Proceedings of the First European Academic Research Conference on Global Business, Economics, Finance and Social Sciences (EAR15Italy Conference) ISBN: 978-1-63415-028-6
Milan-Italy, June 30-July 1-2, 2015, Paper ID: I525

Liquidity and the Cross Section of Equity Returns: The Case for South Africa

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Abstract

A vast amount of literature regarding capital market efficiency is promptly available to investors and researchers. The findings of these studies are not unanimous, resulting in support for and against capital market efficiency. A number of researchers that oppose market efficiency have shown that certain firm-specific factors are highly significant in explaining the cross section of equity returns and that these factors can be used in the investment decision making process to obtain sustainable significant abnormal returns. Specifically, it appears that factors capturing value, momentum and size effects are regarded as the most significant in this regard. Although the majority of studies focus on developed markets, similar effects have been reported for the South African equity market. Compared to developed markets however, the South African market is regarded as a less liquid market which is dominated by a handful of companies. Therefore liquidity could have a significant impact on the results of studies concerning the cross section of equity returns on the Johannesburg Securities Exchange (JSE). In this study the impact of liquidity on the identity and explanatory power of firm-specific factors regarding the cross-section of returns are examined. Our results suggest that, of the three previously identified effects, only the value effect is not affected by market liquidity. The significance associated with the size and momentum effects are found to be sensitive to market liquidity, indicating that liquidity is a key factor to consider when constructing portfolios based on previously documented market effects.

Keywords: *Liquidity, cross section, equity returns, value, size, momentum*