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Abstract

The quantitative research paper helps investigate the existence of market inefficiency in the Karachi Stock exchange (KSE 100 Index). Market inefficiency exists when a number of stocks trading in the stock market are overpriced and others may be underpriced as compared to the true market value (fair Value). Also the CAPM theory becomes unreliable in determining the stock price because it assumes that the market is efficient. Investors can exploit the market inefficiency by earning above average returns compared to the overall market returns.

The Efficient Market Hypothesis (EMH) states the all the information available in the stock market is reflected in the stock prices which mean that the stocks are trading at a fair value. With stocks having fair value, no investor can earn an above average return.

This paper will investigate the existence of Size effect (Also called Size Premium) and Value premium (Price to Earnings (P/E), Price to book (P/B) and Dividend Yield (DY)). The existence of either or both (Size Premium or Value Premium) will point towards inefficiencies in the stock market and investors can earn an above average return than the market.

Five portfolios of KSE100 companies were formed and sorted based on Attributes of Size (Market Capitalization), Price-to-Earnings ratio (P/E), Price-to-Book ratio (P/B) and Dividend Yield (DY). Within each portfolio, companies above the average and companies below the average stock returns (in terms of the specific attributes) were compared.

After analyzing the stock returns, this paper makes an attempt to show that low Price/Earnings (value stocks) have given a higher return than growth stocks (High Price/Earnings ratio stocks), which means the Value premium exists in the Karachi stock Exchange (KSE). Our results have proven that inefficiency exists in the market.

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