

CHAPTER 1 : INTRODUCTION

1.1 Introduction

Stock returns and their volatility depends upon number of factors which ultimately affects investors and shareholders. This research is associated with determination of the consequences of equity multiples, stock returns and stock volatility. The research includes literature associated with the topic, theoretical background in which three important theories have been included linked to the topic. Furthermore, empirical model and estimation method have been discussed to depict variables of the study so that regression equation can be formed and analysis technique is also discussed. Last section describes data and sample for the study.

There is a stimulating as well as considerable relationship among the equity multiples and stock returns and volatility. Volatility is known as an act of dispersion throughout the average or mean return of the security. It is known as the measure that helps in measuring the range of the price of an asset. It was analysed that if there is a label of volatility over any stock then such stock is considered as plausible and there is a presence of systematic variance of the mean of its overtime. On the other hand, such stock that is less volatile would have a amount that would slightly vary over the time (Patton and Sheppard, 2015). A number of underlying reasons are behind the fact that there are numerous reasons due to which there is an increase in disclosure regarding the information of accounting by which stock volatility should be decreased.

The disclosures of the accounting helps in reducing magnitude of the influence of the news that is related to the performance of the firm by which the stock price vitality is reduced (Degiannakis and Potamia, 2017). As per the market microstructure theory, it is suggested that by enhancing the amount of information of the public, it is estimated that the disclosure would

lower the asymmetries of the findings in the value of market which results in pronounced changes of price while responding to the changes that are emerged in the demand for the stock.

1.2 Background of the study

In Pakistan, the security market or bond market as well as the stock market is referred as the main principal of the financial market. Whereas, it is analysed that financial intermediaries are composed of the financial arrangements along with the institutions by which finances are offered indirectly to the debtors. The overall banking sector of Pakistan is included in the financial intermediaries. These are known as such banks by which there is a flow of money from the savers towards the borrowers. There are two major categories of financial markets in Pakistan that are capital market and money market. Money markets are known as those organizations that have concern with such proceedings that are of credit instrument that is short-term (Shah and Noreen, 2016).

Bonds as well as the treasury bonds are considered as the best example of this. The capital market is not present physically as there is a physical presence of stock market. Whereas the capital market is referred as the network that consists of suppliers, demanders as well as brokers that are of treasury bills and bonds that are of short-term and are applied in the whole country. On the other hand, the capital markets in Pakistan are referred to those institutions where financial securities of long-term are traded (Shah and Amir, 2017). Stocks, bonds as well as shares are considered as the best example for this.

From the independence of Pakistan, the currency of Pakistan is associated with the Pound from September 1971 and after that, it is related with the dollar of United States. But after some time, there is a huge alteration in the arrangement and it was transformed to the floating exchange rate system that is managed which was said to be effective from 8th January 1982.

General Zia-ul-Haq was responsible for this as he was the ruling person at that time and the main aim behind this was to sustain such balance of payment that is favourable and in which export competitiveness is ensured (Saeed and Hassan, 2018). By following this system, the value of the currency of Pakistan was said to be settled on regular basis that is also associated to the currency basket of the main trading partners and competitors of Pakistan. When Pakistan became the atomic power and after its nuclear detonation successfully in 1998, there was imposition of numerous economic sanctions on Pakistan by its donors. This is the main reason due to which the foreign exchange reserves of Pakistan sharply drop. After the nuclear detonation, there was a launch of dual exchange rate and two-tier regime that is floating exchange rate of interbank and official rate of exchange in 1998 that become effective in 1999. There was introduction of market-based floating exchange rate system along with the integration of exchange regime. The rate of currency is determined as Dd-Ss forces of Fx market under this system.

The floating rate is prevailed by the Pakistan presently in which there are separate exchange rates of every commercial bank that depends over the positions of time spanning (Shah, 2018). There were number of purchases of unofficial markets by the State Bank of Pakistan in order to change the course of flow of foreign exchange from such merchandises that are not official to the market dealing with the banks. Now Pakistan has adopted such regime of exchange rates that are free floating.

1.3 Objectives

Major objective of this analysis is to portray the aftermath of equity multiples on stock returns and volatility: An Empirical Analysis of Pakistan Stock Exchange. This aim has been achieved through following objectives;

- To conceptualize equity multiples, stock returns and stock volatility.

- To depict factors affecting returns on stock.
- To assess relationship between equity multiples, stock returns and risk.
- To depict the influence of equity multiples on stock returns and volatility in Pakistan stock exchange.

1.4 Research Question

The queries that are focused in the research in order to get answered are as follows:

1. What are the concepts of equity multiples, stock volatility and stock returns?
2. Which factors affect the returns on stock?
3. What is the relationship among equity multiples, risk and stock returns?
4. What is the affect of equity multiples on stock returns and volatility in Pakistan stock exchange.

1.5 Problem Statement

The principal aim of this research was to find out the influence of equity multiples on stock returns and volatility of stock market. This topic is also the main research domain for the policymakers, economists, experts of business community and financial analysts as it leads to the growth of the country on the economic basis . As per the finance theory, it is suggested that there is a strong connection among the stock market and equity multiple that is one of the major macroeconomic variable. Out of these macroeconomic variables, the exchange rate and the rate of interest is known as the major variables that exerts influence that is momentous over the volatility of stock market. One of the important monetary and economic factors is change in interest rate that impacts that return of stock market and value of stocks (Laeven, Ratnovski and Tong, 2016).

The relationship of the rate of interest with the rate of exchange has impact over the value of stock in both directions. Similarly, the prices of stocks are affected by the level of inflation but still the relation among these two variables seems to be unclear.

Irrespective of the knowledge that depends upon the theories as well as the importance of the alliance among volatility of stock market and the macroeconomic factors, it is suggested by the empirical evidence that there is a proper dichotomy regarding the relation among equity multiples that is macroeconomic factor and volatility in stock market. The correlation among the equity multiple and the stock market and volatility is considered as the major issue that is faced by the investors as it has number of adverse effects on the profitability of the investors (Fornell, Morgeson and Hult, 2016).

It is mandatory for the analysts to investigate the performance of the variables since the association among these variables is not obvious. In Pakistan, there are very fewer findings that inquire about the relationship among these factors whereas there are some studies that are on conducted within the similar domain but mostly investigate exchange rates and the KSE-100 index interactions. Therefore, this research is considered highly significant as it fills the identified gap in literature and investigates the relation among the equity multiples and the stock return and volatility that are long-run as well as short-run.

1.6 Rationale and significance of the study

Investment depends upon number of factors and investors consider multiple elements while making an investment decision. Among these factors few important factors are equity multiples, stock returns and stock volatility since these elements impact the profits of investors. Therefore, the impact of equity multiple on stock returns and risk is important to be determined.

For economic development as well as growth of the country, a major role is played by well-functioned and well-developed financial sector. The imperative job of properly organised financial system is structured as well as effective utilisation of the capital resources. The scarce resource of the economy moves to the borrowers from savers through the system of finance. The surplus income is provided by savers to the system of finance with the expectations in order to achieve such rates that would be highest in future (Sha, 2017).

On the other hand, the demand of borrowers are the funds that are from the same system and the idea behind is that, it is necessary to repay the amount along with the rate of interest for the future. There are two main classes for the financial system of the country that are financial intermediary and financial markets. Financial market is known as the institutions as well as arrangements by which the sellers and the buyers of financial instruments are brought together. The function that is referred to be elementary in the financial market is allocating proper saving by the individuals in the economy (Arslan, Iltas and Kayhan, 2017). This is due to collection of funds from such saving surplus unit and after that they are saved in the deficit unit.

1.7 Structure of the Study

This findings include five chapters. The main topic of the study is to interpret the influence of equity multiples over the stock returns and the volatility in context of Pakistan. Basically, this study is the empirical analysis of Pakistan Stock exchange. The first component of the study is the introduction of the study in which the complete background of the research is given along with the aim and objectives that are followed in the study. Along with this, this chapter also includes the research questions that are need to be answered and the research

problem is also discussed. The reason and the importance of the study is also included in this chapter.

The second chapter of the research is literature review in which the literature that is relevant to the topic is reviewed and interpreted in the study. The main concepts of the variables, the relation among the variables and the factors that affects those variables are involved in this chapter along with the theories that can be applied in the study

The third component of the study is the findings methodology which is followed in the study. The method of research is discussed along with the philosophy and the approach that is followed in the findings. The strategy of both, research and research design is discussed along with the method of data collection and analysis. The social considerations are also involved in this part along with the limitations that are faced by the analysts in order to conduct the research.

The fourth chapter consists of the discussion and analysis of the study. The data that is gathered by using the methods of data collection is analysed by correlation and regression analysis. That data is interpreted in this chapter as well as there is a detailed discussion over the aims of the study. The last section of the findings is conclusion in which the findings that are concluded by analysing the data are elaborated. At the end of the study, there are set of recommendations in which there are different recommendations for improving the system of stock market and minimising the adverse impacts of the variables on each other.