

Effects of Monetary Variables on the Risk-Return Relationship

By

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A thesis

presented to the Bahria University, Islamabad

in partial fulfilment of the requirements

for the degree of

Masters of Philosophy

March 2015

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ACKNOWLEDGEMENT

In the name of Allah; The Most Gracious and The Most Merciful. All praises to Allah for His blessings in completion of this thesis. I would like to express deep and sincere gratitude to my supervisor respected Dr. Muhammad Ayub Siddiqui for his supervision, consistent guidance, and vigilance. He is the epitome of courage, hard work, consistency, and loyalty in his field and his great work will keep mounting in the field of research. May Allah Almighty keep him blessed.

I would like to thank my dear mother and father for the endless love, motivation, courage, prayers, and support because without them I wouldn't be able to complete this thesis. I also would like to thank my sisters who are always there whenever I need them; they are my constant source of support. I specially would like to thank my eldest sister Farina Liza who had always wanted me to achieve my goals.

Lastly I would like to express sincere gratitude to my friends; especially Ammara Mujtaba who supported me throughout the thesis with her motivational words. I am also thankful to Mr. Kamran and Mr. Adnan for helping me with the collection of data.

DEDICATION

I would like to dedicate this thesis to my beloved mother Naseem Akhtar and my dear dad M. Aslam Khokhar who are a mounting source of inspiration, motivation, and strength within me. Whatever I have achieved in my life so far is all because of my beloved parents who always want me to shine in all facets of my life.

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Abstract

The main objective of this thesis is to explore the impact of monetary variables on risk-return relationship using daily data from July 2004 to July 2014. Least Squares technique is applied to test the interactive affect of all variables on risk-return relationship and the results of economic model proved that there is insignificant negative effect of interest rate, exchange rate, and interest rate on risk-return relationship. On the contrary, small size has relatively little impact on risk and return relationship than medium size of the firm. Subsequently, large size of the firm has shown highly positive impact on the relationship of risk and return compared to small and medium size. However, the robust tests are also carried out to counter check the results of economic model. Primarily, Vector Autoregression tests are applied to test the effects of monetary variables on prices of the stock and Granger Causality estimates are employed to examine the causal association among the variables. The overall statistical estimates of Granger Causality indicate that there is causal association between stock prices and exchange rates; stock prices and market capitalization. On the contrary, there is no causal association between stock prices and interest rate; stock prices and risk. The Vector Autoregression estimates showed fairly substantial results proving that the relationship among all underlying variables is positive. However, the statistical estimates have indicated that the risk-return relationship is negatively affected by contraction in the monetary policy. The statistical estimates of exchange rates have shown significant positive results throughout the research and it can be said that risk-return relationship improves with the improvement in exchange rate and the results support the theory of Sharpe-Litner (1964-65). The market capitalization has also indicated significantly positive results throughout the thesis and a judgment can be made that risk-return relationship improves with the increase in the size of the firm. Thus, all the monetary variables employed in this thesis except for interest rate significantly affect the risk-return relationship.