHAPTER 1 : INTRODUCTION

Securities trading in Malaysia can be traced back to the 19th century during the British colonial era, initially offering exposure to the rubber, tin and oil palm related stocks. Hence, the concept of equity trading has undergone a long history of transformation and is well entrenched in the Malaysian society. The Kuala Lumpur Stock Exchange (KLSE) has undergone massive changes since its informal inception to the current well structured institution and has become the fourth largest market in terms of market capitalization in Asia, after Tokyo, Osaka, and Hong Kong by end 1996.

Although KLSE is usually categorized as an emerging market, by some standards it can be considered well developed. Market capitalization as a percentage of GDP is around 125 percent as compared with around 60 percent for New York and 90 percent for Tokyo. Average daily turnover as a percentage of market capitalization has for some time hovered around the level of 2 percent which is broadly comparable to Tokyo or Sydney.

The KLSE to-date provides the necessary infrastructure and market micro-structure to facilitate trading for common stocks, preferred stocks, corporate debt securities (loan stocks), transferable subscription rights (TSR), warrants, property trusts and call warrants. As at 31st December 1996, KLSE's market capitalization stood at RM18.47 billions

with 621 listed companies on the main board, 203 listed companies on the second board; and 157 listed transferable subscription rights, warrants and loan stocks.¹

1.1 Stock Market Anomalies : An Overview

The idea of random walk was first attributed to Bachelier (1900) and subsequently the Efficient Market Hypothesis (EMH) was introduced by Fama, Fisher, Roll and Jensen (1969). Large stock markets around the world are known to conform to the weak form of the efficient market hypothesis which implies that the past history of prices cannot provide information that can be used to predict their movements in the future. Stock prices are assumed to reflect all information which may be contained in the past history of the stock itself. In addition, since information itself is random, the stock price movements should therefore be random.

Despite wide acceptance amongst academicians and market participants of the efficient market hypothesis over the years, an increasing number of documented market anomalies were identified using sophisticated statistical techniques. These do not augur well for the efficient market hypothesis as they indicate possible market inefficiency whereby informed investors could exploit the market for abnormal returns.

¹ Computed From Nanyang Business and Financial Weekly, 6th January 1997 Issue.

Could these known market idiosyncrasies or anomalies be mere illusions or mirages, caused by sampling or statistical errors or biases in empirical procedures? Amongst these known market idiosyncrasies are :-

A) The Firm Size Effects And Price Earning Effects.

Firms that are smaller in size in terms of market capitalization are known to have higher returns than firms of larger size. Other measures of firm size such as price earnings ratio (P.E.) and ratio of net tangible asset (NTA) per share to market value per share have shown similarly larger returns for small firms.

B) Mean Reversion In Individual Stock Returns and In Portfolios.

Due to the impact of irrational traders' action to stock prices or possible price manipulation of inactively traded stocks or small firms, there are possibilities that these stock prices may not be at all equal to its intrinsic values. However, past experience showed that these prices have the tendency to revert to their fundamental value once rationality return to the market place, but only over a long period of time. These cause the price deviations to diminish over a long horizon, hence autocorrelations would be negative, exhibiting non random price behaviours which could possibly be somewhat predictable.

C) Calendar Seasonal Patterns.

There exist numerous seasonal patterns on stock returns when they are calculated based on calendar period like January effect, Monday effect, etc.. January return was noted to be higher vis-à-vis the rest of the months of the year when stock return is calculated using end month closing prices leading to what is termed as January effect.

Similarly, Monday return was noted to be lower vis-à-vis the rest of the days in the week when daily closing prices are used to calculate stock return which is termed as Monday effect.

However, if this documented empirical evidence is true, it in turn could cast serious doubts on the widely accepted efficient market hypothesis and therefore necessary theoretical explanation for the idiosyncratic behaviour or anomalies needs further investigation.

1.2 The Importance Of An Efficient Stock Market In Capital Resource Allocations Within The Economy.

Stock market arises from the need to provide further alternatives in balancing national savings-investment gaps to stimulate national economic growth. Its role is to supplement the efforts of financial intermediaries like commercial banks, finance companies, insurance companies, pension funds, etc., in stimulating further savings and allocate scarce capital resources optimally and efficiently towards investments within the national economy. It provides a medium for private and public enterprises to devise efficient fund raising strategies to minimize investment costs and enables investors to construct efficient portfolios that maximize their rate of returns. In order to do so, an efficient market is mandatory so that the price of a security is a reliable estimate of its underlying worth. Thus, an efficient market provides accurate signal for scarce capital allocations.

Macroeconomic fluctuations such as interest rates, inflation, economic growth, terms of trade, monetary liquidity, exchange rates, etc., are known to affect stock prices and international investment fund movements. The exact network through which macroeconomic disturbances affect real stock returns are complicated. In addition, international capital markets and economies are increasingly becoming more integrated, hence leading to high rate of growth for cross-border

trade and investments. The Great Crash Of October 1987 was a testimony to this increasingly integrated global financial network. Therefore, in order to compete and attract increasingly scarce international financial capital, financial markets have to be competitive and efficient. This is to ensure alternatives for funding economic activities and growth at minimum costs becomes possible and available for decision making by all economic agents.

There exists a powerful and irreversible tendency for market efficiency to increase over time as trading volume grows. Market tends to learn from its past experiences and increased participation would aid in reducing opportunities for abnormal returns. Sophisticated and informed investors take advantage of these anomalies to maximize their investment returns. It is therefore expected that any genuine inefficiency will be exploited until they are arbitrated away. Any market anomaly that leads towards market inefficiency would not augur well for any stock market and the economy as a whole. This is because wrong price signals are being generated causing inefficient capital allocation by lenders and borrowers which would result in inefficient portfolio or poor investment funding decisions respectively. Ultimately an efficient market is expected to benefit all market participants in getting a normal return out of their investments.

1.3 Problem Statement : Implications of Seasonality On The Market Efficiency Of The KLSE.

In an efficient market, security prices are expected to fully discount and reflect all available information instantaneously. Stock prices are expected to be a reliable estimate of the underlying worth of a listed firm and errors in prices are expected to be randomly distributed about this true value. Since information is random, stock prices would also be random. Thus, statistical analysis on past historical prices cannot provide information that can be used to predict future price direction. Investors would not be able to outperform the market by applying statistical or other techniques on past prices to obtain abnormal returns due to this random stock price behaviour. This is a necessary condition so that both borrowers and lenders could use price signals to construct optimal fund raising strategies and investment portfolios that maximize their utility or returns respectively.

Any market anomaly or idiosyncrasy suggests that some investors are capable of making money out of the market by developing an investment strategy that could exploit these price distortions at the expense of the poorly informed investors. There will be a transfer of wealth from this group of naive and poorly informed investors to the sophisticated and informed investors who would arbitrage these abnormal market

behaviours to yield a return out of the market. This in turn would cast doubts on the EMH as a working assumption as evidenced by past empirical evidence.