

# Repositioning equity investment

The capital market today is flush with many types of innovative investment instruments and securities and over the last couple of decades, the financial wizards of global investment firms have creatively conjured up various new instruments to squeeze out more returns for investment managers and their investors. The level of innovation and creativity, especially in the derivative and debt markets, has spiralled out of control in an environment of deregulation and free-market mentality.

## Derivatives, CDOs and CDS

Innovation has been compounded to the extent that multiple layers of derivative contracts are created over the same underlying asset. For instance, trading in currencies, commodities, gold and even oil is not exactly based on actual supply and demand for the underlying asset. Rather, it is speculative interest, built through financial futures and forward contracts, that fuels the growth of successive contracts to excessive levels. Indeed, before the current financial market downturn, the global derivatives market was notionally valued at an estimated US\$596 trillion, many times bigger than the world economy's value of about US\$55 trillion and the global equity market's value of about US\$36 trillion.

The repackaging of loan assets through collateralised debt obligations (CDOs) has allowed banks to

sell the securities to investors and raise more capital to support further lending activities. Debts or loans of substandard quality are blended with investment-grade debts to put together a CDO with a sufficiently high debt rating.

To hedge the risk of default on the CDOs, a reverse contract is often applied, through the use of credit-default swaps (CDS). This helps to transfer the risk to the CDS issuer but the same instrument is also used by speculators to benefit from the default on the underlying debt which they do not even own. Of the total global CDS market, notionally valued at US\$32 trillion before the current crisis, an estimated 44% was issued to parties which were not holders of the original debt instrument.

Those who participated in creating, issuing and acquiring these innovative instruments would have enjoyed extraordinary rates of return and healthy fee income over the last decade. This explains why global financial institutions, investment firms, hedge funds, private equity funds and private wealth management outfits eagerly invested in these instruments without carefully examining the risk tolerance level that could be absorbed by them or their clients.

Even institutions such as insurance funds, provident and pension funds and charity funds, which had always been perceived as conservative, bought into these instruments



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## Investor Relations Corner

to enhance their investment performance and give them an edge over the others.

But now the music has stopped, the party is over and the party-goers have been left in a state of frustration, anger and ruin. Many of the derivative and debt instruments are in default and their issuers, which include some venerable financial institutions, have collapsed or are surviving on a lifeline thrown by their governments.

Investors are at a crossroads. Those who are privy to sophisticat-

ed instruments and private wealth management are no longer sure what is real in the market, given the reality of the Madoff pyramid scheme. Many investors have lost trust in the investment banks and financial intermediaries that were supposed to be the bastions of financial and investment management.

## Equities at the core of investing

Investors are beginning to shun derivatives, CDOs and CDS and instruments of hedging, leveraging and speculation. With many casualties in the derivative and debt markets, new opportunities have arisen in the equity capital market.

Trillions of dollars have been lost in this global financial crisis. Equally, trillions of investment dollars are sitting on the sidelines, with investors waiting for the opportunity to acquire valuable assets at marked-down prices. There are numerous buying opportunities in today's equity markets, with many good companies trading at depressed valuations that do not reflect their intrinsic values.

In the wake of the financial cataclysm, investors have become extremely cautious and are examining their investment choices more thoroughly. However, they are also beginning to look at equities as their long-term core investment segment, moving forward. Investors are looking again at the equities of real companies that have real businesses, that make products and

services that are the components of a real industry where there are real consumers and demand.

Public listed companies and stock exchanges should be at the forefront of this shift in investor thinking. Public listed companies should take this rare opportunity to readdress investors in a responsible manner. They should convince investors to support their capital development and growth. Stock exchanges need to put in place a new market regime and regain their rightful place in the eyes of the investor.

Today, governments and regulators are looking to restore investor confidence and instil stronger discipline among market participants. Hopefully, we will see a new spirit of corporate disclosure among public listed companies, tempered by a robust set of regulations and fostered by responsible capital market participants.

Of course, investors are still ambivalent and cautious, and for public listed companies and stock exchanges, it is time to rebuild confidence and redirect investors' focus towards equity investment. ■

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