THADDEUS INVESTMENT ADVISORS AND RESEARCH LTD.

(Growing wealth through integrity)

THE NIGERIAN FINANCIAL MARKET: THE WAY FORWARD

The Nigerian stock market is a frontier market that has had impressive returns over the past two years. The 2007 market performance of 74.7% is almost double that of 2006. This led to the stock market becoming an all-comers affair as people imbibed the concept of letting their money work for them. (The 2008 return of -47% has made most investors embark on a reality check.) This is not a bad idea if investors are well-informed and/or well-advised. Majority of investors fell into neither category.

The stock market craze in the 2006 and 2007 has brought a lot of "sheep" (A sheep is an investor who lacks a focused trading strategy and trades on emotion and the suggestions of others, including family, friends and financial advisors. This type of investor often makes rash investments without reviewing the company's financial viability. The sheep are usually the last to get in on a major market move) into the stock market who are now losing their principal investments. This happened because the regulators and the capital market operators decided to adopt the philosophy of "if it is not broken do not fix it." To make matters worse, our financial market was broken and needed fixing, but the amazing rise in stock prices across the board kept our regulators in a trance-like state unable, to realize the cookie was crumbling and fast. 2008 put a stop to their fantasy and that of innocent investors who got caught up in the delayed aftermath.

We are not here to join the bunch of postulators as to why the market is in a steady and determined downturn. While we admit that we need to know where we are coming from to know where we are going, we shall focus most of this article on the way forward which will definitely touch on some of the ignominies of the past which have helped to bring us to this point.

Kindly note that we are not writing this article now because the market is down 37% year-to-date but because we believe the investing public (regulators, institutional, retail and freelance) are more willing to listen to what we have to say given the market meltdown. Financial markets will always have their peaks and troughs. What makes a market meltdown turn to headline news is when it could have been avoided. This is the case in the developed markets and in a frontier market like Nigeria but for vastly different reasons.

In their quest for unblemished capitalism and monetary greed, financial institutions in the developed markets threw caution to the wind and removed the checks and balances which are necessary as a curb to unbridled passion. In the Nigerian financial market, we have a market downturn due to a combination of doing nothing, doing the wrong thing and in some case doing something instead of doing nothing. We like to term this a "**comedy of errors**.**"** It is time for us to state the way forward for the Nigerian financial market. The way forward that will serve the interest of all and not be superseded by the selfish interest of a few. **In our effort to be concise, we will recommend and not discuss implementation. Here we go.**

- Our economy has to improve; healthcare, unemployment, inflation, security, education, transportation and lack of social amenities need to be tackled urgently among others. If the standard of living of the average Nigerian does not improve, our stock market cannot move forward with any conviction. Let us not been hoodwinked by a 6-7% rise in GDP. We are happy to note that there is now a correlation between how our economy is faring and the stock market. The stock market appeared to be immune to the pulse of the general populace in recent years. This is gradually changing and is in line with developed markets.

- We need **market makers** that **do not** have profit as their number one motive for becoming market makers. Providing liquidity to the stock market should be their number one motive. We also want market makers that are not affiliated to, associated or owned by commercial banks. The banks are part of the problem and should not overnight become part of the solution. **The market makers should not be allowed to determine the stocks that they will be allowed to make a market in and must execute transactions on a first-in-first-out basis once the minimum quote size is met.** Feelers are that our greatest fears will be allowed to happen.

- Every listed company's free float should be at least 40% or higher to enhance liquidity or risk delisting from the stock exchange.

- We need **audited quarterly results that are fully explained to the granular level** as a compulsory measure. We are tired of the vague hyperboles that tell us less and confuse us more. The banks are guiltier of this. Companies can mislead Nigerian investors for three quarters as it is and then set the record straight at the end of their fiscal year once their books are audited. This has to stop if we want the elusive "confidence" to return to our stock market.

- Listed companies are now offering financial guidance by releasing their **annual** forecasts to the media. These annual forecasts should also include pertinent reasons that explain the logic behind the forecasts. We need **quarterly** earnings estimates also.

- The bear market has led to listed companies releasing their quarterly results in record time as they try to garner investor interest in their stocks. This is welcome, but, why did a market downturn have to occur before the right thing happened? This is a good start but still leaves investors and equity analysts far from being satisfied. The Nigerian Stock Exchange needs to create an **earnings schedule** for all listed firms that will be disseminated to the public and strictly adhered to. Therefore, we can all know in advance when to expect a company's result. There should be no more situations of a listed company's result just creeping on us out of the blue.

- Nigeria needs to develop a strong **repurchase agreement (REPO)** market. This market enables those who have securities and do not need them for a period of time, to lend them out, receive cash and buy them back later at a higher price. This will enable companies holding onto long-term investments to make a spread on them and allow those in dire need of short-term cash to have access to it.

- There is too much pressure on our market. We only make money when prices go up. This leads to all kinds of nefarious activities by listed firms, capital market operators, investors etc to ensure prices rise as this is the only way to make money in our market. It is time for change. We need to allow investors to be able to benefit from downturns in our market or profit from companies whose stock prices are expected to fall by allowing them to sell a particular stock first (by borrowing from someone who has it) and buying it back at a later date and hopefully at a cheaper price. This is popularly known in the investing world as "short selling." This will tie in well with the repo market explained above.

- Investors need more than equities and government bonds to invest their money in. We need instruments that derive their value from equities and are not equities; they are called derivatives. Our pick for the Nigerian market is **Options**. Options give an investor the right to buy a particular stock and not an obligation at a specified price up to some point in the future. What we have now are obligations; once a stock is bought, you are actually a shareholder in that company. With options, you are not a shareholder unless you exercise your right. We believe so many investors will cherish the thought of knowing their losses upfront instead of the current scenario where you do not know how much money you have lost until the stock is sold (if you succeed in selling.) This new investment outlet will energize our market and usher in a new dawn.

- We have indecisive regulators who at times appear to go back and forth between different alternatives while ending up doing nothing or prolonging issues. If the bodies in charge of overseeing a frontier financial market do not take quick and decisive action, disillusionment, confusion and panic sets in. This is the fastest way to erode confidence. There are too many chefs and they are all bringing different recipes that are meant to serve different people with different agendas. The only recipe the investing public will get out of this is a market in a freefall as we have now.

Frontier markets already have a negative risk perception; indecisiveness makes this perception a reality.

- The regulators should allow our market to operate as a random walk with no fiat interventions to force an agenda even if it is aimed at benefiting the investing public. E.g. the one percent downward cap on daily price movement should never have been applied in the first place. Interventions of this nature exacerbate the lack of confidence in our market.

- The 5% price bands (now +5%,-1%) should be removed **entirely.** The market needs to roam free. The price bands make our market appear too artificial and make entry and exit from our market very difficult. We need a free market.

- The three-hour trading period is too small in our opinion (even the Kenyan market of 46 stocks is open for a longer period.) The market should be open for at least four consecutive hours. This allows the market more time find its centre of gravity and free itself from market noise and distortions.

- Listed companies need to provide more disclosure in their annual reports. We believe the voluntary approach will not work and hence we want disclosure and transparency to be enforced by compelling all listed companies to adopt IFRS standards (like GT Bank) as from the 2009 fiscal year.

- Investors need the MD/CEO to take more responsibility for figures emanating from their respective firms' annual reports. Sarbanes Oxley needs to be implemented in Nigeria to instil confidence that the books are not being cooked by upper management in their quest to ensure that earnings and profits continue to rise astronomically unabated. Listed companies' books need to be more closely looked at to avoid an Enron debacle happening in Nigeria. The present scenario whereby MDs cannot be held personally liable for what they should be fully aware of does not instil confidence and leaves room for passing of the buck and accounting shenanigans to thrive. Cadbury and Nampak should be enough of a warning for those that are listening.

- We need more disclosure by regulators and journalists when a firm is having a crisis of any sort. As it is now, good news is overhyped and bad news is downplayed or denied outright. Cover-ups will never move our market forward. We do not want 'apparently' healthy banks; we need **'factually' healthy** banks. We would rather have 10 strong, viable banks free from financial shenanigans instead of 24 banks where the more you look, the less you see for the most part.

- The auditors have a part to play in this. The main auditors in Nigeria are multinationals and they should not allow the Nigerian environment to make them lower their world-class auditing standards. We no longer want to see comments like "nothing was brought to our attention." We need proactive auditors and not reactive auditors. We hope they have not acquired the Nigerian disease.

- The NSE should obey its own rules such as the two-week rule which says that a stock's price will be released from technical suspension exactly two weeks after the public offer is concluded. This has rarely been obeyed and does have a significant impact on the returns of investors and the time it takes them to reach their exit point. In addition, the new rule on a company listing its shares by introduction after a private placement at the same price of the private placement is also not being adhered to. The NSE should strive to avoid being a regulator that cannot be trusted and has plenty of bark with a weak belated bite.

- Public offer/private placement prices should not be unilaterally set by the company and the investment bank managing the deal. A price range should be established after book building. The final pricing (within the band or on occasion outside the band) should be based on demand and supply. There are too many companies that have come to the market with rich valuations set by self-serving interest instead of the forces of demand and supply. We can all think of a few so we will not name any.
- People should no longer have to write checks for public offers. Their accounts with their brokerage firms should be funded to cover the number of shares they seek. They will only be debited for the amount of stock allotted (if any). Public offers should therefore be a one day affair like the GDRs that GT Bank and Diamond Bank did.

- Firms that are lead underwriters or part of the selling group to public offers and/or private placements **should not** be allowed to provide recommendations and equity research reports to the public due to the strong likelihood of bias and misleading recommendations. This is what is going on now, which has led to the constant display of buy recommendations for every offer regardless of the state of affairs of the company. These firms want to generate sales commissions and fees from trade and offer deals and have no problems misleading the investor to achieve their selfish aims.

- The NSE should humbly accept its role as a subset of the financial system that takes orders from the SEC. The subtle power play is making our market appear lawless with infantile ambitions.

- Margin trading should be based on 100% of equity contribution (maximum) and not the current 200% which is too much leverage in our opinion. In other words, if you have N100, the most you can get from your broker/bank to buy a **marginable** stock is N100. A science should also be developed that determines how much margin (up to the 100% maximum) can be given for a particular stock based on its risk level and not a case of one size fits all that is currently prevalent. Any stock that is trading below N20 per share should automatically **not be** marginable.

- The banks should reduce their exposure to the capital market directly and indirectly. We need to move beyond the current scenario of when the banks blink our market coughs and vice versa. Our bourse should not be the banks and the banks should not be our bourse. Their undue influence (directly and indirectly) needs to be seriously and immediately addressed.

- The stock market closes at 12:30pm every business day. Why must we wait in excess of two hours to know the index for that day and the percentage market movement relative to the day before? This information should be immediately available as soon as the market closes or a maximum of thirty minutes after market close. Timeliness of key market information is sacrosanct. How the index is calculated should also be made public so we can ensure that the published index figures are what they should be. We have noticed some strange index values in recent times despite the nature of the market on the given day.

- The board of directors and other major shareholders of a listed company must be required henceforth, to seek permission from the SEC before selling or buying the company's stock **and** this information should be disseminated to the public.

- Interested members of the investing public should have access to stockbroker screens that show intra-day price changes, volume and executed trades. This will help to demystify our market and build transparency.

- Equity analysts need easier access to key management staff of listed firms. This is not a favour as they make it appear. Investor relations units should be formed in all listed companies with a direct contact number provided through their website and published in the major dailies.

- Any capital market related committees in the future should have knowledgeable **independent** members make up half of the team. The committee recently set up by the government is filled with members that have vested interest through the companies they run that operate in our financial markets. This does not instil confidence.

- Stockbrokers should do their job of executing trades and leave the job of investment advisory to equity analysts. There is a clear conflict of interest when a broker who lives off of trade commissions is now being asked to advise a client what to purchase. In developed markets, research, sales and trading are clearly delineated. The Nigerian financial market should take a cue.

- The financial services industry regulators (SEC, NSE, and CBN) are trying and more needs to be done; they have been handling their oversight responsibilities without the much needed attentiveness and zeal required to regulate a frontier market like Nigeria. The SEC & the NSE need to do more in monitoring major shareholders and executives trading practices prior to the release of good and bad results and just prior to a firm being placed on technical suspension in preparation for a public offer. Insider trading is going on in Nigeria. For the benefit of those that do now know, insider trading is the release of sensitive (good or bad) information to certain people before public dissemination usually leaving them enough time to react to the information ahead of the investing public.

- Listed firms that own or are affiliated to brokerage firms should not be allowed to buy or sell their own shares on behalf of their clients through these firms.

- Ignorance is not bliss; **regular** investors' forums need to be organized by the Securities and Exchange Commission (SEC), the Nigerian Stock Exchange (NSE), fund managers, investment advisors and broker-dealers to educate investors about the workings of the stock market, investment philosophies and risk tolerance. There should be no ulterior selfish motive attached to this.

- Investors need easier access to annual reports after they are published. This can be achieved by providing a dedicated number to call to receive an annual report in addition to the already existing process of mailing certain shareholders as of a particular date to their addresses on file. Some registrars do not even have enough copies of the annual reports of companies they cater for on file two months after the annual general meeting has been held.

- Use of proceeds from public offers is not accounted for after the monies have been received and spent. This lends credence to the belief that part of the funds are utilized on "other things" not beneficial to investors. The money of the investing public should not be utilized for private concerns. The SEC has started looking into this. Though delayed, the investor has ultimately not been denied we hope.

- Firms in Nigeria change auditors without any categorical statement as to what transpired that led to this important turn of events. This has to change and the SEC needs to take centre stage.

- Banks should not be allowed to lend money to investors to buy their own listed shares through the primary market or to buy the shares of firms they are members of the selling group.

- Regulators' appointments should not be politicized in any way or form. This will give investors the confidence that government will not have undue interference in self-regulatory organizations (SROs) and that the nominated or elected individual is there on merit and not to please certain people in authority and/or a particular ethnic group. The hardest thing to correct on a stock market is "loss of confidence." This is the case now that has led to the persistent downturn in the market.

- The hierarchy of all Nigeria's capital market regulators (Central Bank, Nigerian Stock Exchange and Securities and Exchange Commission) should resign to enable a new way forward. The only constant thing in life is change. They are part of the problem and should not be a part of the solution. It is difficult to see your own wrong-doing.

- Interference of legislators with the activities of SROs. Our capital market cannot grow if the legislators continue to seek "stay of action" on key policy changes by the SROs. While we agree that there should be checks and balances in the system, professionals at the helm should be allowed to perform their statutory functions. Business and politics are immiscible.

- The lagging directives of the SROs. Our SROs usually act after things have already gone awry. While we understand you cannot pre-empt everything, the current state of affairs is quite worrisome. Our SROs spend so much time in solving problems rather than preventing them. If our SROs do not become more proactive, our financial market will spend more time as an "in-patient" in the hospital instead of an "out-patient."

We hope the regulators and the investing public are taking note. Nigeria has never been a country bereft of impressive ideas. Our Achilles heel has always been implementation. What we wrote above is feasible in the near term. If we want to progress from the abyss of being a frontier market, then, we need to heed the above. The above advice if implemented will bring back confidence to our stock market; the negative perception of our market has become a reality. Moral suasion will not right the ship!

We used to be referred to as an emerging market; we are now called a frontier market. We are regressing instead of progressing due to no fault but ours. Sometimes doing nothing produces the same effect as doing something wrong. Once the good of the majority supersedes the selfish interest of a few in our financial system, our market will become developed in the near future.

We are **against any form** of stock market bailout. The greed and self-serving behaviours of a few should not be cushioned by the magnanimity of taxpayers' funds. In addition, we are also against any bailout of any of Nigeria's 24 commercial banks. This is a capitalist society; you should reap what you sow. If a bank becomes too big to manage, then the bank should be ready to break up or be ready to fail. Before any government funds are utilized to buy up any bank's toxic assets, we need to know the details of these toxic assets on the books of each bank, published in-depth in at least three widely read newspapers and the market value of these assets relative to the fair value.

In addition, the government must have provided employment for the 40% unemployed people in the country, provided healthcare, good roads, security of lives and property, better means of transportation, 24-hour electricity (like our neighbours in Ghana) and potable water for all before buying any bank's toxic assets. Life is all about prioritizing; Nigeria should be no different.

We on our own part have decided to help improve our "financial universe" by providing "**Independent investment research and analysis"** to interested members of the public (local and foreign, retail and institutional) among other services. This will benefit the listed firms, the investing public and us. One of the few scenarios in life where there is no loser. We shall continue to pursue our vision of "growing wealth through integrity." Why not partner with us? This article is another product out of the stable of **Thaddeus Investment Advisors & Research Ltd.**

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