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STOCK RETURNS VERSES COMPANY FUNDAMENTAL VARIABLES OF COLOMBO STOCK EXCHANGE-FROM 1991 TO 1996

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Abstract

The Capital Asset Pricing Model developed by Sharpe (1964), Lintner (1965), and Black (1972), is a measure of risk of the stocks. This is termed as the Beta coefficient of stocks (the volatility of a particular stock returns with the market returns). In this model, it is argued that the expected return of a particular stock is dependent on this coefficient. It says that if a stock's Beta is higher relative to other stocks, the expected returns of the particular stock should also be higher. However, some empirical tests on stock returns with the Beta coefficient have not shown a this relationship to hold.

According to some empirical tests which also included the Beta coefficient indicate that factors such as: Size of the company, Earnings to Price (E/P) ratio, Book value to Market value ratio (BV/MV), and Leverage of the company, show a more significant relationship than the Beta coefficient. These variables have shown significant relationships with the stock returns in studies done on certain markets.

Therefore, in this research it is attempted to determine whether the Colombo Stock Market exhibits these relationships in explaining stock returns by taking two separate samples. One sample consists of 120 stocks and while the other one consists of 24 blue chip stocks. It is found that the Beta coefficient is not significant in explaining stock returns other than for the 24 blue chip companies.

However, the E/P ratio showed a very significant positive relationship with stock returns for all analysis. All other variables such as Size, BV/MV and Leverage do not show a significant relationship with stock returns.

Further, the researcher tried to identify whether it is the total return or capital returns plus dividend returns or capital returns only that is explained more precisely than the others by the E/P ratio. In this research it is found that the capital returns plus dividend returns are explained more precisely than the other two by the E/P ratio.

In conclusion, it is found that the E/P ratio is able to explain capital plus dividend returns in the Colombo Stock Exchange much better than Beta coefficient of the CAPM. Thus, investors and portfolio managers could use the E/P ratio in order to make decisions regarding their investments portfolios.