Trading places

Malta's Stock Exchange is characterised by a relatively small market and transactions typically amount to a few hundreds on a good day. University lecturer and PhD candidate ***SILVIO CAMILLERI*** *analyses the situation. He was speaking to* ***Christopher Sultana***

Why is the Maltese stock market usually characterised by such low activity?

The local stock market is very small when compared to international ones. The number of transactions during a typical trading day on the Malta Stock Exchange does not exceed fifty, while the number of daily transactions on other exchanges, such as the New York Stock Exchange, typically exceeds one million.

Trading activity is low primarily due to the fact that a small number of potential investors, results in a restricted number of trading requirements, and therefore low activity. In addition, local individual investors tend to adopt 'buy and hold' strategies, where they typically hold particular securities for a long period of time.

Investors in foreign markets tend to take profits more frequently, meaning that they sell their holdings as soon as they are happy with the realised gains, and invest the proceeds in different securities. Low trading activity usually results in low liquidity.

Liquidity refers to the ease with which a trader can buy or sell a security at the going price. In those cases where liquidity is low, buyers might have to offer higher prices to attract prospective sellers, and conversely sellers might have to submit orders at lower prices to attract potential buyers.

What is the perceived impact of low activity on the Malta Stock Exchange?

As I have just mentioned, traders may have to offer price concessions in order to attract a counterparty to the transaction, and this implies less favourable prices. Low liquidity also impacts on the 'pricing efficiency' of the market. An efficient price reflects the true underlying value of the firm, which basically depends on the expected profits and the different risks attached to the particular investment. Therefore in an efficient market, prices change in response to new information relating to the firm or to the market in general. Price changes which do not emanate from any new information are basically transient volatility and these fluctuations are expected to be reversed subsequently. A reasonable number of transactions are required for the pricing process on a stock exchange to be 'efficient'. In the absence of this, pricing would be more liable to transient volatility effects, perhaps resulting from some unfounded expectations of a few traders.

A further effect of low market activity on the local exchange is that some securities do not trade every day, and therefore the most recent quoted price might have been negotiated quite a few days earlier. In such cases, the market does not immediately reveal the current value of the particular firm.

What are your views about primary market issues?

Empirical studies often point at a 'home country bias' in investors' portfolio selection policies. This means that investors tend to allocate relatively large portions of their portfolios to those securities which were issued in their own country.

One factor which may contribute to this phenomenon includes the possibility of reducing exchange risk when investing in securities denominated in local currency. In addition, investors may avoid the country risk associated with possible political instability or financial distress in foreign economies, when they invest in local securities. This might partly explain the local investors' exuberant responses to primary issues, which are typically oversubscribed. Other possible factors which explain Maltese investors' preference to hold local securities might be the transaction costs and/or fees relating to holding foreign securities and investment schemes.

Another salient factor relating to the local market is that investors tend to prefer fixed rate bonds as compared to equities. This may explain why the activity on the primary market tends to be dominated by bond issues, even if equity issues are still typically successful. Despite this, one may reasonably expect that as the local investors get more financially sophisticated, they become choosier in between equity offers. Subsequent price movements of some particular issues may lead to the argument that they were overpriced. This does not usually happen on developed markets, whereby initial public offerings (IPOs) are more likely to be underpriced, in order to make them more attractive to investors.

This discrepancy is also connected to the fact that primary issues are less common than in developed markets. Therefore investors who hold spare cash at times tend to purchase securities offered on the primary market without much regard to how reasonable the issue price is and the risks that are attached to the particular investment opportunity. In this way, independent financial advisors have an important role to play. It may be regretful to note people

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investing money without seeking sound financial advice or without assessing the company accounts and/or the prospectus. Investors should assess the risks involved in the particular investment rather than buying straight away whatever may be on offer at the time.

How do you regard the operations of the stock exchange with all its limitations of a small size market?

Malta's small size presents quite a number of limitations especially in certain situations where the majority of traders diverge to one particular side of the market and most traders opt to sell. This would result in a comparatively higher price movement. Such fluctuations may also occur when price changes result from a low number of transactions and therefore published prices are likely to reflect the expectations of a few traders rather than those of the market in general.

At times, some price changes might be unfounded given the absence of any news that justifies an upward or a downward price change. The small size of the market may also make it easier for particular traders' actions to influence the market. This may actually translate into a higher potential for market manipulation, although the latter argument is being stated from a purely theoretical point of view, and I am not implying that this has actually taken place!

These factors also present difficulties in applying theoretical research to the local markets given that the price data in such settings is not as 'smooth' as that of more liquid markets.

Most of the above factors are directly related to low liquidity, and the main challenge is to increase liquidity and trading on the local markets. This is not a straightforward task, given that liquidity will not necessarily increase by a change in the trading system. Liquidity might somewhat increase through a change in the investors' habits, where the latter monitor the market more closely and trade upon their expectations or perhaps take profits more frequently.

Yet, the fact that the local investor base is small, given our population size, it still remains listed as a limitation. Some of these problems may be partly tackled by seeking alliances with other exchanges, in order to make it easier for locally-issued securities to trade overseas. Still such policies are no immediate guarantee of success. In addition, it has to be considered whether such potential alliances with foreign exchanges might actually result in a hindrance for local companies to obtain funds, given that the new facilities might become available at a higher cost such as increased listing fees.

Another drawback is that our small size makes us relatively unimportant when compared to other emerging markets. This is evident from the considerable flows of financial investment that are being directed towards developing economies in Latin America, Eastern Europe and Asia. Malta's size virtually excludes it from the international investors' map. Emerging markets reports do not typically feature Malta as a potential source of financial investment and international portfolio managers do not provide products which invest exclusively in Malta, as they do in respect of other economies. In this way, it remains relatively difficult for Malta to tap the international markets to attract financial investment.

Does a small stock exchange like ours constitute any advantages whatsoever?

Perhaps the most important advantage is that most people practically know everybody else. This may make it easier for investors to form opinions about the management teams of quoted companies, although such opinions may also prove to be misconceptions.

Another possible advantage is the fact that the local stock market is to some degree insulated from what happens on other emerging markets. As I have mentioned above, Malta's Stock Exchange is not lucky in attracting huge amounts of financial flows as other emerging economies are doing. Yet, it has to be noted that at times funds tend to flow out of emerging markets even more quickly than they flow in. This often happens at the first signs of financial distress and it aggravates the problems. At least, Malta's stock market is shielded from such large-scale 'herding behaviour'.

What, in your opinion, are the main challenges facing the local stock market?

The local stock market in its organised format is a relatively new one. While some important milestones such as introducing corporate governance practices have been attained, there are still a number of possible improvements which may be effected. The market does not yet allow for short sale activity and no derivative contracts are traded.

Another main problem is the comparatively low activity on the local markets, given that the introduction of such transactions pre-supposes some minimum level of activity. Thus, increasing liquidity levels on the stock market remains an important objective.

A further challenge is to aim at a higher proportion of suitably informed investors in order to promote a more efficient pricing process. This explains why investor education is typically given a high priority. Investors should be aware of the risks associated with various investment outlets. Market research is one important way through which investors keep abreast with the latest events. Yet, research on part of brokers may only be feasible if the level of business justifies the resources spent on such activities; so the puzzle of market liquidity springs up again.

One particular market research activity is the rating of companies in terms of their financial standing. Unfortunately no significant credit rating services are carried out, and this presents a drawback from the point of view of investors. The credit rating of a company gives an instant idea of its credit worthiness, the probability of repayment, as well as the approximate returns which should be expected on the particular investment.

What changes would you like to see in the typical profile of a Maltese investor?

Changing the attitude of the Maltese investor is a long term issue that requires awareness and education. On a positive note, it is encouraging to observe that the public welcomes investor education activities which are organised by different institutions. I think that shareholders have an important role in influencing quoted company policies. Shareholders should not be indifferent to the voting rights related to their investment and they should question company policies or particular expenditures at annual general meetings if they feel the need to do so. Ideally we should also highlight more the importance on socially responsible investments in line with overseas trends. Socially responsible investors scrutinize the companies which they finance, in terms of whether they adopt anti-discriminatory employment policies and pro-environmental policies and how much they actually put them into practice.

In addition local investors should also be educated in terms of wider investment opportunities, how these work and the risks they carry. The advantages of 'capital guaranteed investments' are not given for free; they come at a price in some form or another. Other kinds of investments incorporate derivatives in their portfolios. The expected payoffs from such opportunities might not actually conform to the needs of some particular investors even if they might suit the needs of some others.

Perhaps, a possible improvement in the local investors' profile is in terms of their relationship with brokers and advisors. The first challenge is to encourage investors to ask for more financial advice. The second challenge is to make investors aware of the type of relationship they hold with the people whom they get the advice from.

It is difficult to hold the intermediary responsible for improper advice, if the written evidence shows that he is not giving any advice in the first place! I am not hinting that some advisors do not perform their duties properly; but investors should be aware of such technicalities and they should obviously read any documents prior to signing them!

What do you think of the way in which trading activity is organised on the local market?

There has to be a distinction between the terms trading protocol or trading method and the trading system. The trading protocol refers to how trading takes place and how it is organised such as what type of orders are allowed, whether limits on the price movements of securities apply, and whether market making activity is allowed.

The trading system is the way in which these different trading methods are implemented, thus the trading system is basically a computer programme which is used to organise trading as per the rules specified in the trading protocol. As regards our trading system, trading is dematerialised in the sense that ownership of securities is not evidenced through traditional share certificates. Apart from reducing paperwork, dematerialisation permits instant verification of a trader's ownership of the securities he is selling prior that his 'sell' order is accepted by the trading system. This is important given that until recently, on other emerging markets where trading was not dematerialised such as India, there were frequent problems of 'false trades' resulting from counterfeit share certificates.

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'Ideal choice of trading'

In broad terms, the trading protocol of the Malta Stock Exchange is in line with those of modern exchanges. The actual details of trading protocols tend to vary in between different exchanges. Some trading venues, such as the New York Stock Exchange, start with an opening call auction, whereby the orders submitted during the first minutes are executed simultaneously at the same price. The NYSE then changes to continuous trading where orders are executed instantaneously at the best available prices. NYSE then closes off with another call auction. This is basically the procedure which the local exchange follows, even if the term 'continuous' trading is perhaps a misnomer, given the low number of transactions on the local market. Other trading venues such as Euronext Paris simply have an outright continuous trading session. Other venues may operate through a series of call auctions throughout the day, as was the case with the Tel Aviv Stock Exchange.

Exchanges also differ in terms of whether they permit any market making activities. The presence of market makers who stand ready to buy and sell particular securities at prices which they quote, may contribute to increasing liquidity. Yet, research indicates that such facilities typically come at a cost. In fact, trading systems which are purely electronic offer potential cost savings for medium-sized transactions.

The 'ideal' choice of trading method is likely to vary in between cases, and it also depends on the objectives of the people who are designing the protocol. Such objectives often prove to be conflicting. It is more healthy for share prices to adjust instantaneously in response to new information yet this might also translate into higher volatility. Such considerations require in-depth thinking and this explains why the relatively new research area of market microstructure has been growing so fast. Thus, my comments about the local trading protocol are that it is certainly adequate, yet we should also investigate further whether some modifications might represent any potential for improvements in the light of the prevailing circumstances.

Silvio Camilleri studied Banking and Finance at the University of Malta and at the University of London from where he obtained a Masters Degree in Financial Management. He is currently following a PhD programme at Loughborough University, UK. Mr Camilleri lectures at the Banking and Finance Department of the University of Malta. He also worked at the Group Treasury Department of Air Malta Company Ltd. where he was a member of the Investments Committee.