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## Are Japanese short sellers information detectives?



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### ABSTRACT

**Lee, Bong-Soo, and Ko, Kwangsoo**—Are Japanese short sellers information detectives?

Using Japanese long sample data, we examine whether short sales are informed trades about future stock returns, whether they contribute to future lower stock prices, and whether short sales are related to overvaluation of the market. We find that short interests do not cause lower future stock market returns permanently. However, we find that short interest not only responds to a past temporary decline in returns but also anticipates and contributes to future temporary changes in returns—a decline in the short run but an increase in the long run. Further, Japanese short sales tend to take advantage of current overvaluation. *J. Japanese Int. Economies* **34** (2014) 89–97. Department of Finance, College of Business, Florida State University, 311 Rovetta Building, Tallahassee, FL 32306-1110, United States; Department of Business Administration, College of Business, Pusan National University, San 30, Jangjeon-dong, Keumjeong-gu, Busan 609-735, South Korea.

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## 1. Introduction

The effects of short sales on stock markets have long been a major concern to regulatory bodies as well as practitioners and academics. Critics say short selling encourages speculation and pushes stock prices down, sometimes in a panicked market. Advocates say it provides important information about

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investor views on companies and also maintains liquidity. The most debatable issue is whether short sales exert an unfavorable effect on stock prices. During the recent 2008 global financial crisis, many regulators restricted stock market participants from selling short. Academics have generally argued that such restrictions are against both the efficiency of the price discovery process and the enhancement of market liquidity. Financial historians warned that the bans in 2008 did not work and that such measures were often driven more by political concerns than by proved market theories.

Many studies have investigated the relation between short sales and stock prices. Based on a theoretical framework, [Diamond and Verrecchia \(1987\)](#) conclude that an unexpected increase in short sales has a negative effect on the subsequent individual stock prices. [Desai et al. \(2002\)](#) find empirical evidence of a negative relation between short sales and individual stock prices, which supports the theoretical findings of [Diamond and Verrecchia \(1987\)](#). At the aggregate market level, however, [Woolridge and Dickinson \(1994\)](#) fail to find that short sales artificially drive down the stock index level.

On the other hand, [Daske et al. \(2005\)](#), using a comprehensive data set covering daily short sale transactions on the New York Stock Exchange, find no evidence that short sale transactions are concentrated prior to bad news events, which challenges prior research that short sale transactions tend to precede stock price declines and is inconsistent with the notion that short sale transactions (at least in the aggregate) are based on private information. Recently, [Diether et al. \(2009\)](#) find that short sellers increase their trading following positive returns and correctly predict future negative abnormal returns. Interestingly, their results are consistent with short sellers trading on short-term overreaction of stock prices. While [Blau and Pinegar \(2013\)](#) find a significant inverse relation between pre-announcement short activity and announcement period returns, when they control for the non-announcement ability of short sellers to predict future returns documented by [Diether et al. \(2009\)](#), the significance of the relation between pre-announcement short activity and announcement period returns vanishes. Therefore, they infer that short sellers are not incrementally informed prior to earnings announcements.

Several studies have examined the effect of short-sale constraints. [Jones and Lamont \(2002\)](#) find, consistent with the overpricing hypothesis, that stocks can be over-priced when short sale constraints bind. [Scheinkman and Xiong \(2003\)](#) show that when investors face short-sale constraints, the asset price bubble increases with their overconfidence and more trading is generated during the bubble period. By analyzing forty-six equity markets around the world, [Bris et al. \(2007\)](#) find that prices incorporate information faster in countries where short sales are allowed and practiced, which is consistent with more efficient price discovery at the individual security level. Using data on both short interest, a proxy for demand, and institutional ownership, a proxy for supply, [Asquith et al. \(2005\)](#) find that constrained stocks underperform, although for the overwhelming majority of stocks, short interest and institutional ownership levels make short selling constraints unlikely. Based on a global dataset, from 2005 to 2008, that includes more than 12,600 stocks from 26 countries, [Saffi and Sigurdsson \(2011\)](#) find that lending supply has a significant impact on efficiency. Stocks with higher short-sale constraints, measured as low lending supply, have lower price efficiency. Further, they find that relaxing short-sales constraints is not associated with an increase in either price instability or the occurrence of extreme negative returns.

While most studies have focused on short sales in U.S. stock markets, a few studies have investigated short sales in Asian markets. [Ho \(1996\)](#) shows that short-sale restrictions increase volatilities of stock returns in Singapore. [Chang et al. \(2007\)](#) find that short-sale constraints in Hong Kong tend to cause overvaluation of individual stocks. Therefore, from the cases of Singapore and Hong Kong, they find that short-sale constraints prevent an efficient price discovery process at an individual stock level. [Ko and Lim \(2006\)](#) find a positive relation between short sales and stock prices at the aggregate market level in Japan, which is consistent with the results of [Woolridge and Dickinson \(1994\)](#) in the U.S.

[Isaka \(2007\)](#), using a database of stock lending fees for Japanese centralized margin transactions, shows that short-sales constraints reduce the adjustment speed of stock prices to negative information before the announcements of revised earnings forecasts disclosed by firms in the Tokyo Stock Exchange from July 1998 to December 2001. Therefore, short-sale constraints reduce the informational efficiency of stock prices in the presence of negative information. [Takahashi \(2010\)](#) uses

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