A COMPARATIVE ANALYSIS OF THE TRANSACTION COST AND RETURNS IN THE NIGERIAN MONEY AND CAPITAL MARKETS

(A case study of stocks and treasury bills)

BY

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DECLARATION

I declare the work in the thesis entitled "A comparative analysis of the transaction cost and returns in the Nigerian money and capital market – a case study of stocks and treasury bills" has been performed by me in the Department of Economics. The information derived from literature has been duly acknowledged in the text and list of references provided. No part of this work was previously presented for another degree or diploma at any university.

~~Abdulazeez Olatunji Akowonjo~~ ~~Date~~

CERTIFICATION

This thesis"A comparative analysis of the transaction cost and returns in the Nigerian money and capital market – a case study of stocks and treasury bills", by me Abdulazeez Olatunji Akowonjo, meets the regulations governing the award of the degree of Master of Science (in Economics) of Ahmadu Bello University, and is approved for its contribution to knowledge and literary presentation.

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DEDICATION

This research work is dedicated to my wife Omotayo and our beautiful children – Rukayyah and Naeem Akowonjo.

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ABSTRACT

Financial intermediation is believed to play a significant role in both developed and developing countries. The economic significance of financial intermediation results from the special role it plays in making contractual arrangement that link borrowers and lenders efficiently. Every day in the Money and Capital Markets, individuals and institutions must make important financial decisions. Lenders of funds must make decisions on when and where to invest their limited resources, considering such factors as risk, marketability, and expected return on securities available in the financial market place. This need to be able to make a rewarding financial investment decision resulted in our attempt to carry out a comparative analysis of transaction cost and returns in the Nigerian money and capital market with specific focus on stocks and treasury bills. In doing this, we compared the dividend yield yearly average to the treasury bills yearly average for the period between 1980 and 2009. We also carried out a survey to capture the impact of other factors such as bonus shares, capital gain as well as right issues (which were not factored into the yearly averages for treasury bills and stock returns). From the analysis, we found that though transaction cost is higher in the capital market when compared to the money market, returns is also higher during the post consolidation period (2005 – 2009). In addition, the research also revealed that transaction cost is higher in the secondary capital market than in the primary capital market.

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CHAPTER ONE

1.0 INTRODUCTION

Financial intermediation is believed to play a significant role in both developed and developing countries. The economic significance of financial intermediation results from the special role it plays in making contractual arrangement that link borrowers and lenders efficiently (Williamson, 1987). The financial system is said to be very important and plays a fundamental role in the growth and development of any country. Schumpeter (1911), Goldsmith (1969), McKinnon (1973) and Shaw (1973) have linked the financial system to economic growth through the intermediation activities in the money and capital markets. The financial markets provide funds: for governments (Federal, State, and Local) with which they finance high capital-intensive projects such as the construction of factories, highways, schools and so on at some time, and at other times it serves as an avenue where government can make available their surplus funds for others to use at an interest or gain; for companies the financial market makes it possible for them to raise funds to finance the purchase of new and better equipments, build new branches, take advantage of emerging new opportunities in the market etc., when they otherwise would be unable to finance such projects. There are also times that the companies have excess funds; the financial market makes it possible for those who need more money than their current income access excess fund at a price. And for individuals and households, it is an avenue whereby they can invest when they have excess funds, and liquefy their holdings when they are in need of money.

Fuller and Farrell (1987) define the securities market as “a mechanism bringing together buyers and sellers of a particular type of security or financial asset”. According to them, “securities represent a claim on an asset and any future cash flows the asset may generate”. Whereas most money market instruments are documents certifying that the investor will receive a certain principal and interest payments on a pre-specified date in the

future, a stock is also a document certifying that the investor owns a specified number of shares of a particular company and therefore is entitled to cash dividends and other financial benefits. This, according to Jones (1998) explains why stocks and treasury bills are the most prominent forms of securities used in financial transactions. It is this argument that informs the notion that to understand the investment game is to understand the stocks and treasury bills markets.

As Fischer and Jordan (1995) puts it, "an investment is a commitment of funds made in the expectation of some positive rate of return. If the investment is properly undertaken, the return will be commensurate with the risk the investor assumes" From this standpoint, one can opine that for any capitalist economy to function properly, a strong, reliable, and dynamic financial market must exist to fuel the economic machinery. The financial market propels the economy by channeling funds from individual as well as institutional investors to the most productive sector of the economy. Because of the market's ability to allocate resources optimally, they allow both government and businesses to raise needed funds by selling securities.

When excess fund is available, the length of time that such funds can be owed to the provider will depend on when the provider will need it. This means that if the provider will need it soon after it is considered and provided as excess fund; only bodies that need funds for short-term purposes can borrow it. For long-term projects, borrowers of funds will seek long-term funds providers. This explains the reason for the money market, which is a place or mechanism whereby funds are obtained for short periods of time (from one day to one year), and financial assets representing short-term claims are exchanged; and the capital market on the other hand is designed to finance long-term investments by businesses and governments such as the execution of highly capital-intensive projects.

Whether funds are available for borrowing or not, depends on whether excess funds owners supply excess funds to the financial markets or not. This in turn depends on whether there exists the required incentive for the excess funds owners to make such funds available or not. It should be expected that if there are no incentives, excess funds owners would rather keep their monies than make them available.

In the financial market, there are different kinds of financial instruments either in the capital or money market each with its expected costs and returns; therefore, the choice of which securities one should invest in is an important one. According to Ross (1989), everyday in the money and capital markets, individuals and institutions must make important financial decisions. Lenders of funds must make decisions on when and where to invest their limited resources, considering such factors as risk, marketability, and expected return on securities available in the financial market place.

Henin (1996) posits that a financial market is a place or mechanism for the exchange of financial assets. As in most markets, these financial assets are purchased and sold for money, but, unlike goods and services, these financial assets are not consumed; they are claims that enable their holders, upon disposing of claims, to obtain consumable goods and services.

A vibrant financial market is one in which there is strong healthy competition by the various segments of the market. The depth of its activities breeds creativity in both the design and marketing of capital market products, and creates opportunities for investors to choose from a basket of investment options beyond the basic choice between treasury bills and stocks. One of the most important decisions that an investor faces therefore, is the ability to avoid the numerous pitfalls that are associated with financial investment. And one of the ways by which this can be accomplished is by clearly understanding what the investor can expect to derive from investing in financial assets, and the associated risks. In answer to the

question why do we invest? Jones (1998) asserted that "we invest to make money—improve our monetary wealth, both current and future". In other words, since cash has an opportunity cost, and the purchasing power of cash diminishes over time, investors invest their surplus funds in order to constantly add value to the invested sum. They do so by choosing from a wide range of securities in an attempt to maximize the anticipated returns from the chosen investment.

1.1 STATEMENT OF RESEARCH PROBLEM

While some may believe that money market investments is better in the sphere of financial market investment, partly because investors are sure to get back their capital plus interest on capital, many others patronize the market without exactly knowing that they are participants in the market. They therefore act passively where they should normally act strategically. This can be said to follow from their knowledge inadequacy as to the opportunities and costs in the given market, and the financial market as a whole. In terms of returns, some of the others believe that the capital market instruments produce more returns to investors. However, one cannot be certain about the correctness of any of these positions without closely looking at and evaluating the costs and returns components of the markets.

Another issue worthy of note is that the Nigerian financial market has both the primary and secondary markets where "securities" can be bought and sold. The choice of whether to buy and sell in the primary or secondary markets has great implications on cost and returns on the financial investment. In terms of cost, the purchase of stocks for example has an associated cost element of delayed issuance of share certificate. The cost effect of this delay is that the shareholder cannot sell his shares when he otherwise would have; when share value appreciates before certificates are issued.

Though purchase of stocks in the primary market does not attract any explicit cost in form of brokerage fees, the inconvenience and possible capital loss during the certificate delivery delay could amount to more than the fees payable in a secondary securities market. The problem is that investors and potential investors may transact in one market instead of the other thereby leading to capital loss or a situation where more is added to costs than returns.

Babalola and Adegbite (2001) reported that In the Nigerian capital market, cost of transaction is high when compared to those of other emerging capital markets. The costs which an average investor would have to meet in the course of raising funds includes: brokerage fees, stamp duties, and other charges that may be imposed by the Securities and Exchange Commission (SEC), apart from other fees payable to stockbrokers. Therefore, the cost of going public, raising additional equity or obtaining loan facility from the capital market is high. It has been estimated that the cost of raising US$ 1 million equity capital in the Nigerian capital market is about 4 per cent of the value, whereas, the cost of raising the same amount in Kenya and Ghana is 2.35 and 2.3 percent, respectively. Additional costs come in form of taxes among others. Currently in Nigeria, there is income tax, capital gain tax, withholding tax and company income tax. All these taxes together further increase transaction cost in the capital market and have the tendency of retarding investment because of their burden on investors.

Most investors and indeed potential investors in the Nigerian money and capital markets do not have adequate information as to be able to critically compare money market investment to the capital market investments in terms of transaction cost and in terms of returns which could lead to adverse selection and eventual capital loss on their part.

The fundamental questions this study seeks to answer therefore are:

1. What is the nature of the transaction cost of, and returns on buying and selling stocks in the Nigerian capital market?
2. What is the Nature of the transaction cost of, and returns on buying and selling treasury bills in the Nigerian money market?
3. Comparatively, judging by transaction cost and returns, which of these two markets is better to invest in?

1.2 OBJECTIVES OF THE STUDY

The broad objective of this study is to compare the money and capital market investments in terms of transaction cost and returns. The specific objectives are as follows:

1. To determine the transaction cost of, and returns on buying and selling stocks in the Nigerian capital market.
2. To determine the transaction cost of, and returns on buying and selling treasury bills in the Nigerian money market
3. To determine which, of these two markets, is better (in terms of transaction cost and returns) to invest in.

1.3 JUSTIFICATION OF THE STUDY

An investor is concerned in his choice of investment portfolio, about risks, rates of returns and consistency in performance, dividends and capital gains. In order to accomplish these objectives, the investor must begin by examining and analyzing every investment opportunity that is available. Over the years it has been commonly assumed that stocks offer higher returns on investment in the long run Very little has therefore been done by way of comparison to determine the relative strength of treasury bills yield and stocks, aside from its traditional status as a secure instrument (Umoren).

In the light of the forgoing and in the light of the importance of transaction cost – returns knowledge for any meaningful investment, the need for a comparative study of the money and capital market instruments in terms of transaction cost and returns cannot be overemphasized.

Also, though there are a number of studies that distinguish among the different markets and their instruments in the United States, Europe and parts of Asia. Such studies identify specific relationships between stocks and treasury bills in terms of periodic returns on investment. But even this class of literature is quite limited in Africa in general and Nigeria in particular. The literature on the Nigerian capital and money market is scanty, and only few so far address the issue of comparison of the different markets and their instruments. Thus, scholars and students of finance agonize over the dearth of literature on the subject. It is believed that this thesis will add to the needed literature on the subject of treasury bills and stocks in Nigeria.

CHAPTER TWO

AN OVERVIEW OF THE NIGERIAN FINANCIAL SYSTEM

The Nigerian financial system comprises of enabling regulations, regulators and markets (formal and informal with the formal markets comprising of the money market, the bond market and the stock market). The overview reviews the regulations and regulators and the markets

2.1 FINANCIAL MARKET REGULATIONS AND REGULATORS

In the financial market, there are regulators in both money and capital markets. However, the CBN, as first among such regulators, is president of the financial market. The CBN takes some fundamental decisions which impact on both money and capital markets.

The legal and regulatory environment plays a pivotal role in the smooth operation of the financial sector and in the efficient management and integration of capital flows and domestic savings. The value of the claims of financial institutions on borrowers is dependent upon the certainty of legal rights, coupled with the predictability and speed of their fair and impartial enforcement. Legal and regulatory frameworks that empower the regulator and govern the conduct of market participants form the cornerstone of the orderly operation and development of the financial sector.

To encourage financial sector development, the legal and regulatory environment should provide a framework that enables the development of sustainable markets, facilitates monitoring and enforcement of rules, and ensures investor protection. Accordingly, a well-functioning system combines a repertoire of up-to-date laws and regulations backed by strong institutions with effective monitoring and enforcement mechanisms.

2.1.1 The Central Bank of Nigeria (CBN)

The regulatory functions of the CBN are mainly directed at the objective of promoting and maintaining the monetary and price stability in the economy. To perform this regulatory function CBN formulates policies to control the amount of money in circulation, control other banks and major players in the financial market, control rates of banks credits and therefore the supply of money in the economy. The instruments used by CBN to achieve these functions are:

Open Market Operation (O.M.O), Bank Rate, ,Rediscount Rate, Direct Control of Banks' Liquidity, Direct Control of Bank Credit, Special Deposits, Moral Persuasion, Minimum Cash Ratio

2.1.2 The Securities and Exchange Commission (SEC)

The existence of securities markets is an important element in the financing of a modern economy. Given their central role in the financial sector, their regulation is fundamental to a country's financial sector development efforts as a tool of ensuring the stability of the financial sector, ensuring investor protection, thereby engendering investor confidence, and facilitating an economy's integration with international markets.

Capital market regulation models differ widely across Africa as legislation and regulatory structures vary between jurisdictions, reflecting both local market conditions and varied historical backgrounds. In some countries, capital market regulation falls in the realm of the central bank's regulatory powers; in others, it is within the regulatory prevue of the ministry of finance or an independent securities commission or authority; yet in others, the regulatory role is given to another ministry or office of the state, or to an exchange itself, as a self-regulatory organization.

The core principles of securities regulation (Core Principles), developed by the International Organization of Securities Commissions (IOSCO), are recognized as the key

global standard for securities regulation. Given the wide variation in levels of capital market development, the IOSCO Core Principles identify three key objectives which "form a basis for an effective system of securities regulation", and namely: (i) the protection of investors; (ii) ensuring that markets are fair, efficient and transparent; and (iii) the reduction of systemic risk.

An effective regulatory framework for capital markets thus includes powers for licensing and monitoring market participants and enforcing trading rules and procedures, the ability to undertake trading surveillance, and powers to impose sanctions against market abuse or manipulation. In addition, it includes legal provisions to deal with corporate governance, accounting standards, ownership, transfer of securities and capital adequacy requirements. The current financial crisis has cast financial market regulation under the spotlight. The cost and complexity of regulation needs to be balanced with the level of development of the market while being cognizant of the country's regulatory capacity.

The Commission's functions could be summarized thus: to protect the investor's interest and thereby enhance their confidence in the capital market, and ensuring orderly and equitable dealings in securities business. Also SEC is to promote capital market development and growth, and may order the certificate of a capital market operator to be withdrawn and such market operator to be disallowed from carrying on any capital market functions, if it is in the interest of the public to do so.

2.1.3 The Nigerian Deposit Insurance Corporation (NDIC)

Deposit insurance system are largely established to protect the banking system against possible bank run (unrestricted demand for cash by savers) that can cripple the financial intermediation process, disrupt the payments system, and have severe macro-economic effects (Mass and Talley 1990). These systems (i.e. implicit formal and explicit informal deposit insurance schemes) also protect small depositors from losses in the event of

bank failure and give the nation a formal and consistent mechanism for resolving failing bank situations.

The establishment of NDIC was informed by economic circumstance under the Structural Adjustment Programme (SAP), especially policies relating to banks shareholders support, and because of the bitter experience of previous bank failures in Nigeria and the lesson of other countries with bank deposit insurance scheme (Ebhodaghe 1991).

The NDIC was established by Decree No. 22 of 1988 and charged with the following responsibilities.

(a) Insuring all deposit liabilities of licensed banks and such other financial institutions operating in Nigeria so as to engender confidence in the Nigerian banking system. Certain deposit liabilities are exempted insider deposit (i.e. deposits of staff), and counter-claims, where a customer uses one type of account to collateralize another account.

(b) Giving assistance in the interest of depositors, in case of imminent or actual financial difficulties of banks, particularly where suspension of payments is threatened and avoiding damage to public confidence in the banking system. Such assistance could be (1) taking over the management of a distressed bank. (2) specific changes recommended to be made in the management of the distressed bank (3) a merger with another bank is carried out.

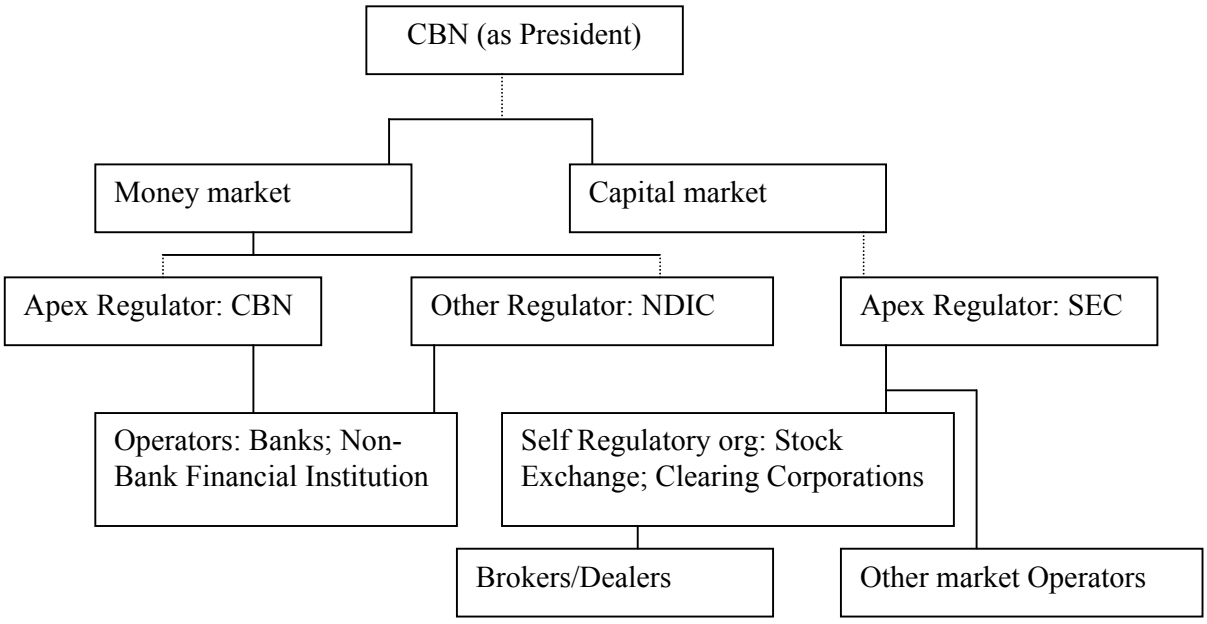
(c) Guaranteeing payments to depositors in case of imminent or actual suspension of payment by insured banks or financial institutions up to the maximum amount of N50, 000 of assessable deposit of an insured bank in the event of the failure.

(d) Assisting monetary authorities in the formulation and implementation of banking policies so as to ensure sound banking practice and fair competition among banks in the country. The corporation has made significant impact in two areas – the development of bank directors and top management staff and assistance to insured bank experiencing liquidity problem.

Since its inception, NDIC has contributed significantly to the budget of the Financial Institutions Training Centre (FITC). In 1989, the sudden withdrawal of government funds from the licensed banks to the Central Bank of Nigeria brought the nascent institution into focus when the NDIC/CBN jointly organized accommodation facility was introduced to assist banks in serious liquidity crises. Financial assistance amounting to N2.3 billion was provided under the scheme.

More so, the importance of NDIC was brought to focus in 1994 and 2006 when more than half of the nation's banks and other financial institutions were submerged in distress and the bank consolidation exercise of 2004 – 2005 respectively.

Fig: 2.1 Financial market Regulation



2.2 THE MARKETS, FINANCIAL INSTRUMENTS AND PLAYERS

The Nigerian financial market comprises of a money market and a capital market. Whereas the former is a market for short term financial investments, the later is a market where long term financial instruments are traded.

2.2.1 The Money market

Different authors have defined these in different ways; one could say that there is convergence in their presentation. For the money market, it is generally believed to be a short-term security market. The controversy has evolved from providing an answer to the question "how long should be considered as short-term". Ross (1989) defines money market as a place or mechanism whereby funds are obtained for short periods of time (from one day to one year), and where financial assets representing short-term claims are exchanged. Nwankwo (1991) defines it as a market for short-term securities, which offers access to a variety of short-term financial instruments that enable economic agents to pool, price, and exchange risk. It also provides services that are essential to a modern economy by facilitating trade and production. From Olowe's (1977) point of view, money market is the market where money is invested for periods of up to one-year maturity. Thus money market is the market for trading in short–term financial instruments with maturities less than one year. According to Oba (1999) money market is a forum where short-term capital is sourced. Therefore the corporate body that requires such fund must create instruments with which to source them. To him, the life span of such funds usually ranges from few hours to about twenty-four months or two years. Odife (1984) stated that money market is the market for financial claims of less than one year to perhaps five years or less for maturity. According to him, money market is thus essentially a framework for trading short-term financial instruments.

There exists a primary money market where short-term funds are obtained at varying rates depending on the source of funds, the credit standing of the borrower. There is also a secondary market, where financial assets representing short-term claim are traded, at rates determined by demand for and supply of short-term financial assets. Most money market securities trade in very high denominations. This limits access for the individual investor. Furthermore, the money market is a dealer market, which means that firms buy and sell

securities in their own accounts, at their own risk. Another characteristic of a dealer market is the lack of a central trading floor or exchange. Deals are transacted over the phone or through electronic systems. The easiest way for an individual to gain access to the money market is with money market mutual funds, or sometimes through a money market bank account. These accounts and funds pool together the assets of thousands of (private) investors in order to buy the money market securities on their behalf. However, some money market instruments may be purchased directly. They can also be acquired through other large financial institutions with direct access to these markets.

In terms of secondary market, the money is largely an over-the-telephone market. The heart of the market machinery consists of about 24 commercial banks, which trade heavily in money market instruments; government security dealers, some of which are banks; some commercial paper dealers and a few bank acceptance dealers; some brokers who specialize in aiding borrowers to obtain funds and placing funds for lenders, and the Federal Reserve Bank which intervenes in the market to implement monetary policy.

Money market obligations traded in the secondary markets are characterized by very high degree of safety and are issued by borrowers of very high credit standing. Although the secondary market has specific location, its ready accessibility by telephone makes it possible for lenders and borrowers in all parts of the country to lend and borrow funds quickly. Thus both safety and liquidity are almost always assured. Henin (1996) relates that in liquidity crisis, safety and liquidity may come into question, as some types of money market instruments may not be paid at maturity, leading to questioning of the liquidity and safety of others.

The Nigerian money market evolved out of the need to create an avenue for investment in short-term funds. This led to the first issue of treasury bills by the CBN in April 1960. The financial landscape in Nigeria was characterized by short-term borrowing

based on London commercial papers. The market moved funds from London to Nigeria to finance export trade. With the creation of the CBN in 1959 however it became imperative to create a local money market to provide avenues for investment in domestic liquid assets. The objective of the money market included facilitating effective and efficient monetary management, providing a strong base for Nigerian deposit money banks and preventing capital flight.

Prior to the establishment of the CBN in 1959, there was no formal domestic money market in Nigeria. The financial institutions, mainly commercial banks which existed at the time were predominantly foreign owned and their main activities centered on financing foreign trade in favour of the expatriate merchants. The expatriate banks were directly linked to the London money market thereby funding investments at home at the expense of Nigeria.

With the establishment of CBN and subsequent political independence in 1960, the CBN embarked actively in the development of a local money market. Specifically, inline with treasury bills ordinance of 1959, the bank designed and issued the first Nigerian treasury bill in April 1960. Also the apex bank introduced the finance bills Scheme in 1962, primarily to provide funds for the marketing boards to boost Agricultural produce. In 1968, treasury certificates were issued for the first time as short-to-medium term government securities maturing either in 12 or 24 months. This instrument was designed to bridge the gap in government's fiscal operations. Certificates of deposits (CDs), Bankers Unit Fund (BUF) and Special Deposits within the CBN were introduced between 1974 and 1976.

The money market is made up of two segments – the primary market and the secondary market. The primary market is the market where new issues are traded while the secondary market deals in the sales and purchase of existing securities. In a well-developed money market, the suppliers of the initial funds include: individuals, large enterprises, the government, international trading or finance companies, etc. In Nigeria, the principal

participants in the primary markets are banks, the non-bank public, the mandate customers, the government and the CBN. The main instrument traded in this market is the Nigerian treasury bills issued by CBN on behalf of the federal government. Since the introduction of indirect monetary management technique in 1993, the secondary market has been relatively active following the auctioning of short-term treasury bills in the open market. Thus over the years, there has been a significant progress in both the primary and secondary segments of the market.

As Oba (1999) puts it … therefore corporate body that requires such fund must create instruments with which to source the funds. This means that the instruments designed to trade in this market must be well designed, packaged, timely and competitive compared to similar products in the industry to enhance acceptability.

Owing to the risks associated with banking business as a major player in the money market, the central banks often scrutinize new banking products before they are introduced into the market. The measure is designed to ensure public confidence and also to protect the interest of the banks' customers. Some of the banking products available in Nigeria are: Savings Deposits, Bills, Certificates, inter-bank/placement transactions, Over Draft, Leasing, E-money and Value Cards. Others money market products include:

Treasury bills – these are promissory notes issued by the CBN on behalf of the federal government. It is a 91-day maturity short-term debt instrument, issued on weekly basis to raise funds for the Federal Government. The instrument is equally used as a monetary policy tool by the CBN to manage liquidity in the banking system through Open market Operation. The liquidity could be sold at a price lower than its nominal value and hence it is a discountable instrument. At maturity, the bill is redeemed at its face value. Unlike other financial market investments, the income earned on treasury bills is exempt from all state and local income taxes. The relationship between, say, the commercial Deposit Rate (RCD) and

the treasury bill Rate (RTB) that leaves an investor with the state income tax rate *t* indifferent between the two, other considerations aside, is RCD(1 – *t*) = RTB. In other words, the investor would be indifferent between investing in treasury bills and commercial deposit so long as the returns on Commercial Deposit after tax is equal to the return on treasury bills.

Trade bills - it is an arrangement whereby the bills are drawn by reputable firms for acceptance by a bank or acceptance house to make funds available for their immediate use. Upon acceptance, the funds are released to the firm. The bill will be eligible for rediscounting at the CBN unless it is secured against export produce. These bills have a usual maturity of one year.

Marketing Board Bills - These bills are no longer in use in Nigeria. They were bills drawn by the then marketing board for financing export produce. Under the arrangement, the marketing board could meet their cash requirement by drawing the 90-day commercial bills of exchange.

Treasury Certificates - The first issue of the medium-term security by the apex bank on behalf of the federal government was in 1968. It was designed to fill the gap between the 91-day treasury bills and the 2years medium-term treasury certificate. The development of the local money market was developed by this instrument (CBN, 2004) which led to the localization of the country's credit base. The instrument can be rediscounted in the money market.

CBN Certificate - The CBN certificate was introduced in February 2001 by the CBN. The aim was to mop up the excess liquidity in the economy. This instrument was issued in two types, one of 180-day and the other of 360-day tender with a minimum of 250,000 and a multiple of 50,000 investment amount. The rate on this instrument was interest determined.

CBN Certificate of Deposits - This instrument was introduced in Nigeria in 1975 with maturity varying between 3 – 36 months. There are two categories of this instrument namely

the negotiable (NCD) and non-negotiable certificate of deposit (NNCD). This instrument, though mostly held by commercial banks, was issued by merchant banks.

Commercial Papers - These are promissory note issued by corporate entities evidencing indebtedness. As a principal supplements to bank loan, they were granted to meet several credit requirements of the private sector. The dominant investors are the deposit money banks.

Money at Call - Introduced in 1972 and abolished in 1974, the call money was an arrangement whereby the parties involved will make funds available for users at an interest. It was aimed at creating investment opportunity for the very short-term excess funds. Among commercial banks, without the direct participation of the CBN, the money at call scheme may still in operation (CBN, 2004).

Repurchase Agreement - This is an agreement between two parties whereby the parties agree to buy a financial instrument with the provision that the other party will buy the instrument at agreed date and price greater than the price that he originally sold it thereby providing the creditor return on the short-term loan.

Eurodollars - Eurodollars are U.S. dollar-denominated deposit at banks outside of the United States. The average eurodollar deposit is very large. The only way for individuals to invest in this market is indirectly through a money market fund.

The key players in the Nigerian money market are the financial institutions, individuals, companies, and governments who at sometime offer short term securities for sale in the market in order to raise short term finance, and at other times buy short term securities. Through this revolving process (which is not necessarily in any consistent order) their financial intermediation role is achieved. Given this crucial role of these market players and the possible consequence of their operations, the monetary authorities are naturally concerned about their activities.

2.2.2 The Capital Market

The capital market on the other hand, is a network of financial institutions and facilities that interact to mobilize and allocate long-term savings in an economy. The long-term funds are exchanged for financial assets issued by borrowers or traded by holders of outstanding eligible instruments. It refers to a collection of financial institution setup for the granting of medium and long term loans (Anyanwu, 1993). It is a market for longer-term instruments which include market for government securities, corporate bonds, corporate shares and mortgage loans.

According to Anyanwu (1993), the capital market is composed of the inner capital market (market for new securities) and the outer capital market (including insurance companies, building societies, savings banks and other bodies not directly concerned with the issue of new securities, but which are engaged in the business of long-term borrowing and lending upon which the issue of new securities depends). Therefore the capital market embraces both new issues (primary) market and secondary (seasoned securities) market. This usually involves consortium underwriting, syndicated loans and project financing; it requires formal stock exchanges and the unlisted securities market. Thus it is a mechanism whereby economic units desirous to invest their surplus funds, interact directly or through financial intermediaries with those who wish to procure funds for their businesses (Phillips, 1985).

The role of capital in the production process and economic performance of a nation has long been recognized. Capital provides the impetus for the effective and efficient combination of factors of production to ensure sustainable economic growth. Moreover, the effective utilization of productive resources accumulated over time would determine the pace of growth of an economy. Growth in productive activities and its distribution determines the social well being of the population. Capital formation, however, can only be achieved

through conscious efforts at savings mobilization and accumulation of resources by both the public and private sectors of the economy (Williamson, 1987). The unique position of the capital market could, therefore, be appreciated from this perspective. Financial markets generally provide avenue for savings of various tenors that are made available for utilization by various economic agents. The capital market, which is a major segment of financial markets, provides a setting through which medium to long-term resources are provided for productive utilization.

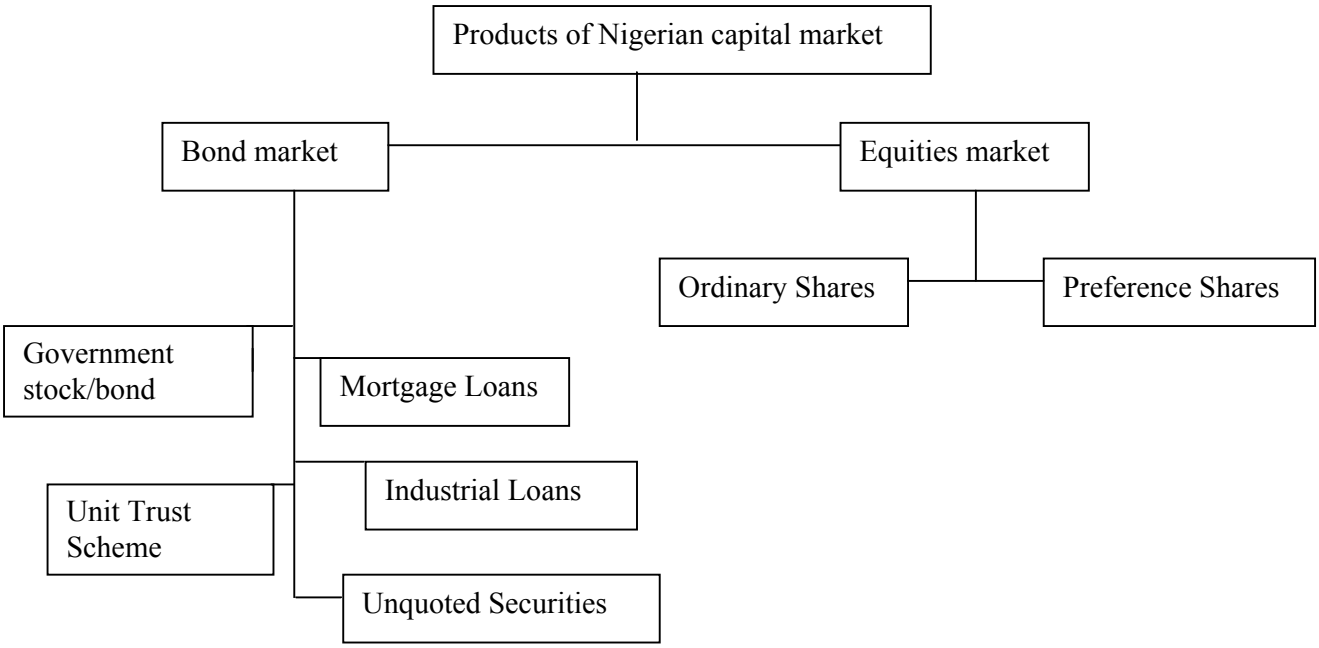
The Nigerian capital market, like any other capital markets in the more developed economies is considered to be the nerve center of Nigeria's national economic order. money creation, and wealth generation over the longer term evolves from the activities that take place at this market (CBN, 2000).

The role of capital market in the economic development of Nigeria has continued to attract increasing attention among policy makers. This derives from the recognition that deeper, broader and better functioning capital market provides long-time finance, which is necessary for economic growth and development. In Nigeria, the capital market provides funds to industries and governments to meet their long term capital requirements for fixed investment like buildings, plants, and other public infrastructure. Empirical investigation revealed that the Nigerian capital market has not contributed significantly to the growth and development of Nigeria. This is evidenced by low market capitalization over the years (CBN, 2004).

The major instruments in the Nigerian capital market are ordinary shares (or equities), industrial loans (debentures, unsecured zero coupons, preference bonds/stocks, specialized projects loans/infrastructural loans, government stocks/bonds, unit trust schemes, unlisted corporate/industrial loans) stock/bond. The capital market instruments/products can therefore be categorized into two broad categories namely equities, which are instruments that confer

ownership rights on the investors; and debt market. Debt instruments are interest-bearing obligations with fixed or floating interest rates. (See figure 2.2)

Figure 2.2 Instruments of the Nigerian capital market



Source: CBN, 2004

Inanga and Emenuga (1997) identify the following features of the Nigerian capital market:

a) Lack of basic information for investment analysis as published annual accounts fail to include information regarding forecast of future cash flows, the market price of the companies' shares at the stock exchange and the average price of the company's share during the year.

b) Settlement process is slow as share transaction takes almost a year to complete while payment of dividends to shareholders is characterized by irregularities; sometimes it fails to reach a good number of investors.

c) Transaction costs are inversely related to the value of equity issues in the market. To the investor, transaction cost includes the profit opportunity forfeited within the one year it takes to receive share certificates after payment and the interest opportunity lost when an investor's money is refunded after a year if the bid is unsuccessful.

d) The cost of public issue of debt in the market is higher than that of equity.

e) Declining capitalization ratio as stock market capitalization fails to keep up with the GDP.

f) High market concentration as the top 20 companies accounted for 70.58 per cent in 1989, though, the concentration is declining.

g) Inefficient asset pricing process as stock prices is serially correlated, suggesting that price changes are not independent.

Like other emerging capital markets, the Nigerian capital market is faced with the following problems:

Excessive taxation of the financial sector has been identified as one of the major problems hindering the growth of the Nigerian financial sector. The problems of the formal financial sector have been compounded by policy-generated increase in costs. According to Collier and Gunning (1997), banking is even more heavily taxed than exports". Pardy (1992) posits that taxation is a crucial factor of capital market development. Unfortunately, taxation as a factor can either be strength or an obstacle in the process of capital market development. Different effective tax rates on either income or capital gains from different financial instruments will distort capital raising and investment decisions.

In the case of the capital market Inanga and Emenuga (1997) reported that policy makers must create the necessary legal framework to guide the operators of the markets. Shareholders and debt holders must have access to reliable reports of the conditions and performance of any company whose securities they wish to hold. More importantly, the

relative shallowness of the Nigerian stock market can be remedied both through increased privatization, as well as by luring more firms to seek listing on the stock exchange. A key incentive here, according to him, is granting attractive tax incentives for quoted companies.

Finally, in spite of the widespread adoption of financial reforms in Nigeria it is nevertheless important for the country to put in place efficient markets and financial institutions as these are necessary to promote savings mobilization and financial intermediation (Collier and Colin, 1989). Price signals transmitted from shallow markets are inherently unstable and volatile reforms of the financial system (Nissanke, 1994).

2.2.2.1 Trading in the Nigerian Stock Exchange

Like in most exchanges all over the world, only members of the Nigerian stock Exchange participate in stock trading on the floor of the exchange. Due to the fact that members perform various functions on the floor of the exchange, they are classified according to those functions (Babalola and Adegbite, 2001). This explains why some members of the stock exchange are referred to as commission brokers, floor brokers, odd-lot dealers, registered traders, or specialists. By the end of 2004, there were four active trading floors in Nigeria, namely, Lagos, Abuja, Port Harcourt, and Kaduna. Each exchange provides a table of listed stocks daily. This table is the regular source of reference for basic stock price and volume of transaction. The statistical information in the table helps the investing public to understand the actual activity that takes place on a particular day, thereby helping them make informed decisions. Securities that have traded each day are recorded in alphabetical order. And as the table below shows, the listings include amongst other things, the public quotation price, the current market price, the highest and the lowest prices, the quantity of shares traded, last dividend paid, as well as earnings per share. These figures provide potential investors with the relevant tools for making educated decisions about the type of

securities to invest in and the appropriate period to take such a plunge. Without a detailed analysis of the performance level of each security, the investing public would try to determine which way to go. The lack of information could indeed work against the growth of the market in general by creating a dichotomy between practitioners who know the workings of the market in detail and the investors who have no knowledge whatsoever. According to Glosten and Milgrom (1985) greater information is associated with a lower cost of capital through reduced transaction costs and/or reduced estimation risk.

Table 2.1: The Nigerian stock Exchange: Daily Official List

Securities	**P.Q.P**	**C.M.P**	**Volume**	**High**	**Low**	**Div**	**EPS**
Access Bank	0.50	2.48	31,642,990	3.01	2.22	0.10	0.13
First Bank	0.50	72.70	30,145,068	72.70	32.00	1.60	3.36
Zenith Bank	0.50	22.00	8,484,548	23.00	16.50	1.10	1.91
Guinness Nig.	0.50	156.85	193,890	158.85	95.50	3.00	5.70
NB. Plc.	0.50	48.40	2,550,686	48.40	30.02	1.05	1.31
Premier Breweries	0.50	0.93	1,000	0.93	0.93	0.06	0.06
UACN	0.50	27.50	2,695,124	27.80	15.91	1.00	1.38
Unilever Nig.	0.50	16.84	1,865,601	22.47	12.80	0.70	0.00
7-Up Bottling	0.50	44.90	107,393	44.90	25.05	1.25	2.27
Nestle Nig.	0.50	216.00	129,039	216.00	183.00	10.00	11.18
Evans Medical	0.50	4.08	480,916	4.25	1.88	0.12	0.43
Law Union	0.50	1.58	85,000	1.58	0.83	0.15	0.18
Mobil Oil	0.50	186.00	54,288	190.00	150.50	9.10	9.69
Total Nig.	0.50	206.00	69,504	206.00	172.90	9.50	9.98
Asaba Textiles	0.50	3.63	200	3.63	3.63	0.20	0.00

Source: Adapted From Financial Standard, August 14, 2006.

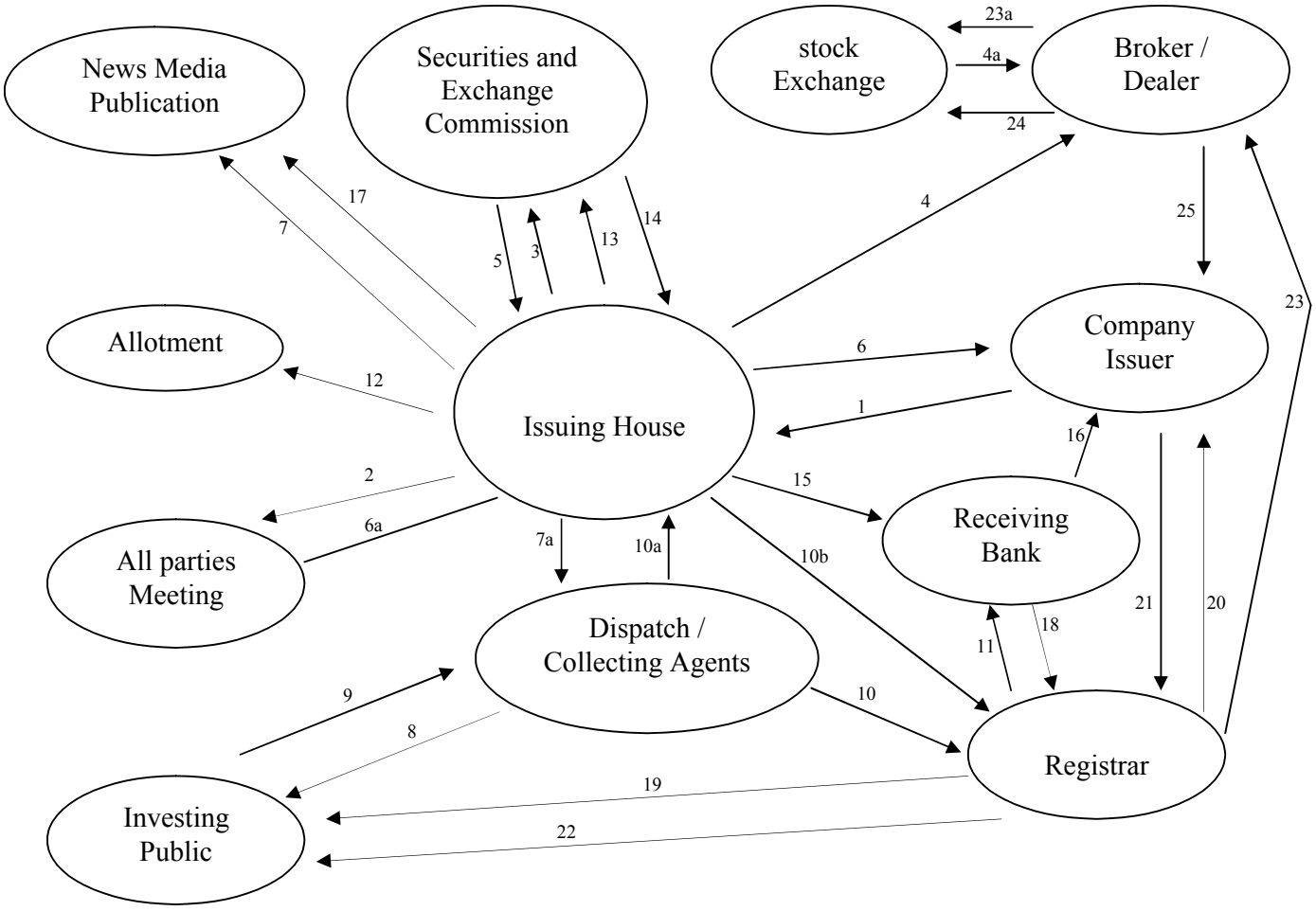
Legend**:**

P.Q.P: Public Quoted Price
C.P.M: Current market Price

Volume: Quantity Traded
High/Low: Years' High and Low
Div: Last Dividend Paid
E.P.S: Earnings per Share

The daily official listings are placed in the public domain to assist would-be investors track the performance of each of the stocks listed. Since capital gain is a major component of the return on investment, investors are keen to find out the fluctuations in the prices of securities. Some of the stocks that are doing very well appreciate in value almost on a daily basis. Where the growth is consistent, there is also the chance that the company will declare good dividends. Together, the appreciation in the price of shares and the dividend declared by the corporation that issued the shares reflect the overall financial strength of the firm. Since these indexes are presented to the public on a daily basis, investors have the opportunity to see for themselves how well their shares are doing. It also shows the poor financial position of the firm as measured by the share price and earnings per share. Like the stock market where there are both the primary markets for new issues, and the secondary markets for existing securities, the Nigerian money market is also divided into the primary and secondary category. Without a viable treasury bills market where treasury bills can be sold before maturity, investors may be reluctant to hold unto an instrument for a very long time, except otherwise, the initial yield is very high. Securities in the Nigerian money market are of various types too with a variety of characteristics regarding the issuer or the buyer. They include the Federal Government treasury bills, Certificates of Deposit, Repurchase Agreements. Federal Government bills are backed by the full faith and credit of the Federal Republic of Nigeria. This particular feature along with their liquidity makes Federal Government bills very attractive to investors.

Fig 2.3: Security Offer Process in the Primary market



Source: Oba, (2001)

In terms of transaction cost, Babalola and Adegbite (2001) reports that, the cost of raising capital in the Nigerian stock exchange, when compared to those of other counties is very high in some cases more than double. This according to them could be due to the exorbitant registration fees paid by market operators.

Registration Fees

A. MARKET OPERATORS

		Initial	Renewal
i.	fund/portfolio manager	20,000	20,000
ii.	Registration of corporate investment adviser	20,000	20,000
iii.	Individual Investment adviser	5,000	5,000
iv.	Registration of brokers/dealer	20,000	20,000
v.	Registration of Issuing House	50 000	50 000
vi.	Registration of Underwriter (Other than Issuing Houses)	30,000	30,000
vii.	Registration of Registrar	20 000	20,000
viii.	Registration of Trustee	20,000	20,000
ix.	Registration of Rating Agency	20,000	20,000
x.	Registration of capital market Consultants	5,000	5,000
xi.	Registration of Sub-broker	5,000	5,000
xii.	Registration of Jobbers	20,000	20,000
xiii.	Registration of Banker to an Issue	20,000	20,000
xiv.	Registration of Share Transfer agent	5 000	5,000

Market Facilities

i. Registration of Securities Exchange and branches

ii. Registration of Securities

Source: NSE annual report, 2007

Transaction cost in other countries

Country	Exchange		stock Trading Fees	Min. Fee
US	American stock Exchange	AMEX	0.1%	USD 15
	NASDAQ capital market	NASDAQ SC	0.15%	USD 15
	NASDAQ Global markets	NASDAQ NM	0.1%	USD 15
	New York stock Exchange	NYSE	0.1%	USD 15
	OTC Bulletin Board on NASDAQ	OTCBB	0.15%	USD 15
	Other OTC on NASDAQ (Pink Sheets)	OOTC	0.15%	USD 15
UK	London International Exchange	LSE_INTL	0.2%	USD 40
	London stock Exchange SETS market	LSE_SETS	0.15%	GBP 15
Australia	Australian stock Exchange Ltd.	ASX	0.15%	AUD 25
Austria	Wiener Börse (Vienna) stock Exchange	VIE	0.2%	EUR 30
Belgium	Euronext Brussels	BRU	0.15%	EUR 40
Denmark	OMX Copenhagen - First North	CSE_FN	0.1%	DKK 19
Denmark	OMX Copenhagen	CSE	0.1%	DKK 19
Finland	OMX Helsinki	HSE	0.1%	EUR 10
France	Euronext Paris	PAR	0.15%	EUR 20
Germany	Frankfurt /Xetra stock Exchange	FSE	0.15%	EUR 20
Italy	Milano stock Exchange	MIL	0.15%	EUR 20
Netherlands	Euronext Amsterdam	AMS	0.15%	EUR 20
Norway	Oslo stock Exchange	OSE	0.1%	NOK 65
Portugal	Euronext Lisbon	LISB	0.15%	EUR 20
Singapore	Singapore Exchange Securities Trading Limited	SGX-ST	0.18%	SGD 25
Spain	Sistema De Interconexion Bursatil Espanol	SIBE	0.15%	EUR 20
Sweden	OMX stockholm - First North	SSE_FN	0.1%	SEK 65
Sweden	OMX stockholm	SSE	0.1%	SEK 65
Switzerland	Swiss Exchange	SWX	0.15%	CHF 30
Switzerland	Virt-X	VX	0.15%	CHF 30

Source: Babalola and Adegbite, 2001

Table: 2.2: APPLICABLE CHARGES ON EXCHANGE-TRADED SECURITIES

APPLICABLE CHARGES ON EXCHANGE-TRADED SECURITIES		
EQUITIES' SECONDARY MARKET CHARGES - SELL SIDE		
	PREVIOUS RATES (%)	**AGREED NEW RATES (%)**
Stockbrokers' Commission		
First ₦250,000	2.75	-
Next ₦250,000	2.50	-
Next ₦500,000	2.25	-
Next ₦2M	2.00	-
Next ₦2M	1.50	-
From Above ₦5M	1.00	-
NSE Fees*	0.30	0.30
CSCS*	0.35	0.30
Stamp Duties	0.075	0.075

EQUITIES' SECONDARY MARKET CHARGES - BUY SIDE		
	PREVIOUS RATES (%)	**AGREED NEW RATES (%)**
Stockbrokers' Commission	As above	As Above
SEC Fees	0.60	0.30
CSCS	0.10	0.06
Stamp Duties	0.075	0.075

Source: Securities and Exchange Commission, Nigeria

Given the daily volume and value of transactions that occur in the money market, the opportunities for loss as the result of default or operational problems are potentially huge. Consequently, over the last decade both market participants and regulators have devoted a great deal of effort to formulating policies for keeping risks within acceptable limits (Mengle 1993). All securities including the money market instruments carry market risk (sometimes called interest rate risk). This refers to the danger that the prices of the instruments will fall (and interest rate will rise), subjecting the investor to a capital loss. Not only can the security price fall, but so can the interest rate which increases an investor's reinvestment risk; that is

the risk that earnings from a loan or security will have to be reinvested in lower yielding loans and securities in future. Investment risks include:

Default Risk - Securities issued by private firms and state and local governments carry default risk; for such securities, there is some positive probability that the borrower will fail to meet some or all of his promised principal and/or interest payments.

Inflation Risk - This is a situation where lenders of funds face the possibility that increase in average level of prices for all goods and services will reduce the purchasing power of their income.

Currency Risk - International investors also face currency risk. This is a possible loss due to an unfavorable change in the value of foreign currency. For example if a Nigerian investor purchases a Ghanaian treasury bill in the Ghanaian money market, the return from this bill may be severely reduced if the value of the Ghanaian cedi falls relative to the Nigerian naira during the life of the investment.

Political Risk - This refers to the possibility that changes in government laws and regulations will result in a diminished rate of returns to the investor or, in the extreme case, a total loss of invested capital. Investors in industries that are closely regulated, such as banking, insurance, and public utilities continually run the risk that new price controls, output quotas, or other restrictions will be imposed, reducing their earning potential.

According to Fischer and Jordan (2005), risk in holding securities is generally associated with the possibility that realized returns will be less than the expected returns. This according to them could result from internal or external factors. Potential investors must therefore evaluate the risk associated with a particular investment option before investing in it. Fischer and Jordan (2005) suggest that risk can be quantified to express a riskless rate plus compensation for individual risks thus:

$r = i + p + b + f + m + o$

Where:

r = real interest rate (risk-less rate)
p = purchasing power risk
b = business risk allowance
f = financial risk allowance
m = market risk allowance
o = allowance for other risks

Though they suggested that treasury bills rate can be used as the riskless rate, they did not say anything as to how to estimate the different risk allowances listed above.

2.2.2.2 The Bond Market

This can also be referred to as a debt market. A bond is a debt obligation representing a promise to pay the interest portion periodically, over a definite period of time and the principal on a specific date in future. They are long term debt instruments, corporate or government that carry a fixed or floating coupon rate with a maturity period of 1 – 30 years. A bondholder unlike the shareholder receives interest (coupon) payments and has no voting rights. Bond issues secured by a specific pledge against the company's assets are called debenture bonds.

Federal Government Development Stocks (FGDS) - These are stocks issued for developmental purposes and are project tied. They are guilt-edged stocks with fixed interest rates and maturity dates. They are usually issued in batches and the interest paid bi-annually. In Nigeria, its origin can be traced to the 1946 issue aimed at promoting development finance for all tiers of government and the tenor was between 7 – 25 years and attracted an interest of between 5 to 12.5 percent. It dominated trading in the capital market, accounting for about 97.3 percent of exchanges between 1979 and 1980. By 1986 however it accounted for only 0.01 percent of traded securities in the market.

Federal Government treasury Bonds

This instrument was established by the Central bank of Nigeria (CBN) in 1989 in order to minimize debt-servicing obligations of Federal Government. The bonds are non-tradable with coupon rates of 5 – 10 percent and tenor of 10 – 25 years. The bonds grew from the conversion of treasury bills that had been used to cover the ways and means Advances of Federal Government at the end – December of every year. Therefore, the instrument is used to finance the fiscal deficit of the government each year and solely held by the CBN.

State and Local Governments' Bonds - The lower levels of government, due to the constraints on bank financing have had to seek funds from the bonds market to augment their internally generated sources of revenue and allocation from the Federation Account, with the aim of financing vital development projects. The then Bendel State Government issued the first of these bonds floated in the market in 1978. Others include the Lagos state, Ogun state, Lagos Island LGA and the Edo state floating Bond. Virtually all bonds offered in the country today are fully subscribed indicating that good potentials exist for deepening the capital market.

Industrial Loan stock - These are project-tied loans, issued by companies listed on the stock exchange and may carry fixed of floating rates, with a maturity date and backed by a sinking fund arrangement for the retirement of the loan. Industrial Loan stock takes the form of debenture stocks, preference shares and corporate bonds. They are a promise by a cooperate body to pay back a certain amount of loan raised through the capital market at a fixed coupon rate paid periodically. The industrial loan stock became popular in the 1990s because it provided cheaper sources of funds, more stable and long-term funds (CBN, 2004)

Unsecured Zero Coupon Redeemable Convertible stock - This stock was introduced in an effort to further diversify products on the exchange. As the name implies, they are unsecured. What makes it attractive nevertheless is the fact that they have no periodic interest payments. They are rather sold at a deep discount to face value, and at maturity, they are redeemed for

the full face value. They can be converted to ordinary shares after a specified period of moratorium.

Unit Trust Scheme - The Unit Trust Scheme is an important mechanism for mobilizing financial resources from small savers and managing such funds to achieve maximum returns with minimum risks through efficient portfolio diversification. In recent times, big savers who do not exactly know how to manage their funds run back to Unit Trust Funds.

2.3 THE FINANCIAL MARKET REFORM

In view of various challenges confronting the Nigerian financial sector, the sector, last decade, has undergone several reforms. Some of them impacting on transaction cost of and returns to investors in the sector. There is a fair agreement in the literature that economic reform, especially what came to be tagged structural adjustment programs (SAP), have almost always been mounted in response to national financial distress whose foundation could be traced to macroeconomic distortions (World Bank 1986). While such distress manifest mainly as deep economic deterioration (stagflation and huge external debts), distortions are often evident in the pursuit of unsustainable fiscal, monetary and exchange rates policies in addition to widespread government intervention in enterprises that can best be handled by the private sector. In general, several analysts believe that economic mal-adjustment is associated with policy pursuits which depart from free market pricing policies (Chiber, et al 1986; Ray 1986). Economic reforms are therefore seen as pursuits of fiscal reforms and market liberalizations, which focus on extensive privatization of state owned enterprises as well as liberalization of financial and foreign exchange markets, with the government limited to provision of the right enabling environment for a private sector led growth.

There is a consensus in the literature that at the heart of economic reforms is the need to address a two-fold task: restructure or get policy incentives right as well as restructure key implementation institutions. Financial sector reforms is that aspect of economic reforms which focus mainly on restructuring financial sector institutions (regulators and operators) via institutional and policy reforms. As part of the financial sector, banking sector reforms is that aspect which focuses mainly on getting incentives right for the banking sector to take the lead role in empowering the private sector to contribute more to economic growth.

In Nigeria, we recognize four phases of banking sector reforms since the commencement of SAP. The first is the financial systems reforms of 1986 to 1993 which led to deregulation of the banking industry that hitherto was dominated by indigenized banks that had over 60 per cent Federal and State governments' stakes, in addition to credit, interest rate and foreign exchange policy reforms. The second phase began in the late 1993-1998, with the re-introduction of regulations. During this period, the banking sector suffered deep financial distress which necessitated another round of reforms, designed to manage the distress. The third phase began with the advent of civilian democracy in 1999 which saw the return to liberalization of the financial sectors, accompanied with the adoption of distress resolution programmes. This era also saw the introduction of universal banking which empowered the banks to operate in all aspect of retail banking and non-bank financial markets. The forth phase began in 2004 to date and it is informed by the Nigerian monetary authorities who asserted that the financial system was characterized by structural and operational weaknesses and that their catalytic role in promoting private sector led growth could be further enhanced through a more pragmatic reform.

Some of these reforms were specifically targeted towards enhancing the capital market's capacity to contribute to the development of the economy. This however has been largely impaired by various inadequacies. The market has been characterized by lack of

depth with few securities; poor liquidity, partly due to inefficiency; poor infrastructure for secondary market operations; basically an equity market, with a largely dormant bond market; high transaction costs; lack of sophisticated products instruments -the market is mainly dominated by traditional instruments such as bonds and equities with limited derivatives; unfavourable tax regime; evolving legal/regulatory environment; and unstable and largely inappropriate in macro-economic environment. As a result of these, the market was therefore not in the best position to contribute maximally to economic growth and the real sector. These inadequacies have made the need for reforms imperative.

To a large extent, the recent reform of the capital market started with the enactment of the Investment and Securities Act (ISA) No 45 of 1999 which replaced the SEC decree of 1988. The ISA enlarged the powers and functions of the Securities and Exchange Commission for the attainment of a more efficient and virile capital market that would meet the needs of the economy. The Act provides that the Commission, among other functions, shall:

- Regulate investment and securities business in Nigeria;
- Register and regulate securities exchanges, capital trade points, futures, options and derivative exchanges, commodity exchanges any other recognized investment exchanges;
- Register securities to be offered for subscription or sale to the public;
- Render assistance in all aspects including funding as may be deemed necessary for promoters and investors wishing to establish securities exchanges and capital Trade points;
- Prepare adequate guidelines, organize training programmes and disseminate information necessary for the establishment of securities exchanges and capital Trade Points;
- Register and regulate corporate and individual capital market operators as well as capital market advisers and consultants such as solicitors, accountants, engineers and surveyors;
- Register and regulate the workings of venture capital funds and Collective Investment

Schemes, including mutual funds;

- Register rotating savings schemes such as esusu and adashe for statistical purposes;

- Facilitate the establishment of a nationwide system for securities trading in the Nigerian capital market in order to protect investments and maintain fair and orderly markets;

- Facilitate the linking of markets in securities through modern communication and data processing facilities in order to foster efficiency, enhance competition, and increase the information available to brokers, dealers and investors.

The ISA provides for the Securities and Exchange Commission to make rules and regulations for the market as the need arises. In effect, the ISA widened the regulatory scope of the Commission and strengthened its capacity to more efficiently perform its traditional functions. It also provided for the establishment of the Investments and Securities Tribunal (IST), which now ensures that all capital market disputes are resolved within 90 days. The IST is an equivalent of a Federal High Court. The ISA has been further reviewed and a re-enactment is soon to be made.

Other reforms that have taken place in the capital market include: Review of minimum capital requirement for operators; Reduction of transaction costs; Introduction of a code of corporate governance (CCG); reactivation of the bond market; introduction of market makers; introduction of shelf registration; development of a commodity market.

The impact of reform on the capital market includes the review of fees. The essence of which is to reduce the cost of doing business in the market in its effort to make the market internationally competitive and investor friendly by authorizing a 40% downward review of fees and commissions charged. This is aimed at making the market more attractive to participants. In the wake of the recent banking and insurance sector consolidation, the Commission also collaborated with the Central Bank Nigeria and National Insurance Commission on initial public offers, public offers, and mergers and acquisitions necessitated

by the exercise, giving concessions were necessary. Another major reform is the recapitalization of capital market Operators. In order to make operators contribute more to the growth of the real sector, the minimum paid up capital has been reviewed upwards. Issuing houses capital requirement moved from N150 million to N2 billion; broker dealers from N70million to N1 billion; clearing and settlement agencies from N500 million to N1 billion and registrars from N50 million to N500 million. Underwriters, who before now had a minimum capital base of N100 million, are now required to have N2 billion; fund/portfolio manager from N20million to N500million, while corporate sub-brokers with a current capital base of N5million have now to shored up their capital base to N50miilion.

The recapitalization of operators in the capital market is to strengthen them financially for international competitiveness and more importantly to match their capital with their exposure. This will also help to weed out quacks from the capital market as the greatest cases of irregularities and fraud are often associated with undercapitalized operators who have little or no investments to loose. It is important to note that this measure will go a long way to position capital market operators to play new roles in the economy, including the real sector.

The introduction of market makers is part of an on-going development in the Nigerian capital market, whose minimum capital base is fixed at 2billion. The commission is currently collaborating with the Nigerian stock exchange to introduce primary dealer market makers for the equity sector of the market. This is in addition to the market makers who already operate in the bond sector. The infrastructure for stock lending and borrowing is also being fine tuned to pave way for the take off of more robust trading in derivatives. The expected implication of these measures is that the market would be more vibrant and liquid; thereby, making its role of financial intermediation more efficient.

Although these reforms have been acclaimed to be necessary, and to have created investment opportunities in the Nigerian financial industry it is however debatable whether or not they yielded the anticipated results (Balogun, 2007).

An outline of the financial sector reform in Nigeria can be subdivided into those targeted towards exchange rate; interest rate and monetary policy; banking and capital market.

A Exchange Rate

1986	Establishment of the first-tier and second-tier (autonomous) foreign exchange markets.
1988	Bureaux de change established.
1992	Devaluation of the official exchange rate.
1994	Reintroduction of exchange controls and suspension of bureaux de change.
1995	Exchange controls relaxed. Operation of bureaux de change permitted. Autonomous foreign exchange market introduced.
1996	Official fixed foreign exchange market operated for Government transactions continued operation of the autonomous foreign exchange market.

B. Interest Rate and Monetary Policy

1987	Deregulation of interest rate
1989	Auction market for Government securities introduced. Continued use of direct monetary policy instruments (cash reserve requirements)
1990	Introduction of stabilization securities for liquidity management.

1991 Reintroduction of interest rate controls. 1992Removal of interest rate controls.

1993 Introduction of indirect monetary instruments (open market operations)

1994 Re-imposition of interest controls. Review of Central Bank operations 1995 Continuation of interest controls initiated fiscal reforms.

1996 Retention of interest controls Continuation of fiscal reforms

C. Banking and capital market

1987 Deregulation of bank licensing

1988 Restrictions on bank portfolio relaxed. Deposit guarantee scheme established.

1989 Review of Banks' capital adequacy standards.

1990 Reform of accounting procedure for banks.

1991 Embargo on bank licensing Strengthening of bank regulation and supervision.

1992 Privatization of banks commenced. Deregulation of the capital market.

1993 Restructuring of distressed banks.

1994 Liquidation of banks.

1995 Liberalization of capital flows.

1996 Liberalization of the capital market continues.

1999 Adoption of distress resolution programmes and the introduction ofuniversal banking

2004 - Bank structural and operational weaknesses led to recapitalization of banks.

CHAPTER THREE

3.0 LITERATURE REVIEW

3.1 EMPIRICAL LITERATURE

A number of researchers eg Kahl (2002) have pursued the search to determine the overall strength of one instrument over the other in a number of ways. Khal (2002) evaluated the United States Federal Reserve's model which involves a simple comparison between the earnings yield of the SP 500 Composite Index, using forecasted earnings for the next 12 months, and the yield on the ten year U.S. treasury bond. Having identified some of the limitations of this model, they developed a modified version of the Federal Reserve's model for their research. The model trailed (most recent twelve months) earnings to calculate the earnings yield because information was available from Standard and Poor's on reported earnings but not forecasted earnings. The 5 year U.S. treasury bond was substituted for the ten year bond. Total return calculations and year-end yields for the 5 year and 20 year U.S. treasury bonds only were obtained from Ibbotson Associates' data base. The 5 year bond was used as the duration (a measure of sensitivity to changes in interest rates) which is closer to that of the S&P 500 Index. At the end of this research exercise, Kahl (2002) noted that "when establishing asset allocation, investors should consider how the relative valuations between stocks and bonds have changed over time". Thus, it was inferred that the valuation model adopted by the U.S. Federal Reserve has poor predictive ability. Consequently, the study recommended that investors should consider modifying their asset allocation when there are large differences between the earnings yield and fixed yield financial securities. The obvious implication of this recommendation is that although the actual result of the research showed that stocks yielded superior returns over the ten year period covered in the study, the methodology was not strong enough to permit any reasonable generalizations (Ntiedo, 2007).

This assertion is amplified by the evidence from other studies such as the one carried out on Switzerland's financial market.

In a 2004 study of the volatility of the fixed interest investments and stock markets, the authors attempted to examine the changes in Switzerland money market and stock market volatility over the period between 1964 and 2003 as represented by the IMF Switzerland long-term government bills total return entries and the MSCI Switzerland equity total return series. In doing so, they employed a methodology that allowed them measure performance of both instruments by comparing the volatility of one instrument against the other. To examine money market volatility relative to stock market volatility, the authors computed The ratio of moving standard deviations of monthly rates of return for 12-month calendar periods for treasury bills to stocks; the ratio of standard deviations for discrete, non-overlapping 12-month calendar-year time periods for treasury bills to stocks; a moving measure of systematic risk (beta) for long-term Switzerland government treasury bills returns relative to returns for the MSCI Switzerland total return series; and the correlation coefficient between the returns on long-term Switzerland government treasury bills and the MSCI Switzerland total return series for moving 36-month calendar periods.

These measures were used to examine and test for changes in bills market volatility relative to stock market volatility during the period of study. According to the authors, because the fixed interest market return series predates the stock market return series by approximately 6 years (February 1964 vs. January 1970), comparisons between money market and stock market volatility were based on the 30-year overlapping time period from January 1973 through December 2002. The results showed that although the Swiss money market volatility moderated recently, during the entire 39-year period money market volatility actually trended upward and the swings in money market volatility became more pronounced. The stock market volatility on the other hand spiked in 1974, moderated in the

late 1970s and early 1980s, and then became more volatile again in the late 1980s and 1990s. Unlike the fixed interest market therefore, the stock market did not exhibit a trend in volatility during the period of study. During the 30-year period of the study, Swiss stock market volatility averaged nearly four times that for the money market. One can draw from this study that the stock market out-performed the money market particularly because volatility is a function of awkward price movements, and such unstable price regime is not good for earnings. But the absence of trend in stock market volatility is a clear indication of a stable price regime which is believed to be good for overall stock returns.

3.2 FINANCIAL MARKET EFFICIENCY

Since profits are the very rate of return, and if the stock market functions to allocate funds to more profitable firms, as well as assume a degree of liquidity for equity financial assets, the efficiency of the stock market is an important matter. As pointed out by Henin (1996), efficiency may be judged by two criteria:

1. Does the market efficiently allocate funds to the most profitable uses?
2. Does the market have low cost of transaction?

Eugene (1970) tested the allocational efficiency of the market by attempting to determine whether the stock market responds quickly to new information. The study supporting the random walk hypothesis have been interpreted by some as indicating that the market does respond quickly to new information. Henin (1996) posits that Tests have also been made comparing prices of stocks on which new information became available (for example, earning announcements) and prices of those on which such information did not become available. These tests have that such information is quickly reflected in the stock prices. Another test has been studies whether insiders, specialists trading on the exchanges, corporate officers and directors have better-than-average trading profitability. The evidence

seems to be that they do, which means the market is inefficient; but, in his opinion, Henin (1996) says that the interpretation of this is in doubt: if a small group have monopolistic trading advantages, does this mean that the market is inefficient or simply that these groups are able to profit in the short period before the market adjusts to the new information.

More direct tests have attempted to determine whether risks perceived by investors correspond fairly closely to actual risk, on the presumption that investors have an aversion to risk. Studies have shown that risks as measured by relative variability of returns seem to be about the same for considerable periods of time. Tests have also been made to determine whether return varies with risk variability in return, which for stocks includes both dividends and capital gains or loses (and for treasury bills include interest on investment)

While reporting the US case, Henin (1996) said that over a long period of time, returns on stocks have been about 9% compared to about 5% on bills is some evidence that returns varies with risk. He added that up to a certain point, returns vary directly with risk, beyond that point, it varies indirectly. Other studies indicate that new issues of stocks have not been particularly good investments over long periods, if it is assumed that new issues are somewhat more risky than seasoned issues and therefore should have higher returns. Friend (1972) indicated in a study that mutual funds performed very little better than the average investors, when the ratios of subsequent earnings to initial price were compared, and when ratios of trends in subsequent earnings and prices were compared. John and Burton (1968) concluded that security analysts' forecast were little better that past earnings growth in predicting future earnings, however only five firms participated in the study and the predictions were made for earnings growth for over five years; perhaps a larger number of participants or a shorter period of forecasting would have given a different result.

As Friend and Herman (1964) put it, a complete review of evidence can not be provided, but perhaps this is enough to indicate the basis for the general conclusion reached:

evidence from studies indicates that the stock market is not very efficient as an allocator of resources, and this may be confirmed by hindsight of evaluation of unwarranted price changes.

In a study of 41 countries covering 1986 to 1993, Demirgnuc-Kunt and Levine (1995) find that Nigeria is among the countries with the least underdeveloped capital markets in the world, with market capitalization to GDP ratios under 0.1 per cent. This indicates that Nigerian stock exchange is characterized by limited trading activity.

While most financiers believe the markets are neither 100% efficient, nor 100% inefficient. However, the main theories describing how efficient the financial markets are can be broken down into two groups, those that believe the markets are generally very efficient, and those that believe the markets are generally inefficient. In general, however, most financiers believe, the more participants in a market the more efficient it becomes.

An efficient market is one in which prices fully reflect available information. An implication of an efficient market is that no excess returns can be made from any information because current prices already reflect the information. However, excess returns (if any) should not be statistically significant from zero (Fox and Opong, 1999). This also implies that an inefficient market will not reflect complete information in the market, thus increasing transaction cost in such markets.

One of the fundamental decisions that every business needs to make is to assess where to invest its funds and to re-evaluate, at regular intervals, the quality of its existing investments (Damodaran, 2001). The cost of capital is the most important yardstick to evaluate such decisions. Not only the hurdle rate for investment projects but the composition of the firm's capital structure is also determined by this variable. In addition, the determinants of cost of capital (especially the cost of equity capital) are relevant to the fundamental analysis literature, which attempts to shed light on the valuation role of accounting. Hence it

is not surprising that a wide range of policy prescriptions in different economies have been advanced to help companies lower this cost. For example, Arthur Levitt, the former Chairman of the American Securities and Exchange Commission, suggests that "high quality accounting standards...improve liquidity and reduce capital costs". The NASDAQ stock market suggests that it's trading system "most effectively enhances the attractiveness of a company's stock to investors", and investment banks routinely solicit business by arguing that their financial analysts will lower a company's cost of capital by attracting a greater institutional following to the stock (Easley and O'Hara, 2004). All these components are regarded as having an influence on the information structure surrounding a company's stock. However, the traditional capital asset pricing model (hereafter CAPM) does not allow any role for information. Easley and O'Hara (2004) therefore note that, "This exclusion (of informational role) is particularly puzzling given the presumed importance of market efficiency in asset pricing. If information matters for the market, why then should it not also matter for the firms that are in it?"

Theory suggests that greater information is associated with a lower cost of capital through reduced transaction costs and/or reduced estimation risk. Glosten and Milgrom (1985) suggest the positive role of information in reducing the bid-ask spread. According to Glosten and Milgrom (1985), "the core idea is that the specialist faces an adverse selection problem, since a customer agreeing to trade at the specialist's ask or bid price may be trading because he knows something that the specialist does not". Amihud and Menedelson (1986) suggest and find evidence consistent with the hypothesis that average portfolio risk-adjusted returns increase with their bid-ask spread. They note that, "liquidity increasing financial policies can reduce the firm's opportunity cost of capital, and provide a measure for the value of improvements in the trading and exchange process". Another strand of theoretical research suggests that parameter uncertainty (estimation risk) influences the perceived unconditional

rate of return distribution upon which investors make their investment decisions. An increase in information in such a setting allows investors to better estimate asset returns, which in turn, lowers the required rate of return (Clarkson et al., 1996; Coles et al., 1988; Coles et al., 1995; Bary and Brown, 1985; Klein and Bawa, 1976; Handa and Linn, 1993 among others).

The link between information quality and cost of capital is one of the most fundamental tenets in Finance and Accounting. Because of information asymmetries arising from dispersion of ownership, adverse selection costs could arise between buyers and sellers of firm shares. This could result in reduced levels of liquidity for firm shares. To overcome the reluctance of potential investors to hold firm shares in illiquid markets, firms must issue capital at a discount. Discounting results in fewer proceeds to the firm and hence higher costs of capital. A commitment to increased level of disclosure reduces the possibility of information asymmetries and hence should lead to a lower cost of capital effect. Also, the firm could reduce its cost of capital by structuring the governance system in a way that allows for transparency and monitoring over managerial actions. In addition, high quality auditing, analyst forecasting, etc. could provide credible information in the market regarding the future prospect of the firm and hence could reduce the cost of capital in general, and cost of equity capital in particular.

3.3 RETURNS MODELS

In the theoretical and empirical literature the most recognizable way of determining the overall financial benefits accruable from investing in stocks and treasury bills, is the measure of the securities' Total returns (Ntiedo, 2007). According to Fischer and Jordan (1995) "return is the motivating force and the principal reward in the investment process, and it is the key method available to investors in comparing alternative investments". returns from common stocks have two components, namely periodic cash receipts (dividends), and

increase in price of asset (capital gains). Therefore, the correct measurement incorporates both dividends and capital gains and can be determined using the Total returns concept (Ntiedo, 2007); according to him, Total returns can be measured for a given holding period as follows:

$$TR = \frac{CPR + PC}{PP}$$

and:

$$PC = PP^* - PP$$

Where:

TR represents Total returns

CPR represents Cash Payment Received

PC represents Price Change over the period, and

PP represents Purchase Price of the asset

PP* represents Present Price

This definition, in his view, can be applied daily, weekly, monthly, quarterly, and annually so long as there is an index showing the prior period prices and current prices, as well as the dividends. However, since the investors may have difficulty in applying this method for each stock over a longer period, there is also the need to describe a series of returns statistically. The statistical approach may be achieved by calculating either the arithmetic or geometric return on the investment. Fischer and Jordan however underscored the use of arithmetic return as this method misses the effect of changing rates or capital gains/loses on investment. They therefore recommended geometric computation thus:

$$G = ((1 + R_1)(1 + R_2) \ldots (1+R_n))^{1/n} - 1$$

Where:

R = Total return

n = Number of Periods

The return model for fixed interest securities is similar to that of stocks. The two key measures of returns are the current yield and the yield to maturity. Ntiedo, 2007 posits that although the financial press would report the current yield, the current yield is not a true measure of return principally because it does not capture the difference between the purchase and redemption prices. The yield to maturity captures both the coupon income and the capital gains/losses.

Purchases and sales of treasury bills represent the largest volume of daily transactions in the money market (Ross, 1989). The higher the price of treasury bills, the lower the returns. Bills yields are determined by the bank discount method – which ignores the compounding interest rates and uses a 360-day year for simplicity. The bank discount rate (DR) is calculated as follows:

$$DR = \frac{\text{Par Value} - \text{Purchase Price}}{\text{Par Value}} \times \frac{360}{\text{Number of days to maturity}}$$

But, because the rate of return on treasury bills is figured in a different way compared to the rate of returns on most debt instruments, one must convert the treasury bills yield so that it will be comparable to other investment yields. As such, the investment yield (IR) on treasury bills is given as:

$$IR = \frac{365 \times DR}{360 - (DR \times \text{Days to Maturity})}$$

Where :

DR represents Discount rate

3.4 INSTITUTIONAL CAHNGE, INFORMATION AND TRANSACTION COST

In financial investment, transaction cost is as important as returns on investment for the investor. It is the cost incurred in making an economic exchange. For example, most people, when buying or selling a stock must pay a commission to their broker; that commission is a transaction cost of doing the stock transaction. When rationally evaluating a potential transaction, it is important to consider transaction costs that might prove significant. According to Coase, Arrow, and Wallis and North, transaction costs are the costs of processing and conveying information, coordinating, purchasing, marketing, advertising, selling, handling legal matters, shipping, and managing and supervising.

Others have defined the concept in terms of particular aspects of transacting. Williamson (1985), who focuses on contracting activities, defines transaction costs to include the *ex ante* costs of drafting, negotiating and safeguarding an agreement, and the *ex post* costs of haggling, costs of governance, bonding costs to secure commitments. Davis (1986) defines transaction costs as those costs associated with "greasing markets" including the costs of obtaining information, monitoring behavior, compensating intermediaries, and enforcing contracts. Barzel (1989) defines transaction costs as those costs involved in transferring, capturing, and protecting rights.

North (1990, 1997), Wallis and North (1986), and Williamson (1985, 1999) have all argued that transaction costs are embedded in layers of governance structures. Their arguments suggest that one must operationalize the concept of transaction costs in particular political economic environments.

Generally transaction costs arise in the course of market exchange and involve the cost of information, search, negotiation, screening, monitoring, coordination, and enforcement. Transaction costs vary by individual, leading to heterogeneous market behavior and heterogeneous portfolio choices (Bardhan,1989; Sadoulet and de Janvry, 1995). The

specificity of transaction costs to individual agents implies that these costs are endogenous to the behavior of market participants and are thus unobservable at the market level (Eleni, 1999). Individuals' effort to minimize transaction costs leads to the emergence of alternative institutional arrangements. The link between transaction costs and the emergence of institutions has long been recognized in institutional economics theory (Alchian and Demsetz, 1972; Coase, 1937; Hoff and Stiglitz, 1990; North, 1990; Williamson, 1985). However, the inherent difficulty of measuring transaction costs at the level of market agents has limited empirical studies of whether particular institutions indeed effectively minimize transaction costs. Yet, empirical analysis is particularly warranted in contexts in which agents operate in a weak market environment and where transaction costs are presumed to be high (Eleni, 1999)

While it is generally accepted that transactions must be governed and that some institutional arrangements are more efficient than others, the nature and existence of an economizing selection mechanism is usually assumed rather than explained (Shelanski and Klein, 1995).

Scholarship in the new institutional economics provides the basis for several different hypotheses about the relationship between transaction costs and institutional change. One hypothesis is that changes in transaction costs induce institutional change. However, changes in transaction costs can arise from technological change, other types of relative price change, or policy changes. This suggests a second hypothesis in which institutional change induces changes in transaction costs. A third possibility is that transaction costs and institutional change interact. That is, institutional change could induce changes in transaction costs, which could induce further institutional change to adjust for the cost effects of the prior change.

Williamson (1985, 1997) explores the important issue of the relationship between transaction costs and institutional design. He inextricably links transaction costs and

institutional change by defining the fundamental question of transaction cost economics to be one of operationalizing the economizing problem in particular environments, aligning transaction costs and governance structures in transaction cost economizing ways, and comparing feasible institutional alternatives. Williamson anticipates the potential for interaction between transaction costs and institutional change when he argues that the alignment between transaction costs and governance is nested in an additional set of institutional arrangements. If this set of arrangements change, transaction costs change. Presumably, changes in transaction costs give rise to changes in governance arrangements however; Williamson does not develop the transaction cost implications of this interaction.

Menard (1997) applies transaction cost economics to analyze the internal organization of firms. Reinterpreting Williamson, he develops taxonomy of governance structures that can be applied to a wide variety of internal contracting dilemmas. While he anticipates the problem of change as well as the interaction between firm governance structures and other governance structures, he does not tackle these issues.

Addressing the question of transaction costs over time from a macro political economic perspective, Wallis and North (1986) measure transaction costs in the U.S. economy and find that the transaction sector grows from 25% of GNP in 1870, to over 50% of GNP by 1970. They attribute this growth intuitively to three main causes:

(1) Increasing specialization and division of labor that creates more impersonal exchange;

(2) Technological change accompanied by increasing firm size;

(3) The diminishing cost of using the political system to restructure property rights resulting from the development of commissions.

Wallis and North did not test the relationship between changes in transaction costs and institutional change, however, their explanation of their empirical findings are consistent with some form of interaction between transaction costs and institutional change.

North (1990, 1997) further develops the empirical context of the relationship between transaction costs and institutional change. He argues that transaction costs change as a function of the interaction between changes in relative prices and existing institutional structures. When changes in transaction costs reconfigure the bargaining power of economic participants, transaction costs act as an incentive to make institutional change. In this formulation, institutional change potentially enters on both sides of a causal argument: changes in an existing institutional structure - institutional change - could alter transaction costs, and changes in transaction costs could create incentives for (additional) institutional change.

3.5 THEORETICAL ISSUE ON TRANSACTION COST AND RETURNS

3.5.1 Liquidity and Asset Pricing

As pointed out by Engle and Lange (1997), "most simply (liquidity) is the ability to perform a transaction without cost." Investors should, therefore, be compensated for holding less liquid securities, as the associated transaction costs will be higher. Further, one would expect more liquid markets to have lower liquidity premiums as compared to less liquid markets.

In defining the costs associated with illiquidity, Amihud and Mendelson (1991) suggested that there were four distinct components: the bid-ask spread, market impact costs, delay and search costs, and direct transaction costs. All these costs should rise with a decrease in liquidity. In determining liquidity proxies, the first obvious one, therefore, is bid-

ask spread. Constantinides (1986) and Vayanos (1998), among others, found that transaction costs primarily affect holding periods and trading volume implying that turnover rate is also an appropriate liquidity proxy. Finally Chalmers and Kadlec (1998) suggested that stocks with similar spreads may trade with different frequencies. They therefore proposed "amortized spread" as a proxy for liquidity being spread adjusted for trading volume.

3.5.2 Bid-Ask Spread and Asset Pricing

Following Amihud and Mendelson's (1986) proposition that there is a first order effect between transactions costs and expected return, there have been numerous empirical studies on the spread-return relationship of stocks with mixed results. Amihud and Mendelson (1986) tested the relationship using OLS and GLS regressions on 1961-80 NYSE data and found that risk-adjusted returns increased with spread. In addition they found that the coefficient of beta declined when the spread variable was added to the return-beta equation, indicating that part of the effect that could be attributed to beta may be due to the spread. The inclusion of a size variable resulted in beta and spread effects prevailing.

Chen and Kan (1989) investigated whether Amihud and Mendelson's (1986) finding of a positive relationship between return and spread was unique to the methodology they used in their study. Using the same spread data, the robustness of the return-spread relationship was estimated using four alternative methodologies. These were the Fama and MacBeth (1973) approach, the Seeming Unrelated Regression (SUR) framework as in Zellner (1962), Gibbons (1982), and Stambaugh (1982), the unconditional two-step approach in Chan and Chen (1988), and an empirical design proposed by Chen, Grundy and Stambaugh (1990) that models the stochastic beta. Estimation of the return spread relationship, taking into account factors such as the stochastic beta, the stochastic risk premium and the importance of the precision of the estimated betas, resulted in no reliable return-spread relationship being evident.

Eleswarapu and Reinganum (1993) investigated whether the return-spread relationship is different in January and non-January months and whether the results of Amihud and Mendelson (1986) are sensitive to their restrictive portfolio selection criteria, which required a firm had to have been in existence for the previous ten years. They found a statistically significant relationship between spread and return only existed in January months. They also found a statistically significant negative relationship between size and return.

Eleswarapu (1997) employed the Fama and MacBeth (1973) and Seemingly Unrelated Regression techniques in his empirical examination of the return-spread relationship for stocks listed on the Nasdaq stock market over the period 1973-90. He found that, although the spread effect was stronger in January months, there was still a statistically significant (at the 5% level) effect over all months. Kothari, Shanken, and Sloan (1995) have suggested that liquidity is a possible explanation of the book-to-market equity effect. However, Eleswarapu (1997) and Hu (1997) found, using NYSE and Nasdaq data respectively, that both spread and book-to-market equity had a statistically significant (at the 5% level) positive relationship with return (when they were both included in the same regression equation). They argued that this suggests that there are two distinct effects – a liquidity premium and a book-to-market equity effect.

Other studies have found evidence against a positive relationship between return and spread. Brennan and Subrahmanyam (1996) found, using NYSE data for the period 1984-91, that there was a statistically significant (at the 5% level) negative relationship. This relationship became insignificant after an inverse price level variable was included, leading Brennan and Subrahmanyam (1996) to conclude that the spread effect occurs "due to the spread acting as proxy for a risk variable that is associated with (the reciprocal of) the price variable." Brennan, Chordia, and Subrahmanyam (1997) also documented a statistically

significant negative (at the 5% level) relationship between spread and return, using NYSE individual company data for the period 1977-1989. When portfolio data was used for the same period, the relationship was found to be both positive and negative, depending on how the portfolios were formed.

Chalmers and Kadlec (1998) investigated the return-spread relationship using the Fama and MacBeth (1973) approach and 1983-92 NYSE data. Their study differed from previous work, in their use of the effective spread as a proxy for transaction costs. Following Blume and Goldstein (1992) and Lee (1993) they defined the effective spread as the transaction price minus the mid-point of the prevailing bid-ask quote. Chalmers and Kadlec found no statistically significant (at the 5% level) relationship between spread and return. The inconclusive empirical evidence regarding the effect of transaction costs on return is consistent with the theoretical models of Vayanos (1998) and Vayanos and Vila (1999). These models propose that transaction costs primarily affect holding periods and trading volumes and that their effect on expected return is second order. Constantinides (1986) had earlier proposed that assets with higher transactions costs are held for longer periods but while the effect of transactions costs on trading volumes is well documented, there appears to be only one study that empirically proves this proposition. Defining holding period as shares outstanding in year *t* divided by trading volume in year *t*, Atkins and Dyl (1997) found strong evidence that, as predicted, the length of investors' holding period is positively related to spreads. This relationship was found to be stronger on Nasdaq where spreads are larger.

3.5.3 Turnover Rate and Asset Pricing

The link between holding period and spread led to the development of a new proxy for liquidity being turnover rate. Datar, Naik, and Radcliffe (1998), who along with Hu (1997, b), were the first to provide theoretical justification for the turnover rate proxy, drew

heavily on the Atkins and Dyl (1997) study. Defining turnover rate as trading volume in year *t* divided by shares outstanding in year *t* (the inverse of the Atkins and Dyl (1997) holding period measure), Datar et al. (1998) were able to conduct a joint test of propositions one and two from the Amihud and Mendelson (1986) model. Datar et al. (1998) concluded that since these two propositions jointly imply that the observed (gross) asset returns must be an increasing function of the expected holding periods, the propositions also imply that the observed asset return must be a decreasing function of the turnover rate of the asset.

In two closely related works, Hu (1997) sought to provide alternative theoretical justification for a negative relationship between turnover rate and return. His first two hypotheses attempt to link the liquidity premium with turnover through transaction costs. His "order-processing" hypothesis argues that in the presence of fixed order-processing costs, a higher turnover can lower dealers' average fixed costs and, by competition, will lower the transaction costs paid by investors. His second hypothesis, the "information-based trading" hypothesis, draws on the finding of Easley, Kiefer, O'Hara, and Paperman (1996) that a higher volume (and hence a higher turnover) stock has a lower probability of information-based trading, and hence a lower spread.

Hu's (1997) third explanation, referred to as the "difference of opinion" hypothesis, for the negative return-turnover rate relationship is borrowed from the volume determinants literature. As in Miller (1977), divergent investor opinions are said to lead to a higher current price and lower expected future returns. In conjunction with increased trading volume, Hu (1997) concluded that this implies a negative relationship between turnover rate and expected returns. Theoretically, turnover rate is a more powerful liquidity proxy than spread, given the Constantinides (1986) and Vayanos (1998) finding that transactions costs primarily affect holding periods and trading volumes, and that the effect on expected returns is second-order.

The return-turnover relationship has been tested empirically on three different markets. Haugen and Baker (1996) used the Fama and MacBeth (1973) cross sectional regression approach to test the relationship between return and turnover using 1979-86 monthly data for stocks listed on the Russell 3000 stock index. Haugen and Baker (1996) calculated turnover rate (they called it "trading volume") as the "total dollar amount of trading in the stock over the trading month as a percent of market capitalization." Using portfolios of stocks based on prior year return, Haugen and Baker (1996) found a statistically significant (at the 5% level) negative relationship between return and turnover rate in the two sub-periods of 1979-86 and 1986-93.

Datar et al. (1998) used the methodology of Litzenberger and Ramaswamy (1979), which is a refinement of the Fama and MacBeth (1973) methodology, to test the return-turnover relationship using all non-financial firms listed on the NYSE between 1963 and 1991. Using individual company data rather than portfolios, they found a negative statistically significant (at the 5% level) return turnover rate relationship, even after well known determinants of return such as size, book-to-market equity, and beta were controlled for. The finding of turnover rate and book-to-market equity both being statistically significant (at the 5% level) is said to confirm the Eleswarapu (1997) proposition that a book-to- market equity effect is distinct from a liquidity effect.

Unlike Eleswarapu and Reinganum (1993), but consistent with Amihud and Mendelson (1986), Datar et al. (1998) found no evidence of a seasonal component in the liquidity premium for NYSE data. Datar et al. (1998) verified the robustness of their findings by running the same tests on a trimmed data set and data from two sub-periods. No material differences were found in the return-turnover relationship. Consistent with Datar et al. (1998), Hu (1997) found, using individual NYSE company data for the period 1963-95 and the Fama and MacBeth (1973) methodology, the return-turnover relationship to be negative

and statistically significant (at the 5% level). In addition to controlling for size, beta, and book-to-market equity, Hu (1997) also controlled for the cumulative return over month *t*-12 to *t*-2, where *t* is the test month. Hu (1997) found that trimming his sample by excluding observations with the highest or lowest 1% turnover had no material effect on the results. He also showed that his results were robust over sub-periods. Like Datar et al. (1998), Hu (1997) found no evidence of a seasonal relationship between return and turnover. When portfolios were formed based on turnover rate, size or book-to-market equity, the return turnover rate relationship remained statistically significant (at the 5% level). However, this relationship became insignificant (at the 5% level) when portfolios were formed using beta.

Using the same methodology on individual NASDAQ company data for the period 1983-95, Hu (1997) found a statistically significant negative (at the 5% level) relationship between return and turnover after controlling for size, beta, book-to-market equity, and cumulative return factors. This relationship was evident in both the full and trimmed samples. When portfolios were formed based on turnover, the return-turnover relationship remained statistically significant (at the 5% level). However, this relationship became statistically insignificant (at the 5% level) when portfolios were formed using beta, size or book-to-market equity.

Hu (1997) tested the return-turnover relationship using 1976-93 Tokyo stock Exchange data. Using the Fama and MacBeth (1973) methodology on individual company data, and controlling for size, book-to-market equity, and cash flow-to-price factors, Hu (1997) found a statistically significant (at the 5% level) negative relationship between return and turnover. However, no statistically significant (at the 10% level) relationship was evident in the 1984-93 sub-periods. Additionally, no clear seasonal pattern was evident. However, rather than a consistent return-turnover relationship in all months, a statistically significant

(at the 5% level) relationship was found only in the months of March, June, November, and December.

Hu (1997) found, using individual Nasdaq company data and the Fama and MacBeth methodology, that when both turnover and spread were included in the same regression, both variables remained statistically significant (at the 5% level) but their coefficients became slightly smaller in magnitude. This led Hu (1997) to conclude that "both turnover and spread are imperfect proxies for the true transaction cost."

3.5.4 Amortized Spread and Asset Pricing

Chalmers and Kadlec (1998) developed a more advanced measure of transaction costs, which they called "Amortized Spread." They pointed out that if stocks with similar spreads trade with different frequencies, the magnitude of the spread is not a sufficient proxy for the amortized cost of the spread. Chalmers and Kadlec (1998) defined amortized spread as the product of the effective spread and the number of shares traded, summed over all trades for the day, and expressed as an annualised fraction of equity value. However, they pointed out that amortized spread is approximately equal to effective spread multiplied by share turnover. Using 1983-92 NYSE and AMEX data and the Fama and MacBeth (1973) methodology, Chalmers and Kadlec (1998) found a statistically significant positive relationship between amortized spread and excess return when beta, size, book-to-market equity, and the standard deviation of monthly returns were all included as control variables. However, no statistically significant relationship (at the 10% level) was found when subsets of these control variables were used.

While they maintain that amortized spread is a superior liquidity proxy than spread, Chalmers and Kadlec (1998) identified several limitations in the amortized spread measure. They acknowledged that the impact of spreads on required returns is determined by expected

holding periods whereas the measure of amortized spread they employ reflects realized holding periods. In addition, they pointed out that their amortized spread measure only reflects the average holding period of all investors. This means that if an individual with an unusually long holding period holds a large portion of a company's stock, their measure of amortized spread may understate the amortized spread for the marginal investor.

3.5.5 Capital Asset Pricing Model

There is substantial empirical evidence questioning the ability of the CAPM to fully describe asset returns. Research on the size effect has tended to show that smaller firm have higher risk-adjusted returns, on average than larger firms but that a significant portion of these higher returns come in the month of January. Banz (1981), Reinganum (1981), Basu (1983), Blume and Stambaugh (1983), Brown, Kleidon, and Marsh (1983), Keim (1983), Cook and Rozeff (1984), and Lamoureux and Sanger (1989). Reinganum (1983) and Roll (1983) proposed a tax-loss selling hypothesis as a partial explanation for this observation.

Aitken and Ferris (1991) found a size effect on the Australian stock Exchange (ASX) for the period 1965-85. Although literature throughout the 1980s provided substantial evidence of a number of potential determinants of stock returns, the relative importance of these different factors remained unclear. In their seminal paper, Fama and French (1992) used 1963-90 NYSE, AMEX, and Nasdaq data to provide a comprehensive analysis of the ability of size, book-to-market equity, beta, leverage, and the E/P ratio to explain stock returns. They found that when used alone, or in combination with other variables, beta had little information about average returns. When used alone, size, E/P, leverage, and book-to-market equity had explanatory power. However, in combinations both size and book-to-market equity were found to "capture the cross-sectional variation in average stock returns associated with size, E/P, book-to-market equity, and leverage" (Fama and French, 1992).

Loughran (1997) shed further light on the findings of Fama and French (1992). Using an exhaustive sample of all firms listed on NYSE, AMEX, and Nasdaq over the 1963-95 period, he reported that the Fama and French (1992) findings were driven by two features of their data: a January seasonal in the book-to-market equity effect and exceptionally low returns on small, young, growth stocks. In the largest size quintile of all firms (accounting for 73% of the total market value of all publicly traded firms), book-to-market equity had no statistically significant explanatory power on the cross-section of realized returns. Lougran (1997) postulated that this explains why the returns on value and growth funds, as documented by Malkiel (1995), are not materially different.

CHAPTER FOUR

4.0 METHODOLOGY AND MODEL SPECIFICATION

This methodology that is adopted in this work is the event study approach. This is against the backdrop that transaction cost is heterogeneous in nature and will differ from person to person depending on investor endowment as it relates to knowledge and information. It will also vary according to the degree of risk averseness of individual investors.

The uniqueness of the study warrants an event study, backed also by historical or trend analysis in order to identify the factors that influence the Nigerian investor viz-a-viz the rational economic agent (investor).

4.1 CONCEPTUAL FRAMEWORK

Since the study is aimed at comparing the returns and cost in the markets, and since transaction cost is heterogeneous, these will vary from person to person also. It is important to see whether the average Nigerian investor would select his portfolio consistent with the assumption of rationality. We therefore assumed rationality of investors and analyze the results from the secondary data to see what choices a rational economic agent (investor) will make. In order not to impose rationality on the Nigerian investors, we shall conduct a survey to see the actual investment behavior of the Nigerian investors. The question as to whether the Nigerian investor's portfolio choice will be consistent with that of the rational economic agent.

In the survey, we tried to know how long our respondents had been investors in the markets. The essence of which was to have an idea about their experience in the market and the quality of their feedback. We also asked open ended questions to enable investor

comment freely on such questions as why do you prefer a given market/financial instrument to another market/financial instrument.

Since portfolio management involves deciding what assets to include in the portfolio, given the goals and risk tolerance of the portfolio owner. The selection will involve deciding which assets to acquire/divest, how many to acquire/divest, and when to acquire/divest them. These decisions always involve some sort of performance measurement, most typically the expected return on the portfolio and the risk associated with this return (e.g., the expected standard deviation of the expected return). However, due to the almost-complete uncertainty of future values, this performance measurement is often done on a casual qualitative basis, rather than a precise quantitative basis. Typically the expected returns from portfolios of different asset bundles are compared.

The unique goals and circumstances of the investor must also be considered. Some investors are more risk averse than others .In the simplified but familiar context of nominally denominated fixed-income financial assets, for example, wealth or rate-of-return maximizing investors cannot choose between one-period securities and multi-period securities without at least implicitly relying on some expectation of the multi-period security's future price. Both economists and financial market participants well appreciate the crucial role which such expectations play in portfolio allocation decisions. Nevertheless, the nature of the process which determines these all-important expectations remains largely unknown.

Many economists who have done empirical research on the term structure of interest rates have based their models on a maintained hypothesis involving some form of adaptive expectations assumption, but have not explicitly tested this hypothesis against plausible alternatives. Furthermore, empirical research on this question has at best been vague about the way in which investors' portfolio behavior presumably responds to their interest rate expectations.

For the purpose of this research, we adopted the rational expectations hypothesis of the portfolio management theory. This provides that economic agents in general form subjective expectations identical to the objective expectations of the true process generating the outcomes in question, conditional on all information available at the time. Hence the actual outcome for the stochastic asset yield is distributed around investors' prior expectation of it, just as any outcome is distributed around its mathematical expectation. In support of this hypothesis is that "rational" (i.e., optimizing) economic agents will efficiently exploit all available information and will therefore form unbiased predictions.

For returns, the traditional method to compute returns is using a money-weighted return calculated over a period such as a month or a quarter. This assumes that the rate of return over that period is constant. In reality however, portfolio returns actually fluctuate frequently and money-weighted returns may only provide an approximation to a portfolio's actual return. These errors happen because of cash flows during the measurement period. We shall employ a more accurate method for calculating portfolio returns by using the time-weighted method. This entails revaluing the portfolio on every date where a cash flow takes place (perhaps every day), and then compounding together the sub-period returns.

4.2 POPULATION OF THE STUDY AND SAMPLING TECHNIQUE

The population of the study shall be the shareholders of the 290 listed securities that are currently trading in the Nigeria Stock Exchange and all the treasury bills investors currently trading in the Nigerian Money Market in the period this research will cover (1980 - 2009). The transaction cost and returns of interest in this research shall be that of the Nigerian Money and Capital Markets hence the choice of respondents shall be investors in the NSE and the Money market instruments operational in Nigeria.

The sample for this study shall be 50 well experienced financial investors in stocks in the Nigerian stock exchange market for the capital market and the Federal government Treasury Bills representing the Money Market. The system by which these respondents were arrived at was two stages of sampling. First we randomly selected 100 investors from the pool of financial market investors, registered through banks. These investors were interviewed to determine their suitability for the survey. Fifty random samples were drawn, and questionnaire administered.

4.3 DATA SOURCES AND DATA ANALYSIS

Consistent with historical case study design, this study shall rely intensely on document review for research data as well as questionnaire. Therefore, most of the data shall be obtained from financial investors, Banks as well as the Nigerian Stock Exchange records and CBN publication covering cases selected as sample. Data shall also be obtained from academic literatures, and the financial press.

CHAPTER FIVE

5.0 DATA, RESULTS AND ANALYSIS

This chapter shall contain the presentation of data and our analysis. It shall be structured into four sections. 5.1 shall be the analysis of the nature of transaction cost and returns in the Nigerian capital market; 5.2 shall be the analysis of the nature of transaction cost and returns in the Nigerian money market; the third section (5.3) shall compare the nature of capital market transaction cost and returns to the nature of transaction cost and returns in money market. Finally, 5.4 shall be the presentation of the summary of our findings.

5.1 ANALYSIS OF THE NATURE OF TRANSACTION COST AND RETURNS IN THE NIGERIAN CAPITAL MARKET

100% of our respondents have investments in the capital market (stocks) (see table 5.1 on page 67). All the respondents participate in the primary capital market, buying new issues (IPOs). This suggests that the capital market investors are more attracted to the primary market than they are to the secondary capital market probably because the process of buying IPOs through agents (e.g. banks) is simple and does not attract any additional explicit cost.

96% of this number also invests through the Nigerian secondary capital market – buying existing shares (see table 5.1 on page 67). Most of these respondents started out investing in the capital market by buying IPOs in the primary market, but since their newly bought new issues can only be redeemed in the secondary capital market, they later became active players in the secondary capital market.

TABLE 5.1 SUMMARY OF RESULT FROM SURVEY

QUESTION ITEM	Response (%)
Respondents that have above 5 years experience as a financial investor.	66%
Respondents that have between 3 - 5 years experience as a financial investor.	34%
Respondents that invest in Nigerian treasury bills	98%
Respondents that invest in stocks	100%
Respondents that invest in new issues (IPOs)	100%
Respondent that invest through the secondary market	96%
Respondents that invest in both money and capital markets	94%
Respondents that feel transaction cost in the money market is high	4%
Respondents that feel transaction cost in the capital market is high	66%
Respondents that feel transaction cost is higher in the money market than in the capital market	2%
Respondents that feel the cost of transaction is higher in the capital market than in the money market	98%
Respondents that feel the cost of transaction is higher in the secondary capital market than in the primary capital market	100%
Respondent that say returns are higher in the capital market than in the market	92%
Respondent that are attracted to the capital market by dividends	94%
Respondent that are attracted to the capital market by capital gain	60%
Respondent that are attracted to the capital market by bonus shares	70%
Respondent that are attracted to the capital market by right issue	62%
Respondent that are attracted to the money market by the low risk inherent	94%
Respondent that are attracted to the money market by the guaranteed returns	68%

From the survey (see table 5.1 above), 96% of our respondents perceive transaction cost as high in the secondary capital market. This high cost as perceived by investors can be linked to the payment of brokerage when they buy existing shares from the secondary market (through the services of stock brokers) as well as when they sell these shares in the same market. The double fees payment on the part of the investor is a major demotivating factor for respondents investing in the Nigerian capital market. Another possible reason for the transaction cost intolerance on the part of investors is the capital market crash which led to continuous depreciation of stock prices.

30% say of our respondents feel the transaction cost in this market is only medium and 4% percent even say the cost of transaction in the Nigerian capital market is low. Though

other events have taken place in the market since then, their position could still be linked to the reduction of brokerage fees and other capital market fees by the regulatory authority in 2006.

In response to the question about the relative transaction cost between the primary capital market and the secondary capital market, a total convergence of position was observed – where 100% of respondents claim that the transaction cost in the secondary capital market is significantly higher than what is obtainable in the primary capital market. This is mainly because when investors buy shares (IPOs) from the primary market, the services of a stock broker may not be required. What this means is that the brokerage fees that would have been paid (which is a percentage of total investment value) would now be saved. In the secondary market on the other hand, brokerage fees will be paid both when buying and when selling shares.

5.2 ANALYSIS OF THE NATURE OF TRANSACTION COST AND RETURNS IN THE NIGERIAN MONEY MARKET

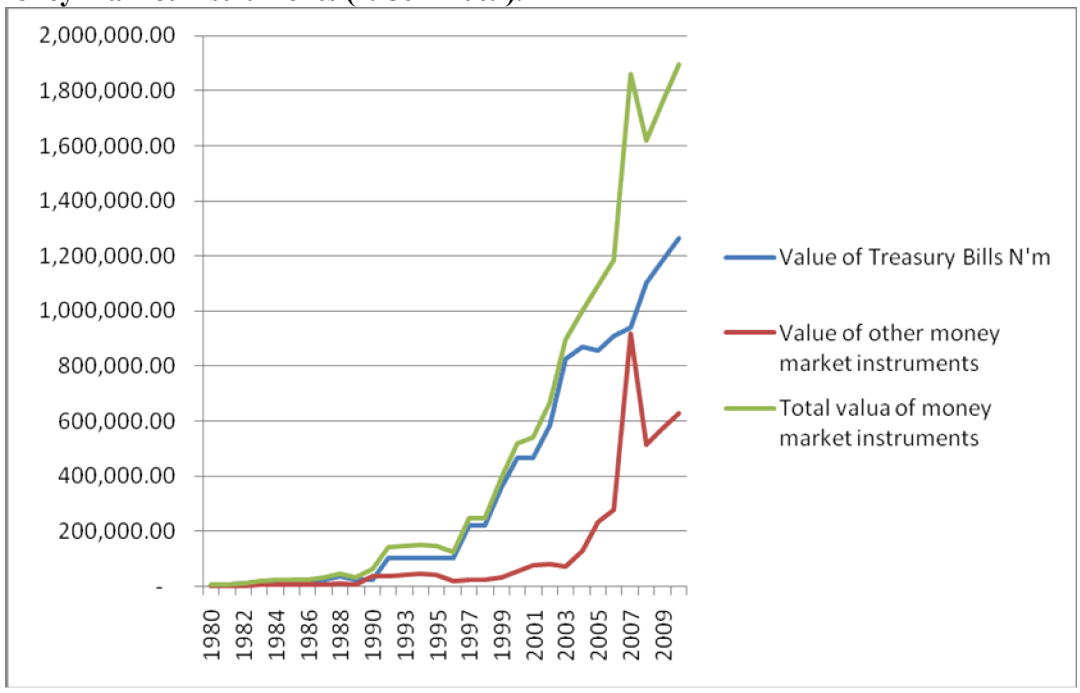
In terms of transaction cost, 62% of our respondents suggest that transaction cost in the Nigerian money market is low. This could mostly be due to the fact that Nigerian treasury bills, which are the dominant financial instrument in the Nigerian money market (see table 5.2 & graph 5.1 on page 69 & 70 respectively) is tax free. Though money market investment through unit trusts attracts a margin (between the buying and selling prices), 34% of our respondents see the cost as average (medium); and to the remaining 4% of our respondents, it is seen as high. In addition to the buy – sell margin in unit trusts, this 4% of the respondents are mostly of the opinion that the waiting time to maturity is usually as costly as to erode the investment of any real financial benefits. Especially as the interest rate on treasury bills are always low.

Table 5.2: An analysis of money market investment in Nigeria

Year	Value of Treasury Bills (N'm)	Value of other money market instruments (N'm)	Total value of money market instruments (N'm)	NTB as a percentage of total investment in the M-Mkt
1980	2,119.00	2,956.60	5075.60	41.75%
1981	5,782.00	2,667.40	8449.40	68.43%
1982	9,782.00	2,240.10	12022.10	81.37%
1983	13,476.00	5,574.70	19050.70	70.74%
1984	15,476.00	6,936.30	22412.30	69.05%
1985	16,976.00	7,094.20	24070.20	70.53%
1986	16,976.00	7,207.70	24183.70	70.20%
1987	25,226.00	8,525.70	33751.70	74.74%
1988	35,476.00	9,369.10	44845.10	79.11%
1989	24,126.00	9,003.20	33129.20	72.82%
1990	25,476.00	36,914.60	62390.60	40.83%
1991	56,728.30	36,353.60	93081.90	60.94%
1992	103,326.50	37,479.80	140806.30	73.38%
1993	103,326.50	41,914.80	145241.30	71.14%
1994	103,326.50	47,270.60	150597.10	68.61%
1995	103,326.50	41,781.60	145108.10	71.21%
1996	103,326.50	20,328.50	123655.00	83.56%
1997	221,800.50	25,551.70	247352.20	89.67%
1998	221,801.50	25,516.40	247317.90	89.68%
1999	361,758.40	33,401.00	395159.40	91.55%
2000	465,535.80	53,183.70	518719.50	89.75%
2001	465,535.80	75,502.40	541038.20	86.04%
2002	584,535.80	82,073.10	666608.90	87.69%
2003	825,050.00	71,670.00	896720.00	92.01%
2004	871,577.00	131,700.00	1003277.00	86.87%
2005	854,828.00	236,695.00	1091523.00	78.32%
2006	907,994.60	279,431.35	1187425.95	76.47%
2007	940,514.90	918,170.65	1858685.55	50.60%
2008	1,101,311.11	516,181.58	1617492.68	68.09%
2009	1,183,030.65	572,925.55	1755956.20	67.37%

Source: CBN statistical bulletin, 2009

Graph 5.1: Graphical presentation of investment in Nigerian treasury bill Vs other money market instruments (1980 – 2009).



5.3 Comparative analysis of the nature of capital market transaction cost and returns to the nature of transaction cost and returns in money market.

66% of the respondents have above 5 years experience as active participants in Nigerian financial investment. The remaining 34% have been financial investors for between 3 – 5years (see table 5.1 on page 67). This suggests that the respondents have good knowledge and experience on the subject matter.

From the survey, 98% of the respondents have experience in treasury bills investment while 100% of our respondents have investments in the capital market (stocks). All the respondents participate in the primary capital market, buying new issues (IPOs). This suggests that the capital market investors are more attracted to the primary market than they are to the secondary capital market probably because the process of buying IPOs through agents (e.g. banks) is simple and does not attract any additional explicit cost.

96% of this number also invests through the Nigerian secondary capital market – buying existing shares. Most of these respondents started out investing in the capital market by buying IPOs in the capital market, but since their newly bought new issues can only be redeemed in the secondary capital market, they later became active players in the secondary capital market.

94% of our respondents invest in both capital and money markets. The significance of the ratio of respondents investing in both money and capital market to total number of respondents suggests that they (the respondents) have requisite experience (and information) as to be able to compare both markets effectively. It also means that investors also seek to diversify their investment across both markets thereby mitigating risk.

On comparative transaction cost in the Nigerian money and capital market, 98% of respondents say that transaction cost is higher in the Nigerian capital market when compared to what is obtainable in the Nigerian money market. In the money market, treasury bills which is the dominant instrument in the market is tax free, thereby making the transaction cost low and attractive to investors. This explains why more money is invested in the Nigerian money market (see table 5.2 & graph 5.2 on page 69 & 70 respectively). Other money market instruments purchased and sold through unit trusts (e.g. mutual fund) attract a small margin between the buying and selling prices. This is also consistent with secondary data

Money market commission

			Margin (N)	commission %
	sell	0.95		
Ethical Fund	buy	0.98	0.03	3.06%
	sell	117.03		
Guaranteed Fund	buy	117.49	0.46	0.39%
	sell	8480.59		
Equity Fund	buy	8739.57	258.98	2.96%
	sell	103.86		
Sibond	buy	103.86	0	0.00%

Source: Stanbic IBTC money market report, 2011

The average transaction cost in the money market is 1.6% when buying and when selling in the market. This when compared to 2% average in the capital market shows that transaction cost is higher in the capital market.

Regarding returns, 86% of respondents are of the opinion that returns in the money market is low while 10% feel the return is medium and 4% of the respondents consider the Nigerian money market returns to be high. Whereas 62% of the respondents say returns in the capital market is high, 36% feel returns are only medium in the capital market. The remaining 2% claim that the returns in the Nigerian capital market are low.

Comparing returns in the money and capital markets, 92% of the respondents presented that returns are higher in the Nigerian capital market when compared to the Nigerian money market. This result is quite consistent with the theoretical expectation of a positive relationship between risk and returns. The risk of investing in the money market – especially in treasury bills is low; so the returns are also expected to be low. On the other hand, risk is higher in the capital market therefore the returns are expected to be higher.

In determining what attracts a particular respondent (investor) to the capital market, 94% of respondents are attracted by annual dividends; 60% of respondents are attracted by capital gain; 70% are attracted by bonus shares; and 62% are attracted by right issue. This reflects that the single most important attraction to the capital market is dividends. The reason for this is that high dividends results to high demand for in the secondary market (for the particular company stock). This in turn leads to higher share price (capital gain). Capital gain is the focus of most short term investors in the secondary capital market and explains more than 50% of total transactions in any stock exchange market. Bonus shares and right issues also depend on company performance and profitability as does dividends.

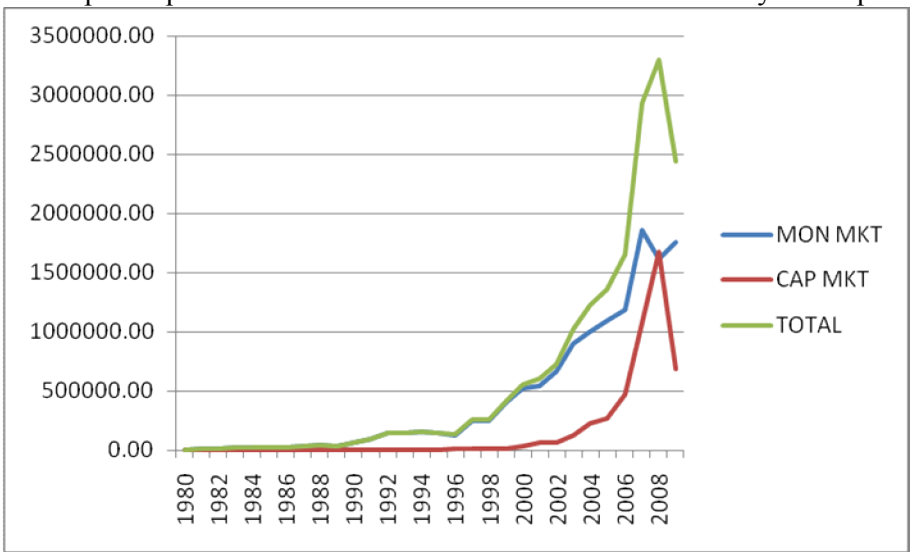
On the other hand, we found that 96% of respondent are attracted to the money market because of its low risk nature; and 68% are attracted to it because returns are guaranteed. Because of the low risk property of this market, it attracts a higher proportion of total financial investment in Nigeria (year on year – from 1980 – 2009) only with the exception of 2008 (before the eventual market crash later in the year) when stock prices were rising continuously and consistently thereby mobilizing funds from every aspect of the economy.

Table 5.3: The value of financial market investment in Nigeria (1980 – 2009)

YEAR	MONEY MKT	CAPITAL MKT	TOTAL FINANCIAL MKT INVESTMENT	MONEY MKT AS A % OF TOTAL	CAPITAL MKT AS A % OF TOTAL
1980	5075.60	388.7	5464.30	92.9%	7.1%
1981	8449.40	304.8	8754.20	96.5%	3.5%
1982	12022.10	215.0	12237.10	98.2%	1.8%
1983	19050.70	397.9	19448.60	98.0%	2.0%
1984	22412.30	256.5	22668.80	98.9%	1.1%
1985	24070.20	316.6	24386.80	98.7%	1.3%
1986	24183.70	497.9	24681.60	98.0%	2.0%
1987	33751.70	382.4	34134.10	98.9%	1.1%
1988	44845.10	850.3	45695.40	98.1%	1.9%
1989	33129.20	610.3	33739.50	98.2%	1.8%
1990	62390.60	225.4	62616.00	99.6%	0.4%
1991	93081.90	242.1	93324.00	99.7%	0.3%
1992	140806.30	491.7	141298.00	99.7%	0.3%
1993	145241.30	804.4	146045.70	99.4%	0.6%
1994	150597.10	985.9	151583.00	99.3%	0.7%
1995	145108.10	1,838.8	146946.90	98.7%	1.3%
1996	123655.00	6,979.6	130634.60	94.7%	5.3%
1997	247352.20	10,330.5	257682.70	96.0%	4.0%
1998	247317.90	13,571.1	260889.00	94.8%	5.2%
1999	395159.40	14,072.0	409231.40	96.6%	3.4%
2000	518719.50	28,153.1	546872.60	94.9%	5.1%
2001	541038.20	57,683.8	598722.00	90.4%	9.6%
2002	666608.90	59,406.7	726015.60	91.8%	8.2%
2003	896720.00	120,402.6	1017122.60	88.2%	11.8%
2004	1003277.00	225,820.0	1229097.00	81.6%	18.4%
2005	1091523.00	62,935.8	1354458.80	80.6%	19.4%
2006	1187425.95	470,253.4	1657679.35	71.6%	28.4%
2007	1858685.55	1,076,020.4	2934705.95	63.3%	36.7%
2008	1617492.68	1,679,143.7	3296636.38	49.1%	50.9%
2009	1755956.20	685,716.2	2441672.40	71.9%	28.1%

SOURCE: CBN STATISTICAL BULLETIN, 2009

Graph 5.2 Graphical presentation of relative investment into the money and capital markets



5.4 ANALYSIS OF RETURNS IN BOTH MARKETS USING SECONDARY DATA

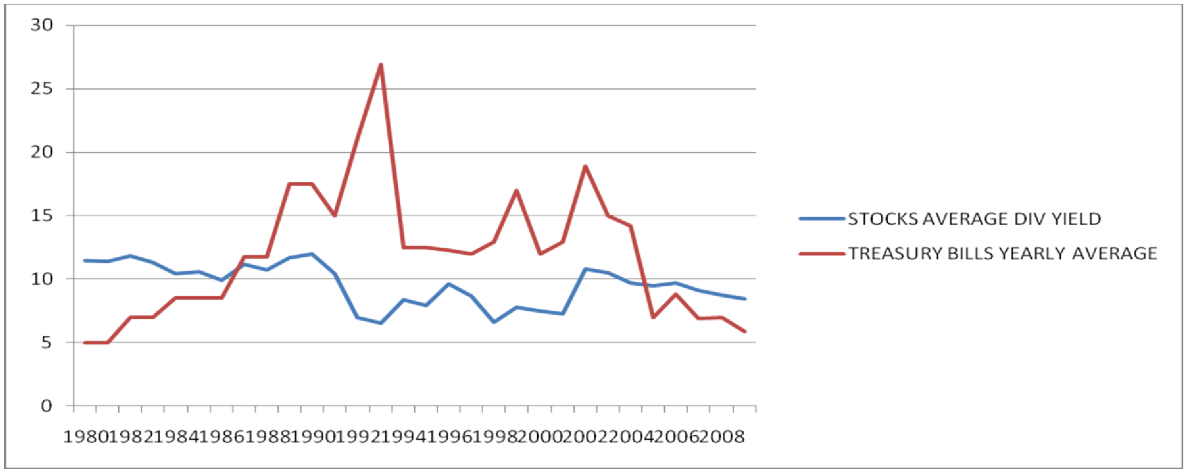
The table below shows the trend of stocks average dividend yield as well as the treasury bills yearly average rates. This shows that dividend returns was higher than treasury bills return between 1980 and 1987. By 1988, the yearly average treasury bills return surpassed the stock average dividend yield. The trend maintained the treasury bills yearly average above the stocks average dividend yield up till 2004 when the yearly average treasury bills rate went below the stocks average dividend yield.

Table 5.4: Stock average dividend yield and treasury bills yearly average

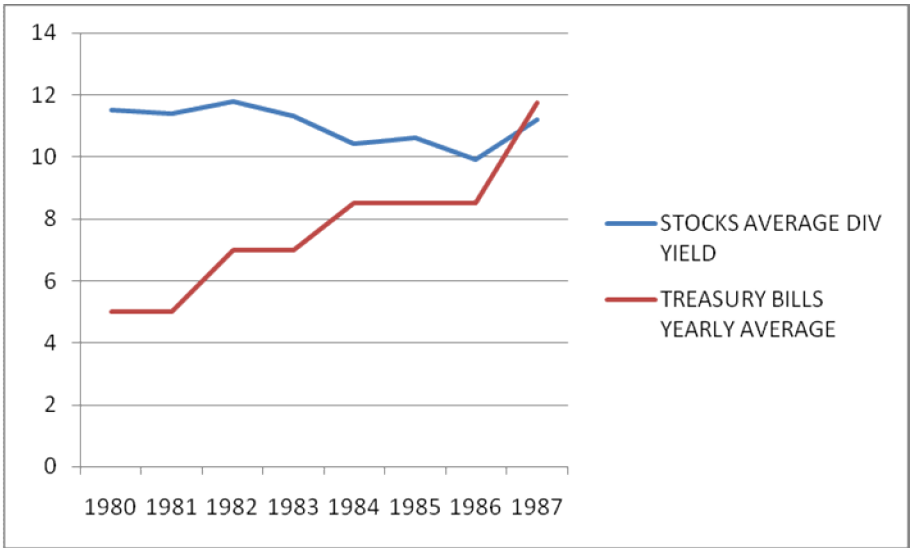
YEAR	STOCKS AVERAGE DIVIDEND YIELD	TREASURY BILLS YEARLY AVERAGE
1980	11.5	5.0
1981	11.4	5.0
1982	11.8	7.0
1983	11.3	7.0
1984	10.4	8.5
1985	10.6	8.5
1986	9.9	8.5
1987	11.2	11.75
1988	10.7	11.75
1989	11.7	17.5
1990	12	17.5
1991	10.4	15
1992	7	21
1993	6.5	26.9
1994	8.4	12.5
1995	7.9	12.5
1996	9.6	12.25
1997	8.7	12
1998	6.6	12.95
1999	7.8	17
2000	7.5	12
2001	7.3	12.95
2002	10.8	18.88
2003	10.5	15.02
2004	9.7	14.21
2005	9.5	7.0
2006	9.7	8.8
2007	9.08	6.91
2008	8.76	6.98
2009	8.44	5.877

Source CBN statistical bulletin, 2009 & NSE report, 2009

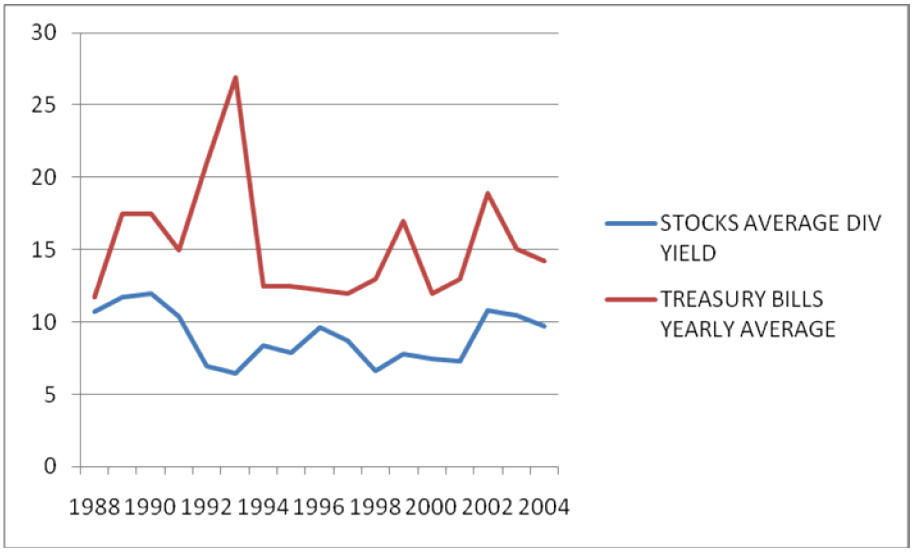
Graph 5.3 Graphical presentation of relative stock Vs treasury bills return (1980 - 2009)



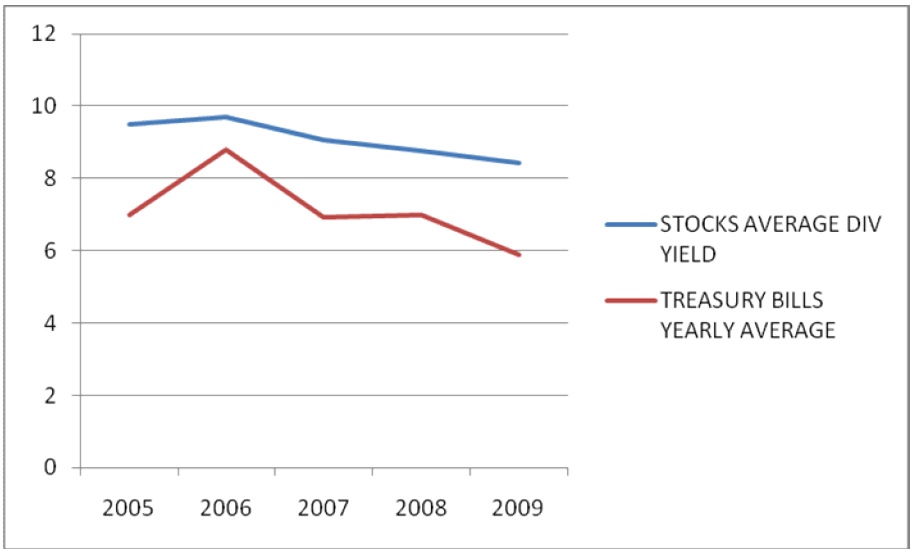
The secondary data showed that treasury bills rate (treasury bills yearly average) remained below stocks yield (average yearly dividend yield) from 1980 – 1987.



From 1988 however, treasury bills average yearly rate rose above the average yearly dividend and remained above it (though by varying gap) until 2004. The steep upraise of the treasury bills rate in 1988 could be linked to the Nigerian financial market reform that took place in 1987 with interest rate deregulation.



Since 2004, the stock dividend yield has been above the Nigerian treasury bills average yearly rate.



We observed that the Nigerian capital market grew steadily with most share prices rising steadily and companies declaring bonus shares and right issues in the period following consolidation. The incentive in the capital market attracted more investors and resulted in further price rise in the market.

This post consolidation "growth" in the capital market was not sustained as prices and other incentives dipped by March, 2008, suggesting that the development in the market was a mere bubble.

5.4 SUMMARY OF FINDINGS

Though the secondary data presents contradictory results when compared to the primary data results. This could be due to the fact that investment in stocks has other return elements apart from dividends (though dividend is the most attractive capital market returns component with 94% of our respondents attracted to the capital because of it see table 4.1 above), which were not factored into stock dividend yield. These stock return components include:

Capital gain – the results from the questionnaire shows that 60% of our respondents are attracted to the capital market by this capital market returns element.

Bonus shares – the questionnaire also shows that 70% of our respondents are attracted to the capital market by this capital market returns component.

Right issue – this is another capital market returns element apart from dividends and it is attractive to 62% of our respondents.

These three capital market returns elements are not factored into the stock yearly average yield. This, in addition to the interest rate deregulation of 1987, explains why the secondary data reports that money market investments yielded more than capital market investment during the period under review.

From the survey, we could see that though the transaction cost is higher in the capital market, returns is also higher in the capital market.

CHAPTER SIX

6.0 SUMMARY CONCLUSION AND RECOMMENDATIONS

This chapter shall contain the summary, conclusion and recommendations

6.1 SUMMARY

Financial intermediation is believed to play a significant role in both developed and developing countries. The economic significance of financial intermediation results from the special role it plays in making contractual arrangement that link borrowers and lenders efficiently (Williamson, 1987). The financial system is said to be very important and plays a fundamental role in the growth and development of any country. Schumpeter (1911), Goldsmith (1969), McKinnon (1973) and Shaw (1973) have linked the financial system to economic growth through the intermediation activities in the money and capital markets.

Fuller and Farrell (1987) define the securities market as "a mechanism bringing together buyers and sellers of a particular type of security or financial asset". According to them, "securities represent a claim on an asset and any future cash flows the asset may generate".

Whereas most Money market instruments are documents certifying that the investor will receive a certain principal and interest payments on a pre-specified date in the future, a stock is a document certifying that the investor owns a specified number of shares of a particular company and therefore is entitled to dividends and other financial benefits. This, according to Jones (1998) explains why Stocks and Treasury Bills are the most prominent forms of securities used in financial transactions. It is this argument that informs the notion that to understand the investment game is to understand the stocks and treasury bills markets.

As Fischer and Jordan (1995) put it, "an investment is a commitment of funds made in the expectation of some positive rate of return. If the investment is properly undertaken,

the return will be commensurate with the risk the investor assumes" From this standpoint, one can opine that for any capitalist economy to function properly, a strong, reliable, and dynamic financial market must exist to fuel the economic machinery.

While some investors may believe that Money market investment is better in the sphere of financial market investment, others believe that the Capital Market instruments produce more returns to investors. However, one cannot be certain about the correctness of any of these positions without closely looking at and evaluating the costs and returns components of the markets. Another issue worthy of note is that the Nigerian financial market has both the primary and secondary markets where "securities" can be bought and sold. The choice of whether to buy and sell in the primary or secondary markets also has great implications on cost and returns on the financial investment. These problems informed the need to carry out this study.

This study therefore attempts to compare the nature of transaction cost and returns in the Nigerian money and capital markets. It also seeks to compare the transaction cost and returns on investing in the primary or secondary markets of the Nigerian capital markets using the event study approach. From the study, it became clear that the transaction cost of investing in the capital market is higher than investing in the money market, though the returns are also higher in the capital market. This result happens to be consistent with theory where returns on investment are expected to be positively related to the risk of such investment.

We also found that the transaction cost of transacting in the secondary capital market is higher than the transaction cost in the primary capital market. This can be explained by the brokerage fees charged by stock brokers when buying and selling on behalf of investors. On the other hand, when investors buy from the primary market directly, brokerage would not apply.

6.2 CONCLUSION

After an indebt study and analysis of the results, the following conclusions were reached:

The cost of transaction in the Nigerian capital market is high. This follows from the fact that 66% of our respondents are of this opinion.

That the returns on investment are high in the capital market. This position was shared by 62% of our respondents

That the cost of transaction is low in the Nigerian money market. This opinion represent the position of 66% of the respondents

That the returns in the Nigerian money market are low. This opinion was presented by 86% of the respondents.

Our secondary sources also showed that transaction cost is higher in the Nigerian capital market than the money market. Returns on the other hand appeared to be higher for most of the period in the money market than in the capital market. This conclusion however may change given a more robust stock returns data which will not only report the dividends but the capital gain, bonus shares and right issue.

We can also infer from the results that the Nigerian capital market is better to invest in when evaluating the markets on the basis of transaction cost and returns. This comes out clearly from the questionnaire that, though transaction cost is higher in the capital market than what is obtainable in the money market; the net return on investment is still better than the returns from the money market.

6.3 RECOMMENDATIONS

Based on our results and findings, we hereby recommend the following:

Risk averse investors should invest their money in the money market. Though the returns may be low, the risk is also low and the principal is mostly “guaranteed”. For short term risk

averse investors who would want to invest in shares anyway, they should do this indirectly through mutual fund where risk is grossly diversified.

Long term investors should buy new issues (IPOs) only. This is because new issues, when bought from agents (e.g. banks) do not attract any explicit cost.

Short term investors who are risk takers should patronize the secondary capital market. Buying from the primary market may result to delayed certificate delivery and eventual capital loss when certificates are not ready when investors would otherwise have sold their shares.

Generally, however, investors should diversify their financial investments to both the money and capital market in ratios that will reflect their disposition to risk.

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Appendix I

QUESTIONNAIRE

Dear respondent,

This questionnaire is aimed at comparing the transaction cost in the Nigerian capital market to that of the Nigerian money market as well as comparing investor returns from both markets (as an M.Sc. research work in the department of economics, Ahmadu Bello University, Zaria). The aim of which is to provide potential investors with relevant information/guidance concerning the subject matter.

The information you shall provide will be helpful in carrying out this task and will be treated with confidentiality.

Thank you.

Akowonjo Olatunji Azeez
(MSc.\Soc-Scie\48275\05-06)

1. How long have you been a financial investor?
   1 – 3years ( ) 3 – 5 years ( ) above 5 years ( )
2. Do you invest in fixed income securities (e.g. treasury bills)?
   Yes ( ) No ( )
3. Do you invest in stocks (shares)?
   Yes ( ) No ( )
4. Do you invest in new issues (IPOs)?
   Yes ( ) No ( )
5. If yes, why do you invest in new issues (IPOs)?

   ---

6. Do you invest in the secondary market?
   Yes ( ) No ( )

7. If yes, why do you invest in the secondary market?

   ---

8. Which market(s) do invest in?
   Money market ( ) Capital Market ( ) Both Capital and Money Markets ( )

9. What is your view about the cost of transaction in the money market?
   High ( ) Medium ( ) Low ( )

10. What is your view about the cost of transaction in the capital market?
    High ( ) Medium ( ) Low ( )

11. Which of these claims do you agree with?
    a) Transaction cost is relatively higher in the money market than it is in the capital market
    b) Transaction cost is relatively higher in the capital market than it is in the money market

    Comment: ---

    ---

12. Which of these claims do you agree with?
    a) Transaction cost is relatively higher in the primary capital market than it is in the secondary capital market
    b) Transaction cost is relatively higher in the secondary capital market than it is in the primary capital market

    Comment: ---

    ---

13. Which of these claims do you agree with?
    c) Returns relatively higher in the capital market than it is in the money market
    d) Transaction cost is relatively higher in the money market than it is in the capital market

Comment: ----------

---

14. What is your view about returns in the money market?
    High ( ) Medium ( ) Low ( )

15. What is your view about returns in the capital market?
    High ( ) Medium ( ) Low ( )

16. What is (are) your attraction(s) to the capital market?
    Dividends ( ) Capital gain/loss ( ) Bonus shares ( ) Right issue ( )

17. What is (are) your attraction(s) to the money market?
    Low risk ( ) Guaranteed returns ( )

Appendix II

FREQUENCY TABLE

How long have you been a financial investor?

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	3 - 5 years	17	34.0	34.0	34.0
	above 5 years	33	66.0	66.0	100.0
	Total	50	100.0	100.0	

Do you invest in fixed income securities (e.g. treasury bills)?

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Yes	49	98.0	98.0	98.0
	No	1	2.0	2.0	100.0
	Total	50	100.0	100.0	

Do you invest in stocks (shares)?

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Yes	50	100.0	100.0	100.0

Do you invest in new issues (IPOs)?

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Yes	50	100.0	100.0	100.0

Do you invest in the secondary market?

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Yes	48	96.0	96.0	96.0
	No	2	4.0	4.0	100.0
	Total	50	100.0	100.0	

Which markets do you invest in?

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Money market	1	2.0	2.0	2.0
	Capital market	2	4.0	4.0	6.0
	Both Capital and money market	47	94.0	94.0	100.0
	Total	50	100.0	100.0	

What is your view about the cost of transaction in the money market?

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	High	2	4.0	4.0	4.0
	Medium	17	34.0	34.0	38.0
	Low	31	62.0	62.0	100.0
	Total	50	100.0	100.0	

What is your view about the cost of transaction in the capital market?

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	High	33	66.0	66.0	66.0
	Medium	15	30.0	30.0	96.0
	Low	2	4.0	4.0	100.0
	Total	50	100.0	100.0	

Which of these claims do you agree with?

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Transaction cost is relatively higher in the money market than it is in the capital market	1	2.0	2.0	2.0
	Transaction cost is relatively higher in the capital market than it is in the money market	49	98.0	98.0	100.0
	Total	50	100.0	100.0	

Which of these claims do you agree with?

		Frequenc y	Percent	Valid Percent	Cumulative Percent
Valid	Transaction cost is relatively higher in the secondary capital market than it is in the primary capital market	50	100.0	100.0	100.0

Which of these claims do you agree with?

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Returns is relatively higher in the capital market than it is in the money market	46	92.0	93.9	93.9
	Returns is relatively higher in the money market than it is in the capital market	2	4.0	4.1	98.0
	3.00	1	2.0	2.0	100.0
	Total	49	98.0	100.0	
Missing	System	1	2.0		
Total		50	100.0		

Which of these claims do you agree with?

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Returns is relatively higher in the capital market than it is in the money market	46	92.0	93.9	93.9
	Returns is relatively higher in the money market than it is in the capital market	2	4.0	4.1	98.0
	3.00	1	2.0	2.0	100.0
	Total	49	98.0	100.0	
Missing	System	1	2.0		
Total		50	100.0		

What is your view about returns in the money market?

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	High	2	4.0	4.0	4.0
	Medium	5	10.0	10.0	14.0
	Low	43	86.0	86.0	100.0
	Total	50	100.0	100.0	

What is your view about returns in the capital market?

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	High	31	62.0	62.0	62.0
	Medium	18	36.0	36.0	98.0
	Low	1	2.0	2.0	100.0
	Total	50	100.0	100.0	

Is dividend one of your attractions to the capital market?

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Yes	47	94.0	94.0	94.0
	No	3	6.0	6.0	100.0
	Total	50	100.0	100.0	

Is capital gain one of your attractions to the capital market?

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Yes	30	60.0	60.0	60.0
	No	20	40.0	40.0	100.0
	Total	50	100.0	100.0	

Is bonus shares one of your attractions to the capital market?

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Yes	35	70.0	70.0	70.0
	No	15	30.0	30.0	100.0
	Total	50	100.0	100.0	

Is right issue one of your attractions to the capital market?

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Yes	31	62.0	62.0	62.0
	No	19	38.0	38.0	100.0
	Total	50	100.0	100.0	

Is the low risk in the money market your attraction to the market?

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Yes	47	94.0	95.9	95.9
	No	2	4.0	4.1	100.0
	Total	49	98.0	100.0	
Missing	System	1	2.0		
Total		50	100.0		

Is the guaranteed returns in the money market your attraction to the market?

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Yes	34	68.0	68.0	68.0
	No	16	32.0	32.0	100.0
	Total	50	100.0	100.0	

Table 5.5 Four Year Pre and Post Consolidation Analysis of Two Investors

	4 YEARS PRE CONSOLIDATION (2002 - 2005)				4 YEARS POST CONSOLIDATION		
	SHARES (Mr. Aliyu Ahmed)		NTB (Mr . Ado Abba)		SHARES (Mr. Aliyu Ahmed)		NTB (
	ROI	NET VALUE	ROI	NET VALUE	ROI	NET VALUE	ROI
INITIAL OUTLAY		200,000.00		200,000.00		200,000.00	
YEAR 1 ROI	21,600.00	221,600.00	37,760.00	237,760.00	19,400.00	219,400.00	17,600
YEAR 2 ROI	21,000.00	242,600.00	30,040.00	267,800.00	18,160.00	237,560.00	13,820
YEAR 3 ROI	19,400.00	262,000.00	28,420.00	296,220.00	17,520.00	255,080.00	13,960
YEAR 4 ROI	19,000.00	281,000.00	14,000.00	310,220.00	16,880.00	271,960.00	11,754
TOTAL ROI	**81,000.00**		**110,220.00**		**71,960.00**		**57,134**