Is Idiosyncratic Risk Ignored In Asset Pricing: Sri Lankan Evidence?

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Abstract

A four factor model with idiosyncratic volatility designed for capturing the market, size, value and idiosyncratic risk yields better than Fama-French (1993) three factor model and performance of the model is not sensitive to the technique its factor variables are defined. Fama-MacBeth cross sectional regression, residual graphs and GRS test all confirms the superiority of four factor model over two three factor models. Finally study findings confirm that there is a high importance for idiosyncratic volatility risk factor in investment decision of Colombo stock exchanges stocks. Hence, investor should compensate for holding such risk factors in the portfolio.

Key Words: Asset Pricing, Idiosyncratic risk, Factor models, Fama-MacBeth cross sectional regression, Risk

JEL Codes: G12