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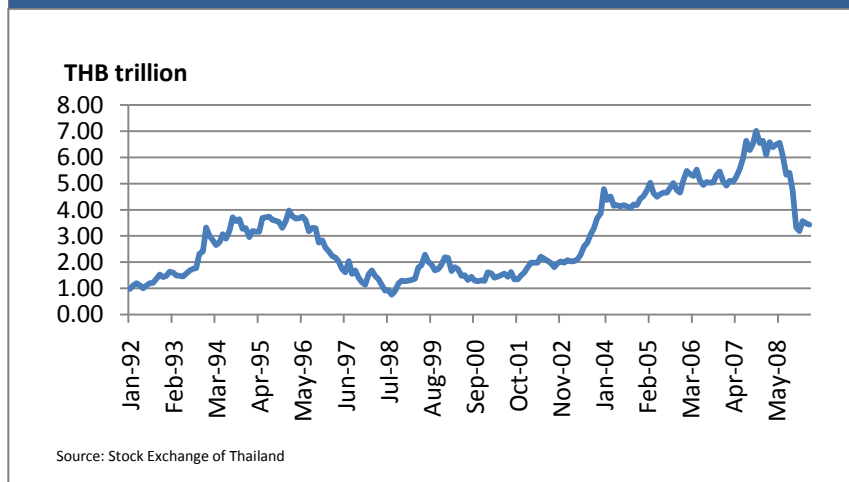
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Thailand's Big Bang

Building demolition experts know this well: it only takes a few sticks of dynamites in the right places to bring down a tall building. It's all about structure. It's not even that loud. Poof! And the building crumbles into tiny rocks and dusts.

Improving the capital market breadth, depth, and even volatility requires those same metaphorical sticks of dynamite placed strategically. It's all about structure. By the end of this article, I hope to have convinced you that a negotiated trading commission is precisely those few sticks of dynamites that will improve market breadth, depth and volatility.

Chart 1: Thailand Market Capitalization (1992-Now)

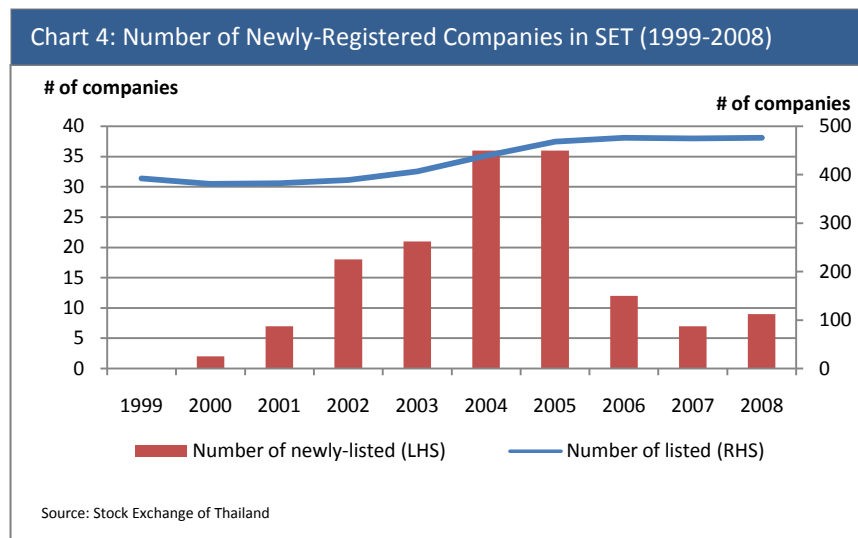


There's a saying "if it ain't broke, don't fix it". Doctors are well advised to diagnose whether there's any symptoms of malaise in the first place before any prescription. The expansion of the capital markets in Thailand has been slow. Sixteen years ago, the size of the Thai stock market was a trillion Baht and now it's about Bt3.2 trillion which works out to be a compound growth rate of only about 7.5% per annum – hardly a stellar growth for an emerging market. Secondly, Thailand is but a blip on the radar screen (see tiny green dot in Chart - 2). Thirdly, its market-cap-to-GDP% at 65% has a long way to catch up with other developed markets. These, are the symptoms. The good news is: there's plenty of

room for growth. The Stock Exchange of Thailand is moving towards a Demutualization. The SET is visionary in her re-organization in preparations for the Demutualization. The government recognizes that such liberalization is necessary and positive for the market.



The total market capitalization is calculated by the sum of the number of shares of all listed companies multiplied by their respective share prices. Thus, the number of new issues is one key dimension of the expansion of the market's aggregate market capitalization (the other dimension is rising stock prices). New-issues is the market's breadth. New issues are attracted to the market's liquidity and its ability to absorb new issues in the first instance. The dynamics of the primary market is very dependent on the secondary market and its activities (liquidity).



Today, the members of the press are eager to hold on to every quote from Warren Buffett. A hundred years ago, they hounded the financier John Pierpont Morgan for a prediction of what the stock market will do tomorrow which he quipped in reply: "it will fluctuate". For investors, volatility is uncertainty and uncertainty is simply risk. Unless you are a derivatives<sup>1</sup> trader and using combinations of puts and calls strategy, you would generally not like volatility. Worse yet, you would not like "irrational volatility". I have a volatile cantankerous aunt who would blow up every time if she didn't see nephews with clean hands at the dining table. But I know why she gets angry. It's rational. You can predict that she would get very angry if you had dirty hands in waiting for dinner. Market fundamentals can explain away a lot of the volatility because it is rational.

Irrational volatility, I contend, are brought about by information asymmetry. I'm tempted to say "knowledge asymmetry". Right now I am caught between a rock and a hard place. On the one hand, I can get accused of being pedagogical for using words like "information asymmetry". And on the other hand if I define what I mean by that, I can get accused of being an elitist for being biased towards certain group of investors. But in reality information and knowledge asymmetry means that people who trade without information and knowledge are speculating for the sake of speculating. At the expense of becoming personally unpopular to this particular group of investors, I'd stick my neck out and say that speculating for the sake of speculating happens a lot more in retail investors than they do in institutional investors. Call this my hedging strategy then!

### **A Date With Big Bang.**

In the effort to liberalize the securities industry, the Thai authorities have set from top of 2012 to move from the current fixed trading commission (25 basis points) to a negotiated spread. Prior to that starting from top of 2010, trading commissions would be lower than current using the scheme of graduated spread where a certain spread is charged for the first step and lower spreads are charged on steps beyond the first step.

### **Sticks of Dynamite**

Because deregulation of the commission structure is likely to cause a sweeping change, let's take a look at a few case precedents of Big Bangs, namely, in the U.S. and the U.K.

### **The US Big Bang 1975**

On January 23, 1975 in the United States, the SEC adopted a rule which banned securities exchanges from fixing brokerage commission rates. As a result of this ruling, an industry which had practiced fixing transaction price since 1792 was forced to move to negotiated pricing in May 1975.

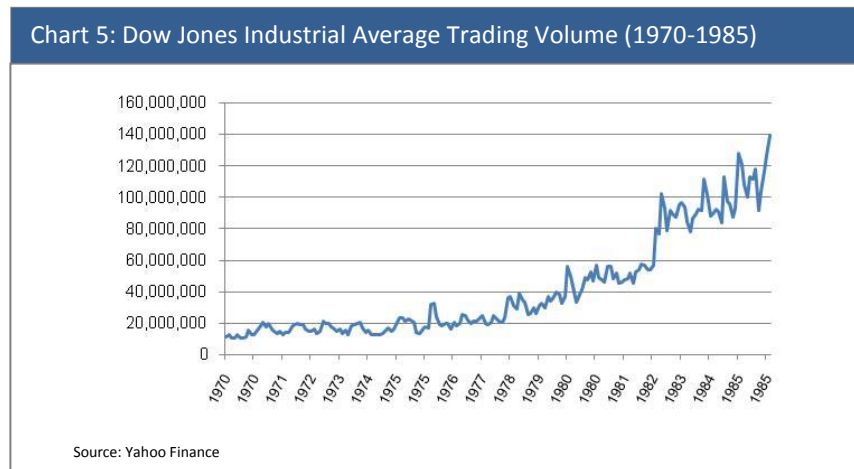
The deregulation started in 1968 when the volume discounts were incorporated into the commission scale for orders larger than 1,000 shares. Then, the modifications of sliding scale towards negotiated commissions were put in place

prior to a fully negotiated commission which kicked on May 1, 1975.

Liberalization in brokerage commissions produced an immediate, dramatic reduction of about 25% in mean commission rates, which had risen steadily during the previous 40 years. Even the institutional rates, which already had been lowered significantly before the deregulation, fell an additional 50% by 1980. However, the individual traders of fewer than 1,000 shares appeared to have higher commission rates. Rates on these smaller trades increased an average of about 17% from 1975 to 1980. But all in all, the average commission came down to tenth of what it was (c.1%) in the ensuing ten years.

While commission rates dropped (not good for member firms), trading volume rose 10 folds from 1975 to 1985. Chart 5 illustrates that for the DJIA alone (30 stocks) the trading volume went up 7 folds in the same ten years. Rising trading volume is generally good economics for member firms. Fast forward to March 2009, the trading volume even in this depressed market is 8.3 billion shares (it was 120 million shares a day in 1985).

The share of assets accounted for by the largest twenty-five NYSE member firms rose from 56% in 1971 to 77% by 1980. This increase in share showed the rise in industry consolidation. The large brokerage firms grew partially through mergers. According to the research, 376 NYSE member firms disappeared between 1972 and 1980. Mergers accounted for 215 of these disappearances, while dissolutions accounted for the other 161.



### The UK Big Bang 1986

On October 27, 1986, the London Stock Exchange under the directives of Prime Minister Margaret Thatcher underwent the same deregulation that included the elimination of fixed commissions and the removal of barriers to foreign entry into the exchange.

A minimum scale for commissions was eliminated and rates were opened to negotiations. This was especially significant for large bargains, and actually half of

equities turnover after Big Bang was done net, with no commissions at all. According to a survey of firms, 1986 commission rates for small bargains increased slightly; for instance, the average commission on a £5,000 trade rose from 1.26% to 1.60%. However, institutional rates fell dramatically.

The average daily turnover in London was £643 million for the first 9 months of 1986. In the first three months after Big Bang, the average daily turnover nearly doubled to £1,161 million. Larger transactions have become more common and were subject to minimal price movements at transactions. Trades exceeding £1 million rose to 25.2% of total turnover three months after the Big Bang, up from the 12.2% in the three months prior to the Big Bang. The market had already begun to institutionalize.

### **Conclusion**

Deregulation is about enabling the market to set its own price of trades via negotiations. As prices are driven down, there's a necessity for brokers to wring out costs and become more efficient. Witness the consolidations of brokers in both the US and UK markets after their respective Big Bangs in their pursuits of scale and economies of scale. In seeking out more revenues, market participants are apt to become more innovative in both new products and distribution. In new products, we have seen the development of securitization, derivatives, and other garden-variety kinds of new financial products. And in the hybrid, we have seen the quest to expand globally as well as the use of electronics trading and the Internet.

As transaction costs come down, markets attract more trades and raise the market's liquidity. This is the improvement in market depth. As markets have more depth, it attracts more primary listings and in the process expands breadth. These are two key dimensions of the expansion of the capital markets.

One additional emphatic trend is that deregulated markets have more institutional trades. And because institutional investors are driven much more so by the analysis of the market fundamentals, such trades are relatively more rational (and I don't mean profit-seeking rational versus loss-seeking irrational). Markets tend to institutionalize because institutional investors like a mutual fund has some clear advantage over a retail investor in the following three areas:

1. An institutional investor has more bargaining power than a retail investor when it comes to negotiating commissions. A Fidelity can transact paying only a single-digit basis points to the broker. The same broker will, however, tell the retail investor what he has to pay and that commission could be 10-30 times higher than what an institutional investor pays. This is purely a bulk discount issue because an institutional investor trades on much larger volume than a retail investor. In the last decade, the Internet trading has leveled off this advantage for the institutional investors and against retail investors a bit.
2. An institutional investor has more access to research than a retail investor. These bodies of knowledge come from the brokers' research

analysts, sales network, and traders that spend more time to serve institutional investors. This is the knowledge asymmetry I talked about earlier. Some people would go so far as to say that mutual funds have better funds management skills than retail investors. But yet the performance of many mutual funds is below the market performance. So this means that in some cases, having a monkey throw 15 darts at the stock pages of a daily newspaper to pick stocks can do just as well as hiring a fund manager to do the same thing (and I sure hope they too don't use the same method of throwing darts).

3. If a retail investor has US\$1000 marked for investments, it would be very difficult or impossible to practice diversification because there's not enough money to spread around over the 15 or so stocks. But a retail investor can achieve diversification if s/he buys the unit trusts of a mutual fund who handle the diversification for her as well as achieve lower effective trading commissions working on superior body of knowledge about the market.

Because of the above reasons, there is a propensity for markets to institutionalize after deregulations. If you can't beat them, join them. This institutionalization also helps to eliminate some of the "irrational volatility".

<sup>1</sup> Derivatives derive their value from underlying assets, say, stocks. So, derivative traders are just as reliant on a liquid market for both the stocks and their derivatives.