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Discussion of delegated trade and the pricing of public and private information

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ABSTRACT

Taylor and Verrecchia (2015) show that idiosyncratic risk can be priced in efficient but imperfectly competitive equity markets. We discuss how the model is structured, how it might apply to the pricing of financial reporting quality, and how empiricists might test its predictions.

1. Introduction

Does the quality of a firm's financial reporting affect its expected returns? Empirical research supports a wide range of views: that reporting quality has no association with expected returns (e.g. Core et al., 2008), that it behaves like a value-relevant firm characteristic (e.g. Barth et al., 2013), that it amplifies an asset's exposure to systematic risk factors (e.g. Leuz and Schrand, 2009), and that it behaves as a risk factor distinct from other factors (e.g. Kim and Qi, 2010). Corresponding theoretical research supports a narrower range of views. Following the Capital Asset Pricing Model (CAPM) of Sharpe (1964) and Lintner (1965), reporting quality should have no association with expected returns if its only effect is to reduce the idiosyncratic risk of a firm's equity. Lambert et al. (2007) extend the CAPM to a Bayesian setting in which low quality reporting regarding the *systematic* component of cash flow affects a firm's cost of capital by amplifying its assessed covariances with underlying systematic risk factors. However, we are aware of no theoretical work demonstrating that expected returns are affected by the quality of reporting regarding the *idiosyncratic* portion of cash flows, in an efficient market.

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Taylor and Verrecchia (2015) break new ground by showing that in efficient but imperfectly competitive markets, idiosyncratic risk becomes 'entangled' with systematic risk, and is therefore priced. This result potentially provides theoretical footing for the ambitious claim that reporting quality is priced as a risk characteristic distinct from systematic risk factors (such as β), and moreover, that reporting quality and systematic risk factors have an interactive effect on expected returns.

In this discussion, we focus on the implications of TV's results for the pricing of reporting quality. In Section 2 of this discussion, we highlight the modeling techniques TV use to balance the need for tractability with the goal of showing the pricing effects of institutional features they incorporate into their baseline setting. In Section 3, we provide some intuition into the main result of the paper, which is that imperfect competition causes idiosyncratic risk to become 'entangled' with systematic risk in an asset's risk premium. In Section 4, we provide some advice for those who might want to test the implications of the model for the pricing of reporting quality.

2. Balancing tractability and institutional richness

TV base their analysis on the standard noisy rational expectations framework of Grossman and Stiglitz (1980). TV extend that framework by incorporating three institutional features: (1) they distinguish between systematic and idiosyncratic risk; (2) they include both a public and a non-public signal about the idiosyncratic component of cash flow; and (3) they allow investors to self-direct trades, as in GS, or choose instead to pay 'delegates' (effectively money managers) to collect information and trade on their behalf. TV show that when investors cannot employ delegates, the degree of idiosyncratic risk and the signals that reveal it have no effect on pricing, which suggests that variation in reporting quality has no effect on pricing either, if reporting provides information only about idiosyncratic aspects of the firm. However, when investors can delegate their trading to large financial intermediaries, prices are influenced by both systematic and idiosyncratic risks. However, showing these results in a tractable manner requires some modeling choices worth a careful look.

2.1. Systematic and idiosyncratic risk

To allow two possible roles for reporting quality, the authors create two forms of uncertainty about fundamental value: one component to reflect systematic risk, and another to reflect idiosyncratic risk. However, to allow tractability, the authors focus on a market with a single risky asset. These two features of the model are in tension, because how is one to distinguish between systematic and idiosyncratic risk in a world with only one risky asset?

The authors resolve this tension by focusing on the limiting situation in which the number of risk-bearing investors grows toward infinity, and assuming that one form of risk remains strictly positive in the limit, while the other vanishes to 0. This is an elegant and tractable way to describe the former as systematic risk and the latter as idiosyncratic risk, but has two implications that require careful interpretation. First, the definitions of systematic and idiosyncratic risk are metaphorical. Literal definitions would require investors who can form diversified portfolios of infinitely many assets, so that the systematic risk of any single asset would capture the uncertainty about its value in an optimally diversified portfolio, while idiosyncratic risk would capture the uncertainty of the asset that exists in isolation but disappears through diversification. The metaphorical definition in the model simply assumes these two components, and shows that they behave as if investors were diversifying and categorizing risk in this manner. Second, the model assumes that the total risk of the single asset grows without bound as the number of investors does. We take no issue with the authors' choice of modeling strategy, since it accomplishes their twin goals of tractability and institutional richness. Moreover, other models of infinitely large markets would likely rest on similarly peculiar assumptions. However, readers should not interpret the model overly literally, and should be aware that results obtained in limiting conditions (in this case, as the number of investors approaches infinity) can be sensitive to assumptions and mathematical techniques that seem unimportant in finite settings.

2.2. Information

The authors make several assumptions about the information available to investors. First, no investor has access to additional information that would reduce the systematic risk of the asset. However, investors can purchase additional information about the asset's idiosyncratic risk. While the authors restrict their discussion to how this information structure affects the pricing of the asset, we encourage readers—especially those considering empirical tests of the model—to impose their own assumptions about how reporting quality affects the uncertainty investors face. Most of the literature assumes that better reporting reduces the idiosyncratic risk perceived by those who purchase no additional information, and it seems hard to justify assuming the opposite. The literature is less clear on what one might assume about the informativeness of the additional (purchased) signal about the idiosyncratic component of cash flow. One possibility is that better public disclosure reduces the information that can be acquired through additional research. Alternatively, better disclosure may provide more data that investors can process, but at a cost (as proposed by Bloomfield, 2002). We return to this issue when we discuss the challenges of testing the model empirically.