

CHAPTER XIX

THE SECURITIES MARKET

1. MAIN DEVELOPMENTS¹

Total securities issues — shares and bonds (net) to the public — rose slightly in real terms in 1978 to reach IL 1.2 billion. Their composition changed, with demand for bonds picking up and the share market boom subsiding. The public's bond portfolio shrank 8 percent in real terms, slightly lower than in the previous year. There was an unprecedented spurt in redemptions, but bond purchases shot up even more; net issues, though negative, were 14 percent up on 1977. The market value of shares grew by a real 15 percent, far below the extraordinary growth recorded in 1977; almost all the increase was due to the large volume of issues, which checked the real rise in prices. Total stock issues fell only 8 percent short of the huge 1977 volume.

The securities market in 1978 was marked by contrasting trends, both in developments in the two segments of the market and in developments in the two halves of the year. During the first part of the year there was a slump in the bond market, while the share market recovered quickly from the crisis which hit it at the end of 1977 to yield a high 16 percent real return. In the second half of the year there was a turnabout: demand for bonds recovered, and shareholders suffered real losses of 11 percent due to a greatly increased flotation of new issues, which depressed prices. The real return for bondholders was 2 percent for the entire year, and 3 percent for shareholders; the fluctuations in returns diminished substantially, but still remained higher for shares than for bonds.

In 1978 holdings of short- and medium-term financial assets (as defined in Table XVII-1) grew by 9 percent in real terms, a much lower rate than in the previous year. The sources of growth were the increase in total private savings, and, even more, the availability of ample financing. The huge expansion of total resources was sufficient to feed the extra

¹ This chapter deals with securities issued by prospectus (including government and Jewish Agency securities which are exempt from this requirement) listed for trading on the Stock Exchange, with the accent on transactions of the public (viz. households and nonfinancial firms). Due to statistical limitations, the data on issues to the public also include purchases or redemptions by the financial sector (except for savings schemes of securities of the kind issued to the public). Compulsory loans (which are not tradable) are not included in the calculation of net issues, but redemptions of compulsory loans which became tradable (and were held voluntarily) have been subtracted.

TABLE XIX-I

DEVELOPMENTS IN THE SECURITIES MARKET, 1976-78

	1976	1977	1978		
			Total	1st half	2nd half
A. Bonds					
1. Net issues at 1978 prices (IL billion) ^a	(-)5.1	(-)9.4	(-)6.8	(-)4.5	(-)2.3
To the public	(-)3.9	(-)5.0	(-)4.3	(-)3.9	(-)0.4
For savings schemes	(-)1.2	(-)4.4	(-)2.5	(-)0.6	(-)1.9
2. Overall real rate of return on index-linked and option-type (percent)	11	2	1.9	(-)1.2	3.1
3. Stock Exchange turnover at 1978 prices (IL billion)	7.8	8.0	7.2	3.0	4.2
B. Shares (and convertible securities)					
1. Issues at 1978 prices (IL billion)	1.5	6.0	5.5	1.9	3.6
2. Percent increase in issues at constant prices compared to previous year (annual rates)	(-)28	300	(-)8	(-)37.0	20
3. Overall real rate of return (percent)	8.9	34.3	(-)3.4	15.8	(-)10.7
4. Volume of trade (IL billion, at 1978 prices)					
(a) Stock Exchange	3.3	19.0	16.6	9.0	7.6
(b) Stock Exchange and over-the-counter market	6.1	34.9	34.7	17.1	17.6
C. Total securities market					
1. Total issues at 1978 prices (IL billion) (A1+B1)	(-)3.6	(-)3.4	(-)1.3	(-)2.6	1.3
2. Weight of bonds in total Stock Exchange trading (percent)	74	37	30	25	36

^a The net issue data for 1976 and 1977 (the total and its distribution) are an estimate, which is less reliable than the other data.

demand for financial assets, even though a larger percentage of the increment was diverted to physical investments than in 1977. The stronger demand for financial assets can be credited to the opportunity to invest in Patam,² which increased the “returns-liquidity” investment portfolio combinations; the raising of the yield on bonds and savings schemes, the more vigorous effort made to sell shares; and the diminished variability of returns on securities.

At the same time, the public continued to shift its financial savings away from securities to alternative channels at the extremes of the liquidity scale; to institutional savings, which have a low liquidity (approved savings schemes and provident funds), and to Patam. This new medium struck the public as being highly liquid and profitable, and it became the big “hit” in financial investments: the public deposited IL 16.5 billion in Patam (compared to IL 600 million in net bond and share issues to the public in 1977). This shifting of demand to Patam came at the expense of investments in securities as well, whose market value increased by only 2 percent in real terms, compared to 14 percent in the other short- and medium-term financial assets held by the public. Foreign investment in securities traded on the Tel Aviv Stock Exchange may also have experienced a net growth. Throughout most of 1978 bonds were highly liquid: the average period to redemption decreased, and the fluctuations in returns also diminished. At the end of the year, as redemptions gained force, the liquidity of the portfolio dropped from the standpoint of its maturity structure. The renewal of a significant portion of the portfolio, which lengthened the average life of the securities, caused this development.

The serious crisis which struck the share market at the end of 1977 was of extremely short duration, and by the beginning of 1978 real share prices started to turn up and continued in this direction throughout most of the first half of the year. The recovery can be chiefly credited to a stronger institutional demand,³ with the public’s demand slowing after its unprecedented growth in the previous year. This slackening should be viewed against the steep rise in share prices in recent years relative to the profitability of the companies whose shares are listed on the Stock Exchange. The supply rose due to a large issue during the second half of the year, which checked the rise in prices; in light of the weakening of demand at the end of the year, share prices even went down in real terms. It should be recalled that the share market is largely influenced by the dominant role played by banks in stock exchange trade and by share purchases of institutional investors (some of whom are connected with banking institutions, the principal issuers of shares).

² Foreign currency depositors of local residents.

³ Among the institutions which increased their demand for shares were “interested parties”, the social insurance funds, and mutual funds, some of which are connected with the issuers.

The sale of shares, part of which was financed by credit (some of it foreign), which tax considerations render more profitable to the purchaser, also contributed to the reawakening of the market. It should be noted that even though share issues diminished in real terms from the year before, which was quite exceptional in this regard, they remained three times as large as their yearly volume in 1972–76, and their market value grew during 1978 by 15 percent in real terms. The large proportion of shares in securities portfolios, issues, and trading volume has drastically altered the structure of the securities market.

Redemption of bonds from the public's portfolio still exceeded issues in 1978, but was 14 percent lower than in the previous year. A number of factors explain this development: the improvement of the return on original-issue bonds; the growing awareness of the public that partially-linked bonds fully preserve the real value of the investment and the sagging demand for shares.

Beginning in 1978 banks were required to invest part of the accumulation in approved savings schemes in bonds traded on the Exchange. This diminished the segmentation of the bond market, and the banking system is expected to help improve trade in the secondary market and to reduce the yield differentials between it and the primary market.

As regards currency assets, the public preferred to invest in Patam in 1978 rather than in bonds linked to or traded in foreign currency, for which the return on new issues was not adjusted to the dollar interest rate; this was reflected in relatively small purchases of "double-option" bonds or those linked to the dollar (22 percent of total gross purchases of bonds), and a slight rise in prices: the real return on bonds traded in dollars was negative (–19 percent).

2. DEMAND FOR SHARES AND BONDS

The demand for holding securities continued to grow in 1978, though at a slower rate than in 1977; the sources for the expansion were the growth in private savings and the availability of ample financing, part of it credit extended to those purchasing shares. The upward trend in demand for shares relative to that for other securities, which has been evident since 1975, carried over through the year reviewed (see Tables XIX-1 and XIX-2), but the pace slowed because of the substantial rise in share prices. The efficient marketing apparatus of banking concerns (the principal issuers of shares) has been a weighty factor in market developments. Its importance was heightened in 1978 in consequence of the huge volume of bonds which came due this year: this increased the public's dependence on investment advisers, most of whom are bank employees. The marketing of shares was also given a fillip by the provision of credit (some of it from abroad), which tax considera-

TABLE XIX-2

MARKET VALUE OF SECURITIES LISTED FOR TRADING ON TEL-AVIV STOCK EXCHANGE, 1975a-78b
(IL billion)

	Market values				Weight in total securities held by the public (%)				Percent increase in market value			
	1975	1976	1977	1978	1975	1976	1977	1978	1976 Real	1977 Real	1978 Nominal	1978 Real
A. Bonds												
1. Linked and traded in foreign currency ^c	2.8	3.4	5.1	7.0	9.8	8.7	8.1	7.4	-12.0	5.2	37.2	(-)7.3
2. Index-linked issued to the public ^d	9.4	15.2	23.8	43.5	33.0	38.8	37.7	45.6	17.3	9.8	82.8	23.4
3. Option-type loans (linked - unlinked)	11.9	14.3	15.9	6.1	41.8	36.5	25.2	6.4	(-)12.9	(-)22.0	(-)61.6	(-)74.1
4. Double option (index or dollar-linked)	-	-	-	2.8	-	-	-	2.9				
5. Estimate of bonds not yet listed for trade ^e	1.7	1.4	0.6	3.5								
6. Total bonds	25.8	34.3	45.4	62.9	90.5	87.5	71.9	66.1	(-)3.6	(-)7.1	38.5	(-)6.5
Thereof:												
7. In portfolio of banks	3.6	5.3	7.1	10.3	12.6	13.5	11.3	10.8	6.8	(-)6.0	45.1	(-)2.1
8. In the Bank of Israel portfolio	0.5	1.5	2.6	4.1	1.8	3.8	4.1	4.3	117.5	21.6	57.6	6.5
9. Estimate of bonds held by the public ^f (6-7-8)	21.7	27.5	35.7	48.5	76.1	70.2	56.6	50.9	(-)8.1	(-)8.9	35.9	(-)8.3
B. Shares^g												
10. Traded in IL	5.3	9.8	23.6	40.9	18.6	25.0	37.4	43.0	34.1	68.9	73.3	17.0
11. Traded in foreign currency ^c	0.7	1.0	2.0	1.8	2.5	2.6	3.2	1.9	3.6	40.3	(-)10.0	(-)39.2
12. Total shares and options (10+11)	6.0	10.8	25.6	42.7	21.1	27.6	40.6	44.9	30.5	66.3	66.8	12.6
13. Convertible securities	0.8	0.9	1.8	4.0	2.8	2.3	2.9	4.2	(-)18.4	40.3	122.2	50.0
14. Total shares and convertible securities (12+13)	6.8	11.7	27.4	46.7	23.9	29.8	43.4	49.1	24.8	64.3	70.4	15.1
C. Total bonds held by the public and shares (9+14)	28.5	39.2	63.1	95.2	100.0	100.0	100.0	100.0	-0.3	12.9	50.9	1.9

a Excludes securities not intended to be listed for trade such as certain institutional bonds.

b The 1978 data are provisional.

c The market value of securities traded in foreign currency was calculated until 1976 at the Natad rate.

d Excludes bonds issued to institutional investors.

e The face value plus accrued linkage differentials and interest.

f Since the portfolios of institutional investors contain bonds that were issued to the public, this estimate is biased upward, though the bias may decrease over time; includes investments through mutual funds.

g Includes shares in portfolios of institutional investors.

SOURCE: Tel Aviv Stock Exchange and Bank of Israel.

tions render more profitable to the purchaser. Among the institutions which increased their demand for shares were “interested parties”,⁴ provident funds managed by banks, and mutual funds, some of which are connected with the share issuers. The foreign currency reform and the concomitant steps taken in late 1977 go a long way to explain developments in the securities market in 1978.

The reform immediately terminated the unprecedented share market boom: during the last two months of 1977 demand was diverted from shares to index-linked savings schemes and to Patam.

In addition to the advancing of purchases of indexed assets at the end of 1977, which diminished the demand for bonds thereafter, the strong attraction of Patam accounts also depressed bond demand in early 1978. In spite of the improved return on original-issue bonds and the greater array of monthly instruments offered the public, bond redemption was IL 600 million higher than new issues in the period January-July (see Table XIX-3), a real growth of 50 percent over 1977. Prices of index-linked bonds fell during the period January-April, and their return⁵ was then 3.4 percent in real terms.⁶ Along with the slow-down in demand for bonds, that for shares increased: during the first half of 1978 their real return was 16 percent. These trends – the recovery of the share market and ebbing demand for bonds – were sharpened because of the substitutability of these two markets.

In the second half of 1978 the situation was reversed: the bond market recovered while the share market weakened. The mounting attraction of bonds relative to other financial investments stemmed from a gradual intensification of inflationary expectations and uncertainty regarding the dimensions of inflation, which reached a peak at the end of the year, and from the slackening of the advance in share prices. The rebounding of demand for bonds was strengthened by the diminished profitability of Patam investments in late 1978. In addition, there was probably a growing awareness among the public that partially-linked bonds safeguard the full real value of the investment therein and even

4 The available data relate to “interested parties” in companies, which the law defines as those who hold 10 percent or more of the capital stock issued by the company, of the voting rights, or of the power to appoint managers. The reliability of the data is low; in addition they do not relate to other concerns which are associated with the issuer.

5 The term “return” refers to the overall rate of return, unless otherwise specified, for the period ending on the 23rd of the month (before 1977, the end of the month), in order to eliminate temporary end-of-month (end-of-year) influences. Therefore the discussion deals with the return on shares for a period which began at the nadir of the price slump.

6 In this chapter purchasing power has been converted into constant-price terms (or real growth rates) using the consumer price index (or its growth rate). Annual flows (e.g. issues) have been deflated by the annual average price index.

exceed it (this was the aim of a Bank of Israel publicity campaign). Quotations of index-linked bonds started to rise in real terms in May (see Table XIX-6 and Figure XIX-2), and their real return for the period May-December was 11.9 percent. Net issues of bonds to the public, which became positive in August, averaged IL 600 million a month between August and November, as against a negative net monthly issue of a similar amount in the preceding months.

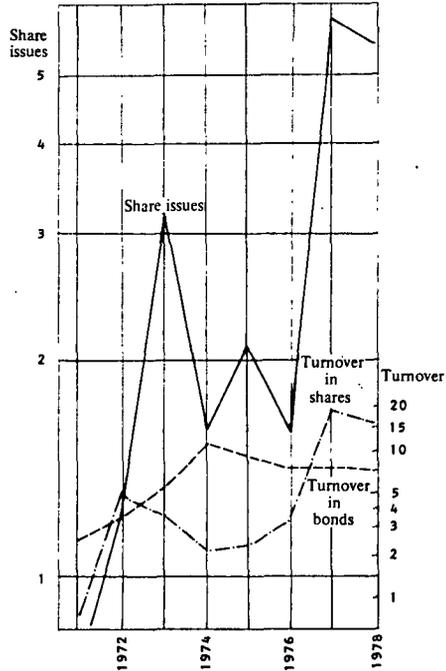
By contrast, as mentioned, the second half of the year witnessed a slowdown in the rise of share prices. This can be ascribed to the substantial growth of supply due to new issues (IL 4.5 billion in May-October); it is reasonable to assume that short-term investment demand was diverted from the share market to bonds. In the period June-November the real return on shares was -14 percent.

The high inflation which prevailed at the end of the year, along with the huge volume of bonds falling due (see Table XIX-3), enhanced the profitability of buying bonds with short-term financing even before they reached maturity, so as to benefit from the linkage to the index of the month preceding redemption. In December net bond issues were again negative, despite the large redemption expected in January 1979. A contributory factor was the recovery of the share market after several months of sluggishness: this was reflected by a real rise in prices which brought the real return up to 3.9 percent that month.

3. THE SHARE MARKET

In new share issues, the bulk of which were floated in the second half of 1978 the weight of the financial sector was less dominant than in the previous year while a large number of new companies turned to the Stock Exchange to mobilize capital. Another striking feature this year was the heavy purchase of shares by "interested parties" and

FIGURE XIX-1
NET SHARE ISSUES AND SHARE AND BOND TURNOVER ON THE STOCK EXCHANGE
 (IL billion, at 1978 prices)



Semilogarithmic scale.

TABLE XIX-3
DOMESTIC SECURITY ISSUES AND NET CAPITAL MOBILIZED, 1976-78^a
(IL million)

	Bonds sold to the public ^b					Total net capital mobilized from the public (4+5) (6)	Tradable bonds issued for savings schemes		
	Sales (1)	Redemption ^c (2)	Net Bank of Israel purchases in and outside the Stock Exchange (3)	Net capital mobilized (1-2-3) (4)	Shares and convertible securities ^d (5)		Sales ^e (7)	Redemption ^f (8)	Net capital mobilized (7-8) (9)
1976	1,875	3,173	647	-1,945	754	-1,191	-	600	-600
1977	1,223	4,330	239	-3,346	3,973	627	-	2,900	-2,900
1978	10,668	15,228	-258	-4,302	5,545	1,243	1,892	4,386	-2,494
January	27	877	79	-929	180	-749	-	144	-144
February	291	776	47	-532	100	-432	-	64	-64
March	500	739	101	-340	345	5	-	411	-411
April	213	988	75	-850	9	-841	197	91	106
May	430	940	7	-517	71	-446	497	760	-263
June	317	977	41	-701	1,223	522	506	360	146
July	685	1,236	-77	-474	1,490	1,016	241	264	-23
August	1,023	1,024	-90	89	489	578	172	665	-493
September	928	729	-79	278	1,121	1,399	72	75	-3
October	2,312	615	-92	1,789	164	1,953	130	137	-7
November	2,324	2,322	-169	171	60	231	42	358	-316
December	1,618	4,005	-101	-2,286	293	-1,993	35	1,057	-1,022
1979									
January	955	3,375	-89	-2,331	101	-2,230	7	296	-289
February	2,661	320	-178	2,519	140	2,659	21	48	-27

^a The data have been rounded off. Does not include compulsory loan issues and redemption of nontradable compulsory loans. In 1978 there may have been purchases in the secondary market to cover savings schemes; the data on issues for the latter would therefore be biased upward and those on issues to the public downward.

^b Includes sales to and redemption of bonds purchased by the financial sector, other than for savings schemes (until 1978), of the type issued to the public.

^c Repayment of principal and payment of interest and linkage increments.

^d The parent company of one of the commercial banks committed itself to buy IL 522 million of the bank issue in 1977 (IL 154 million in 1976), while it issued shares for a bigger sum; in order to avoid double-counting of this issue, the sum has been netted out.

^e "Double-option" bonds, purchased to cover 40 percent of the accumulation in the "dollar-option" schemes.

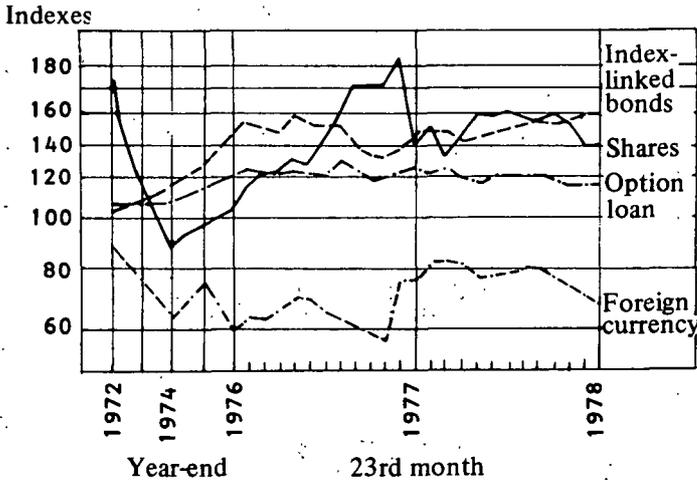
^f The data for 1976 and 1977 are estimates, and hence less reliable.

SOURCE: Bank of Israel calculations.

FIGURE XIX-2

INDEXES OF CUMULATIVE OVERALL REAL RATES OF RETURN
ON SECURITIES AND FOREIGN CURRENCY

(Base: end-1971 = 100)



Semilogarithmic scale.

NOTE: The data on foreign currency relate to the Natad dollar until October 1977, and after that to a basket of currencies. This index is of exchange rates and not the overall rate of return, as in the other indexes in the diagram.

financial institutions, which, it is reasonable to assume, consisted mostly of shares of finance companies. The variability of the returns on shares declined by about 40 percent, but remained high compared to the period before 1977 and to that of bond returns. Total share turnover was about the same as in 1977 in real terms (six times the average annual volume in 1972-76), but the proportion of transactions conducted outside the walls of the Stock Exchange grew in the year reviewed. The buoyant demand for shares was manifested in their total market value, which reached IL 47 billion by the end of 1978, a real growth of 90 percent since the end of 1976.

The much larger quantity of shares offered through new issues is explained by the fact that mobilizing capital this way has become less expensive due to the steep real rise in share prices since the middle of 1976. The size of new issues depends to a great extent on the expected demand for them; this demand grew as the public became increasingly familiar with the stock market because of the 1977 boom and the efficiency of the marketing apparatus of the banking concerns. The latter factor gained in importance with the mounting dependence of the public on investment advisers, most of whom are bank employees; the huge redemption of bonds in 1978 - IL 15 billion (compared to only IL 4 billion the year before) - made large sums available for reinvestment.

TABLE XIX-4
**YIELD AND STANDARD DEVIATION OF MONTHLY REAL^a CHANGES IN PRICES OF BONDS,
 SHARES, AND NATAD DOLLAR AND IN PURCHASING POWER OF MONEY, 1972-78**
 (percent)

	Index-linked bonds	Option- type loans	All ordinary shares	Finance & insurance shares	Industrial shares	Foreign currency ^b	Purchasing power of money
Arithmetic average for 1972-75							
Annual yield ^c	6.47	3.16	2.91	1.72	(-)5.08	(-)6.44	(-)17.45
Annual standard deviation ^d	2.13	2.04	5.26	4.11	5.58	3.08	1.74
Monthly standard deviation ^e	2.28	2.58	5.17	4.24	7.33	2.91	1.76
1976 Annual yield	15.74	5.26	6.61	8.23	0.83	-19.4	(-)27.5
Annual standard deviation	4.02	4.55	5.34	5.63	4.52	2.80	1.11
Monthly standard deviation	3.66	3.55	3.04	3.21	4.61	2.21	1.63
1977 Annual yield	(-)0.08	3.92	34.58	48.34	(-)6.70	8.63	(-)29.8
Annual standard deviation	4.89	2.27	18.37	16.88	16.20	6.64	2.69
Monthly standard deviation	4.43	3.00	12.63	11.96	12.67	6.01	2.69
1978 Annual yield	8.03	(-)7.15	3.44	-1.35	-10.55	-10.35	(-)32.5
Annual standard deviation	2.11	1.60	7.18	5.47	10.75	3.43	1.20
Monthly standard deviation	1.85	2.06	7.10	5.24	10.20	3.19	3.34

^a Deflated by the consumer price index.

^b Until 1977 the Natad dollar; in 1978 a basket of currencies.

^c Overall rate of return for the year.

^d This measures the risk involved in holding an asset for more than one month. It is calculated as the square root of the sum of the square differences between the monthly index of prices and the trend index during the year (end of previous year = 100), divided by the number of degrees of freedom. The trend index during the year is calculated by regressing the prices against the variable "time".

^e This measures the risk involved in holding an asset for one month. It is calculated as the square root of the square differences between the monthly rate of change in the index of prices and the average rate of change therein, divided by the number of degrees of freedom.

Since every issue involves substantial fixed charges and the expenditure of considerable time and effort on the part of management, companies tend to avoid frequent, small flotations. When the issuer is a large company, the emission is likely to significantly increase the supply of stocks in general and those of the issuer in particular.⁷ To avoid unsettling the market the banks gave credit to some investors,⁸ thus regulating demand. The supply was also regulated when "interested parties" purchased about IL 1.3 billion of the issues, with the intention of selling them gradually in the future.⁹ The total value of new issues was IL 5.5 billion in 1978, while the annual average market value of shares was about IL 37 billion. Intervention in the market was most pronounced in the purchase of about a third of the peak issue in June-August (IL 3.2 billion)¹⁰ and the purchase of IL 600 million of shares in January-February.¹¹ (On the reliability of the figures on purchases by "interested parties" see note 4.) No data are available on the intervention of the financial institutions as a whole, nor is it known to what extent purchases by "interested parties" or the marketing of shares on credit increased in 1978. The bulk of the trade by "interested parties" involved bank stock, which explains the relatively small fluctuation in returns and dispersion of shares in the finance and insurance group (see Table XIX-4 and XIX-9). Among the financial institutions the net purchase of IL 850 million of shares in 1978 by bank-administered provident funds stood out.

The composition of issues was again typified in 1978 by the sale of "packages", consisting of shares, convertible bonds, and options; the weight of shares in total issues even fell from 70 percent to 53 percent in 1977. Diversifying the issue makes it possible to promote its marketing and to sell inferior securities as well. It also makes it possible to issue shares without an additional prospectus when the time comes to exercise the convertibility rights; thus the continuity of share offers is increased, with a corresponding savings in prospectus costs. The drawback of "inclusive issues" is that the average poten-

7 In 1978 there were three large issues, totalling IL 0.7–0.9 billion each.

8 For those who are not defined as traders by the tax authorities, this kind of transaction has tax advantages: the interest rate on credit is recognized as a deductible expense, dividends are taxed at a relatively low rate, and capital gains on listed shares are tax exempt.

9 In favorable market conditions, the reverse timing is possible: the gradual sale of shares in anticipation of the issue, when "interested parties" replenish their portfolios.

10 The purchase figures for "interested parties" represent more than market intervention, since they also include purchases obviously made for the portfolios of parent companies (sometimes for the purpose of gaining control).

11 In discussing institutional intervention, note should be taken of the formidable weight of banking concerns and affiliated firms in total share market activity and their consequent ability to alter development trends.

tial buyer is not equipped to evaluate the profitability of purchasing the different securities based on market price considerations; "inclusive issues" also complicate trading on the Stock Exchange.¹² In 1978 the Tel Aviv Stock Exchange decided to discontinue trade in "packages", and to trade the securities separately from the day they are listed.

The timing of the issues during the year (see Table XIX-3) was influenced by their lag behind the prevailing market conditions. The offering of new issues some time after prices begin to rise has a destabilizing effect on prices. The uncertainty caused by the crisis at the end of 1977 was one of the reasons for the small volume of new issues in the early part of 1978.

The timing of issues was also influenced by the exemption from the obligation to publish an interim financial report, which was granted to companies bringing out balance sheets to the end of December for stock issues through the end of August. For this reason issues fell off at the beginning of the year, when balance sheets were still in preparation, and increased in the second half of the year. The growth in offers was further stimulated by fiscal circumstances.¹³

The strongly bullish tone of the share market induced a greater resort to the Stock Exchange for mobilizing capital; 15 companies took this route for the first time in 1978, compared to a yearly average of less than three companies in 1970-77: these included five industrial companies, five financial institutions, two investment and holding companies, one in the building and land groups, one in commerce and services, and one in oil exploration. The weight of the finance and insurance group in the offerings of these new companies (which, at IL 1 billion, amounted to nearly 20 percent of total new share capital this year) was relatively low - 40 percent.

The preponderant weight of banks in offerings can be attributed to their experience in mobilizing equity capital on a scale adequate to finance their expansion. Nevertheless, 1978 was the third straight year of decline in the weight of the financial sector in total issues. This was apparently caused by the booming demand for shares, which encouraged even nonfinancial companies to issue stock. The weight of the financial sector in total offerings dipped from 94 percent in 1975 to only 73 percent in 1978 (and that of the

¹² The average for each of the three banks that issued securities of numerous types was ten securities at the end of 1978 (shares, options, and capital notes).

¹³ Under an amendment to the law in July, the tax authorities recognize the flotation costs of industrial companies (about 7 percent of the proceeds) as a deductible expense, to be written off in three equal yearly instalments beginning in that year. Another tax relief was awarded to industrial companies: the listing of existing shares on the Stock Exchange along with the offering of an emission to the public by means of a prospectus will exempt shareholders from tax on the capital gains accumulated up to the time of listing, provided they hold the listed shares for at least five years after the date of listing.

TABLE XIX-5
STOCK EXCHANGE AND OVER-THE-COUNTER MARKET TURNOVER, 1975-78

	Bonds (on the Stock Exchange)							On Stock Exchange			Total trade on Stock Exchange and over-the-counter ^b	
	Total ^a	Government bonds	Linked to c-o-l index	Option-type loans	Linked to exchange rate or traded in foreign currency	Double option	Unlinked	Convertible securities	Shares	Total securities traded	Shares	Bonds ^c
	(IL million)											
1975	3,517	2,890	1,338	1,873	306	0	0	103	780	4,400	1,362	19,677
1976	3,844	3,369	1,558	2,017	269	0	0	178	1,432	5,454	2,826	.. ^d
1977	5,307	4,771	2,647	2,299	351	0	11	1,291	11,345	17,943	21,861	..
1978	7,170	6,422	4,189	2,168	473	312	28	2,233	14,356	23,759	32,468	..
	Percent annual increase											
1975	17.2	17.6	68.1	-7.1	61.9	-	-	37.6	50.4	23.1	41	49
1976	9.3	16.6	16.4	7.7	-12.1	-	-	72.7	83.6	24.0	107	..
1977	38.1	41.6	69.9	14.0	30.5	-	-	625.3	692.2	229.0	674	..
1978	35.1	34.6	58.3	-5.7	34.8	-	-	73.0	26.5	32.4	48.5	..
	Weight in total Stock Exchange turnover (percent)											Over-the-counter trade as a percent of total trade
1975	79.9	82.2	30.4	42.6	6.9	-	-	2.3	17.7	100.0	42.7	81.6
1976	70.5	87.6	28.6	37.0	4.9	-	-	3.3	26.3	100.0	49.3	..
1977	29.6	89.9	14.8	12.8	2.0	0	0	7.2	63.2	100.0	48.1	..
1978	30.2	89.6	17.6	9.1	2.0	1.3	0.1	9.4	60.4	100.0	55.8	..

^a Excluding trade in unlinked bonds and the Short-Term Loan.

^b Over-the-counter trade - according to the reports of Stock Exchange members.

^c Includes convertible bonds. The data are statistically less reliable.

^d .. No data.

SOURCE: Tel Aviv Stock Exchange.

TABLE XIX-6
MONTHLY OVERALL RATE OF RETURN INDEX FOR LISTED SECURITIES^a
AND MUTUAL FUNDS AND INDEX OF RATES FOR A BASKET OF
CURRENCIES AND THE DOLLAR, 1978
(December 1978=100)

	Index linked IL bonds			Bonds traded in foreign currency	IL shares		Index of foreign currency rate ^c		Mutual funds
	Total	Index-linked	Option-type		Ordinary and preferred ^b	Convertible bonds	Basket of currencies	Dollar ^d	
1972	18.9	17.1	20.6		31.4			28.3	
1973	23.5	21.7	25.1		24.9			30.5	
1974	36.6	35.0	38.3		27.9			40.4	
1975	46.8	45.7	48.3	58.0	36.6	47.0		58.0	
1976	69.0	70.2	67.5	63.2	52.1	65.6		64.9	63.6
1977	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1978									
January	100.6	101.1	99.9	104.1	110.5	104.1	110.2	104.8	102.7
February	102.8	102.3	103.5	97.3	98.4	93.4	113.1	106.2	103.2
March	103.0	103.3	102.5	100.9	111.4	106.7	115.5	108.6	105.9
April	108.3	109.8	105.9	105.0	130.4	123.2	114.6	109.6	112.4
June	116.7	118.9	113.5	114.3	136.7	124.5	121.7	115.8	120.0
July	122.9	123.8	116.6	118.7	136.6	121.3	127.9	119.1	123.0
August	124.9	128.8	119.2	121.2	137.7	121.7	129.2	120.3	126.1
September	126.8	131.0	120.5	122.4	146.6	127.6	126.8	120.1	128.6
October	134.1	140.2	124.9	120.9	147.3	130.3	131.7	120.4	133.1
November	145.8	154.8	132.5	121.4	142.6	125.1	131.0	123.6	135.6
December	151.0	160.0	137.5	120.2	153.2	132.7	132.8	122.9	141.1
Real Index for December	101.9	108.1	92.9	81.1	103.4	89.6	89.7	82.9	95.3

^a Since 1977, data are for the 23rd of each month. Previously indexes were calculated for the end of month, and excluded interest payments and cash dividends.

^b The weight of preference shares in the total is very low.

^c This is an index of foreign exchange rates rather than of overall rates of return, as in the rest of this table; the difference between the two indexes is the interest rate.

^d Before 1977 the Natad dollar.

SOURCE: Central Bureau of Statistics; foreign currency exchange rates – Bank of Israel.

TABLE XIX-7

**MARKET VALUE OF EXISTING SHARES BY ISSUING GROUP AND NEW ISSUES
OF SHARES AND CONVERTIBLE SECURITIES,^a 1978**
(IL million)

	Market value of listed shares and convertible securities ^b			Sales of newly issued shares and convertible securities, 1978					Weight of new issue in total market value of the group's shares at end of 1977 (percent)
	Weight of group in total market value, end of 1978 (percent)	Percent real rise in mar- ket value in 1978	Weight of group in total issue				1978 IL m.		
			1975	1976	1977	1978 %			
Commercial banks and bank holding companies	28,473	61.0	13.4	85.0	80.2	70.0	59.4	3,291	19.4
Mortgage banks	2,649	5.7	(-14.8)	4.6	6.9	5.0	7.5	416	19.8
Specialized financial institutions	1,599	3.4	(-47.0)	0.6	0.0	1.7	0.5	30	1.5
Insurance	1,333	2.9	30.9	3.6	2.5	5.0	5.1	282	41.0
Total financial sector	34,054	73.0	5.6	93.8	89.6	81.7	72.5	4,019	18.5
Commerce and services	570	1.2	(-22.8)	0.0	3.5	0.8	0.3	19	3.8
Land, building, development, and citrus ^c	2,651	5.6	64.9	2.1	0.3	1.9	6.9	384	35.4
Industry	3,948	8.5	2.6	4.1	6.6	12.4	11.4	632	24.3
Investment and holding companies	5,454	11.7	160.6	0.0	0.0	3.2	8.9	491	34.8
Total	46,677	100.0	15.1	100.0	100.0	100.0	100.0	5,545	20.3

^a Excludes bonus shares, conversion of convertible bonds, issues not against cash, and existing shares listed for trade on the Stock Exchange.

^b The data on the total stock and its breakdown for the end of 1978 are provisional.

^c Includes an oil exploration company founded in 1978, which issued IL 100 million of shares.

SOURCE: Tel Aviv Stock Exchange and Bank of Israel.

commercial banks from 85 percent to 59 percent). Issues by industrial companies were down 1 percent in 1978, to stand at 11 percent of total offerings, and amounted to 10 percent of total industrial investment. And this despite the tax concessions granted them, as mentioned; and the raising of the proportion of social insurance fund accumulation which could be invested in industrials. The small share of this sector in total new issues is a direct result of the availability of cheap industrial investment finance. It would be reasonable to expect that such government assistance would encourage the financing of investments with equity capital, in constituting a supplementary source. In practice, however, it serves as a substitute for issuing stock, and industrialists prefer to obtain additional funding from the government, while equity capital is mobilized in other ways – without the expenses, administrative effort, and disclosure that are bound up with share offers to the public by prospectus. It can therefore be said that capital mobilization through bonds, issued either by the government or in accordance with its directives, serves as a substitute for the mobilization of capital shares. Investment and holding companies¹⁴ increased their weight in new issues in 1978, accounting for about one-tenth of the total, while land and development companies expanded their operations with the boom in construction and increased their weight in the total to 5 percent, double the 1977 figure.

To whom did the issuers turn? Rights issues decreased in 1978, depressing their weight in total offers from 47 percent in 1977 to 36 percent. The fourfold increase in the weight in new issues of companies whose stock was previously not traded on the Exchange also influenced the weight of existing stockholders. In addition, the proportion of advance purchases by institutional investors in total issues dropped in 1978 to about half its 1977 level. This was caused by the decrease in their orders, together with the instruction to curtail their allocation in case of oversubscription.

The return on bank shares was 2.9 percent, while that for the entire finance and insurance group was -1.3 percent. The land, building, and development group yielded a high 27 percent real rate, since it enjoyed excellent market conditions. Investment company shares also turned in an outstanding performance, scoring a 43 percent return, while industrial and commercial and service shares suffered substantial losses. Examination of the annual average rate of return index, which is less influenced by temporary fluctuation,¹⁵ reveals that the real return on all stocks was 0.5 percent, for the finance and insurance

¹⁴ Which invest, *inter alia*, in stocks and bonds traded on the Stock Exchange.

¹⁵ The overall rate of return represents the expected return in 1978 on a random investment in shares of the group under consideration (with the probability of investing in a particular stock varying in proportion to its weight in the market value of the listed capital of the group), whereas the annual average growth rate represents the expected return on an investment held for 12 months, beginning in some random month in 1977.

TABLE XIX-8
**CUMULATIVE OVERALL RATE OF RETURN INDEX FOR SHARES LISTED FOR TRADING
 ON STOCK EXCHANGE, 1974-78**
 (Base: December 1977 = 100)

	General Stock Exchange index	Finance and insurance							Land, building, develop- ment ^a
		Total	Commercial banks	Mortgage banks	Specialized financial institu- tions	Invest- ment com- panies	Industry	Commerce and services	
End of year									
1974	26.6	24.0	27.4	20.0	31.2	30.4	34.1	25.9	23.4
1975	36.0	32.9	34.6	24.4	38.4	42.9	52.0	47.4	35.6
1976	52.1	47.3	48.3	41.8	54.8	61.9	75.2	62.8	59.6
1977	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1978, end of quarter									
March	111.4	109.8	109.9	107.0	107.7	124.1	107.4	102.7	120.0
June	136.7	131.8	130.6	133.5	136.6	158.9	137.0	128.7	155.1
September	146.6	138.6	142.1	116.2	125.5	195.1	137.8	115.8	182.7
December	153.2	146.1	152.5	106.4	124.0	211.8	132.5	114.4	188.1
Real index for December	103.4	98.7	102.9	71.8	83.7	143.0	89.5	77.3	127.0
Real change in annual average index ^b (percent)	0.5	7.1	13.3	18.5	(-)23.4	(-)3.4	(-)22.0	(-)16.0	(-)5.4

^a Until 1976, includes citrus.

^b The conversion into real terms was done monthly, using the consumer price index.

SOURCE: Central Bureau of Statistics.

TABLE XIX-9

NET OVERALL RATES OF RETURN ON ORDINARY STOCKS LISTED ON TEL AVIV STOCK EXCHANGE, 1977-78
(percent)

	Overall rate of return			Dividend yield (weighted by listed capital)	Lowest overall rate of return	Highest overall rate of return	Deciles of the distribution of the rates of return					Index of dispersion ^c	Number of shares	Number of companies
	Arithmetic average	Weighted by listed capital ^a	Weighted by annual Stock Exchange turnover ^b				10	25	50	75	90			
1. Banks, insurance companies, and financial institutions														
1977	117.0	102.2	104.4		44.0	261.7	79.0	84.2	94.0	145.7	188.3	0.56	34	22
1978														
1st half	39.1	42.8	39.6		-19.7	102.6	1.0	13.7	20.1	30.8	44.0	0.36	49	23
2nd half	-3.9	12.7	10.5		-39.5	29.7	-25.2	-20.6	-6.4	12.2	22.0	0.50	49	23
Total	18.0	38.9	37.0	2.1	-26.3	58.3	-17.9	-7.7	17.7	38.1	54.8	0.62	49	23
2. Land and development companies														
1977	122.9	119.4	102.1		24.1	248.1	58.5	76.9	112.0	143.1	244.0	0.88	13	10
1978														
1st half	39.1	42.8	39.6		3.6	75.0	6.1	29.1	36.4	54.2	63.0	0.42	15	11
2nd half	31.9	26.5	20.1		-15.0	177.5	-13.6	-11.3	20.5	52.9	110.1	1.03	15	11
Total	80.7	77.2	63.9	1.1	20.4	243.0	24.9	29.2	53.5	98.0	208.1	1.12	15	11
3. Industrial and commercial companies														
1977	63.7	51.2	74.9		-16.3	248.1	0.8	17.0	52.0	76.4	167.1	2.09	36	24
1978														
1st half	25.8	18.4	28.1		-13.5	95.2	-0.2	9.1	24.1	34.4	53.1	0.43	43	25

2nd half	7.0	-0.1	-2.5		-37.6	141.8	-23.0	-17.6	-3.7	24.0	39.4	0.65	43	25
Total	35.1	18.5	24.9	2.8	-32.2	208.3	-14.6	-6.3	23.3	54.3	86.8	0.82	43	25

4. Investment companies

1977	69.8	80.3	75.4		19.1	165.0	23.4	42.1	69.0	88.2	110.9	0.52	27	21
1978														
1st half	25.2	27.2	30.5		-12.3	65.7	2.6	7.1	19.5	39.3	60.3	0.48	31	19
2nd half	20.4	16.0	16.7		-21.6	255.3	-16.1	-6.0	3.0	31.5	63.5	0.77	31	19
Total	50.8	48.8	52.1	3.2	-15.1	294.9	-12.2	9.2	43.0	65.4	154.9	1.17	31	19

5. Total ordinary shares

1977	88.7	91.5	95.1		-16.3	261.7	19.1	52.0	80.6	115.8	173.5	1.41	110	77
1978														
1st half	26.2	23.6	26.1		-19.7	102.6	2.6	11.7	22.5	37.4	54.2	0.42	138	78
2nd half	8.8	11.9	10.2		-39.5	255.3	-23.0	-15.5	0.1	20.5	43.8	0.67	138	78
Total	37.1	38.7	38.8	2.2	-32.2	294.9	-13.6	3.0	26.8	53.5	96.1	0.87	138	78

- a Weighted by the listed capital at market prices, at the end of the previous calendar year.
- b Weighted by Stock Exchange turnover during the calendar year.
- c The index of dispersion is calculated as follows: the overall rate of return for the lowest decile is subtracted from the overall rate of return for the highest decile; the remainder is divided by 1 plus the return for the median group. E.g., the index of dispersion in 1977 for the banking, insurance, and financial institution group is calculated as follows:

$$\frac{\frac{188.3}{100} - \frac{79.0}{100}}{1 + \frac{94.0}{100}} = 0.56$$

SOURCE: Bank of Israel calculations.

group 7.1 percent, and banks 13.3 percent. Examination of the returns for the calendar year (Table XIX-9)¹⁶ does not greatly alter the picture. The nominal dividend yield on and for the finance and insurance group was about 2 percent in 1978¹⁷ (see Table XIX-9) which was different from the figure for the remaining groups. The low weight of dividends in the overall rate of return constitutes an advantage to the investor since dividends are taxable, whereas capital gains are not. (This is only one of the considerations in determining dividend distribution policy.)

There was no real change in total share trading in 1978, though a larger proportion was carried on outside the Stock Exchange: 56 percent compared to 48 percent in the previous year (see Table XIX-5). The increased institutional investors contributed to this development.

4. THE BOND MARKET¹⁸

The market value of the public's bond portfolio amounted to an estimated IL 49 billion at the end of 1978; this represented a decline of 8 percent during the year and followed a 9 percent drop in 1977 (see Table XIX-2). The falling trend in the demand for bonds slowed this year, the excess of redemptions over issues being 14 percent less than in 1977.

To help the bond market snap out of the crisis which beset it in recent years, the terms of such paper were improved. In February the (gross) interest rate on bonds issued at source was increased by one percentage point (following a two point rise in October, 1977); this brought up the real net yield to maturity by about half a point. The variety of bonds available to the public was increased with the addition of two new types; one offering the option of linkage to either the consumer price index or the dollar exchange rate, and the second linked to the dollar. At first the public preferred the double-option type bonds, but in the second half of 1978 purchases of index-linked bonds grew stronger. This development was intensified by the hiking of the interest paid on deposits and the

¹⁶ The discussion of returns relates to the year beginning on December 22, 1977, when share quotations were at their nadir. The real return for the calendar year was much lower (-6 percent compared to 3 percent) because of the differential rise in share prices in the last week of the two years in question: 10 percent in 1977 and no change in 1978.

¹⁷ If we calculated the amount of capital mobilized through shares in the same way as for bonds (subtracting interest payments from the issue amount), we would have to deduct about IL 500 million from the share issue figure on account of dividend payments.

¹⁸ The short-term loan is discussed in Chapter XVII.

fading attraction of dollar-linked bonds due to the nonadjustment of the interest rate. The paltry volume of dollar-linked bond sales led to discontinuance of their issue in 1979.¹⁹

In addition to raising the interest rate on new issues, the Bank of Israel acted to dampen the volatility of yields, thereby enhancing the attraction of bonds in the secondary market and stimulating sales in general. The need to intervene in secondary market trading in order to moderate price fluctuations was due to the insignificant intervention of institutional investors in the Stock Exchange: special bond issues, carrying preferential terms and not listed for trade on the Stock Exchange, were floated for them, while the tradable bonds in their portfolios were frozen.

In the middle of 1978 banks were obligated to invest 40 percent of their accumulation in "dollar-option" saving schemes in "double-option" bonds. As a consequence, the banks purchased tradable bonds in 1978 to the tune of IL 1.9 billion, reducing their net acquisition of such paper from -IL 2.9 billion in 1977 to -IL 2.5 billion in 1978. Since the portfolio of tradable bonds was frozen, it was influenced only by new issues. Because of the aforementioned requirement, the banks have become more active in Stock Exchange bond trade on own account, a trend that is expected to gain momentum.

In January-April 1978, when the demand for bonds took a nose-dive, the Bank of Israel purchased about IL 100 million worth a month in the secondary market (see Table XIX-10). With the change in market conditions, the Bank acted in the opposite direction: net purchases shrank to about IL 40 million a month in May and June, while in July-November there was a net sale from the Bank's portfolio to the tune of about IL 80 million a month. Total purchases by the Bank on the Stock Exchange amounted to IL 100 million for the year, compared to IL 400 million in each of the previous two years. The

¹⁹ The terms and yields to maturity in the primary market are as follows:

Bond terms/average annual inflation rate (%)	Net real yield (%)		Life of bonds (years)	
	25	40	Final maturity date	Early redemption
1. 7% interest, 80% index-linkage	2.4	2.1	10	5
2. Double-option 5% interest, 80% index-linkage				
80% index-linkage	1.1	0.9		
100% dollar-linkage	2.9	2.8		
3. 5.5% interest, 100% dollar-linkage	3.6	3.6	6	

NOTE: In calculating the yield on dollar-linked bonds the rate of devaluation is assumed to be equal to the rate of inflation.

TABLE XIX-10

**BANK OF ISRAEL OPERATIONS ON THE STOCK EXCHANGE,
1975-78^a**

	1975	1976	1977	1978 (quarterly)				
				Total	I	II	III	IV
Net purchases (IL million)	173	412	415	97	292	186	(-)150	(-)231
Volume of trade (IL million) ^b	614	691	720	1,782	437	360	406	579
Weight in total trade (percent)	9.6	9.7	7.3	13.4	15.2	14.0	13.3	12.0

^a Does not include the Short-Term Loan or over-the-counter transactions. Since the data on net purchases appearing in Table XIX-3 include redemptions and purchases of newly issued bonds for the Bank of Israel portfolio they differ from the data published here.

^b Until 1977 trade in index-linked and option type; in 1978 also double-option bonds.

SOURCE: Bank of Israel calculations.

weight of the Bank in total bond turnover on the Exchange rose from 7 percent in 1977 to 13 percent.²⁰

The amount of bonds in the public's portfolio which came due shot up from IL 4 billion in 1977 to IL 15 billion in 1978. In a market where economic units act rationally, the volume of redemptions has no impact on decisions concerning net purchases, since an investor can change the composition of his portfolio at any time through the secondary market without regard to redemptions. But when other than rational considerations motivate the public, redemptions can influence the composition of securities portfolios and financial investments in general. In 1978, when a sizable redemption took place, the public became more dependent on investment counsellors, while the Bank of Israel, on the other hand, launched an information campaign to encourage reinvestment in bonds, emphasizing their advantage in ensuring a real return.

²⁰ Since a substantial fraction (of unknown and variable dimensions) of the trade in bonds takes place outside the Stock Exchange, no far-reaching significance should be attached to the change in the share of the Bank of Israel in trade on the Exchange (Table XIX-10). The change in this datum does not necessarily indicate any change in the Bank's involvement in the trade in government bonds, since their weight in total turnover can vary. This further diminishes the significance of the growth of the Bank's share in 1977.

TABLE XIX-11

AVERAGE REAL NET YIELDS TO MATURITY OF BONDS, MONTHLY, 1978
(percent)

Interest Index linkage rate (percent)	4%		6½%	Traded in foreign currency
	100	90	100	
1978 January	1.97	2.34	0.28	3.60
February	2.44	3.04	0.05	3.48
March	2.17	2.56	(-)1.07	3.70
April	1.95	2.41	(-)1.59	3.75
May	1.67	2.84	(-)1.10	3.64
June	1.48	2.32	(-)1.36	3.76
July	1.50	2.40	(-)1.50	3.66
August	1.04	2.34	(-)2.43	3.73
September	0.94	2.47	(-)2.09	3.88
October	0.43	1.32	(-)4.07	4.21
November	0.50	1.85	(-)3.83	6.23
December	0.01	1.62	(-)5.59	5.79

NOTES:

1. The yields shown in this table are averages of end-of-week data for government bonds.
2. The yields were calculated using an index of consumer prices estimated by the State Loans Administration for each month.
3. Bonds traded in foreign currency are represented by Hollis bonds.
4. The yield to maturity of original issue bonds linked 80 percent to the c-o-l index was 1.8 percent until mid-February 1978, and 2.4 percent since then, assuming a 25 percent annual average inflation rate. Assuming an inflation rate of 40 percent, the yields are 1.5 and 2.1 percent, respectively.

SOURCE: Bank of Israel calculations.

The real fluctuations in bond prices (measured by their standard deviation, and which reflect the real return risk diminished in 1978 by about 55 percent for index-linked bonds and by 30 percent for option-type loans, and were even lower than during the period 1972-76 (see Table XIX-4). This made it even more worthwhile to hold bonds as liquid means.²¹ The importance of primary market trade (redemptions or purchases of new issues) increased this year with the sharp growth in the amount of bonds reaching maturity, as was noted above.

²¹ Although the rate of return on shares is much more volatile than that for bonds, the velocity of Stock Exchange turnover for the former is three and a half times faster than that for bonds.

TABLE XIX-12

MUTUAL FUND ASSETS AND THEIR COMPOSITION, NET ISSUES AND RATES OF RETURN, 1978
(IL million)

Classification of funds by their specialization ^a	Composition of assets portfolio ^b 31.6.1978 (percent)			Assets at market value (end of year)		Net issues ^c			Real rate of return weighted by market value of funds (percent)		
	Index-linked and option-type	Foreign currency	Shares in Israeli currency	1977	1978	Jan.-June	July-Dec.	Jan.-Dec. 1978	Jan.-June	July-Dec.	1978
1. All types of securities	32	33	32	2,192	1,647	(-)377	(-)64	(-)441	3.4	(-)7.8	(-)4.7
2. Index-linked and option-type bonds and foreign currency	52	34	11	4,687	8,560	31	569	600	0.2	(-)6.5	(-)6.3
3. Index-linked and option-type bonds	83	12	3	6,516	9,216	180	1,590	1,770	0.1	(-)1.7	(-)1.6
4. Foreign currency assets	1	98	1	620	1,606	276	149	425	(-)1.8	(-)13.2	(-)14.8
5. Index-linked and option-type bonds and shares	39	4	55	1,273	1,830	82	(-)150	(-)68	6.7	(-)9.0	(-)2.9
6. Shares or foreign currency assets and shares	5	23	72	442	611	154	(-)250	(-)96	20.7	(-)14.8	2.9
7. Total funds	54	27	17	15,730	23,470	346	1,844	2,190	1.7	(-)6.3	(-)4.7

^a The funds were classified according to their actual specialization at the beginning of each quarter (nonspecialized funds are presented in the first line). Two groups of funds were aggregated in line 6.

^b Does not add up to 100 percent, because of the omission of cash and the rounding of figures.

^c Mutual fund shares sold less redemptions, on a cash basis.

SOURCE: Bank of Israel.

The weak demand for linked bonds during the first half of the year was reflected in relatively high yields to maturity (see Table XIX-11). In January and February, expectations of an improvement in the terms of new issues increased the return on long-dated bonds. The surging demand for bonds during the second half of the year (with the intensification of inflationary expectations for October and the raising of fuel and electricity prices), depressed the yields to maturity, especially of bonds falling due in the near future. As a result of the upping of the interest rate on new issues in February and the decline of secondary market yields, the gap between the return on long-dated bonds and that on new issues shrank. Since the return on new issues was higher than that for long-dated secondary market bonds at the end of every month in the second half of 1978, the purchase of bonds in the primary market was preferable to that in the secondary market.

The development of the real overall rate of return on bonds is a mirror image of the development of the real yield to maturity. The real yield on index-linked bonds was 8 percent in 1978 (see Table XIX-6): in the first quarter it was -4.1 percent, but subsequently it turned up rapidly, particularly in the second and fourth quarters, when it reached 5 percent per quarter. The real yield on option loans was low in 1978 (-7 percent) because of their approaching redemption date (a substantial portion was redeemed each month during 1978). Since the redemption value of bonds is determined according to the last price index published before maturity date, one holding the bond to the end of its life sustains some (unknown) loss of linkage increment. This risk, together with the short period remaining before redemption, brought the yield on the bond closer to that in the money markets. The approaching large redemption of option loans may also have depressed their price.

5. MUTUAL FUNDS

Net issues of mutual fund shares²² plunged 33 percent in real terms in 1978; this was a poorer performance than in the previous year, and it occurred despite an increase in the number of funds and in their areas of specialization. The weight of the mutual funds in the total market value of securities traded in Israeli currency on the Tel Aviv Exchange stabilized at 17 percent. The foreign currency component of the portfolios was responsible for the low real return on mutual fund holdings (-5 percent).

The shrinkage of net sales of shares in 1978 continued the uninterrupted retreat from the peak level reached in 1975, up to which time sales had grown fourfold in two years

²² Defined as the amount of shares issued at issue price less redemption at redemption price.

TABLE XIX-13

MUTUAL FUND OPERATIONS, 1974-78
(percent)

	Net issue ^a (IL mil- lion)	Real change in net issues	Net issue divided by funds' assets at end of previous year	Weight of funds' assets in secu- rities portfolio listed for trade at end of year	Composition of funds' assets portfolio at end of year ^b		
					Bonds traded in IL	Shares traded in IL	Foreign currency assets
1974	1,000	98	108 ^c	3	74.1	7.7	18.2
1975	1,869	34	80	13	72.5	8.2	19.6
1976	1,822	(-)26	35	15	68.5	7.5	22.7
1977	2,182	(-)11	25	17	62.4	12.7	24.9
1978	2,190	(-)33	14	17	58.8	15.2	26.0

^a Defined as shares sold at issue price, less redemptions at redemption value.

^b Does not include cash.

^c An approximation; calculated by summing the funds' assets at the end of 1973 according to a series of data which do not exactly correspond to the data for the following years.

SOURCE: Bank of Israel computations.

(see Table XIX-12). The volume of sales is connected with the growing preference of the public for holding assets in which they are accustomed to invest through the funds.

The composition of the mutual fund industry's portfolio is determined by the fund managements and the investing public combined. The managers offer the public a variety of funds, whose prospectuses specify the types and range of their investment. The public's preference is expressed by the purchase of the certificates of those funds whose asset structure appeals to them. The role of management is manifested in possible changes in the composition of the portfolio. This explains the decline in the proportion of linked bonds in the portfolios during 1978, despite the fact that funds specializing in this type of investment accounted for the bulk of sales during the year. It is evident that shareholders have a preference for index-linked bonds, as reflected by their high weight in the funds' Israeli currency assets at the end of 1978: 80 percent, at a time when such bonds accounted for only 45 percent of the market value of the public's holdings of listed IL securities (compare Tables XIX-13 and XIX-2).

On the other hand, mutual fund shareholders show little liking for stocks traded in Israeli currency: their proportion of total fund assets was 20 percent at the end of 1978, compared to 55 percent in aggregate listed securities traded in Israeli currency. The reason

for this is not clear, since the advantages of fund management expertise and diversification of investments are much greater in share than in index-linked bond investment.

Since the public prefers to invest directly in Patam and shares, and not through the funds, the latter were hit by the booming demand for shares in recent years and by the preference for Patam in 1978. In the second half of 1978, when bonds became increasingly attractive, sales of mutual fund shares netted five times as much as in the first half of the year, when this segment of the market was in a slump. The drop in sales for the entire year may have been connected with their low profitability for banks, who prefer to promote their own shares and savings schemes. The profitability of such sales was diminished even more for banking concerns by the fact that during most of the year they were not permitted to issue linked bonds, which are not only a profitable source of income but for which the mutual funds are a potential customer.²³

During the year reviewed 12 new funds were opened, a growth of 40 percent. Seven new funds were launched by veteran managements in order to diversify their areas of specialization. Four managements, three of which have no connection whatsoever with the banks,²⁴ opened five new funds. At the same time two existing funds began to issue new certificates, for the first time in many years.

The fund group which had the largest sales in 1978 (accounting, in fact, for nearly all sales of the industry) was that specializing in index-linked bonds (see Table XIX-12). Its sales increased during the second half of the year, when inflationary expectations intensified, and amounted to IL 1.8 billion. On the other hand, the group of funds which do not specialize in any particular type of asset has a net redemption of certificates — IL 400 million — notably during the first quarter of the year when demand for shares and Patam was booming. Another outstanding development was the heavy sale by funds investing in linked bonds and foreign currency during the third quarter — IL 600 million — and by those specializing in foreign currency — IL 400 million.

²³ The view that there is an institutional motivation for the decline in issues by the industry is strengthened by the large variance in the year-to-year differences in issues by the funds belonging to the various banking concerns. This development indicates that when the management so desires, its funds issue shares.

²⁴ The funds can be used to circumvent the tax regulations which apply to investments made by a portfolio manager, as this also permits tax concessions. This avoids the risk of being defined as a trader who is liable for taxes on capital gains on certain profits accruing from foreign currency investments, which otherwise would be subject to the assessee's marginal tax rate. On the other hand, switching from an investment through a portfolio manager to one in a mutual fund may deprive the investor of the advantage inherent in the management of a portfolio adapted to his own tastes and needs.

The overall real rate of return on mutual fund investments was close to -5 percent, about what might have been expected in the light of the market returns on the various components of the funds' portfolio. The low return stemmed principally from the investment in foreign currency assets. In this connection it should be noted that mutual funds have the advantage of a low variability of yields, due to the greater diversification of investments than what the individual investor is likely to attain.

The composition of funds portfolio showed a 25 percent rise in the weight of stocks, a slight increase in foreign currency, and a decline of about 6 percent in index-linked bonds.