

CHAPTER 1

INTRODUCTION

1.1 BEHAVIOUR OF STOCK MARKET PRICES/RETURNS

The study on the way security prices fluctuate has been a popular area of research in financial economics. A French mathematician named Louis Bachelier (1964) set forth formal models in which security prices were regarded as random outcomes that had probabilities attached to them. John Maynard Keynes (1936) suggested that people are concerned not with making long range forecast of the probable yield of an investment over its entire life but with forecasting changes in the conventional basis of valuation a short time ahead of the general public.

Stories about securities markets that have been published will probably furnish one with many misapprehensions but very few clues about the economic process that actually determines security prices. These sensational stories leave many people wondering if massive fraud and price manipulation are rampant in security markets. Although the price fluctuations may appear to be chaotic, they are random fluctuations that result from the random arrival of new information. Studies conducted on stock returns however revealed certain empirical irregularities unexplained by the known Capital Asset Pricing Model (CAPM) and Arbitrage Pricing Model (APT).

These anomalies are not region specific, as shown through findings of studies by Annuar and Shamsir (1987) for Kuala Lumpur Stock Exchange, Wong and Ho (1986) for Singapore Stock Exchange, Cross (1973) for New York Stock Exchange, Jaffe and Westerfield (1985) for London, Canadian and Australian markets.

1.2 THE EFFICIENT MARKET HYPOTHESIS

Fama (1965) published an empirical study on stock price movements of all the stocks that make up the Dow Jones Industrial Average. His study was designed to measure the degree of randomness with which stock price fluctuated. He thought that financial information arrived randomly and assuming that prices responded efficiently to the new information, the prices should fluctuate randomly too.

Fama delineated three levels of market efficiency . The first hypothesis is the weak form efficient market hypothesis. The weak form efficient market hypothesis stipulates that historical price and volume data for securities contain no information which can be used to earn a trading profit above what could be attained with a naive buy-and-hold investment strategy. This hypothesis suggests that technical analysis is well recorded but worthless folklore.

Fama's semi-strong form efficient market hypothesis specifies that markets are efficient enough for prices to reflect all publicly available information.

Consequently, only those insiders who have access to valuable information could earn a profit larger than what could be earned with a naive buy-and-hold strategy in a semi-strong form efficient market.

Fama's third hypothesis is called the strong form efficient market hypothesis; it claims that no one can earn a profit larger than what could be earned with a naive buy-and-hold strategy by trading on short-term security price movements. Securities market can be strong form efficient if the rates of stock price changes are independent random variables and none of the market participants use inside information.

Sanford (1995) viewed that markets have an allocational role; even in the absence of news about payoffs, prices change to facilitate trade and allocate resources to their best use. Allocational price changes create noise in the signal extraction process, and markets where such trading is important are markets in which we may expect to find a failure of informational efficiency. An important source of allocational trading is the use of dynamic trading strategies caused by the incomplete equitization of risks. Incomplete equitization causes trade. Trade implies the inefficiency of passive strategies, thus requiring investors to determine whether price changes are informational or allocational. He went on to define informational efficiency as a situation where prices aggregate and convey all current information about future asset returns in the sense of being a sufficient statistic. His views are also shared by Hayek (1945).

1.3 RESEARCH OBJECTIVES

The objective of this research is to explore the existence of the month-of-the-year effect of 32 large capitalized stocks that are component stocks of the KLSE Composite Index. This study will investigate the pattern of seasonality, if any, and make some inferences about the impact on the Main Board market efficiency.

1.4 ORGANIZATION OF THE STUDY

The study is organised through a brief introduction to the behaviour of stock market prices, the efficient market hypothesis and the research objectives in Chapter 1. Subsequent to this is the literature review in Chapter 2. Chapter 3 encompasses the research methodology of various statistical tests used; both parametric and non parametric. The parametric tests employed are one-way ANOVA, t-test, Bartlett Box F test, Tukey HSD test whilst the non parametric tests employed are the Kruskal-Wallis test and Mann-Whitney U test. The analyses and results of this study are presented in Chapter 4. Finally, the summary and conclusion of the study will be laid down in Chapter 5.