

New Economy - Old Fundamentals Technology, Investors, and the Market

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First of all, I wish to explain that as a financial regulator, it is not my role to explain how, what and when to invest - that is the job of investment advisers. Indeed, by definition, the regulator knows less than the market about which stocks are winners and which losers, or about forecasting index levels. No less an authority than Alan Greenspan, when he spoke of "irrational exuberance" having "unduly escalated asset values", in February 1997, could have foreseen the Dow rising another 40% and the NASDAQ Composite nearly tripling to recent levels.

But it is my job as the regulator to give health warnings, to help explain the risks, and to point to potential issues.

Recently, the Hong Kong market reached record levels, and many investors must have made lots of money. Some may have forgotten that barely 18 months ago, the Hang Seng Index (HSI) saw record lows. Less than 30 months ago, we had a fever in Red Chips. Perhaps market movements in these few days are a good reminder to us all. The faster the market rises, the higher the risks.

This time round, it is High-tech Chips that everyone is excited about. Although I have made the same risk warnings, many small investors have rightly asked me how have tech stocks changed the way the market behaves? Are they wrong in chasing tech stocks? Is it wrong to chase high-tech stock numbers 5354 or 8589 (I wish to stress that there are no such listed companies with these numbers) when

the small investor has great difficulty understanding what technology is all about? I then realized that we have a huge investor education programme on our hands. This is what this lecture is all about. When you buy or recommend a company's shares, do you know what you are buying or recommending your client to buy?

There is no doubt in my mind that technology is transforming our lives, and the securities market, in ways that no one can predict with any certainty. It has unleashed a potent combination of demand for capital by entrepreneurs of the New Economy, and a large supply of investors wishing to participate in this social and economic revolution. Technology has outstripped the capacity of many societies, including the regulatory framework to cope with this rapid change. With more complex technology and knowledge, come greater opportunities as well as higher risks. Market professionals, investors, the Stock Exchange, and the regulator - that is, all of us - should take a hard look at the profound changes, so that we do not just focus on the good times, and forget to plan for what is around the corner.

By the third quarter of this year, when the new electronic trading system of the Stock Exchange AMS3 goes live, online trading in Hong Kong will be a reality. Once NASDAQ shares can be quoted in Hong Kong and further alliances with other regional and international exchanges are entered into, it is likely that an investor in Hong Kong will be able to buy and sell Hong Kong and global securities via their computer, mobile phone, or WebTV at home. Since even betting on the Hong Kong Jockey Club can soon be via the Web, it would not be untrue to say that potentially, we could have a 24-hour investing or gambling machine in every home via the Web.

The Securities and Futures Commission (SFC) as a market regulator should not stand in the way of growth. Indeed, we have tried to facilitate positive development wherever we could. There is no denial, however, that there are new risks. Hence the regulator has to walk a tight rope between facilitating change and investor protection.

In the area of technology, the speed of change is so fast and bewildering that, although most people are aware something important

is happening, we have difficulty understanding the full implications. Consequently, it is quite rational for many investors to wish to participate in this New Economy in any way they could. This wave of interest has created the current "tech fever" which is sweeping the US, Europe, Japan and now Hong Kong.

Hong Kong is not alone in facing these challenges and risks. The same concerns have arisen in other developed and emerging markets. The Technical Committee of the International Organization of Securities Commissions (IOSCO), which includes representatives of the securities regulators of all the world's major markets, has agreed to work together on an urgent basis to compare notes and to reach agreement on how to respond to the risks that we all perceive.

I recently went to the US to try to catch up on trends there. We at the SFC try to exchange experience and approaches with our fellow regulators and market participants internationally. I think it would be useful to share with you some of my personal views on what has happened so far in the securities market, and what implications the New Economy will have for investors, issuers, market intermediaries, exchanges and regulators.

The New Economy

Speaking as a former central banker, the recent rise in stock markets has both macro and micro origins. At the *macro* level, the world is awash with liquidity, ironically partly because of the Asian crisis, which caused a monetary easing in 1997-98 to prevent a global meltdown. Secondly, an aging population in OECD markets has increased investor interest in equities for their retirement savings. Thirdly, financial deregulation and innovation has created greater investor choice, improved intermediation and made markets more efficient and global. Fourthly, companies have become more efficient in the 1990s through greater competition, consolidation and merger, as privatization and technology have driven change.

But there is no doubt in my mind that technology has become a major driver of change. The Silicon Valley has been described as "the greatest legal creation of wealth in the history of the planet". Through changes in telecommunications, media and the Internet, and changes in capital-raising capabilities via venture capital and markets such as NASDAQ, entrepreneurs are now able to tap increasing resources for new ideas and new investments in technology. At no time in history have the financial markets been so friendly to small entrepreneurs with big ideas.

Currently, Hong Kong legislation will not allow small companies to raise capital from the public without the publication of a prospectus and a formal initial public offering (IPO) process. But technically speaking, some US companies have already gone direct to investors through the Web to raise their capital. What risks do these hold for both the investor and the issuer, if the traditional intermediaries, the stockbroker and the exchanges are cut out from the loop?

On the demand side, one worldwide trend is that technology is leveling the playing field for the small investor, giving him or her access to information previously available only to the specialist or the professional. The Internet has also enabled just about anyone to become an online trader. Add to these two factors increasing globalization, we can see that a small investor today has access as well as easy tools to trade in markets and financial products that the traditional investor never dreamt he or she could buy and sell.

Online trading has caught on rapidly in the US, accounting for nearly one quarter of trading on NASDAQ. But, who could have dreamt that Korean online trading, almost non-existent two years ago, could be almost as large as that of the US? Once Japanese, European and other Asian investors catch on, the global securities market will be a reality, not a dream.

What is happening, in essence, is that technology is empowering the masses. And we are only at the beginning. I am not sure where

this development would lead us, but I am certain the process to get there will have many new challenges.

One potential challenge stems from the fact that supply of shares in each IPO is usually very limited, while retail investors naturally want to have a piece of the action. A number of other regulators and market thinkers have related to me what they see as happening. The combination of limited supply and aggressive demand means share prices go up. Mix in an element of momentum trading and you get an explosion. As one Silicon Valley analyst said, "Dreams and greed were a potent combination".¹ As is the experience in other markets, initially it is the professional investors and retail day-traders who trade these high-risk stocks.

But when a company's market cap grows large enough, it gets included in an index. Then institutional investors start buying, many because they are required by law or by their own policies. In fact, traditional value-investing fund managers are being "punished" by the market for their low performance relative to these high fliers. Thus, when the prudent institutional investors and the high-risk day-traders both chase limited supply of high-tech stocks, this sends share prices to stratospheric levels. I am not sure how to go about proving or disproving this theory. We are raising it with people and trying to learn more. Obviously if it is true, there is some very explosive thermal dynamics going on. What goes straight up can come straight down. The last investor holds the losses.

A second worldwide trend, going hand-in-hand with the increasing impact of retail investors, is the increasing number of technology companies raising money in the securities market. This to some extent just reflects the fact that there are a lot of tech companies around. But tech stocks do often differ from traditional listings in some respects.

¹ David A Kaplan, "The Silicon Boys and their Valley of Dreams", 1999.

First, many technology companies come to the market much earlier than traditional companies and even before they have any record of earnings. This throws all existing pricing models out the window.

Second, technology itself is changing so fast that it is hard for anyone to judge whether a tech company will be the next Microsoft or the next bankruptcy. Statistics so far indicate that many tech companies do not make it. In the US, 75+% of venture capital investments fail, while roughly only one in 10 make money for their investors. In a sample of 1999 IPOs, 83% had negative earnings, but still witnessed price increases.²

Obviously as a regulator I cannot comment on the valuation of individual stocks, but it might be useful to sum up the current state of the market and quote a few facts and market comments on the subject of tech stocks:

- Current US P/E ratios are already well above the prior historical peak in September 1929;
- Japanese TMT (technology, media and telecommunications) market cap, mostly not included in the traditional index, is now 90% of the traditional Nikkei 225 market cap;
- The current rally in HSI, driven by interest in tech and telecom stocks, is already higher and faster than the previous boom with Red Chips in 1997 (Chart 1);³
- Out of 1,200 tech US IPOs over 18 years since the debut of the PC, 66 stocks or roughly 5% of the total are up 1,000+%, and have created 86% of the wealth;
- Analysis of IPOs in Hong Kong between 1992 and 1998 indicates that following first day's trading, the heavily oversubscribed stocks tend to under-perform the Hang Seng Index over a one-year period (Chart 2).⁴

² Steve Galbraith, Bernstein Research, March 14, 2000.

³ Source: Bloomberg.

⁴ Source: Morgan Stanley Dean Witter.

Markets move in cycles with the ebb and flow of supply and demand. New companies arrive with new technology and sometimes supplant old companies that cannot compete in the new environment. This time round the transition is faster and more turbulent, because of the new forces of supply and demand that technology has unleashed. But we can be certain one thing always remains unchanged - the market demands that eventually a company makes money. Sometimes, companies can delay making profits (and run short-term losses) if it delivers high growth in revenue, but ultimately it must deliver net earnings. As one seasoned Internet investor said, "I've gotten used to buying companies without earnings. I am not yet to the point of buying companies without revenues." If the market trusts that the company will eventually make money, the share price will rise, but the market is depending on trust. Confidence and trust are ultimately the bedrock of all markets, even for high-tech markets.

Role of Investors

Investors should remember that for companies without earnings and without track records, they are buying into concepts. Concepts are described in plans with words. If they have any physical existence, their value usually rests in intangible things such as entrepreneurship, good management and positive forecasts. They often are not embodied in tangible assets or operating businesses.

In other words, investors are placing their trust in concept stocks, essentially in promises and predictions. Each investor in a high-tech company owes a duty to himself or herself to understand what he or she is really investing in. US Securities and Exchange Commission (SEC) Chairman Arthur Levitt calls this "investing with your eyes open".⁵

⁵ Arthur Levitt, "Investing with Your Eyes Open", Los Angeles Times 4th Annual Investment Strategies Conference, 12 February 2000.

Will management deliver the promises of earnings growth? Management must ultimately deliver earnings. They cannot forever deliver concepts.

Moreover, just because an existing company adds "dot com" behind their name does not mean that it can become a high-tech growth miracle overnight.

Investors should also understand that increased availability of information has also led to information overload, information hype and misinformation. According to one observer, "On the Internet, any firm can look enormous, research can sound credible, individuals can seem qualified, all without any real foundation".⁶ In short, "in cyberspace, it is easy to be larger than life". No wonder that many US Internet companies spend a fortune in advertising and hype.

Some analysts suggest that you need to ask several simple questions when investing in a high-tech company:

- Where is their market and are they focused in their business?
- Can they make profits from this business? What are their margins?
- Do they have proprietary technology - in other words, can someone duplicate their technology easily and take away their business?
- Will they get paid? Everyone wants to use the Web, but so far few people pay for these services.
- Do they have strong and reputable management?
- Are they backed by the right groups, such as venture capitalists with track records?

Basically, what I am saying is that an investor must at least understand what he or she is getting into - "know what you are buying". No one is trying to stop an investor wanting to get rich by investing in concept stocks or following IPOs. These carry high risks. Remember that if you might get rich quick, you could also lose quickly.

⁶ Barbara Perrier-Dreyer, in Technology Roundtable, US SEC, April, 1998.

A prudent investor must manage his or her risks. In horse racing, no one begrudges an adult from punting his pocket money at the Hong Kong Jockey Club. But everyone would feel very sad if the same person bets away his housekeeping money, or savings for his children's education or his retirement. The same must hold true for the average investor. You should understand exactly how much you are prepared to allocate in concept stocks. Don't blame anyone else for losses, if you follow stock tips blindly or just chase a number.

Moreover, buying on margin may look easy, but leverage increases risks considerably. You are betting your future on borrowed money. As Chairman Levitt says: if you use borrowed money, you may double your money, but you can also double your losses. If you are in doubt on what to do, seek the advice of a qualified investment advisor. There is also an increasing number of investor education programmes available on the Web.

However, investor education has tended to focus on the buy side. There is a need to think through the sell side too. The converse of "know what you are buying" is "know what you are holding and when to get out". Investors should keep a close eye on companies' efforts at turning concepts into businesses and delivering on their promises. If you are uncomfortable, you could vote with your feet. Perhaps old wisdom contains the simplest truths. "It never hurts to take profits and diversify". And "greed is the most common source of downfalls".

Role of Issuers

We noted earlier that investors are placing their trust in the issuers' promises and predictions that their business plans would eventually bring profits.

Issuers should take this trust seriously. They are able to raise capital because investors believe in their creativity, diligence, and business acumen. For those who have good track record, their reputation is at stake. All their skills should be applied to materializing concepts and delivering on promises. Many have also been rewarded with share option schemes to induce performance.

My father used to say that there are three ways of making money. The first way is through blood, sweat and tears. Most small entrepreneurs make it this old-fashioned way. When you reach a certain stage of success, money makes money. Finally, your name makes money. Since many small investors cannot distinguish one technology from the other, it is not surprising that they go for those with good names and reputation.

What I am saying is that for the issuers, raising public money carries public responsibilities. If things do not work out despite a lot of honest, hard work, then no one could be blamed. But if the controlling shareholders and management abuse the trust placed on them, misuse the capital given to them to turn concepts into real businesses and instead divert or squander it for private benefit, then they have wronged their investors. This will not be tolerated.

The public and the regulatory authorities should be vigilant against potential fraud and manipulative behaviour. On our part, we will do our best to work with the Hong Kong Exchanges and Clearing Limited (HKEx), the Commercial Crime Bureau of the Police, and if needs be international regulatory bodies, to minimize financial fraud and crime.

Incidentally, the fact that investors have placed their trust on the issuers implies more than requirement of faithful efforts to materialize concepts and deliver on promises. It also implies an obligation to keep investors informed. The main objective of financial reporting is to provide reliable, decision-useful and timely information to shareholders and prospective shareholders so that they have a sound basis for investment decisions.

To strengthen the sanctions against false or misleading information, there is now a Bill before the Legislative Council (LegCo) that creates offences for anyone who provides the SFC and the recognized exchanges and clearing houses false or misleading information. The Composite Bill, which will be published for public consultation next month and is expected to be put into LegCo before the end of the year, will contain a number of provisions aimed at strengthening corporate disclosure. Our legal framework has to ensure that issuers and management do not provide bad or misleading information.

Role of Intermediaries and Market Professionals

Intermediaries and market professionals are part of the trust relationship too. They do not just intermediate transactions of money and securities. They also disseminate information as well as provide outside checks on issuers and management.

Intermediaries obviously have a major role, providing financial advice as well as a lot of market and other information. Investment bankers and securities houses make recommendations on investments. Independent auditors express their opinion on the true and fair view of financial statements, which are essentially objective assessments of the state of play in materializing concepts and delivering promises. Lawyers perform due diligence on the veracity of statements in public issue and other documents. Professional appraisers provide an outside opinion on valuation of assets. Responsible investment advisers and brokers explain to their customers what risks their clients are entering into.

As I indicated earlier, concept stocks raise particular problems in valuation. They raise difficulties for accountants who may have to express an opinion on the business plans of companies. I earlier mentioned use of options as incentives for management performance. But as US Federal Reserve Vice Chairman Roger Ferguson has

observed, in many cases options are not being recorded as compensation at the time they are granted. They estimate that the value of these options would translate into a 10 percent reduction in the income of S&P 1500 companies. This vividly shows how important accounting treatment is as a measure of economic value.

The SFC has noted on some occasions where valuations seem inflated. It has therefore asked the issuer to ask their valuation experts to disclose the basis for valuation, so that the public can judge for themselves whether these methodologies are credible. The SFC is now working with the Hong Kong Society of Accountants' Financial Accounting Standards Committee to examine the basis for valuation of interests in high-tech companies. These are important work in progress.

Because of the expertise of market professionals, investors place their trust on these professionals as much as on the issuers. They are charged with a duty of due care and should take the trust placed on them seriously and perform their jobs ethically, diligently, and properly. So much of the small investors' savings is at stake.

Role of Exchange and Regulator

The Stock Exchange, as the first-line regulator of listed companies, and SFC as the statutory regulatory body, also have a role. We have become more and more aware that those elements of merit-based regulation in our system must move towards increasingly disclosure-based rules.

In the Main Board, investor protection is achieved through listing rules that allow only companies with track records to offer their securities to the public. This serves essentially as a gatekeeper function. For issuers on the Growth Enterprise Market (GEM), however, with less than two years of track record and no profit record, the future of these companies is more uncertain, and the risks for their shareholders

much higher. So we have to rely more on disclosure and the role of sponsors, that is, professionals who should be able to judge the quality of companies better than the layman. It is also why investors have to sign risk statements when they trade on the GEM market.

Listing of high-tech stocks on GEM has sometimes been compared with listing on NASDAQ. And some people see a degree of regulatory competition, in that issuers argue they will list in NASDAQ unless the conditions for listing on the GEM are waived or relaxed to be comparable with NASDAQ or US regulatory standards. This argument misunderstands the differences between Hong Kong and US regulatory approaches. In the US, all corporate disclosure statements and financial accounts are filed with the SEC, which, incidentally, also has oversight over the accounting profession. Disclosure of false or misleading information to the regulator is a criminal offence. The US regime also carries significant fines for misconduct. Moreover, their legal system allows private class action, with potential for monetary awards at three times the actual damages suffered. These potentially financially crippling lawsuits, made easy and accessible to minority shareholders by contingency legal fee arrangements, are a critical link in the US approach to deterring poor disclosure, bad management and misleading information. In Hong Kong, our enforcement tools and regulatory framework are still under debate and evolving. Hence, the risks for the uninformed and uneducated investors are higher.

Moreover, NASDAQ is a developed market, with many experienced professionals and seasoned day-traders in the business. Hong Kong is still largely a retail market, with many small investors being neither experienced nor educated in dealing in volatile concept stocks.

For these reasons, it is not surprising that the Commission views with caution arguments for waivers of regulatory conditions for listing. The Commission will work closely with the HKEx to improve on the regulatory framework that will not discourage small growth enterprises

from listing in Hong Kong, while balancing it with the need for adequate investor protection.

Helping small growth enterprises, including high-tech companies, raise capital to turn concepts into real businesses is the very purpose of GEM. Small and medium enterprises have been the bedrock of Hong Kong's success. Big companies are built from small ones. High tech does not change the value in entrepreneurship. Personally, I am confident that GEM, with its mission to facilitate the nurturing of this spirit, will play a positive part for Hong Kong.

There is one area where Internet time will not wait for regulatory reforms. The million or so investors who have queued regularly for IPOs will find electronic access to IPOs much more user-friendly. The SFC and HKEx have set up a task force to push ahead on this front. First, sometime this year the fully automatic exchange trading system AMS3 will go live. Online trading creates a whole new set of challenges for the brokers in their executorial capabilities, capacity and advisory skills. It also provides instant trading opportunities for investors as well as instantaneous risks.

Accordingly, the Commission will work closely and urgently with HKEx and Hong Kong Securities Institute (HKSI), as well as the securities community, to develop investor education programmes on the rules of the game for online trading. We put out materials on these issues regularly and you will find us increasing our efforts further. Some advice on day-trading was just published on our Website last week. By mid-year, our eIRC (electronic Investor Resources Centre) will be launched, to bring better investor education information to the public.

Our role is to maintain a level playing field and to regulate the trust relationships mentioned earlier. We will continue to conduct surveillance for manipulative activities or unfair trading. We will push for full and timely disclosure by issuers. And as explained earlier, if an issuer or its management abuses the trust investors have placed on

them, diverting capital from efforts to materialize concepts and to deliver on promises for private benefit, the SFC, the Stock Exchange, and the Commercial Crime Bureau of the Police will be there with all the legal and enforcement powers available to us.

Conclusion

Technology has changed our lives and the securities markets beyond recognition. It is not the role of the SFC to prevent investors trying to make money, nor inconvenience issuers from access to capital. However, the Commission is charged with maintaining fair, transparent and efficient securities and futures markets. It is our duty to provide as much protection for the investing public as the law permits us. But the best protection is an informed and knowledgeable investor. We will do our best to remind everyone of the risks and devote greater efforts to investor education. In this area, we will have to work much more closely with HKEx and HKSI.

Technology may have created the New Economy and changed market dynamics. But it has not changed the fundamental functions of the securities market:

- IPOs help entrepreneurs raise capital to invest in businesses that yield a return for their shareholders;
- Shareholders expect the entrepreneurs to be honest, dedicated, transparent and fair in delivering value for their investors; and
- Investors expect markets to be fair, transparent and efficient.

Guiding everything is the Principle of Trust and Confidence. If issuers maintain the trust of investors by delivering on promises, if we maintain fair, transparent and competitive markets, then the trust and faith in Hong Kong as an international financial centre will be maintained. Technology can change overnight; trust and confidence of investors are not built overnight, but they can be lost overnight.

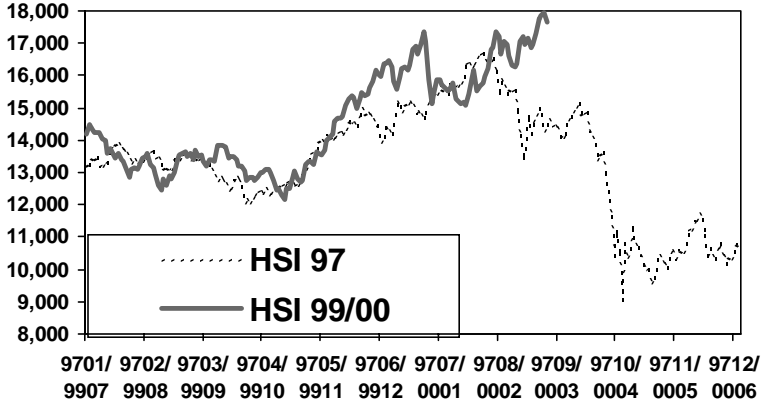
The potential of the New Economy is huge and Hong Kong should be in the forefront of that growth. The Commission will help to facilitate and support that growth, which will bring opportunities and jobs for our citizens. But every society has to balance the need to innovate and the need to regulate. Regulators cannot prevent every accident or every financial crime. In a society governed by the rule of law, regulators can only regulate according to the powers and resources given to them by the people. There are limits to what regulators can do.

Speaking as a former central banker, I have always liked what former US Federal Reserve Chairman William McChesney Martin said, "The job of a central banker is to take away the punch bowl just when the party gets interesting." Everyone likes to join a party, but no one likes to clean up the mess. As the "drink don't drive" campaign says, the best party is when everyone enjoys themselves and knows their limits. When you invest in the New Economy, understand the risks and know your limits.

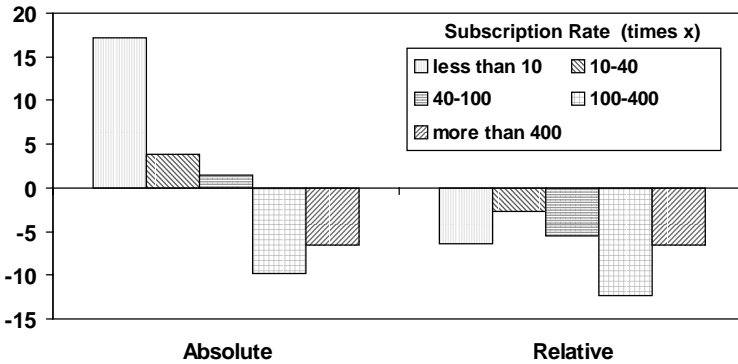
To sum up, we all have a role in making sure that our markets are vibrant, open, fair, competitive and efficient. But the Commission cannot achieve this without the active cooperation and support of the securities and futures industry and more importantly, our community at large, because the regulator can only function effectively within its powers and authority delegated to it by our community. This is the trust that the Commission has been given, and we will do our best to fulfill that public trust, as openly and fairly as we would expect of those under our supervision.

Chart 1: HSI 1997 vs. 1999/2000

Source: Bloomberg



**Chart 2: Performance of IPO from 1992 to 1998
(1-Year from 1st Trading Day, %)**



Remarks: Absolute refers to stock prices vs. IPO issue prices;
Relative refers to stock prices vs. HSI

Source: Morgan Stanley Dean Witter