



Contents lists available at ScienceDirect

Journal of Accounting and Economics

journal homepage: www.elsevier.com/locate/jacceco

When knowledge is power: Evidence from the municipal bond market[☆]

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ARTICLE INFO

Article history:

Received 4 May 2016

Revised 30 July 2017

Accepted 16 November 2017

Available online xxx

JEL classification:

D82

D83

D43

Keywords:

Dealer markets

Municipal debt

Information asymmetry

Asymmetric bargaining power

Dissemination

ABSTRACT

I investigate whether access to fundamental information enhances retail investors' bargaining power, reducing the premium that small municipal bond investors pay over large investors. I find a reduction in this small trade premium after the introduction of an online disclosure repository that lowers retail investors' information acquisition costs. This finding is limited to issuers whose disclosures are disseminated through the repository. The finding is pronounced for issuers that impose high information acquisition costs on investors ex-ante and those that exhibit high disclosure quality ex-post. These results suggest that as investors' information sets align, so does their bargaining power with dealers.

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1. Introduction

Despite its size and importance, the municipal bond market remains opaque relative to other financial markets. Pre-trade price quotations are only available upon request, and issuer disclosure is notoriously poor. Trading takes place over-the-counter and broker-dealers exert substantial market power over investors, particularly when those investors are small. Thus, in contrast with exchange-based equity markets, small municipal bond investors pay more for the same bond than large investors.

The market structure literature provides two theoretical explanations for dealers' asymmetric bargaining power over small investors relative to large investors. The first, which is the focus of this paper, is information acquisition costs. Sophisticated investors with access to price-relevant information negotiate better prices because of their superior ability to assess the true value of a bond (Green et al., 2007b). The second explanation, which is not the focus of this paper but is still important, is counterparty search costs. Investors with access to more trading counterparties negotiate better prices because of their superior ability to solicit price quotes (Duffie et al., 2005). Information acquisition costs and counterparty search

[☆] I thank Joanna Wu (the editor) and Brian Bushee (the referee) for constructive and thoughtful feedback. I am grateful to Peter Schmitt of DPC DATA for providing data and information about the structure of the municipal market and to participants at the 2016 NYU Accounting Summer Camp for their comments. A preliminary draft of this paper benefited from comments from Ray Ball, Phil Berger, Hans Christensen, Joseph Gerakos, Christian Leuz, Michael Minnis, Jonathan Rogers, and Douglas Skinner. I gratefully acknowledge financial support from the Stern School of Business at New York University.

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<https://doi.org/10.1016/j.jacceco.2017.11.002>

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costs limit retail investors' bargaining power and, together, they help to explain the premium small investors pay relative to large investors.

Empirical research shows that public dissemination of post-trade price data lowers information acquisition costs and reduces the small trade premium (Edwards et al., 2007). Whereas large institutional investors are knowledgeable about bond values irrespective of public transaction reporting, small retail investors negotiate better terms of trade when they are privy to the prices paid by other investors. However, the municipal bond market is deeply illiquid, reported prices include non-trivial transaction costs, and information remains costly. Therefore, prices do not fully reflect all available information, which limits the usefulness of post-trade price reporting (Grossman and Stiglitz, 1980).

In this paper, I consider whether access to fundamental information enhances the relative bargaining power of retail investors. Institutional investors continuously search for relevant economic and fundamental information about the bonds they hold because they price their positions frequently. Retail investors, whose trades are primarily liquidity driven, also have incentives to use fundamental information to accurately price the bonds that they trade because it affects their yield.

However, fundamental information acquisition costs are high. Many issuers do not publicly disseminate financial statements or budgets and, before 2009, they filed these documents in designated fee-based information repositories. Moreover, the dissemination of fundamental information through the press, the rating agencies, and issuer websites is limited for small, lesser-known issuers.

I capitalize on the 2009 introduction of a centralized repository for municipal disclosures. The Electronic Municipal Market Access website (EMMA) is free to access and replaces the fee-based information repositories that historically collected issuer financial statements. EMMA reduces information acquisition costs and allows retail investors to access fundamental information previously only available to large institutions. I expect access to fundamental information to align the bargaining power of retail and institutional investors, enabling retail investors to trade at prices closer to those at which institutional investors trade.

Before exploring the effect of EMMA's disclosure repository, I provide cross-sectional evidence that retail bond buyers negotiate better prices when they have access to fundamental information through the press, the rating agencies, and issuer websites. However, retail sellers do not necessarily negotiate better prices when they have access to fundamental information.

I attribute this disparity between purchases and sales to two factors. First, retail municipal bond sellers often seek immediate liquidity, and therefore are particularly sensitive to counterparty search costs. Second, brokers regularly monitor the bonds they hold in inventory, some of which they may have underwritten, for risk management and regulatory capital purposes. Thus, brokers are better informed about the fundamentals associated with the bonds they hold in inventory (those which customers purchase) than bonds they do not (those which customers seek to sell). Together, these two factors suggest that more of the broker's advantage stems from fundamental information when investors purchase, rather than sell, bonds.

The advantage of using EMMA's filing repository to evaluate the role of fundamental information in enhancing small investors' bargaining power is the clear change in their information set. I draw identification from bond-level changes in transaction costs on retail-sized trades relative to those on institutional-sized trades around the introduction of EMMA. This design uses large traders, who have access to available financial disclosures irrespective of the repository, as a control group.

To isolate the change in access to information, I focus on bonds whose issuers comply with their disclosure obligations to the fee-based repositories before EMMA, and subsequently comply with their disclosure obligations to EMMA. Controlling for bond fixed effects, interest rates, market risk, volume, and trade size-specific time trends, I find that the premium small investors pay for these bonds falls 13.8 basis points (bps) after the dissemination of their disclosures through EMMA. This reduction represents an economically significant 33% convergence of small and large trade transaction costs relative to pre-dissemination levels.

The disadvantage of this setting is the timing of the repository's inception, which coincides with the end of the 2007–2009 financial crisis. To help attribute the reduced small trade premium to dissemination, I identify a falsification sample of bonds whose issuers comply with their disclosure obligations to the fee-based repositories before EMMA, but subsequently choose not to disclose in EMMA. I find that the small trade premium increases for the falsification sample. Thus, of the bonds whose issuers comply with their disclosure obligations before EMMA's inception, only those bonds whose issuers make their disclosures available through EMMA experience a significant reduction in the small trade premium.

To lend further support, I explore several sources of cross-sectional variation. I find that the premium reduction is pronounced for bonds whose issuers' financial information is not easily accessible through alternative channels, such as the press and issuer web sites. The reduction in the premium is also pronounced for bonds whose issuers file timely financial statements in EMMA and for bonds with a high concentration of trading in close proximity to financial statement filings. Further, the premium reduction is not explained by lower counterparty search costs after the crisis.

This collection of evidence shows that access to fundamental information helps to improve bargaining power and reduces the premium small bond buyers pay above large bond buyers. However, I do not find that dissemination plays a role in small investors' ability to price the bonds they sell. This finding corroborates the idea that fundamental information acquisition costs are a more important determinant of bargaining power in bond purchases than in bond sales.

This paper makes several key contributions. First, it is one of the first to show a relation between financial disclosure and investors' bargaining power. The disclosure literature documents that tightly regulated corporate disclosures reduce information asymmetry among equity investors, thereby reducing the expected cost of adverse selection and the bid-ask spread (Bushee and Leuz, 2005; Greenstone et al., 2006). However, the expected cost of adverse selection in over-the-counter

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