

CHAPTER 1

INTRODUCTION

1.1 Selectivity and Market Timing

Forecasting, selectivity and market timing are vital in planning and decision making, either qualitatively or quantitatively depending on data availability. The qualitative methods using judgment may not be as efficient as the systematic quantitative methods when numerical data are available.

The interest of both the academic and practitioner communities, especially the fund managers and investors, in the management of fund performance has increased in recent years. Fund managers are called stock pickers or market timers where they are expected to be equipped with security selection skills and market timing skills. Normally, investment managers focus on the history of fund performance. They invest in portfolios according to their selection skills and risk preferences.

Portfolio excess return can be decomposed into a passive and active component. The passive return component is based on public information as non-informed investors can earn this return by investing in the benchmark portfolio and in risk-free assets according to their risk preferences. The passive return is an indicator for the diversification capabilities of the portfolio manager. The fund

manager's ability is reflected in the performance of mean-variance-efficient portfolios constructed based upon public information.

Private information is an added advantage relative to the public information. This component is a necessary condition to achieve good performance. But the possession of such information is only one thing. It is also necessary that the asset manager knows how to translate this valuable information to correspond with security exposures and that the needed information-based trades are executed before the information spreads. Private information therefore includes private selection and private timing information.

The active part of excess return includes the components based on selection and timing information. There exists a tradeoff between diversification and selectivity. Unsystematic risks are taken when trading on selectivity information, due to the changes of the composition of the passive mean-variance portfolio. The implementation of timing information is possible while keeping the portfolio mean-variance efficient. In addition, acting on private timing information means adjusting the systematic risk which is measured by the beta coefficient for the portfolio. Therefore, the beta coefficient also depends on the risk preference of the investors.

The goal of a performance analysis is the identification of the active and passive return components. As it can be seen, active return is further broken down into a timing and a selectivity return component. Statistical techniques are used to

distinguish these systematic performance effects from pure chance and to account for the risks taken to earn them.

Market timing strategies try to predict the direction of the overall market performance. Overperformance by timing the market can be achieved by adjusting the overall market exposure of the portfolio. There are various techniques to time the market such as the tactical asset allocation, timing within an asset class and derivative instruments. The technique of tactical asset allocation is based on changes in the asset class mix. This technique is also known as 'rotation', either the sector rotation or asset class rotation. Timing within an asset class means changing the security mix by shifting the proportions of conservative (low betas) and dynamic (high betas) securities. The derivative instruments technique is used especially for index futures.

In other words, the macro-forecasting skill is the market timing ability, whilst the micro-forecasting skill is the identification and differentiation of its selection. Timing is a decision to be in or out of the stock market that is to be made by the manager. Being out of the market has a higher risk compared to being in the fixed income market. The effects of risk level change due to market timing decision can result in a nonlinear relationship between portfolio returns and market returns. Investors and fund managers use these skills in planning a medium-term portfolio or long-term investment. The changes in the composition of stocks in a portfolio can impact on the systematic risk of the fund. Market timing will give a greater impact on a fund's systematic risk compared to the selection skill.

Risk may be defined as uncertainty of the rates of return on investment. A considerable portion of the fluctuations in the market price and all payments in the form of cash dividends and stock dividends depend on the ability and the willingness of the stock issuers to pay and the stock investors' appraisals of the issuers' ability and willingness. The cause of uncertainty refers largely to financial risk. If the profitability of a firm increases, uncertainty about its ability to pay decreases.

The concept of a relationship between risk and expected rate of return has become widely accepted by both theorists and practitioners. This concept has been extensively documented for well-developed and mature markets like New York Stock Exchange (NYSE) and also for fast developing stock market like the Kuala Lumpur Stock Exchange (KLSE).

The systematic risk is used with implications in risk measurement. The computation of systematic risk for an individual security relates to an aggregate market index return. Investors use the stock index in examining the total returns for an aggregate market. In predicting the performance of a portfolio, the returns are used as benchmarks. A relationship between the systematic risk of a fund and market timing ability of the fund manager should be established. Fund managers use the stock market index as a guide in developing portfolios, and as a proxy in examining the influence of aggregate price movements. Based on risk adjustments over time, studies show that only a few fund managers can out-perform a market index.

Beta coefficient is the measure of systematic risk of a security. Beta of a stock measures the sensitivity of a stock to market movements. Therefore, the relationship between the return of a stock and the return on the market is a risk measure.

Many investors are not prepared to take a loss on their investments and therefore opt for investments with low volatility. Some investors, provided that they receive increased rewards, are willing to take on additional risk. It is very important that investors not only have a good understanding of their risk tolerance, but also know which investments match their risk preferences. Investors who are very risk averse should put their money into investments with low betas such as utility stocks and treasury bills. Those investors who are willing to take on more risk may want to invest in stocks with higher betas.

Numerous empirical studies show that there is a relation between risk and expected rate of return, for example, Black, Jensen and Scholes (1972), Blume and Friend (1973), Fama and Macbeth (1973), and Blume and Friend (1974). One of the important contributions in this area which investigated in detail the behaviour of the Malaysian and Singapore stock exchanges is the work by Lee (1977).

1.2 Objectives and Scope of Study

This study focuses on the finance stocks listed on the Main Board of the Kuala Lumpur Stock Exchange (KLSE). The main objective of this study is to examine whether timing ability exists for this segment of the stock market. In other words, it

will be examined whether the stock returns and market returns have a nonlinear relationship after accounting for the systematic risk. In a similar context, this study also investigates if the selected finance stocks have excess returns over and above the reward for taking systematic risk. Together with this, the selection ability of the stocks is examined. As will be elaborated, this study limits the scope to selected finance stocks due to the reason that the data processing is very time consuming.

1.3 Significance of Study

This study highlights the best model that indicates if the finance stocks have market timing ability, as well as selection ability. The modelling issue is interesting from the academic point of view. Stocks with these abilities are obviously good candidates for investment. This study identifies performing finance stocks in this regard, and therefore provides useful information to the practitioners.

1.4 Organization of Study

This study is organized into six chapters. Chapter 1 briefly describes the selectivity and market timing ability. The objective and scope of this study is also stated.

Chapter 2 presents a brief history of KLSE and some important features of the KLSE Composite Index. It also reviews the development of the literature on the past theoretical and empirical studies that are concerned with the market timing and investment performance.

Chapter 3 gives a description of the data used, the sample and also the time period covered. A brief discussion on the calculation of daily returns is given and this chapter also explains the methodology employed in the study.

Chapter 4 presents the results and analysis of the findings for different market models. The analysis includes discussions on the abnormal return specific to stock selection, abnormal performance and abnormal return specific to market timing activity.

Stock returns are known to display time-varying volatility. Chapter 5 provides a comparison of the results with the findings in Chapter 4 after taking this behaviour into consideration. This represents an effort that was not been explored in the literature.

Chapter 6 presents the summary and conclusions that are drawn from this study.