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Index fund rebalancing and market efficiency

| Published: June 1994

| Volume 18, pages 219–229, (1994) [Cite this article](#)[Journal of Economics and Finance](#)[Aims and scope](#) →[Submit manuscript](#) →[A. Steven Graham¹](#) & [Wendy L. Pirie Ph.D. candidate²](#) **25** Accesses  **7** Citations [Explore all metrics](#) →

Abstract

Stocks newly added to the S&P 500 Stock Index experience significantly positive abnormal returns on the date of their inclusion. This study looks at the rebalancing required by index funds when RJR/Nabisco was replaced by First Union. On that date, approximately one percent of the market capitalization was removed and had to be reallocated among the remaining 499 stocks in the Index, but there was no change in information or attention for these 499 stocks.

We find that while there was abnormal trading volume on the original takeover date, there were no abnormal returns. The only hypotheses consistent with previous results, as well as these results, are the information or the attention hypotheses, that stocks newly added to the index have positive information disclosed or experience increased investor attention.



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Cite this article

Graham, A.S., Pirie, W.L. Index fund rebalancing and market efficiency. *J Econ Finan* **18**, 219–229 (1994).
<https://doi.org/10.1007/BF02920524>

Issue Date

June 1994

DOI

<https://doi.org/10.1007/BF02920524>

Keywords

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