

2019-08-31

## The plight of retail investors in the Pakistani stock market

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*Master of Science in Journalism*

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### iRepository Citation

Jamil, A. (2019). *The plight of retail investors in the Pakistani stock market* (Unpublished graduate research project). Institute of Business Administration, Pakistan. Retrieved from <https://ir.iba.edu.pk/research-projects-msj/30>

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# **THE PLIGHT OF RETAIL INVESTORS IN THE PAKISTANI STOCK MARKET**

This research report is submitted to the Faculty of Business Administration as partial fulfillment  
Masters of Science in Journalism degree

by

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Summer Semester 2019

Institute of Business Administration (IBA), Karachi, Pakistan

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## **The plight of retail investors in the Pakistan Stock Market**

PSX has a reputation for being biased towards big investors; Experts blame lack of information, brokers' disinterest in smaller returns, and govt.'s indifference towards spreading investment awareness

### **Introduction**

Investopedia defines the 'Stock market' as "The collection of markets and exchanges where regular activities of buying, selling, and issuance of shares of publicly-held companies take place." (Chen, 2019) In developed economies, the stock market provides a trustworthy platform for both big and small investors. Of course like any legal and reliable investment opportunity, the returns correspond directly to the strength and amounts of investments, which means to say that bigger investors have a higher chance of higher returns as well as success. However, that does not eliminate the opportunity for smaller investors. Things are not as ideal in developing economies, like Pakistan, where the stock market is much less developed, much less transparent, and much more riddled with corrupt practices and insider trading. This study is done to identify the factors that cause these inequalities in opportunity for investments, and to identify solutions to problems posed by such inequalities.

### **Where did it all begin?**

The first stock exchange in Pakistan was established in September 1947 but was formally incorporated under the name of Karachi Stock Exchange in 1949. To meet the trading needs of the provincial metropolis of Punjab, a second exchange was set up in Lahore in 1970, while the Islamabad Stock Exchange was set up in 1989. Owing to the three exchanges having different management and separate trading interfaces and separate indices, the Stock Exchanges Act, 2012 was promulgated in 2016, which merged the three exchanges into one, under the name of the Pakistan Stock Exchange (PSX).

PSX has made significant strides in its history, having a small presence of five listed companies initially with a total paid-up capital of Rs 37 million. In 1960 there were 81 companies with a market capitalization of Rs 1.8 billion whereas now, as of Calendar Year ending December 31, 2018, there are 546 companies listed in the bourse with a market

capitalization of Rs 7.692 trillion. The newest member of the PSX is Interloop Limited, a hosiery manufacturer, whose IPO was the biggest for any private company in Pakistan's history.

Richard Morin, former CEO of PSX, had greatly emphasized on the importance of the stock market in the economy of Pakistan. Speaking at an event organized by the Pakistan Business Council, shortly before his resignation, Morin said the central mission of PSX is capital formation and efficient allocation of that capital in the economy. "We bring the life-blood capital to the businesses that create jobs and economic boom for Pakistan. Let me be clear. There can be no economically successful Pakistan without a vibrant capital market," said Morin.

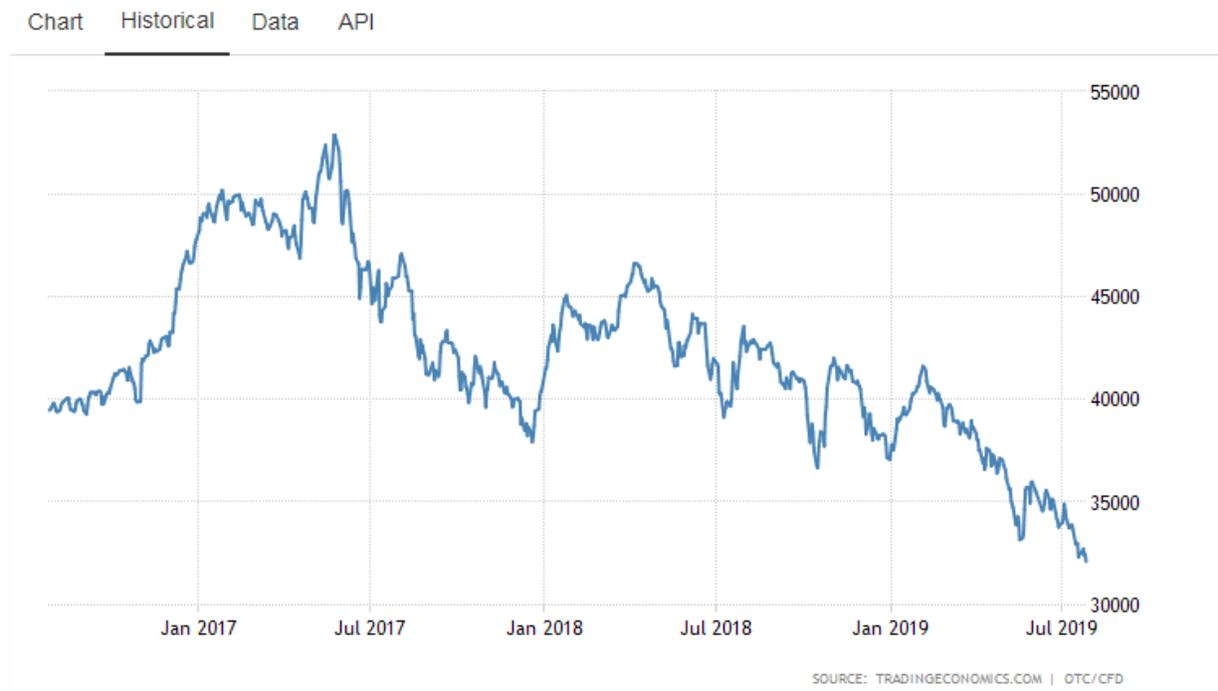
The current chairman of PSX, Sulaiman S. Mehdi took charge in July and has continued with the passion set off by Morin, but has added the direction of attracting female investors. In an awareness session in Islamabad held jointly by PSX and a private securities' company, he expressed his amazement at the interest shown by the female segment in the stock market. He also suggested to women entrepreneurs to explore the potential of listing on the SME [Small and Medium Enterprises] Board of PSX.

## **Background on trading numbers**

Pakistan Stock Exchange has had some successful periods but on average when the market hits the top spot is big enough news to make it to the main news bulletins on all TV channels.

Thankfully when there is an extraordinarily horrible day that too is news worthy, so PSX is an average performing index at best, it might suggest. However, another interesting thing about Pakistan's investment climate is that it does not seem to get affected by the external factors that are considered significant for exchange trading worldwide. There is a bump here or there with political fluctuations such as former Prime Minister Nawaz Sharif's arrest, or former finance minister Asad Umar's resignation. But at the same time, there is not much to trace with economic changes, such as currency devaluation or global financial crunch.

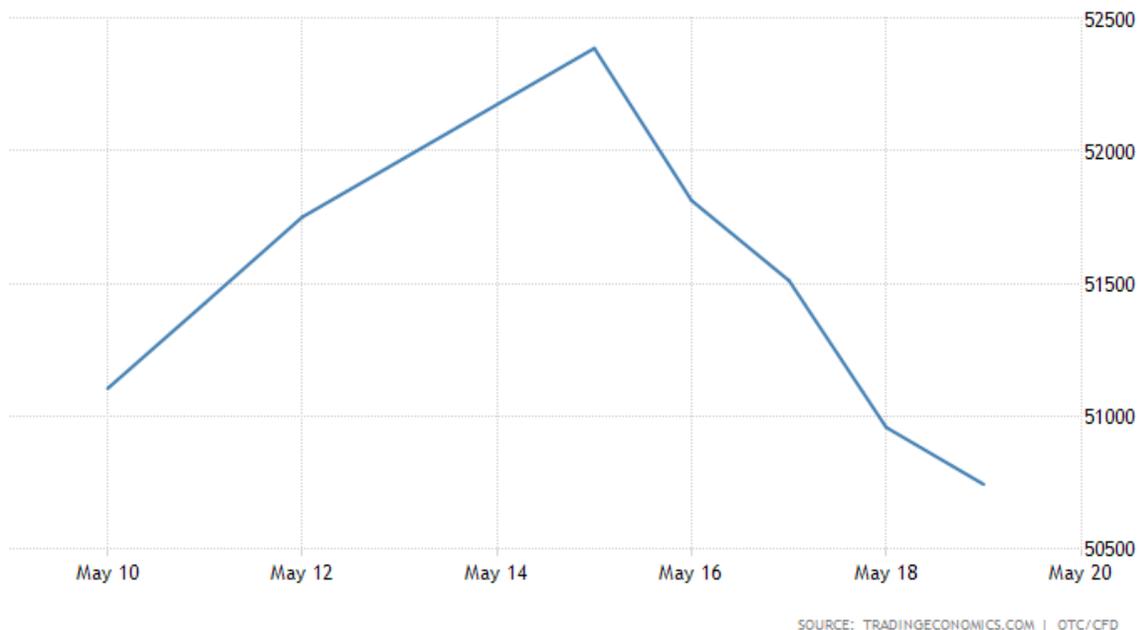
One of the reasons for this is that Pakistan's stock market is not much integrated globally. Secondly the economic environment in the country is not primarily debt based, which means that if the economy takes a turn for the negative, the usual effects are lower investments and slower markets but the stock market seems to remain relatively isolated.



## MSCI and other ratings

Pakistan Stock Exchange has had an equally rocky history with the international trading rankings and ratings as it has had with the local investors and trading associations. The MSCI world index is part of 'The Modern Index Strategy', which is a broad global equity index that represents large and mid-cap equity performance across 23 developed markets countries. It covers approximately 85% of the free float-adjusted market capitalization in each country and MSCI world index does not offer exposure to emerging markets.

When MSCI index ranks a developing country's economy, let's say in Frontier Markets or Emerging Markets, the international investors base their decisions accordingly. These days we are ranked as an 'Emerging Markets'. When it happened was in May 16, 2017 – after nine years of us staying in the Frontier Markets – our stock market opened to a global investment of approximately \$1.4 to \$1.7 trillion. However, keeping up with the tradition of not behaving as per wide held expectations, the stock market actually dipped the very next day. In the first hour and a half of trading, the market had lost 900 points.



The initial reason for the dip given by the market experts was that too many companies were made part of the new ranking which diluted the investors' interests. In 2019, there were serious concerns that the MSCI index will kick Pakistan out of the Emerging Markets index, but against all odds we managed to hold on. PSX and therefore Pakistan as an investment opportunity as a whole is still not out of risky zone yet. What happens in the future is anybody's guess? Let's turn our attention back to the local problems for now.

### **So, what's the main problem?**

From the above discussion we infer that while on the one hand the Pakistan Stock Exchange has made the fortunes of many, but on the other it has also caused many more to lose their life's savings. All over the world, stock exchanges are meant to be for both big and small investors who don't wish to keep their money idle in the banks or are prepared to take higher risks for higher returns. In Pakistan, however, like most means of production, stock exchange has also become a playground for only the rich. Smaller investors often find themselves in impossible situations with usually one of the two options – either hold investments for really a long run and walk out with little to no capital gains but no massive losses, or take bigger risks and possibly lose all their money.

Morin said the objective of the exchange is to bring more Pakistanis into the stock market. “This is a fundamental issue to be dealt with. When PSX succeeds in bringing new investors, it would transform the capital market of Pakistan and contribute to its economic success,” he said in an interview last year. Morin also cited examples of other developing countries and the participation of retail investors in those countries. He said Sri Lanka has 700,000 active investors in a population of 20 million while Pakistan only has around 250,000 investors. Similarly, he said, Bangladesh has 2.5 million investors in their stock market and Vietnam with a population of 90 million had 6 million retail investors in the capital market. (Pakistan Today, 2018)

However, the engagement with new investors continues to pose the biggest challenge for the stock market. Investors Lounge Co-Founder and Director Business Development Sennen D’Souza said, “Small investors don't usually have a finance background and if some small investors do have a finance background, it does not necessary mean that they understand the market. The market is very complicated. You need to understand the fundamental and technical aspects of the market as well as the mood of the market. There are a lot of things to understand about the market.”

A story published in a business publication called *Profit* in April, titled “Why people don’t invest in PSX, and why you should”, sheds more light on the matter. The piece said, there is a shocking dearth of any awareness-raising campaigns by the government, or any entity including the PSX itself, to educate potential investors on various avenues of investment. The only examples that can be found are sessions held by the PSX at chambers of commerce and industry in various cities. (Pakistan Today, 2019)

Hammad Bin Noaman, a graduate of Institute of Business Administration, Karachi and a small investor, said, “When people who don't understand the stock market, they become easy targets for brokers. I personally know people who have put money in the stock market but don't actually understand what that money is used for. They simply don't understand what stocks are and what they’re buying when they invest in stocks.”

Syed Zafar Abbas, general manager at Zahid Latif Khan Securities (Pvt.) Ltd. who had also spoken to the publication highlighted that, “The maximum investment news is a one-liner about the direction that the stock market took for the day; how, then, can we hope that the public will develop any interest [in investing]?” Co-founder of Investors Lounge agrees. He said,

“There is a serious lack of knowledge, even amongst the educated class, about the functionality and the complexities of the market and there isn't enough awareness being carried out for its understanding.”

A rare incident took place in the form of the website “JamaPunji” launched and managed by the Securities and Exchange Commission of Pakistan (SECP), to educate interested investors. (Securities and Exchange Commission of Pakistan (SECP), 2018) The website includes a stock trading simulator and explains the different types of investments that can be made in the stock market. Approximately two dozen people who expressed interest in the stock market were asked if they were aware of this platform's existence, yet none of the interviewees said yes. The only group that knew of the platform are people who are already traders.

The broadest argument perhaps is that the investment culture in Pakistan is low to begin with. Private borrowing for investment is even lower, as is apparent by the condition of the commercial banking sector as well. Second argument can be seen from the fact that there are less than 600 listed companies on the PSX as opposed to a more than 150,000 registered companies. This means that the public can only share the equity and profits of less than 1 percent of the industry in the country. On top of it, the stringent regulations of IPOs and the code of corporate governance itself is a discouraging factor for many large conglomerates who are still not comfortable opening up to the open market.

D'Souza said, “The investor thinks he doesn't have the time and expertise so who do I turn to? So the investor opens up an account with a broker and asks the trader what to buy and sell. Traders are mostly non-qualified people who on the basis of hearsay and general discussion and gossip in the offices and WhatsApp groups, they do the trading on your behalf. So if someone had a bad experience in the market because of their trader, that they lost money in the market, the investor thinks that if the expertise of the broker couldn't help me make money, then either the stock market isn't the right place to make money or everyone is a thief.”

Then there is the elephant in the room of unprotected small investors. No effort, to date, has been made to attract smaller investors towards the stock market. The culture of privatization is also at a standstill which is the easiest and the quickest way to open up new avenues of investment in the stock exchange for the general public. Inability to retain investors who did come to the market is as big a problem as the inability to attract new ones. Some investors do so

because they have made losses, others find the environment biased towards richer and bigger investors, while some leave the market owing to their own bad money decisions.

Hammad said, “Brokers in my experience try to influence you for buying and selling of stocks a lot. Often the feedback of the broker is conflicting from what the discussion was on online or in professional business circles. If the brokers land themselves a big portfolio, they start to neglect the smaller investor’s portfolio and investment.”

One practice that can be described as the investors’ own fault is ‘margin financing’. This means that an investor trades on more than their actual invested capital. Consider this: you invest Rs 100,000 but, through margin financing, you take on three or four times the liability of the invested amount – say Rs. 400,000 – and trade on that. You will pay interest on this additional amount which is compounded daily. This means that if your bets about the market are correct, the returns you make on this investment will far exceed the cost you pay in commissions and interest. But if you falter, the loss is equally massive. This can be understood as a legal form of gambling but the only practical difference comes in the form of no criminal charges. The risks, rewards, and therefore speculative part of the deal remain the same.

However, the problem of the investors registering with the PSX but not following through far exceeds the number of people who leave just because of losses made from margin financing. D’Souza said, “So there are around 2.5-3 lac Unique Identification Numbers registered with the market. These are small investors that at some point registered but currently, in my knowledge, there are only 20-30 thousand active monthly traders in the market. Pakistan isn't even close to countries like India and Sri Lanka in the number of investors in the market. Less than 1% of the population is in the market.”

Many people think that the root of the problem lies with the illegal and unfair practices rampant in the industry. While SBP and SECP have tried several times to counter practices like information leakage and insider trading, there is still no dearth of these and other similar practices making it impossible for a common man to earn anything significant from the stock exchange, as it is all controlled by a few big investment brokerage houses. A regular visit to the PSX will bring you across dozens of traders ever complaining of the persistence of this menace yet being completely helpless in doing anything about it. There is an overarching lack of trust in the traders themselves.

The point to note here is that insider trading and stock price manipulation is not exclusive to the Pakistani stock market. The plethora of Bollywood and Hollywood movies alone should be enough to see how rampant the practice is – in our neighboring country as well as in one of the world’s most developed markets. The solution then is not to steer clear of investing in the stock market altogether, rather choose investments that steer clear of such manipulative influences. As the story in Profit recommends, “One way to avoid getting mired in a sticky situation like this is to steer clear of investments offered by securities companies themselves which may create a conflict of interest for brokers.”

Pakistan Stock Exchange also operates on the rule of ‘undisclosed trading’ whereby traders, brokers or individual investors are not supposed to know the buying and sale of each other. However, this information is also rampantly disclosed and leaked, causing as much harm to smaller investors as it benefits those indulging in techniques like insider trading.

A lot has been done in this regard. In 2017, the Securities and Exchange Commission of Pakistan (SECP) ordered an investigation into this leakage of trading information. A committee was formed to investigate and uncover the culprits behind this. But there was never a result that was published. If a report did come out, it never saw light of the day. A reputable publication published a comment from an unnamed senior broker who said on record, “If I recall correctly, this was the fourth committee set up over time to investigate the matter, but except for footing the bill worth around Rs 30 million, nothing has been achieved so far.”

The only tangible impact of SECP’s regulations has come from the strong reaction to those investment analysts’ reports that were found guilty of publishing false information. That is to say an extremely minor part of these unfair practices, but it was still worthy of commending since small investors who do not have access to the quick updates on insider information are solely dependent on these reports.

Another reputable fortnightly publication printed a response from SECP in May 2018 that said, “The SECP conducted detailed inspection in relation to rumors regarding data leakage and the PSX has implemented various measures to bolster data integrity based on recommendations.” (Pakistan Today, 2018) While this quote did not deny the existence of such practices, there was still no answer as to the results of the researches and investigations being conducted. The direct quote from PSX CEO Morin also called this investigation a “top priority.”

Ahmed Raza Munaf, a financial analyst at Intermarket Securities Limited, says one of the reasons for low participation of retail investors in the stock market is perception. “People think the market is rigged and unfair and there’s no protection for the investor,” says Munaf. He also says a lot of the times brokers end up defrauding their clients and there’s no way for investors to get their money back.

There’s also a general lack of awareness about the stock market itself, says Munaf. “People don’t know the first thing about investing in the stock market. It’s an alien concept to them,” he says. Shahrukh Saleem of AKD Securities also thinks awareness is a big reason why small investors don’t invest in stocks. “People have the tendency to invest in gold and local committees and bonds. Stock market has never been properly marketed to the people,” says Saleem. (Saleem, 2019) He also says that while recently people have started to invest, they’re investing more in mutual funds rather in individual stocks.

Saleem says to increase the participation of retail investors in the stock market, young investors need to be attracted to it. “It’s hard to change the mindset of the older generation to bring them towards stocks, but the young generation will be more willing to invest if they’re properly targeted,” says Saleem. Munaf says that to increase retail investors, brokerage houses need to step up and maximize their reach by targeting smaller cities and increasing their agents.

Saleem and Munaf also highlight another hurdle in the process of investing in the stock market — documentation. “There’s a lot of paperwork. To open an account, I’ll have to fill forms and get statements from my bank and then submit them to the brokerage house.” But Syed Sanakhawan, a financial analyst at JS Securities, thinks it’s not that big of a problem. “People think it’s a long and tedious process to open account with a brokerage firm, but it’s not. It’s just like a bank account,” says Sanakhawan. (Sanakhawan, 2019)

Sanakhawan thinks there’s low participation of the public across the board, be it bank accounts or the stock market. He also says there’s a trust deficit between the investor and the broker, especially more so since the 2008 financial collapse in which people say they were misguided by brokers. “Brokers make a commission every time their clients trade, and they try to convince clients to trade even if sometimes, the investor would benefit more by not trading. This permanent role of the broker is also irritating for the investor,” says Sanakhawan.

D’Souza also had a nugget to add here, and he talks about the main operating model of the trading market being problematic itself. In her words, “If the model of the broker-investor

relation was based on profit percentages, then the broker would be incentivized to make more money for the investor. The current model has the broker making money on the trading done by the investor. So the broker would want you to buy and sell more shares, effectively earning him more broker fees. The broker's earning is directly proportional to the trading done by the investor, whether the trading ends up bringing profit or loss for the investor himself. So this will continue until the model is changed."

Junaid Hanif, an economic graduate from Lahore who's never invested in stocks, highlights another aspect of the role of brokers between the investor and the stock market. "The stock market is so complex and difficult to understand, even for a finance and economic student like myself, so I'll always need a broker to guide me and will never be able to take decisions myself," says Hanif. He says the investing in the stock market should be easier and decision power should be in the hands of the investor and not with the broker.

Hanif also says that from his understanding of the stock market, only a considerable amount of capital can guarantee good monetary returns. "My time, interest and business intellect in the stock market will account for nothing if I don't have a huge sum of money to put in the stock market," he says. Hanif thinks playing with stocks is a game for the rich, and those who have large sums of excess money lying around. "For people like me, belonging to middle-class families, I cannot afford to invest in stocks, knowing that the market is unfair and almost always results in losses for the small investor," he says. (Hanif, 2019)

Another reason people don't invest in stocks is the availability of alternative investment avenues. Sanakhawan compares a piece of land or a property to a stock. "If someone buys land, they can go and see what they've bought. But how can you physically verify a stock?" he asks. Awareness about the stock market is at the heart of the problem. Saleem thinks half of the people that have some knowledge of the stock market think it's *haram* and that's why they keep away from it.

Then there are the government bonds and national saving schemes that are more attracting to people because they offer a risk-free return, as compared to the stock market. "If the rate of government bonds is as high as 12-13%, which it is these days, people would obviously invest in those securities because they're getting a guaranteed high risk-free return," says Munaf.

Saleem says people still believe putting money in bank accounts is better than investing in stocks. “They don’t understand that money in banks loses its value over time, but if they invest in stocks, there’s a chance to earn profits,” he says.

Sanakhawan also blames the huge local informal economy for the low number of investors in the stock market. “People who deal in the informal or the black economy will never invest in stocks because they’ll have to disclose their assets,” he says. He says that this is a big chunk of the economy that might never get invested in the stock market. (Sanakhawan, 2019)

## **Final Word**

The above discussion makes it fairly obvious that the current model and operational procedures of the Pakistan Stock Exchange make it a place less friendly to the smaller investors inclining it in favor of those with bigger and deeper pockets.

However, that is no cause for disappointment. Any market in the world needs investors’ confidence to work, and any economic model – or even a product – needs an established customer base for it to succeed and continue to remain relevant. The minimum amount of investment in most trading companies in Pakistan is Rs 50,000. Mind you, that is still lower than the retail price of 1 *tola* gold. That is to say that the PSX is an opportunity waiting to be explored by the smaller investors. Yes, it is not on its best behavior but to take it there it will require a higher number of smaller investors – higher enough to make the combined investment by smaller investors become significant enough for the movers and shakers of the stock market.

The authorities can help in this regard by strengthening their anti-corruption laws and penalties while enabling easy information and access to general public. Students and market players can also play their part in educating their friends and colleagues and to help build a narrative of trust, confidence, and fair trading in the Pakistan Stock Exchange.

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