

## **ILLIQUIDITY EXPOSURE OF SIZE AND VALUE IN MALAYSIAN EQUITY RETURNS**

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### **ABSTRACT**

*This study examines pricing implications of size, value, illiquidity and momentum effects in Malaysian stock returns. It employs time series and panel methods in testing APT-motivated pricing models over a sample period of 14 years up to 2013. Results indicate the significance of illiquidity over size and value factors. Capital Assets Pricing Model (CAPM) poorly performs in explaining average stock returns. An asset's exposure to size, value, momentum, and illiquidity characteristics subordinates CAPM's explanatory power. Momentum trading strategy is profitable in short to intermediate horizons, yet momentum risk factor is unable to improve the efficiency of pricing models. Application of illiquidity adjusted Fama-French three-factor model is apparently persuasive for investments and related decisions in Malaysia.*

**JEL:** G10, G12

**KEYWORDS:** Illiquidity, Pricing, Risk Factors, Malaysia

### **INTRODUCTION**

The variation in average stock returns in cross section has been a topic of explanation for large numbers of studies over the last several decades. Static single-period CAPM (Sharpe, 1964 and Lintner, 1965) shows low battery at the power and relative performance of multifactor Arbitrage Pricing Theory and Intertemporal CAPM motivated models. Among these models, the three factor model (Fama & French, 1993) has been successful in many markets even though some authors, including Rahim and Nor (2006) find it to be inconclusive in general. The evidence in favor of other explanatory factors and anomalies including momentum and liquidity premiums, with its recent attention on behavioral explanations, has stimulated asset-pricing research. Especially, the research seeks empirical evidence from emerging markets where information asymmetry is observed in common, suggesting that most of the anomalies are differently formed relative to the US markets.

The interest of extending the work to emerging markets can be attributed to many relative differences. Emerging markets are different (Iqbal et al., 2010; Gunathilaka, 2012) in institutional, political and macroeconomic perspectives and these conditions are known to be volatile. This volatility disallows parameters to remain constant over time. Hence, the present study examines CAPM and other - Arbitrage Pricing Theory (APT) motivated-pricing models in an advanced emerging market, the Kuala Lumpur Stock Exchange. The idea of this article is to present evidence of higher returns in market illiquidity and demonstrate significance of illiquidity and momentum risk factors in APT motivated-pricing models. We focus on evidence of improved efficiency in asset pricing models and in extending the literature by studying an emerging context, which is, arguably, an ideal context to investigate illiquidity effects. This is true because these markets are mostly illiquid relative to that of developed markets. More specifically, the two-fold objectives of this paper are: Examine pricing implications of illiquidity and momentum in the presence of market risk premium, size and book-to-market, the well documented risk factors, and; Discuss the significance of illiquidity risk factor adjusted pricing models in Malaysia. The rest of the paper covers