THE RELATIONSHIP BETWEEN FIRM SIZE AND STOCK RETURNS

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ABSTRACT

As an extension of research explaining the behavior of stock returns, the present study examines the relationship between firm size (as measured by market capitalization) and stock returns. This anomaly, now known as the "size effect", has been the focus of many recent studies. According to this anomaly small firm stocks tend to earn statistically higher returns than large firms.

Since the relationship between firm size and stock returns lacks empirically tested evidence from the Karachi Stock Exchange (KSE) thus this study concentrates on determining this relationship and exploring its nature.

A sample of twenty firms was selected from the KSE 100 index and two portfolios were constructed namely "small-cap" and "large-cap". Then Pearson Product Moment Correlation was applied to find the degree of relation between average stock returns and market capitalization for all the firms of each portfolio. Thus when market capitalization is used as a measure of firm size the "size-effect" continues to be useful although somewhat weaker for Pakistani stocks.

For further analysis and confirmation of these results other measures of firm size like total assets, revenues and employment should be included while increasing the sample size.

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