

# TESTING THE EFFICACY OF INFORMATION TRANSMISSION: IS EQUITY STYLE INDEX BETTER THAN STOCK MARKET INDEX?

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## Introduction

Equity style index has been widely used in the field of investment management since the introduction of return-based style analysis by Nobel Laureate William Sharpe in 1992 [30]. The style index is used as one of the independent variables in decomposing the fund returns to their respective allocation in different asset classes. Many researchers have followed suit in their respective research like Fama and French ([14], [15], [16]) and Lakonishok et al. [25]. In addition, International equity styles have also been studied by Sharpe et al. [5] and Sinquefeld [32].

The popularity of equity style indices is further propelled with the introduction of Style Box by Morningstar in late nineties. In the money management industry, many equity style indices have been created as benchmark for performance attribution, evaluation and measurement by Index providers like MSCI, S&P and FTSE. Various types of funds are also been classified using the equity style indices created by different Asset Management Companies (AMC).

The study on the role of equity style index is important in the context of emerging capital market. Without a proper recognition of its role, from investment product point of view, investors lose out an opportunity to have additional investment products which focus on different segments of the stock exchange. Likewise, fund managers would lack of the chance to benchmark their performance if they intend to focus specifically on the growth / small and value / large segments of the stock exchange.

Interestingly, there is yet to be a study that links equity style index and stock index, or equity style index and business cycle indicators. If equity style index is indeed that useful, it should possess economic content that is justifiable for its usage in capital market. In this paper,

firstly, we intend to study the causal relationship among equity style index, leading economic index and stock market index. Secondly, we intend to compare the efficacy of information transmission between stock market index and equity style index.

As known by many practitioners, leading, coincident and lagging economic indices are published by Department of Statistics on monthly basis to gauge the business sentiment. They are composite indices as within each index, there are components that underpin the measurement. For example, for leading economic index (LEI), there are eight leading indicators used. Leading indicators inform users on where the economy is heading, particularly for the forecasted period of six-month ahead. Among the earlier signs that an ongoing expansion may start to decelerate is a sustained decline in the leading growth rate.

On the other hand, coincident indicators inform users on the current state of the economy. In contrast, lagging indicators inform users what had happened to the economy, especially on performance of cyclical movements of the leading and coincident indicators. In this respect, we examine the components of all the three indices as shown in table 1.

As shown in table 1, coincident, leading and lagging indices have six, eight and five components respectively. These economic indicators are jointly developed by the Department of Statistics, Malaysia and Center for International Business Cycle Research (CIBCR) at Columbia University. Among the components in Leading Economic Index, Bursa Malaysia Industrial Index – a stock market index is included.

From economic perspective, the effective of leading economic index becomes questionable if its component is insensitive to the change of business cycle. This would enable inaccurate

**Tab. 1: Components of leading, coincident and lagging economic indices****Coincident Economic Index Components (CEI)**

1. Index of Industrial Production
2. Real Gross Imports
3. Real Salaries and Wages, Manufacturing
4. Total Employment, Manufacturing
5. Real Sales, Manufacturing
6. Real Contributions, EPF

**Leading Economic Index Components (LEI)**

1. Real Money Supply, M1
2. Bursa Malaysia Industrial Index
3. Real Total Trade: Eight Major Trading Partners
4. CPI for Services, Growth Rate (Inverted)
5. Industrial Material Price Index, Growth Rate
6. Ratio of Price to Unit Labour, Cost of Manufacturing
7. Number of Housing Permit Approved
8. Number of New Companies Registered

**Lagging Economic Index Components (LGEI)**

1. 7-day Call Money, Rate
2. Real Excess Lending to Private Sector
3. Number of Investment Projects Approved
4. Number of Defaulters, EPF (Inverted)
5. Number of New Vehicles Registered

Source: Department of Statistics, Malaysia [10]

signal on the part of data collection and dissemination by Department of Statistics and Central Bank. The weaknesses of the existing indicators have been discussed by some researchers. According to Ahmad [1], there exists some limitation to the existing Leading Economic Index as it is unable to predict the magnitude of change in the economy. A study done by Yap [35] shows that turning point detection is not impressive for troughs and in addition to that, lead times are variable.

If stock market index is replaced by equity style index, will the Leading Economic Index become more sensitive to the change in business cycle? Henceforth, this paper intends to investigate the role played by equity style index in transmitting information, and justify on economic grounds that equity style index has its role to play in the process of information flow. Thus, further research in the future can be done to identify steps that could enhance the informational efficiency among these indices.

The rest of this paper is arranged as follows: Section one discusses the prior studies on leading, coincident economic indicators

and their relevance with business cycle. This is followed by a number of studies that utilize growth value style index in recent years. Section two discusses data and methodology used. Section three reports the findings, and final section concludes the study.

## 1. Literature Review

The initial study related to forecasting with statistical indicators was undertaken by Burns and Mitchell and their colleagues at the National Bureau of Economic Research in 1937 as part of research program on business cycles. A list of variables that were used as leading and coincident economic indicators was first compiled by Mitchell and Burns in 1938, followed by the second and third lists which were compiled by Moore in 1950 and 1960 [9].

The indicators developed by them have been useful in constructing leading and coincident indexes that are used for summarizing and forecasting macroeconomic activity. In other study, Yeats [36] reviews historical performance of the Federal Reserve Board Sensitive Price Index. He finds that the SPI performs well as

an indicator for business conditions. Stekler et al. [33] examines the two aspects of the forecasting record of the index of 12 Leading Series. Their results indicate that ILS is a better indicator than a quantitative predictor.

Stock and Watson [34] revise those earlier indices using the tools of modern time series econometrics. As a result, they have created three experimental monthly indexes: an index of coincident economic indicators, an index of leading economic indicators and a Recession Index. They report that their experimental CEI tracks the coincident index produced by the Department of Commerce (DOC), although the methodology of producing these indexes differ. They relook into the definition of coincident indicators of which was defined as the "reference cycle" by Burns and Mitchell [5, pp. 46] as a broad-based swings in economic activity. The swings in the GNP is defined as the reference cycle.

They conclude that it is more appropriate to state that the reference cycle reflects co-movements of a broad range of macroeconomic aggregates such as output, employment and sales. Hence, they define the CEI as an estimate of the value of a single unobserved variable,  $C_t$  as "the state of the economy". They use "dynamic factor" model for the coincident variables to measure the co-movements across aggregate several time series. On the other hand, they propose a new LEI is the estimate of the growth of the unobserved factor over the six months, using a set of leading variables. They are more interested in the relative growth rather than the absolute level of economy activity.

Diebold et al. [11] evaluate the ability of the composite index of leading indicators to predict business cycle turning points. They use formal probability assessment scoring rules to turning points generated from the leading index via a Bayesian sequential probability recursion. Layton et al. [26] develop indicators that are combined to make a composite coincident index of aggregate economy activity in the service sector. They also construct a composite leading index and, they find that the index is able to give advance warnings of major swings in the growth of the service sector.

In another study, Diebold et al. [12] examine the ability of the composite index of leading economic indicators to predict future movements in aggregate economic activity. They perform real-time analysis by using

partially revised data for the leading index along with recursive out-of-sample forecasts. They find substantial deterioration of forecasting performance in the real time framework. Filardo [17] examines the differences in expansionary and contractionary phases of business cycle. He finds that many of the economic variables that determine the time-varying probabilities help to predict turning points.

Hamilton et al. [21] find that the composite leading index is useful for forecasting gross national product, both in sample and in out-of-sample real-time exercise. They find that better forecasts are provided by a simple linear relation between current GNP growth and the growth rate of the CLI during the previous quarter along with an error-correction term. Kim et al. [23] study the business cycle turning points by creating a new coincident index and testing the duration dependence based on a dynamic factor model with regime switching. They find the new index was useful in practice and both the features of the business cycle are relevant. The two defining characteristics of business cycle are (i) co-movement among economic variables through the cycle and (ii) non-linearity in the evolution of the business cycle, that is, regime switching at the turning points of the business cycle.

Daniel [8] examines the episodes of banking system distress and crisis in a large sample of countries to identify which macroeconomic and financial variables can be used as leading indicators. Birchenhall et al. [3] use logistic classification methods for identifying and prediction of postwar U.S. business cycle expansion and contraction regimes as defined by NBER reference turning-point dates.

Forni et al. [18] develop a methodology for the construction of coincident and leading indicators for Euro Area. They find that the coincident indicator is well forecasted by the average leading variables. Camacho et al. [6] propose an optimal filter to transform Conference Board Composite Leading Index into recession probabilities the US economy. They analyze the accuracy of in anticipating US output growth. They confirm the usefulness of CLI, even in real-time analysis.

On the other hand, there are some literatures which look at the causality relationship between stock market indicators and GDP. These studies have established the causality relationship between stock market indices and Growth of

Gross Domestic Product (GDP). It is found that movement stock market index precedes the movement of GDP ([7], [22]). Since real GDP is often used as reference cycle, these studies established stock market index is a leading economic indicator. Even during East Asia Financial Crisis in 1997 and 98, Broome and Morley [4] found that domestic stock prices in Hong Kong and US are significant leading indicators during the period. In summary, there has been no study done to examine the role of equity style index as a leading economic indicator.

## 1.1 Theoretical Framework

As mentioned in above, growth style and value style indices are used as the equity style indices in this study. Since equity style index has economic content, it is hypothesized that:

**Hypothesis 1:** *there will be a causal relationship between equity style index and leading economic index if equity style is a leading indicator.*

**Hypothesis 2:** *there will be a causal relationship between equity style index and stock market index if equity style is a leading indicator.*

**Hypothesis 3:** *there will be a causal relationship between equity style index and broad market index.*

As discussed in above, equity style index is a refinement from stock market index. Hence, the information content from the movement of growth stocks and value stocks should precipitate the movement of other indicators. Hypothesis 1 is a strong hypothesis. If equity style is a leading indicator, it should Granger cause existing leading economic index theoretically.

In similar argument, hypothesis 2 is set to state that equity style will Granger cause stock market index like Industrial sector. If equity style is a leading indicator, it should possess information earlier than other indicators. Hence, equity style should Granger cause industrial sectoral index.

Hypothesis 3 is set to confirm whether there is a relationship between equity style index and broad market index. It is expected that both will have feedback effect between them.

Theoretically, most of growth stocks are big capitalization stocks similar to the component stocks in broad market index like Kuala Lumpur Composite Index (KLCI).

## 2. Data and Methodology

This study uses three types of data. The first type of data used is Malaysian economic indicators which consist of leading economic index (“LEI”), coincident economic index (“CEI”) published by the Department of Statistics, Malaysia on month-to-month basis.

The second type of data used is Morgan Stanley Capital International (MSCI) equity style indices which consist of two equity style indices. They are MSCI Malaysia Value Style Index (“Value”) and MSCI Malaysia Growth Style Index (“Growth”).

The third type of data used is stock market indices which consist of two indices. They are Kuala Lumpur Composite Index (“KLCI”) and Bursa Malaysia Industrial Index (“Industrial”) sourced from Kuala Lumpur Stock Exchange. Monthly data from May 1997 to July 2007 are used for this study.

### 2.1 Unit Root Test

Unit root test will be conducted to ensure the stationarity of variables being tested. For this study, Phillips-Perron [29] unit root test is more preferred for small sample study as per to Hallam and Zanolli [20] and Obben [28].

The PP test equation is

$$\Delta y_t = \mu + \beta t + \delta y_{t-1} + \varepsilon_t \quad (1)$$

The hypothesis to be tested is

$$H_0: \delta = 0 \quad \text{versus} \quad H_1: \delta < 0.$$

Non parametric corrections are made to the test statistic to account for serially correlated and heteroscedastic error term. The critical values are given by Mackinnon [27]. If  $H_0$  is rejected, the series  $y_t$  is said to be stationary.

In order to confirm the result of the unit root test, stationarity tests have also been carried out. In this instance, KPSS test by Kwiatkowski, Phillips, Schmidt and Shin [24] is used. Under the null hypothesis, the series  $y_t$  is assumed to be stationary. On the contrary, under the alternative hypothesis,  $y_t$  is non-stationary. So that by default under the null the series will appear stationary.

$$H_0: y_t \sim I(0)$$

$$H_1: y_t \sim I(1)$$

### 2.2 Vector Autoregression (VAR)

Vector autoregression model VAR ( $p$ ) is an extension of the univariate autoregression model to model multivariate time series model. In the case where the  $k$  variables are not co-integrated, a VAR model with lag  $p$  is defined as

$$y_t = c + A_1 y_{t-1} + A_2 y_{t-2} + \dots + A_p y_{t-p} + \varepsilon_t \quad (2)$$

where  $y_t$  defined as  $(y_{1,t}, y_{2,t}, \dots, y_{k,t})$  of  $k \times 1$  vector, each  $c$  is a  $k \times 1$  vector of constant (intercept), each  $A_i$  is a  $k \times k$  coefficient matrix and  $\varepsilon_i$  is  $k \times 1$  error terms vector.

The lag length for the VAR( $p$ ) model may be determined by using model selection. A standard practice Akaike Information Criterion (AIC)

$$AIC = n \sum \hat{u}_t^2 + 2(k+1) \quad (3)$$

where  $u_t$  denoted as residuals is applied in selecting lag length.

### 2.3 Granger's Causality Test

Next, causality tests are used to assess the information content of leading indicators. Granger's [19] test used within a bivariate context, states that if a variable  $x$  Granger causes the variable  $y$ , the mean square error (MSE) of a forecast  $y$  based on the past values of both variables is lower than that of a forecast that uses only past values of  $y$ . Equation (4) shows the autoregression where the Granger causality test is carried out. However, differencing is only restricted to variables with unit roots.

$$\Delta y_t = \alpha + \sum_{i=1}^p \beta_i \Delta y_{t-i} + \sum_{i=1}^p \gamma_i \Delta x_{t-i} + \varepsilon_t \quad (4)$$

and testing the joint hypothesis

$$H_0 : \gamma_1 = \gamma_2 = \dots = \gamma_p = 0.$$

$H_1$ : At least one of the  $\gamma_i$  is not equal to zero.

If the asymptotic chi-square test rejects the  $H_0$ , then Granger causality from the leading

indicator  $x$  to the coincident indicator  $y$  is established. A significant test statistic indicates that the leading indicator  $x$  has predictive value for forecasting movements in the chosen coincident indicator  $y$ , over the information contained in the past of  $y$ .

In Granger's causality test, the direction of causal effect between equity style indices and stock indices, equity style indices and economic indicators, stock indices and economic indicators is tested using restricted  $F$  test statistic as shown equation (5). Using optimal lag length, the parameter of the model is tested with null hypothesis that there is no Granger causality between two series. As proposed by Engle and Granger [13]:

$$F = \frac{(RSS_R - RSS_U) / p}{RSS_U / (n - 2p - 1)} \quad (5)$$

where  $RSS_R$  is the residual sum of squares of restricted model while the  $RSS_U$  is the residual sum of square of unrestricted model;  $n$  represents sample size and  $p$  is the number of restricted parameters.

### 2.4 Cross Correlation Analysis

Cross correlation is a standard method to estimate the degree to which two series are correlated. Consider both to be examined series  $x_t$  and  $y_t$  at time  $t$ , the cross correlation function:

$$r_{xy}(k) = \frac{c_{xy}(k)}{\sigma_{xx} \sigma_{yy}} \quad (6)$$

where  $c_{xy}$  is sample cross covariance of two series at lead  $k$ ,  $\sigma_{xx}$  and  $\sigma_{yy}$  are the standard deviation of processes of  $x_t$  and  $y_t$  respectively.

### 3. Results

Table 2 presents the descriptive statistics of all the series. It can be observed between the two economic indicators, leading economic index is more volatile than coincident economic index as shown by the standard deviation of 21.06 versus 10.75. In addition, Industrial Index is more volatile than KLCI Index. Finally, between MSCI Malaysia Value Style Index and Growth Style Index, the former is more volatile than the latter.

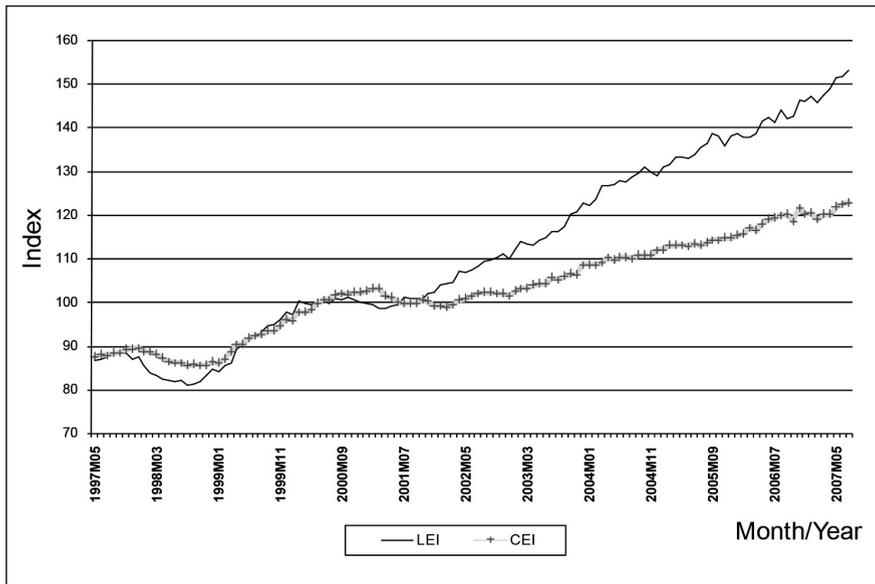
Figure 1 shows both LEI and CEI have upward trend for the period from May 1997 to July 2007. However, LEI is relatively steeper

Tab. 2: Descriptive statistics

|              | LEI      | CEI      | KLCI     | INDUSTRIAL | GROWTH   | VALUE    |
|--------------|----------|----------|----------|------------|----------|----------|
| Mean         | 111.9146 | 103.0187 | 793.4977 | 1586.717   | 47.69187 | 106.3748 |
| Median       | 107.2000 | 102.1000 | 779.2800 | 1450.980   | 46.50000 | 104.7000 |
| Maximum      | 153.0000 | 122.7000 | 1373.710 | 2635.930   | 100.0000 | 200.7000 |
| Minimum      | 80.90000 | 85.40000 | 302.9100 | 639.4400   | 22.20000 | 29.00000 |
| Std. Dev.    | 21.06235 | 10.75063 | 197.0823 | 426.7843   | 13.17089 | 32.75369 |
| Skewness     | 0.274197 | 0.009767 | 0.552798 | 0.314005   | 1.399041 | 0.395683 |
| Kurtosis     | 1.808670 | 1.996161 | 3.953978 | 2.584559   | 6.152321 | 3.680999 |
| Jarque-Bera  | 8.815018 | 5.166377 | 10.92864 | 2.905811   | 91.05272 | 5.586350 |
| Probability  | 0.012185 | 0.075533 | 0.004235 | 0.233890   | 0.000000 | 0.061227 |
| Sum          | 13765.50 | 12671.30 | 97600.22 | 195166.2   | 5866.100 | 13084.10 |
| Sum Sq. Dev. | 54121.93 | 14100.27 | 4738653. | 22221672   | 21163.61 | 130882.2 |
| Observations | 123      | 123      | 123      | 123        | 123      | 123      |

Sources: Department of Statistics, MSCI and Bursa Malaysia [10], [2]

Fig. 1: Leading economic index (LEI) and coincident economic index (CEI)



Source: Department of Statistics, Malaysia [10]

**Tab. 3: Trend in level and first difference**

| Variable     | t-statistics | Variable              | t-statistics |
|--------------|--------------|-----------------------|--------------|
| InKLCI       | 2.90***      | $\Delta$ InKLCI       | 0.55         |
| InValue      | 3.31***      | $\Delta$ InValue      | 0.10         |
| InGrowth     | 2.41**       | $\Delta$ InGrowth     | 0.72         |
| InLead       | 3.58***      | $\Delta$ InLead       | -0.28        |
| InCoincident | 2.89***      | $\Delta$ InCoincident | -0.38        |
| InIndustrial | 4.00***      | $\Delta$ InIndustrial | 0.42         |

Source: own

The asterisks \*\*\*, \*\* and \* denote statistical significance at 1%, 5% and 10% level respectively

than CEI. As observed, LEI depicts the level of economy activities with turning points at 1997:07 (the beginning of economy slow down), 1998:09 (the beginning of recovery), 2000:10 (the beginning of another slow down) and 2001:09 (the beginning of an expansion). It can be concluded that the turning points correspond to events like Asian financial crisis (1997:07), the imposition of capital control (1998:09), dot-com bubble (2000:10). Overall, it can be seen that CEI tracks LEI at different pace and degrees of amplitude. It can be concluded that LEI leads CEI based on the composite of leading macroeconomic variables used by the Department of Statistics.

We conducted the procedure developed by Stock and Watson [34] to check on the presence of deterministic trend in the series both in level and its first-difference in table 3. The t-statistics on the coefficient of the time trend indicate that time trend is present in all the series in level. However, the series are detrended after first difference.

### 3.1 Unit Root Test Results

All series are transformed into natural logarithm before the unit root test is conducted. Phillips-Perron (PP) [29] tests for unit root are conducted on the logarithmic series of the respective variable of leading economic index (*InLEI*), coincident economic index (*InCEI*), Kuala Lumpur Composite Index (*InKLCI*), Bursa Malaysia Industrial Index (*InIndustrial*), MSCI Malaysia Value Style Index (*InValue*) and MSCI Malaysia Growth Style Index (*InGrowth*).

Since the preliminary test of trend in series indicated that all variables contain trend in level, we will proceed to test the unit root test with assumption of constant with trend in level.

As shown in table 4, PP test has shown that InKLCI, InValue, InGrowth and InIndustrial are stationary at level. As for InLEI and InCEI, they are stationary after taking first difference. According to Hallam and Zanolli [20] and Obben [28], the result from PP test is more preferred for small sample study as the test is more powerful.

For KPSS test, InKLCI, InValue, InGrowth and InIndustrial do not reject  $H_0$ . Hence, they are stationary. Finally, InLEI and InCEI are stationary after taking first difference. Therefore, we concluded that InKLCI, InIndustrial, InValue and InGrowth are I(0) while InLEI and InCEI are I(1) processes. Subsequently, we take first difference for InLEI and InCEI in VAR model.

### 3.2 Granger Causality Results

We proceed to form vector autoregression model (VAR) and conduct Granger's Causality test for first model without equity style indices. Lag length criteria is checked and the model is at its optimal lag length one. However, as shown in table 5, none of the series shows any causality with significant result.

Next, a second model is formed by taking into account both value style and growth style indices. Based on the VAR model in table 6, looking at the last column, the asymptotic Granger Chi-squared statistics are statistically significant at one per cent for growth style index to granger cause LEI, KLCI, industrial index and value style index. The results also showed that another equity style, MSCI value style index (Value) has some significant influence on InKLCI and InGrowth, however, it is not as influential as growth style index.

The relationship from table 6 is summarized in figure 2. Firstly, there is unidirectional

Tab. 4: Unit root and stationary test results

| Variable     | Phillips-Perron |                  | Kwiatkowski-Phillips-Schmidt-Shin |                  |
|--------------|-----------------|------------------|-----------------------------------|------------------|
|              | Level           | First difference | Level                             | First difference |
|              | Trend           | No trend         | Trend                             | No trend         |
| InKLCI       | -3.44 (6)**     |                  | 0.10(8)                           |                  |
| InValue      | -3.45 (9)**     |                  | 0.04(8)                           |                  |
| InGrowth     | -3.56 (6)**     |                  | 0.14(11)                          |                  |
| InLEI        | -2.91 (6)       | 11.06(6)***      | 0.16(3)**                         | 0.15(6)          |
| InCEI        | -2.27 (6)       | 11.97(6)***      | 0.18(2)**                         | 0.06(6)          |
| InIndustrial | -3.96 (8)**     |                  | 0.12(8)                           |                  |

Source: own

The asterisks \*\*\* and \*\* denote statistical significance at 1% and 5% level respectively. Figures in parentheses are the optimal lag length chosen. Critical values are based on Kwiatkowski, Phillips, Schmidt and Shin [24]. For Phillips-Perron test, critical values are based on Mackinnon [27].

Tab. 5: Granger causality test results based on VAR for four series

| Dependent Variables | Variables          |                     |                     |                    |
|---------------------|--------------------|---------------------|---------------------|--------------------|
|                     | $\Delta$ InLEI     | $\Delta$ InCEI      | InKLCI              | InIndustrial       |
| $\Delta$ InLEI      |                    | 0.753179<br>(0.385) | 0.024698<br>(0.875) | 0.00092<br>(0.975) |
| $\Delta$ InCEI      | 0.75106<br>(0.386) |                     | 2.205876<br>(0.137) | 1.05520<br>(0.304) |
| InKLCI              | 0.01126<br>(0.915) | 0.28708<br>(0.592)  |                     | 0.79283<br>(0.373) |
| InIndustrial        | 0.23210<br>(0.630) | 0.13766<br>(0.710)  | 0.42272<br>(0.515)  |                    |

Source: own

Note: \*, \*\* and \*\*\* denote statistical significance at 1%, 5% and 10% level respectively. All estimates are asymptotic Granger Chi-squared statistics. Values in parentheses are p-values.

causality from growth style index to LEI. This result strongly supports hypothesis 1 at one percent level that growth style index precipitates the movement of LEI. There is information flow from growth style index to LEI.

Secondly, there is unidirectional flow from as growth style to Industrial sectoral Index as shown in figure 2. This result lends strong support to hypothesis 2 that growth style index transmits information to the Industrial sector index at 1 percent significance level based on table 6.

Thirdly, there is bidirectional relationship between growth style index and broad market KLCI. This result supports hypothesis 3 and shows that there is feedback effect between them. Lastly, there is bidirectional flow between growth style and value style. It should shows there is feedback effect between the two equity style indices.

These empirical results underscore that growth style index economic information that precedes leading economic index and Industrial index. In the context of Granger causality, we

**Tab. 6: Granger causality test results based on VAR for six series**

| Dependent Variables | Variables         |                   |                      |                   |                     |                      |
|---------------------|-------------------|-------------------|----------------------|-------------------|---------------------|----------------------|
|                     | $\Delta \ln LEI$  | $\Delta \ln CEI$  | $\ln KLCI$           | $\ln Industrial$  | $\ln Value$         | $\ln Growth$         |
| $\Delta \ln LEI$    |                   | 0.6733<br>(0.411) | 5.3055<br>(0.021)**  | 0.1937<br>(0.659) | 2.1431<br>(0.143)   | 6.9721<br>(0.008)*** |
| $\Delta \ln CEI$    | 0.2285<br>(0.632) |                   | 2.0411<br>(0.153)    | 1.0169<br>(0.313) | 0.5246<br>(0.468)   | 1.4344<br>(0.231)    |
| $\ln KLCI$          | 1.2049<br>(0.272) | 0.5046<br>(0.477) |                      | 0.0263<br>(0.871) | 4.0266<br>(0.044)** | 13.296<br>(0.000)*** |
| $\ln Industrial$    | 0.5931<br>(0.441) | 0.2799<br>(0.596) | 5.4337<br>(0.019)**  |                   | 1.4744<br>(0.225)   | 9.6592<br>(0.002)*** |
| $\ln Value$         | 1.5581<br>(0.211) | 0.5709<br>(0.449) | 8.5005<br>(0.003)*** | 0.2154<br>(0.643) |                     | 14.075<br>(0.000)*** |
| $\ln Growth$        | 0.7319<br>(0.392) | 0.5453<br>(0.460) | 7.7909<br>(0.005)*** | 0.1424<br>(0.706) | 3.0108<br>(0.083)*  |                      |

Source: own

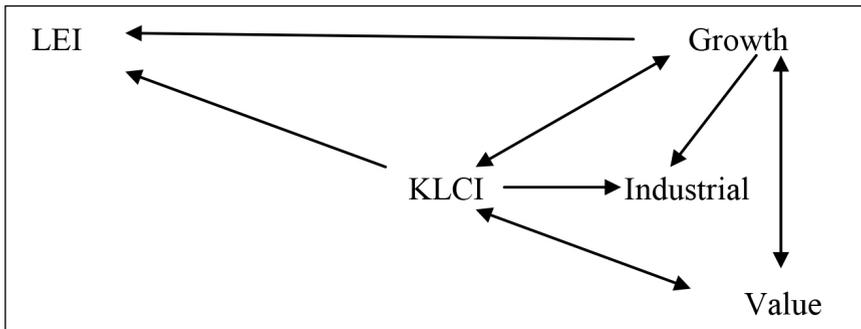
Note: \*, \*\* and \*\*\* denote statistical significance at 1%, 5% and 10% level respectively. All estimates are asymptotic Granger Chi-squared statistics. Values in parentheses are p-values.

can state past values of growth style can be used to predict the current value of leading economic index and industrial index. This lends support that growth style Index should be included as a component of leading economic index instead of Industrial Index. This new evidence should be examined by policy makers who involved in the design of leading economic index and earning warning system of financial crisis.

### 3.3 Cross-Correlation Results

To increase robustness to our result, we further examine the cross-correlation between Industrial Index and LEI. As shown in table 7, the variance of the cross-correlation coefficient under the null hypothesis of zero correlation is approximate to  $1/n$  where  $n$  is the length of the series. On the assumption that the coefficients are also asymptotically normal, the approximate critical values at the 5 per

**Fig. 2: Short-run causal relationship**

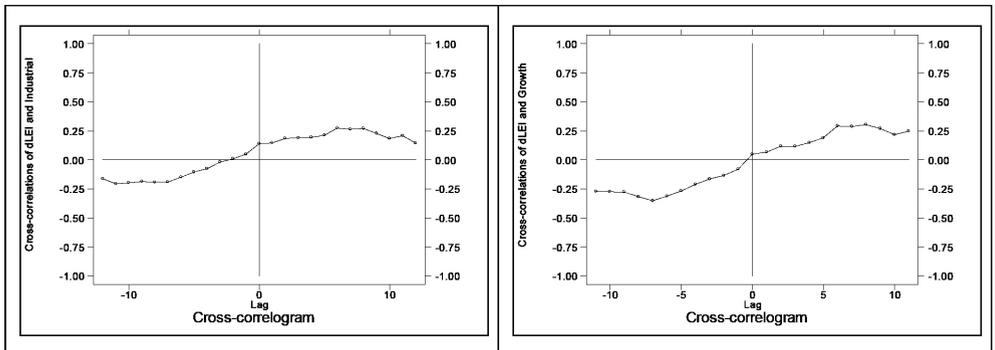


**Tab. 7:** Cross-correlation between LEI and Industrial Index (left – 7a)  
Cross-correlation between LEI and Growth Style Index (right – 7b)

| DLNLEAD, LNIND(-i) |  | DLNLEAD, LNIND(+i) |  | i  | lag     | lead   | DLNLEAD, LNGRO(-i) |  | DLNLEAD, LNGRO(+i) |  | i  | lag     | lead    |  |
|--------------------|--|--------------------|--|----|---------|--------|--------------------|--|--------------------|--|----|---------|---------|--|
|                    |  |                    |  | 0  | 0.1402  | 0.1402 |                    |  |                    |  | 0  | 0.0501  | 0.0501  |  |
|                    |  |                    |  | 1  | 0.0485  | 0.1463 |                    |  |                    |  | 1  | -0.0820 | 0.0661  |  |
|                    |  |                    |  | 2  | 0.0100  | 0.1828 |                    |  |                    |  | 2  | -0.1344 | 0.1178  |  |
|                    |  |                    |  | 3  | -0.0197 | 0.1906 |                    |  |                    |  | 3  | -0.1656 | 0.1165  |  |
|                    |  |                    |  | 4  | -0.0772 | 0.1934 |                    |  |                    |  | 4  | -0.2120 | 0.1493  |  |
|                    |  |                    |  | 5  | -0.1061 | 0.2126 |                    |  |                    |  | 5  | -0.2685 | 0.1902  |  |
|                    |  |                    |  | 6  | -0.1485 | 0.2740 |                    |  |                    |  | 6  | -0.3115 | 0.2918  |  |
|                    |  |                    |  | 7  | -0.1906 | 0.2637 |                    |  |                    |  | 7  | -0.3523 | 0.2876  |  |
|                    |  |                    |  | 8  | -0.1934 | 0.2708 |                    |  |                    |  | 8  | -0.3181 | 0.3034  |  |
|                    |  |                    |  | 9  | -0.1866 | 0.2282 |                    |  |                    |  | 9  | -0.2769 | 0.2700  |  |
|                    |  |                    |  | 10 | -0.1977 | 0.1829 |                    |  |                    |  | 10 | -0.2740 | 0.2173  |  |
|                    |  |                    |  | 11 | -0.2059 | 0.2086 |                    |  |                    |  | 11 | -0.2714 | 0.2480  |  |
|                    |  |                    |  | 12 | -0.1615 | 0.1449 |                    |  |                    |  | 12 | -0.1930 | 0.1697  |  |
|                    |  |                    |  | 13 | -0.1386 | 0.1665 |                    |  |                    |  | 13 | -0.1583 | 0.1878  |  |
|                    |  |                    |  | 14 | -0.0978 | 0.1321 |                    |  |                    |  | 14 | -0.0935 | 0.1230  |  |
|                    |  |                    |  | 15 | -0.0930 | 0.0772 |                    |  |                    |  | 15 | -0.0734 | 0.0503  |  |
|                    |  |                    |  | 16 | -0.0770 | 0.0667 |                    |  |                    |  | 16 | -0.0292 | 0.0312  |  |
|                    |  |                    |  | 17 | -0.0324 | 0.0446 |                    |  |                    |  | 17 | 0.0251  | -0.0129 |  |
|                    |  |                    |  | 18 | -0.0303 | 0.0623 |                    |  |                    |  |    |         |         |  |
|                    |  |                    |  | 19 | -0.0004 | 0.0408 |                    |  |                    |  |    |         |         |  |
|                    |  |                    |  | 20 | 0.0261  | 0.0214 |                    |  |                    |  |    |         |         |  |

Source: own

**Fig. 3:** Cross-correlogram between LEI and Industrial Index (left – 3a);  
Cross-correlation between LEI and Growth Style Index (right – 3b)



Source: own

cent level are  $\pm 2/\sqrt{n}$ . As observed, Industrial Index is leading LEI from t+2 to t+11 with the strongest lead at t+6 with positive correlation of 0.2740. Based on Based on the calculation of  $\pm 2/\sqrt{n}$ , the critical value is 0.18107. In contrast, for cross-correlation between growth style index and LEI in table 7b, Growth style index is leading LEI from t+5 to t+13, with the strongest lead at t+8 with positive correlation of 0.3034. Hence, it can be concluded that growth style index is a better candidate as predictor for LEI.

Taking a closer look at the figure 3(a) on the left, the cross-correlation between LEI and Industrial Index is relatively positive at zero lag. The diagram also shows the relationship is non-proportional in nature. For figure 3(b) on the right, it can be observed that LEI and growth style is not correlated at zero lag, and the correlation between input variable at time t and output variable at t+i is more proportional as time increases. This reaffirms the earlier conclusion as growth style index is better in terms of proportionality.

**Conclusion**

This study has managed to unravel the missing link among these groups of indices. It shows that equity style index like growth style index is more sensitive to new information in the capital market as compared to stock market index like Bursa Malaysia Industrial Index. The implication of this study can be manifold. Firstly, equity style index is more sensitive, hence a better candidate to be a component of leading economic index that helps to detect turning point in business cycle.

Secondly, this study adds another stylized fact that equity style index has economic content and the ability to transmit information far from what is recorded in literature. This underscores the third point that equity style index can be used to construct Early Warning System of financial crisis. Last but not least, equity style index are more suitable to be used in mutual fund classification of which has been a practice in advanced financial markets as compared to emerging markets. This type is classification is more meaningful as equity style index by itself has economic content to begin with. It is right time for the relevant authority to review the components of the economic indices with respect to their efficacy in transmitting information.

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## Abstract

**TESTING THE EFFICACY OF INFORMATION TRANSMISSION:  
IS EQUITY STYLE INDEX BETTER THAN STOCK MARKET INDEX?****Wee-Yeap Lau, Chin Lee**

*This paper examines the ability of equity style to predict future movement of composite leading economic index in a multivariate Granger causality framework. By comparing the efficacy of information transmission between equity style index and Bursa Malaysia Industrial Index, our results show that there is unidirectional causality from growth style to leading economic index. Second, there is also unidirectional flow from growth style to Bursa Malaysia Industrial Index. Third, there is a bidirectional relationship between growth style and KLCI broad market index. Finally, there is bidirectional causality between both growth style and value style. Further analysis from cross-correlation function reveals that growth style index is better than Bursa Malaysia Industrial Index. The former provides accurate and stronger cross-correlation with leading economic index. From these empirical evidences, it can be concluded that growth style index is a leading indicator which has more economic content than stock market index. It is better than stock market index in its efficacy of information transmission. The study brings to the awareness to policy makers and practitioners of the usefulness of equity style in constructing future leading economic index and early warning system of financial crisis.*

**Key Words:** Equity style index, composite leading index, leading economic indicators, business cycle, Granger causality.

**JEL Classification:** C58, E32, G17.

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