ABSTRACT

The principal issue examined in this study is the market timing ability and whether the individual stock returns are dependent on market returns. This study uses daily data of the Kuala Lumpur Stock Exchange Composite Index as the market benchmark index and a sample of 15 finance stocks listed on the Main Board of KLSE selected randomly. It also investigates the selection ability, that is, whether the selected finance stocks have excess returns after taking systematic risk into account. The period of study is from 1 April 1994 to 30 November 2000.

The investigation involves two different market timing models. The quadratic returns market model and the dual-beta market model are used to asses the returns behaviour and for analysis of the stock timing and selection abilities. In addition, the specification tests suggested by Jagannathan and Korajczyk (1986) are applied as further tests of market timing ability. The specification tests are based on the cubic model which is augmented by a third-order term for the quadratic market model, and the exclusion restriction test that uses the dual-beta market model specification augmented by a quadratic term.

The analysis is divided into two major parts. The first part uses the two market timing models. Although rather strong evidence of market timing ability is found, the models however, suffer from non-trivial misspecification problem. In addition, the models are also statistically inadequate, in that they fail to capture significant autoregressive conditional heteroscedasticity (ARCH).

The variance of the error term is modelled as GARCH(1, 1) process in the second part of the study, and the two market timing models are reestimated. The severity of the misspecification problem is reduced by about half. Excluding those misspecified, 7 stocks exhibit favourable market timing performance for the quadratic market model, while 6 stocks share the same characteristics for the dual-beta market model. No evidence of stock selection ability is found. To some extent, the market timing performance is offset by the stock selection ability.

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