Fellows Program | Koret Milken Institute

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Impact of Israel's Market Reclassification

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About the Koret-Milken Institute Fellows Program

The Koret-Milken Institute Fellows Program accelerates Israel's economic growth through innovative, market-based solutions for long-term economic, social, and environmental issues. The program focuses on connecting government, philanthropic, and business resources that are vital to national growth and development.

Directed by the Milken Institute Israel Center, the Koret-Milken Institute Fellows Program awards annual fellowships to outstanding graduates of Israeli and international institutes of higher education. Fellows serve yearlong internships at the center of the nation's decision-making—the Knesset, government ministries, and other Israeli agencies—and aid policymakers by researching and developing solutions for various economic and social challenges.

In addition, fellows craft their own policy studies aimed at identifying barriers to economic and employment growth in Israel. The fellows' studies, carried out under the guidance of an experienced academic and professional staff, support legislators and regulators who shape the economic reality in Israel. The program offers the ultimate educational exercise, combining real-life work experience with applied research five days a week.

Throughout the year, fellows receive intensive training in economic policy, government processes, and research methods. They acquire tools for writing memorandums, presentations, and policy papers, and they develop management, marketing, and communication skills. The fellows participate in a weekly workshop, where they meet senior economic and government professionals, business leaders, and top academics from Israel and abroad. They also participate in an accredited MBA course that awards three graduate-level academic credits that are transferable to other universities in Israel. The course, which focuses on financial and economic innovations, is taught at the Hebrew University of Jerusalem's School of Business Administration by Professor Glenn Yago, Director of the Milken Institute Israel Center and Director of Capital Studies at the Milken Institute in California.

Fellows Program alumni can be found in senior positions in the public and private sectors. Some serve as advisers to government ministries while others work at private-sector companies or go on to advanced studies at leading universities in Israel, the United States, and Great Britain. Within the program's framework, more than 80 research papers have been published, catalyzing reforms, reducing barriers, bringing about economic growth, and improving the quality of life for Israeli citizens.

The Koret-Milken Institute Fellows Program is nonpolitical and nonpartisan. It is funded by the Koret Foundation, the Milken Institute, and other leading philanthropic organizations and individuals in the United States and Israel.

More about the program: www.kmifellows.org
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Introduction

Over the past decade, the Israeli capital market has been gaining ground on its peers in the world's developed economies. The Israeli capital market's growing sophistication and accessibility to world markets have led a succession of organizations to categorize Israel as a developed economy.

Most recently, the world indexing organization MSCI announced in June 2009 that Israel's capital market was moving from the Emerging Markets Index to the World Index, a decision made after a year of consultations with capital market activists.

The reclassification exposes Israel's capital market to a new pool of investors who typically do not invest in emerging markets and who are less familiar with the Israeli market. Conversely, the move will most likely cause the departure of investors who specialize in emerging markets. The great challenge facing the Israeli stock exchange is attracting new foreign capital while preventing current investors from taking their money elsewhere.

The Issues

Certainly, classification as a developed country reflects Israel's growing status among world markets and is a positive development for the economy in the long term. However, several issues must be taken into account when assessing the effects of the upgrade on foreign investments.

- The reclassification turns Israel into a "small fish in a big pond." While Israel's share of the Emerging Markets Index was about 2.87 percent, its share of the World Index will be about 0.37 percent. Teva stock, which also trades on Wall Street, accounts for half of the Israeli market. The combination of Israel's small index share and Teva's dominance could drive investors to invest in Teva alone through the New York Stock Exchange, avoiding the need to trade in shekels, preventing direct investment in the Tel Aviv Stock Exchange (TASE), and minimizing the possibility of investment in other promising Israeli companies. As a result, the upgrade could significantly reduce net foreign investment in the Israeli stock exchange.
- Generally, funds that invest in emerging markets choose their investments according to each country's performance, while investments in developed markets are chosen according to each company's global performance and sector worldwide. In the past, Israeli companies competed with each other for investors, but soon they will compete with companies in the same sectors across the globe. This presents both quantitative and qualitative challenges: Not only will Israeli businesses be competing with a large number of large companies, but those companies will also be from some of the world's leading economies.

- The relative weight of each country in the MSCI indices is determined according to the total free float—the value of shares that are actually available to investors. The free float rate in Israel is significantly lower than in other developed countries, making Israel's weighting in the MSCI index low in relation to the market value of the companies trading in it. A low free float rate has other disadvantages. Research dealing with corporate governance shows that over-concentration and the way ownership is maintained in public corporations limits the liquidity and efficiency of the capital market and reduces competition. In the competition for attention from international investors, a low free float rate is a significant weak point.

- Israel's capital market lacks the liquidity needed for investors to nimbly enter and exit investments. This low liquidity level already causes foreign investors to keep their distance from the Israeli market, and liquidity expectations are even higher among World Index investors. Israeli stocks will be less attractive to investors if liquidity does not improve.

- Two other countries that graduated to the World Index from emerging markets status—Greece in 2001 and Portugal in 1997—faced short-term crises in their capital markets. They recovered in the long term, but Israel should consider the possibility of a negative short-term financial impact and prepare accordingly.

- Israel's capital market has some idiosyncrasies that could act as barriers to foreign investment. For example, trading on the TASE is conducted on different days than other world markets, companies must use Hebrew for reporting, and the trading currency is the Israeli shekel.

These factors negatively affect the outlook for foreign investment in Israel after the reclassification. To evaluate the potential impact, we must quantify the amount of currency expected to leave Israel as a result of the upgrade. In addition, it is important to know the primary source of the foreign currency invested in Israel and how it is distributed.

Key Findings

- Based on our analysis of available data from the Bank of Israel and Thomson Financial and on interviews with local market professionals, it appears Israel's market is in danger of losing roughly 19.2 billion NIS (about US$4.75 billion), which represents the maximum amount of index-related foreign investments in Israel as an emerging market. This figure represents 3.44 percent of current public equity holdings (558.6 billion NIS, or approximately US$139 billion) in the TASE as of May 2009.

- Investors in the United States hold more than 60 percent of Israeli stock, and those in Great Britain hold around 18 percent, according to Bank of Israel figures. Other countries hold at most a few percent of Israeli stock. Reaching new investors should become a high priority for Israeli companies and the TASE.

- Approximately 600 companies trade on the Israeli stock exchange, but just a few enjoy foreign investment. Roughly 55 percent of the foreign investment in Israel is concentrated in just two companies, over 70 percent is invested in the largest four companies, and 93 percent is invested in just 10 companies, according to Bank of Israel figures.

Israel's situation is complex. All parties in the economy—both public and private sectors—must work diligently to provide leverage for the upgrade. While there is no magic pill, we recommend a number of steps that should be taken. Combined, these measures could bring about change and transform the upgrade into a springboard for the Israeli economy.

Table 1: Recommended measures and their influence on the capital market

	Increase free float	Increase market value	Increase liquidity	Reduce concentration	Minimize information asymmetry for foreign investors
Raise the TASE free float requirements in leading stock exchange indices.	✓	×	✓	✓	×
Divest government holdings in publicly held companies, and encourage target companies to meet MSCI's free float minimum.	✓	✓	✓	✓	×
Adjust trading days and hours.	×	✓	×	×	✓
Require reporting in English.	×	×	×	×	✓
Focus "social investment" marketing at the appropriate institutions.	✓	✓	✓	×	×
Create alternative investment products: exchange-traded funds, mutual funds, and unit investment trusts.	×	✓	✓	✓	×
Adjust release dates of annual and quarterly statements to match the customary dates in developed markets.	×	✓	×	×	✓

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