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in Portfolio Investment Decisions**

Ai-Gek Beh
George Abonyi

Project: "Portfolio Investment and Structural Adjustment: The Case of Thailand", funded by the International Development Research Centre (IDRC)

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Ai-Gek Beh
Associate Fellow
August 1998-July 2000

George Abonyi
Associate Senior Fellow
August 1996-June 2001

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STRUCTURE OF THE ASSET MANAGEMENT INDUSTRY: ORGANIZATIONAL FACTORS AND PORTFOLIO INVESTMENT DECISIONS

Abstract

Portfolio investment has played an important role in the rapid growth of Asia's emerging economies. It has also played a key — if uncertain — role in the Asian Crisis; and is expected to play a significant role in Asia's recovery and restructuring. Therefore understanding portfolio investment behaviour and key factors shaping such behaviour, could make an important contribution to an understanding of Asia's sustainable recovery.

To put this in context, total net portfolio equity investment in emerging markets stood in 1996, just prior to the crisis, at \$33.7 billion, or approximately 4.6 times net official flows. For Asia/Pacific emerging economies net portfolio equity investment in 1996 was \$17.2 billion, or over 2.7 times net official flows. Looking to the future, by some estimates over \$200 billion in equity is likely to be needed by Asia's crisis economies to recapitalize the banks and restructure heavily indebted corporations. Against this, the net assets of pension funds in the US and UK, US mutual funds, and international hedge funds, together stood in 1996 at over \$7.3 trillion — an enormous pool of capital to support development.

Portfolio investor behaviour in emerging markets is a complex process. It is shaped by a wide range of factors, that are as yet not well understood, as underlined dramatically by the Asian Crisis. One important set of factors that shape portfolio investor behaviour — and that has received limited attention to date — are organizational factors. This paper seeks to improve understanding of investor behaviour by focusing on organizational factors: the structure and workings of the global asset management industry. It is hoped that a better understanding of the actual workings of the asset management industry is likely to lead to more effective policies by both governments and international financial institutions to support the process of economic recovery and restructuring in Asia.

I. Introduction

1. Background: Portfolio Flows and Emerging Markets

The focus of this paper is on examining the structure and workings of the asset management industry as key factors shaping global investment flows in the context of

the Asian Crisis. This is of particular interest since foreign portfolio investment, including equity investment, fueled the rapid growth of Asian markets in the years before the crisis; seemed to play a significant — if unclear — role in the financial crisis; and is likely to be an essential factor in restructuring the corporate and banking sectors, critical for Asia's sustainable recovery.

It may be useful to put the role of portfolio flows, in particular portfolio equity flows, in context. Total net external financing to emerging economies stood at \$337.1 billion in 1996, of which net private flows constituted \$329.8 billion, or almost 98%, as compared with net official flows of \$7.3 billion. Of the total net private flows, net portfolio equity investment flows made up \$33.7 billion, or approximately 4.6 times net official flows. Asia/Pacific emerging economies just prior to the Asian Crisis present a similar picture. Net private flows to the region stood in 1996 at \$176.4 billion or 96.5% of total external financial flows. Of this, net portfolio equity flows stood at \$17.2 billion, or over 2.7 times net official flows of \$6.3 billion. Therefore portfolio equity flows played a key role in financing the development of emerging economies, in particular Asian economies.¹

A glance at the total assets of foreign institutional investors provides an even more dramatic picture of the potential role of foreign portfolio investment in emerging markets. In 1996 pension funds in the US and UK alone had assets of \$5.5 trillion; US mutual funds had net assets of \$1.7 trillion; and international hedge funds controlled estimated net asset of \$90 billion.² This is an enormous pool of potential capital for development.

The total capitalization of Asia's emerging markets (i.e. China, Hong Kong [China], Indonesia, the Republic of Korea, Malaysia, Philippines, Singapore, Taiwan [China], Thailand) rose from \$370 billion in 1988 to \$1.7 trillion in 1996.³ Aggregate market capitalization of 4 crisis countries (Indonesia, the Republic of Korea, Malaysia, Thailand) stood at only \$129 billion at the end of the 1980s; soared to \$637 billion in 1996. A significant proportion of the growth in this market capitalization was from new capital mobilization as distinct from growth in the value of existing equity. One measure of the Asian crisis is the crash of these 4 markets to \$188 billion in 1997, a decline of 70%.⁴

The role of foreign ownership measured as a percentage of total market capitalization seems relatively modest. For example, in 1997 foreign ownership in the equity markets of the 4 Asian crisis countries stood at 29% in Indonesia; 12% in Korea; 50% in Malaysia; and 21% in Thailand. However, the picture changes once we take into account the concentration of ownership in these markets and associated privately held shares that are not available on the open market.⁵ The share of foreign ownership of publicly outstanding shares, or the ‘free float’, is much higher, standing in 1997 at 76.3% in Indonesia; 19.3% in Korea; 69.4% in Malaysia; and 44.6% in Thailand.⁶ Furthermore, there are indications that the holding period for foreign investors (e.g. mutual funds) seems to be significantly longer (e.g. in Indonesia and Korea).⁷ Therefore foreign investors can play a significant role in Asian emerging markets as a source of corporate finance.

2. Context: Portfolio Flows and the Asian Crisis

The Asian Crisis was characterized by rapid outflow of funds, similar to a run on a bank. This was especially dramatic and unexpected, since by conventional standards, most ‘crisis governments’ were following sound macroeconomic policies: government budgets were generally balanced, and monetary policy was not generating inflation problems. There were signs, however, that not all was necessarily as it seemed. For example, Thailand, the ‘trigger country’ in the Asian Crisis, had a relatively large and growing current account deficit just prior to the crisis — the counterpart to substantial capital inflows; excessive foreign currency borrowings by both corporates and financial institutions; and investor sentiment in fact began to change in 1996 putting downward pressure on the exchange rate (resisted by the Bank of Thailand). Nonetheless the rapidity, depth and severity of the Asian Crisis caught governments, investors, and International Financial Institutions (IFIs) generally by surprise.

Given the dominant role of private capital flows to emerging markets in general, and to Asian economies in particular, attention focused on the role of foreign investors and their relative role in the crisis, in particular, on ‘market herding behaviour’, i.e. whether foreign investors were responsible for the turmoil. One view holds that foreign portfolio flight contributed significantly to the Asian Crisis.⁸

Others attempt to show that equity flows were in fact more resilient during the crisis than assumed.⁹ The picture is by no means clear.¹⁰ (It may be noted, in passing, that there is no such ambiguity about private debt: there was significant withdrawal of short-term loans by international banks.)

The picture of investor behaviour becomes even more complex if we look at relative returns prior to the crisis. For example, in general, equity returns in the Asian emerging markets — that attracted significant and sustained portfolio inflows — failed to exceed returns on less risky securities in more developed markets.¹¹ Furthermore, they deteriorated well before the onset of the crisis in 1997.¹² Market fundamentals — profitability, relative value — seemed to have played a very limited role at best, in Asian markets. For example, information was available that Asian corporate managers increasingly leveraged their companies as profitability declined. Yet such information seems not to have had a significant impact on investor behaviour. Indications are that foreign investors relied extensively on growth and market performance, expecting presumably that this would translate into higher corporate profitability in the future.¹³

Therefore there is a gap in our understanding of what shapes (foreign) investor behaviour in emerging markets. This paper seeks to close this gap in understanding by examining the structure and dynamics of the global asset management industry. In approaching this, a ‘composite model’ of the asset management industry is presented, built on the analysis of particular cases of asset management firms.

II. Asset Management Industry

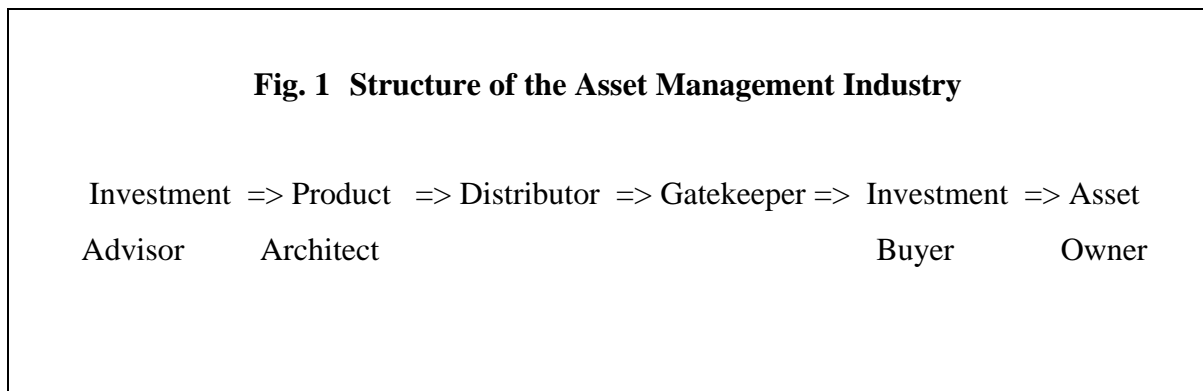
1. Overview

The asset management industry is large, complex and fragmented. With assets in the range of tens of trillions of dollars, the industry is noted for the wide scope and depth of its investments, ranging from equities, bonds, money market and currencies, to their equivalent derivatives thereof. This had led to a perception that the industry has immense potential to affect/disrupt almost any economy in the world with its activities alone. By and large, however, the industry has remained a background player, generally taking a passive role as a minor share or bond holder on most investments in almost all bourses around the world. This is not surprising when we

understand the business rationale of the industry, as we know it, is primarily that of generating fee revenues (see Section IV (B)) for which any market disruption, whether caused by others or themselves, would be counter-productive. But the industry is comprised of more than just fee generators. It also has investment buyers or asset owners, distributors, product architects and gatekeepers. Some of these players may have objectives different from those of the asset managers (e.g., short-term risk aversion may prevent accumulation of high-return investments), and such difference may contribute, directly or indirectly, to market disruptive behavior on the part of the industry.

It is useful to begin by identifying the various components of the industry and the complex value chain of marketing, consultation and organizational hierarchy which links the ultimate individual investor to the assets invested. The normal chain of players and events involved in a decision by an asset owner to invest and an asset manager/advisor to provide investment advisory services are presented in Fig. 1.

2. Components of the Asset Management Industry



a. Investment Advisor

In the United States alone, there are some 20,000 registered investment advisors whose sole job is to select the best stocks, bonds, or other securities from the open market for their clients' portfolio. These advisors generally operate in teams either in specialized investment advisory firms or as part of a larger operation in institutions such as mutual fund companies, insurance companies, brokerage firms

and commercial banks. The function is primarily fee-driven and as such, advisors need to constantly be aware of maintaining an image and reputation that would be attractive to a target clientele.

The advisor's position at the first point of the value chain highlights his dependence on every other component of the chain to reach his ultimate client, the asset owner. Marketing efforts have to be directed not just at the asset owners but at every component of the value chain, i.e., to the product architect to ensure that adequate effort is put into designing investment products which are appropriate to the advisors' skills and expertise; to distributors to ensure their awareness and willingness to identify clients for the advisor; and to the gatekeepers, investment buyers and asset owners to convince them that the advisor is best suited to select the optimal investment package on their behalf. Some or all of these parties may be in the same firm or even the same team, or exist as separate entities altogether.

b. Product Architect

The product architect is responsible for packaging financial services into marketable investment products such as mutual funds, annuities, insurance contracts, trust instruments and deposit products. This role varies in complexity depending on whether its an exclusively architectural role or one which encompasses investment advisory, architecture and distribution. The packages designed will meet the needs of the advisor who may have specialized skills catering to special classes of investors, as well as to the distributors who, depending on their distribution channel, may require the products to have varying levels of mass-appeal. Depending on the class of investors, which could range from the retail investor, high net-worth individual, corporates and governments/municipalities with their corresponding variation of 7 days to 2 year cash availability or institutional investors with long-term funds, the degree of tailoring and active management required would be different as would the need for

supporting systems to monitor the portfolio's risk tolerance levels and performance.

c. Distributor

This is the connecting link between the asset owners as consumers and the advisors as producers of investment products. The link, however, can take many forms depending on whether the sale is through direct or indirect channels, or if the distribution is internal or external. Direct channels proceed straight to the asset owners and investment managers. Examples include mutual fund companies, who through direct marketing, sell directly to individual households; insurance companies, who through their in-house agents, sell annuities to customers; or investment advisory firms who sell its products directly to pension funds and other institutional investors. Indirect channels deal through gatekeepers who act on behalf of the asset owners and investment managers to screen products. Examples include mutual fund companies selling funds through investment firms, banks or financial planners, insurance companies selling policies through independent agents, or investment advisors buying on behalf of pension fund managers. Internal distributors would encompass the entire value chain of investment management, i.e., from asset owners to investment advisors. Examples would include commercial banks buying their own internal portfolios, large corporations buying on behalf of their own retirement funds, and corporations investing their own corporate cash.

d. Gatekeepers

These are the financial consultants, pension advisors and planners, trust managers, etc. who operate in the interest of the asset owners and investment buyers to screen the myriad of investment products. Prominent in this field are three international firms used by the larger investors: Watson Wyatt, Frank Russell and William Mercer.

Gatekeepers are largely responsible for translating the vague investment goals of these investors into an investment strategy with specific investment guidelines, and generally will also screen the performance of investment advisors accordingly. Thus, a pension fund manager may specify low risk and a certain minimum return, and the gatekeeper will convert this into specific portfolio “value at risk” (VAR) figures and allowable volatility bands, cash proportions, etc. therein. Investment packages, as presented by the distributor, who claim track records and investment styles which meet such VAR figures, will be reviewed for selection along with the investment advisor concerned. The gatekeeper will also be responsible for monitoring the performance of the advisor or fund selected to ensure their compliance with the investment guidelines set forth. Occasionally, such monitoring may involve intensive review of the asset management firm and the implications for the client of its future strategy, e.g., when Mercury was being acquired by Merrill Lynch, the issue of whether clients could be comfortable with the firm’s new management practices and organizational culture were explored.

e. Investment Buyers

These are organized institutions who represent large pools of asset owners to buy investment products on behalf of this group of consumers, usually at discounted prices. Examples include retirement plan sponsors, universities, local government funds, union trusts, insurance agencies and various bank trust departments. The officers of these institutions have specific fiduciary duties towards their consumers, which will dictate the returns and risk tolerance guidelines for investment of these funds. They then hire gatekeepers to help them quantify the expectations of these consumers and identify advisors who can invest the funds in accordance with such expectations.

f. Asset Owners

These are the ultimate consumers of the industry; the owners of investment product. They fall into 2 categories: individuals with assets in the form of deposit instruments, direct securities, packaged products and pension fund assets; and corporates and governments, with liquid assets held in the form of direct securities or packaged products. In the past, asset management has been primarily directed at the latter type of consumer, but with increasing pressure on management fees and growing competition in the institutional market, the potential of the retail sector is becoming more relevant. This marks an important development in the behavior of the various components of the value chain, particularly among the advisors, product architects and distributors, as the expectations of the retail sector can differ from that of the institutional sector (see Section IV (A)).

g. A Note on Analytical Models

Various portfolio tracking and monitoring models measure the level of actual and recommended level of risk exposure for given target returns. These models are used by the gatekeeper to translate the risk appetite of the client into quantifiable figures which the advisor, in consultation with the product architect, will use to build a portfolio. Increasingly, fund managers are also turning to these same software packages to help them track their current risk levels as well as predict their potential future performance.

While these analytical models generally do not determine asset allocation, they are a valuable performance analysis tool, e.g. in addressing issues of essential risk analysis and portfolio construction across single or multiple asset classes as well as with a mix of geographic/macro risk indicators. They can also be used to construct optimal asset allocation strategies within specific investment views and risk estimates. The following details some specific functions performed by the models:

- Examine total and active risk relative to Financial Times, Morgan Stanley Capital Index (MSCI), JP Morgan, Salomon Brothers, or any custom benchmark.
- Examine portfolio risk characteristics relative to any benchmark or market.
- Interactively measure the impact of portfolio changes on a local market and currency risk perspective.
- Identify which assets are the least and most diversifying.
- Hedge portfolio currency risk and construct hedged benchmarks.
- Analyze total and active portfolio performance over time.
- Calculate portfolio value at risk.
- Evaluate complex portfolios, including short positions and simulated index derivatives, if such instruments are allowed in the guidelines

III. Institutional Investors

1. Key Characteristics

Institutional investors are the large asset owners and investment buyers in the value chain and as such are major players in the asset management industry. A large majority of these investors are pension trusts or insurance agencies, and as such, have constituents which expect annuity or pension payments which are above prevailing bank or money market rates. Consequently, funds under their management cannot simply be placed in bank or money market instruments — yields here are below those required to meet annuity or pension obligations to their constituents. Equity and fixed income investments, however, while subject at any time to risk of principal loss, have historically provided an average long-term return that is significantly above average long-term interest rates.

The degree of investment in equity or fixed income instruments, as well as the range of risk tolerance levels to allow of such investments, however, is complicated. Most of these institutions do not dedicate professionals to selecting investments. Instead, investment consultants are hired to advise and structure an investment program and investment advisors then selected to undertake the actual investments. Decisions on the mix of asset classes, country and sectoral allocation, volatility allowances and benchmark selection, to name but a few, would be left to these consultants to formulate and the advisor to implement. Thus, the consultant would

determine the clients' target return figures based on an analysis of the flow of funds (both inflow such as insurance premiums or pension contributions, and outflow, such as annuity payments and pension payments), apply actuarial table computations to determine allowable risk tolerance limits, and design an appropriate portfolio model for the client. This gatekeeper function will then move on to identify advisors and/or funds, which meet their recommended criteria for risk, returns and other factors.

2. Advisor selection

Investment performance has always been assumed to be the primary criterion for selection of an advisor. A study of institutional investors, however, indicates that the decision is not quite so simple. If there is a single key factor governing advisor selection, it would be that of risk management. In recognition of this, asset managers design funds with specific risk profiles. The risk exposure of such portfolios is generally measured by the VAR index, which quantifies the average desired risk level of a given portfolio or fund. This same index is also used to monitor the advisor's actual compliance with the risk and returns parameters agreed upon.

A management firm may have a number of different funds, each designed by their product architects to yield different VARs. The institutional investor, on the advice of the consultant, would select a mix of VARs, and appropriate funds, to construct a portfolio with an average VAR suitable to his risk tolerance level. Each selected advisor will be expected to follow investment guidelines, which maintain the stipulated VAR, and will track the portfolio quarterly to ensure continued compliance. In addition to volatility guidelines, the gatekeeper could also impose limits on cash positions, e.g., no more than 5% of the portfolio can be in cash over a quarter period. This limit ensures that the advisor is performing his job of investing funds, the theory being that if the client had wanted to stay in cash, he could presumably manage such cash positions himself and not need to pay the advisor fees to do so.

While performance within a given VAR would be an important consideration in advisor selection, various studies have confirmed that greater performance almost invariably comes with increased risk. This is the reason why consistent long-term over-performance is virtually impossible to achieve. Most studies have found that virtually no fund managers could out-perform their 5-year equity benchmarks

although a small number were able to do so over a 3-year period. Past performance is just not an indicator of future results. For institutional investors who comprehend this law (and most do), customer satisfaction is replacing performance as the key factor in advisor selection. Of the numerous aspects that make up such satisfaction, the main ones are seen as the following:

- The investment manager's ability to rigidly adhere to investment policies within narrowly defined asset classes
- The investment manager's ability to avoid material long term under-performance
- The investment manager's ability to avoid cataclysmic losses
- The distributor's ability to provide quality support services
- The product architect's ability to design effective investment products

IV. Asset Management Firms

1. Institutional vs. Retail Clients

In the past, the client base of the asset management industry has been primarily institutional, i.e., directed at the investment manager. The administrative cost of managing funds meant that only very large investors provided necessary economies of scale for the industry. As the industry became more competitive, however, management fees have been pushed down. At the same time, expectations for higher levels of service, information, records and performance have increased infrastructure costs.

Technology improvements in information management has meant that the systems required to service these large investors can now easily accommodate even small investors at relatively low overheads. With the explosion of self-managed pension plans in the USA and the increasing participation of individual investors, the potential of the retail sector has ballooned, eclipsing even some of the largest institutional pension funds. For example, at US\$91 billion, the Fidelity Magellan Fund's portfolio under management is larger than that which any asset manager may hope to receive from any one institutional investor. While there are many differences between managing institutional clients versus retail clients, the two main ones are:

- i. *Flow of funds* when dealing with retail clients is unpredictable. This unpredictability is generally hidden when dealing with institutional clients as the latter manage their own flow of funds, particularly their cash positions, smoothing it out themselves as their needs dictate, and providing only set amounts to the appropriate asset manager at such times as is deemed optimal. They also select their asset managers with care, and they tend to leave their funds with a firm for at least three years before deciding, if indeed they do, to change asset managers. Their freedom to add or redeem funds may, in any case, be restricted by the asset manager himself to certain time periods, although this largely depends on the clients' arrangement with the asset manager. Retail clients, on the other hand, may add as and when they like, in the full expectation that their funds will be almost fully invested per the investment guidelines of the mutual fund, and may also redeem funds at will, although such flexibility may be somewhat constrained by the imposition of sales/entry or redemption fees by some funds.
- ii. *Performance expectations* relative to peers is a greater factor with retail clients than performance relative to a bench-mark as such clients can more easily switch fund managers and often do. Investment guidelines of retail funds, therefore, are generally less restrictive and structured to allow greater risk-taking, e.g., allowing greater volatility ranges (no maintenance of a VAR figure required) and leveraging to improve performance.

2. Revenues and Expenses

Asset management firms derive their revenues from fees, whether they concentrate solely on the advisory end or encapsulate the product architecture, distribution and gatekeeper roles as well. Fees are generally negotiated on a case-by-case basis with each major client in accordance with their asset management needs and the size of their assets; clients with more specific and unique investment guidelines will be charged higher fees. Calculation of this fee may comprise one or more of the following methods, depending to some extent on the client's choice of performance indicator:

- flat dollar figure regardless of the average asset value
- flat percentage figure on the average asset value
- Bonus percentage points calculated on average portfolio value on performance above target figures
- Penalty percentage points on performance below target figures.

3. Organization Structure

Given the competitive nature of the industry, an efficient and effective organization structure is necessary to ensure low overheads without sacrificing performance and other asset management services. This is not easy given the diversity of the client group and their varying investment objectives. With institutional investors, the common vehicle used is to divide assets under management into various pool vehicles. Each pool represents a set of common investment objectives, asset class and geographic areas, and a client is then allocated shares in one or more pools depending on his specifications of performance target, asset class and regional interest. With retail clients, the vehicle would be the mutual fund or unit trust, which similarly specializes in specific investment objectives, asset class and geographic areas — the difference being that the allocation into the various funds is done by the retail client himself or by his financial planner.

In asset management firms, advisors generally operate in teams. The main roles include the following:

- Asset class allocator — considered the most important part of an investment, determining the amount available to a fund manager for investment and associated guidelines;
- Fund Manager — generally specializes in a region and asset class. For larger funds, there may be more than one fund manager, each responsible for a sector, country and/or client base.
- Analysts — evaluate the macro and micro information of the securities concerned and present recommendations to the fund manager. In some firms, a majority of these analysts' recommendations must be reflected in the firm's fund manager investments.
- Client Manager — primarily a marketing role more common to firms with institutional clients. Serves as liaison between the fund manager and clients.

In general, a matrix structure links the duties and functions of each of the above. Thus, asset allocators will discuss and recommend the apportionment of the clients' assets to various pools with the client managers. Depending on the clients' objectives, the client's funds may be distributed among one or more fund managers in one or more of the following areas: global equities, emerging market bonds, major currencies, etc. Similarly, the fund manager for, say the Asian equities pool vehicle,

may work with several client managers who have clients with some level of investment interest in Asian equities.

The hallmark of asset management firms is their active management of a portfolio. To do this, the following aspects is generally common to most such firms:

- Strong research and rigorous fundamental analysis, both from a bottom-up (enterprise/industry focus) and top-down angle (macroeconomic focus), are critical to identify opportunities of imperfect pricing in different markets.
- Team approach to decisions — issues of research, investment ideas, investment decisions and portfolio characteristics are debated frequently; in the largest firms, daily meetings via videoconference are common.
- Quantitative Tools — used extensively to monitor performance and fine-tune asset allocation and/or investment selection.

4. Performance and Returns

Asset management firms market themselves as active managers, able to create value for clients by taking investment decisions on a day-by-day, hour-by-hour basis. They do this in tandem with two key over-view perspectives:

- i. A *long-term approach* to investments with the focus on identifying, and staying with, investments with quality management, competitive positions, profits, cash flows and shareholder value.
- ii. *Benchmark* relative, i.e., seek to outperform client-specified or fund-specified targets via asset allocation/holds of weights above or below the relevant benchmark.

The latter is important as a performance indicator to ensure the firm carries out its investment mandate adequately. Benchmarks generally fall into one or more of the following categories:

- Benchmark against relevant index, e.g., against the MSCI Free Asia Index for an Asian equity portfolio.
- Performance against peers — generally selected by more conservative clients who see attempts to match or out-perform benchmarks as a risky strategy.
- Absolute return — generally selected by more aggressive clients who seek higher-risk returns.

The advisory team will therefore be mindful of the relevant performance indicator when selecting securities for a given portfolio. Thus, in the case of benchmark based returns, the fund manager will be mindful of being at any time either underweight or overweight relative to the concerned indices. A given firm may practice further conservatism by specifying a percentage limit by which they may be so under or over weight relative to the aggregate index or benchmark.

It should be noted that performance is generally measured net of expenses. Therefore too high fees and/or expenses will decrease performance. Studies have shown that a low expense ratio is one of the most important reasons for a fund doing well. Furthermore, in this highly competitive industry, fee rates have come under increasing pressure. Firms must therefore either look to manage larger pools of funds to obtain the same gross fees at these lower rates; or cut costs with increases in efficiency. This has led on one hand to more homogeneity in product offerings as the same few software systems in the market are bought by most firms to offer more efficient packages and appealing to the same mass audience. On the other hand, because performance tracking is now more standardized and easily compared, “going it alone” is now a higher risk strategy. Being ‘wrong’ in such cases will require considerable explanation and could risk loss of the account and of one’s job. Generally, however, as long as the fund manager has remained consistent in his investment strategy (e.g., value-oriented even when the market is liquidity-driven) and adhered strictly to investment guidelines, under-performance as a result of such adherence will be quite acceptable.

5. Investment Styles

A key issue for the advisor is whether the portfolio is to be managed with a minimal amount of his time or if active management is desired. The former method generally entails the process known as index investing. This seeks to duplicate the movement of agreed indices by matching as far as possible the securities comprising the concerned index. Matching rather than out-performance to the benchmark would be the target. As the number of stocks involved in most indices is far larger than any portfolio could or would want to manage (e.g., the MSCI Emerging Markets Index contains over 1,000 stocks), some level of selection will be required. But the task of

the advisor will still largely be administrative in nature, entailing the running of computer programs, which perform most of the actual investing functions.

Under active management, the advisor will dedicate considerable time and resources to analyzing and evaluating investment options. The goal here is to outperform the benchmark for which higher fees can be charged and bonus points awarded on success. Such advisors will generally choose to be either a growth or a value investor. *Growth investors* seek to buy companies they consider good even if the price is currently at a premium. *Value investors* would seek to buy companies they consider under-valued. In this, a top-down or a bottom-up approach would be used. Thus, a *top-down approach* would focus on the macro-economic environment, i.e., GNP growth prospects, capital and trade accounts. A *bottom-up approach* focuses on financial aspects such as debt levels, price-earnings ratios, etc. to identify quality companies regardless of the macro-environment. Regardless of which approach is taken, a sell or buy decision is ultimately subjective, relying largely on the manager's long experience of the markets for deconstruction of both the top-down and bottom-up data.

In Asia where long experience has indicated the country (top-down) selection has been a greater factor in performance than stock (bottom-up) selection, current views of the macro environment are critical. Thus, positive bottom-up figures suggesting strong financials may be deconstructed to a hold or even sell position if the manager feels macro indicators will prevent or limit growth of the corporate. Similarly, poor earnings may still prompt buying if deconstruction of the data results, for e.g., in an opinion that the economy has excess liquidity which will serve to drive up the market and the poor earning stock with it. There are indications that the Asian Crisis seems to have strengthened the focus on 'bottom-up' factors — assessing corporate and industry fundamentals as a basis for investment — with the likelihood of more of a blending of top-down/bottom-up investing strategies over the medium term.

Regardless of the style chosen, advisors tend to stay with a stock once its selected unless events arise to change the base level assumptions under which the stock was first selected. It should be noted, however, that limitations on cash positions may push the advisor to invest even when the fundamentals, macro or

micro, are not quite what he would have liked. In such a situation, the strategy would be to purchase stocks with the cheapest valuation (value investors) or most liquid (growth and top-down investors) with a view to under-weight the index until such time as the fundamentals are seen as more positive, at which time, stock accumulation would change to an over-weight strategy.

6. Prudential Practices

Reputable asset management firms are known for their commitment to the highest standards of risk control, within both client portfolios and the day-to-day business. Consequently, the practice of prudential controls forms a critical component of the operations of such firms. It should be noted that prudential practices not only serve to contain risk, they are also directed towards cost reduction and thus improved performance and net returns. The following are some of the more common practices:

- Liquidity — Given the relatively large size of some funds, liquidity of a particular issue, particularly in the smaller markets, is an important factor. Buying and selling large lots would move values on less liquid stocks and result in the manager constantly failing to get the lowest ask or bid prices at best; at worst, he may fail to find buyers or sellers when needed.
- Size of investment — As the degree of research and due diligence of each security selected is considerable, some investment managers may choose to select a few larger issues whose performance will have a measurable effect on their portfolio rather than a wide group of smaller investments. This, however, is generally a matter of style as research indicates that portfolio performance for managers with a large number of securities vs. those who concentrate on just a few is about the same. The former, however, entails higher transaction costs, which can have an impact on net performance.
- Ownership and Capitalization — For administrative purposes, most asset managers prefer to remain passive investors and will therefore stay below the level where ownership disclosure could be required by a stock exchange. However, for a stock to have an impact on the performance of the overall portfolio, the stock should have a value of at least 0.5% if not 1.0 % of the portfolio value. Small-capitalization stocks could therefore cause the fund to breach ownership limits in order to own a sufficient amount of the stock, and are thus generally avoided.
- Turnover — Limits on the level of turnover or churning of the portfolio serves to ensure the asset manager will focus attention and resources only on issues with fundamental long-term value, a lower risk strategy, rather than those with short-term trading value, a high-risk approach. Reducing churning also serves to reduce transaction costs which cuts directly into performance levels.

- Leverage — Some degree of margin trading or borrowing can improve performance considerably but will necessarily increase the risk level of the portfolio concerned. Consequently, leveraging is generally not allowed for the more conservative portfolios of institutional clients. It may be allowed with certain specialized funds where gearing is an advertised feature, linked to achievement of the fund's target return rates. The competitive retail sector also features many mutual funds with bylaws which allow them to use bank loans to meet redemption requests and thus avoid forced selling to satisfy unexpectedly large redemption flows. In this way, the retail fund may mitigate the disruptive effects of uneven fund flows.
- Use of options and derivatives — As above, this could be extensive depending on the risk levels allowed within a given portfolio. Some conservative portfolios may require the purchase of certain types of options, such as those which cap losses, yet not allow the sale of these same options should they turn profitable. Such practices would ensure that fund managers focus on options purely as a defensive play and not as a way to leverage performance potential.

7. Staff Compensation and Management

The base salary and fringe benefits of asset managers are generally highly competitive within the financial sector. This means that managers will primarily see themselves as members of a profession, aligning themselves with institutional objectives such as “observing the most rigorous professional standards and attracting and retaining people of the highest quality” than focusing only on individual performance. Bonuses thus become more of a secondary issue, an incentive for outstanding performance, but where such performance is measured as much by subjective criteria like teamwork, perceptions of peers, and contribution towards marketing — as by objective performance statistics.

The amount of bonus provided also depends as much on the firm's overall profitability as it does on the performance of the manager's own portfolio. Thus, the adverse effect of the Asian crisis on firms managing global portfolios will cause a reduction in the bonuses of staff managing American and Asian portfolios alike. However, since fund managers are not usually paid in accordance with the size of the average asset value under their management, even if the firm's fees are dictated by the size of total assets under management, the bonuses of Asian fund managers with shrunken portfolios will likely not fall as much as they otherwise would have.

Nonetheless, on average, bonuses will also be tied to a manager's portfolio performance, measured both against the benchmark target and by comparison to

counterparts in competing firms. Thus, for managers overseeing portfolios with benchmark targets, performance over the benchmark will yield higher bonuses, usually calculated on an exponential basis. Similarly, league ranking, e.g., making the Forbes annual Top 20 mutual funds list, would affect bonus calculation. In order to discourage the use of high-risk strategies to obtain strong performance for a year, some firms escrow bonuses for fund managers and pay them on a 3-year rolling basis. This is particularly popular with firms favored by conservative institutional investors who tend to use 3-year benchmarks to measure performance. Sometimes escrowing of bonuses is done to both fund managers and analysts as a way to encourage managers, who tend to plan in yearly cycles, and analysts, who evaluate in longer time-frames, to work within a common time-frame.

V. Investment Selection in changing economic environments

In this section, the focus is not on exploring whether investors left/did not leave Asia during the crisis. The relevant fundamental point to this paper may be phrased as follows: as long as funds are available for investment in Asia, they must be invested in some way, i.e. as per their guidelines. The question we are then concerned with is where these funds were/are likely to be invested and how such investments could be justified within an organizational discipline of fundamentals and prudence. To explore this question, we will look in an admittedly simplified way at an asset manager's buy-sell process of Thai stocks. Thailand, as a market with a rather small constituency in the MSCI Asia Index, represents a market that is likely to be of interest for reasons of opportunity rather than benchmarking. Hence, entry into this market by benchmark investors will not be for reasons of prudence (with reference to appropriate risk weighting vis-à-vis the MSCI benchmark) but largely because Thai stocks represent performance opportunities for the growth or value investor.

The following three sections will look at the decision-making process before, during and after the economic crisis from two views: the asset or market allocation stage, i.e., how funds get allocated to Thailand and why; and the stock allocation stage, i.e., which Thai stocks could the asset manager justify buying and why. In practice the 2 stages are intertwined, as strong individual companies can make a compelling reason for entering a market as much as a market that is itself growing can

stimulate interest, leading to an iterative process between the decisions of asset allocation and investment selection.

Pre-Crisis Scenario

This is the period prior to mid-1997, when Asian markets were seen as stable, their economies well established on a high growth path, and the effectiveness of regulatory regimes and broader institutional issues largely irrelevant. Within this macro environment, the decision-making process can be interpreted as follows:

- **Market allocation** — At this time, Thailand, like most of the other Asian markets in the region, was looking forward to robust 7-8% annual growth. The domestic economy was expanding; the Thai baht was stable; Thai bureaucracy well-regarded; and the politics stable in terms of implications for economic performance. From a top-down perspective, therefore, the Thai market looked attractive — certainly no less attractive than other Asian emerging markets. From the bottom-up perspective, the argument was rather less strong: the financial returns of Thai corporates showed a marked deterioration relative to other Asian corporates, with returns on financial, strategic and operational performance falling on a yearly basis from as early as 1994, and in some cases, even before.¹⁴ The result was generally investment strategies that included Thailand, but there was no massive over-weighting in Thai stocks on most global portfolios even during this period. Overall, there was no compelling reason seen to not assign portfolios their appropriate weightings of Thai investments, but neither was there any compelling reason to over-weight Thai holdings.
- **Stock selection** — On an individual basis, selective Thai stocks still represented good growth and value plays. From a growth perspective, stocks catering to an economy growing at 8% per year would represent strong fundamentals and good investments. From a value perspective, such stocks were not attractive unless their share price was a fair reflection of their revenue stream and asset base. Given the fall in the Thai SET from its highs in the early '90's, some stocks which fulfilled this latter requirement in the 1996-97 period. Consequently, finding stocks that matched the fund manager's investment style, whatever it may be, was not a problem at this time.

Crisis Scenario

This is the period from mid-1997 to end-'98, i.e., from the time Thailand first devalued to a time when the massive swings of volatility and contradictory

projections seemed to have ended, or at least, become accepted/factored into the investment process:

- Market allocation — The crisis turned projected data on its head. GDP growth figures now turned negative while the sharp currency depreciation, loss of reserves, and financial constraints, crippled the government's ability to cushion the impact. The top-down argument for Thailand was now clearly less than compelling. In addition, the fundamental assumptions regarding the capabilities of Thailand's economic and political leaderships were now suspect. It would seem that while Thailand's ability to manage a growing economy had not been an issue, its ability to manage one in crisis or even recession was of concern. Being the first country in crisis, a top-down argument for re-allocation out of Thailand to other Asian countries clearly made sense. With Thailand's share of the MSCI index falling to an almost negligible figure as its currency plunged, some funds took Thailand out of their portfolios altogether while others went to a heavily under-weight position. The latter had a double whammy as such under-weighting meant that the proportion of Thai stocks in a given portfolio would now be less than its already diminished share of the index. But as other Asian countries began to show the same deterioration of fundamentals, asset allocation now followed a best-of-the-worse selection basis with markets prominent in the MSCI benchmark receiving greater attention and weighting than those, like Thailand, whose size and consequent impact had diminished.

The top-down strategy continued to play a key role in asset allocation, but with greater attention to political and policy factors, i.e., which country (and government) seemed most likely to be capable of putting in changes that would lead to improvements in macro fundamentals soonest. Quantitative macroeconomic data such as current account deficits, became less relevant as fund managers deconstructed all data to fit their view of the political environment. Thus, positive data could be re-interpreted within a political context of conflict and inaction to lead to an expectation that the data will soon return to negative territory, or negative data re-interpreted as being at the bottom in the light of positive trends in the macro regulatory or political environment. In this sense, the top-down strategy has become more welded to the bottom-up strategy as the restoration of both the market and the corporates were now clearly dependant on the restoration of a positive macro environment.

- Stock selection — The crisis, including currency depreciation, resulted in a major re-evaluation of the viability of both growth and value investments. Corporates chosen on the basis of their linkage to the domestic boom now clearly were unlikely to meet revenue projections or growth prospects. Similarly, corporates chosen for their value may see that value wiped out as the local currency value of their external debt ballooned, and their capacity to service that debt declined. For funds that remained, the new growth stocks became those with high export revenues, especially using domestic inputs — able to increase sales with the greater competitiveness provided by a weak

baht. Value investors had better opportunities during this period. As the baht fell, the share price of corporates dropped correspondingly in foreign currency terms, resulting in some cheap buys in corporates with large fixed assets and low debt levels.

Post-Crisis Scenario: The Present

This is the period from early 1999 to the present (May 2000). It is composed of 2 stages: the first stage involved a seeming resurgence of the Thai market, only to be followed by a significant and (at this writing) continuing and significant decline. Fundamentally, there seems to be a basic discrepancy between macro-economic indicators, such as the balance of payments, that are generally moving in positive direction; and market performance, which is rapidly deteriorating. This confusion was vividly illustrated in the Business and Finance Section of the respected English language daily, The Nation. The headline on its back page read: “Thai performance lauded by IMF as ‘impressive’”; while the headline on its front-page read: “Market slips to new low as investors flee”.

- Market allocation — The top-down approach at this time seems to be operating within a macro economic environment that is cautiously optimistic, for example as reflected in the balance of payments figures (and the IMF endorsement). Thailand’s steps in this direction have not been exceptional in terms of its Asian neighbors (e.g. Korea, Malaysia), with the consequence that fund managers have continued their pattern of under-weighting the country in their portfolios. But the macroeconomic environment is now comparatively acceptable, and hence funds which had taken Thai investments out altogether *should be* gradually coming back in, even if in small amounts. This does not seem to be happening to any extent, either because of perceptions of a more uncertain political environment (with elections looming) offsetting to some extent the more positive macroeconomic indicators; or because investors are unconvinced of the sustainability of the momentum of Thai macroeconomic performance at the micro-level, e.g. as reflected in the pace and extent of addressing financial sector problems and corporate debt restructuring — also indicating a potential shift in emphasis to ‘bottom-up’, i.e. industry/firm-level factors. The Thai market is generally underperforming other markets in the region in terms of investment returns, capitalization, and trading volume, making it a less attractive ‘buy’. Benchmark investors’ interest is likely to be further dampened by the expected reduction of Thailand’s rating in the MSCI index..
- Stock selection — Growth prospects are looking more favorable and debt restructuring has improved the balance sheet of some corporates. From the growth investor perspective, Thai corporates catering to the domestic market

are now looking more attractive again. For the value investor, the initial rise in the SET index and the appreciation of the Thai baht may have made Thai stocks expensive, particularly if revenue prospects have not improved greatly. However, the recent decline in both the SET index and in the value of the baht may make some stocks relatively more attractive. However, for such investors, the valuation of Thai stocks relative to other stocks in the region (on a sector basis), will be the key determinant on which, if any stocks they would buy.

VI. Conclusion

Portfolio investor behaviour in emerging markets is a complex process. It is shaped by a wide range of factors, that are as yet not well understood. The Asian Crisis underlined dramatically the limits on understanding of investor behaviour in emerging markets. One important set of factors that shape portfolio investor behaviour in emerging markets are organizational factors — the structure and workings of the global asset management industry — the focus of this paper.

Portfolio equity investment is likely to play a key role in supporting economic recovery and restructuring in Asia. By one estimate, recapitalizing the banks and restructuring heavily indebted corporations in the region may require an injection of at least \$200 billion in equity over the medium term.¹⁵ Therefore a better understanding of the actual workings of the asset management industry is likely to lead to more effective policies by both governments and international financial institutions to support the process of economic recovery and restructuring.

NOTES

1. *Capital Flows to Emerging Markets*, Institute of International Finance, April 13, 2000
2. Barth and Zhang
3. Pomerleano and Zhang
4. Barth and Zhang
5. See for example Claessens et al on ownership concentration
6. Barth and Zhang

7. *ibid*
8. Radelet and Sachs
9. Choe, H., B.C.Kho, and R.M.Stulz
10. See Porametee Vimolsiri on Thailand
11. Pomreleano and Zhang
12. Abonyi on Thailand; Pomerleano on cross-country comparison of Asian corporate performance.
13. Abonyi ; Pomerleano; Pomerleano and Zhang assessing behaviour of capital markets.
14. See Abonyi (1999); Pomerleano (1998)
15. Barth and Zhang

About the authors

Dr George Abonyi is an Associate Senior Fellow at the Institute of Southeast Asian Studies and is Project Director of the IDRC funded project, “Portfolio Investment and Structural Adjustment: The Case of Thailand”. He may be contacted on e-mail at abonyi@loxinfo.co.th

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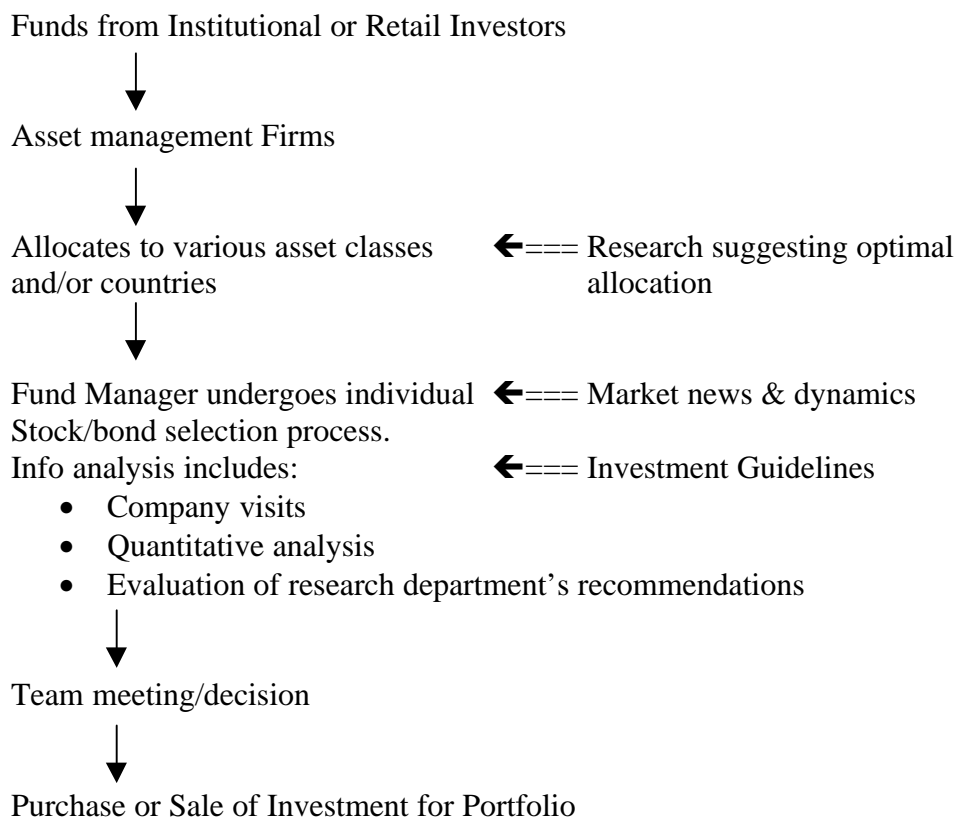
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APPENDIX I. The Buy-Sell Process

Fig. A1. Schematic of Typical Buy-Sell Process



The above illustrates how, in the course of a normal day, asset managers undertake buy-sell activities to optimize the mix of investments in a given portfolio. Generally, however, when an investment is first entered into/bought, the strategy is one of gradual accumulation. Should the fundamentals of another investment/company look better, the strategy may change to one where new funds are used to buy this new investment, i.e., the first investment may not necessarily be sold. Generally, a sell decision on existing positions only happens when cash is needed to meet redemptions (in which case the investment with the least potential will be sold) or if the reasons for entering into the investment in the first place (e.g., strong balance sheet and earnings or a growing macro environment) have changed.

However, organizational factors can trigger a buy-sell decision not directly related to the investment's performance in a portfolio. While adherence to such 'rules' may be waived by appeal to the funds' Trustees or a compliance committee, they nevertheless do serve to constrain the level of freedom asset managers have in buying and/or selling investments. Generally, these organizational factors fall into one of two areas as follows:

Availability of funds

Asset management firms market themselves on their active management of funds and actively solicit funds towards such purpose. Thus, once a client provides funds, these must be invested within days, particularly since management fees are charged on such funds immediately. In addition, some clients and funds may have investment guidelines stipulating a maximum cash position.

Where the clients' or funds' investment guidelines allow the asset management firm some degree of flexibility in asset allocation, the amount of funds made available to the asset manager is controlled by the asset allocation manager. In practice such decisions are largely a result of team discussions on whether and how much an asset class team (and within it, a geographic specialty) can invest effectively. Where the guidelines are more restrictive, such flexibility within the firm will not be possible and the funds must be invested per the guidelines regardless of market conditions.

In the event market conditions are exceptionally bad, the fund manager may apply to its trustees or the compliance committee to allow the use of alternative investments (e.g., local bank deposits) until such time as the market outlook improves. Similarly, if outflow of funds occurs so that sale of existing positions is required to meet this outflow, the fund manager will have to find investment positions to liquidate. This is necessary, regardless of how positive market conditions may seem and the consequent negative impact of such liquidations on his portfolio's performance.

Portfolio Readjustment due to breach of investment or prudential guidelines

Various indicators are tracked at all times to monitor a portfolio's adherence to its investment guidelines and to prudential practices. Due to the constant movement of the various financial markets, a portfolio could breach one or more of its limits, such as:

- Value of a single stock within portfolio greater than maximum allowed, as when a stock has disproportionate appreciation relative to other stocks in the portfolio.
- Value of a single stock drops below the minimum prudential level (usually at least 0.5% of a portfolio's value). In such situation, the manager would have to decide to either further accumulate, thus raising the stock's value in the portfolio, or remove (sell) the stock from the portfolio.
- Portfolio's measured VAR exceeds range allowed such as may happen when a manager chooses to select non-benchmark shares to constitute a considerable proportion of the portfolio, and such stocks then experience significant price fluctuation
- Macro fundamentals change in conditions so that the investment no longer fits the criteria specified by the investment guidelines, e.g., investment-grade bonds being down-rated.

In addition, a manager also has to be aware of his trading turnover otherwise he may find himself too close or even exceeding the limit of trading turnover permitted in his guidelines. If such is the case, he would either have to restrain his buy-sell activities for the rest of the year or appeal for an increase in such turnover. While appeals for waiver of investment guidelines can be granted, the manager is expected to present sound reasons for such and not simply carelessness in tracking his portfolio positions.

Conclusion

In general, organizational factors and pressures may alter an asset manager's stock selection strategy, forcing a manager to ignore his usual stock selection strategy (top-down, bottom-up, growth or value) and buying stocks that would not fit most or even any of his usual criteria. Thus, when a bottom-up manager is given investment funds for Asian equities, and he finds himself presented with stocks with weak balance sheets and declining earnings, he may have to step outside his usual criteria and actually buy such stock on the assumption that the overall market is rising and such stock will also rise, or if he assumes that the stock will not depreciate more than the relevant benchmark/index.

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