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The Next Step Towards More Liquid GCC Markets

Liquidity Defined

Stock market liquidity can be broadly defined as the ability to execute large volumes of trading with ease and without disrupting or causing price volatility. Liquidity also leads to price discovery and enables fair valuations of listed securities. The advantages of having a liquid market are many as it essentially gives investors the ability to enter and exit positions with minimal hassle and reduced risk. Liquid markets are generally characterized by the following key features:

Breadth refers to the bid/ask spreads which dictate the cost of reversing a position over a short period. The tighter the spread is the easier it is to enter and exit the market at the lowest possible cost

Depth is the availability of multiple bids and offers that will protect the market from wild swings resulting from the execution of large orders.

Resilience is the ability of the market to quickly recover from swings in prices resulting from large orders or other short-term shocks.

Given the importance of maintaining a liquid stock market, we believe that exchanges, regulators, and capital market participants in the GCC and MENA can take further actions to enhance liquidity and improve their efficiency of trading which will in turn help to attract more investments and stimulate economic growth across the region.

As a case in point, we can identify two main areas that GCC exchanges and regulators can focus on to further grow market liquidity:

• Promoting the development of a diverse investor base with a focus on attracting local and international institutional investors through liberalization, the relaxation of regulatory barriers and most importantly investor education and protection.

• Increasing the pool of securities and associated financial products by increasing the number of local listings, launching derivative and ETF products, and creating market linkages.

To enable the above to work effectively, it is very important to ensure that the size of the free float is sufficient enough to encourage trading from a diverse base of investors.

Liquidity is a Win-Win for All

- **For investors** liquid markets mean lower costs of trading and the ability to move in and out of an asset class within a short period of time
- **For issuers** it means attractive market entry as the cost of raising capital improves
- **For exchanges** it means greater market access, greater investor confidence, and the ability to attract new stakeholders resulting in increased revenues
- **For economies**, the ability of companies to raise funds increases local and foreign investments in those economies thus resulting in greater productivity and increased employment

The Important Role of Market Maker and Other Forms of Liquidity Provision

It is fair to say that Market Making is still in its nascent stages in the GCC and much work needs to be done before it can be truly effective as a liquidity enhancer. . It is also interesting to note that 'own book market making' has been in place in markets like Bahrain where SICO has acted as a market maker since 1996, long before the concept was regulated. The practice has evolved over the years in the absence of hedging tools, as market operators like SICO have adopted a modified version in the form of Liquidity Provision schemes that encompass all the features of a standard market making program.

Market Making

A market maker commits their own capital to provide liquidity for a stock or a group of stocks. The operator under this arrangement profits from the bid/offer spreads as a result of investor's trading activities. There is also another P&L element resulting from the inventory the market maker maintains which may rise or fall in value depending on stock prices.

Various GCC markets have recently introduced Market Making programs as part of their overall revamp of the capital markets and some of these coincided with the inclusion into the major Emerging Market indices. Widespread adoption of these programs has yet to pick up but we expect them to gain momentum once market participants have had a chance to evaluate the positive outcomes.

Liquidity Provision

This is an arrangement between an issuer and an operator acting as agent to provide liquidity with absolute discretion at an arm's- length basis. Liquidity provision follows the principle of a quote driven market whereby multiple bids and offers are sent to the market as well as maintaining minimum market presence throughout the day.

GCC regulators have set forth regulations that govern the relationship between the issuer and the liquidity provider to make sure the liquidity provider focuses on the only key requirement which is providing liquidity and to abstain from any attempts to manipulate prices. To this end, caps have been introduced on the holdings under such an arrangement which ranges between 3-5%. The shares held in the liquidity provision programs are considered part of the Treasury shares in some GCC markets hence do not qualify for corporate actions such as dividend.

Key misconceptions

Why share prices don't always rise in the presence of a liquidity provider?

The liquidity provision mandate and the related market regulations clearly define the role of the liquidity provider as actively engaging in providing continuous bids and offers to increase the depth of the market, minimize price spreads which will encourage investors to actively trade. The liquidity provider is to have full discretion on the portfolio, thus working independently and free from pressure from the issuer. The regulation is therefore, very clear on the role of the Liquidity Provider which is providing liquidity to assist with the price discovery while steering away from manipulating prices.

While deep liquidity provides strong ground for price discovery and fair valuations, other factors such as investor appetite, financial position and performance as well as the level of disclosures also have a significant impact particularly for long term investors.

We strongly believe that a strong investor relations program also plays a major role in supporting price discovery and yields better results. Investor relations in our part of the world is gaining momentum and has become an important ingredient that helps investors understand companies beyond the published financials and other disclosures. Potential investors need to better understand the current and future road map of listed companies and the strategies that they will utilize to meet their goals, as it creates an open forum between investors and management to address current and potential investor concerns. Regulators have been actively engaged in the promotion of IR highlighting its importance as a bridge between investors and listed companies. The Bahrain Bourse for example has recently introduced their Investor Relations Best Practice Guide to help listed companies on the bourse adopt best practice and highlight the importance of investor relations on the valuation and the overall competiveness of the market.

Research is also a great tool to help listed companies enhance their IR campaigns and attract sophisticated investors who tend to look beyond the numbers and want to engage with management to better understand strategy and its impact on future earnings.

What is better for stock prices? liquidity provision or market making

The answer to this question lies in the liquidity of a given stock. In order to stimulate liquidity we strongly believe a Liquidity Provision (LP) program is the answer given that its characteristics and regulatory requirements have more presence in the market. A sample of the most important regulatory requirement imposed on a liquidity provider as follows:

- to maintain a certain participation rate among top orders

- to post multiple bids/offers of a certain number and value through the trading session
- to maintain presence for a minimum time during the trading session

Considering these requirements, it is very clear that MM have much less presence in the market; MM need to post one bid/offer versus multiple bids/offers under LP. Also Market Makers are more likely to pull out of the markets if conditions turn negative which can affect their P&L.

In the early cycle of the market developments, we believe Liquidity Provisions are more suited as a tool to increase market depth and more importantly maintain it for some time. Further down and with the development of these markets and the introduction of hedging tools the Market Making programs will become a viable option for participants because hedging will help these players mitigate risks