**LAIKIPIA UNIVERSITY COLLEGE**

**Attempt Question ONE and choose TWO other questions**

1. *If anyone can find such a thing as an “unregulated industry,” he can sell it at a profit to the Smithsonian (Quote by George Champion).* With reference to the financial sector regulation in Kenya,
2. Briefly outline and explain **FOUR PRINCIPLES** of financial sector regulation. (8 mks).

* **Clear Objectives**
* **Independence and Accountability**
* **Adequate Resources**
* **Effective Enforcement**
* **Comprehensiveness of**
* **Cost-Efficient Regulation**
* **Market Developments and Industry Structure There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.**
* **Accounting and auditing standards should be of a high and internationally acceptable quality.**
* **Regulation should require disclosure,**
* **There should be ongoing regulatory supervision of exchanges and trading systems (2 marks for @point and explanation)**

1. State and discuss **FOUR** examples of regulations implemented by the Government of Kenya to regulate the financial sector (4 mks).
   * **Restrictions on Entry.**
   * **Disclosure.**
   * **Deposit Insurance**
   * **Restrictions on Asset Holdings and Bank Capital Requirements.**
   * **Assessment of Risk Management. (ONE MARK EACH)**
2. Give a **CRITIQUE** of the consolidated financial sector regulatory framework (as found in the U.K.) (11.5 mks)

**CASE AGAINST CONSOLIDATED FINANCIAL SECTOR REGULATION**

* **Market developments**
* **Economies of scale and cost reduction**
* **Reduce regulatory arbitrage**
* **Strengthen accountability**

**CASE AGAINST CONSOLIDATED FINANCIAL SECTOR REGULATION**

* **Reduced effectiveness**
* **Loss of focus**
* **Diseconomies of scale**
* **Moral hazards**

**(A MINIMUM OF SIX POINTS. 2 MARKS PER POINT AND EXPLANATION)**

1. Although real assets comprise the true productive capacity of an economy, it is hard to conceive of a modern economy without well-developed financial markets and security types. How would the productive capacity of the Kenyan economy be affected if there were no markets in which one could trade financial assets? (23.5 mks)

**Real assets determine the wealth of an economy, whereas financial assets merely represent claims on real assets. Nevertheless, financial assets and the markets in which they are traded play several crucial roles in developed economies. Financial assets allow us to make the most of the economy’s real assets.**

**Consumption Timing**

**Some individuals in an economy are earning more than they currently wish to spend. Others— for example, retirees—spend more than they currently earn. How can you shift your purchasing power from high-earnings periods to low-earnings periods of life? One way is to “store” your wealth in financial assets. In high-earnings periods, you can invest your savings in financial assets such as stocks and bonds. In low-earnings periods, you can sell these assets to provide funds for your consumption needs. By so doing, you can shift your consumption over the course of your lifetime, thereby allocating your consumption to periods that provide the greatest satisfaction. Thus financial markets allow individuals to separate decisions concerning current consumption from constraints that otherwise would be imposed by current earnings.**

**Allocation of Risk**

**Virtually all real assets involve some risk. When GM builds its auto plants, for example, its management cannot know for sure what cash flows those plants will generate. Financial markets and the diverse financial instruments traded in those markets allow investors with the greatest taste for risk to bear that risk, while other less-risk-tolerant individuals can, to**

**Separation of Ownership and Management**

**Many businesses are owned and managed by the same individual. This simple organization, well-suited to small businesses, in fact was the most common form of business organization before the Industrial Revolution. Today, however, with global markets and large-scale production, the size and capital requirements of firms have skyrocketed. (8 MARKS FOR EACH POINT WITH DISCUSSION AND ILLUSTRATION)**

1. a. Discuss the following terms as used in the foreign exchange markets.
   * 1. Free float exchange rate system(4 mks)

**Under the free float system, the Value of the currency is determined solely by market demand for and supply of the currency in the foreign exchange market.**

* + 1. Managed float exchange rate system (4 mks)

**The dirty float or a managed float is where the governments always step in to address any excesses in the changes of value. This is the most prevalent regime for example Kenya.**

* + 1. Pegged float exchange rate system (4 mks)

**In case of the pegged exchange rate, the currency may be attached to a group of** [**currencies**](http://www.economywatch.com/exchange-rate/regime.html) **or even precious metals like gold. A good case is that of the Chinese Yuan/ Renmimbi, which is pegged to a basket of currencies, including the Dollar and the Euro.**

* + 1. Fixed exchange rate system (4 mks)

**In case of the fixed exchange rate regimes or the pegged exchange rate, as it is also known, the rates are meant to be converting directly to some other currency.**

* 1. The interest rate in Kenya currently stands at 8%, while the rate in Ethiopia is 12%. If the current exchange rate is 0.1 Birr to a Kenyan shilling, compute the forward rate between the shilling and the Birr (7.5 mks).

**1 + ik = F / S \* (1 + ie) (2 MARK)**

**1+ 8% = F/0.1 \*(1+0.12) (2 MARK)**

**1.12 F = (1.08)\*0.1(1 MARK)**

**1.12 F= 0.108 (1MARK)**

**F=0.108/1.12 = 0.096 Birr to a Kenyan shilling. This is an appreciation of the Birr and depreciation in The Shilling because investors will prefer to invest in Ethiopia where interest rates are higher. This drives up the demand for the Birr, hence its appreciation. Calculate the % appreciation/ Depreciation of the Birr/ Shilling. (1.5 MKS)**

1. Discuss the following terms as used in securities markets, **CITING RELEVANT EXAMPLES** from Kenya and elsewhere in the world.
   1. Over the counter Market (OTC) (4 mks)

**This is an informal network of brokers and dealers who negotiate sales of securities (not a formal exchange). EXAMPLE, forex market (EXAMPLE) example is the foreign exchange markets where currencies are traded over the counter in banks and forex bureaus.**

* 1. Shelf registration ( 4 mks)

**Advance registration of securities with the CMA for sale up to two years following initial registration. A company may seek approval for securities and when granted, the shares are issued over a period of time. (EXAMPLE)**

* 1. Red Herring (3.5 mks)

**This is the INITIAL PROSPECTUS submitted to CMA for approval before securities can be issued. (EXAMPLE)**

* 1. Initial public offer (4 mks)

**Stock issued to the public for the first time by a formerly privately owned company. Example Safaricom IPO (EXAMPLE)**

* 1. Insider trading (4 mks)

**Trading by officers, directors, major stockholders, or others who hold private inside information allowing them to benefit from buying or selling stock. There are a number of cases involving insider trading of Uchumi Supermarket shares.**

* 1. Limit orders (4 mks)

**Refers to an order from a client specifying a price at which an investor is willing to buy or sell a security. (EXAMPLE)**

1. *a.* Briefly explain the concept of the efficient market hypothesis (EMH) and each of its three forms**—**weak, semi strong, and strong**—**and briefly discuss the degree to which existing empirical evidence supports the EMH. (15 mks)

*b.* Briefly discuss the implications of the efficient market hypothesis for investment policy as it applies to:

i. Technical analysis in the form of charting (4 mks).

ii. Fundamental analysis (4.5 mks).

1. **The weak-form EMH assumes that current stock prices fully reflect all security market information, including the historical sequence of prices, rates of return, trading volume data, and other market-generated information, such as odd-lot transactions, block trades, and transactions by exchange specialists. Because it assumes that current market prices already reflect all past returns and any other security market information, this hypothesis implies that past rates of return and other historical market data should have no relationship with future rates of return (that is, rates of return should be independent). Therefore, this hypothesis contends that you should gain little from using any trading rule that decides whether to buy or sell a security based on past rates of return or any other past market data (This is a vindication to the Technical analysts- Chartists). (3 MKS)**

**The semi strong-form EMH asserts that security prices adjust rapidly to the release of all public information; that is, current security prices fully reflect all public information. The semi strong hypothesis encompasses the weak-form hypothesis, because all the market information considered by the weak-form hypothesis, such as stock prices, rates of return, and trading volume, is public. Public information also includes all nonmarket information, such as earnings and dividend announcements, price-to-earnings (P/E) ratios, dividend-yield (D/P) ratios, price book value (P/BV) ratios, stock splits, news about the economy, and political news. This hypothesis implies that investors who base their decisions on any important new information after it is public should not derive above-average risk-adjusted profits from their transactions, considering the cost of trading because the security price already reflects all such new public information. (3 MKS)**

**The strong-form EMH contends that stock prices fully reflect all information from public and private sources. This means that no group of investors has monopolistic access to information relevant to the formation of prices. Therefore, this hypothesis contends that no group of investors should be able to consistently derive above-average risk-adjusted rates of return. The strong form EMH encompasses both the weak-form and the semi strong-form EMH. Further, the strong form EMH extends the assumption of efficient markets, in which prices adjust rapidly to the release of new public information, to assume perfect markets, in which all information is cost free and available to everyone at the same time. (3 MKS)**

**Evidence in Favor of Market Efficiency**

1. **Performance of Investment Analysts and Mutual Funds. (1.5 MKS)**

**We have seen that one implication of the efficient market hypothesis is that when purchasing a security, you cannot expect to earn an abnormally high return, a return greater than the equilibrium return. This implies that it is impossible to beat the market. Many studies shed light on whether investment advisers and mutual funds (some of which charge steep sales commissions to people who purchase them) beat the market.**

**Consistent with the efficient market hypothesis, mutual funds do not beat the market. Not only do mutual funds not outperform the market on average, but when they are separated into groups according to whether they had the highest or lowest profits in a chosen period, the mutual funds that did well in the first period do not beat the market in the second period.**

**The conclusion from the study of investment advisers and mutual fund performance is this: Having performed well in the past does not indicate that an investment adviser or a mutual fund will perform well in the future. This is not pleasing news to investment advisers, but it is exactly what the efficient market hypothesis predicts. It says that some advisers will be lucky and some will be unlucky. Being lucky does not mean that a forecaster actually has the ability to beat the market.**

**The Wall Street Journal, for example, has a regular feature called “Investment Dartboard” that compares how well stocks picked by investment advisers do relative to stocks picked by throwing darts. Do the advisers win? To their embarrassment, the dartboard beats them as often as they beat the dartboard. Furthermore, even when the comparison includes only advisers who have been successful in the past in predicting the stock market, the advisers still don’t regularly beat the dartboard.**

1. **Do Stock Prices Reflect Publicly Available Information? (1.5 MKS)**

**The efficient market hypothesis predicts that stock prices will reflect all publicly available information. Thus if information is already publicly available, a positive announcement about a company will not, on average, raise the price of its stock because this information is already reflected in the stock price. Early empirical evidence confirms this conjecture from the efficient market hypothesis: Favorable earnings announcements or announcements of stock splits (a division of a share of stock into multiple shares, which is usually followed by higher earnings) do not, on average, cause stock prices to rise.**

1. **Random-Walk Behavior of Stock Prices. (1.5 MKS)**

**The term random walk describes the movements of a variable whose future changes cannot be predicted (are random) because, given today’s value, the variable is just as likely to fall as to rise. An important implication of the efficient market hypothesis is that stock prices should approximately follow a random walk; that is, future changes in stock prices should, for all practical purposes, be unpredictable. The random-walk implication of the efficient market hypothesis is the one most commonly mentioned in the press, because it is the most readily comprehensible to the public. In fact, when people mention the “random walk theory of stock prices,” they are in reality referring to the efficient market hypothesis. It has generally been confirmed that stock prices are not predictable and follow a random walk.**

1. **Technical Analysis. (1.5 MKS)**

**A popular technique used to predict stock prices, called technical analysis, is to study past stock price data and search for patterns such as trends and regular cycles. Rules for when to buy and sell stocks are then established on the basis of the patterns that emerge. The efficient market hypothesis suggests that technical analysis is a waste of time. The simplest way to understand why is to use the random walk result derived from the efficient market hypothesis that holds that past stock price data cannot help predict changes. Therefore, technical analysis, which relies on such data to produce its forecasts, cannot successfully predict changes in stock prices. Tests conducted discredit technical analysis: It does not outperform the overall market.**

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**ii. Fundamental analysis**

**An overly doctrinaire belief in efficient markets can paralyze the investor and make it appear that no research effort can be justified. This extreme view is probably unwarranted. There are enough anomalies in the empirical evidence to justify the search for underpriced securities that clearly goes on. Fundamental analysis can thus be applicable in investing.**