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## Plenary 3

# Global Portfolio Investments - Opportunities and Barriers in Emerging Markets

*16. Speech by Mr. Datuk Ali Abdul Kadir*

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# Global Portfolio Investments: Opportunities And Barriers In Emerging Markets

Speech by
Datuk Ali Abdul Kadir
Chairman, Securities Commission, Malaysia
at the
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Panel 3
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Honourable Chairman, Mr. Jose Osorio, Chairman of CVM of Brazil
Chairman of the Capital Markets Board of Turkey, Mr. Dogan Cansizlar
Distinguished panel members,
Colleagues, ladies and gentlemen:

It is a pleasure and an honour to sit on this panel of distinguished speakers this morning, and to be given the opportunity to share some of my thoughts on the opportunities and barriers with regard to global portfolio investments in emerging markets. The topic is clearly a significant one at this juncture—and a re-assessment of the issues that concern it all the more timely—given the strong expected recovery of international portfolio capital flows to emerging market economies.

## Portfolio Investments in Emerging Markets

Measuring the value and direction of global capital flows is a notoriously difficult exercise, but estimates do suggest that after recording a slight net outflow of just under US$2 billion in 2001, emerging markets will attract around US$14 billion of portfolio equity investment in 2002. Asia/Pacific and Africa/Middle East markets are expected to receive the bulk of these flows, with the latter making a particularly strong recovery from a net outflow of nearly US$6 billion last year to a forecast net inflow of US$4.6 billion[1] this year.

That said, the nascent nature of global economic recovery, the prevalence of risks from many quarters and the inherent volatility of such flows, among other factors, give cause for us to remain, at best, "cautiously optimistic" about the prospects for emerging-market portfolio flows. So let me not dwell so much on what might happen with regard to emerging markets, but rather on what is actually happening in terms of providing opportunities for global portfolio investors. In my presentation, I will speak from the market regulator's point of view.

## Concerns of the Portfolio Investors

Why would portfolio investors want to invest in emerging markets when they can easily invest in developed markets which they probably understand better? **The first point I'd like to make is that emerging-market**

[1] Source: "Capital Flows to Emerging Market Economies", The Institute of International Economics Inc, Jan 30th 2002. Net portfolio flows into Asia/Pacific markets for 2001 and 2002 are estimated at US$6.2 billion and US$8.2 billion respectively

**investment still offers portfolio investors diversification benefits over the long term.** Evidence has quite clearly shown that in spite of the financial crises of the 1980s and '90s, as well as the presence of certain constraints on trading in these markets, developed-market stock portfolios gained significant benefits from diversifying into emerging market stocks over the last quarter of a century.[2]

So there are clear benefits of emerging markets with respect to portfolio investments. But what about the likelihood of returns? **The second point that I would argue here is that there are also increasingly attractive growth opportunities for portfolio investors as well.** From a macro perspective, emerging markets on the whole are providing a more value-added investing environment, while growth is also being unlocked at the micro level. The investing value provided by emerging markets was a point also made by the honourable Minister of State Kemal Dervis in his address at the opening ceremony yesterday.

Let me now address the concerns of the portfolio investors, the barriers, when they consider investing in emerging markets – and generally these include political stability, governmental policies and managerial capabilities, market efficiency and systemic risk, liquidity and of course, value.

[2] "Should US Investors Hold Foreign Stocks?" by Asani Sarkar and Kai Li, *Current Issues in Economics & Finance*, Federal Reserve Bank of New York, March 2002.

## The Challenges for the Emerging Market

When it comes to attracting international portfolio investment, the ability to draw and maintain order-flow has become one of the biggest challenges to the traditional mainstay of emerging markets—the equity market. One impediment concerns the relatively small size of our markets. On a pure market-capitalisation basis, emerging markets account for 6.8% of the total global market capitalisation in 2000[3] and, for less than 5% of a widely-followed world stock index, compared to 95.2% for developed markets.[4]

The problem is further compounded by the low proportion of "free-float" typical of many emerging market stocks. In Asia, this can range anywhere from 30% to around 65% of outstanding shares, still far below that of developed markets, which can record free-floats of even around 90%.[5] The impact of adjusting stock indices for free-float (as well as other related issues, such as foreign-ownership limits, and the availability of sizeable and liquid securities) is not insubstantial. And many index providers are making these adjustments. After taking into account free-float and other related factors, the weight for emerging markets in the world stock index I spoke of earlier falls from just under 5% to 3.7%, with a corresponding rise in the weight of developed markets.

Amid the greater use of indexation in fund management, therefore, these impediments arguably present a "natural" barrier to portfolio investment in emerging markets. International portfolio investors understandably want to

[3] According to the World Federation of Stock Exchanges.
[4] Morgan Stanley Capital International All-Country World (Free) index, as of May 2002.
[5] Calculated from publicly-available estimates of free-float levels of individual stocks.

take or give up large positions, which smaller markets simply cannot accommodate without an adverse impact on price bid-ask spreads. These factors therefore increase execution costs and can detract global portfolio investments in emerging markets.

Aside from costly trade-execution, information asymmetry can also serve as a barrier to portfolio investments. In such circumstances, the signalling effect of investment decisions by large and influential portfolio investors can have a significant impact on the reputation and performance of emerging markets. I would, however, caution major portfolio investors that they ought to make their assessments carefully and in an informed manner. The cost of basing a decision on wrong information is to ignore the very real efforts by emerging markets in trying to enhance the value proposition of their markets. This herd instinct is clearly one that should be avoided, by ensuring that investment decisions are based on an accurate and transparent representation of the investment environment.

These challenges are clearly significant but not insurmountable, so long as emerging markets have the right attitude and are committed to tapping the benefits of international portfolio flows. This is imperative. Global portfolio investments bring tremendous benefits to developing markets, by helping to achieve vibrant capital markets that complement strong banking systems, which in turn ensures a more well-functioning financial system for the economy. Thus, to the extent that information asymmetries exist, it is vital that investors get a direct feel and appreciation of the situation “on the ground”. **The third point which I would like to stress is that emerging**

**markets must therefore actively engage with portfolio investors and manage their value-expectations appropriately.**

That said, we must of course be aware of the risks involved when emerging markets open up to portfolio flows. Being short-term, portfolio flows are by their nature volatile and can cause economic displacement when they are abruptly reversed. But what this means is that emerging markets must learn to manage the risks of portfolio flows, and not avoid them. For by avoiding the risks of portfolio flows altogether, emerging markets also avoid the very real benefits that such flows bring.

<u>Initiatives by Emerging Markets</u>

Emerging market countries have learnt their lessons well. Most are showing great determination and resilience in facing the challenges of regional financial crises etc. and are pursuing sounder financial policies, improving transparency in policy-making and addressing possible imbalances that could trigger further crises, as well as providing a more persuasive economic story. In most cases where there are changes in the political masters, the new governments elected are usually those with strong business orientation or background, and well-equipped to steer their countries out of the financial crises.

**Another important point, and one which I had emphasised at the last APRC Meeting in Bali and which I wish to reiterate here, is that emerging markets must work together and help each other if they wish to attract global portfolio investors, as such investors would prefer to**

**invest in a diversified regional portfolio rather than in a single country.** It is not much of an attraction being the only flowering bush in an otherwise barren garden, for only a beautiful garden with lots of flowers will attract visitors.

Towards this end, Malaysia is doing its small part by initiating an "Emerging Markets Programme" to help elevate the capabilities of emerging market countries, and we are being ably supported resource-wise by the more advanced markets in the region including Hong Kong, Singapore and Australia – Chairman Mr David Knott was kind enough to present a paper at one of our programmes. Other regional initiatives are also being undertaken. Countries have begun developing their own training programmes and even offer practical training such as attachments. There is a particular interest among members of APRC to develop better co-operation in the enforcement of securities regulation and the APRC is also currently studying the alternatives available for investor recourse and safeguards, among other initiatives.

Emerging markets have learnt that they need to help themselves and they are determined not to remain as the poor stepsisters but to make themselves into Cinderellas. In many Asian economies, levels of external debt have been brought down, and persistent current account surpluses have resulted in increasing foreign reserves that contribute to external liquidity. Exchange rate mechanisms are also being managed better. This prudent economic management is beginning to pay off, and many economists are expecting growth to accelerate in 2003.

In many economies previously affected by the crisis, strong efforts at reform and restructuring have led to an overhaul of the corporate and financial sectors. Insolvent institutions have been closed down, weak banks re-capitalised, and public asset-management companies created to deal with non-performing loans. In Malaysia, for instance, Danaharta, the national asset management company, has acquired USD14.1 billion of the banking system's non-performing loans, and is expecting to recover over half of that amount. In Korea at the end of 2001, the level of NPLs in the banking system was down to only 3.5%.

The upshot of all this is that companies are back on their feet and in a position to provide value to investors. But in order to ensure that they actually do so, efforts are also being directed at raising standards of corporate governance and encouraging more explicit shareholder value recognition. In many instances, governments themselves are behind systematic efforts at institutionalising ownership, enhancing the professionalism of management, and providing greater controls, checks and balances.

Further Initiatives

Yesterday, Andrew Sheng of the Hong Kong Securities and Futures Commission made the point that emerging markets are playing in the global field with global players but with domestic rules. Global investors, in accepting this risk, nevertheless want policies and rules to be consistent and clear. Indeed, investors, local and foreign, issuers, market institutions all look for systematic and pragmatic development of the capital market – and a roadmap of the future direction of capital market development would provide clarity of vision to all stakeholders. **My fifth important point to emerging market regulators is exactly that – provide portfolio investors with a masterplan or blue print for the longer term development of your markets and serious mechanisms for implementation.**

Malaysia, for example, developed our Malaysian Capital Market Masterplan, which charts the proposed development of the Malaysian capital market for the next 10 years, and this was released in February 2001. The plan was developed after extensive consultation with all stakeholders, and not only that, but implementation of the plan is also being overseen by a Capital Market Advisory Council, comprising 15 representatives of the various stakeholders.

One of the priority areas being addressed by the Malaysian master plan and the development blueprints of other jurisdictions is liquidity of these new product markets. The extent to which they present viable investment opportunities will depend on how fast they can achieve a critical mass of liquidity in order to enhance and maintain order-flow. In the case of derivative markets, some have already achieved an impressive level of activity in a short space of time.

Also, in Malaysia's case, we have made significant progress in implementing the 70 recommendations of the Finance Committee on Corporate Governance, which is now included in our Capital Market Masterplan. Listed companies must now disclose the extent of their compliance with the Malaysian Code on Corporate Governance every year.

We have introduced higher disclosure standards, including quarterly reporting for PLCs. Efforts are also ongoing to support minority shareholders' rights, to strengthen investor protection, and to enhance auditors' responsibilities. A vital issue is that of instilling market participants with a keen awareness of their own rights and duties. Therefore, greater shareholder activism is being encouraged. To this end, we have set up a body, comprising large institutional investors, known as the Minority Shareholders Watchdog Group to facilitate efforts in this area. Similar efforts at improving corporate governance were reported by Korea, India and Pakistan in their country briefings to the APRC.

**My final point is that emerging markets must develop a niche market and new products.** In addition to a more value-added investment environment, there is also greater scope to enhance portfolio risk-return profiles through a wider range of opportunities in product markets—especially those in fixed-income instruments, niche areas and hedging tools.

Domestic bond markets have become a major focus of development for emerging markets in recent years, and the results of a survey conducted by the Emerging Market Committee's Working Group on secondary-market regulation suggests a huge potential for growth. The last six or seven years alone has seen some Asian corporate bond markets almost double in size. The outstanding value of corporate bonds in Malaysia at the end of 2001 amounts to 45.2% of gross domestic product from 18.4% in 1996, while in Singapore the figure has grown from 20% in 1996 to 30% in 1999.

With regard to niche markets, one that offers significant growth prospects over the next few years is the Islamic capital market. Recent estimates indicate that there are approximately US$1 trillion of funds originating from Islamic countries presently invested in banks throughout the world which could be tapped for capital market investment. Many emerging markets in South East Asia and of course in the Middle East as well as in our host country Turkey, are suitably placed, in this regard, to offer viable and robust alternative investment options for portfolio investors.

The growth of derivative markets within several emerging market jurisdictions arguably means that there is now greater scope going forward for managing investment risk within these markets. In China, a number of products will be introduced this year to revive the futures market, including stock index futures, state-bond futures as well as commodity futures. Malaysia's derivatives exchange, MDEX, recently launched five-year government bond futures, and plans to further increase its range of products to include single-stock futures and Islamic stock index futures. And the Brazil derivatives market, we know, has been a phenomenal success. Whilst Korea's futures exchange, for instance, saw a quadrupling of volume last year, making it one of the world's busiest derivatives exchange in 2001.

The introduction of new products to increase investment and hedging opportunities, as well as the general development of capital markets, is being undertaken in a much more systematic and pragmatic way by many emerging market jurisdictions. And investors are constantly kept in the loop with regard to these developmental efforts.

## Conclusion

In summary, then, emerging markets must not be selfish and must work together in their region or grouping to help one another, to provide a large enough combined market for the portfolio investors to be attracted. They must also engage continuously with portfolio investors and manage the value expectations, and continuously brief them of the initiatives and progress being undertaken. They must try to develop their own niche markets and new products. Finally, they can provide a lot of reassurance to investors if they can provide a masterplan or blueprint for the long-term development of the capital market.

Such initiatives will address the problem of short-term capital flows as well because portfolio investors will continue to invest in an environment where the risks have been managed and the rewards are more tangible. This strategy will allow emerging markets to reap the benefits of portfolio investment flows allowing for stronger economic growth.

Thank you for your kind attention.