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R-Squared Around the World: New Theory and New Tests

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Stewart C. Myers (https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=17423)
Massachusetts Institute of Technology (MIT); National Bureau of Economic Research (NBER)

Li Jin (https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=255842)
Harvard Business School - Finance Unit

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Abstract

Morck, Yeung and Yu (MYY, 2000) show that R2 and other measures of stock market synchronicity are higher in countries with less developed financial systems and poorer corporate governance. MYY and Campbell, Lettau, Malkiel and Xu (2001) also find a secular decline in R2 in the United States over the last century. We develop a model that explains these results and generates additional testable hypotheses.

The model shows how control rights and information affect the division of risk-bearing between inside managers and outside investors. Insiders capture part of the firm's operating cash flows. The limits to capture are based on outside investors' perception of the value of the firm. The firm is not completely transparent, however. Lack of transparency shifts firm-specific risk to insiders and reduces the amount of firm-specific risk absorbed by outside investors. Our model also predicts that opaque stocks are more likely to crash, that is, to deliver large negative returns. Crashes occur when insiders have to absorb too much firm-specific bad news and decide to give up.

We test these predictions using stock returns from all major stock markets from 1990 to 2001. We find strong positive relationships between R2 and several measures of opaqueness. These measures also explain the frequency of large negative returns.

Keywords: Corporate control, international financial markets, firm-specific risks, information and market efficiency, crashes

JEL Classification: G12, G14, G15, G38, N20

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