

Evidence of maturing of the Colombo Stock Exchange: Informational efficiency perspective

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Abstract

Due to the dynamic nature of capital markets, understanding the informational efficiency of financial markets has become crucial for investors. An implication of an efficient market hypothesis is that no excess returns can be gained from available information, since it is believed that information is priced already in the stock. The objective of this study is to assess market efficiency of the Colombo Stock Exchange (CSE) in Sri Lanka, which is one of the emerging markets in the world. In order to test for weak form efficiency, stationarity of the selected time series is tested using *Augmented Dickey-Fuller* test. Sri Lanka stock market as a whole and the top three sectors with the highest market capitalization, exhibit random walk processes. Event study methodology is used to assess semi-strong efficiency. Preliminary analysis using both market model and *GARCH* model revealed that information disclosure of the selected companies has no significant impact on the returns in the CSE as a whole or on the returns of the particular sector.

Keywords: Event study, market efficiency, *GARCH* model, market model

Introduction

The Colombo Stock Exchange (CSE) has seen investor focus ever since the end of the conflict situation in 2009. CSE has been constrained by its size (approx. rupees 3 trillion), ill liquidity and limited local investor appetite in risky assets. However, with economic development, international investors have shown interest with foreign inflows amounting to over 105 billion last year as per the latest CSE statistics. The informational efficiency of the CSE indicates that it is maturing. Initial studies suggest that CSE is not even weak form efficient (Fernando and Peter, 2014). Previous studies also report evidence to support weak form hypothesis (Fernando and Jayasinghe, 2010). Edirisinghe (2015) however, do not find support for the market becoming semi strong form of efficiency. With the change in global investor sentiment towards Sri Lanka, especially over the last 3 to 4 years, it is prudent to review whether the previous findings of weak form and semi-strong form of efficiency still holds.

Methodology

The sample was drawn from 295 companies representing 20 business sectors at the CSE. The initial sample consisted of companies that were listed during 2014 to 2016, traded actively during that period, showed unusual or unexpected changes in the dividends (a fifty percent change of dividend was considered as a change) and had high market capitalization (market capitalization to total capitalization ratio of at least 0.3. Market moving announcements such as bonus and rights issues, stock splits in a one-month window period around dividend announcements were not considered. The final sample comprised of 34 companies with a total of 65 dividend announcements. The *Augmented Dickey-Fuller* (ADF) Test was used to test the null hypothesis that CSE is weak form efficient.