CHAPTER 1:

INTRODUCTION

1.1 Background of the study

The movement of stock market has been long thought to be highly correlated to arrival of public information, both internal and external. The most common internal factors that are widely believed to be able to affect the performance of stocks in general include dividend announcements (McCluskey et.al, 2006; Deshmukh et al, 2008), mergers and acquisitions (Gersdorff and Bacon, 2009; Selcuk and Yilmaz, 2011; Wilcox et al, 2001; Rhéaume and Bhabra, 2008) and stock splits (Fama et al., 1969; Elfakhani and Lung, 2003) in various industries. While stock performance is closely related to its internal factors, its sensitivity is also very much dependent on news and incidents from the outside world such as macroeconomic news (Bernanke &Kuttner, 2004; Nikkinen et.al, 2006; Basistha and Kurov, 2008) and political events (Ali et.al, 2010; Beaulieu et.al, 2011; Kollias et.al, 2011; Białkowski et.al, 2008).

Traditional finance theories propose that the current stock price is determined by the present value of the rationally forecasted future cash flows and the discount rate (Ross et al., 2010; Berk and Demarzo, 2007; Damodaran, 2001). Rationally speaking, if a news announcement does carry any relevant information that can affect either expectation about future dividends or discount rates, the arrival of such news will trigger a movement on the daily stock price (McQueen and Roley, 1993). This is similar to say that investors tend to adjust their expectation on market conditions, based on the new information arrived and consequently, the price of a stock will move to equilibrium (Soultanaeva, 2008). Stock price will increase if the news leads to a positive upward revision of expectation by investors and vice versa. Another characteristic of stock price movement is identified by its volatility. As pointed out by Äijö (2008), an arrival of information can either increase or decrease the volatility of a stock, depending on the state of economy, as well as the scope and nature of the news. The volatility of a stock price will increase due to more information faced by investors, their divergent in interpreting the news or higher uncertainty if the announcements convey negative or unexpected content. On the other extreme, the volatility of a stock price will be lowered by announcements that convey good news or reduce market uncertainty.

This research intends to study the impact of different political and national budget announcements on local stock market. Theoretically grounded on the Efficient Market Hypothesis (EMH), behavioral finance theory and Uncertain Information Hypothesis (UIH), this research intends to explore whether Malaysian stock market does react to new arrival of various political and national budget information and if it does, in what manner? Does it react efficiently or tend to overreact?

Such information dependent behavior of stock performance has already motivated scholar such as Fama et al. (1969) and Fama (1991 & 1998) to conduct study decades ago to test how efficient the capital market in reflecting information. If the market is efficient by nature, then theoretically speaking, it will reflect all relevant information on timely basis and thus there is no opportunity to make abnormal profit from the market even if an investor possess any information, because the market will adjust its price to the new equilibrium immediately after the arrival of new information. However, this efficient market argument has also been challenged by scholars based on the theory of behavioral finance which contends that psychology factors such as biasness and heuristics tend to mislead someone from making rational decision and therefore the correct stock price might not be reached.

This study is motivated by a few factors. Apart from the contradictory argument of the two theories, it is the fact that emerging markets are highly sensitive to political factors (Durnev et al., 2004; Goriaev and Zabotkin, 2006). Beaulieu et al. (2005) found that political risks are seen as major phenomenon that affects most national bonds and stock market since last century. As for the national budget, it contains major macroeconomic information such as the GDP, GNP, balance of payment, government fiscal and tax policy that carry useful information to the stock market.

In Malaysian context, the impact of various kinds of political news on the local stock market behavior is of special research interest not only because of the abundance of dramatic political events, but also due to the politically-connected nature of the many large companies that form the FTSE Bursa Malaysia KLCI. It seems rational to assume that any political and national budget announcement would have impact on the stock of these firms and the stock market as a whole.[1] Obviously, it is also interesting to find out

[1] As at December 2011, the FTSE Bursa Malaysia KLCI consists of 30 largest companies by market capitalization that covers about 70% of FTSE Bursa Malaysia Emas Index

whether the political and national budget announcements do form any risk perception in the mind of these investors.

1.1.1 Bursa Malaysia and the FTSE Bursa Malaysia KLCI

The Stock Exchange of Malaysia was established in the year of 1964. With the secession of Singapore one year later, it became known as the Stock Exchange of Malaysia and Singapore. In 1973, due to the cessation of the interchangeability of currency in both countries, the Stock Exchange of Malaysia and Singapore was then separated into Kuala Lumpur Stock Exchange Berhad and the Stock Exchange of Singapore. On 14 December 1976, the Kuala Lumpur Stock Exchange (KLSE) was incorporated to take over the operations of Kuala Lumpur Stock Exchange Berhad. On 14 April 2004, the KLSE changed its name to Bursa Malaysia Berhad following a demutualization exercise that serves a purpose to enhance competitiveness and responsiveness towards global trends.

The Industrial Index launched on 2 January 1970 was the first barometer of Malaysian stock market. However, by 1985, the Industrial Index was no longer been able to reflect the stock market and was then replaced by Kuala Lumpur Composite Index on 4 April 1986 which is more reflective of market performance, sensitive to investors' expectation and indicative of Government policy changes.

KLCI initially consists of top 100 companies in Malaysia by market capitalization. Recently in 2009, the KLCI adopted FTSE's global index standards and is now known as the FTSE Bursa Malaysia KLCI (KLCI). Due to the changing of index calculation methodology, the current constituents of this enhanced KLCI are reduced to 30 largest companies by market size (see Appendix 1) and covers about 70% of the FTSE Bursa Malaysia Emas Index. In other words, the overall performance of the main board of Malaysian stock market relies heavily on the stock movement of these 30 firms. Interestingly, out of these 30 companies, 14 are government linked companies (GLCs). Together with other GLC which are not in the list, they represent almost half of the total market capitalization (Marimuthu, 2011). Therefore any political or macroeconomic announcement that can cause the downfall of these GLCs will mirror the collapse of the whole equity market in Malaysia.

1.2 Problem Statement

Despite numerous empirical studies from the past decades to test the market efficiency from various perspectives, whether the market is efficient in reflecting political and national budget news remains controversial. Therefore, there is a strong need to conduct a study to examine the relationship between market reactions to political as well as national budget announcements.

We have sufficient evidence to believe that the sensitivity of the market is closely linked to the arrival of new political information. However, the focus on political scenarios differs among studies and is country-specific most of the time. There are a number of researches which examine the impact of political news based solely on election events. Nickles (2004) solely focuses on the stock market performance to US Presidential elections cycle. Kithinji and Ngugi (2010) conducted a study to test the performance of

Nairobi Stock Exchange before and after elections and found that the stock market in Nairobi is greatly influence by expectations around the election period. While many studies solely examine the election events, some tried to interpret the market reactions by using country-specific political events. Aktas and Oncu (2006) investigate the pricing behavior of the Turkish stock market in case of a political events that had economic impact on the investors whereas Abdelrehim et al. (2011) investigate how the nationalization of an oil company can lead to negative abnormal return of stock market under such instable political environment. This study, however, distinguishes itself from others by looking into a wider spectrum of 38 political events consist of general and party elections, shift of country's Premiership, cabinet reshuffle and some extraordinary political events within the past three decades.

Besides that, the existing researches mostly study the impact of political events and national budget factors on stock market reaction in separate papers and therefore a juxtaposition comparison of the two influencing factors cannot be made. In addition to that, while most studies examine the impact of political events *as a whole* on stock market reaction, only few zoom into the impact of each individual event. This study intends to fill this gap by also looking at how market reacts to *specific types* of political events and further delves into the impact caused by *individual* political as well as national budget announcement, in addition to studying the collective effect of each political and budget factor to the stock market.

Apart from the lack of juxtaposition comparison and individual events inspection presented in previous studies, there is also significantly lack of evidence on stock market reaction within the scope of politics and macroeconomic factors in Malaysia. In Malaysia context, a fraction of past studies on the stock market reaction can be found from the work of Hameed and Ting (2000), Ali et al (2010), and Lai et al. (2003). The focus of their research is mainly on examining the overreaction and underreaction hypothesis on Malaysian stock market based on different scenarios. Lai et al. (2003) examine issues related to investor overreaction based on the concept of contrarian strategy on a long run basis. Ali et al. (2009) focus their study on relationship between stock overreaction and financial bubbles. In another study by Ali et al (2010), though they test on a wider spectrum of factors inclusive of political events, the political factors are only limited to General Elections during 1990s and the removal of the then Deputy Prime Minister Anwar Ibrahim. On the other hand, Hameed and Ting (2000) investigate the possibilities of making contrarian profits under different level of trading volume. In a nutshell, most of the Malaysian studies are to test the weak-form Efficient Market Hypothesis and there is no study to test the market efficiency at semi-strong form level by using publicly available information, such as political and budget announcements. In addition, apart from studies on the relationship between political issues and market, there is hardly any study that emphasis on the relationship between a national budget announcement and the stock market reaction in Malaysian context.

Even if there is a plethora of researches that look into the relationship between the variables, conflicting results have been observed from past researches. While Döpke and

Pierdzioch (2006) finds no strong evidence that support the impact of political events on stock market movement, there exists abundance researches that show a significant relationship between stock market reactions and various kinds of political events. Bialkowski et.al. (2008) examine the degree of stock market volatility around national elections in 27 industrialized nations. Their in-depth analysis proves that stock market volatility is tremendously raised around national elections. They found evidence that investors are surprised by the election outcome, thus suggested that the market behavior may be explained by the general election. In a study of the response of Canadian and Quebec-based firms' stock return to political news in Canada, Beaulieu et.al (2005) reports that the political news is an important determinant of the volatility of stock market. Schneider and Troeger (2011) run a time series analysis in an attempt to assess interrelationship between world economy and war conflicts. Their results show that international financial markets react negatively to war events in general. However, in another similar study on economic effects of violent conflict conducted by Guidolin and La Ferrara (2010), a contrast results show that on average the national stock markets are prone to react positively rather than negatively to international conflict onsets.

The research objectives formed in the next section thus intends to close the gaps mentioned above.

1.3 Research Objectives

This research generally aims to contribute to the current literatures by empirically investigating the stock market reaction to the announcement of a series of 38 political events over a period of thirty one years (1981—2011) and fifteen budget announcements over a period of fifteen years (1998—2011). In the light of this, the research objectives can be further identified in a more specific manner which attempt to justify whether political and national budget announcements concern the equity investors and if they do, to what extent market reacts to those information?

The first objective is to examine the efficiency of the Malaysian market in reflecting to both political and budget announcements *in general*. Therefore, this part of research is going to look at how the market reaction, as indicated by abnormal return (AR) and cumulative abnormal return (CAR), fluctuates on average around a particular period of announcement. In order to achieve the desired collective results, AR and CAR will be aggregated across events to examine the collective impact of events on market reaction on average. From the results, we are also able to conclude, on a collective basis, any evidence of leakage of information before an announcement, existence of abnormal return possibilities and behavior of overreaction / underreaction of stock market at a particular time during the period of analysis.

The second objective is to further segregate the 38 political events into six different categories according to their common features and examine the impact of each category of events on the Malaysian stock market. The six types of events under investigations are: (1) Dissolutions of the Parliament (2) General Elections (3) Changing of administration leadership (4) Party elections (5) Cabinet reshuffles and (6) Extraordinary events. From the analysis, we are able to conclude which types of political events carry information impact to the stock market and which types do not concern the market in general.

The third objective is to delve into each and every single political and budget announcement and identify the impact of these individual events on the market *in specific*. Again this part of research is looking at significance of each announcement in affecting the market reaction. Therefore this part of analysis intends to answer the question of whether a particular political / budget announcement specifically gives rise of significant market reactions.

The fourth objective is to compare the impact of both political and budget announcements to the stock market in Malaysia. Put it in other words, this study intends to find out whether market reacts differently to both political and budget announcements.

To a broader extent, one can conclude, by achieving these four objectives, that whether the Malaysia stock market adheres to Efficient Market Hypothesis (EMH) proposed by Fama (1970) in reflecting new arrival of political and budget announcements. If it does not, what are the theories that can explain the observed behavior of the stock market whenever news on politics and budget arrive?

In order to conduct a more comprehensive study, a good number of 38 major political events are selected for the past thirty one years from 1981—2011 whereas 15 national budget announcements have been collected from 1998—2011.

For political announcements, particular attention is given to a series of prominent political events within the thirty-one-year time frame, including all the national elections and selected party elections, cabinet reshuffles and the shift of Prime Minister and Deputy Prime Minister Premiership. These events are selected because of their likelihood to affect the orientation of government in setting future policies which is concerned by almost all industries in the economy. Apart from political events that occur on a cyclical basis, there are also extraordinary political actions which shook the Malaysian society, e.g. the MCA crisis in 1985, "Operation Lalang" in 1987, the sudden removal of Anwar Ibrahim as Deputy Prime Minister in 1998, as well as two rounds of "Bersih" rallies in 2007 and 2011 respectively. Therefore, it is rational to include these events into the study as well. As for budget announcement, fifteen years of budget announcement are selected from 1998 until 2011 in order to study the collective effect of government fiscal policy, the GDP, the balance of payments, taxes and other macroeconomic factors to Malaysian stock market.

1.4 Research Questions

In order to investigate the relationship between market reaction and political / budget announcements, these research questions will be dealt with:

1. How does the market react when political news is announced *in general*?
2. How does the market react when a national budget is announced *in general*?
3. How does the market react to specific types of political announcements?

4. What is the difference between market reaction to political announcements and budget announcements?

5. How does the market react to each individual political and national budget announcement?

These questions are raised to address two key issues: Do major political activities and national budget news affect the performance of Malaysian stock market? If they do, then how does the market react to this information?

1.5 Significance of the study

This study extends the existing empirical research in Malaysia in three dimensions. First, this study extends the timeline of study. While Ali et al. (2010) focuses on the research on Malaysian market from 1987 until 2006, this research extends to a wider study period of thirty years from 1981 until 2011. Second, it also covers a wider scope of political events to allow a more comprehensive view on the issue. Besides General Elections and the removal of Anwar Ibrahim as DPM, this research covers up to 38 political events that include party elections and other extraordinary political incidents which were not dealt with previously. Third, the study of the impact of national budget on stock market is particularly rare in Malaysia. This study therefore closes the gap through examination of how local market reacts towards the budget announcements.

Previous studies done by Lai et al (2003) and Ali et al (2010) are using individual firms by segregating them into winner and loser portfolios in order to determine reaction of

Malaysian stock market. In this study, however, a different approach is adopted. The KLCI is used as a dependent variable to study the reaction of Malaysian market. Lasfer et al. (2003) contend that the analysis of market indexes allows us to identify shocks (measure by Abnormal Return) and evaluate the market's post-shock performance. In line with the studies that have looked at individual stock return (Ali et al., 2010; Lehman, 1990; Brown et al., 1988), this research analyses the behavior in market index over very short time periods, thus providing contrasting evidence to previous studies that mainly looked at winner—loser behavior on long- or medium- term horizons.

Finally, besides studying the impact of political and macroeconomic announcements on market reaction *in general* across the events, this research also zooms into *specific sets* of political events as well as *individual* events announcement to determine in detail the effects of different types of announcement to the stock market. This part of study, as what the researcher believes, has never been previously conducted within Malaysian context.

1.6 Organization of the study

This research study is organized as following:

Chapter 1 introduces the background of this study by incorporating the theory, brief description of history of the Malaysian stock market and the motivation of conducting this study. The problem statement is identified and research objective as well as research questions have been clearly described and formed. Besides, it also states the significance of the study.

Chapter 2 reviews past literatures that cover theories and empirical studies which are closely related to this research study.

Chapter 3 presents a brief description of the 38 selected political events and the contents of the national budget from 1998—2012.

Chapter 4 begins with the formation of theoretical framework and hypotheses, and lays emphasis on the research methodology used in this study. The empirical model and measurement of the variables are clearly defined.

Chapter 5 presents the results and findings from analysis of the study.

Chapter 6 summarizes the research findings in comparison with past studies. Implications, limitations of the study and suggestions for future research are presented, thus conclude the whole research study.