Chapter 1

<u>INTRODUCTION</u>

1.1   Overview Of Malaysian Capital Market

The capital markets in Malaysia comprise the conventional and Islamic markets. The equity market dealing in corporate stocks and shares, and the bond markets dealing in public and private debt securities are the two main conventional capital markets in the country. The Malaysian capital market has experienced significant progress and development in the last decade. The role of capital market in the financial sector has also increased rapidly during this period. Among the various markets, the equity market is the most mature and developed market.

There are several major developments in the domestic capital markets in the last ten years. First, of course, is the establishment of the Securities Commission in 1993 as a central authority to regulate and develop the capital markets in the country. Second, the setting up of the private debt securities market to complement the Government securities and equity markets. Thirdly, the introduction of the financial futures and the establishment of respective exchanges, namely the Kuala Lumpur Options And Financial Futures Exchange (KLOFFE) in 1995 and the Malaysia Monetary Exchange (renamed the Commodity And Monetary Exchange of Malaysia, COMMEX) in 1996. It was also during this period that the Kuala Lumpur Stock Exchange (KLSE) implemented several modernization programs to improve the

efficiency of the trading and settlements of securities transacted. Among others, the trading system (SCORE) was fully automated by October 1992; all stockbroking firms were equipped with the KLSE's latest computerised broker front-end system (WinSCORE) by early 1995 and the prescription of all securities into the central depository system. These developments, in total, transformed the KLSE into a world class stock exchange that is fully scripless and automated.

In terms of performance, the stock market experienced a superbull run in 1993, in that share prices and turnover registered new record high. The Kuala Lumpur Stock Exchange Composite Index (KLSE CI) reached the all-time high of 1,341.46 points on 5 January 1994, while the total turnover in 1993 exceeded the combined turnover for the previous two decades. Nevertheless, during the period of 1997-August 1998, the stock market experienced its sharpest correction ever as a consequence of the Asian financial crisis. The KLSE CI closed at its lowest level in eleven years at 262.70 points on 1 September 1998. With the introduction of selective capital controls on 1 September 1998 and the introduction of measures to maintain systemic stability, strengthen market intermediaries, improve market transparency and corporate governance, the KLSE CI turned around and increased by 286% to 1,013.27 points as at 18 February 2000. The KLSE CI closed at 833.37 on 30 June 2000.

1.2 Kuala Lumpur Stock Exchange

The Malayan Stock Exchange was established in 1960 and Bank Negara Malaysia was then the clearing house for the stocks or shares traded. Nevertheless, the Malayan Stock Exchange was separated into the Kuala Lumpur Stock Exchange (KLSE) and Stock Exchange of Singapore in 1973. The KLSE is a self-regulatory organisation which governs the conduct of its member stockbroking companies in securities dealings; enforces the listing requirements which spell out the listing and disclosure standards to be maintained by public listed companies; as well as responsible for the surveillance of the market place.

As at 30 June 2000, there are a total of 773 counters traded on the KLSE, with a total market capitalisation of RM572.31 billion.

1.3 Efficient Market Hypothesis

According to Findlay and William (2000), the financial market efficiency can be defined as operational efficiency and informational efficiency. Operational efficiency refers to a market's ability to provide liquidity, rapid execution of transactions and settlements, and low trading costs. Informational efficiency is defined as a market's ability to determine the true fair value of a security. FAMA (1970) bases the efficient market hypothesis (EMH) on this definition of information efficiency.

The EMH, according to FAMA (1970), postulates that market prices fully reflect all available information i.e that the market processes information

efficiently. An implication of the theory is that new information is impounded into price rapidly and without bias. Thus, by the time one hears news, it is too late to profit from trading on it. According to this theory, only unpredictable news can cause a change in prices given that old news is already discounted. As unpredictable news is not predictable, so are stock price changes. Therefore, investors are not able to beat the market consistently except by taking a bigger risk or by luck.

For the past thirty years or so, the EMH has been further subdivided into weak, semi-strong and strong form efficiency, based upon the set of information assumed to be reflected in the price. With weak form efficiency, the information set is limited to the past share price and perhaps, volume data. This implies that any information about future price movements contained in past price movements is already reflected in the current price. This means price movements are random and successive price changes are independent. Thus, technical analysis of the stock market will not be useful in this market.

Under semi-strong efficiency, all publicly available information is impounded in stock prices. In this case, fundamental analysis undertaken by securities analysts will not be beneficial. Under strong-form efficiency, all information, both public and private are accurately and rapidly reflected in the value of a stock. Therefore, techniques based on historical prices and/or fundamental analysis should not result in abnormal or excess risk-adjusted returns. If this condition held, even insiders could not trade at a profit.

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1.4   Stock Market Anomalies

There are a significant number of researches conducted to test the EMH in the 1960s and 1970s; and the EMH has, thus, been hotly debated. Although there is substantial evidence from the empirical studies to support the theory, there is also significant evidence in the recent years which documented the departures of financial markets from the EMH. This evidence is based upon a number of detected anomalies such as the firm size, dividend yield, earning/price ratios, book-to-market value ratios, weekend, holidays and turn-of-the-year (January) effects, etc. on market returns. These anomalies may lead to superior investment results without the individual bearing the additional risk. If an anomaly works, investors should be able to earn higher returns than the market returns without additional risk.

1.5   Objective of Study

The objective of the study is to test for the presence of seasonal patterns in stock price volatility and trading return of 44 stocks listed in the KLSE as well as the KLSE CI using differing statistical methodologies. In particular, this study examines the day-of-the-week effect of stock price volatility and trading return.

Apart from investigating the day-of-the-week effect for both stock price volatility and trading return for the whole period under study, the data sets are further sub-divided into three sub-periods, which correspond with the market performance, such as the stable market, declining market and rising market.

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The three sub-periods are also corresponding with the periods prior to the Asian financial crisis, the beginning of financial crisis up to the implementation of selective capital controls and after the implementation of the capital controls.

In addition, this study also examines the causal relationship between stock price volatility and trading return as well as the stock price volatility and trading volume.

1.6   Organisation of Report

This report is organised into 5 chapters and the coverage under each chapter is briefly explained as follows:

- *Chapter 1*

    This chapter provides an introduction to the whole report. It covers a brief discussion on the Malaysian capital market and its development in the last decade; role and functions of KLSE; efficient market hypothesis; stock market anomalies; and the research objectives.

- *Chapter 2*

    Chapter 2 covers the literature review carried out during this study. A detailed report on the relevant researches conducted previously and the findings are documented in this chapter.

- *Chapter 3*

    The description of the data set and the research methodologies are provided in this chapter. All statistical tests, both parametric and

nonparametric, used in this study are described and defined in detail in this chapter.

- *Chapter 4*

  Chapter 4 presents the findings and results from the various statistical tests as well as the analysis conducted.

- *Chapter 5*

  This final chapter provides the conclusion and discussion of the study. Recommendations for further research are also provided in the chapter.