CHAPTER 1   INTRODUCTION

INTRODUCTION

1.1 Introduction

A stock market index is usually used for measuring the performance of the overall stock market or sector of the market. Stock market generally is a market where people come together to buy and sell shares, i.e., stocks are traded.

There has been a lot of significant studies examining the stock market anomalies where stock returns tend to not follow the normal paradigm of market efficiency. Among others, calendar anomalies, where we observed systematic variations in stock prices in relation to the calendar year, are most widely studied by researchers. This poses a challenge to the Efficient Market Hypothesis (EMH).

Calendar anomalies or seasonal effects in securities markets have been widely discussed in the developed and emerging stock markets. Here, we are only interested in the calendar anomalies. Therefore, three calendar anomalies have been examined in this study such as the pre-holiday effect, half-monthly effect, and time-of-the-month effect. These calendar anomalies are carried out by using the daily closing prices of forty trading/services stocks traded on the Kuala Lumpur Stock Exchange (KLSE). The period is from 3 January 1995 to 2 November 2000.

1.2 The Efficient Market Hypothesis

In this study, an efficient market can be defined as one in which the stock prices always fully reflect all available information. The idea of an efficient market is central to finance theory. The Efficient Market Hypothesis (EMH) states that stock prices fully reflect all information at any given time. The markets can be considered as efficient if the new information reflect quickly into market prices and vice versa.

There are three forms of the Efficient Market Hypothesis (EMH) as below:
(i) The weak form of the EMH states that all past market prices and data are fully reflected in securities prices, thereby debarring technical analysts from making abnormal returns.

(ii) The semi-strong form of the EMH states that all publicly available information is fully reflected in securities prices. An empirical finding is that

prices do change as a result of information documented in an annual report. In other words, we cannot use the fundamental analysis.

(iii) The strong form of the EMH states that all published and unpublished information is fully reflected in securities prices. In other words, the insider information is not important to investors to make abnormal profits in the stock markets.

The notion of market efficiency and many researches conducted in this area have come a long way over the past thirty years. According to Fama (1970), EMH assumes that successive one period stock returns are independently and identically distributed over time, i.e., follows a random walk. Fama (1970) examined the serial correlation of daily price changes for each of the thirty stocks of the Dow Jones Industrial Average for five years prior to 1962. The result was insignificant and this implied that there is no serial correlation in the price changes. If the random walk hypothesis holds, then the weak form of the EMH must also hold.

Saw and Tan (1986) investigated the new Stock Exchange of Singapore All-Share Price Indices over the period 1975 to 1984. They concluded that the stock market is inefficient in the weak form, but it appears to be efficient when monthly data are used. Yong (1987) conducted a study in the Kuala Lumpur Stock Exchange (KLSE) by using weekly price on 170 stocks from January 1977 to May 1985. He concluded that a thin market, i.e., an inactive market which the trading volume is low is less efficient (in the weak sense of

the EMH) compared to larger stock markets in the United States. Neoh (1985) examined the semi-strong form of EMH on the Malaysian stock market. Neoh (1985) employed the 182 bonus issues over the period 1968 to 1983. The results for the information contained in dividend announcement are not consistent but inclined toward semi-strong form inefficiencies.

1.3 Stock Market Anomalies

An anomaly is defined as an exception to the rule or a difference from what is normal. Many researchers have studied several stock market anomalies such as fundamental anomalies, technical anomalies, calendar anomalies, and other anomalies. More recently they have produced substantial evidence and significant results on these stock market anomalies.

(i) Fundamental Anomalies

The anomalies based on fundamentals and value that have been documented to outperform the market in long-term studies will be discussed as follows:

(a) Low Price-to-Book Value

Fama and French (1992) have examined the performance of low price-to-book value stocks. The stocks were divided into ten groups by book/market and were re-ranked annually. The lowest book/market stocks outperformed the highest book/market stocks 21.4 per cent to 8 percent with each decile performing worse than the previous. They also found that the low

price-to-book value stocks had lower risk and the high price-to-book value stocks had the highest risk.

(b) Low Price-to-Sales

A number of researches have shown that the stocks with low price-to-sales ratios outperform the market and stocks with high price-to-sales ratios.

(c) Low Price-to-Earnings

Numerous studies have concluded that stocks with low price-to-earning ratios tend to outperform the market and stocks with high price-to-earning ratios.

(d) High Dividend Yield

Many researchers have shown that high yielding stocks tend to outperform low yielding stocks. Based on this finding, the Dow Dividend Strategy, consists of buying the ten highest yielding Dow stocks, has received a great deal of attention recently.

(ii)   Technical Anomalies

An extensive research and debate on whether past prices and charts can be used to forecast future prices have been widely discussed by researchers. Technical analysis is one of the techniques that attempt to predict future price changes by examining past security prices and related statistics. It can identify patterns in the past price trends and suggests some trading strategies to the investors that can help them to earn abnormal returns. The implication is that the market is weak form inefficient.

The common techniques, which have been used by many researchers, include strategies based on relative strength, moving averages as well as support and resistance. A lot of researchers have tested the technical trading systems and they found that prices adjust rapidly to stock market information. They also found that these technical analysis techniques are not likely to give any information to investors who used them. However, some researchers argue that there is validity to some technical strategies.

(iii)   Calendar Anomalies

A large number of studies dealing with the calendar anomalies have been documented for financial markets across the world. These calendar anomalies in stock prices have been of great importance to financial practitioners, financial manager, and also investors. The existence of these calendar anomalies is a contradiction to the weak form of the Efficient Market Hypothesis (EMH) in financial economics. Calendar anomalies in stock market returns have perplexed financial economists for over 50 years. The most prevalent of these calendar anomalies appears to be a January effect, where returns are much higher in January than in any other months, a weekend effect, with a significantly negative return on Monday and positive return on Friday, and a turn-of-the-month effect, where returns are highest on the last trading day and first three trading days of the month.

(iv)   Other Anomalies

Some studies have documented that small firms (based on market capitalization or assets) tend to outperform large firms. But other researchers

have argued that size is not an important factor in their study. Several researchers also studied the announcement effects, where the price changes tend to persist after the initial announcements. Numerous studies have shown that Initial Public Offerings (IPOs) and secondary offerings also underperform the market.

1.4 The Kuala Lumpur Stock Exchange: A Brief Overview

The Kuala Lumpur Stock Exchange (KLSE) is a self-regulatory organization, and is the only stock market in Malaysia. It governs the conduct of its members and also member stockbroking companies in the securities. KLSE enforces the listing requirements and disclosure standards. It is also responsible for the surveillance of the market place.

The securities industry in Malaysia began in the late nineteenth century as an extension of the British corporate presence in the rubber and tin industries. The rubber boom drove the early development of the securities industry in the early twentieth century. As a result, the stockbroking firms increase rapidly at that time.

The Singapore Stockbrokers' Association was established on 23 June 1930. This is the first formal organization in the securities business in Malaysia. The association was registered again as Malayan Stockbrokers' Association in 1937, but there is still no public trading of shares in that association. Malayan Stock Exchange was formed in March 1960 and the first public trading of shares commenced on 9 May 1960. Then, Stock Exchange of Malaysia was

formed in 1964. With the separation of Singapore from Malaysia in 1965, the common stock exchange continued to operate but renamed as the Stock Exchange of Malaysia and Singapore (SEMS). The Stock Exchange of Malaysia and Singapore was split into the Kuala Lumpur Stock Exchange Berhad (KLSEB) and the Stock Exchange of Singapore (SES) in 1973 consequent upon the termination of currency interchangeability. Despite this, Malaysian incorporate companies continued to be listed and traded on Singapore Stock Exchange, and vice versa for Singapore incorporated companies.

In 1973, the KLSE took over the functions of KLSEB as the stock exchange. Thereafter, on the 26 April 1994, the previous name changed to Kuala Lumpur Stock Exchange (KLSE). A very important event has been achieved for the KLSE in 1990, which is the delisting of Singapore incorporated companies from the KLSE and vice versa for Malaysian incorporated companies. Consequently, the KLSE will act as a stock exchange with a truly Malaysian identity. KLSE has launched the Institutional Settlement Service, which is a service provided by Securities Clearing Automated Network Services Sendirian Berhad (SCANS) on 15 July 1999.

1.5 Reseach Objective

The objective of this study is to investigate the existence of some calendar anomalies of forty stocks of the trading/services sector in the Kuala Lumpur Stock Exchange (KLSE). The calendar anomalies analysed on these stocks are the pre-holiday effect, half-monthly effect, and time-of-the-month effect.

Furthermore, this study further examines these calendar anomalies over two subperiods. The data set is partitioned into two subperiods in order to test for the persistence and consistence of any calendar anomalies. In addition, this study also aims to show whether these calendar anomalies are analogous to those found in other major stock markets.

1.6 Format of Report

This section contains a brief introductory information of every chapter in this research paper.

The first chapter is the introduction to this study, which briefly reviews the concept of the Efficient Market Hypothesis (EMH) and the stock market anomalies, the characteristics of the Kuala Lumpur Stock Exchange (KLSE), and the research objective.

The second chapter is the literature review. It gives a quite detailed review of the literature dealing with the calendar anomalies and covers some historical and recent research papers.

The third chapter is on data and methodology. It gives a description of data and methodology used in testing various hypotheses of the calendar anomalies for the forty stocks of the trading/services sector in the Kuala Lumpur Stock Exchange (KLSE).

Chapter four gives the empirical results of calendar anomalies. It elaborates the findings of the analysis and results of the calendar anomalies for the forty stocks of the trading/services sector in the Kuala Lumpur Stock Exchange (KLSE).

Finally, chapter five is the conclusion and discussion of this study. It concludes with a summary of the results of the empirical evidence and overviews the implication of the calendar anomalies observed for the Malaysian stock market.