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Short sales and the weekend effect—Evidence from a natural experiment ☆

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A B S T R A C T

Price pressure induced by the short-seller's systematic unwinding and rewinding short positions around the weekend allegedly contributes to the weekend effect. On the Hong Kong Stock Exchange, short-selling was prohibited before 1994 and was allowed only for some stocks after 1994. Exploiting this natural experiment, we find a strong weekend effect during the pre-1994 period and during the post-1994 period for both stocks that are allowed to be sold short and those that are not. Moreover, the difference in the weekend effects between the two groups is economically and statistically indistinguishable. These results are inconsistent with the above-mentioned hypothesis.

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1. Introduction

There is ample research on the topic of calendar patterns in stock returns. Finance academicians and practitioners have for decades been interested in the implications of the day-of-the-week effects, one of which is the weekend effect. One of the explanations for the weekend effect is short positions (Fields, 1931, 1934; Chen and Singal, 2003a, 2003b). The intuition is straightforward—the inability to trade over the weekend causes short sellers to close their speculative positions on Fridays and re-establish new short positions on Mondays, causing stock prices to rise on Fridays and fall on the subsequent Mondays. However, the empirical evidence is inconclusive and still a matter of debate. Chen and Singal (2003a, 2003b) provide empirical evidence consistent with the above-mentioned hypothesis using U.S. data by investigating how the weekend effect varies with firms that have different levels of short interest. However, Angel, Christophe, and Ferri (2003), Blau, Van Ness, and Van Ness (2009), and Christophe, Ferri, and Angel (2009), using short-sale transactions on the NYSE and NASDAQ, provide evidence inconsistent with the hypothesis that short selling can be an explanation for the weekend effect.

We adopt a different approach to the question of whether short selling could be an explanation for the weekend effect. Instead of testing the implication of the hypothesis in levels, this paper focuses on changes in levels. It does so by examining a natural experiment. We take advantage of the fact that on the Hong Kong Stock Exchange (HKSE) short selling is allowed by regulators for stocks that meet certain requirements.[1] The HKSE is one of the largest and one of the most liquid equity markets in the world where short selling is practiced (Bris, Goetzmann, and Zhu, 2007).

Specifically, short selling was prohibited on the HKSE before January 1994. After January 1994, only some stocks were allowed for short selling, while others were not. The list of designated securities for short selling was revised on a quarterly basis—stocks that met the criteria of "eligible stocks" were added into the short-sale list, while those no longer eligible were removed from the list. In this case, we have a complete history of whether each individual stock is allowed for short selling on each day. We can therefore conduct both cross-sectional (stocks allowed for short selling vs. stocks not allowed for short selling) and time-series (before and after the regulation change) analysis of the relation between short selling and the weekend effect. The fact that stocks become eligible for short selling on different dates is an advantage in that it implies a reduced likelihood that comparisons will be affected by contemporaneous changes in market-wide factors affecting the inferences of the relationship between the variables we study (Bessembinder, 2000). The details of the regulation on the selection of stocks eligible for short selling is provided in the Appendix A. Generally, stocks eligible for short selling on the HKSE are to a great extent large and liquid stocks.

Our main empirical strategy is an event study of the lifting of the short-sale prohibition for stocks in the list of "eligible stocks."[2] We match the eligible stocks to a control group of stocks that were not allowed to be sold short to control for changes in overall market conditions. We then perform tests using a difference-in-difference approach, comparing the difference between the eligible stocks and the control group of stocks before and after an event change. As the regulation changes are not random and the choice of stocks to be allowed for short selling is not entirely exogenous, using a control sample and control covariates in the empirical methodology is critical. Such a methodology allows us to make more reliable inferences.

The results of our analysis are inconsistent with the claim that short selling contributes to the weekend effect, as suggested by Fields (1931, 1934) and further investigated by Chen and Singal (2003a, 2003b). First, we find a strong weekend effect for the pre-1994 period when short selling was prohibited. Second, for the post-1994 period, strong weekend effects are present for both the stocks that were allowed to sell short and those that were not. Moreover, the difference in the weekend

[1] According to the regulations of the Security and Futures Commission (SFC) of Hong Kong, breach of the short-sale constraint is a criminal offense punishable by fines and imprisonment according to the security laws in Hong Kong. The levels of fines and imprisonment were revised (from a maximum of HK$10,000 and six months) to HK$100,000 and two years imprisonment with the introduction of the Securities (Amendment) Ordinance 2000 on July 3, 2000.

[2] Bris, Goetzmann, and Zhu (2007) also perform an event study for the countries with regulatory changes in their sample. This methodology approach eliminates cross-sectional differences that might explain the results.

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