Stock Market Reaction to Political Events: 
A Study of Listed Companies in Colombo Stock Exchange of Sri Lanka

S.RAMESH
PhD Scholar, School of Management, Huazhong University of Science and Technology, Wuhan, Hubei, China
ramesk9@yahoo.com

Dr.S.RAJUMESH
University of Jaffna
rajumesh3@yahoo.com

Abstract
This study examines market efficiency and market reaction to political events in Colombo Stock Exchange (CSE) using a sample of 40 major political events of the emerging market of CSE which represents different industry sectors from 2008 to 2012. Standard event study methodology is employed to find the results. The results reveal biggest impressive negative AARs of -2.27 percent and strong negative significant (t=-3.27) at 1% level which produced on the political event date. This result shows that political events indicate significant negative information to the CSE. On average, market reacts negatively to market related informational event. Further, largest negative cumulative average abnormal returns (CAARs) of -1.71 percent is found during the 21 days window period. In this negative CAARs, investors’ overall believe that this event result in incremental negative future cash flows of the stock exchange of Sri Lanka. In addition to these findings, this speed market response support to the efficient dissemination of information to stock market participants since stock price adjusts very quickly to political risk information. Furthermore, stock market participants cannot earn abnormal returns by trading in the stock after the event day. Despite, the event day is unprofitable, the market is informational efficient under the market related informational event.

Keywords: Abnormal Returns, Event Study, Market Efficiency, Political Event, and Window Period

1. INTRODUCTION
This study focuses on the market reaction to political information by Sri Lankan listed companies in Colombo stock exchange (CSE). Political event is one of the crucial factors influencing the operation of a country’s stock market as widely claimed by numerous studies. The political events adversely affect the confidence of both domestic and foreign investors as the volatility of stock market is increased which lead to the uncertainty of the investment expected cash flows (Kongprajya, 2010). The example of empirical case of the impact of political event on the whole economy is the sudden and devastating tragedy of September 11th, 2001 in the US. It can come in many forms such as introduction of government policy, government election, civil war, terrorists and suicidal bombing attack, political action of pressure groups, peace talks, government budget, corruption case, major labour union protest and natural disaster. These political incidents may have both favorable and unfavorable effects on stock prices of listed companies in the CSE. The political situation in Sri Lanka has a large impact on the foreign and domestic investors’ perception to buy shares.

Capital market is an important body in contributing to economic development. CSE plays a major role in contributing much towards economic development in Sri Lanka. The CSE is the organization responsible for the operation of the stock market in Sri Lanka. CSE is an important emerging market of the region among the developing countries. The CSE has fifteen stock broking firms and 287 listed companies representing twenty business sectors with a market capitalization of 2167.6 billion rupees (over US $17.3 billion) which corresponds to approximately 29% of the Gross Domestic Product of the country in 2012. But most of the companies’ stocks do not trade frequently. The CSE is concentrated two main price indices such as All Share Price Index (ASPI) and Milanka Price Index (MPI). ASPI is used to measure the movement of share prices in all listed companies. MPI is used to measure the price movement of share prices of 25 selected companies. These Companies have been selected on the basis of liquidity and market capitalization. With effect from 1st January 2013, the MPI was replaced by a newly introduced index, S&P SL20. The S&P SL 20 index, which was introduced on 27th June 2012 to meet investors’ demand for a transparent and a rule based benchmark.

The greatest amount of research in finance has been devoted to the effect of an announcement on share price. Researchers around the world have studied some of these impacts and these studies are known as ‘event studies’. Event studies focus on the various announcements like firm specific informational events such as bonus issue, right issue, stock splits, earnings, dividends, mergers and acquisitions, stock repurchases, etc. or market related information events like bomb blast, political changes and political risk. These studies are known as
“event studies.” Initially event studies were undertaken to examine whether markets were efficient, in particular, how fast the information was incorporated in share price. The event study method is developed as a statistical tool for solving questions like this, which are focused on abnormal returns (ARs). The general applicability of the event study methodology has led to its wide use and nowadays it is one of the most frequently used analytical tools in financial research (Luoma, 2011).

Political risks not only cause an unpleasant impact on the macro-level economy, but extreme political events also affect the economy on a micro-level as well. Many empirical works have examined the effect of political risks either on certain industries or the country’s stock market however much of those works focused on the political issues in developed countries and less works are carried out in the context of emerging or developing countries even though the political environment in these countries is less stable which make them a motivating topic for the research purpose. One developing country where political situation is now being in public attention is Sri Lanka. Talking about political situation in Sri Lanka, basically political distress in this period in which private-sector property remained largely intact, the listed firms on Colombo Stock Exchange the event study methodology has led to its wide use and nowadays it is one of the most frequently used analytical tool for solving questions like this, which are focused on abnormal returns (ARs). The general applicability of

This study is designed to give some ideas about the relationship between share prices of listed companies and political incidents. Therefore, the aim of this study is to analyze in the extent which a company’s stock price would reflect the political incidents according to the semi strong form efficiency which states that stock prices react so fast to all public information and no investor can earn an abnormal return after the announcement is made. Information is the key to the determination of the share prices and the key issue of the efficient capital market (Keane, 1986). An efficient market is one, where the stock prices quickly and fully reflect all available information about the assets. According to the Fox and Opong (1999) an efficient market is one in which prices fully reflect available information. An implication of a semi – strong efficient market is that no abnormal returns can be made from this information because adjustments had already been done in the stock price. The market has already been adjusted. Therefore, the only way to outperform the market in this case would be by using inside information. Therefore, in the present study, is initiated to find out that how far the political information reacts on share prices.

1.1 Objective of the Study
Following objectives are taken for the study
a. To examine the stock market reaction to political information.
b. To find out the degree of the significant reaction of political events on stock prices.
c. To empirically test Efficient Market Hypothesis (EMH)

2. LITERATURE REVIEW
The political risks can be defined as “risks to a firm’s profitability that are principally the results of forces external to the industry and which involve some sort of government action or, occasionally, inaction”. These government actions which could change the business environment of firms are expropriation, policy shifts in taxation or regulation, imposition of capital and foreign exchange controls (Beaulieu, Cosset and Essaddam, 2002). In Sri Lanka, political event is associated with general election, parliament election, provincial council election, governmental policy changes, domestic/international conflicts, civil war and any other terrorist attack activity. In these events are called market related informational events. Investors and researchers view political risk as an influential factor in asset pricing. In this study, political risk refers to the uncertainty that arise from incidents that have strong political implications which can significantly affect on stock prices.

According to Abeysekera (2011) the civil war was waged between the government of Sri Lanka and a separatist guerrilla group, the guerrillas attempting to break off the north and east regions of the country as a separate sovereign state. The terror attacks were directed towards destroying government-owned infrastructure such as roads, rail, airports, and seaports, and were seldom aimed at privately owned property. This is a characteristic of civil war that sets it apart from a fully fledged war: In a fully fledged war, property is destroyed indiscriminately rather than selectively. Contrary to expectations in a fully fledged war, during the civil-war period in which private-sector property remained largely intact, the listed firms on Colombo Stock Exchange reported increases in profits (CSE, 2000). The effect of guerrillas’ activities was also felt outside the north and east regions of the country, separatist guerrillas detonating bombs in other regions of the country to destroy government-owned property and human life. Such destruction heightened the uncertainty during the civil-war period, and was felt in the capital market with a decrease in listed firms’ market capitalization due in fall in investor confidence rather than due to economic activities.

Beaulieu, Cosset and Essaddam (2002) examined the impact of political risk in Canada on the volatility of stock returns. Results suggest that political news associated with a possible separation of Quebec from Canada plays an important role in the volatility of stock returns. They also show that the volatility of stock
returns varies with the degree of a firm’s exposure to political risk, namely, the structure of assets and the extent of foreign involvement.

Chen, Binand and Chen (2005) investigated the possible impact of various political events on Taiwan’s stock performance. When market-adjusted techniques are applied, seemingly Taiwan’s stock market often reacts to the occurrences of political incidents with a significant abnormal price performance. Nevertheless, after employing an MVRM framework that accounts for market risk differences across firms and for distributional tendencies in daily returns, find that price reactions to most of the political events are rather insignificant, implying those events be largely uninformative with only a few exceptions. The abnormal return behaviors are also frequently comparable between firms with small- and large foreign institutional ownerships.

Kongprajya (2010) examines impact of political news on Thai stock exchange. This study proved that returns appear to be negative on the day in which unfavorable news was released and the opposite occur on the day in which favorable news was released. Further, study found the leverage effect of political news on stock market persistence of shocks from the news on stock volatility.

Abeysekera (2011) examines Civil war, stock return, and intellectual capital disclosure in Sri Lanka. The findings of this study provide insights into the intellectual capital disclosure practice and its influence on stock return in a civil-war environment. Julijana (2011) analyzes the response of capital markets to political events. An event methodology is employed, and the results suggest that the market respond to all political events connected —name issue. The results also indicate that there is no difference between the means of abnormal returns before and after the event. Sensitivity of the Macedonian stock market investor related to any information connected to the word "name" is enormous. The Macedonian investor belief is that if —name issue would be solved, regardless of possible negative real economic flows stock exchange will increase.

Khan, Saif, Rehman and Roohullah (2013) examined the impact of events of different nature like: political, natural calamities and terrorism on the share prices of the financial sector of Pakistan. The results indicate that events have significant impact on the stock prices and prices behave negatively when a major event emerges on national or international front.

Bryan Kelly (2013) analyzes the pricing of political uncertainty, guided by a theoretical model of government policy choice. He finds that political uncertainty is priced in the option market in ways predicted by the theory. Options whose lives span political events tend to be more expensive. Such options provide valuable protection against the risk associated with political events, including not only price risk but also variance and tail risks. This protection is more valuable in a weaker economy as well as amid higher political uncertainty.

Abeyaratna, Bandara and Colombage, (1999) examined the semi-strong form efficiency of the CSE in Sri Lanka using Granger causality test and a modified version of the market model on weekly indices of fourteen sectors for the period January 1993 to December 1997. Only three sectors (i.e., bank, finance and insurance; hotels and travels and manufacturing) are found to be semi-strong form efficient. A majority of the sectors lag the market indicating the possibility of predicting market movements of the EMH.

Disa Bandara and Samarakoon, (2002) investigate the informational content of dividend announcement and analyze the impact of dividend announcement by firm size and dividend growth using a sample from the Colombo Stock Exchange in Sri Lanka. They find that dividend have a significant information content in Sri Lankan Stock Market. On average, market reacts positively to dividend announcements. The information content is stronger for the smaller firms and for firms announcing high dividend growth. They also find a considerable anticipatory effect for smaller firms, the largest firms and for firms announcing lowest dividend growth. The market takes considerable time to fully incorporate information contained in dividend announcement by the smallest firms, the largest firms and by firms announcing the highest dividend growth. Overall, the results are inconsistent with an informationally efficient stock market.

Mallikarjunapa and Manjunatha (2004) examines the stock price reactions to dividends, one of the publicly available information, to test the semi-strong form of EMH. The analysis of the results shows that AARs do not approximate to zero and CAARs show wide fluctuations indicating that abnormal returns can be earned several days after the event day. CAARs show that abnormal returns can be earned 24 days after the event day. From this he concludes that Indian market is not efficient in the semi-strong form.

Carlos (2009) found that the firms’ public stock split announcements did not affect stock price on the announcement day. Results support the semi-strong form efficient market hypothesis since stock prices adjust so fast to public information that no investor can earn above normal return by trading on the announcement day.

Disa Bandara and Perera, (2011) studied the impact of dividend announcements of CSE in Sri Lanka. They find that significant abnormal returns around dividends announcement day. The results show that overall sample support informational content of dividend hypothesis. This study confirms that the significant anticipatory responses to dividend announcements one week before the event and price adjustment process have been enhanced. Gunmathilaka and Kongahawatte (2011) examined stock splits in Sri Lanka. Stock split announcements create significant positive market reaction and the sharp – adjustments in the stock prices on the day of announcement. It suggests that the market is informational efficient. The stock’s trading volume is
improved significantly with the split announcement.

3. DATA AND METHODOLOGY

3.1 Sampling Design

The sample consists of 40 major events from 69 companies listed in the CSE which covers the period 2008 to 2012 using judgmental sampling from different industrial sectors. This choice of the sample period is governed by the availability of data. Reasonable care has been exercised in order to select a large sample to derive more valid findings. The final selection criterion is the availability of daily closing price and daily all share price index (ASPI) data in a manner that is necessary for the application of the ‘event study method’. Daily closing price should be available for at least 180 days out of the total period of 191 days that include the 180 days estimation period (-11, -180) and the window period 21 days. In the literature the estimation period, of size between 120 – 200 days used in most studies, is the period immediately before the event window (Telang, and Wattal, 2005). Therefore, to be precise on testing the market efficiency, this study considers daily data which is important to measure the reaction of the political issues using the smallest feasible interval. The following table 1 shows the breakdown of sample according to year of political events over the study period of 2008 -2012.

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Events</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>05</td>
</tr>
<tr>
<td>2009</td>
<td>18</td>
</tr>
<tr>
<td>2010</td>
<td>08</td>
</tr>
<tr>
<td>2011</td>
<td>05</td>
</tr>
<tr>
<td>2012</td>
<td>04</td>
</tr>
<tr>
<td>Entire Sample</td>
<td>40</td>
</tr>
</tbody>
</table>

3.2 Data Source

In the present study, we used only secondary data which is the CSE’s C-D. The study computes daily returns for individual securities on the basis of daily closing stock prices and its political events date. The major political news is obtained from the website of CSE. In cases where price for the non-traded on a given date, the following traded price is taken as the price for the non-trading date. The stocks with insufficient data points, either as a result of high non-trading or lack of financial and market information, were excluded from the sample. The market return is calculated as the change in the daily All Share Price Index (ASPI), which is the value-weighted price index of the entire share listed in the CSE.

3.3 Mode of Analyzes

This study uses the ‘Standard Event Study Method’ to estimate the announcement effect of political issues such as abnormal returns (AR), average abnormal returns (AARs) and cumulative average abnormal returns (CAARs) around political event date (the event-day). The event date is the date on which the effect of an event is presumed to take place, or the date around which a diffused effect is presumed to be distributed. In this study, researcher has taken 21 days around the event, and study has designated -10,-9,-8 …………….-1 as the 10 days prior to the event, 0 as the event day, and +1, +2, +3…………., +10 days after the event and AARs and CAARs were computed for 21 days surrounding the event-day. Kothari and Warner (2006) expressed that event studies which evaluate the content of financial and economic information disclosure. Later studies have attempted to manage to contemporaneous factors by using high frequency data such as intra-day and daily data.

4. FINDINGS

Researcher presents descriptive statistical information for the stock market reaction to political events of AARs. The mean, median, range, standard deviation, minimum, maximum and skewness were calculated for 40 major events related to the CSE in Sri Lanka over the 5-year period. They are reported in table 2. Standard deviation shows the variation in the return. A standard deviation of 0.83 percent observed which high value is compared with mean value of -0.08 percent which indicates that the data points are spread out over a large range of values. When a distribution is skewed to the left the tail on the curve's left-hand side is longer than the tail on the right-hand side, and the mean is less than the mode. This situation is also called negative skewness. The returns for stocks showed negative skewness, an indication that the return distributions of the stocks in our sample have a higher probability of being negative. The returns for stocks showed negative skewness of -184.02 percent. This negative high skewness indicates that Stock market badly reacted from major political events which depicts the negative reaction of investors to this event. During this time investors are waiting to take investment decision. The maximum and minimum AARs are 0.95 percent and -2.72 percent respectively. Further, Aggregate AARs for the 21 days window period is -1.71 percent.
Table No 2: Descriptive and Statistical Information for Sample Companies

<table>
<thead>
<tr>
<th>AARs</th>
<th>Value (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean</td>
<td>-0.08</td>
</tr>
<tr>
<td>Median</td>
<td>0.25</td>
</tr>
<tr>
<td>Standard Deviation</td>
<td>0.83</td>
</tr>
<tr>
<td>Sample Variance</td>
<td>0.01</td>
</tr>
<tr>
<td>Skewness</td>
<td>-184.02</td>
</tr>
<tr>
<td>Range</td>
<td>3.67</td>
</tr>
<tr>
<td>Minimum</td>
<td>-2.72</td>
</tr>
<tr>
<td>Maximum</td>
<td>0.95</td>
</tr>
<tr>
<td>Sum for window Period</td>
<td>-1.71</td>
</tr>
<tr>
<td>Window Period- Investigation period</td>
<td>21</td>
</tr>
</tbody>
</table>

The table 3 presents the daily percentage average abnormal returns (AARs %), daily percentage cumulative average abnormal returns (CAARs %) and T value of AARs % of the 21 days window period. T (AARs) indicates significance for the investigation period (t= -10 to +10). The number of events with positive and negative abnormal returns in each day is summarized under the column plus (+): minus (-) sign.

Table No 3: Average Abnormal Returns (AARs) of Overall Sample

<table>
<thead>
<tr>
<th>Window Period</th>
<th>AARs%</th>
<th>T(AARs)</th>
<th>CAARs%</th>
<th>Plus : Minus</th>
</tr>
</thead>
<tbody>
<tr>
<td>-10</td>
<td>-0.06</td>
<td>-0.07</td>
<td>-0.06</td>
<td>17:23</td>
</tr>
<tr>
<td>-9</td>
<td>-0.74</td>
<td>-0.89</td>
<td>-0.80</td>
<td>18:22</td>
</tr>
<tr>
<td>-8</td>
<td>0.06</td>
<td>0.07</td>
<td>-0.74</td>
<td>17:23</td>
</tr>
<tr>
<td>-7</td>
<td>0.42</td>
<td>0.51</td>
<td>-0.32</td>
<td>19:21</td>
</tr>
<tr>
<td>-6</td>
<td>-0.39</td>
<td>-0.47</td>
<td>-0.71</td>
<td>17:23</td>
</tr>
<tr>
<td>-5</td>
<td>0.72</td>
<td>0.86</td>
<td>0.01</td>
<td>18:22</td>
</tr>
<tr>
<td>-4</td>
<td>0.43</td>
<td>0.51</td>
<td>0.43</td>
<td>19:21</td>
</tr>
<tr>
<td>-3</td>
<td>-0.57</td>
<td>-0.69</td>
<td>-0.14</td>
<td>15:25</td>
</tr>
<tr>
<td>-2</td>
<td>-0.18</td>
<td>-0.21</td>
<td>-0.32</td>
<td>17:23</td>
</tr>
<tr>
<td>-1</td>
<td>0.30</td>
<td>0.36</td>
<td>-0.02</td>
<td>21:19</td>
</tr>
<tr>
<td>0</td>
<td>-2.72</td>
<td>-3.27**</td>
<td>-2.74</td>
<td>16:24</td>
</tr>
<tr>
<td>1</td>
<td>0.51</td>
<td>0.61</td>
<td>-2.24</td>
<td>15:25</td>
</tr>
<tr>
<td>2</td>
<td>0.59</td>
<td>0.71</td>
<td>-1.65</td>
<td>17:23</td>
</tr>
<tr>
<td>3</td>
<td>-0.70</td>
<td>-0.84</td>
<td>-2.34</td>
<td>18:22</td>
</tr>
<tr>
<td>4</td>
<td>0.33</td>
<td>0.40</td>
<td>-2.02</td>
<td>19:21</td>
</tr>
<tr>
<td>5</td>
<td>-1.47</td>
<td>-1.77*</td>
<td>-3.49</td>
<td>17:23</td>
</tr>
<tr>
<td>6</td>
<td>0.30</td>
<td>0.36</td>
<td>-3.18</td>
<td>15:25</td>
</tr>
<tr>
<td>7</td>
<td>-0.03</td>
<td>-0.04</td>
<td>-3.22</td>
<td>12:28</td>
</tr>
<tr>
<td>8</td>
<td>0.25</td>
<td>0.30</td>
<td>-2.97</td>
<td>19:21</td>
</tr>
<tr>
<td>9</td>
<td>0.31</td>
<td>0.38</td>
<td>-2.65</td>
<td>22:18</td>
</tr>
<tr>
<td>10</td>
<td>0.95</td>
<td>1.14</td>
<td>-1.71</td>
<td>26:14</td>
</tr>
</tbody>
</table>

** Significant at 5 %  * Significant at 10%

The table 3 consists the values of AARs which are slightly fluctuating returns both positive and negative related to the major political event day. These values are 50 percent positive before 5 days and 70 percent negative after 3 days of the event day. During the 21 days window period selected for the study, the AARs are 58 percent positive for more number of days (12 days) than negative for less number of days (42 percent for 9 days) both pre and post reaction of the event day “0”. Further, the trend indicates that on the event day and day +1, there is high negative stock market reaction to political events. The number of positive versus negative proposition is 16:24 on the event day and 15:25 on day +1. Therefore, this situation indicates that it is possible to earn negative returns on majority of the days which depicts the negative reaction of investors to this political event.

The level of significance is used 1% and 10%. There is not statistically significant in the pre event period. As a result, AARs are significantly lower during the pre-event period. This study also finds negative magnitude of the share price reaction of AARs on day 0 is -2.72 percent, this is statistically significant at 1% level. The results from short-term evidence suggested that, on average, shareholders suffer a significant loss of -2.72 percent on the day of event. This implies that the market absorbs very quickly the adverse signal of the
political events.

Therefore, this result suggests that on the event day “0” provide stronger terrible signal to the market than other days. This trend clearly indicates that major unfavourable incidents provide stronger negative signal to the firms and investors.

In addition to, the largest significant negative AARs of -1.47 percent is found on day +5, which refers to the fifth day after the event is occurred due to bad signal in the market. It is statistically significant at 10% level. This means that the return is negative on average during the fifth day after the event day at 90 percent of the probability. Finally, this study found that market participants’ reaction is rational to the new political information. Market normally react to stocks prices to this unfavourable new information.

Evidence depicts the CAARs during the day -10, 0 period is -2.74 percent which may be due to surprise information and the CAARs for the (day 0, +10) period is -1.69 percent due to bad signal quickly to be reflected in stock prices. These negative CAARs during the post event period disclosures recommend that political event do convey information which market takes necessary ground situational decision about political incidents. Therefore, this speed response has the potential of generating negative AARs based on publicly available information, which runs counter to the semi-strong efficient market hypothesis. This quick responsiveness may be attributed to a fast in disseminating the political event information to market participants. It may be a result of the efficiency of the information dissemination process. Finally, CAARs increased to -1.71 percent over the window period of 21 days. The market related information of political events, CAARs are high negative value of -1.71 percent depending on investors overall believe that the event result in incremental negative future cash flows of the stock exchange of Sri Lanka over the event window period. This new unfavourable information is negative signal to the investors and stock market. This largest negative return negatively influence and create uncertainties on their wealth management. Investors highly reduce their investment activities during this period.

![Figure 1: AARs and CAARs Values](image)

Another issue worthwhile for an inspection of the figure 1 is how stock prices respond to the release of major political news. Market participation expectation is that stock price should be decreased on the day in which bad news has been announced and vice versa for the day in which good news has been announced. The Figure 1 also shows that value of AARs has irregular yielding both positive and negative before and after the event day and which revealed that the change in the positive and negative signs suggested that the political situation in Sri Lanka was unstable. The behavior of the stock price is an uncertainty in stock market in the study period. The high negative significant AARs of -2.72 percent and CAARs of -2.74 percent are produced on the event day. It is confirmed that the market perceives major political events as adverse information and CSE is a rapid development in a communication system which enables an individual to access all political information and quickly response to that news. This information may be created strong buying and selling pressure in the stock
market. Therefore, negative upward and downward movement of the CAARs suggests that there is a quick price adjustment in pre period and in post event period.

Table No 4: Direction of Abnormal Returns (ARs) on Day 0

<table>
<thead>
<tr>
<th>Direction</th>
<th>Number of Events</th>
<th>Percentage of Events</th>
</tr>
</thead>
<tbody>
<tr>
<td>Positive</td>
<td>16</td>
<td>40</td>
</tr>
<tr>
<td>Negative</td>
<td>24</td>
<td>360</td>
</tr>
<tr>
<td><strong>Total Events</strong></td>
<td><strong>40</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

In addition, table 4 indicates that ARs are evenly distributed over the window period for the 40 events. Results shown as 40 percent of the days are positive abnormal returns and 60 percent of the days are negative abnormal returns. When we compute ARs into AARs (Day “0”= -2.72) which indicates more unfavorable negative signals than positive signals. Positive signs are good political news and negative signs are bad news to the stock market. Moreover, the change in the abnormal returns signs (positive/negative) suggested that the political environment in Sri Lanka was still unstable.

5. DISCUSSION

This study attempted to investigate the Colombo Stock Exchange (CSE), the emerging stock market reaction to political events by examining the sample of 40 major events in Sri Lanka during the period of 2008 to 2012. The results of the study reveal that there is a dominant pattern in negative average abnormal returns (AARs) around the window period. However, AARs of -2.72 percent are statistically significant (t=-3.27) at 1 % confident level on the event date. Therefore, there is a negative quick market response to political events related announcements on the event day. The empirical results of this study are consistent with many theoretical models suggest that market related informational events convey unfavorable information about future operating performance of the companies. The findings of the market reaction to political events support the informational content of political risk which promulgates the manager’s assessment of future potential growth of the firm.

This study found stock market negatively reacts to political incidents. This shocking information speedily spread in the market. This is proved by CAARs which value is negative -1.71 percent during whole window period. The trend of negative returns is more pronounced around the political event date. Therefore, the evidence of this study provides strong support for the semi strong form of efficient market and the market quickly incorporates the information related to political event.

The result of this study is consistent with EMH and inconsistent with the work of Dissa Bandara and Perera (2011) who studied the impact of dividend announcement of CSE in Sri Lanka. Nevertheless, the results of the study of Samarakoon (2005) confirm that Sri Lankan Stock market is indeed predictable and inefficient in sense of weak-form market efficiency. The result found here contrast with the finding on semi-strong form of efficient market hypothesis. Furthermore, Abeyratna, Bandara, and Colombage (1999) tested the semi-strong version of efficient market hypothesis in Colombo Stock Exchange of Sri Lanka. The result of the study indicates that the majority of the sectors (11 out of 14 sectors) are not a semi-strong form of efficient market. This result also consistently support with inefficient market hypothesis.

6. CONCLUSION AND POLICY IMPLICATION

The study examined political risk in Sri Lanka, in particular whether or not political issues impact on stock price movement and test efficient market hypothesis for the emerging market of Colombo Stock Exchange (CSE). This study addresses five major empirical issues. These issues were employed by using the standard event study methodology.

- How and when does the Sri Lankan stock market respond to political events?
- Does Sri Lankan stock market react quickly or slowly to political events?
- How does adjust stock prices after the event date?
- Are there any information leakages in pre event date?
- What does happen on the event date?

The empirical results for the political events provide strong significant negative average abnormal returns. This findings support the signaling hypothesis, thus, political events give negative information to the Colombo Stock Exchange (CSE). However, there is a evidence of negative high effect (CAARs = -2.74%) during the pre announcement period (-10, 0) because, no one can know leakages of any political information and also negative value of CAARs (-1.71%) is observed during the window period due to investors adjust quickly their stock prices to the political information and a less amount of time passes before the prices fully incorporates relevant information in this incidents. Therefore, the negative abnormal returns are generated after the event date. In conclusion, these results imply the importance of political instability on the health of Sri Lankan stock market.

Several important and interesting policy implications were obtained from this study. First, the evidence
of a significant reaction of political incident news on stock market instability suggests that political threat news should be one of the factors to be considered when forming stock market volatility. Second, the results which indicate a significant impact of negative political events on stock volatility. It is verified that political instability is an influential factor which capable to determine the direction of stock market movement. Though this market related external factors may sometimes unavoidable for this political event to occur and unanticipated political shocks cause asymmetric stock market returns: ‘good’ news lead to more pronounced reactions than ‘bad’ news, it is crucial for the country to minimize this instability in order to maintain investors’ confidence and the stability of country’s stock market.

Also finally, large institutional and foreign investors should be attracted and encouraged to participate on the CSE. The widely held consensus is that institutional and international investors have a greater capacity to conduct extensive security analyses. On the whole it is expected that, by reducing information asymmetry amongst market participants, the activities of institutional investors would help improve availability of relevant information and the overall quality of the information environment of the CSE. It is also expected that this would positively impact on corporate governance practices of domestic firms, protection of the rights of minority shareholders and general market discipline and transparency. La Porta, Lopez-de-Silanes and Shleifer (2003) found evidence of a positive correlation between the quality of shareholder protection and liquidity of stock markets in 49 countries.

Many empirical works have examined the effect of political risks either on certain industries or the country’s stock market however much of those works focused on the political issues in developed countries and less works are carried out in the context of emerging or developing countries or in Sri Lankan context. The future research could be extended on this phenomenon for different sectors and examine the impact of favorable and unfavorable major political news on stock returns and volatility. Furthermore, a study can be conducted to extend this study too, since this study considers only a limited number of variables. It is obvious that economic, specific informational internal events and trading frequency may be important for determinations of stock prices and stock returns.

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