Determinants of Stock Returns: A Comparative Analysis of Stock Markets in Sri Lanka and in the United Kingdom

L. M. C. S. Menike[a]*, Priyanga Dunusinghe[b] and Athula Ranasinghe[b]

[a] *Department of Accountancy & Finance, Sabaragamuwa University of Sri Lanka, P.O. Box 02, Belihuloya 70140, Sri Lanka.*
[b] *Department of Economics, University of Colombo, P.O. Box 1490, Colombo, Sri Lanka.*

*Correspondence: *lmcsmenike@gmail.com*

This study examines the determinants of stock returns of Colombo Stock Exchange (CSE) and London Stock Exchange (LSE) for the period spanning from 2000-2012. The study applies a panel data approach in a multifactor assets pricing framework using seven firm specific variables and nine macroeconomic indicators. 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 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 listed companies. 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 CSE and LSE whereas unemployment and Foreign Portfolio Investments (FPI) become statistically significant only in CSE. Thus, the results do not reveal big differences between the systematic and unsystematic risk factors which are priced in both the LSE and the CSE stocks. It can be concluded that the stock markets of the UK and Sri Lanka are more sensitive to macroeconomic changes and the findings of this study disagree with the predictions of Fama's (1970) semi-strong form of the market efficiency. Hence, it seems that, based on the publicly available information, the investors can make abnormal profits through stock trading strategies and the multifactor assets pricing models work effectively in both the CSE and the LSE.

Keywords: Colombo Stock Exchange, Determinants, London Stock Exchange, Panel Data Regression, Stock Returns