MEASURING THE COST OF EQUITY OF EMERGING MARKET FIRMS: THE CASE OF MALAYSIA

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ABSTRACT

Valuation in an emerging market like Malaysia poses to be a great challenge because there is no clear single 'best practice' for the valuation of assets and securities in emerging markets. Adopting some of the emerging market models reviewed in Pereiro (2001), together with the two-factor CAPM models proposed in this study, we make a comparison between standard risk measures and downside risk measures to estimate the cost of equity of Malaysian firms over the period of 2000–2007. Overall, the results are consistent with the literature which supports downside risk measures over standard risk measures. Also, our model, which considers both local and global risk factors, has higher explanatory power than models that consider only one kind of risk factor. Most importantly, the results show that unsystematic risks, or firm-specific risks, may have increased in recent years.

Keywords: CAPM, cost of equity, downside risk, firm

INTRODUCTION

The full impact from the worldwide recession triggered by the US subprime mortgage crisis in 2008 was felt in Malaysia in the first quarter of 2009, when the country’s economy contracted by 6.2%. In the third quarter of the same year, the contraction slowed to 1.2%. The improvement has been driven primarily by domestic demand, and its role in the economic recovery is expected to continue into 2010. The Malaysian government realises the important role of domestic demand, and one way of promoting it is to promote domestic investment activity. To make sound investment decisions, investors need valuation practices that are