UNIVERSITI TEKNOLOGI MARA

SIZE PREMIUM AND VALUE PREMIUM IN BURSA MALAYSIA SECURITIES

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ABSTRACT

A myriad of studies have shown that the presence of size and value premiums are robust in developed markets. This thesis seeks to provide new evidence on the study of size and value premiums in the developing stock market, such as Bursa Malaysia over a period 1990-2004. It also aims at examining the empirical validity between Capital Asset Pricing Model and Fama-French Three-Factor Model in addressing the issue of asset pricing. The study employs two methods, a method used by Jensen, Johnson, and Mercer (1998) and another method by Fama and French (1993), to examine the presence of size and value premiums in Bursa Malaysia Main and Second Boards. Following the method used by Jensen, Johnson, and Mercer, the study forms two groups of portfolios: small-cap and large-cap portfolios and value-growth portfolios. These two groups of portfolios are analyzed with regard to their performances and risk-return tradeoff. A hypothesis testing was performed to determine whether there is any statistically significant difference in the mean returns of the two competitive portfolios in each group. The empirical results show that the small-cap portfolio is superior to large-cap portfolio at all categories and the difference in their mean returns is significant in both Main Board and Second Board. However, the outperformance of small-cap portfolio is accompanied by higher level of risk. The study also finds that the small-cap portfolio consistently beats market portfolio, while market portfolio persistently outperforms large-cap portfolio. Yet, for each case, the difference in their mean returns is overall insignificant. In relation to the study of value premium, the value portfolio appears superior to growth in each category, but the difference in their mean returns is insignificant in both markets. As expected, the higher rate of return in value portfolio is mostly driven by higher level of risk. The study also finds that the outperformances of value portfolio over market portfolio and market portfolio over growth portfolio are insignificant at all categories. Interestingly, the test results from Fama-French three-factor model (1993) reveal strong and significant evidence of size and value premiums in both markets. In comparing the credibility between Fama-French Three-Factor Model and Capital Asset Pricing Model in explaining returns, the former is considered a better model as it possesses statistical properties which are more appealing. The empirical findings presented in this thesis have important implications in the area of corporate finance, particularly with respect to asset valuation and portfolio management.

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CHAPTER 1

INTRODUCTION

1.0 Background of the Research

Investment strategies have become imperative in the modern equity capital investments. The underlying objective of all the investment strategies is to maximize stock returns and at the same time being able to minimize the level of risk associated with the investment. It is important to note that the ability to gain maximum returns from the equity market is not merely a function of luck, but rather it involves other relevant factors, such as investment strategies, credible pricing models, and understanding in risk-return relationship. All these factors are addressed in Capital Market Theory which emphasizes on the elements of financial asset pricing and equilibrium relationship between risk and expected return.

Investment strategy is an investor's blueprint that reflects his or her investment objectives, designed to provide guidelines on risk-return tolerance and asset allocation. Every investment strategy is unique and it is very much related to an investor's investment philosophy. At present, there are a number of investment philosophies which are preferred by investors simply because they have been empirically proven to be consistent in providing higher rate of return than the market return. As such, it is important to investigate to what extent these investment philosophies can be held true and where they can be applied.

Value investing and small-cap investing are some of the preferred investment philosophies embraced by investors. Value investing has caught the attention of many researchers who are interested in investigating the effectiveness of this strategy. Value investing or fundamental investing puts the emphasis on investing in companies whose share prices are trading below their intrinsic value. The computation of the