SKEWNESS PREFERENCE AND MEASUREMENT OF ABNORMAL RETURNS: A COMPARATIVE EVALUATION OF CURRENT VS. PROPOSED EVENT STUDY PARADIGM

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If asset returns have systematic skewness, expected returns should include rewards for accepting this risk. Many recent empirical studies such as by Kraus and Litzenberger (1976), Sears and Wei (1988), Harvey and Sddique (2000) etc. have shown that the pricing of assets can be better explained by the three-moment capital asset pricing model that accounts for systematic skewness, rather than the traditional two-moment CAPM. Event studies in finance are concerned with abnormal returns after removing an estimate of the portion of total return that represents the premium for bearing risk. Till date event studies have used the return generating models that are consistent with some form of the traditional capital asset pricing model. Typically the market model (linear characteristic line model) or a variant of it is used as the underlying return generating process in the computation of event specific abnormal returns. We investigate the possible implications of recognizing skewness preference for event study by using the quadratic characteristic lines model (QCL), which is the return generating model consistent with the three moment CAPM. We replicate the pioneer event study on stock split by Fama, Fisher, Jensen and Roll (FFJR) (1969) on a new data set using their methodology as well as other methodologies used by other event studies. First we test the conditions when QCL will be the appropriate return generating model and be applicable to the given data set. With the market model we obtain the same intertemporal trend in the abnormal return as reported by FFJR. Using QCL the same trend is maintained but the level of the values of the abnormal returns are statistically significantly different than that obtained using the market model.