

CHAPTER 2

LITERATURE REVIEW

In recent years, empirical research on capital markets have discovered several anomalies in stock returns such as January, weekend, holiday and size effects. Several studies have concluded the existence of the calendar month effect or the month-of-the-year effect whereby the returns on January (say) exhibit mean returns that are statistically different from the returns of the other months of the year.

Tay (1991) in his empirical research investigated the size effect and seasonality of monthly stock returns in the KLSE from January 1974 to December 1990 and found that monthly raw returns exhibit a seasonal effect with a pronounced January effect. He went on to state that all stocks regardless of firm size have their highest stock returns in the month of January.

Rozeff and Kinney (1976) first documented a January seasonal effect in stock returns. They examined monthly returns of the CRSP equally weighted index for NYSE stocks covering the period from 1904 to 1974. They found that the average return for January was 3.48 % compared to only 0.42 % per month for the other eleven months.

Besides US market, the January effect has also been documented for other countries. Gultekin and Gultekin (1983) examined various stock market indices for

the period 1959 to 1979. They found that the stock exchange of Belgium, Canada, Denmark, France, Germany, Japan, Netherlands, Norway, Singapore, Spain, Sweden, Switzerland and United Kingdom have a January effect on stock returns that surpasses all other months.

Barone-Adesi and West (1987) examined Canadian stocks in the Laval-Wood Gundy data file for each January during the period from 1950 to 1980. They found that both large and small Canadian firms earned abnormally high excess returns in January.

Yong (1989) studied the sectoral indices (Industrial, Finance, Hotels, Properties, Tins and Plantations) of the KLSE and found that except for the hotels sector, the other sectors consistently exhibited the highest returns in January. Yong (1989) postulated that this may be due to the investors being predominantly Chinese, who enter the market to derive speculative gains for the Chinese New Year.

Ho (1996) found the possibility to predict the pattern of stock returns by analysing past price data. He went on to conclude that the KLSE may not be weak form efficient. However, it is generally accepted that, when transaction costs is factored into the 'equation', it is unlikely for an investor to derive abnormal returns even with the knowledge of this pattern of price behaviour.

Research findings of Shiller (1981) dealt a blow to the efficient market theory. Shiller (1981) used empirical data for (1) the 1921 through 1979 Standard & Poor's 500 Composite Stocks (S & P 500) Index and (2) the 1928 through 1979

Dow Jones Industrial Average (DJIA). He used per share cash dividends and stock price data that had been adjusted to remove inflationary effects and other factors that might confound his tests. He found significant differences between the present value of the two stock indexes' cash dividends and their market prices. Since the theory of finance suggests that the true economic value of a security equals the present value of its cash dividend income, hence Shiller' findings suggest that the market is inefficient.

Seyhun (1986) analysed insiders' trading between 1975 and 1981 for all the stocks in the NYSE. Seyhun (1986) reported that insiders earned trading profits above the naive buy-and-hold strategy. He also found that, on the average, outsiders who traded on the latest available information reported by insiders to the Securities Exchange Commission (SEC) were unable to earn profits above that of a naive buy-and-hold investor.

Another return regularity that has been observed for decades is the tendency for stock prices to decline slightly during the last few trading days of December and then move up smartly during January. Observers have hypothesized that tax-loss selling in December followed by reinvesting during the next few weeks might cause the January effect. The appearance of the January effect as it reappears in many different studies such as by Wilson (1987), Kiem (1983) and Arbel (1985) infers an imperfection in the weak-form efficient market hypothesis.