Role and Function of Financial Markets

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Structure of unit trust funds

- Investors
  - Pay $\rightarrow$ Unit Trust Fund

- Trustee

- Trust deed

- Fund manager

- Portfolio of shares, bonds and other securities.

Portfolio consists of shares, bonds and others. How do you benchmark the performance?

How do you create a fund which reflects the market’s performance?
Financial markets

- Forum to facilitate financial transactions through the creation, sale and transfer of financial securities,
- Part of the economy,
- Companies and governments need to raise capital,
- Allow investors to invest in financial securities and earn a reasonable rate of return,

29 Oct, 1929
Operations of financial markets

- Primary market
  - Where financial securities like bonds and stocks are issued by issuers to investors,
  - Also known as IPO,

- Secondary market
  - Where the issued securities are traded,

The primary and secondary markets are inter-related and inter-dependant.
Functions of a primary market

- Supplier of funds (Surplus or savings unit)
- Demanders of funds (Deficit unit)

To facilitate the efficient allocation of funds
Secondary market

- Primary market will not function without well-organized and efficient secondary market,
- Must have “depth” and “width”
- Crucial characteristics:
  - Transparent
  - Liquid
  - Low transaction costs
  - Incorporates all available information
  - Well regulated
Organization of Secondary Market

- **Capital markets** - to raise long term capital like bonds and stocks,
  - More than one year tenor
  - Bursa, STI, HK Stock Exchange, NYSE

- **Money market** – shorter term instruments, like Treasury Bills etc
  - Discount instruments.
  - Short tenor (less than 6 months)
Malaysian Financial Markets

REGULATORS

LOFSA

BNM

SC

SSM

FINANCIAL MARKETS

LIOFC

MFE

MGS

PDS

MDEX

BM

MESDAQ

Source: Bank Negara Malaysia

LEGEND

LOFSA - Labuan Offshore Financial Services Authority
BNM - Bank Negara Malaysia
SC - Securities Commission
SSM – Companies Commission (Suruhanjaya Syarikat Malaysia)
LIOFC - Labuan International Offshore Financial Centre
MFE - Money and Foreign Exchange
MGS - Malaysian Government Securities
PDS - Private Debt Securities
MDEX - Malaysia Derivatives Exchange
BM – Bursa Malaysia
MESDAQ - Malaysian Exchange of Securities Dealing and Automated Quotation

Source: Bank Negara Malaysia
Stock market indices

- What do they represent?
- An index:
  - To keep track of portfolio performance.
  - Widely published, and publicly available “market” portfolio that is composed of many different stocks.
- To reflect the overall movements of a group of securities (portfolio).
Other functions

- Computing total return for overall stock market,
- Create an index portfolio or tracker fund,
- Calculate market risk
- Technical analysis
How are indices created

- As it reflects overall market, how it is created is important
- Factors include:
  - Appropriate sample
  - Weightage
  - Computation method
Widely used indices

- Dow Jones Industrial Index ("Dow")
- Nikkei 225 (Japan)
- Hang Seng (HK)
- S&P500
- Nasdaq
- Eurostoxx

- Available via Bloomberg.com
DJIA vs. Nikkei vs. Euro

Source www.finance.yahoo.com function charts
Custom indices - RICI

- Diapason Commodities Index® TR (DCI®)
- Rogers International Commodity Index®
- S&P Goldman Sachs Commodity Index TR (GSCI®)
- Dow Jones - AIG Commodity Index SM TR (DJ-AIGCISM TR)
- Reuters-CRB Continuous Commodity Index (CRB)
Dow Jones Islamic Indices

Reflecting beliefs and values
Custom Indices – Alpha Centurion

Alpha Centurion European Index is based on a long (buy) / short(sell) market neutral investment strategy

- **The strategy:**
  - Every week identifies the 20 best & 20 worst performing shares of the previous week
  - **Buys** the 20 *worst* performing shares of the previous week
  - **Sells** the 20 *best* performing shares of the previous week
- Process is repeated on a weekly basis until maturity
- **Strategy is subject to dynamic risk adjustment:**
  - Daily changing exposure based on the performance of the strategy
- Selection universe for the Alpha Centurion European Index contains the *most actively traded and highly capitalized stocks* listed on European exchanges
  - Diversified sectorially and geographically
  - Sample constituents are: Siemens, BP, Nestle, Nokia, Tesco, HSBC, Barclays, Vodafone
Custom Indices – Alpha Centurion (Performance)

Strategy of Buying Low and Selling High with dynamic adjustment
Category of Indices

- Price weighted
  - Based on arithmetic average of current prices
  - E.g. Dow Jones (oldest)
- Value weighted
  - Current market value of component stocks compared to its base value
  - E.g. KLCI
- Unweighted
  - stocks carry equal weighting regardless of their prices and/or market values.
Short Quiz

1. What is the role of capital markets?
2. Identify the difference between the capital market and money market.
3. Why do businesses and the government need to raise funds from the capital market?
4. What are the different securities issued by the government?
5. The operations of the financial markets can be divided into two components. Name the two components.
6. What is the main function of the primary market?
7. What is primary role of the Securities Commission (SC)?
8. What are the common financial securities that investors in Malaysia can invest in?
9. What is an Index?
10. The Kuala Lumpur Composite Index (KLCI) is a:
    1. Price weighted index, or
    2. Value weighted index, or
    3. Un-weighted index.
Thank you