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What happens when a stock is added to the Nasdaq-100 index? What doesn't happen?

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Purpose

– Prior research on additions to the S&P 500 and the smaller MidCap 400 and SmallCap 600 indexes reach different conclusions regarding the key variables that explain the cross-section of announcement period abnormal returns. Most notable in this regard is that liquidity measures, long thought to be of importance, do not appear to explain abnormal returns of the S&P 500 when other factors are controlled for. By contrast, they do appear to matter for additions to the smaller stock indexes. To explore this difference, the purpose of this paper is to analyze the abnormal returns upon announcement that a stock will be added to the Nasdaq-100 Index in a cross-sectional manner, controlling for several possible alternative factors.

Design/methodology/approach

– This paper analyzes abnormal returns upon announcement that a stock will be added to the Nasdaq-100 Index. The authors consider several possible sources of the positive price effects in a multivariate setting that controls simultaneously for measures of liquidity, arbitrage risk, operating performance and investor interest and awareness. The authors then analyze both trading volume and the bid-ask spreads. The authors finally examine analyst and investor interest, focussing on changes in analyst coverage.

Findings

– The authors find that only liquidity variables are significant, but that factors representing feedback effects on the firm's operations and level of managerial effort are not. The authors find that the average bid/ask spreads of stocks added to the Nasdaq-100 index are lower after the addition. The authors also find that the number of analysts following a stock increases significantly after addition, verifying increased analyst interest. Both forms of evidence are consistent with the hypothesis that the additions are associated with enhanced liquidity for the stocks.

more analysts are drawn to it, and its market liquidity is enhanced. The authors conclude that what does not happen is that there is no evidence of significant effects of enhanced managerial effort or operating performance associated with the inclusion. This difference is noteworthy because it suggests that a certification effect of additions to the S&P indexes associated with S&P's selection process are unique to it and do not apply to the Nasdaq-100 Index additions based on market cap alone. The results provide indirect evidence on the existence and significance of the certification effect associated with additions to the S&P indexes.

Keywords: Finance, Investment analysis

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