CHAPTER I

INTRODUCTION

1.1 Background

Investors and stock market analysts will always be interested in what determines the return of stocks, as knowing these factors could lead to understanding what maximizes portfolio returns. Two popular studies that attempt to predict stock returns have emerged such as the CAPM model (utilizes risk free rate, market risk, and expected return of market) and the Fama-French model (utilizes firm size, firm book value, and excess return on market). There have been many studies that attempt to do the same, but those two are the most popular models in explaining how returns are acquired by investors.

The emergence of the two models has led to studies that try to find out what other factor that might also help explain stock returns. One of those factors is liquidity. Three past studies (Amihud & Mendelson, 1986; Datar et al., 1998; Jun et al., 2003) have found out that liquidity plays a significant role in predicting the returns of a stock.

This is further backed up by more recent findings (Liang & Wei, 2012), where it is suggested that the 2008 financial crisis was caused by stock market illiquidity, and therefore liquidity risks play an important part in shaping stock returns. Furthermore, this study that they perform in developed markets show that liquidity risk positively affects stock returns. This means that lower liquidity leads to investors demanding more return for bearing the risk of illiquidity. While this lines up with the results of the 2 previously mentioned studies (Amihud & Mendelson, 1986; Datar et al., 1998), one study that was performed in 27 emerging stock markets from the year of 1992 to 1997 found that higher liquidity leads to higher stock returns (Jun et al., 2003).

There are two other separate studies that were conducted on the Johannesburg Stock Exchange (Marozva, 2019) the Stock Exchange of Thailand (POJANAVATEE, 2020). The study in conducted on the Johannesburg Stock Exchange found that stock liquidity is positively significant in determining stock returns, while the study in the Stock Exchange of Thailand found that it is only significant in certain sectors. Because of these varying recent findings, the author is interested in finding out what affects stock returns in Indonesia by implementing a Four Factor asset pricing model, as the significance of stock liquidity toward stock excess returns may differ across countries. This model uses stock excess returns, firm size, firm value, and liquidity as independent variables.

1.2 Problem Statement

This study is intended to answer the following questions

- Do expected return, size factor, firm value factor, and illiquidity factor affect stock excess returns?

1.3 Objective

While this study is not intended to provide a definite answer of which relationship is correct, the author hopes that the result of this study can help guide readers, whether they are investors or scholars, in finding out what are the factors that can explain stock returns as well as what are their relationships toward stock returns. Investors or scholars will then be able to use the results of this study to determine the best investment strategy when investing in Indonesian stocks.

1.4 Contribution of Research

This study may be used as reference, or expanded upon, by the following:

- Researchers, professors, and lecturers, may they be from the Faculty of Economics and Business of Universitas Pelita Harapan or outside of it
- Students looking for references for their own thesis.

1.5 Writing Systematics

To make the contents of this study easier to read and understood by the readers, a writing systematic is necessary to set up the framework of how this study is arranged. Thus, listed below is how this study is arranged:

1.5.1 Initial Section

Refers to the title page, Final Assignment and Upload Agreement, Thesis Approval, Thesis Defense Committee, Abstract, Preface, and Table of Contents.

1.5.2 Main Setion

Refers to the chapters and its contents:

1.5.2.1 Chapter 1

This chapter discusses the background, problem statement, objective, contribution of research, and writing systematics of this thesis.

1.5.2.2 Chapter 2

This chapter discusses the results of existing literature that are relevant to this study. Those studies include definitions of these independent variables: risks, excess returns, size factor, firm value factor, as well as stock liquidity.

Additionally, it also includes the possible significance and relationship of said variables and the formation of the hypothesis used for this study.

1.5.2.3 Chapter 3

This chapter discusses the data used for this study, the specification of the empirical model used for this study, the variables used for the empirical model, as well as the process of data diagnostics performed in this study.

1.5.2.4 Chapter 4

This chapter discusses the results of the data diagnostics performed for this study, the regression results of this study, as well as the interpretation of the regression result.

1.5.2.5 Chapter 5

This chapter discusses the conclusion of this study as well as suggestions that may be considered by future researchers should they take an interest in a similar topic to this study.

1.5.3 Final Section

This section includes the references used for this study as well as the appendix, which includes screenshots of the data diagnostics performed and the regression result