CHAPTER 5

CONCLUSION AND RECOMMENDATIONS

The final chapter presents the conclusion and summary of this research. Next, suggestions for further research are presented. Finally, the chapter ends with valuable implications and recommendations.

5.1 Summary and Conclusion

Foreign exchange risk exposure refers to changes in the currency rate that influences the firms' value, which is represented by stock return in this study. This is what increases the business' risks. The expected and unexpected fluctuation in foreign exchange rate movement affects stock return and has created concern among firms and investors. This motivates the research to investigate the significant effect of foreign exchange exposure towards stock return and assesses any significant changes in the foreign exchange exposure during the pre- and post-crisis period.

After examining the coefficient in the lag regression of a two factor market model, the analysis findings establish that stock return is not significantly exposed to foreign exchange rate changes but the exposure changes as time evolves because the foreign exchange exposure effect is likely to be stronger during the crisis compared to before the crisis. The evidence obtained is not enough to conclude that there is a significant relationship but this study definitely contributes to the understanding that larger firms should be aware of the exposure and protect themselves against it, if needed.

The reason for the insignificant relationship due to larger firms' hedging activities which is to reduce the exposure is not considered in this study. Firms are able to mitigate the foreign exchange exposure through netting or matching tools. Furthermore, the gain or loss from foreign sales or receipts can be netted off against foreign costs or payments when those transactions are done in the same currency. In addition, the Malaysian government has obviously succeeded in managing foreign currency volatility under the managed float regime.

The study also discovered that the magnitude and size of exposure varies across the currencies. Most firms basically have greater exposure to the U.S. and EURO dollar, which might be due to the fact that the United States and Europe are the main trade business partners in Malaysia. Furthermore, foreign trading activities are mainly contracted or denominated in U.S. dollar and some in EURO dollar. Therefore, if the U.S. dollar currency changes significantly, then this will directly affect the firm's value through the trade flow impact. Besides that, firms in tradable sectors are more sensitive to change in the exchange rate compared to non-tradable firms. This is because of the nature of the business as the tradable sector is assumed to be actively engaged in export and import.

Consistent to a previous study (Chan, 2002), this paper shows that there is a limited success in identifying the significant contemporaneous correlation between exchange rate fluctuation and firms' stock return. This demonstrates that stock price does not immediately react to the change of exchange rate.

Besides that, the time variation of exposure across sample is also reflected in the adaptability of firms to exchange rate risk. Firms that find themselves highly exposed in one period will react by changing operational or financial policies to offset (or exploit) any adverse (favorable) consequences of the exposure (Dominguez and Tesar, 2006). However, no detail is available to confirm this conjecture. Nevertheless, the foreign exchange rate tends to be more volatile during the crisis compared to the normal period due to economic uncertainty as well as interest rate changes that consequently increase the foreign exchange risk exposure.

In conclusion, based on the sample firms, the foreign exchange risk exposure in Malaysia is not significant due to the above-mentioned reason or justification. However, the exposure may vary depending on the economic situation, exchange rate evolution and time variation.

5.2 Limitations of the Study

The results are differs from theory because there are other factors or independent variables – not included in this study – that affect the subject. Apart from that, the two factor model which is used to evaluate the overall firm value exposure, does not address the economic exposure or impact on firm's cash flow which are important. To provide strong and established justification or reason supporting the results requires in-depth and detailed understanding of the firms' behaviour or nature such as reviewing the financial statements. In addition, the study is only limited to large listed firms therefore; these findings may not be a generalization of all firms in Malaysia.

5.3 Suggestions for Future Research

The research should be extended by using another approach that is the cash flow model adopted by Batram (2007) to substitute the traditional approach. The cash flow of the firm – instead of stock price or return – that represents the firm value is regressed against the foreign exchange. Then, the comparison of results between these approaches can be rationalized. In addition, the measurement of exposure can be improved by using different variable characteristics or criteria such as leveraging on trade-weighted or firm-specific exchange rate. The subject of the samples can be based on industry (oil and gas), activity (exporting or importing) and nature of business (domestic and multinationals). Since this research focuses on large firms, the next research could focus on small firms to estimate the exposure. Besides estimating the exposure, the potential research should also consider investigating the significant factors that determine the size and direction of exposure in Malaysia.

Foreign exchange risk management, particularly hedging, is an important area to investigate to find out the costs and benefits of hedging apart from providing a better understanding on the importance of hedging. The research can be conducted to investigate the determinants or factors influencing the usage of hedging instruments. Hopefully, future research will be able to provide a more conclusive finding and result that benefit managers, investors, other relevant parties and the economy and trade business.

5.4 Implications and Recommendations

Based on the findings and conclusion, although firms in Malaysia are not significantly exposed to foreign exchange risk, that does not mean firms should not pay attention to it. Firms should always be aware of the exchange rate fluctuation as well as its impact on firms regardless of whether the exposure is significant or not. As observed, when a crisis strikes, firm value tends to be more volatile and becomes subject to higher risk due to the uncertainty in the foreign exchange movement. Consequently, the firm's future growth performance will be affected when the profitability and cash flow of the firms are unstable. Investors will begin to demand for a higher return due to the increase of the market or foreign exchange risks that is distressing the required rate of return. As a result, the cost of capital increases.

Besides that, firms should consider whether to proactively be involved in managing the exchange risk by hedging or using the derivatives as a solution. According to Dekle and Ryoo (2007), hedging can take better advantage of favorable business opportunities to increase cash flow or reduce the impact of the currency shock. Making a decision on which currency to use in business transactions is vital to reduce losses due to conversion. Banks can play an important role in promoting and providing hedging services and instruments based on the firms' requirements and needs, such as forward or futures.

Investors should be confident when investing in Malaysian firms due to the smaller exposure effect. The lower risk with a stable rate of return is able to attract more foreign investors to Malaysia. Hagelin and Pramborg (2005) suggest that the impact of past foreign exchange rate changes on firm performance or hedging activities should be reported in the earnings announcements so that investors are able to assess the level of risk involved. The government should continue to manage the floating exchange rate for the benefit of the economy.