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Fundamental and Behavioural Determinants of Stock Returns: With Special Reference to Sri Lanka

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Abstract

The study compares and contrasts the firm-specific and macroeconomic determinants of stock returns in Sri Lanka and the United Kingdom (UK) in order to investigate which risk factors priced in each stock market and how those factors change across the two countries as an emerging market and a developed market. The study tests the determinants of stock returns of the CSE and LSE by using a panel regression analysis for the period from 2000 to 2012. Seven firm fundamentals are empirically used as proxies for unsystematic risk factors and nine macroeconomic indicators as the systematic risk factors. The annual data on 107 listed companies in the CSE and 228 companies in the LSE were gathered and analysed. The fitted one-way fixed effects firm factor regression indicates that Return on Assets (ROA) and sales growth rate play a significant role in explaining variation in stock returns in Sri Lankan listed companies while one-way random effect firm factor model in UK shows that E/P ratio, B/M ratio, fixed assets growth rate, size and ROA are the most dominants priced factors in London Stock Exchange (LSE). The explanatory power of regressions increases considerably when we incorporate macroeconomic indicators controlling for firm effects and results show that inflation, GDP and exchange rate remain leading predictors of stock returns variation in both Colombo Stock Exchange (CSE) and LSE whereas unemployment and Foreign Portfolio Investments (FPI) become statistically significant only in CSE. The study jointly tests the multifactor asset pricing model and Fama's semi strong form efficiency of the CSE and LSE using annual data and the results confirm the validity of the multifactor models in the semi strong form efficiency of the EMH.

The study further aims at examining whether some behavioural and contextual factors influence on irrational behavior of individual investors decisions and performance in the CSE. A survey was conducted on 164 active investors by administering a semi-structured questionnaire and applied factor analysis and multiple regression technique in order to determine which behavioural biases prevailed among individual investors in the CSE. The results show that the individual investors in the CSE are influenced by four behavioral biases: Herding, Heuristics, Prospect, Market and the contextual factors in which each dimension includes certain behavioural and contextual variables. The herding, heuristics and contextual factors have to be influenced

positively on individual investors' performance. Although the prospect variables (two sub groups; regret aversion and loss aversion) are supposed to have a positive impact on investment performance, it is found that regret aversion is to be influenced positively while in contrast negative impact existed between loss aversion and investment performance. The results prove that individual investors do not act rationally all the time when making investment decisions and confirm the presence of psychological biases among Sri Lankan individual investors.

Moreover, the study investigates how individual investors perceive government fiscal and monetary policy decisions and how they respond to such policy changes to make profitable investments. The study concentrated only on the active investors and 164 clients were selected among them using stratified random sampling technique. A semi-structured questionnaire was administered based on numerous future scenarios on the fiscal and monetary policy changes and asked their level of agreement or portfolio strategies. Factor analysis and multiple regression techniques were used to analyse the data. The results reveal that, market participants react positively to a decreasing interest rate as companies could offer increasing returns to their investors. Investors view growing government expenditure and tax cut as good news for their investment performance and act accordingly to achieve higher returns. Investors opine that they tend to make investment strategies if excess money is available as a result of increased money circulation among the investors. The findings strongly support the Keynesian model which predicts that increase in government expenditure leads to higher economic growth that it boosts the domestic output and fuels the growth of the economy thereby potentially increasing the stock prices.