

Research in an Emerging Malaysian Capital Market: A Guide to Future Direction

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ABSTRACT

In this concluding chapter, a number of key findings from published research studies on the Malaysian capital markets are summarized. There are close to 70 emerging markets in the world, and the local financial and capital markets share many of the peculiarities of these emerging markets. Based on the evidence of local share market behavior, although the market is highly volatile similar in characteristic with all emerging markets, we conclude that the local share market could be grouped among the ten most liquid and orderly emerging markets in the world with a long-run return of 18% per annum and a risk-free rate of 6%. However, the local share and bond markets behave in ways that are much closer to the more developed markets. In some respects, as will be shown in this chapter, research evidence on the local market is similar to the findings reported of the behavior of the 30 more developed matured markets.

Keywords: Capital Markets, Asset Pricing Models, Bond Market, Banking Industry, Corporate Governance.

INTRODUCTION

A substantial body of findings has emerged over the last two decades on emerging market finance: Bekaert and Harvey (2003). Specifically, evidence on economics

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and financial integration and on asset risk and returns are found in Bekeart and Harvey (1995); and findings on the integration process, with reference to the speed of the integration process, are found in Edison and Warnock (2003). Important findings on the change in pricing behavior of asset returns, dividend yields, changes in capital flows and even market infrastructure for good governance and use of accounting standards are found in Bakeart, et al. (2002) and Bhattacharya and Daouk (2002). There is also documentation of how integration impacts market volatility in Kim and Singal (2002), diversification and contagion (Li, et al. 2003; Bae, et al. 2002), efficiency of emerging markets (Choe, et al. 2002), link between real economy and finance (Henry, 2000) and the role of foreign investors in emerging markets economic crisis (Stiglitz, 2000).

These and other less known publications provide evidence contributing to a better understanding of how emerging markets are converging from less developed to emerging and, in some cases, closer to developed market status. There is better understanding of how capital markets are in fact nurtured to become more important for capital mobilization in some important economies such as China, India, Egypt and Poland. The actual market microstructure designed to nurture these markets to correctly sequence in the development process is better understood today than at earlier period. As the markets began to grow in liquidity and integration with more developed markets took place, there was a predictable impact on asset returns and risk, volatility, informational efficiency and also the improved liquidity that comes from flow of capital to markets with a more liberal bend. In essence, the development process reduces, to some extent, the risk of spikes in contagion from crisis hitting a particular market.

There are opportunities to further substantiate or provide new evidence on costs of capital in these markets and the impact of financial, legal and macroeconomic reforms in these newly evolving markets (Eichengreen, 2001, Beim and Calomiris, 2001). There are policy issues of how best to optimize the sequencing of reform and its impact on the economic growth and capital mobilization prospects of the countries (Edwards, 1987). The institutional, legal and regulatory requirements and their impacts on asset returns and prices are found in Cherkaoui and Ghysels (2003) and the impact from liberalization efforts, at firm level, is found in Chari and Henry (2001). The agency issues in the firms (see Harvey,

et al. 2002), political risks and its relationship with financial reforms and economic growth in emerging markets (see Das and Mohapatra, 2002) and the impact of liberalization (see Quinn, et al. 2001) are also policy issues which are now better Understood due to these studies.

While the discussion to this point has focused on emerging markets in general, We need to assess the evidence from capital market research in Malaysia in the rest of the paper. Most of the documented evidence discussed is sourced from studies that address the relevant issues in multiple countries, as competition has made it difficult to publish single country studies in top refereed journals. This paper focuses on as the Malaysian capital market behavior using mainstream ideas in finance. Specifically, issues relating to exchange rate, efficiency, asset pricing and derivatives, the special behavior of the banking sector, the financial management sector, investment management sector, and accounting, auditing and governance issues are examined.

THEORY BASED RESEARCH

Equity Markets

Most theories about capital market behavior originated whilst studying developed markets with long histories. Emerging markets in general and the Malaysian market in particular have short histories, and are characteristically different from developed markets. The emerging markets, therefore, provide opportunity to validate developed market theories in new market settings. Finance theoreticians have developed equilibrium pricing theories using the classical approach of supply-demand analysis. These include CAPM, APT, Multi-index Model, Single Index Model, Options Theory and Consumption-based CAPM which examine securities Pricing in market places. These are core theories in finance, and are widely applied in Professional practice and academic training.

Capital Asset Pricing Model (CAPM)

The CAPM predicts that asset returns are positively correlated with asset risk measured as systematic risk to test the risk-return relationship, risk measures must be stable (this is likely if risk is measured over a lengthy interval) and these must

be corrected for non-synchronous errors. Ariff, et al. (1998) tested the relationship between portfolio returns and portfolio risk in Malaysia's emerging capital market. The variables specified as independent are beta and beta-squared measures while the control variables are size, leverage, earnings-price ratio and book-to-market equity ratios obtained from a sample of 60 industrial firms listed and traded over a recent 15-year period. It was found that only beta, beta-squared and size variables are significant in explaining stock returns. The negative effect in risk-return trade-off with beta-squared values and size is not acceptable, while the positive effect from beta is consistent with theory. Hence, there is a need for more carefully constructed tests using a longer time frame and a larger sample to further validate the insights on the behavioral aspect of stock returns and its determinants. There is also a need to further validate the Arbitrage Pricing Model (APT), which is an extension of the CAPM and overcomes some of the basic flaws in CAPM.

Arbitrage Pricing Model (APT)

Lim (2005) tested the applicability of the APT on stocks listed on the Kuala Lumpur Stock Exchange, KLSE (*Bursa Malaysia*) by identifying both macroeconomic and firm-specific factors which are correlated with price changes. The findings supported a conclusion that there is a weak applicability of APT in this market for the data over a 21-year period. This finding is consistent with Hossari (1994) who found only one factor for the Malaysian market using a one-year test window. Further research is therefore warranted in this area, with lengthier test windows, using refined measures and robust methodology such as the one used by Lim *op cit*. For example, although a wide range of commonly reported economic and financial variables were used, *the relevant variables* had not been identified (although this is not very likely as the variables chosen are the main economic indicators observed by market players). The factors identified by factor analysis do not exactly correspond to economic variables as these are a combination of variables. Further, macroeconomic variables are measured with much noise (see Wasserfallen, 1989), and as such the coefficients are measured with errors in the first stage regression resulting in the errors-in-variables problem in the second stage regression. However, tests of APT are sensitive to the different analytical tools used. A large number of these tools are cited in literature: Full

Information Maximum Likelihood or FIML canonical correlations and co-integration.

Efficient Market Theory (EMH)

The concept of an efficient market describes time series independence of price formation in a competitive market in addition to prices reacting rapidly to randomly arriving information (Fama, 1991). This basic idea is widely applied to emerging markets to verify how information relating to shares in thinly-traded emerging markets is captured with a time delay. Traditional tests of informational efficiency indicate that any competitive capital market is broadly efficient although reports of significant but unexploitable systematic anomalies continue to challenge this idea in several markets when compared with the more established capital markets. With sufficient levels of efficiency. The efficiency of this market has been well documented (Annuar, 1990; Annuar, et al. 1992) but previous studies conducted Used small samples with short time spans, and are hence unreliable.

Annuar, et al. (1994) conducted a weak and semi-strong form efficiency study addressing all the crucial identifiable weaknesses of previous studies and reported that the Bursa Malaysia market is generally efficient though there are pockets of inefficiencies at the margins. Kok and Goh (1994) also documented evidence of Weak-form efficiency using monthly data for the period 1984-1992: if a market is not shown to be efficient on a daily basis, it is useless to show weak-form efficiency in any lengthier intervals. They show that KLSE generally transformed from Weak-form inefficiency in the mid-1980s to weak form efficiency by the early 1990s.

Further validation of the results could be done by using better models, larger samples and longer time periods and testing for speed of adjustment of information in share prices. Documented evidence suggests two prominent features of price formation in most emerging markets (Ariff and Johnson, 1990): significant over-reactions to information and slow speed of adjustment to information. In this respect, Jothee (2006) tested the speed of adjustment to materially sensitive information from important public announcements of selected macro and micro events. He documented that it takes as long as a week for macro information to be absorbed, which, if true, is slower than price reactions observed in the Hong Kong and Tokyo

markets. Given the lack of speed in price responses to new information, further research should examine the reasons for the impediment to efficient formation of prices.

Asset Valuation or Discounted Cash Flow Models (DCF)

The valuation paradigm suggests a broad-based principle that the value of a financial asset is the sum of the present values of expected future cash flows from an asset discounted at the risk level appropriate for the cash flows. Hence, in valuing securities, Gordon's Dividend Valuation Model (DVM), is widely used in applied finance. This valuation model assumes that the fundamentals incorporated in the valuation theorems ought to price securities in any market. If the idea is true, then a test to ascertain if the fundamentals incorporated in the valuation models are indeed driving the security prices could be carried out. It has been shown that the fundamental factors are related to share price changes: Ariff, et al. (1995). It was shown that changes in six fundamental factors are highly correlated with changes in share prices in this market: in a reduced model it was shown that just 3 variables explain 26 per cent of the variation in share prices.

This creates great concern among investors and others such as stockbrokers, fund managers and investment analysts. Ariff, et al. (1998) addressed the issue of whether the DVM (Gordon, 1962) could explain share price changes in this market. They documented that the non-linear Gordon's model is able to explain, in excess of 60 per cent, the changes in share prices. This is startling in that the model is relevant and more so in its non-linear form. This appears to suggest that Gordon's model with its book value measure of required rate of return on equity (k) can be reliably used by investors to value common stock prices in this market.

However, Imbarine (2006) suggests that the DVM is the best method to appraise stock price during bearish markets, for example during an economic crisis. The Earning Multiplier Model or the Price-Earning Model approach remains popular among analysts as they believe that dividends and earnings are the main predictors in these valuation techniques. It is important to investigate other valuation techniques that are relevant for all economic conditions. Further tests over a longer period and probably more variables could be used to further validate the applicability of the Gordon model in pricing shares in this market. It is also interesting to ascertain

the superiority of various techniques in valuing assets in different economic conditions in this emerging market.

RESEARCH RELATED TO BOND MARKETS

Predictive Power of Malaysian Government Securities (MGS) yields

The bond market in this economy had developed over many decades, but secondary trading is low thus sharing the common problem of continuous trading which is characteristic of many bond markets in emerging economies. Further, given the appetite for sovereign borrowing for development financing, there is a large Treasury market, which is similarly lacking in secondary trading activity. There are issues of corporate bonds but these bonds are not freely traded in the market. There has not been much research on bond market behavior. Noor and Rasidah (2001) examined the predictive power of term-spread - difference between long and short term interest rates - of Treasury Bonds (also known as Malaysian Government Securities). They confirmed that the term spread is useful as signals for the long run direction of stock returns.

In a more recent study, Neoh (2005) investigated the term structure of interest rates using Fisher's Pure Expectation Hypothesis. He also investigated Fama's hypothesis that implied forward rates are predictors of future spot rates. Neoh documented that the forecasting power of implied forward rates was good for bonds with remaining maturities of 2 to 5 years, but rather weak for longer terms. There is need for further research on the bond market. For example, Neoh's research could be extended by controlling the effect of term premiums in the forward rates and then using adjusted forward rates to predict future spot rates. Term structure and long term inflation and also duration as an additional factor could explain the relationship between spot and forward rates. There is also no documented evidence on the validity of ratings done on corporate bonds by both the Rating Agency Malaysia (RAM) and the Malaysian Rating Corporation (MRC).

Corporate Bond Market

There are about 50 listed firms that have issued corporate bonds. It is known that Malaysia has the highest ratio of corporate bonds issued per dollar of GDP among

all the emerging markets. For example Korea has 22 percent in corporate bonds: Thailand has 13.6 percent: Singapore has 31.6 percent: Malaysia has 37.3 percent. In the last case the total value of government and corporate bonds is almost equal even though corporate bonds were issued only after year 1999 (IMF working paper No: 152, 2005). There are numerous research issues that could be explored in the corporate bond market. For example, the validity of the rating assigned by rating agencies, the predictive ability of yield curves from these bonds and the relationship between Treasury bond yields and corporate bond yields. More sophisticated applied research could search for the price value of re-rating of companies, and the spread between different ratings. A constant complain is that the ratings given by local rating agencies and the international agencies are significantly different. If that is true, the price premiums for the ratings must be different, a topic for a very useful study.

Derivatives Markets

There is a rush to introduce more derivative securities in emerging markets, despite the documented losses suffered by established enterprises dabbling in futures contracts (in China, Malaysia, United States, Germany, United Kingdom and Indonesia) and the failures of many futures contracts in exchanges (Hong Kong and Singapore). The push for introduction of derivatives is to attract institutional investors and increase the liquidity in the market, as these investors usually resort to derivative contracts to manage their investment risk. Should the spot market's price risk increase, they could hedge their position using contracts in the futures markets. It makes good economic sense, from their points of view, to justify futures markets. The three key issues in the feasibility of futures instruments are: demand, underlying market resilience for price discovery and the overall contribution to risk management. It is a foregone conclusion in financial economics that viable demand for derivatives requires (a) speculative demand to reveal prices and (b) hedge demand to create opposite positions. In the local market, commodity futures contracts on palm oil and rubber have been traded for almost three decades with speculators providing liquidity for producers to cover price risk, resulting in very efficient pricing of commodities (this is despite the failure of Tin market in the 1970s). The financial derivative contracts started in the mid-1990s.

There is scarcity of evidence on the pricing efficiency of Malaysian Derivatives Exchange (or MDEX) traded instruments. Abdul, et al. (1999) examined several issues related to the introduction and trading of stock index futures contracts. They document no evidence of increasing volatility, expiration date effect, mispricing and no lead-lag relationship between the stock market and futures market. Taufiq, et al. (2007a) documented evidence on the pricing of stock index futures contract traded on the MDEX. The latter study took into consideration transaction costs and different regulatory regimes before and after the 1997-8 financial crisis and the capital control regimes. They reported that the difference between the actual Price and theoretical price of contracts is small and that the deviations became Very large immediately after the financial crisis, for the most cases, in one direction. The actual futures prices became lower than the theoretical price. Transaction costs had little influence on this deviation. The behavior is explained as the traders' joint efforts to widen the spread when risk suddenly increased as a result of an unexpected financial crisis. Mispricing tended to decrease when the contract approached expiration date hence limiting arbitrage opportunity, as is the case in developed markets as well.

Mahadhir, et al. (2002) examined the temporal relationship between the price common stock futures contract (FKLI) and its underlying stock index, the KLSE CI. The five-year test period was split into three sub-periods to observe the price Co-movement patterns under different volatility levels. The findings suggest that the futures market tends to lead the spot market by one day during periods of stable market conditions: there was a mixed lead-lag relationship between the two markets during periods of high market volatility.

Taufiq, et al. (2006) documented the pricing behavior of interest rate futures contracts i.e. the 3-month KLIBOR futures contract. Evidence indicates that the level of mispricing for shorter maturities is minimal compared to long maturity contracts. It was also observed that the financial crisis had minimal impact on the Pricing of KLIBOR futures contracts. However, these contracts lack liquidity Probably due to managed interest rate policies implemented since the onset of the financial crisis, and perhaps also due to the absence of institutional interest in this market compounded by lack of awareness and also lack of confidence to use these contracts for hedging interest rate risks.

Taufiq, et al. (2007b) analyzed the informational efficiency of Crude Palm Oil (CPO) futures contracts by separating the futures prices according to their maturity life cycles. If futures price formation follows rational expectations, then information will flow from futures to spot and not the other way around. The results are generally consistent with the expectations. All distant month error terms in spot equations are statistically significant for three sub-period samples (1987-89, 1990-92 and 1996-98). The findings are consistent with the notion that all expectations will converge in the terminal month prices and the spot market plays a dominant role, along with futures, in adjusting prices. These findings are similar to those observed in more developed commodity futures markets.

Documented evidence on the local derivatives markets is scarce and there are lots of opportunities for further research on these financial derivative markets and the relatively matured commodities futures markets. There are now new products being introduced such as the option on the stock index and the 5-year MGS and the options on selected stock counters traded on the main board. There are critical issues that need to be addressed to make the derivatives markets relevant for global investors as is the case in the Hong Kong and Korean markets which started at about the same time as the Malaysian market but are already attracting global players with good liquidity. For example, the equity index futures contract in Korea has the highest liquidity in the world.

Systematic Risk and Thin Trading

The Malaysian market is a thinly-traded market and consequently there is non-synchronous trading bias on prices. Estimate of parameters in asset pricing models based on information from these markets are usually inaccurate and require some adjustments to increase the validity of parameters. Ariff and Johnson (1990) showed a correction procedure to correct these errors and investigated the relative efficiency of different methods for correcting the bias, while also identifying the optimal lags and leads required in the adjustment procedure in the Singapore and Malaysian stock markets. The Fowler and Rorke method specifying three lags and leads was found to be relatively more efficient. They extended the Fowler and Rorke's two lag/lead equation to a three lag/lead equation for application in a very illiquid market. With the significant changes in the market microstructure after the 1997-

8 financial crisis, it would be interesting to revisit this issue in the local stock exchange.

A somewhat related topic is the signaling value of switching listing from a lower board to a higher board. This organizational effect was studied on a sample of firms that switched their listings to the main board from second board. The finding established the evidence that the up-ward move from lower board to the first board leads to significant abnormal return to the firms moving up the quality market: see Ariff and Shamsher (1998).

Diversification Theory

Diversification is an integral part of portfolio management which is applied to create efficient portfolios. Modern portfolio theory (Markowitz, 1958) dictates that an efficient portfolio should be one that is made up of widely differing securities or sectors to obtain maximum risk reduction. Sazali, et al. (2004) applied Markowitz's seminal work in the local market which identifies how diversification could be effectively achieved across sectors and international boards. The findings suggest that international diversification across foreign markets had significant reductions in risk, especially over long periods. Diversification across six sectors Produced more efficient portfolios with greater risk reduction than was the case of diversification across fewer, says two sectors: the effect is greatest if the portfolio is held over longer periods, for example, five years. There are still opportunities for further research on diversification across different share markets across different countries and economic sectors.

Exchange Rate Equilibrium and Regulation

Bo and Ariff (2007) examined the exchange rates of different countries in different regions of the world. They investigated how periodic historical volatile exchange rates affect the overall economy and the values of financial assets arising from temporal changes in the values of currency. It is obvious that the relatively higher Volatility of currencies of developing countries, given their greater exposure to international trade, introduces potential risk factors to financial systems of developing countries, thus causing the economies of these countries to experience

periodic crises. Countries in the Asian region have all suffered from this phenomenon from time to time.

Since it is not likely for most developing economies to adopt common currencies such as the Euro dollar and neither would there be consensus among regional leaders to fix the currency to a single currency in the near future, this means that exchange rate risk is an endemic risk factor that will prevail in financial markets, including the local market. A more in-depth study on the impact of exchange rate volatility on macroeconomic factors and the contagion impact is needed to gain better insight on how this critical market works for currency price equilibrium.

RESEARCH ON THE BANKING INDUSTRY

The local banking industry dates back to the colonial days when the British established a banking system based on ethnic specialization in trading of commodities which originated in Malaysia and Singapore. Since 1957, the incoming post-independent governments have nurtured the banking sector, first to serve the people and not just the trading interests of businesses, and hopefully to also develop financial skills in the banking business among all the peoples of the country. As a consequence, banking has developed with good penetration across the country. Since the consolidation of 54 deposit-taking institutions into 10 large well-capitalized bank groups in 2002, the credit quality of the banks have gone up: non-performing loans which had historically defied attempts to reduce it from about 8 percent, has since then come down to a 3 percent level with capital adequacy also improving to 12 percent. There are a large number of foreign banks 23 in all since historical times, involved in conventional full banking activities: these banks, though locally incorporated since 1994, operate under their parents' names. Islamic commercial banks in the country began in 1983, and now in 2007, there are 3 Islamic banks and 14 non-Islamic banks operating parallel Islamic windows to serve customers who wish to bank on Islamic principle-consistent banking products. Though prior to 2002, there was not much documented research evidence on banking industry behavior, in recent years there have been efforts towards greater research focus on this industry. An early study was by, Padzil (2001): it researched the scale and scope economics of the then 54 deposit-taking institutions. He found

that there is evidence of very weak scale efficiency of banks (about 3%) for bank sizes (total assets) ranging from RM 1 to 20 billion. That is, larger and very small banks did not obtain scale economics or increasing returns to scale and it was also documented that foreign banks appear to be 3 times more efficient than the weak local banks. However scope economics varied significantly. The study also revealed that the banking sector as a whole – with the exception of one bank – suffered a sudden decline in efficiency to the negative region when the 1997-8 financial crisis occurred. The findings suggest that most commercial banks operate in the region of almost constant or decreasing returns to scale although some banks with assets in the range of RMI to 20 billion gained from increasing returns to scale. Scale economies were generally higher during the five years of high economic growth, but not during economic recessions. Local banks offering multi-products gained significant *scope* economies across all sizes, though this was not true of foreign banks. These new insights on the commercial banking sector, known for its financial fragility, are clearly policy relevant. There is a need to update this Study using more advanced econometric tools and more recent data as there has been considerable policy and structural change since this study was conducted.

Rubi and Ariff (2007) explain the 10-year program adopted by the regulators to diversify the financial system to strengthen the domestic financial institutions to operate in a more liberalized global environment. The local financial system comprises not only the conventional banking and non-banking sectors but also an Islamic banking and financial services sector which runs parallel to the conventional system. The Islamic financial system comprises Islamic banks, Islamic insurance, Islamic capital markets and Islamic money markets as well as Islamic derivative markets. By Islamic it is meant first the profit-and-risk-sharing lending activities, non-provision of capital to economic activities dealing with gambling, liquor and Prostitution and mutual-insurance as against join-stock insurance companies. They explain the development of the financial system with emphasis on some of the measures initiated by the government to create a globally competitive financial system. Emphasis is made in explaining the consolidation efforts in the banking and non-banking sectors.

Sudin, et al. (1992) examined the determinants of customer choice of the services provided by both conventional and Islamic commercial banks. They

documented that there are many similarities between both banking systems when selecting banking services except for the fact that Muslim customers are more knowledgeable about Islamic banks.

Norhayati and Ariff (2007) documented evidence on eight key literature based determinants of credit risk of commercial banks in emerging and developed economy banking systems. Australia, France, Japan and the U.S. represented developed economies; emerging economies were India, Korea, Malaysia, Mexico and Thailand. The findings show that regulatory capital is significant for banking systems that offer multi products and that management quality is critical in the cases of loan-dominant banks in emerging economies. Contrary to theory, leverage is not correlated with credit risk. The model developed in this study could be applied to test other emerging economy banking systems to generalize the findings.

Badr (2007) examined the issue of revenue, cost and profit efficiency of Islamic and conventional banks in over 19 countries, over the 1990-2005 period. Banks in both streams strive to maximise the rewards on their investments, except that Islamic banking is strictly guided by the Islamic law or *Shad 'ah* precepts. The cost, revenue, and profit efficiencies were also based on size, age, and region. The findings suggests that, there are no significant differences between the overall efficiency results of conventional versus Islamic banks irrespective of the method of analysis, the size and the age. However, geographical location explains the significant differences in revenue and profit efficiency between both streams of banks. Further, the results show that, on average, banks are better in utilizing their resources than in generating revenues and profits. This finding can be explained by the ability of banks to control their inputs more than their outputs due to their limited ability to influence the external environment.

Over a time period, the average cost efficiency is higher and is relatively more stable than revenue and profit efficiencies in both banking streams. In general, most inefficiency comes from the revenue side in both average efficiency scores and scores over a period of time. Thus, banks in both banking streams should improve their revenue efficiency.

RESEARCH ON CORPORATE FINANCIAL MANAGEMENT ISSUES

Initial public offers (IPOs) comprise an important component of equity financing in the local economy. Further, private placements and rights issues are the next important financing tools. The procedures applied to IPO market-makings differ in the local market since the offer price is not totally market-driven -since it is not based on book-building price discovery -but are largely regulator and investment bank determined until 1999. Underpricing IPOs is a well-documented phenomenon in this local market, where one study puts it at 135 percent, besides the peculiar way in which the final offer price is determined.

New Public Share Issues

Dawson (1994) provides evidence of high underpricing for new issues and suggests that the cost of underpricing IPOs is high in the local market. In a follow-up study, Dawson (1995) documented that for original shareholders, selling shares on offers incurred the greatest loss from IPO underpricing compared to when public offers are made, and those original shareholders that did not participate in the offer for sale did not incur any loss from the IPO underpricing.

Ariff and Shamsheer (2004) explain the high IPO underpricing of 135 percent, and offer regulatory intervention in the price setting process as the factor explaining the excessive listing-day premium in the local market. They also report that the very high initial premium declined to a third of the first-day traded value in the third year (i.e. in the long-run). The first-day premium during a non-regulatory-intervention (before new regulations on compulsory share allocation to native owners and fixed offer prices) was also a third of the premium generated during the intervention period. Further study on this issue could be done using new methods and taking into consideration the structural changes that has since taken place to make this market more globally competitive.

Norzalina, et al. (2004) examined the relative performance of Government-linked IPOs and private IPOs for the period 1984 to 2002. The overall results show that shares of both categories are underpriced on their first day of trading but there is no significant difference in their premiums. There is no significant difference between short and long-term performance. Government IPOs performed better

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than private IPOs before the economic crisis period while private IPOs had better performance in the post-crisis period. Government IPOs in the trading and service sectors performed better than private IPOs in the sector, but for other sectors there were no significant differences. Firm characteristics explained 38 to 40 percent of the variation in the excess returns of both types of IPOs respectively. More research work is warranted to examine the real long-term productive and social welfare gains and not just the announcement day wealth effects. The findings will help policy makers to formulate policies that will facilitate the firm's management of equity financing decisions.

Shamsher (2004) examined the level of forecast errors in prospectuses of firms applying for listing. The forecast errors were positive but were on the decline from 1975 and became negative during the 1997-2001 period. The negative errors are difficult to explain as this period coincided with the financial crisis. This suggests the need, on the part of regulators, to review disclosure requirements for firms seeking listing. It was also documented that investors did not differentiate the quality of audit service provided by audit firms of different sizes and the level of forecast errors had no significant relationship with the size of audit firms. There is a need for continuous assessment of this governance issue to ensure that the quality of governance is improved over time to meet international standards.

Capital Structure

Ariff, et al. (1998) describe the capital structure of local firms over a 15-year period. The results suggest that (with the exception of the finance sector) the capital structure of firms differ significantly within and between industries. However, the instability of the leverage ratios over time for the industrial sectors suggests that firms in the various sectors respond to rapid changes in the local economic environment. The findings are consistent with those documented by George and Mansor (1994).

The findings are not consistent with that documented in developed capital markets. There is no significant relation between beta risk and capital structure. The average debt-equity and debt-asset ratios of Malaysian listed firms over this period are 1.18 and 0.41 respectively. The level of debt in capital structure is not only a signal to the market by management about the expected future financial

health of the firm but it is also affected by factors within and outside the firm. Though the theory of capital structure is well entrenched in literature, there is a need to establish the validity of the theory in the capital market. Further research is warranted on the issue of what determines capital structure.

Isa (2005) estimated the factors driving capital structure adjustment of financially distressed and also healthy firms. The results identified 13 significant Variables, which included many macroeconomic variables previously not studied as well as firm specific variables. This study also estimated the adjustment parameters using a new dynamic adjustment model applied to an unbalanced panel data set of distressed and healthy firms. It is found that the adjustment parameters are different in the short term and long term and, on average, the speed of adjustment coefficient is 0.47 which is well below those of US, UK and Spain but above those of France and Switzerland. Since the speed of adjustment is inversely proportional to transaction costs, it implies that it is costly to achieve optimal capital structure if the coefficient is nearer to zero as is the case of this local market.

Dividends Announcements

Annuar and Shamsher (1993) provide evidence that management decision to change dividends is a lagged adjustment process of current earnings and past dividends which do affect share prices. Firms do adjust their dividend policies to reflect current earnings and past dividends in much the same manner as was observed in a number of studies in the developed markets: about one of two dividend announcements are for changes. There appears to be long-term target dividend Payout ratios adopted by firms. However, the speed of adjustment and the target Payout ratios are much smaller in this market, which is consistent with the more Volatile earnings environment at the current stage of development of the local capital market. There is greater need for financing projects using current earnings. Fauzias and Puan (1994) examined share price reaction to dividends and earnings announcements of firms and reported that, for firms that change dividends, the impact of dividend effect dominates the earnings effect. For firms that pay no dividends, the earnings effect dominates the dividend effect.

Norhayati (2005) examined the direction and magnitude effects of dividend change announcements on stock prices. Specifically, the validity of the cash flow

signaling, the dividend clientele and free cash flow hypotheses were tested on a sample of listed firms for the period 1986 to 2000. A significant relationship was documented between unexpected dividend changes and stock returns. The findings are supportive of the cash flow signaling hypothesis: it had mixed support for the dividend clientele and free cash flow hypotheses. Further research in this area is required over a period beyond the crisis period as inclusion of firms under financial distress in the test period could have given incorrect signals. There is also a need to do a direct measurement in testing the cash flow signaling hypothesis using analysts' forecasts rather than actual earnings as proxy for future expected cash flows. There is also a possibility to test the effects of special dividend announcements on share prices.

Private Equity (Seasoned Equity) Announcements

Normaziah, et al. (2006) examined the stock prices and volume of trade surrounding the announcements of private placements in the market. The wealth effects of private placement announcements were also examined over different economic conditions, based on different use of proceeds from placement exercises, and of premium and discounted offer prices. The findings show significant positive wealth effects before the announcement day and negative wealth effect on the announcement day. Significant negative price reaction was observed when private placement proceeds are earmarked for working capital requirements. However, when the proceeds are earmarked for investment, the short-term reaction around the announcement day is negative but there is significant positive reaction in the post-announcement period. The average volume of trade increased significantly for the entire analysis period.

Accounting Announcements and Share Revaluations

Cheng, et al. (2001) addressed the issue of whether the widely documented evidence of the effect of accounting earnings on share prices in a few *institutionally more developed* capital markets is also applicable to a less developed emerging market of Malaysia. The price effect of earnings disclosures is found to be less pronounced in this institutionally *less developed* emerging market. The findings show that, while significant price-to-earnings relation is evident, the (a) strength, (b)

Consistency and (c) magnitude of the relation are not as pronounced as reported in institutionally more developed markets. The price adjustment measured is more pronounced in a long window, which is consistent with speculative trading in emerging markets. Firm-specific variables such as revenue, firm size, and debt-equity have no effect on prices. The overall results seem to be consistent with the theory and evidence from developed markets, perhaps due to the experience and higher level of development of the local market compared to a typical emerging market.

Shamsher and Annuar (1997) tested the "first-to-innovate" and "spillover" effects on share prices of companies that announce an increase in research and development expenditure. The findings reported only weak evidence on both hypotheses. Shareholders of high-tech companies making this announcement benefited the most, consistent with the belief that such companies need research and development expenditure to survive in the long-term. Rival company shareholders in this high-tech sector also benefited from the announcements.

Owner Structure and Performance of politically linked firms

Chen (2005) studied the firms associated with the major components of the national ruling party. The findings indicate that the performance of politically linked firms was weak, probably due to the moral hazard problem. Politically linked firms had 1.5 times more risk than independent sampled firms, a high level of leverage, higher probability of financial distress and inferior performance during both good and poor economic conditions. However, further research could address this issue using a larger sample and expanded to include issues of corporate governance.

RESEARCH ON INVESTMENT MANAGEMENT ISSUES

There are more than 100 unit trusts in the local market, of which the Permodalan Nasional Berhad accounts for 90 percent of the traded assets. Some of these funds accept new issues, and therefore, the returns generated are not only from alleged stock-picking expertise but also from underpricing of new share issues allocated to the fund. On average, the unit trust performance is at best modest, and there is no evidence that the fund managers are able to consistently outperform the market.

Unit Trust Fund Performance

Shamsher and Annuar (1995) analyzed the performance of 54 unit trusts for the period 1988-92 whereas Tan (1995) analyzed 21 unit trust funds for the period 1984-1993. They concluded that the returns on investments in unit trust funds are *below* the risk-free rate of returns and in best years, below market returns. The actual risk-return characteristics of the funds are inconsistent with the stated objectives and level of diversification of the fund.

The performance of unit trusts is usually benchmarked against the market portfolio or another matching mutual fund. Using market portfolio as a benchmark for fund performance might not be objective, as the asset class of investments in the market portfolio does not necessarily reflect a fund's composition. Thus using that benchmark could provide misleading information on the fund's performance. Leong and Aw (1997) examined the performance of unit trusts funds using the KLSE Composite Index and EMAS index and concluded that funds were not as diversified as the market portfolios and only a few managers had a forecasting ability better than the 'buy-and-hold' strategy. Overall, they concluded that the choice of benchmarks did not have any impact on the fund's performance. Tan (2000) used the 'Snail-Trail' approach as a refinement to the conventional measure of fund performance and analyzed 17 growth funds. He reported significant changes in relative performance of most of the funds analyzed.

In a more recent study, Sabarina (2004) analyzed the performance of unit trusts using the *modified tradisional market portfolio* and a *mimicking portfolio* as benchmarks for evaluation. The results show that unit trust performance is sensitive to different benchmarks and significant difference in performance could be observed when using the mimicking portfolio. These findings indicate the importance of correctly benchmarking unit trust performance. Failure to do so will lead to misleading information on performance and consequently all decisions based on this information will be suboptimal.

The increasing demand for alternative investment vehicles which conform to the *Shari'ah* principle has prompted regulators to introduce various measures with the aim of boosting Islamic capital market (ICM) placements. The result is the availability of Islamic financial instruments complying with Islamic investment principles in direct financial markets. In the case of financial services, for instance

Islamic banking, it is not much of a hassle for a conventional bank to open up Islamic banking windows as an Islamic investment arm.

However, in the case of Islamic investment instruments for example, Islamic unit trusts, fund managers do face some limitations in selecting stocks that are *Shariah* compliant to include in their portfolio. Furthermore, due to the absence of an Islamic money market, Islamic unit trust funds depend solely on the equity market for investment. For conventional equity unit trusts, fund managers do not invest solely in the equity market. Rather, a fraction of their investment goes to the money market. Fikriyah, et al. (2007) analyzed 65 unit trusts, both Islamic and conventional funds, over a ten-year study period from 1992-2001. It was documented that the performance of the funds is influenced by economic conditions. For instance, Islamic funds performed better than conventional funds during bearish economic periods while conventional funds showed better performance compared to Islamic funds during bullish economic conditions. Both conventional and Islamic funds were unable to achieve at least 50 percent market diversification levels, but the conventional funds are relatively marginally better diversified than the Islamic funds.

The results suggest that fund managers are unable to correctly identify bargain stocks or to forecast market price movements. There is a vast opportunity to extend this study to other types of Islamic financial services, for example, commercial banks with Islamic widows, banks that are total providers of Islamic financial services, which are operating parallel to the conventional banks. There are also issues of risk, cost of capital, capital structure, scope and scale economics of Islamic banks/operations .

.Analysts' Equity Valuation Method

Shamsher and Annuar (1997) examined the methods commonly used by investment analysts in all brokerage houses to evaluate shares. They suggest that the analysts Used a combination of methods to assess the value of shares, though the emphasis is on traditional fundamental analysis. They use a three-year earnings forecast Period, they also prefer accrual earnings to cash flows, and use a variety of information sources. The emphasis is on financial information from audited financial statements, substantiated by qualitative information gathered through

company visits by analysts. Overall, though the findings are inconclusive regarding the most common methods used for share price valuation, the professional preference is for the earnings multiplier approach.

There is a need to research not only the methods commonly used but also the determinants for the choice of methods and the effectiveness of the methods over time as measured by investment performance. The findings will provide better insights to potential and current investors on the credibility of the analysts' and brokerage information and consequently the quality of service to their clients. This is an area of important policy goals.

RESEARCH ON AUDITING AND CORPORATE GOVERNANCE ISSUES

Validity of audited information

The 1997-1998 financial crisis led to many listed firms weakening financially becoming distressed firms. Financial distress is the consequence of cumulative problems over an extended period of time, which is not addressed in time to avoid serious consequences. There must have been some indications or signals that the auditors or managers picked up but which were either not in their purview to report (for example, external auditors) and/or that the management perceived as minor problems *6r* where they disguised the problems. Shamsher (2004) examined annual reports of 94 financially distressed companies for indication of information of financial distress before these firms were categorized as distressed or PN4 (Principle Note 4) listed for the period 1995 to 2001. The findings verified that most external auditors only disclosed firms' financial difficulties after 1997.

Analysis of the auditor's report, chairman's statement and management report of distressed firms shows that the majority of the firms reported profits in the years 1995 to 1997 when they were actually making a loss. Big four auditor firms audited more than 70 percent of these distressed firms: this reflects badly on the quality of the audit services provided by these reputable firms. This supports the survival bias behavior of audit firms in a non-litigation conscious local market environment. These findings have serious implications on disclosed-based regimes in the markets. Follow-up research is important to ascertain the status of the opaqueness over time. The most important implication from this finding is the need for regulators

to review objectively auditor and management responsibilities to help increase timely disclosure of mandatory and voluntary information by the firm. When investors are aware of the real financial condition of firms, they are more likely to revise their expectation of the future performance of these firms and consequently any consolidation exercise would be gradual and orderly.

Auditor switch decision

Auditor switch decision involves change of the incumbent auditor. Changes in management, perceived expertise of audit firms and deterioration of financial health of clients have been commonly cited factors associated with auditor change/switch decisions. Changes in a firm's activities and perception of advances in audit technology have been associated with the choice of quality differentiated audit firms. Though there is substantial documentation on the determinants and revaluation effect of auditor switch in developed markets, there is very little documented evidence on the issue in an emerging market such as the local one. Buson, et al. (2000) examined the determinants, and the wealth effect of auditor switch decisions by listed firms. The auditor change decision involves both upward switch from Tier 2 (Non-Big 5) to Tier 1 (Big-5) firms and downward switch from Tier-I to Tier-2 audit firms. Changes in management and growth in turnover explained the switch decisions. However, there was no significant wealth effect from the switch announcements. There is a need for further validation of the findings Using larger and more recent data sets.

Mergers and Acquisitions

In a market economy, scarce resources are allocated to those that can generate maximum returns per unit of risk. One of the many ways to efficiently allocate scarce resources to where they are most needed to generate maximum output per Unit of input is through promotion of mergers and acquisitions. Mergers and acquisitions weed out inefficiency in companies, in management and their businesses, and ensures efficient use of assets. Consequently, there is increased confidence in the market. Merger and acquisition literature show that the target firms almost always gain significant abnormal returns compared to the acquiring firms. Mansor and Lim (1993) examined the share price behavior around the dates

of acquisition announcements using data over the 1984-1989 period. They reported that, in successful merger exercises, target firms enjoy positive gains in the pre-announcement period but lose all these gains in the post-announcement period, a result contrary to those observed in any other market. Successful bidders earned only normal returns. In unsuccessful merger exercises, the target firms also gained in the pre-announcement period but these gains were not lost in the post-announcement period. Fauzias (1994) examined the effects of takeover announcements on bidding firms' share prices and reported that bidders only earn normal returns. This anomalous pricing behavior in the post-announcement period for successful targets may be explained only by applying the idea that management of bidding firms are engaged in hubris behavior, that is, there was false impression given of synergy gain in the bidding process.

Saiful Hafizah (2006) analyzed the performance of bidders, and both listed and unlisted targets, and documented that acquiring firms earn significantly larger abnormal returns around announcement times. Also, the announcement effect seems to persist over longer periods before and after the event. This finding is consistent with the behavior observed in other markets, thus casting doubts on the previous studies.

There is quite a bit of documentation on the wealth effect of bidders and targets in mergers and takeovers in Malaysia, but there is a need to ascertain the real long-term gains in these activities and the synergy effect from the capital investment exercise.

Corporate Spin-offs

Besides mergers and takeovers, spin-off decisions also affect the share prices of listed companies. Yoon and Ariff (2007) examine a sample of 85 spin-off cases, and confirm a positive announcement effect on stock prices. The parent of these firms also earn positive abnormal returns over the two days before and after the announcement day while the spun-off companies experience comparable effects after the listing date. They reported that only capitalization and age factors explain the variations in the abnormal returns. The price changes surrounding the spin-off announcements are positively correlated with capitalization (the larger the size,

the greater the value) and age is negatively correlated with share price changes (the older the parent the lower the price change).

CONCLUSION

In the last two decades many research-based publications on the emerging markets have appeared. There are more than 150 emerging economies in the world at different stages of development and about 70 of them have share markets. These markets are in the process of converging from less developed to more developed status and share peculiar characteristics that make them different from developed markets. This provides opportunity for researchers to test established theories in these new market settings. The local market has thus been examined as described in this paper. The overall impression one gets from these studies is that the Malaysian market is not similar to the very recently-established emerging markets -there are about 25 such markets in the world today -and that the Malaysian market behavior is very much closer to the behavior of some of the developed markets (about 30 in the world) despite some peculiar behavioral characteristics which is due to regulatory reasons (excessive IPO premium) or due to the lack of analyst intensity (the very low mutual fund performance).

In case we have left out some of the published studies, it is due more to the unavailability of such studies from readily accessible sources rather than from any effort, on our part, to ignore such publications.

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