THE PRESENT VALUE MODEL OF STOCK PRICES UNDER RATIONAL AND ADAPTIVE EXPECTATION: A BURSA MALAYSIA CASE

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THIS DISSERTATION IS BEING PREPARED TO FULFILL PART OF THE REQUIREMENTS REQUIRED TO BE CONFERRED THE BACHELOR OF SCIENCE WITH HONOURS DEGREE

MATHEMATICS WITH ECONOMICS PROGRAMME
SCHOOL OF SCIENCE AND TECHNOLOGY
UNIVERVSITY OF MALAYSIA SABAH

2006

ABSTRACT

The study of expectation formation has been one of the most important developments in econometric. Expectation formation has been used rigorously in various fields such as macroeconomic and financial market. Two of the most famous expectation hypotheses are the rational and adaptive expectation. Rational expectation hypothesis has been the central expectation hypothesis used by economists because of its strong theoretical base while the adaptive expectation hypothesis has been considered by many as outdated and inefficient because the expectation is unable to fully exploit all information available and required to help economic agents to forecast. The aim of this study is to determine which expectation formation hypotheses explain the behaviour of investors in Malaysia's stock market. This is an empirical study of Chow's (1988) method in which the expectation hypotheses are applied into the present value model of stock prices for Malaysia's stock market data which consists of stock prices and dividends data for 13 companies for a span of 21 years. The result provides a strong statistical and econometric prove to support that the adaptive expectation hypothesis explains the behaviour of investors better than the widely accepted rational expectation hypothesis. This finding has been parallel to other findings done by Chow and his co-authors. The financial crisis that occurred in Malaysia back in 1997 has been used as evidence to support the allegation of adaptive expectation hypothesis.