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02-09-2008: Ride the volatility

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Gone were the days when we see retailers punt the market when prices start to recover. Sad to say, for many years, we have not seen enormous crowd of retail investors flocking to the public gallery of stockbroking firms. There are various reasons for the lack of retail participation.

Market is volatile

One of the reasons for the lacklustre retail participation, though not the main reason, is the high volatility in the stock market. Sharp fluctuation in the stock market, especially in a declining market, makes stock investment a risky game. Previous market champions who buy hundreds of thousand of shares each time are nowhere to be seen.

For those in the middle-income group who have been enjoying steady returns from their property investments, dabbling in the stock market is definitely a high-risk game they choose to avoid. A 10%-12% per annum average return from property investment is definitely better than similar long-term return from investment in shares, judging from risk-adjusted point of view.

Stock market is like casino

In Chinese dramas, story lines featuring disastrous endings for those who speculate excessively in the stock market are not uncommon. The morale of these dramas is that investing in the stock market is a no-no for retailers. The stock market is often described as a game for the rich and also for the professionals, with the common impression that many syndicates are out to con unsuspecting retailers.

Many bad experiences locally

Many local retail punters suffer from bad experiences over the years, with losses arising from fraud by certain directors and siphoning funds out of companies.

Investors also suffered from mismanagement of companies. There was also a string of companies which did not meet profit forecasts right from the first year of listing. Many others struggled to show mediocre profit and their returns on equity (ROE) were below the fixed deposit rate for many years.

The large number of poor-grade companies admitted to Bursa Malaysia over the years has caused many investors losing their hard-earned money. After a series of losses, many investors started to lose confidence in our local bourse. Getting these investors back into the stock market will require a number of good performances on earnings as well as stock prices.

Roller-coaster ride

For those who have seen the big bull of the 1970s, then 1980s and 1993 super bulls, as well as the fierce bears of Pan Electric Crisis, Black Monday, Asia Financial Crisis; the stock market is a volatile yet challenging place. The excitement in a bull market and the anxiety in a bear market are akin to a roller-coaster ride.

The greed and fear over-rule fundamentals from time to time, in fact more than half the time. The rise during a bull market defies gravity and definitely beyond the fundamental reasoning.

Similarly, in a depressed bear market, fundamentalist investors were fearful of the least possible events. During the financial crisis in 1997/98, investors were also wary of investing in fundamentally strong companies due to the fear that some of them may be called upon to do national service and salvage the poor companies.

Stock provides higher return

Based on the past performance of KLSE Composite Index (KLCI), the compounded return of KLCI is 8.1% per annum between 1977 and June 2008. That is to say, a typical investment based on the components of KLCI is better than fixed deposit rate from banks. Incidentally, the returns of S&P 500, the benchmark index of New York Stock Exchange, is similar to that of KLCI during the same period.

Table 1: KLCI vs S&P500 (1977-2008)

KLCI	M-o-M	Y-o-Y	S&P500	M-o-M	Y-o-Y
Max Gain	34.2%	98.0%	Max Gain	13.2%	34.1%
Max Loss	-34.9%	-52.0%	Max Loss	-21.8%	-24.0%
Average Gain	1.0%	8.2%	Average Gain	0.7%	8.2%
Std Deviation	7.9%	27.4%	Std Deviation	4.2%	14.7%
Return/Risk		29.8%	Return/Risk		55.8%

Source: PCM

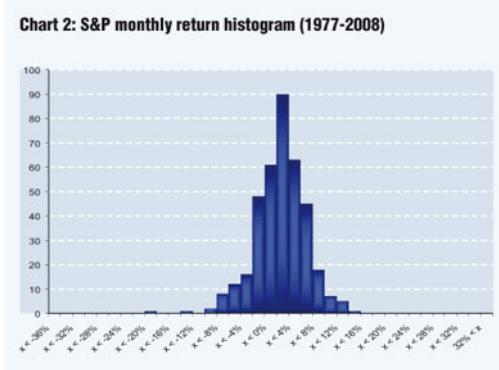
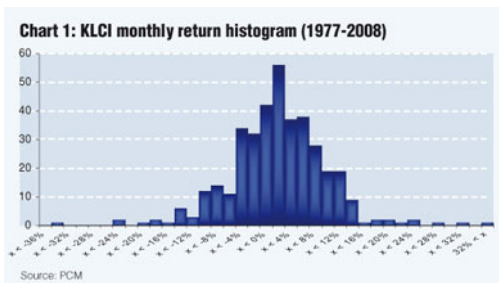
The return on investment of the stock market varies depending on which time frame we take. If we have taken the return over the past 10 years, it would be 11.4%. The actual return of an individual investor varies substantially from the benchmark index KLCI due to the different type of stocks invested — some may have a handful of blue chips while others have a basket of speculative lower liners.

KLCI more volatile

The stock market either registers a gain or a loss in a single month, such occurrences of monthly gain or loss can be compiled to form a histogram showing the frequencies at different levels. As expected, markets show a small percentage of monthly gain or loss most of the time.

But there were incidences of large surges in prices and large collapses in prices. From the histogram, the wider the fluctuation indicates a more volatile market. There were times when KLCI fell as much as 34.9% in a single month (Oct 1987 financial crisis) and there were also times when it went up to the tune of 34.7% (April 1999). The 30-plus percentage gain or loss in a single month depicts the volatility of our stock market.

US key benchmark S&P500 was less volatile. The biggest single monthly gain of S&P500 during the same period was in January 1987 +13.2%



and the biggest loss happened in October 1987, -21.7% due to the Black Monday collapse.

Over the past 31-½ years or 378 months, KLCI was up 217 months and down 161 months. In terms of % gain/loss month, KLCI has 57% gain months and 43% loss months which was less favourable than S&P500's 61% gain months and 39% loss months.

US market less volatile

On the other hand, similar histogram developed from monthly performance of S&P 500 over the past 31-½ years showed that the US market is less volatile.

The distribution of monthly returns is narrower. The swing between biggest gain and largest loss in a month was not as much as KLCI.

The annualised standard deviation of return, a common measure for risk, for S&P500 was 14.7% and the corresponding risk for KLCI was 27.4%. One reason for our high volatility is the substantial inflow (which causes our market to rise) and outflow of foreign funds (which causes our market to fall).

Volatility equates to risk

High volatility in prices resulting from wide fluctuation of return simply equate to high investment risk. The high risk phenomenon makes investment in the stock market very risky. Due to the high volatility of our market, buy-and-hold strategy may not be the best method. Like other emerging markets, our stock market is still very much sentiment-driven.

On top of that, the substantial movement of foreign funds in and out of the market also have substantial influence on local market sentiment. In a down market when substantial foreign funds move out or when market sentiment is poor, almost every stock suffers. Even the fundamentally strong stocks suffer from price erosion in a bear market.

As such, investing in the Malaysian stock market is a difficult task. For a fund manager, this is definitely a challenging place to be in. As such, abilities to time and trade in Malaysia are also crucial.

Volatility means opportunities

On the other hand, volatility also means more opportunities to make money especially when we are able to buy at a low and sell at a high. Hypothetically, substantial profit can be made if we are able to buy at the bottom of the market and sell at the top.

Because of the big swing in our market, partly due to frequent flow of funds by international fund managers, such opportunities always occur if we wait patiently.

Looking at past patterns, this sounds easy. **In reality, spotting the bottom and peak of a market is not easy as we see the market evolve day by day, from bullish optimistic phase to bearish pessimistic period. By the time we notice a correction has evolved into a bear market, it could be too late to sell.**

Similarly in a bull market, the initial run-up is always misunderstood to be a bear trap. It's always easier to speak from hindsight. **Even if we do not know exactly where the bottom of the market is, it is definitely a bargain to buy when the market has fallen 20-30% from its peak with some stocks plunging by 40-50%.**

Because we are not sure whether the market has reached the bottom at the point of purchase, we can always keep some cash for future averaging purposes, just in case the market falls further. If the market recovers after the first purchase, we are happy because we have made some money from the shares just bought. If the market goes down further, we are also happy since we can now buy cheaper. In this way, we can benefit from the down market as well as manage our sentiment.

Similarly, when the market recovers substantially, perhaps it is time to lock in some profit by selling some of our positions. If the market goes up further, we still have some shares in hand to sell.

Investment guru Warren Buffett makes his money by buying into investment-grade stocks at market bottom. His cheaper entry cost allows him to keep the shares for many years without selling. If he could have sold some of those shares bought at market bottom when they are high, he could have made more.

Buy low sell high

Buy at the bottom and sell at the top is a simple advice. In practice, buying low and selling high requires substantial amount of discipline and patience. Investors need to overcome the fear at bear bottom and greed during bull market in order to be a contrarian.

By going against the crowd, there is some value added. It is definitely better than holding to some dead stocks and not doing anything for years.

Trading on Bursa Malaysia is particularly crucial on stocks whose profits correlate highly with the fluctuation of their product prices or the cycle of a particular industry.

Typical examples of cyclical stocks are property stocks, construction and building material stocks, plantation stocks, stockbroking firms, tech stocks, warrants, political-linked stocks, speculative third liners, situational and conceptual stocks.

These stocks are not advisable to be held for long, and they must be disposed of at certain points in time. They are generally higher beta stocks which make them the ideal candidates for trading purposes.

Foreign fund managers investing in emerging markets also like to trade on these stocks due to the high potential capital gain but eventually they will sell them causing the share price to collapse. When the time is ripe for the next cycle, several years down the road, these foreign fund managers will come back and paint a rosy picture again to lure unsuspecting and greedy punters into the game again.

It is a conceptual game with a theme so that more people will jump onto the bandwagon to join in the game — some will make money along the way while many will be caught eventually.

Perhaps only a handful of solid blue chips with very stable earnings base can be kept for long term. Presently, some of such resilient stocks in current bearish market are Public Bank, DiGi, F&N, Nestle and Amway. It should be noted that there is no guarantee that a resilient stock today backed by strong fundamentals may not fall in the next bear market.

Bear will go and bull will return

The present bear market has caused many stocks to trade below book values, provide high dividend yields and low price-earnings ratios. Stocks are undeniably very cheap now. They will recover one day. The million dollar question is when is that one day?

If you have a long enough horizon, say in two years, chances are you will be right to buy now. If you only want to invest for six months, the domestic political uncertainties may cap the upside even if global equity markets recover following the fall of commodity prices led by crude oil.

Prices of stocks now reflect the bearish sentiment and have factored in the worst scenarios. If there is improvement in the bearish factors, then markets will recover faster than anticipated.

Notwithstanding all the negative elements in the market, the significant stock market volatility provides opportunities for those who dare and are willing to take some risk for big capital gain. After a stock has fallen 50% from RM10 to RM5, it only takes the stock to recover to RM7.50 to provide 50% capital appreciation.

The risk of buying during bearish sentiment is certainly much lower than buying during the bullish period where stock prices were substantially higher.

Buying in a bear market could be very rewarding for those with patience and also the holding power. For those who know how to take advantage of market fluctuation, such volatility which is not available in other asset classes such as property market, may turn out to be the main attraction of the stock market.

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