

EXECUTIVE SUMMARY

"Traditionally, investors have viewed bonds as boring investments that do not give good returns and that burdens portfolios," says Dale Bryant, a portfolio manager. "They couldn't be more misled. Sometimes bonds can do better than equities. Adding bonds can reduce portfolio volatility." Bryant's statement forms the crux of this research project.

This paper investigates the co-movement of stocks and bonds on a monthly basis from April 1996 to May 2001. Average returns and standard deviations for the bond and stock market are computed and a comparison is performed to establish which market provides a better return and is less volatile. Regression analyses are also performed in order to investigate the relationship between stock and bond returns. In particular, we examine whether studies done by Shiller and Beltratti (1992), and Campbell and Ammer (1993), who found that the theoretical correlation between stock and long-term bonds return is only slightly positive, but seemingly increasing over time, is applicable in the Malaysian context.

Our finding indicates that the bond market on the average has out-performed the stock market during the period of study. We attribute this phenomenon to the 1997 Asian crisis and the economic contraction leading to low interest rates and a falling equities market. The low interest rate regime as a result of interest rate cuts further increases bond yields and makes them a safer and more attractive investment when compared to stocks. And because bonds are less volatile than stocks, they are a good stabilising force in a portfolio. However, this phenomenon may be short-term pending the recovery of the stock market.

Our regression analyses provided several interesting results. Firstly, the regression analysis on market volatility clearly indicates that the stock market volatility is negatively correlated to the bond market. However, the regression

analysis on market returns was not statistically significant to imply a positive correlation between stock and bond returns. Another explanatory factor, namely fixed deposit rates was later introduced. The regression analysis proved to be statistically significant with the introduction of the additional independent variable.

We therefore conclude that bond and fixed deposit returns, are not the only explanatory factors that have an impact on stock returns. It is therefore not surprising that a growing body of research has focused on forecasting stock and bond returns using economic and monetary factors. Fama and French (1988, 1989), Fama (1990), and Schwert (1990) focus on economic factors, Booth and Booth (1997) examined monetary policy stance, while Zhou's (2000) paper finds that the stock market movements are closely related to shifts in the state of the term structure of interest rates.