2.4. The Effect of Firm Size and Book-To-Market Equity on Stock Return

The previous research was done by Fama and French (1992). They found that two variables, those were market equity (ME) and the ratio of book-to-market equity (BE/ME) captured much of the cross-section of average stock returns. When stocks were priced rationally, systematic differences on average return were due to differences in risk. Therefore, with rational pricing, firm size (ME, stock price times outstanding shares) and BE/ME must be a proxy for sensitivity to common risk factors in return. Thinking about firm size and BE/ME effects, it is important to remember that these variables have emerged as the winner in a sequential process of examining and eliminating many other variables.

By testing the equally and value weighted returns for portfolios formed on book-to-market equity, Walid Saleh (2005) found that high book-to-market stocks (value stocks) have higher return than low book-to-market stocks (glamour stocks), except for 3-month period. He also found that firm size plays an important role in explaining the difference in returns between value and glamour stocks.

The relationship between BE/ME and returns is weaker and less consistent than that in Fama and French (1992). In article by (Kothari, Shanken, and Sloan (1995)), they re-examine whether BE/ME captures cross-sectional variation in average returns over a longer 1947 to 1987 period using a somewhat different data set. They had some conclusions. First, it is likely