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Short sale constraints, dispersion of opinion, and stock overvaluation: Evidence from earnings announcements in China

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ABSTRACT

Using a clean setting in China, we test the Miller (1977) hypothesis that stocks are overvalued in the presence of short sale constraints and dispersion of opinion as an extension of Berkman et al. (2009). We find that stocks with short sale constraints have significantly negative abnormal returns during earnings announcement periods, especially when investors have diverse opinions. These results are robust to alternative measures of abnormal returns and endogeneity concern. The findings help to explain the impact of short sale constraints on pricing efficiency and have important policy implications for relaxing restrictions on short selling and improving regular information disclosure in emerging markets.
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1. Introduction

Short selling is controversial. Given that short sellers profit only when the price of a shorted stock drops, policy makers, corporate executives, and regulators often allege that short selling pushes stock prices downward and destabilizes orderly markets, especially in a falling market (Fox, Glosten, and Tetlock, 2010). Another concern is the possibility of using short sales to manipulate stock price or profiting from inside information (Feng & Chan, 2016). Hence, it is not surprising that most capital markets in the world have short sale constraints or even an outright ban on short sales. In fact, during financial crises, regulators are more likely to impose temporary bans on short selling to safeguard the stability of stock markets. For instance, Belgium, France, Italy, and Spain announced a temporary ban on shorting financial institution stocks on August 11, 2011, due to a concern on the stability of financial institutions during the sovereign debt crisis in Europe.

In opposing view, many studies argue that short selling can facilitate information flow, improve market liquidity, and enhance informational efficiency (Diamond & Verrecchia, 1987; Jones & Lamont, 2002; Miller, 1977). Indeed, recent literature also questions the effectiveness of the 2008 short selling bans by the U.S. Securities and Exchange Commission and the U.K. Financial Services Authority on stock price volatility and market trading liquidity (Aromi & Caglio, 2008; Boehmer, Jones, & Zhang, 2013; Clifton & Snape, 2008; Marsh & Niemer, 2008) and offer indirect support the informational efficiency view. Ever since Miller (1977) pioneers the hypothesis that when stock price is subject to short sales constraints, dispersion of investor opinion leads to overvaluation, several studies (e.g., Bris, Goetzmann, & Zhu, 2007 and Berkman, Dimitrov, Jain, Koch, and Tice (2009)) examine the validity of Miller's hypothesis. Specifically, Berkman et al. (2009), using U.S. data and earnings announcements, document convincing support to Miller's hypothesis. With the exception of a few, the majority

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of the short selling literature focuses primarily on short selling in developed markets. The few studies on emerging markets focus mainly on the impact of newly added shortable stocks on contemporaneous pricing efficiency (Chang, Cheng, & Yu, 2007; Chang, Luo, & Ren, 2014), speed of stock price adjustment (Chen & Rhee, 2010), and informed trading (Feng & Chan, 2016 and Meng, Li, Jiang, & Chan, 2017). Thus, there is a gap for further research on the impact of short sale constraints in other contexts in emerging markets. Hence, it is interesting to revisit the validity of Miller's hypothesis in emerging markets, where regulators are even more concerned about the consequences of relaxing short sale constraints on the overvaluation in the presence of dispersion of investor opinion.

Our study is an extension of Berkman et al. (2009). Both Berkman et al. (2009) and our current study examine the validity of Miller (1977) hypothesis by studying the relation between stock overvaluation and dispersion of opinion among investors around earning announcements in the presence of short sales constraints. The major difference is that Berkman et al. use U.S. data while we use data from an emerging market with less noisy measure of short sales constraints in China. Given that institutions are very different in emerging and developed markets[1], it clearly is a research question whether the effect of short sale constraints is the same for both market types. Beginning March 2010, China officially began to allow some designated stocks to be shorted on the Shanghai and Shenzhen Stock Exchanges. Thus, stocks that could be sold short coexist with stocks that cannot be sold short. This unique regulatory environment enables us to compare stocks with and without short sale constraints, since the short selling ban is the most direct form of short sale constraint. Therefore, unlike other short sale constraint measures, such as breadth of ownership and institutional ownership, which are commonly used in most U.S.-focused literature (e.g., Boehme, Danielsen, & Sorescu, 2006; Chen, Hong, & Stein, 2002; and Berkman et al., 2009), China's direct form of short sale constraint (ban) is able to generate convincing evidence on the Miller (1977) hypothesis in an emerging market. In addition, unlike U.S., China does not trade options on individual stocks, thus alleviating any concern on synthetically relaxing short sale constraints through options trading. Consequently, the China environment provides a *clean* setting to examine the impact of short sale constraints and dispersion of investor opinion on stock overvaluation around earnings announcements. Indeed, Chang et al. (2014) suggest that Chinese shortable stocks experienced pricing efficiency improvement after they were added to the official short sale list. These authors, however, do not examine whether removal of short sale constraints can reduce stock overvaluation. Using a unique Chinese database, we investigate the relations among short sale constraints, dispersion of opinion, and stock return during corporate earnings announcement periods. Our analysis complements that in Chang et al. (2014) on the effect of short sale constraints on price discovery.

We find that stocks with short sale constraints have significantly negative abnormal returns during earnings announcement periods, especially when investors have diverse opinions, relative to stocks without such constraints. These findings are consistent with those in Berkman et al. (2009) and are robust to alternative measures of abnormal return and endogeneity concerns. That is, under a clean setting in China, we document that Miller hypothesis is valid in an emerging market; suggestion suggesting that Miller (1977) prediction is generally valid. Our results help to discern the impact of short sale constraints on pricing efficiency and carry important policy implications in China. For instance, high abnormal negative return for short sale constrained stocks suggest that regulators can gradually expand the list of shortable stocks to enhance pricing efficiency and lower stock market volatility, even in an emerging market.

Our study is also related to Chang et al. (2007) and Chang et al. (2014), which respectively discuss stock price movements before and after designated stocks are added to the shortable list on the Hong Kong and China markets. However, we use a different event, earnings announcements on the Shanghai and Shenzhen Stock Exchanges, and we discuss a related but different question, stock overvaluation. Therefore, Chang et al. (2007, 2014) conclude mainly that release of short sale constraints facilitates price discovery, while our results suggest that information disclosure through compulsory or voluntary means improves market efficiency further. Our findings complement those in Chang et al. (2007, 2014) in understanding the effect of short sale constraints in emerging markets.

We make two contributions to the literature. First, while Berkman et al. (2009) show that stock overvalues with short sales constraint and dispersion of investor opinion, the evidence is based on developed market. We document that the Chinese market follows closely what the Miller's hypothesis predicted. Hence, stock market reactions to short sales constraints in emerging market are similar to those in developed markets, despite there are many differences in the two types of markets. Thus, we support the findings in Berkman et al. (2009) and clarify that Miller's model is likely more superior than other models in describing stock price overvaluation under short sales constraints in emerging markets. Second, most literature on testing the Miller (1977) hypothesis uses monthly returns on portfolios of stocks sorted either by dispersion of opinion or short sale constraints separately. Instead, we examine both conditions for stock overvaluation simultaneously and use daily short sales trading. Overall, emerging markets, such as China, also behave consistently with the Miller hypothesis, as the developed markets.

The remainder of this paper proceeds as follows. Section 2 discusses related literature and our hypothesis. Section 3 describes our data and main variables. Section 4 examines the effect of short sale constraint and dispersion of opinion on earning announcement return, and it discusses the endogeneity of the short sale constraint. Section 5 discusses our conclusions.

[1] Different from the developed markets, such as U.S., where short sellers are often hedge funds, emerging markets like China are often dominated by individual investors. In addition, emerging markets often have fewer sophisticated instruments, and weak investor protection.

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