VALIDITY OF FAMA-FRENCH THREE FACTOR MODEL FOR DIVERSIFIED FINANCIAL COMPANIES LISTED ON THE COLOMBO STOCK EXCHANGE

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This study aims to test the validity of the Fama and French Three-Factor Model (FF3FM) in explaining the cross-sectional variation in stock returns of the diversified financial companies listed on the Colombo Stock Exchange (CSE). It adopted the Fama and French (1992) approach to construct the portfolios. Accordingly, six portfolios were constructed using a 2x3 annual sorting procedure based on market capitalization and book to market equity ratio. The sample period spans for five years, from April 2014 to March 2019 and the sample is included 37 diversified financial companies listed on the CSE. The data analysis is based on both descriptive statistics and inferential statistics which are derived on correlation analysis and multiple regression analysis. The results indicate that FF3FM performs well in explaining cross-sectional variation in stock returns. All three factors of the model - market risk premium, size premium, and value premium exhibit significant relations with excess portfolio returns. The study also finds that marker risk premium is the most prominent factor of the model, while the other two factors share equal explanatory power. The results further confirm that FF3FM outperforms Capital Assets Pricing Model (CAPM) in explaining cross-sectional variation in stock returns. The study supports the prediction of Fama French (1992) that high BE/ME ratio portfolios outperform the portfolios with low BE/ME ratios. Considering these findings, it is recommended that, in addition to stock beta, size and value information should be made available to stock investors for conducting better assessment of uncertainties associated with investment returns.

Keywords: *Colombo Stock Exchange; Diversified Financial Companies; Fama and French Three Factor Model; Market Risk Premium; Size Premium; Value Premium*