THE IMPACT OF FINANCIAL DISTRESS RISK TO MALAYSIAN STOCK RETURN

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ABSTRACT

If financial distress risk can be accurately predicted, the stock price of high distress risk companies should be discounted so as to enable investors to earn higher expected returns. Investors which have invested in high risk companies should be rewarded with high returns as the compensation in baring the risk due to the theory of risk and return trade off. This study set out a direct approach to examining the risk-return relationship of Malaysian companies. By applying Z-Score bankruptcy prediction model as the proxy of distress risk and the realized stock returns of the companies, this study found that the distress risk is not statistically significant enough to explain the expected stock returns. This result is contradicted with past research such as Shumway (1996) and Griffin and Lemmon (2002) which is firm with distress risk earn higher positive returns. However the size and book to market equity have shown significant relationship in explaining the stock returns of the companies. The theoretical expectations of the size and book to market equity effect on stock returns are supported in the Malaysian companies. These results are consistent with by Chan and Chen (1991), Fama and French (1992, 1995), Dichev (1998), Chen and Zhang (1998) and Griffin and Lemmon (2002) which found that size and book to market equity can be used in explaining stock returns.

ABSTRAK

Jika risiko kesulitan kewangan boleh diramal secara tepat, harga saham syarikat-syarikat berisiko tinggi seharusnya lebih murah sehingga membolehkan pelabur mendapatkan pulangan yang diharapkan lebih tinggi. Pelabur yang telah melabur di syarikat berisiko tinggi seharusnya mendapat pulangan yang tinggi sebagai pampasan dalam menanggung risiko yang tinggi sebagai menepati teori risiko dan pulangan. Penyelidikan ini dibuat bagi mengkaji hubungan di antara risiko kesulitan kewangan dengan pulangan yang diperoleh melalui aktiviti pelaburan dalam syarikat di Malaysia. Dengan menggunakan Z-Score model sebagai pengukur tahap risiko kesulitan kewangan dan purata pulangan bulanan sebagai pengukur pulangan saham syarikat, kajian ini mendapati bahawa risiko kesulitan secara statistik tidak cukup bermakna untuk menjelaskan pulangan saham seperti yang diharapkan. Keputusan ini bertentangan dengan kajian terdahulu seperti Shumway (1996) dan Griffin dan Lemmon (2002) yang mendapati bahawa dengan risiko kesulitan yang tinggi akan menjana keuntungan saham yang tinggi. Namun saiz dan nilai sebenar berbanding nilai pasaran ekuiti telah menunjukkan hubungan yang bermakna dalam menjelaskan keuntungan saham syarikat. Keputusan ini sejajar dengan keputusan kajian yang di buat oleh Chan dan Chen (1991), Fama dan Perancis (1992, 1995), Dichev (1998), Chen dan Zhang (1998) dan Griffin dan Lemmon (2002) yang mendapati bahawa saiz dan nilai sebenar berbanding nilai pasaran ekuiti boleh digunakan dalam menjelaskan return saham.

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LIST OF ABBREVIATIONS

PN17	Practice Note 17 of the Listing Requirements
BMV	Book-to-market equity ratio
Bursa Malaysia	Bursa Malaysia Berhad
BMV	Book to Market value
Z-Score	Altman's (1968) Z-Score bankruptcy prediction model
MKT CAP	Market Capitalisation
MAR	Monthly Average Returns
SPSS	Statistical Package for Social Sciences

CHAPTER 1

INTRODUCTION

1.0 Introduction

This chapter attempts to provide overview of the study and market condition which related to this study. This chapter also states the problem statement, research question, research objective, significant of the study and also the limitation of the study.

1.1 Overview of the Study

Company failures are common in a competitive business environment. This is synonymous for an event of default refers to the events associated with other places, including the inability to meet the financial difficulties of debt payments, apply for bankruptcy protection or even closure. Risk of financial difficulty is the uncertainty introduced by the method by which the finance company investments. If a company uses only common stock to finance the investment, the company may bare business risk only. It is difference for a company borrows money to finance an investment the company will bare business risk and financial risk in the form of interest and principal which is obligate for them to meet. Thus, the ability to meet financial obligations to creditors determines the company's financial difficulties. In addition, financing costs have priority on the distribution of earnings to shareholders and hence increased uncertainty back to the common equity. Uncertainty of returns will result in increased risk premiums required by investor to the particular stock. As conjectured by the risk and return trade off theory and asset pricing theory

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