

[Home](#) > [Journal of Economics and Finance](#) > Article

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

Published: June 1996

Volume 20, pages 75–85, (1996) [Cite this article](#) [Save article](#)[View saved research](#) >**Journal of Economics and Finance**[Aims and scope](#) →[Submit manuscript](#) →[Robert O. Edmister<sup>1</sup>](#), [A. Steven Graham<sup>1</sup>](#) & [Wendy L. Pirie<sup>1</sup>](#) **53** Accesses  **36** Citations [Explore all metrics](#) →

## Abstract


This paper tests the effect on stock value of an expected change in future trading costs. The capitalized value of a reduction in trading costs is hypothesized to increase the stock value, a trading cost effect. Improved liquidity reduces trading costs. Inclusion as an S&P 500 Index replacement stock is an event hypothesized to increase liquidity. We use 114 observations between January 1, 1983 and October 12, 1989 of stocks added to the Index as replacements for stocks removed. The abnormal return of each stock is regressed against the ratio of the bidask spread to the price of the stock, the change in trading volume of the stock,

and the open interest in the Index futures contracts at the close of the month prior to the replacement announcement.

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 reduction is capitalized in the value of the stock at the time of the replacement announcement. These results are consistent with a trading cost effect.

 This is a preview of subscription content, [log in via an institution](#)  to check access.

### Access this article

Log in via an institution →

### Subscribe and save

✓ Springer+

from €37.37 /Month

- Starting from 10 chapters or articles per month
- Access and download chapters and articles from more than 300k books and 2,500 journals
- Cancel anytime

[View plans](#) →

**Buy Now**

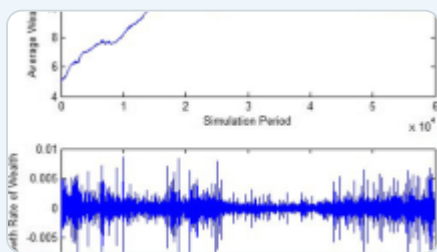
**Buy article PDF 39,95 €**

Price includes VAT (Poland)

Instant access to the full article PDF.

[Institutional subscriptions](#) →

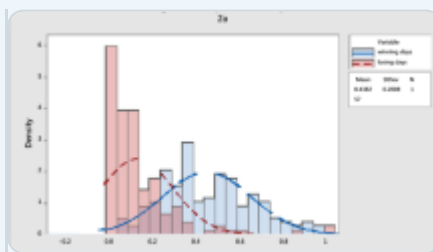
## Similar content being viewed by others



### **Cost-benefit analysis of trading strategies in the stock index futures market**

Article | Open access

05 October 2020



### **Does The Association Between Abnormal Trading Volumes And Historical Prices Explain Disposition Effect?**

Article | 21 July 2020



### **Price Change and Trading Volume: Behavioral Heterogeneity in Stock Market**

Article | 01 December 2021

## Explore related subjects

Discover the latest articles, books and news in related subjects, suggested using machine learning.

[Capital Markets](#)

[Corporate Finance](#)

[Financial Economics](#)

[Investments and Securities](#)

[Market Psychology](#)

[Procurement](#)

## References

Ajinkya, B.B. and P.C. Jain, 1989, The Behavior of Daily Stock Market Trading Volume. *Journal of Accounting and Economics* 11, 331–59.

Amihud, Y., and H. Mendelson, 1986, Asset Pricing and the Bid-Ask Spread.*Journal of Financial Economics* 17(2), 223-49.

[Article](#) [Google Scholar](#)

Amihud, Y., and H. Mendelson, 1988, Liquidity, Volatility, and Exchange Automation.*Journal of Accounting, Auditing and Finance* 3, 369-395.

[Google Scholar](#)

Amihud, Y., and H. Mendelson, 1991, Liquidity, Asset Prices and Financial Policy.*Financial Analysts Journal* 47(6), 56-66.

[Article](#) [Google Scholar](#)

Beebower, G., 1989, Evaluating Transaction Costs. In W.H. Wagner,*Complete Guide to Securities Transactions: Controlling Costs and Enhancing Investment Performance*, New York: John Wiley & Sons.

[Google Scholar](#)

Benston, G.J. and E.L. Hagerman, 1974, Determinants of Bid-Ask Spreads in the Over-The Counter Market.*Journal of Financial Economics* 1, 353-364.

[Article](#) [Google Scholar](#)

Branch, B. and J.E. Finnerty, 1981, The Impact of Option Listing on the Price and Volume of the Underlying Stock.*Financial Review* 16, 1-15.

[Google Scholar](#)

Branch, B. and W. Freed, 1977, Bid-Asked Spreads on the AMEX and the Big Board.*The Journal of Finance* 32, 159-163.

Brown, S.J. and J.B. Warner, 1985, Using Daily Stock Returns: The Case of Event Studies,*Journal of Financial Economics* 14, 3-31.

[Article](#) [Google Scholar](#)

Copeland, T.E. and D. Mayers, 1982, The Value Line Enigma (1965-1978): A Case Study of Performance Evaluation Issues,*Journal of Financial Economics* 10, 289-321.

[Article](#) [Google Scholar](#)

Demsetz, H., 1968, The Cost of Transacting,*Quarterly Journal of Economics* 82, 33-53.

[Article](#) [Google Scholar](#)

Detemple, J. and P. Jorion, 1990, Option Listing and Stock Returns: An Empirical Analysis,*Journal of Banking and Finance* 14, 781-801.

[Article](#) [Google Scholar](#)

Dhillon, U. and H. Johnson, 1991, Changes in the Standard and Poor's 500 List,*Journal of Business* 64, 75-85.

[Article](#) [Google Scholar](#)

Edmister, R.O., A.S. Graham and W.L. Pirie, 1994, Excess Returns of Index Replacement Stocks: Evidence of Liquidity and Substitutability,*Journal of Financial Research* XVII, 333-46.

[Google Scholar](#)

Graham, A.S. and W.L. Pirie, 1994, Index Fund Rebalancing and Market Efficiency.*Journal of Economics and Finance* 18(2), 219-29.

[Article](#) [Google Scholar](#)

Harris, L. and E. Gurel, 1986, Price and Volume Effects Associated With Changes in the S&P 500 List: New Evidence for the Existence of Price Pressures.*The Journal of Finance* 41, 815-29.

[Article](#) [Google Scholar](#)

Jain, P.C., 1987, The Effect on Stock Price of Inclusion in or Exclusion from the S&P 500.*Financial Analysts Journal* 43(1), 58-65.

[Article](#) [Google Scholar](#)

Jacques, W.E., 1988, The S&P 500 Membership Anomaly, or Would You Join this Club?*Financial Analysts Journal* 44(6), 73-75.

[Article](#) [Google Scholar](#)

Lamoureux, C.G. and J.W. Wansley, 1987, Market Effects of Changes in the Standard and Poor's 500 Index.*Financial Review* 22, 53-69.

[Article](#) [Google Scholar](#)

Luskin, D. L., 1987,*Index Options & Futures: The Complete Guide*. New York: John Wiley & Sons.

[Google Scholar](#)

McInish, T.H. and R.A. Wood, 1992, An Analysis of Intraday Patterns in Bid/Ask Spreads for NYSE Stocks.*The Journal of Finance* 47(2), 753-64.

[Article](#) [Google Scholar](#)

Pruitt, S.W. and K.C.J. Wei, 1989, Ownership And Changes In The S&P 500.*Journal of Finance*, 44(2), 509-514.

[Article](#) [Google Scholar](#)

Shleifer, A., 1986, Do Demand Curves for Stocks Slope Downward?*The Journal of Finance* 41, 579-90.

[Article](#) [Google Scholar](#)

Scholes, M. and J. Williams, 1977, Estimating Betas from Nonsynchronous Data.*Journal of Financial Economics* 5, 309-27.

[Article](#) [Google Scholar](#)

Stickel, S. 1985, The Effect of Value Line Investment Rank Changes on Common Stock Prices.*Journal of Financial Economics*, 14, 121-43.

[Article](#) [Google Scholar](#)

Stoll, Hans R., 1989, Inferring the Components of the Bid-Ask Spread: Theory and Empirical Tests.*The Journal of Finance* 44, 115-134.

[Article](#) [Google Scholar](#)

Tinic, S.M., and R.R. West, 1972, Competition and the Pricing of Dealer Service in the Over-the-Counter Stock Market.*Journal of Financial and Quantitative Analysis*, 7(3), 1707-27.

[Article](#) [Google Scholar](#)

White, H., 1980, A Heteroscedasticity-Consistent Covariance Matrix Estimator and a Direct Test for Heteroscedasticity.*Econometrica*, 48, 817-38.

[Article](#) [Google Scholar](#)

Woolridge, J.R. and C. Ghosh, 1986, Institutional Trading and Security Prices: The Case of Changes in the Composition of the S&P 500 Index.*Journal of Financial Research* 9, 13–24.

[Google Scholar](#)

—, 1990, 1994*Standard and Poor's Security Price Index Record*. (Standard and Poor's Corporation, New York).

[Google Scholar](#)

## Author information

---

### Authors and Affiliations

**Department of Economics and Finance, University of Mississippi, 38677, University, Mississippi**

Robert O. Edmister, A. Steven Graham & Wendy L. Pirie

## Rights and permissions

---

[Reprints and permissions](#)

## About this article

---

### Cite this article

Edmister, R.O., Graham, A.S. & Pirie, W.L. Trading cost expectations: Evidence from S&P 500 index replacement stock announcements. *J Econ Finan* **20**, 75–85 (1996). <https://doi.org/10.1007/BF02920893>

Issue date

June 1996

DOI

<https://doi.org/10.1007/BF02920893>



# Keywords

<a href="#">Abnormal Return</a>	<a href="#">Trading Volume</a>	<a href="#">Trading Cost</a>	<a href="#">Cumulative Abnormal Return</a>	<a href="#">Open Interest</a>
---------------------------------	--------------------------------	------------------------------	--	-------------------------------

## Search

Search by keyword or author



## Navigation

Find a journal

Publish with us

Track your research

