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Sensitivity on Stock Returns and Volatility: The Case Of Shari'ah-Compliant Securities in Bursa Malaysia

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ABSTRACT

The introduction of the shari'ah-compliant securities by the SAC in the stock market has gained attention among the Muslim investors. Whether SAC announcements on shari'ah-compliant securities are a source of the abnormal returns and volatility of securities is the focus of this study. Hence, statistical evidence needs to be discovered in order to know the significance of the event of SAC announcements on the shari'ah-compliant securities. Data on MCARs for each addition/deletion announcements and volatility by subsamples partitioning is used. Then, the Event Study methodology was applied for each subsample. It was found that there were no significant abnormal returns on the securities prices before and after the announcements. As for the volatility, the addition of securities partitioned by market directions shows that MCARs are positive while deletion is negative when the market is up. For the volatility market subsamples, it was found that investors under-react to good news during low volatility market and over-react to bad news during low volatility market. It can be said that market efficiency is anomalous. Although the results and analysis may provide the beginning of a more complete understanding of the puzzling returns of common stock surrounding the shari'ah-compliant securities addition and deletion, the phenomenon deserves further investigation.

Key words: Event study, shari'ah-compliant, abnormal returns, volatility

INTRODUCTION

Event studies have become an essential part of empirical research in the area of finance. According to Peterson (1989), the objective of the event study is to assess whether there are any abnormal or excess returns earned by security holders accompanying specific events where an abnormal or excess return is the difference

between observed return and that, appropriate given a particular return generating model. Various studies have explained the impact of the addition and deletion of a security from the stock market. However, less focus has been made on the *shari'ah*-compliant securities. Considering the emergence of Islamic capital market in Malaysia; particularly in the field of Islamic stock market, being labeled as *shari'ah*-compliant securities is seen as important to the investors. Consequently, this study assumed that the impact of the addition and deletion of a security from the Shari'ah Advisory Council (SAC) list should results prominent impact on the stock returns and volatility. It is argued that Islamic funds or Muslim investors will take corresponding action by adding or dropping those stocks from the portfolio. Further, the concern of this study is also to ascertain the investor's reaction towards the volatility of the stock returns according to the market direction. Investors may over-react to good news (addition) and may under-react to bad news (deletion) during the up market (i.e. boom market). Volatility may impair the smooth functioning of the financial system and adversely affect economic performance. Similarly, stock market volatility also has a number of negative implications on the economy through its effect on consumer spending via the wealth effect (Mala and Mahendra, 2007). Thus; there is a crucial need for a related research as guidance to the investors.

To partly fulfill that role, this study will answer the empirical question of the impact of 'do changes in the *shari'ah*-compliant securities affect the implicated stock returns and volatility characteristics of these stocks?' In other word, this study will present evidence of the effect of addition and deletion of *shari'ah*-compliant securities in Bursa Malaysia. Moreover, it will be an indication on how important is a company to be listed in the SAC list.

THEORETICAL BACKGROUND ON THE EFFECT OF SAC ANNOUNCEMENTS ON STOCK RETURNS AND VOLATILITY

Being a component of *shari'ah*-compliant securities does not necessarily mean that good news will show significant positive effects. Sometimes, the effect might be based on the market direction and economic situation. Several articles question the strength of the relationships between the news announcements and the market activity. Among them is Damodran (1989) who reported that although there is a day-of-the-week pattern in the information content of dividend or earning announcements resembling that of stock returns, the announcement only explains a small fraction of the week's effect. In contrast, Haugen, Talmor, and Torous (1991) do not find any linkages between the major news announcements and large movements (volatility) in market prices. The lack of strong relations between the news and market activity suggest that any joint patterns are merely coincidental. Mitchell and Mulherin (1994) who used the reporting number of announcements of

the Dow Jones as proxy news, found that neither trading volume nor market returns is significantly different on days having macroeconomic announcements.

It is well established in the literature that when a stock is added, it earns positive abnormal returns. Studies on the impact of addition/deletion of *shari'ah*-compliant securities on the volume and returns have long been an interest to researchers. Abdullah and Batcha (2001) studied the effects of inclusion and exclusion of *shari'ah*-compliant securities on stock returns and volume by using the Event Study Methodology. Their study involves data from 4 May 1998 until 22 September 1999 which consists of 60 companies (39 additions and 21 deletions). They found that an inclusion into the SAC list of *halal* stocks had a positive impact on stock prices; however the price increase was not immediate and there was no change in the trading volume, while for deletion, the results implied a negative impact on both stock returns/prices and trading volume, but on a delayed nature.

In another context, Ibrahim, H. (2002) applied the Event Study Methodology to study the performance of Kuala Lumpur Composite Index (KLCI) against the Kuala Lumpur *Shari'ah* Index (KLSI) concurrently with the impact of delisting from the KLSI. This study found that there is no effect on stock prices after being delisted from the KLSI. Thus, there is no privilege to be listed as a *shari'ah*-compliance security. Sanger and Peterson (1986), after examining 520 stocks by using the standard Event Methodology found that the listing stock in NASDAQ earned significant positive abnormal returns in the pre-event period while for the post-event period abnormal returns was statistically significantly lower than the pre-event period. On average, both periods showed significantly positive abnormal returns.

Lynch & Richard (1997) revealed a distinct pattern of stock-price movements (This study relied on the separation of data between the announcement and change days)². Specifically, for additions, while they found a significantly positive announcement effect, they also found a positive abnormal return of about 3.8% over the period starting the day after the announcement and ending the day before the effective date of the change. Furthermore, they found a significant negative abnormal return following the addition. Firms being deleted from the index also exhibited a significant post-announcement drift and a significant price reversal, but in directions opposite to those for additions.

Stock return volatility is highly persistent especially in developing markets like Malaysia. Many researchers have provided evidence concerning this characteristic of

¹ They used an event-study methodology with two event dates for each sample: the announcement date of the addition/deletion (AD) and the effective date of the addition/deletion (CD)

stock return volatility using the class of ARCH/GARCH model. Among others are Karolyi (1995), Aggarwal, Inclan and Leal (1999)³; who expected volatility to be very high in emerging markets as it shows positive skewness. In this study however, volatility is examined by using the Event Study Methodology as suggested by Docking and Koch (2005). In their study, the sensitivity of investor reactions to recent market direction (i.e. up, normal, down) and volatility (i.e. high, medium, low) were investigated by examining if stock market's reaction to dividend change announcements is systematically associated with the direction of volatility. As their sampling techniques were effective, a similar method was implemented in our study. Also, in their study, mean and standard deviation of daily value-weighted market index returns for each announcement was calculated and divided into three (3) partitions by using quartile. Docking and Koch (2005) assumed that the increase in dividend is associated with the increase in stock price (good news), whereas the decrease in dividend is associated with decline in stock price (bad news). The results show that the investors will under react to good news (a dividend increase) in bad time (down market) and on the other hand, investors will over react to bad news (a dividend decrease) in good times (an up market). Hence, the assumption is not always true as the investors may not always interpret a dividend increase (decrease) as good (bad) news because circumstances surrounding an action make it good or bad.

Crouzille, Lepetit and Tarazi (2004) who studied the Asian and Russian financial crises, assessed the issue of asymmetric information in banking within a framework based on the behavior of bank stock prices. Their results show that unexpected increase in bank stock volatility cannot be easily detected using standard proxies of bank asymmetric information derived from public data. In the case of event-related volatility increases, one-half is associated with acts of violence by individuals, countries, or by nature. In the case of event-related volatility decreases, the majority is associated with enactments or announcements by political leaders. Interestingly, in many cases, the same type of event associated with one type of volatility change is also associated with the other (Haugen *et. al.*, 1991). The extensive literature suggests that a wide range of factors may be relevant in explaining the stock return volatility. However, in emerging markets, not all factors are at play in explaining the stock return volatility, as factors like levels of political risks, goods prices, money supply and exchange rates may be analyzed to see the empirical links with the stock returns volatility (Mala and Mahendra, 2007)

² This study determined when large changes in the volatility of emerging stock market returns occur and then examined global and local events (social, political, and economic) during the periods of increased volatility.

DATA AND METHODOLOGY

A set of data taken from Bloomberg terminal consisting of 150 *shari'ah*-compliant companies from year 2005 until year 2007⁴ is used where 93 of the companies were identified by addition and 57 were identified by deletion. To estimate abnormal returns, daily data on common stock returns (R_i) and daily KLCI (R_m) for all 150 companies were collected 60 days before and after the announcements. This time frame has been considered to see whether the effect of addition/deletion is immediate or gradually effected within the months following Abdullah and Batcha (2002) who considered the same even window periods. On the other hand, pre-announcement period of (-31,-2) were selected subsequent to Docking and Koch (2005). No attempts were made to exclude companies that had confounding news at the time of announcements as this will reduce the sample size greatly.

For the stock returns, the market model formula is used to find the Mean Cumulative Abnormal Returns (MCARs). Then, event study is applied into subsamples based on portfolios for every addition and deletion for each year. Moreover, overall portfolios for both addition and deletion consist of all 3 years of data. For the volatility, the sample partitioning is based on Docking and Koch (2005) who used the same method for the dividend announcement study. Six announcements (addition and deletion) were paneled according to the *shari'ah*-compliant announcements and volatility experienced during the 30-trading-day interval preceding the event date (-31,-2). The sample partition is as follows:

1. Full sample of events is ranked according to the mean market returns experienced over this pre-announcement and sample is partitioned into quartiles. The up market is then defined as the quartile with the highest mean market returns, the down market as the lowest quartile and the normal market as the middle 50%.
2. Next, the full sample of events is ranked according to standard deviations of market returns experienced over this pre-announcement period and sample is partitioned into quartile. Quartile with the highest standard deviation is defined as the high-volatility market, the lowest standard deviation quartile is defined as the low market and the middle 50% is defined as the medium volatility market.⁵

⁴ SAC is responsible to review the *shari'ah*-compliant securities list on every March and November every year. For this study, 6 announcements are considered and these time frames were chosen to identify the most recent effect of addition and deletion of companies from the *shari'ah*-compliant securities list.

⁵ In all volatility tables, one might expect the (25%)-(50%)-(25%) partitioning scheme to yield proportional sub-sample sizes. Actually, the entire sample of 148 events is first ranked by market mean or market standard deviation and the entire ranked sample is partitioned into quartiles. Only after that the entire sample is divided into addition and deletion. Although, the entire sample of 148 events is partitioned according to the proportions (25%)-(50%)-

3. Within each category of market direction, this is classified into the analogous three categories of market volatility. That is, the sample is partitioned into nine cells to investigate possible interactive influence of both market direction and volatility.

4. For every cell in each partitioning scheme, the sample is divided into two parts, to be analyzed separately for addition announcement and deletion announcement. The event study methodology is then applied to every sub sample in this partitioning scheme.

EMPIRICAL EVIDENCE ON THE STOCK RETURNS AND VOLATILITY

Effects on the Stock Returns

Overall addition and deletion table consists of data from year 2005 until year 2007 is shown below despite the subsample of each addition/deletion for each year.

Overall Addition

TABLE 1: Overall Addition Portfolio Year 2005-2007

Event window (days)	MCAR	T-statistic
(-60, -1)	-2.393484	-0.5608159
(-10, -1)	-2.573381	-1.26907
(0, 2)	0.8660611	0.9320078
(0, 9)	0.3568999	0.2112873
(0, 60)	2.420687	0.3888027

Table 1 shows the overall effect of addition of the *shari'ah*-compliant securities into the SAC list. There is no evidence that the abnormal returns occur before or after the event. There is no significant t-statistics gathered by the result.

(25%), these exact proportions are not carried through to the subsamples of addition and deletion.

Overall Deletion**TABLE 2: Overall Deletion Portfolio Year 2005-2007**

Event window (days)	MCAR	T-statistic
(-60, -1)	-1.492945	-0.3331746
(-10, -1)	-2.787275	-1.666678
(0, 2)	0.2048482	0.3109807
(0, 9)	-1.414993	-1.111796
(0, 60)	1.496397	0.441397

Table 2 confirms that there is no abnormal returns (MCARs) occurring either before or after the addition and deletion announcements of *shari'ah*-compliant securities. The deletion result is supported by Chandy *et. al* (2004) who found significant negative stock price reaction. From Malaysia's perspective, the negative result might be because of the new emerging of Islamic capital market in Malaysia⁶ (especially in Islamic stock market) where the market is still at an early stage to be tested and thus, any news announcement (e.g. *shari'ah*-compliant announcements) does not give significant effect on the stock market at large. The public may be aware of the addition and deletion announcements, but since the market is relatively small and there are not many Muslim players involved in the market, the effect is less apparent. These results are in contrast with Abdullah and Batcha (2001), who found positive MCARs for addition. This study challenges their results since the effect was not immediate and occurred only after the 30 and 60 days window period respectively. Other events or factors may have taken place within this period of 30 days or 1 month, is considered as extended time. However, the results on MCARs for deletion are consistent with Abdullah and Batcha (2001). This study is also not consistent with Abdullah and Batcha (2001) and other previous researches such as Shleifer (1986) who argues that the price increase upon Standard and Poor's (S&P) 500 addition is permanent and driven by increased demand in the presence of downward sloping demand curves. Shleifer (1986) finds that, since September 1976, stocks that are newly included into the S & P 500 Index, have earned a significant positive abnormal return at the announcement of the inclusion. Their results are similar with Lynch and Richard (1997). The results of this study might be consistent with theirs if the centre of attraction is on the conventional stock market. Therefore,

⁶ According to Bursa Malaysia (2008) estimates, 36% of total listed Islamic equity funds are available in this country.

it does not concur with Abdullah and Batcha (2001) as both the economic and statistical evidence are available. This study believes that the results will be gradually consistent with Abdullah and Batcha (2001) considering the emerging Islamic capital market in Malaysia. Interestingly, a research done by Ibrahim (2002) on the Kuala Lumpur Syariah Index (KLSI) by using the Adjusted Sharped Index, the Treynor Index and the Adjusted Jensen's Alpha Index to measure the performance of the KLSI against the KLCI, found that the deletion of stocks from the KLSI would not affect stock prices and argued that being a component of KLSI would not be a special privilege.⁷

Partitioning by Market Direction Alone

In Table 3, the results shown for the addition and deletion of *shari'ah*-compliant securities when partitioning is made based on market direction only. For the addition of securities as shown in Panel A, the Mean Cumulative Abnormal Returns (MCARs) are positive for the up (1.63%) and normal (0.97%) and while negative for the down (-0.02%) market. The MCAR is smallest for the down market and highest for the up market. According to Veronesi's model (as cited by Docking & Koch, 2005), investors under-react to good news in bad times and down market should experience

TABLE 3: Mean Cumulative Abnormal Returns of *Shari'ah*-Compliant Securities Changes for Subsamples Partitioned by Market Direction

	Market Direction			Total
	Up	Normal	Down	
Panel A: Addition				
MCARs (%)	1.6332	0.9695	-0.0159	2.5868
z-statistic	4.1020	4.2977	-0.0944	8.3053
N	19	46	28	93
Panel B: Deletion				
MCARs (%)	-1.6168	3.2039	1.1509	2.7380
z-statistic	-3.1449	9.5236	2.4283	8.8070
N	18	28	9	55

the smallest positive MCAR. The results of this study and Veronesi's are the same in its economic sense; however, it shows less statistical evidence to support the model. For the deletion of *shari'ah*-compliant securities as shown in Panel B, the results

⁷ Event study methodology for 21 days and 61 days surrounding the event has been used. No difference in performance before and after the delisting.

demonstrate negative MCAR for the up market (-1.62%) and positive for both the normal and down market. Negative MCAR for the up market may indicate bad news perceived as worse news when times are good. For this partition, we reject H_0 at $\alpha=0.05$ since the Z-test is greater than 1.645. Thus, there is sensitivity in the MCARs to recent market direction after the pre-announcement. In other words, both market direction and volatility do affect the firm's stock price reaction.

Partitioning by Market Volatility Alone

TABLE 4: Mean Cumulative Abnormal Returns of *Shari'ah*-Compliant Securities Changes for Subsamples Partitioned by Market Volatility

	Market Volatility			Total
	High	Medium	Low	
Panel A: Addition				
MCARs (%)	0.2058	2.6714	-0.4158	2.4614
z-statistic	0.6571	12.4463	-1.0236	12.0798
N	17	53	23	93
Panel B: Deletion				
MCARs (%)	1.4038	2.3370	6.2700	10.0108
z-statistic	3.2275	6.5998	5.3054	15.1327
N	20	21	14	55

Table 4 shows the results for both addition and deletion of *shari'ah*-compliant securities when partitioning by market volatility only. All subsamples show positive MCARs except for addition when the market experiences low volatility. The largest positive MCAR yield during the deletion period is when the market experiences low volatility. Low market volatility seems to strongly contradict each other. Investors under-react to good news during low volatility market and over-react to bad news during low volatility market. For this partition, H_0 is rejected for both addition and deletion at $\alpha=0.05$ since the Z-test is greater than 1.645. Thus, there is sensitivity in MCARs to recent market volatility after the pre-announcement. In other words, market volatility does affect the firm's stock price reaction.

Partitioning by Market Direction and Volatility**TABLE 5: Mean Cumulative Abnormal Returns of *Shari'ah*-Compliant Securities Changes for Subsamples Partitioned by Both Market Direction and Market Volatility**

	Market Volatility			Total
	High	Medium	Low	
Panel A: Addition				
Market Direction				
<u>Up</u>				
MCARs (%)	-1.6330	-0.8499	4.8153	
z-statistic	-2.1957	-0.2425	5.4433	
N	7	3	9	19
<u>Normal</u>				
MCARs (%)	4.1490	-1.1230	0.5032	
z-statistic	3.7526	-2.6478	0.6346	
N	12	23	11	46
<u>Down</u>				
MCARs (%)	-0.3981	0.5166	-1.6409	
z-statistic	-1.0877	1.3022	-5.4409	
N	5	16	7	28
Total	24	42	27	93
Panel B: Deletion				
Market Direction				
<u>Up</u>				
MCARs (%)	-5.7632	-1.1162	n/a	
z-statistic	-2.2533	-2.1151	n/a	
N	2	16	0	18
<u>Normal</u>				
MCARs (%)	4.3266	4.7014	-0.5081	
z-statistic	3.9343	6.9085	-1.6187	
N	7	13	8	28
<u>Down</u>				
MCARs (%)	-1.6045	4.8656	-0.8549	
z-statistic	-3.1455	2.4692	-0.7096	
N	4	3	2	9
Total	13	32	10	55

Partition by both market direction and market volatility for both addition and deletion is shown in Table 5. For the addition of securities, considering the high

volatility cell, the greatest MCAR occurs when the market is normal (MCAR=4.15%). This result is fairly consistent with Docking and Koch (2005) whereby the results indicate that investors tend to react more positively to good news in a normal market where there is high volatility. The statistical evidence proves that this study does not have robust evidence to accept H_0 . However, the results point out that the greatest MCAR for the addition occurs when volatility is low during the up market (MCAR=4.82%). This might indicate an investor's perception that good news is more informative in the low volatility market. Thus, investors over-react to good news during the low volatility market. More generally, there is evidence that investors tend to be more uncertain about the future growth rate of the economy during recessions (down market), thereby partly justifying a higher volatility of stock returns (Veronesi, 1999).

In Panel B of Table 5, results for deletion are provided. Interestingly, in this case, the results in the subsample of events in an up market with high volatility show a negative MCAR that is the highest among other cells. This result yields a consistent finding with Docking and Koch (2005). Similarly, the normal market during the high volatility reveals the same positive results (MCAR=4.33%) as the addition of securities. Thus, we can say that the performance of MCARs is the same during the normal market when there is a high volatility. Overall statistics shows that there is a strong evidence not to accept H_0 . This is also supported by Ederington and Lee (1993), Harvey and Huang (1991) and French, Leftwich and Uhrig (1989) (as cited by Mitchell, M. L., & J., H. M., 1994) who found a related line of research that links market volatility patterns to the timing of the release of macroeconomic and government announcements and suggested that any joint patterns they share are merely coincidental.

From this study, it can be concluded that there is no significant abnormal returns for the overall addition and deletion portfolios before and after the announcements. No statistical evidence was found to conclude that the announcements will yield any abnormal returns and the results of this study are supported by Chandy *et. al* (2004) and Ibrahim, H. (2002).

As for the volatility, its effect really depends on the market situation where some do show sensitivity towards the market direction and market volatility while others do not. The results of this study are mixed and this might be due to time period taken and size of the sample which is 148 companies. Yet, part of the results still yields a consistent finding with Docking and Koch (2005).

CONCLUSION

Trading in the capital market is the game of few wealthy people in the Muslim countries. Thus, the wealth keeps on circulating among them. This situation is certainly contrary to the teachings of the Al-Quran, which commands that wealth should not make a circuit between the wealthy (*Al-Hashr: 7*). Therefore, a headway through Islamic capital market is needed to encourage people of small means to be involved in the share trading. Of course, if Muslims develop a habit of acquiring stocks, bonds and other financial instruments with their savings, then they will contribute towards a wider circulation of wealth as well as the enhancement of capital formation. Although the results and analysis of this study may provide the beginnings of a more complete understanding of the puzzling returns of common stocks surrounding *shari'ah*-compliant securities addition and deletion, the phenomenon deserves further investigation. Further extension of current study should investigate the abnormal returns and volatility by using the newly introduced FTSE Bursa Malaysia Emas Shari'ah Index and FTSE-Bursa Malaysia Hijrah Shari'ah Index. These indexes are tradable and the results are expected to have an even stronger impact. *Wallahhualam.*

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