The Study on the Relationship between Stock Returns, and Size and Book-to-Market Equity: Empirical Evidence in case of Colombo Stock Market

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Registration No: SEU/IS/06/MG/10

Index No: MG 0485

A Dissertation Submitted to the Faculty of Management & Commerce, South Eastern University of Sri Lanka, in Partial Fulfillment of the Requirements of the Bachelor of Business Administration Degree

Department of Accountancy & Finance

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Oluvil

2012

ABSTRACT

This study investigates the performance of common stock returns with respect to two popularly known firm level characteristics: size and book-to-market ratio of selected companies to explain the cross-sectional variation in expected returns in the stock market of Sri Lanka. The selected companies are grouped into two categories on the basis of financial classification of Sri Lankan emerging markets: financial companies and non financial companies. The sample of the study covers a six-year period from 2005 to 2010. The formal tests use the Fama-MacBeth (1973) cross-sectional regression model. In the formal tests, returns are regressed on size and book-to-market-equity both individually and jointly, in every year in the cross-section.

The results show that, no size effect in all the markets and a significant book-to-market effect in all the groups. When the test allow for both variables, the positive relationship between size and stock return is not significant and negative relationship between book-to-market equity and stock return is significant. The inclusion of book-to-market equity seems to absorb the role of size in selected Sri Lankan stock returns.

Although small firms have to a certain extent higher average return than large firms in selected Sri Lankan markets, the book-to-market variables seems to have a consistently stronger role in average returns. The negative value effect found in this study has practical implications for investor in the Sri Lankan stock market.