Call for action - by Reaz Islam

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Excess and disequilibrium in any market is not sustainable overtime and what we have experienced in the capital markets recently is a painful price correction of an overpriced market to a large extent triggered by profit taking, de-leveraging by financial institutions to reduce exposure, some overreaction/panic selling as well as liquidation related to year end book closing by financial institutions. In my view, this is not at all unusual compared to the corrections experienced in many developing markets. Since the market was up over 85 percent in 2010, a correction of 30-40 percent is just logical since 85 percent was not warranted based upon the fundamental growth of the economy and earnings of the listed companies.

The silver lining

Although the correction was very painful both financially and physiologically, we can certainly benefit from the experience as long as we deal with the issues head on. In my view, the correction that has taken place is not likely to materially impact the real economy this time around because the market appreciation did not have any material positive impact on the real economy in the first place other than causing some inflation to the real estate market. Most of us were pleasantly surprised and impressed that our honorable finance minister had the wisdom and courage to take responsibility and take the lead for a solution. Recognition of the problem is the first step and in most cases winning half the battle; now let us all work (public and private sector financial professionals and investors) collectively to understand the source of the problem and then do our parts to address the issues constructively for the greater good of the capital markets and ultimately for the benefit of the real economy.

Back to reality

In my professional view, the overall market's projected price to earnings ratio is 15x as of Feb 17 that is generally consistent with other frontier markets, so no need to panic. Although further downside risk persists due to technical factors (lack of confidence) and some excess leverage that exists still required to be unwound. Nevertheless, for long-term investors (horizon of over one year), some attractive investment opportunities do exist in many sectors. As always buyers beware; do homework before investing and do not invest based upon rumors.

Buyers beware

If something is too good to be true, it probably is not true or sustainable. Investors must be able to understand the basics including the following:

1. Company data: Investors must be able to read basic financial data like the price to earnings ratio, price to book value, historical growth of revenues, expenses and profits. Investors should look out for answer to fundamental questions like will the company be missed if it did not exist, are the products competitive and so on.

2. Industry data: Investors must have reasonable understanding of the industry in which the investable companies operate in, the stakeholders of the industry, the industry's life-cycle, competitive advantage and other relevant facts integral in evaluating company stocks.

3. Equilibrium: The aggregate economic growth to a large extent dictates the capital market return. There should be logical correlation between individual company's earnings growth versus stock price movement. Any abnormal gain is naturally accompanied by the potential for above-average risk.

If investors do not take the pain of conducting some level of analysis, they run the risk of losing beyond the original capital invested in the long term. We must do much more to educate the investor base and certainly increase the portion of real institutional investors who generally will sell in an overpriced market and buy when the market is below its intrinsic value.

Call for action

So what can we do to avoid this in the future? Let us focus on two items, (1) Probable cause and (2) Potential solution.

1. Probable cause: Policy mistakes over the medium and short term, if any, must be identified. The policy directives from various regulators, including the finance ministry, Bangladesh Bank, Securities and Exchange Commission (SEC) and parliamentary standing committee, can be analysed to locate the policy mismatches. It would be worthwhile to chalk out the chain of events that took place, intentionally or unintentionally, to create and prolong the bubble and to deflate it hastily. Could something be done differently? What have we done to develop a more stable/sustainable market, more institutionalised and more matured investor base?

Different institutions including banks, non-bank financial institutions, merchant banks, and brokerage must evaluate how each of them have contributed to the bubble by financing overpriced securities or allowing loan proceeds for different purposes to end up in the stock market due to lax monitoring. Could they have protected the investors at any point? Did they sell out from the own portfolio while clients kept on pouring money into the overheated market? Did they realise the risks only after it became unmanageable? Could they avoid force selling at a loss by being proactive and existing early?

Retail and institutional investors must take responsibilities for their action or inaction. Did they do minimum due-diligence, did they rely on rumors, did they use leverage and understand the consequence of using leverage? Did they risk their entire savings into the capital markets? Did they have abnormal return expectations?

2. Potential solutions: Policy coordination across finance ministry, central bank, SEC and parliamentary standing committee is essential for the capital markets and the health of the financial system. I believe Bangladesh Bank is the most qualified to take the lead since they are the ultimate driver of direct and indirect liquidity of the money market and, to a large extent, capital markets in terms of sourcing margin on stocks. We must have short, medium and long-term policies that not only control inflation and encourage employment but also control liquidity in and out of the capital markets as needed. The SEC must ensure that laws in the books are properly enforced, proper disclosure rules are followed, and valuations are reasonable in initial public offerings. Monitor if investors are ill-advised, and provide retail investors with better protection and safer invest options.

Financial institutions including banks, NBFI, merchant banks, and brokerages must implement better internal control so that they are not exposing uninformed investors or risking their own capital. They must invest in systems and controls, develop sound policies and most importantly dedicate proper human resources for capital markets businesses.

Retail and institutional investors must take responsibilities for their action or inaction. Everyone should know that investment in capital market involve risks, including loss of partial or all of invested principal. In addition, leverage or margin loan increases the risk of capital loss significantly. Without the basic understanding of company valuation and fundamentals, one must not come into the markets. One must know why he/she bought the stock and when to exit. If we do not do basic research, we expose ourselves to unwarranted risks. We must prudently invest in the capital markets and should only invest a portion of net-worth in the market.

Let us not procrastinate

We cannot reverse what has happened but we can certainly take steps to avoid or minimise future challenges. After everything is said and done, inaction will be our biggest enemy, and in the second time around if it happens to be under a weaker economic backdrop we may not have a second chance unless we take actions to address the causes of the initial tremors now. As the markets stabilises, it is rather easy and tempting to look the other way, but a weak/flawed foundation and cracks in the financial system unaddressed will certainly set the financial markets for a material collapse in the future. A collective effort is required for a functional capital market and all the stakeholders (regulators, intermediaries and investors) must make an honest effort. Complete and comprehensive solutions may not be practical immediately but by implementing sound coordinated policies by regulators, improving controls and strategies by market intermediaries to protect the long-term interest of the investors and

themselves, and finally more prudent investing will take us a long way from the status quo, and will not deprive the country of a sound capital market and potentially great benefits to the real economy.

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