Revival of the Pakistani Stock Market

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Since the stock market crash of 2008, investors seem to have lost interest in the Pakistani stock market. Average daily trading volumes have dropped sharply from around 212 million shares in FY 2007 to around 162 million shares in FY 2010. The Capital Gains Tax (CGT) on the stock market has further dampened the investors' sentiments. A key question is how and when the investors' confidence will be restored in the market.

The Pakistani stock market has been in existence for over six decades. Yet if we gauge the number of investors in the market by the number of Unique Identification Numbers' (UIN) in CDC, there are around 270,000 UINs of which more than half are inactive. If we compare this with around 30 million bank deposit holders in Pakistan, the Pakistani stock market has not been successful to attract a substantial investor base. One of the reasons is that the risk (standard deviation) of the Pakistani stock market at 25% is much higher relative to other stock markets in the region. Thus investors have found stock market investment very risky and have shied away from it. This has partially to do with the high economic, political and security risk factors in the country. However, excessive leveraging and the mind set of investors to take short-term speculative positions rather than long-term investment positions are other factors that have made our market more risky than others. Also, stock investing has been limited to a few large investors and has not spread among millions of small investors, as is the case in other emerging markets. This is the reason why our stock market has lacked the necessary depth and breadth, which is imperative for an efficient market.

Just about every stock market of the world has an option for investors to take leveraged positions in the market. These options provide the market the necessary liquidity, which is important for price discovery and unfettered entry/exit for investors. Margin financing and derivative products (options and futures) are the more common options used by the investors globally. In Pakistan, COT or *'badla'* were more commonly used leveraged products, which evolved to CFS and later CFS MK-II. As this product evolved over time, its risk parameters have improved. CFS MK-II had the added advantages that it was market-driven, and had good price-discovery, documentation, standardization and transparency features. The stock market crash of 2008 put this product to test with both the Financees and Financiers ending up in court. However, almost all of CFS Financiers got their entire amount back without experiencing any material losses. Following this episode, CFS MK-II was discontinued pre-maturely without having any alternative financing product in place.

Since then, there have been significant discussions as to which leverage product suits our market the best. In my view, all leveraged products, which include margin financing, margin trading (an improved version of CFS MK-II), options and futures should be available to investors, so that they can choose the one that suits their needs. An option being considered by the KSE and SECP is a margin trading product in which the investor (borrower) will put 25% equity in the form of cash while the remaining 75% will be provided by the Financier (lender). In addition, both the mark-to-market losses and concentration margins will be collected in the form of cash. Thus, this product will provide better protection relative to CFS MK-II.

The Pakistani stock market declined by approx. 58% in CY2008. It rose by 60% in CY 2009 and has risen further by 12.1% in CY 2010 to-date. With the recovery already underway, it is just a matter of time before investors will start returning to the market. However, based on the high volatility of the Pakistani stock market we suggest investors to invest in equities via asset allocation or balanced funds.