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Liquidity provisions by individual investor trading prior to dividend announcements: Evidence from Taiwan

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ABSTRACT

This paper investigates the role of liquidity provisions played by individual investors prior to dividend announcements in Taiwan. We first document a positive relationship between aggregate individual trading before dividend announcements and abnormal stock returns in the one month after the events. We find that this positive relationship varies with liquidity. We then decompose the abnormal returns following the event into information and liquidity provision components. The information component is not significant at all, but the liquidity component is positively significant, which shows that it is individual investors' provisions of liquidity to institutional investors prior to dividend announcements that drives the positive relationship between pre-event individual trading and post-event returns.

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1. Introduction

In this paper, we investigate the role of liquidity provisions played by individual investors prior to dividend announcements in an emerging market, using a unique data set from the Taiwan Stock Exchange (TWSE). Given the fact that individual investors are often viewed as noise traders in the literature, we document a surprising positive relationship between aggregate individual investor trading in the two weeks prior to dividend announcements and abnormal stock returns in the one month following the events. Considering further the naiveté of Taiwanese individual investors as documented in the relevant literature,[2] this positive relationship between individual investor trading and stock returns is even more surprising, although it is consistent with the case in the American stock market, a mature market with more sophisticated individual investors.[3]

We further find that the predictiveness for future returns of net individual trading varies with liquidity, indicating that the liquidity provisions by individuals may explain to some extent the positive predictiveness of post-event returns by net individual trading. We further decompose the abnormal returns from net individual trading during the two weeks prior to dividend announcements into information and liquidity provision components. Although the information component suggests that Taiwanese individual investors do not have an information advantage, the liquidity provision component shows that individual investors earn a liquidity premium for their liquidity provisions. Therefore, the positive relation between individual trading during the two weeks before dividend announcements and post-event abnormal returns seems to arise from the liquidity provisions by individuals to institutions. Our finding contributes to the related literature in light of recent interest among financial experts in the role of liquidity in stock return patterns, emphasized by Kaniel et al. (2012) and Hartzmark and Solomon (2013). Our study, focusing on the Taiwan stock market, also contributes to a better understanding of emerging markets, as Wang and Mayes (2012) point out that the reaction of stock markets to news varies across different countries.

There are some features that make our paper interesting. First, Taiwan's firms announce dividends annually rather than quarterly, as is the case in the United States. Second, the TWSE adopts call auction through trading hours. Third, the TWSE is characterized by a majority of individual investors, which makes the relationship between individual investor trading prior to dividend announcements and post-event stock return more economically meaningful.

There is a rapidly growing literature on the role played by different types of investors in financial markets. A strand of this literature focuses on the role of individual investors, but does not reach a unique viewpoint. On one hand, the traditional finance theory deems individual investors to be noise traders because they are subject to psychological biases and fads. From this point of view, the relationship between individual investor trading and future stock returns is negative. Taylor (2010) finds that American individual investors suffer losses around earnings announcements. On the other hand, Kaniel, Saar, and Titman (2008) and Jackson (2003) document a positive relationship during normal periods. Kaniel et al. (2012) and Vieru, Perttunen, and Schadewitz (2006) further confirm this point around financial reports.

In a quote-driven market, liquidity is provided by market makers in general. However, this is not the case in an order-driven market, and it is the limit order book that provides liquidity rather. However, which type of investor is responsible for this task, especially during financial announcements? When it comes to this issue during financial announcements, Kaniel et al. (2012) find that individual investors provide liquidity. However, their study is limited to the American market. In the context of Taiwan, Lee, Liu, Roll, and Subrahmanyam (2004) find that Taiwanese individual investors succeed in providing liquidity. However, they do not tell us who provides liquidity during financial announcements in Taiwan.

In sum, we know little about the relationship between individual investor trading prior to dividend announcements and returns following the event in emerging markets, and nothing is known about

[2] See, for example, Barber, Lee, Liu, and Odean (2009), Chen, Lin, Ma, and Zheng (2013), Chen, Johnson, Lin, and Liu (2009), Goo, Chen, Chang, and Yeh (2010) and Ho (2011), among others.
[3] See, for example, Kaniel, Liu, Saar, and Titman (2012).

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