STOCK EXCHANGE IN MALAYSIA : PROBLEMS AND REFORMS

by

Mohd Aminudin Bin Othman

(830086)

Project paper submitted in partial fulfillments for the degree

of

Bachelor of Economics

Kulliyah of Economics
International Islamic University
MALAYSIA

April 1987

Dedication

This Project Paper is dedicated to my mother,
y father and those who have contributed in
atever means. May Allah swt. give His Blessing
all of them. " I have created Jinns and Men,
at they may serve Me " (Al-Dhariyat: 56)

ABSTRACT

Stock exchanges, along with financial institutions, should constitute the most convenient form of investment available to a majority of savers, who have neither their own business to invest in nor the ability to evaluate running businesses or becoming sleeping partners. This papers is concerned with the problems and reforms in stock exchange to ensure that shares prices reflect more or less the under - lying economic conditions and do not fluctuate erratically in response to speculative forces.

The study was aimed at four aspects. Firstly, to give a general understanding of investment in stock market and its role. Secondly, to identify the problems in general and particularly relating to stock market. Thirdly, to review proposed reforms and measures being undertaken by KLSE. The study included reforms from Islamic perspective and a hypothesis of Islamic stock exchange. Last but not least, to suggest recommendation for improvement and proposals for further research in relation to stock exchange.

In addition, literatures concerning basic concept and hypothesis of stock exchange were reviewed in Chapter 3.

CONTENTS

LIST OF FIGURES

ABBREVIATIONS

BMF.	Bumiputra Malaysia Finance
CBT.	Criminal Breach of Trust
CIC.	Capital Issues Cimmittee
DY.	Dividend Yield
EMH.	Efficient Market Hypothesis
FIC.	Foreign Investment Committee
GNP.	Gross National Product
IIA.	Institute of Internal Auditors
IIU.	International Islamic University
ISE.	Islamic Stock Exchange
KLSE.	Kuala Lumpur Stock Exchange
LIFO.	Last In First Out
MISC.	Malaysia International Shipping Corporation
MSP.	Maximum Share Price
MTI.	Ministry of Trade and Industry
NST.	New Straits Times
OCBC.	Oversea Chinese Banking Corporation
OTC.	Over - The - Counter
PER.	Price Earning Ratio
RIIAM.	The Research Institute of Investment Analysts Malaysia
ROC.	Registrar of Companies
SCANS.	The Securities Clearing Automated Network Sdn Bhd
SE.	Stock Exchange
UKM.	Universiti Kebangsaan Malaysia

CHAPTER 1

INTRODUCTION

The financial system is an important component of the economic system of a nation. The various institutions in the financial system function in order to channel resources (money capital) that are needed to finance the economic activities in the economy. How efficient this system is, will determine to a certain extent the economic development of the nation.

The financial system comprises of financial institutions (intermediaries) which traded financial instruments (money, securities) on the financial market in order to transfer money capital from the surplus units to the deficit units. Generally, the system can be divided into two, based on the types of intermediaries (Central bank, Commercial banks, Merchant banks, finance companies and discount houses) and the non - banking intermediaries (Development Finance institutions, Provident and Pension Funds, Insurance Companies, Unit Trust and Security Market).

This paper will concentrate on a section of the second group i.e. the securities market or capital market (as opposed to money market) as it is commonly known the Stock Exchange. Existing stock exchange have many drawbacks and problems. Before identifying the problems, which is the main objectivesof this study, it is appropriate to have a general understanding of investment, share and stock exchange.

The approach to the nature of the problem is comprehensive in which we take into account the economic, ethical values and ' religion '. This is in conformity with the Islamic approach in solving problems where compartmentalize of any problem from other system as a whole is discouraged.

1.1 Concept of Investment

An understanding of the nature of investment and the fundamentals of investment that underly the operation of a stock market is a necessary prerequisite for comprehending the studies that are presented in this paper.

Investment in a broad and general sense signifies the use or employment of capital for purposes of gain. It always involves the application of capital. In other word, an investment is the commitment of resources for asset with the hope that the asset will yield regular future income and / or an increase in the value of the asset such that the sum of such incomes together with the eventual value of the asset is greater than its purchase price. The regular incomes and / or the increase in the value of the asset is known as ' return on investment '. The first is usually known as the ' current income ' while the second is known as ' capital gain '. By this definition, there can be many types of investment.

The opportunity of obtaining a big return alone is not the only consideration when one is making an investment, however big that return pontential may be. An investment has three other important characteristics which an investor has to consider together when he is making up his mind whether to invest or not. Most people do this instinctively without consciously realising what they are doing. But to be better than a mere mediocre investor, one has to weigh these three factors consciously and intelli - gently. The three characteristics are liquidity, uncer - tainty and relative proportion of regular income versus capital gain. The balance between these three characteristics of a particular type of investment determines the size of the return that an investor can expect to get from his investment. The combination of these three characteristics and return potential of an investment also determines whether a particular type of investment is suitable for a particular investor.

1.11 Characteristics of Share Investment

Let us look at these three characteristics of an investment more carefully.

(a) 'Liquidity' is a word used by economists to describe how easily an asset can be turned into cash. Thus a savings account is a very liquid investment. However, some investments are not very liquid.

(b) An investment involves uncertainty with regard to the size and probability of the future returns.

(c) An investment usually produces a combination in different proportion of two type of income; a regular income and capital gain resulting from the increase in the value of the asset.

On first glance, one will think that share investment can be classified as a highly liquid investment since shares can be sold and cash be collected within a few days. In reality, however, shares can be very illiquid investment for several reasons. The first being that most investors let themselves be caught in a psychological trap. Most people find it extremely difficult to ' cut losses ' and sell out when the market turns down. The instinctive reaction is to hold on and hope that the market will turn better. But since the bear market can last anything up to two years, an investor hoping for a higher price may have to wait as long as three or four years. Besides, buying and selling shares involves brokerage. If one buys and sells too often, brokerage can eat up a large proportion of any profit there is.

The second reason for the lack of liquidity is linked to the various aspects of our market. The first being the very big difference between trading volume of the bear market verses the bull market. Investors who have chased up the price of a market favourite can easily find out of this particular share has suddenly disappeared totally during the bear market phase. Second, certain ' hot ' shares can become suspended for months, if not years, during a critical time of the market cycle such that investors find their investment completely frozen during the time when the market is falling heavily. Third, registration and splitting of certain shares can on occasions take an uncomfortably long time. A small investor can easily be caught with no scripts whatsoever when the market is rising heavily or even worse, plunging sharply.

For these reasons therefore, shares cannot be regarded as very liquid investments, at least not in the local context. Since it is not a very liquid asset, investors have a right to expect higher return than other more liquid form of investments.

The return on the investment one can expect to get is not definite or predictable. It is impossible to predict with certainty what the future price of a share is going to be like. Anyone who claims to be able to forecast share prices accurately is either a fool or a trickster. This is true because a person who can do so is in possession of the key to limitless wealth.

The more uncertain is the return of an investment the higher must be the potential return in order to attract people into investing it. Since return on share investment is very uncertain, its return must be very much higher in order to compensate those investors willing to put money into it. Many new investors do not understand this very important principle. They assume automatically that the returns on share investment is both predictable and high. If this so, it would be in blatant contravention of the statement that: ' There is no such thing as a free lunch '. One cannot get something for nothing in this world. Share investment only provides high return because it is so uncertain. If you dislike risks and uncertain - ties, you ought to put your money in a safer investment avenue.

As investment usually produces a combination of a regular income stream and a capital gain when eventually the asset is sold off. Different types of investment produce different combinations of these two types of return to the investor. Two important characteristics of these two types of return are indicated. First, an investment which relies on capital gains to reward its investors. should generate much higher return than one which relies on a regular income stream. This goes back to the law of supply and demand. An investment which relies on capital gains alone to reward its investors is less attractive than one which provides the investors with regular income because the latter is much more certain than the former. Second, an investment which promises high capital gain is a much more risky investment than one which has no possi - bility of capital gain. The much higher return has been accompanied by a much risk in share investment because much of the return from it has been in the form of capital gain which is highly unpredictable. Historically, about three - quarters of the total return obtainable from share investment has been in the form of capital gain. The high return on share investment has been obtained by a combina - tion of good years when the return may be higher than 100 per cent as well as of bad years when the loss may exceed 50 per cent. The changes in the price of shares have been so large that they totally swamp the small regular dividend income one can get from shares (in the region of 4 per cent on the value of the initial investment).

Share investment brings with it many risks and many people are just too conservative to want to invest in shares. Whilst it is true that historically shares had produced very high return for some investors, such invest ments are not without some drawbacks. In exchange for such high returns, investors in shares have to pay a high price in terms of peace of mind and soundness of sleep at night. Shares can be a very illiquid; it is also very uncertain in terms of the return that can be obtained. However, a high proportion of the return on share invest - ment is in the form of capital gain which only obtainable when the share is sold sometime in the uncertain future.

1.12 <u>Difference between Investment, Speculation and Gambling</u>

As a prerequisite in understanding the stock market, it is necessary that we understand

the differences between Investment, Speculation and Gambling. Firstly, we focus on the difference between investment and speculation. Investment is rationally based on the knowledge of past share price behaviour. From such knowledge, it is possible to compute the possi - bility of future return. A common method of investment analysis is to study the past range of PER (Price Earning Ratio) or DY (Dividend Yield) of a particular share or a class of shares. From this study of its past price range we can predict the likelihood of its price being out of this range in the future. By comparing its current price with the expected future price range (future price ≑ future PER x future earnings) we know whether the current price is too high or too low and take the necessary action accordingly. In sharp contrast, speculation is purely based on the hope that future price will be higher rather than on anything that is tangible.

Secondly, investment requires an investor to do some work before hand and decision are made based on known facts and figures. Speculation is usually based on wild rumours and unsubstantiated hearsay which cannot be checked for accuracy. Undoubtedly, speculation is a lot easier than investment but one tends to reap what are sows.

Thirdly, investment is made for the long term (ie. two years or more) based on the idea that one is much more certain when one is trying to predict the cumu - lative results of many daily movements. One invests with the knowledge that over the long - run, the real investors will always make a gain. Speculation is usually for the short run (i.e three months or less unless one is caught whence a speculator is then forced to become an investor), based on the idea that certain events may result in a rise in price (bonus, rights takeovers, and others).

Finally, speculation is not based on anything concrete, its result is not at all predictable. Speculation can occasionally produce very high gains just as it can produce very high losses. Over a long period of time, speculation is most unlikely to produce better return than true investment. The speculator will always have to be on the alert to take the necessary quick action to catch the right moment. True investors have a fairly good idea of the possible extent of their loss and gain before hand. Besides, since they are investing for the long term, they can forget about short - term movements and ignore the market most of the time.

There is only one real difference between invest - ment and gambling. In investment, one can expect to make a profit over the long run but: gambling will always result in a loss over the long run although the gambler may not know it. Over the long run, the laws of statistics will prevail i.e. the law of the Large Number[1] gambler will always lose.

There are certain situations in the world of investment which resemble gambling and investors are well advised to keep clear of time. To buy shares when the market is at its ' hottest ' is definitely gambling because like all bull markets, once everyone interested has been sucked in, there are no more lambs left, and the market can only go down. To sell shares which have been held through a long period of decline is also a gamble because the market is cyclical; it will recover after a long period of decline.

---

1 this law states that the larger the number of occurance of an event, the closer it will conform to the underlying probability.

1.2 Share and its benefits.

To understand what a share is, we must first have some understanding of what is meant by the ' capital structure ' of a company. The capital can be obtained from three sources. Firstly from shareholders - this is known as new equity capital. Secondly, from borrowing - this is known as debt capital. Thirdly, from its own profit which is not distributed to its shareholders - this is known as retained earnings. There are limits to how much debt and retained earnings a company can use and equity capital is still the most important source of capital. In return for their money, the investors are provided with share certi - ficates in proportion to the amount of money they each invested in the company (also known as the paid - up capital). In Malaysia, the usual value of a share is $1, therefore the number of shares issued would be the same as the initial paid - up capital of the company in dollar terms. The number of shares each investor holds out of the number of shares issued determines the percentage of the company he owns.

What then are the benefits of buying shares in a company? Under the Companies Act as well as common law, a shareholder in a public company is entitled to certain benefits. The real benefits are as follows:

(a) He is entitled to sell his shares anytime he sees fit.

(b) He is entitled to take up any right issues in proportion to his ownership of the company.

(c) He is entitled to a share of the dividend declared in proportion to his ownership of the company's issued shares.

(d) In the event of the liquidation of the company, he is entitled to a share of the assets after all creditors have been paid off in proportion to his ownership of the company issued shares.

1.21 <u>Basis for valuation of share</u>

There are three underlying principle to the understanding of the basis on which shares should be valued.

First, whatever value of the company or whatever profit the company makes has to be shared out among all existing shareholders in proportion to their individual shareholding. It is vital that we should understand this principle since shares are bought and sold based on its individual value. The value of an individual share depends on two things - the overall size of the company and the number of shares there are. The total value of the company divided by the number of shares gives the value of each individual share. Thus it is important to understand the difference of per share value as against the overall value of a company. Therefore, what is important to the share -

holders is the per share benefit which can be obtained rather than the overall benefit to the company.

Second, investor must realise that what they are sharing is any dividend which may be declared by th company. Profit pe se is of no immediate benefit to him as shareholders. What is of greater importance to the shareholders is the immediate benefit in the form of dividends which is paid out by the company. However, this depends on the type of investors. Some prefered to have the controlling power. It may be of interest for local investors to know that all of the most widely accepted valuation methods are based on dividend or a close substitute rather than on profit.

Third, the value of the assets of the company is only of real importance if the company is to be liquidated. What is important to the shareholders in the normal situation is how these asstes of the company is utilised to generate profit which can be paid out to the shareholders.

1.3 Stock Exchange and its role

So far, we have discussed the concept of investment, share and its benefit, and the underlyinf principle to the understanding of the basis on which shares should be valued. Sebsequently, we will try to dicuss what is meant by stock exchange and its role in the economy.

Stock Exchange is an organised market place in which securities such as shares, stocks and bond are bought and sold. These market are meeting places where those seeking capital can negotiate with representative of those who have capital to invest.

The organised exchanges are actually auction markets where traders and investors, through brokers, negotiate by setting ' offer ' prices and making ' bids ' on securities. In other words, stock exchange is a vehicle or market place where trading of shares can take place in a conducive environment.

Once the securities are sold to general public, they may be traded on the secondary market, which includes various Stock Exchange and over - the - counter (OTC) market. When investors decide to sell their stocks or bonds they need to contact potential investors (directly or through brokers) who may be willing to buy. This trading of Stock Exchange therefore transfer the title of ownership of the shares.

One of the principle role of stock exchange is to raise capital for financing the development of the national economy, mobilising the available fund as effectively and efficiently as possible[2].

Securities market can be divided into primary and secondary market. In the primary market, stock exchange

---

[2] For specific function and importance of stock exchange See Information Malaysia pg. 147.

provide business enterprises for capital formation by raising external finance in order to expand the economic activities by new securities issues. It enable, holders of the securities to obtain liquidity by selling shares and bonds in the secondary market. The secondary market make it possible for those who desire to make long term real investments to obtain the money capital to savers who have no intentions of committing themselves for long - term commitments in real capital that are financed with savings of a short - term nature. In other words, it provide a central mechanism for the ' trading process ' be conducted efficiently, so that it does not discriminate between firms of comparable risk. Thus, primary market is where new shares are issued and secondary market is where the existing shares are bought and sold.

Consequently, stock exchange allow savers to participate fully in the fortunes of business enterprises, on the other hand, it allow business enterprises to separate business and economic operations from financial activities.

.4 Objectives of the study.

(a) ' To give a general understanding of investment in Stock Market

As cited above, the identification of the problems need some understanding of the working of investment in the stock market. In other words, the study will be wducative in nature. Under - standing of investment in stock market will be exposed in relation to its fundamentals, measure - ment of price movement and evaluation of share value. It will not cover every aspects of stock exchange but with these exposition hopefully, would give a better understanding of Stock Exchange .

(b) ' To identify the problems

The identification of the problems is not limited to the problem of the Stock Exchange specifically, but it is related to other problem such as the system in which it is based, and the most important is the problem of man himself. Hence, problems in the philosophical foundation of system, in which Stock Exchange is based, would be identified and the problem of man in relation to his creator will also be discussed. In other words, the identification will be comprehensive and multi - discipline in nature.

On the other hand, specific problems of the existing Stock Exchange will be given preferences too. The identification of these problems need the understanding of the working of the Stock Exchange and its role in the economy.

(c) <u>To provide possible solutions and reforms to the cited problems.</u>

As mentioned earlier, the approach of identification of the problems is comprehensive. Therefore, the solutions and reforms recommended will be comprehensive in nature too. The reforms will not confined to stock exchange specifically but to other related problems such as education, economic and moral aspect.

Hopefully, with such approaches not only specific problems of Stock Exchange could be tackled but the root and foundation of the problems will be uprooted too.

(d) <u>To suggest recommendation for improvement and reforms</u>.

The suggested recommendation for improvement and reforms would be comprehensive as well as specific. The recommendation would include proposals for further research in relation to stock exchange. The alternatives or amendments of certain aspects of stock exchange will be