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Analyzing Factors Affecting the Performance of Pakistan Stock Exchange

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Abstract

The paper is aimed to determine the factors that affect the performance of Pakistan Stock Market. The study identifies the determinants which cause volatility in the Stock Market. Pakistan Stock Exchange, being the only platform to provide equity funding for corporations, has got major attention of investors over the decades. After several stock market crises such as March 2008 where investors lost millions and billions of rupees, it is important for both investors and investees to know the major factors that drive Stock Exchange performance. The research is qualitative in nature and specifically content analysis tool is used to analyze data. The interviews are conducted from various people who keep on participating in stock markets i.e. fund managers, research analysts, directors, CEOs, equity traders of various brokerage houses, fund management and asset management companies. After interviews, major themes are covered based on repeated answers such as fundamental factors, macroeconomic factors, political instability, foreign investment and other factors.

The research concludes that the major drivers of the stock market are fundamental factors such as corporate earnings, dividend yield, bonus and company size, macroeconomic factors such as interest rates, inflation and balance of payment, foreign investment which is indicated by Foreign Portfolio Investment (FIPI) and Foreign Direct Investment (FDI) and political instability in the country.

Keywords: Pakistan Stock Exchange, Foreign Portfolio Investment (FPI), Performance

Introduction

Every stock exchange provides the platform for investors to invest the money and corporations to raise the capital in primary market. Moreover, stock exchange further provides the secondary market where investors easily trade their shares. Pakistan Stock Exchange, being the most attractive in regional markets, provides its investors' liquidity i.e. ease of buying and selling of shares without much affecting share price, efficiency (simultaneous flow of information) and transparency in market.

Pakistan's stock market has gone through extensive transformation and has become very attractive and productive place for domestic as well as foreign investors as it trades lowest valuation multiple i.e. trailing and leading Price-to-Earnings ratio of 7.62 and 6.68 respectively among Asian Stock Markets.

The research relates to the factors affecting performance of Pakistan Stock Exchange. It will identify the loopholes that are impediments to the stability and efficiency of stock market. Historically, Pakistan Stock Exchange's performance has been tremendous; however, due to high speculation, it seldom goes down and volume plummets. Stock market, being the backbone of every economy, has got greater attention of investors over the decades. The historical analysis reveals that market has remain very volatile i.e. large ups and downs in stock market and therefore, it is important to identify the factors that drive Pakistan Stock Exchange. The research will help to answer questions about the major problems through which the market has become unstable. The major question to be asked is to analyze that what are the factors that drive Pakistan Stock Market trend?

The objective is to determine and analyze the factors that have an impact on performance of Pakistan Stock Market. The study has taken into account the factors which impel PSE market, the impact of political instability on local and foreign investments in KSE market. The findings of the research cannot be generalized to any other stock houses. The research will be based on the current & historical scenario of KSE market.

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Literature Review

The Pakistan Stock Exchange, as every stock exchange in the world, provides secondary market for trading of shares of listed companies. For many years the managers, researchers, economist and statisticians having finance as area of specialization remained interested in testing and developing stock price behavior models. The performance of shares is directly or indirectly driven by factors such as company fundamental factors, political factors, macroeconomic factors, foreign investment i.e. Foreign Direct Investment (FDI)/Foreign Investor Portfolio Investment (FIPI), rupee parity with other major currencies and degree of integration with other regional stock markets. On top of the list concern for investors remained to understand these factors and invest accordingly.

Fundamental factors

The fundamental variables and their relationship with stock market returns have attracted a significant amount of research attention in Pakistan and other stock markets of the world. Many researchers throughout the world have conducted many studies on fundamental factors. Louis, Yasushi, and Josef (1990) revealed in their findings that there is significant relationship between fundamental factors and stock market expected return in Japanese market. Their paper relates to the cross sectional differences in Japanese stock markets to the underlying behavior of four fundamental variables: book-to-market ratio, cash flow yield, size of company and earning yield. Their findings reveals that 1) after adjusting the other fundamental variables and market risk, small companies i.e. neglected companies tend to outperform larger companies, 2) a stock with high earning yield (E/P) ratios would be more profitable than one with low E/P ratios, 3) a stock with high cash flow yield (CFO/P) would outperform the one with low cash flow yield and it has significant impact on expected returns, and 4) the predictive power of book to market ratio is not specific to only month of January and this ratio is directly related to stock market return.

Wang and Xu (2002) analyzed that not only book-to-market ratio and a firm's size (market capitalization) explain the cross-sectional differences in average stock return in Chinese stock market but also captures most differences in time variations in individual stock returns. They argued that book-to-market ratio approximates the most of the risks in firm's fundamentals and capture other unknown risk factors but one should not find this variable useful when either investor do not pay much attention to fundamentals or the book value of the firm is difficult to evaluate.

Kalay (1982) revealed in research paper that the correlation between the dividend yield and ex-dividend relative price drop is positive which is consistent with tax induced clientele effect and tax effect. Campbell and Shiller (1998) showed in their results that a long moving average of real earnings helps to forecast future real dividends. The ratio of the company earnings to the current stock price is a powerful predictor of the returns on stock.

Mcnichols and Dravid (1990) provided evidence in their research that the many companies when going for stock splits or stock dividend signal their private information about future earnings. Furthermore, they revealed in their research that changes in stock price at stock split and dividend announcement is directly correlated with split factor, holding all else constant.

Patel (1976) revealed in concluded in their research that 1) there was a statistically significant upward price change during the week of earnings forecast disclosure, beyond that explained by movement of the market as a whole, 2) regardless of the sign of the estimated change in market expectations of future earnings, on average, the immediate forecast week was the occasion of upward price revision.

Foreign Portfolio Investment

According to Hasan and Nasir (2008), foreign investment inflow in stock market produces liquidity and this leads to higher market prices of shares. Researchers used the stock market data from 1998 to 2008 and found that foreign portfolio investment is positively correlated to equity market returns. It was further highlighted that in stock market, foreign portfolio investment has been considered as proxy of shareholder confidence. In another study related to Foreign Direct Investment and Stock market Development, Adam and Tweneboah (2009) argues that investor participation increases with foreign capital inflows and this FPI indicator has long term impact on stock market development. Researchers further noted that foreign investment is linked with capital market reforms and transparent dealing in stocks and these factors increase confidence of investors in domestic markets.

Security exchange commission of Pakistan (2008) reported that foreign investors have a tendency to drive stock market and on the news of foreign investors entering and taking their money out of Pakistan capital market affect the performance of Karachi stock exchange.

Parthapratim (2006) study shows that foreign Portfolio investment's important advantage is that it supports the domestic stock prices, increasing demand push the stock prices. He further reveals that FPI has positive impact on the Price-earnings ratios of the company due to its higher domestic prices. The Indian stock market has been positively influenced by the incursion of high volume of foreign portfolio investment over the years. Je Cho Y in Asian Development Bank's published book on Indian Capital Markets illustrated that foreign investment in stock market have resulted positively on equity price movements in India, data shows the positive relationship between BSE Sensex and investment by foreign investors.

According to Financial Stability Review (2008), foreign equity investment stabilizes local stock markets and decrease capital cost by diminishing the country's risk premium. On the whole foreign portfolio investment provides confidence to domestic investors to put money in stocks and further strengthen the performance of equity market. It is further highlighted in the report that foreign portfolio also creates volatility in market and it has huge impact in short term. Positive feedback trading and foreign investor's herd instincts have potential to shift stock prices away from fundamentals.

Macro-Economic Factors

Ho & Lyke (2017) analyzed relationship between macro-economic factors and stock market performance and found positive relationship.Ali et al, (2009) analyzed the macroeconomic indicators and its impact on the prices of Stock Market and conclude that there is no relationship between the equity market and economy of Pakistan. The study suggests that one cannot determine the performance of stock market based on macro-economic factors of the country.

Zafar et al, (2008) suggests in his research states that there is strong correlation of interest rates with stock market volatility and the increase in interest rates tend to shift investors from stock market to other saving instruments. There is possibility to predict the performance of stock market based on the trend of interest rates.

Mueller (2009) in his article comments that the main idea behind increase in the interest rates to decrease the circulation of money and thus reduce the inflation which tends to increase the borrowing cost of companies and tends to decreases in the prices of their stocks. He further elaborates that there is no only interest rates which determine the trend of stock market.

Mohammad, Husain and Ali (2009) in their quantitative study found that investors cannot take decision based on the change in macro-economic factors. There are few variables like exchange reserve which may reflect the change in stock prices.

Ahmad, Rehman and Raoof (2010) in their research proved that there is always impact of macroeconomic variables on stock market. The interest rates have direct impact on the business cost which ultimately lowers the profitability of the firms. They applied multiple regression models to examine the effect.

Akbar (2010) in his article has analyzed the impact of discount rate from 2007 onwards and found that stock market went down due to increase in interest rates. He further concludes that the interest rate does have effect on the KSE Market along with other fundamental factors.

Political Events & External Affairs

Many researchers have identified that political uncertainty is closely linked with high volatility of Stock market. Researcher such as Chan and Wei (1996) consider political risk with respect to stock market volatility. Furthermore, Clark and Tunaru (2005) define political events with significant negative economic and financial consequences.

Campbell and Hentschell (1992) worked on stock market volatility and their finds suggest that required return on stock and level of stock prices are highly affected by volatility of any magnitude. Another study in which Suleman (2011) state that good news shows positive impact on the returns of the KSE100 index which decreases the volatility and bad political news has negative impact on the returns (decrease the returns) and increase the volatility (positive effect). Ahmed,H, Shah,SZA & Shah, IA (2010) research claimed that appalling law and order situation in 2008 may also be considered responsible for crash of Karachi stock exchange in 2008.Furthermore, Nishat &

Mustafa (2002) identified that political events affected the KSE market due to which the trading volume and the stock return are fluctuated

Different researcher's study suggests that external affairs and world events are also related with the Stock Markets. Ashfaq (2005) stated that news that is directly related to USA and Pakistan changes the behavior of the Stock Market. Furthermore, Khan & Ahmed (2009) study identified that change in index level is directly proportional to the good relation with countries and indirectly proportional to the conflicting relations with countries. Cutler, Poterba, and summers (1989) identified US market has significant effects due to political news. Niederhoffer (1971) relates movement in S&P 500 immediately after world events i.e. reaction of stock prices to occurring of world events. Zach (2003) studies the reaction of the Israel stock market due to political events. Zach (2003) study shows that political events results in high volatility in return on stock in Israeli stock market compared to return on the underlying index in other days.

Research Methodology

Research Design

The study is exploratory and subjective in nature, in which problems, issues and variables been identified in previous studies and the research objectives derived from the literature review. Interviews have been conducted from industry experts and in this study the researchers enquires respondent's views on the factors that drive Pakistan Stock Exchange. Researchers have used qualitative research tool of content analysis to summarize the interview comments into meaningful categories.

The population consists of

- All brokerage houses
- All Asset Management Companies (AMCs)
- Pakistan Stock Exchange
- Capital Market investors

The Judgmental sampling is used for conducting interviews for the research. Judgmental sampling enables a researcher to use his/her judgment to select the respondents that best enable him/her to answer the specific research questions and meet the research objective. The sample of eleven respondents related to industry experts who could be accessed is taken. The capital market experts include the representatives of all four categories given above in population, i.e. brokerage firms, asset management companies, Pakistan Stock Exchange and capital market investors.

Primary data is collected by conducting semi structured in-depth interviews of the respondents. The interviews follow the same questions with little variability. The interviews were recorded in the form of audios, whereas some of the respondents were not comfortable with the video or audio recording so they gave their views in writing.

Data Analysis and Findings

Through the interviews, following factors have been identified that drive Pakistan Stock Exchange.
Company Fundamental Factors

- Macroeconomic Factors
- Political Instability
- Foreign Investment
- Others

Fundamental Factors

According to the respondents, major factors that highly affect the performance of Pakistan Stock Exchange are company specific fundamental factors and foreign investment followed by moderate effect of macroeconomic and political instability. Moreover, company expected earnings growth, expected dividend yield and bonus issue are the major factors that actually drive the stock market performance. According to them, company size and capital structure have moderate impact followed by company market share having lower impact on company performance. Since, the impact of company size, capital structure and market share is already incorporated into stock price so it does not impact stock price at point in time. The impact of earning and dividend announcement can be seen by analyzing past trends of stock performance such as companies having June as financial year end tend to outperform perform during April to Aug. other fundamental factors such as company size, market share and capital structure have moderate impact on scrip performance since their impact is already incorporated in scrip price.

The investors tend to invest in companies which are blue chip with high liquidity, transparency, stability and are the market leader in industry. So, directly or indirectly investors tend to value these factors while investing in particular scrip.

Stock market is the major player of the overall economy and is greatly affected by company performance. Moreover, whether company post handsome earnings or earnings growth but the performance of stock depends upon what the research analyst or market expects. If the company post earnings or declare dividends below expectation of research analyst then stock shall underperform rather outperform. Higher trading in any stock depends on its expected and actual earnings announcement and dividend yield of the company. If companies regularly pay high dividends then investors participation will increase and, hence, trust and confidence in the market will increase.

Foreign Portfolio investment

The data collected shows that 10 respondents out of 11 reported that foreign portfolio investment highly affect the Pakistan stock exchange. However one of the respondents asserted that foreign portfolio investment doesn't have any role in driving the stock market.

Foreign investments in Pakistan Stock market are very crucial, as it revives the confidence of local investors and secondly it increases foreign reserves which are positive indicator for economy. Moreover, the investment of foreign investors is in huge number so it creates an attractive sign for other local investors.

The sharp movement in portfolio investment is also one of the vital reasons for volatility in stock market because with Foreign portfolio investment liquidity in stock market increases and index gains point and similarly with disinvestment index comes down.

Political Stability

According to respondents, political stability is important for upward movement of Pakistan stock market. All respondents agree on the political stability as factor affecting performance of stock market. Out of 11, 6 asserted that it highly affects performance and rest of the respondents was of moderate view towards political stability factor. According to the respondents, political uncertainty has been driving the market down and they accused present coalition government for not focusing on the economy. Other respondent asserted that stock market has been in turmoil due to the political uncertainty and law & order situation in the country. If political uncertainty abates, Power crisis and gas load shedding ends and government is able to have working relations with International monetary fund then it will not only revive the confidence of local and foreign investors but it will contribute in ameliorating company earnings.

Macro Economic Factors

In the view of respondents, there is high impact of macroeconomic factors on the performance of stock market. The mainly important economic factors are interest rates, inflation, taxes, balance of payments and foreign exchange rates. Ten respondents believe that interest rates and inflation has high impact whereas only one was in favor of moderate effect. As far as taxes are concerned, six respondents suggested the moderate effect, four high and the remaining one suggested low effect. The factor BOP has moderate impact said by five respondents, low impact by four respondents and high impact said by the rest two respondents. The five respondents think that foreign exchange has moderate effect and the four thinks low impact and the remaining two thinks high impact.

The interest rate is inversely proportion to Stock market performance that is decrease in interest rates leads to increase in performance of index or vice versa. Stable economy invites more investments in risky venture therefore the macroeconomic factors weights high on performance that can be classified as Top-Down approach. The participation in Money market and Stock market is determined by level of interest rates set in the market. Higher interest rates favor money market instruments and lower rates increase participation in stock market. Interest rates levels have an impact on company earnings. Company with high leverage get benefit with lower interest rates and goes for expansion programs and similarly high interest cost reduce their profitability.

Other Factors

The understanding of the psyche or behavior of stock market money is as important as the management of this strange market.

Majority of the respondents stated that the market should not be allowed to soar as high as to threaten the economy with an impending crash, therefore they believed that the growth should be sustainable, broad, based and supported with capital formation. Moreover, six of the respondents were of the idea that stock market prime purpose is to fund industrial investments but nowadays it has degenerated into arenas of volatile speculation, engaged in the parasitic extraction of wealth from the productive economy, where the profit drives not from a maturing productive investment, but from wild fluctuations in asset values. Two of the respondents mentioned that speculative money has bit the stock market twice which resulted leaving the market crash. Furthermore, they were of the view that the speculative money destabilizes the economy first by making exit from the stock market and then by entering another sector of the economy with the objective of destabilize it too in due course of time.

In contrast, one of the respondents claimed that majority of the investments in the stock market has speculative bearings and speculation is solely employed for quick profiting. We call them "Punters", they are the ones who spread the rumors and news based on speculation in the stock market.

One of the respondents elaborated on the phenomena of these investments. According to him, domestic or foreign such money is ultra-smart and recognizes coming changes from a distance. The managers managing such funds make a swift exit from the market. The foreign fund managers enter a different region with better economic environment while the local fund managers enter another sector of domestic economy with a potential to accommodate speculative investments. Sectors like real estate, currency, metals, food etc. welcomes speculative money with open arms. The targeted sector suddenly finds lush with speculative money and start experiencing a managed boom situation. Once the sector is heated to the potential, speculative investments by the big players find exit to another sector. The sufferers are the common man or small investors and the economy.

Discussion and Conclusion

The research on the basis of primary and secondary data concludes Pakistan stock exchange as the prominent stock market in Asia, providing investment opportunities to local and foreign investors and providing platform for companies to raise capital. However there are many factors which drive market and are highlighted by respondents. Major factors are Corporate Earnings, Macroeconomic Factors, Foreign Investment, Political uncertainty and other factors. Moreover, the stock market is driven by expectation of these above factors rather current or past performance such as expected corporate earnings, expected change in yield curve, expected foreign investment etc. So, before investing, both institutional and retail investors must know all these factors and then invest accordingly according to his/her risk appetite.

The study has highlighted the performance of Stock Market towards the economic development of Pakistan. It has also depicted an in-depth understanding, the rationale behind volatility of the Stock Exchange coupled with fundamental factors. Besides this, the research will help the investors (retail and institutions), brokers and fund managers to understand the dynamics of the Pakistan Stock market. It will also broaden our knowledge base about stock market and better understanding of dynamics and fundamentals for PSE.

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