CHAPTER 1
INTRODUCTION

1.1 OBJECTIVE OF STUDY

As the economy progresses and the resulting affluence of individuals, the bond market in Malaysia has received increased attention. The main objective of this chapter is to describe the Malaysian bond market and present a number of facts that are relevant to the Malaysian bond market.

1.2 SIGNIFICANCE OF STUDY

In the Malaysian bond market, the development of bonds has been relatively slow by the exceptional growth of equities. In fact, equities have captured the interest of investors for so long that, as an investment option, bonds are relatively ignored by the Malaysian investor. As a result, Malaysians have tended to exclude bonds from their investment portfolio. However, this is set to change in the near future. The 1997 Asian financial crisis has highlighted the critical need for a more balanced mix of equity and bonds as financing and investment choices in the capital market.

Indeed, with the stock market languishing for most of the year, it is not surprising that many investors are giving bonds a closer look. At The Edge/Liberian Malaysian Unit Trust Fund Awards 2000, the Commerce Trust Lifetime Award for bond fund beat 80 other funds to win the next Overall Performance award for the one-
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INTRODUCTION

1.1 OBJECTIVE OF STUDY

As the economy progresses and the resulting affluence of individuals, the bond market should provide individuals with an investment alternative. The main purpose of this dissertation is to examine whether the Malaysian bond market is a more viable investment alternative than the stock market. Along with this, the paper also analyses the development of the Malaysian bond market and presents a number of facts that apply to the Malaysian bond market.

1.2 SIGNIFICANCE OF STUDY

In the Malaysian capital market, the development of bonds\(^1\) has been totally outpaced by the mercurial growth of equities. In fact, equities have captured the investment limelight for so long that, as an investment option, bonds are little known to the average Malaysian investor. As a result, Malaysians have tended to exclude bonds from their investment portfolios. However, this is set to change in the near future. The 1997 Asian financial crisis has highlighted the critical need for a more balanced mix of equity and bonds as financing and investment choices in the capital market.

Indeed, with the stock market languishing for most of the year, it isn’t surprising that many investors are giving bonds a closer look. At The Edge-Lipper Malaysian Unit Trust Fund Awards 2000, the Commerce-Trust Lifetime Bond Fund beat 90 other funds to win the Best Overall Performance award for the one-

\(^1\) A bond is basically a loan that is similar to an IOU. However, it differs from an IOU in that the obligation to repay the loan (principal or face value) is represented by a debt instrument issued by the borrower (issuer) in the form of a certificate (the bond). The original bondholder need not hold a bond until maturity. Instead, the bond can be traded, that is, sold to or bought from investors before the maturity date.
year category. It achieved the highest absolute return of 9.81 per cent last year. The conservative nature of bond investments attracted investors who wanted to limit their risk and yet reap good returns.

1.2.1 WHY INVEST IN BONDS?

Stocks and bonds have very different risk-return characteristics. In general, while stocks are more volatile than bonds, over the long run, stocks are expected to yield higher returns than bonds. If so, why invest in bonds? As a low risk, liquid asset with fairly good returns, the bond in general offers attractive advantages to the investor:

- It provides the investor with a steady income stream. This comes from the regular coupon payments that the borrower has contracted to pay throughout the tenure of the bond. Meantime, the principle sum is preserved.

- It gives relatively attractive yields, which are usually higher than the interest received from bank savings and deposits. Should the investor purchase the bond at a discount, he is able to enjoy a capital gain on redemption at maturity.

- It offers high liquidity, a welcome feature to investors who are faced with the problem of not being able to fully recover their money on demand. It is the marketability of the bond, which renders it a liquid asset, as the investor is able to sell his bonds to convert his investment into cash when needed.

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• The bond is a safer investment than shares. It is a low risk asset. For as long as the issuer does not default, the investor gets paid the coupons irrespective of whether the company makes a profit.

• The hybrid bond\(^3\) provides the opportunity for bondholders to profitably convert their convertible bond or warrant into shares of the issuing company in the future, should the price of the share appreciate beyond the conversion or exercise price.

• As stated previously, in the event of the borrower becoming insolvent, bondholders as providers of loan capital have a prior claim on the company’s assets. This is contrasted to equity, which is known as risk capital because it is invested at the shareholder’s risk.

1.2.2 BUT AT WHAT RISKS?

Investing in bonds is not without risk. However, bond investing has a safeguard in the mandatory prerequisite that any bonds issued must be rated for the issuer’s ability to meet repayments. The credit ratings issued by the rating agency serve as a warning bell to investors on the possibilities of default. Amongst the risks that an investor must consider are as follows:

• **Credit risk.** That the issuer might not be able to meet its obligations is the greatest concern an investor has. The default could take several forms: coupon payments could be delayed or totally missed; the money might not be available upon maturity for the issuer to redeem the bonds, or only part payment might be repaid.

\(^3\) A hybrid bond combines the features of both a fixed rate bond and a share, which a corporation can issue to raise funds to finance its activities. This type of bond is in the form of a convertible bond or a bond with equity warrants.
• **Interest rate risk.** The price of a bond is highly sensitive to changes in interest rates, where every change in the level of interest rates has an inverse effect on the price. When interest rates rise, the price of an outstanding bond will fall and when interest rates fall, the price of an outstanding bond will rise.

• **Reinvestment risk.** Calculating the yield on a bond assumes that cash flows from coupon interest will not be spent but reinvested. The interest earned on interest depends on the prevailing rates at the time of reinvestment. Variability in this reinvestment rate gives rise to reinvestment risk.

• **Event risk.** Occasionally, the ability of an issuer to make full and timely repayments of interest and principal can be affected by natural accidents, regulatory changes or corporate restructuring. This type of risk, as opposed to credit risk, is called event risk.

• **Liquidity risk.** There is a risk in the ability to sell the bond without delay or incurring a loss in its value. A major downward re-rating of bonds issued by a particular issuer may have the effect of drawing buyers away and sellers may find that there is simply no market. This is liquidity risk.

• **Inflation risk.** Inflation remains a risk to the bond investor. The bond might not keep pace with the rate of inflation and this will have an impact on the real purchasing power of the bond.

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4 The yield is simply the rate of return that an investor expects to get from investing in the bond. Yield to maturity (YTM) is generally what bond traders are referring to when they use the word “yield”. The YTM gives the total return an investor will receive if he holds the bond until maturity, taking into account the price paid to buy the bond, the coupon earned by the bond over its tenure which is reinvested to earn interest, and the amount of principal repayable on maturity.
1.3 SCOPE OF STUDY

The study will be conducted on the Malaysian stock market and the Ringgit bond market (hereafter referred to as the bond market). For the purpose of this study, the bond market shall comprise only Malaysian Government Securities (MGS) and corporate bonds or private debt securities (PDS) listed on the Kuala Lumpur Stock Exchange (KLSE). The indices, as well as the time series of returns (stocks) and yields (bonds), of these three components will be tabulated and regressed, in order to analyse the correlation and significance of their respective returns and volatility over a period of time.

1.4 LIMITATIONS OF STUDY

Although the government bond market is relatively large in size compared to the total amount of bonds issued in Malaysia, it is narrow in terms of range of maturities issued and traded. There is some fairly active trading in certain MGS issues, particularly among commercial banks and the discount houses. Other long-term institutional investors such as the Employees Provident Fund (EPF) and insurance companies also rely on the government bond market for investment in risk-free, long-term fixed income assets. However, no overall indicator or benchmark is publicly available to enable fund managers to better monitor and evaluate the performance of their investment portfolios. The market currently lacks an accepted benchmark yield curve, despite efforts to establish a yield curve using both Cagamas and Khazanah papers as the benchmark.

Due to the thinness of the corporate bond market, it is not possible to compile a full set of data for comparison with the stock market returns. As the participants in the bond market are mostly institutional players, most bonds, unlike shares, are traded in the “over-the-counter” (OTC) market. In comparison, there are bonds listed on the KLSE (referred to as listed bonds), which caters to retail investors, but they are small and decreasing in number. Rating Agency Malaysia Berhad (RAM) publishes a Listed Bond Index on a monthly basis. The index was
first introduced in April 1996 and formulated to measure the overall performance of the corporate bonds market in Malaysia. Therefore, we have taken the pragmatic approach by selecting only listed bonds, where monthly bond indices are freely accessible, and individuals have easy access to buy and sell bonds, for the purpose of this study.

However, the period of our study is constrained by availability and consistency of the bond index. When the bond index was first published in April 1996, the bond index comprises more than twenty listed bonds, which satisfies RAM's criterion for inclusion in the index computation. As at 30 November 2001, there are only two listed bonds in the bond index computation. This was attributed to the declining issues of listed bonds and imminent redemption of existing listed bonds. For instance, the exclusion of AMMB Holdings Berhad's RM435.06 million redeemable unsecured bonds from the bond index in June 2001\(^5\) reduced the outstanding volume by 49 per cent. The shortage of listed bonds caused the monthly turnover for listed bonds traded on the KLSE to jump 267 per cent to 3,899 lots in June 2001. Prices for these bonds, as reflected by RAM's Listed Bond Index, doubled from 111.381 (May 2001) to 222.344 (June 2001). For the purpose of this study, we have excluded this anomaly, as it will distort the consistency, predictiveness and accuracy of this study. Hence, the period of our study will be from April 1996 to May 2001.

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\(^5\) AMMB Holdings Berhad's redeemable unsecured bonds are due to mature on 13 May 2002. The bonds were dropped from the bond index as it had less than a year to maturity.
1.5 ORGANISATION OF STUDY

This paper is organised as follows. Section 2 describes the development of the Malaysian bond market. In this section, we also address the shortcomings or constraints prevalent in the bond market. Section 3 provides a literature review of this study. Section 4 describes the data on the monthly returns for stocks and bonds, as well as explains the methodology employed in the study. Section 5 performs the analysis and Section 6 concludes the paper.