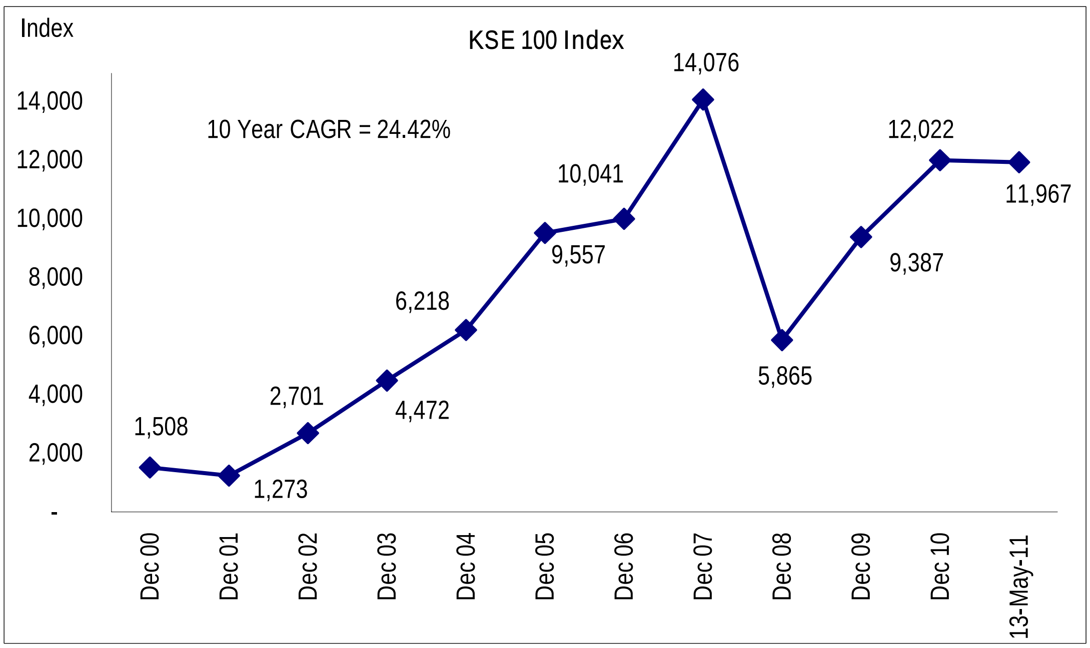
Making the Most of the Stock Market

Stock markets play a principal role in raising long-term funds for corporations (primary market) and provide a platform for trading securities (secondary market). Stock exchanges encourage investment through the pooling of resources enabling corporations to raise capital for business expansion. Stock exchanges also facilitate the channeling of both domestic and foreign savings towards investments. In the context of Pakistan, where the savings rate has remained sticky at about 15%, the importance of the stock exchange in aggregating savings and channelizing them towards investment requirements cannot be over emphasized. Over the last decade, the Karachi Stock Exchange has posted a phenomenal return CAGR of 24%. However, this has been achieved with high bouts of volatility.



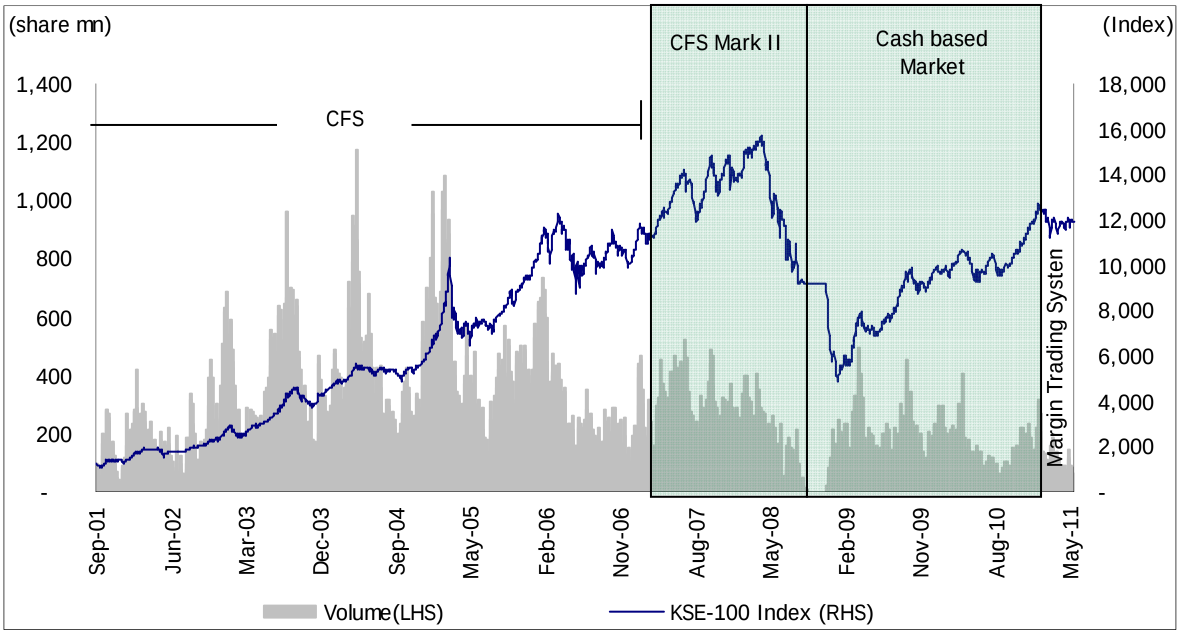
Unfair negative perceptions: It is felt that there is a general ignorance regarding the essential role that Pakistan's stock exchanges are playing in achieving equitable, broad-based and sustainable economic development of the country. These are often lost in translation due to certain events such as the infamous market meltdowns of 2005 and 2008 leading to controversy and censure. Before turning to the benefits of stock markets, it is necessary to address the following concerns first.

Market leverage & challenges: Since the last decade, the Karachi Stock Exchange (KSE) has faced continuous challenges in implementing various leverage products. Different products were initiated but due to their misuse on the back of certain shortcomings they were discontinued, hence penalizing the product rather than holding accountable the people who misused and exploited the product. As the history goes, the KSE adopted the Badla system which originated in the Bombay Stock Exchange as a solution to the perpetual lack of liquidity in the secondary market. However, the Indian stock markets discontinued the use of Badla in 2001 and moved onto derivatives while Pakistan continued to stick with Badla and its evolved variants through the major part of the last decade.

Why penalize the product? Stock markets have been overly criticized with the tendency of speculators to be leveraged long, placing brokers in a position to remove the financing facility (in this instance Badla or its evolved variants) leading to a sharp decline in stock prices – this is known as the so-called "pump and dump" which is the assigned reason for systemic failures of the past. While we as market participants have been quick to discontinue and abandon leverage providing products because of their shortcomings have we ever gone as far as holding accountable the people responsible for exploiting the shortcomings of risk management of the leverage products? The answer is no and as a result, people tend to overlook the benefits the stock exchanges provide the country. If we actually go on to hold exploiters accountable, the benefits of the stock exchanges to the broader investment community, inclusive of small retail participants, would be more lasting. If we take the case of the 2008 stock market meltdown, the index dropped 69% from its 2008 peak and bottomed out at an index level of 4,815 points. During this phase, the Government announced the option of Share Buyback providing corporates an attractive opportunity to repurchase their shares at throw away valuations. Despite this opportunity we have not seen any tangible development of the Buy back theme indicating a failure to deliver on the required confidence building measures for this to occur. We would let the reader decide who is to blame for the still-born status of the Buy back process.

Where have volumes gone? Market talk these days revolves around the lack of share volumes. This is despite the reintroduction of a leverage product (Margin Trading System). However market participants in general tend to find the product to be over regulated with strict risk management measures and demanding margin requirements (in this instance cash margins). As a result, it remains important that regulators and market participants continue to engage in a constructive process to revitalize products that are available for investors. That said, it is also important for us to accept the commodity investments are an asset class here to stay. The ease of access and rise of commodity based ETFs have led to global shift in speculation from equities to commodities. AKD Research recently released a report – AKD StockSmart "Is there any respite for equity volumes" dated: 30-04-2011 which shows a global drop in equity volumes and a corresponding rise in commodity volumes. However, with equity volumes now returning close to their 2008 peak levels, the indication is that value buying remains. Despite this, global brokers including our domestic fraternity remain extremely concerned regarding the lack of volumes and leading to a downturn in the brokerage business and rising unemployment. That said any moderation of returns from commodities should lead to a broader improvement in equity volumes going forward.

Another factor explaining the lack of volumes traces its roots into the 2008 market meltdown in which most of the stock market participants were badly burned. Although valuations are back to pre-crisis levels, the older players have been affected by immense wealth destruction that has also restricted access to liquidity. As a result, they are unable to play their expected role in the market. Moreover, this opportunity has not been grasped by the emergence of any new major equity market participant, with their issues emanating from CGT and fear over an overregulated market. As and when both the aforementioned factors are rectified, domestic equity market volumes can be expected to pickup.

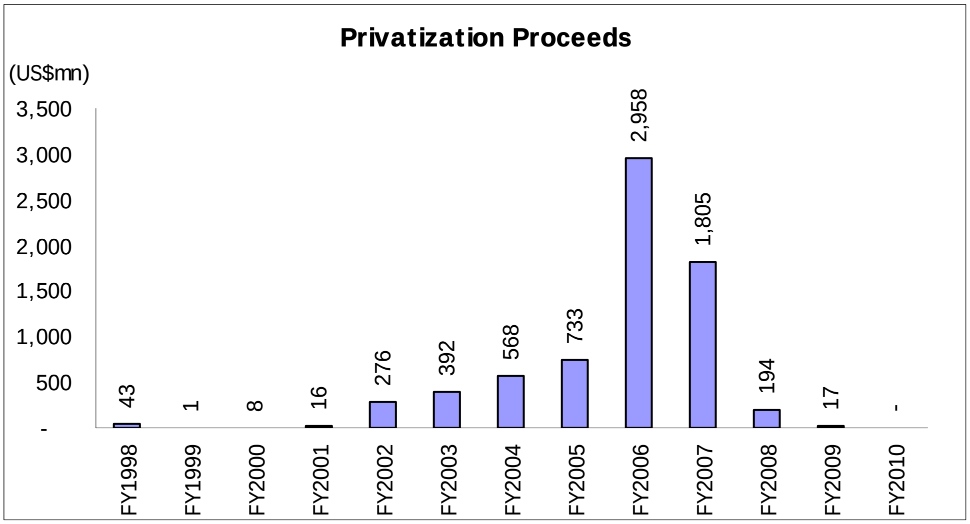


The Importance of Stock Markets

Stock exchanges serve as an economic barometer and can give important signals to economic policy makers regarding how their decisions related to interest rates, taxes and currency volatility impact different sectors of the economy. Historically, the KSE has been a leading indicator of changes in the real side the economy and an effective predictor of growth. The stock markets therefore help both policy makers to adjust their actions and for regulators to effectively monitor.

Government the main beneficiary: The stock exchange has also helped the government as well as private sector to raise money through privatizations and GDR offerings. In fact, given its majority shareholding in several large companies, it can be said that the Government has been the single biggest beneficiary from the stock market. In this regard, Government divestments in the last couple of years have added color to the local stock exchanges and given them much needed float, depth and breadth. Since the initiation of economic & financial reforms in the early 90's, the GoP has raised a total amount of PkR475bn through the successful privatization of government enterprises especially those in the Financial and Oil & Gas sectors. This not only helped the Government raise much needed funds for priority spending on infrastructure development but also improved the financial performance and service quality of these companies by promoting a greater level of competition. The stock exchange has also allowed domestic companies to tap foreign savings through foreign flows – this is illustrated by the fact that foreign ownership is more than 7% (~US$2.5bn) of domestic market capitalization.

Unlocking Value: Over FY02-FY07, Pakistan generated US$6.7bn through privatization proceeds with a record inflow of almost US$3bn in FY06. Sustained privatization flows were at the core of macroeconomic stability during the review period. During FY02-FY07, when privatization proceeds were at their strongest, the Government's fiscal deficit averaged a manageable 3.7% of GDP while the Current Account Deficit during the review period averaged 0.7% of GDP (with surpluses recorded over FY02-FY04). Other economic metrics also remained healthy i.e. headline inflation averaged 6.5% p.a. and the currency actually appreciated by 0.9% p.a. vis-à-vis the US$. To encapsulate the improvement in the overall economy, real GDP growth averaged at 6.2% p.a., importantly coinciding with strong privatization flows. Taking cue from history, the revival of the privatization program in Pakistan contains the potential to kick start the domestic economic growth process.



Contribution to Tax Collection: At the same time, the stock exchanges are directly contributing to the national kitty through tax collected - initially through Capital Value Tax (CVT) and withholding tax (WHT) on share transactions - and presently through the Capital Gains Tax (CGT). However, in view of the lack of volumes, Government collection in the form of tax from equity markets has declined. Specifically, the imposition of CGT and resulting investor apprehensions related to interaction with tax authorities has led to a sharp drop in market volumes.

Benefit to the People: In the case of Pakistan, with per capita incomes sticky at the US$1,000 mark, the stock exchange helps to create investment opportunities for small investors. They can own shares of companies just like large investors, and earn similar rates of return. In this context, stock exchanges help in redistribution of wealth through stock price increases and dividends with investors getting the chance to share in the wealth of profitable businesses. That said, there is room for improvement. The AKD Research Database shows that only 46% of the KSE-100 Index companies have paid out cash dividends over the last 3 years. If profitable companies are encouraged to initiate or raise payouts, this feature would serve to ensure a fair return for all classes of investors. This would also serve to increase the penetration levels. At present, our AKD Trade Division for retail trade estimates total retail client market size at close to 200,000. This is against 25mn bank deposit account holders implying a penetration of less than 1%! To further incentivize the channeling of funds, taxation measures need to be rationalized where the current final tax charge on deposit returns is only 10%.

Conclusion: From a corporation's perspective, listing provides for improved governance and creates the platform for the emergence of powerhouse business groups such as the Nishat Group and the Dawood /Engro Group. Given the important role that the stock exchanges play, it is urged that all interested stakeholders play their part in reviving local equity markets. It is imperative that issues such as the success of the leverage product and CGT collection are addressed. Regarding the latter, we have on numerous forums reiterated that the best way to ensure smooth CGT collection and minimize direct interaction with tax authorities is for at-source deduction i.e. through NCCPL. Concluding on a positive note, the Pakistan equity markets still offer exciting prospects. The companies in the AKD Research Universe are projected to deliver 11%YoY growth in FY12, which can trigger further valuation upside together with expected valuation rerating (Discount Rate has likely peaked). Recent precedence, whereby both market volumes and market returns picked up in late CY10/early 2011, is also encouraging and we feel there is no reason why this momentum cannot be rebuilt and sustained over a longer period.