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The Finnish Stock Market: A Survey of some Empirical Evidence and its Practical Relevance

This article reviews the main results of the88 refereed journal articles focusing on the behavior of the Finnish stock market that are authored or co-authored by the researchers of the University of Vaasa, which is the most active research institution in terms of internationally published scientific articles in this area. The studies are divided into three main categories: market microstructure; asset pricing models and fundamentals; and the predictability of stock returns.

The Finnish stock market is characterized by very thin and infrequent trading. As a consequence, stock prices are more clustered on round prices than in large markets. It also seems that the Finnish market cannot accommodate large trades without price pressure. Market indices consisted of even the most frequently traded Finnish stocks are biased because of infrequent trading. Risk estimation problems are serious in Finland, especially when short return intervals and firms with small market value are investigated. This is the case, for instance, when calculating the risk-adjusted returns of mutual funds. Poor liquidity also leads to high bid-ask spreads in the HSE.

Several fundamental variables, such as earnings, dividends, leverage and macroeconomic variables are reported to be significantly related to asset returns in Finland. There may also be possiblities for profitable trading strategies producing abnormal risk-adjusted returns using these fundamentals and certain seasonalities, such as the day-of-the-week or turn-of-the-month effects. Whether these profits are 'true' abnormal profits or simply due to increased risk taking is still under intensive investigation.

The results of the empirical financial market research have numerous implications for corporate financial managers. Various textbooks suggest that managers should employ asset pricing models, such as the Capital Asset Pricing Model (CAPM) or the Arbitrage Pricing Theory (APT), to calculate the cost of capital for investments. However, numerous studies in Finland as well as in major markets report that the traditional risk measurements, such as betas, based on historical stock market returns and derived from asset pricing models do not capture the cross-sectional variation of asset returns as well as several other variables, such as earnings,

E/P ratios, book-to-market ratios, financial leverage or firm size. Therefore, financial managers may want to include these factors when calculating firms' cost of capital.

The empirical results may also have implications for firms' financial decisions. Assuming that the stock market is behaving efficiently, the market value of the firm reflects the present value of the firm's expected future cash flows. However, similar to various studies abroad, several studies suggest that the assumption of market efficiency may not hold in Finland. This has direct implications for the financing decisions of the firm. In an efficient market, firms' stock are either under- or overpriced with respect to its future cash flow expectations. Assuming that the managers know more of the current status of the firm than the market, managers may want to issue either debt or equity. If the firm's stock is under/(over)valued, managers should favor debt (equity) over equity (debt) financing.

There are several changes that have recently occurred or are about to happen that may affect the future price behavior of the Finnish stock market. Most notably, the foreign ownership has increased considerably in Finland, largely due to the abolition of foreign ownership restrictions in 1993. Moreover, with the European Monetary Union's (EMU) elimination of much of the currency risk, probably by the end of this century, portfolio diversification for international investors and intra-European capital raising will be easier. These effects will be reinforced by the likely harmonization of accounting standards throughout Europe. It can be presumed that the international ownership will strengthen the relationship of the Finnish stock market to major markets in the near future and consequently considerably change the behavior of the HSE. Another interesting recent development is the EU directive on investment services, which permits brokerage firms in one country to conduct business on another country's exchange.