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

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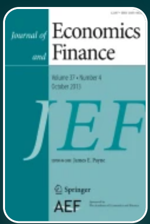

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Abstract

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.

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