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Abstract

We combine two concepts of informed trading – contrarian trades and stealth trading – to develop proxies for the probability of informed trading. These proxies are used to test the link between informed trading and adverse selection as measured by bid-ask spreads and stock illiquidity. The estimation results show that these proxies, which are based on the probability of contrarian trading (PC) and progressively refined thereon, are all highly significantly positive in various empirical specifications of the cross-sectional determinants of spreads and illiquidity across stocks, and after controlling for important firm characteristics and trading factors. The robustness of our PC-based proxies for informed trading in these analyses, especially for the further refined measures, suggest that they successfully capture the adverse selection component of bid-ask spreads and illiquidity due to information asymmetry.

JEL Classification: G10, G14, G19

Keywords: Adverse selection; Informed trading; Private information; Bid-ask spreads; Stock illiquidity; Contrarian trades; Stealth trading; Market microstructure

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