Trading cost expectations: Evidence from S&P 500 index replacement stock announcements

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We find that the positive abnormal returns for replacement stocks are related to increased daily trading volume after inclusion in the Index. Further, the trading cost effect is proportional to percentage bid-ask spreads prior to inclusion. The trading cost effect increases as trading in derivatives of the Index increases. The volume and stock price changes after replacement are not transitory, indicating an improvement in liquidity.

Three alternate hypotheses suggested in prior research to explain the abnormal returns for replacement stocks are tested. Testing each of the three models previously considered: price pressure, inelastic demand curves, and information, we find that none can be accepted with statistical confidence.

The abnormal returns of Index replacement stocks are consistent with rational pricing of an anticipated reduction in future transaction costs. This anticipated

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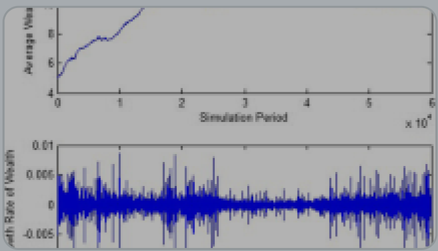

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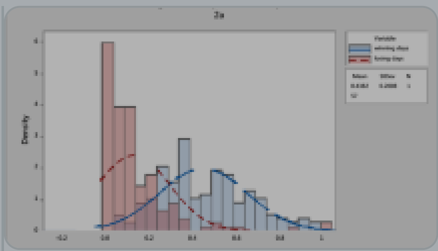

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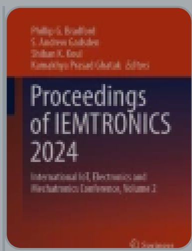

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