



Daily short covering activity and the weekend effect: Evidence from Taiwan



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ABSTRACT

By using a unique dataset of daily short covering volumes obtained from the Taiwan Stock Exchange, we first examine, in general, what drives daily short covering activity in the cross-section and its return predictability; we then investigate, in specific, the relation between short covering and the weekend effect. In general, we find that short covering activity is positively related to short selling activity; and short sellers on average are contemporaneous contrarians. Large-cap stocks, growth stocks, high-price stocks and stocks with high institutional ownership generally have greater short-selling and short-covering activities. We present evidence that regardless of firm characteristics, short-sellers are capable of identifying stocks whose prices tend to decline when they initiate short positions. However, the ability of short sellers to successfully cover their positions is less clear. In specific tests of the weekend effect, we find that when short covering activity is relatively high, Friday returns are more negative. Furthermore, firms with high short selling activity have a larger Monday return compared to firms with low short selling activity. Our findings are contrary to the hypothesis proposed by Chen and Singal (2003), but consistent with the notion that short sellers are contrarian in contemporaneous stock returns.

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1. Introduction

Short sellers can influence stock prices and reveal their views about stock values when they short sell stocks and when they eventually cover their short positions. Much attention in the literature has been devoted almost exclusively to short selling activities and their impact on stock returns and price efficiency (for example, Figlewski 1981; Desai et al. 2002; Boehmer et al. 2008; Diether et al. 2009b). Unfortunately, few studies examine the equally important short covering activities, largely due to the lack of short covering data.

In the United States, monthly short-interest data and short-sale transactions data can be obtained from the NYSE/Nasdaq, and the TAQ NYSE Short Sales data/Nasdaq's Automated Confirmation Transaction Service respectively. At best, researchers can back out the number of shares covered by short sellers in a month, by adding up all the shares shorted in a month from transactions data and by utilizing the short interest identity.¹ Unfortunately, employing monthly data in studies where finer data is more desirable may lead to different and even biased results (Hong et al. 2012; Engelberg et al. 2012).

In this study, we take advantage of a unique dataset of daily short covering volumes obtained from the Taiwan Stock Exchange (TWSE) and adopt a general-to-specific research approach.

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¹ Short interest at the end of a month equals short interest at the beginning of the month plus the number of shares shorted minus the number of shares covered during the month.

We first examine, in general, what drives daily short covering activity and the return predictability of short covering activity. We find that short covering activity is positively related to short selling activity, indicating that when more shares are sold short on a given day, more shares are also covered. We also provide evidence that short sellers on average are contemporaneous contrarians. They sell shares short when contemporaneous returns are high and cover their positions when contemporaneous returns are low. In addition, we find that large-cap stocks, growth stocks, high-price stocks and stocks with high institutional ownership have greater short-selling and short-covering activities than small-cap stocks, value stocks, low-price stocks and stocks with low institutional ownership. In addition, more short covering and short selling activities are associated with stocks whose risks are high and whose hedging demand is high. In terms of return predictability, we show that short covering (short-selling) activity is positively (negatively) and significantly related to future returns in the full sample. When we group stocks by firm characteristics, it seems that short-sellers are capable of identifying stocks whose prices tend to decline when they initiate short positions, while the ability of short sellers to successfully cover their positions is less clear across stocks.

We then study, in specific, the relation between short covering and the weekend effect, which is one of the well-known pricing anomalies. [Chen and Singal \(2003\)](#), henceforth referred to as CS, argue that the inability to trade over the weekend tends to make short sellers close their speculative positions on Fridays and reopen them on Mondays, leading to the weekend effect, where the stock prices rise on Fridays as short sellers cover their positions and fall on Mondays as short sellers reestablish new short positions.

To test the CS hypothesis directly and thoroughly, one needs to investigate whether there is more short selling on Monday AND whether there is more short covering on Friday. To the best of our knowledge, there has not been any empirical analysis of the relation between short covering activity and the weekend effect. As [Blau et al. \(2009\)](#), henceforth referred to as BVV, put it clearly, “having this information (short covering) is important in testing the CS hypothesis, because the closing of the short positions on Friday adds to the buying pressure and increases prices relative to Monday, when the opening of short positions decreases prices.”

We present evidence that Monday's short covering activity (Friday's short selling activity) increases relatively more compared to Friday's short covering activity (Monday's short selling activity), as the magnitude of the weekend effect increases. These findings are largely inconsistent with the CS hypothesis that more shares are bought back (sold short) on Friday (Monday). We also find that when short covering activity is relatively high, Friday's return is significantly negative. In addition, firms with high short selling activity have a Monday return that is 1.04% larger than the Monday return for firms with low short selling activity. Our findings are contrary to the CS hypothesis, but consistent with the notion that short sellers are contrarian in contemporaneous stock returns ([Diether et al. 2009a](#)).

Our paper's main contribution to the literature is twofold. First, we are among the first to examine daily short covering activity empirically. Prior studies of short covering almost exclusively use monthly short interest data. However, many short sellers cover their positions very rapidly ([Diether 2008](#)) and such monthly short covering changes are a noisy and likely biased way to pick up the short covering effect ([Hong et al. 2012](#)). Hence, the use of this daily flow data can address research questions that cannot be properly analyzed using monthly short interest data. Second, this study is the first to explore the relation between short covering activity and the weekend effect. To provide a more complete picture of the role played by the short sellers around weekends, one must investigate both short selling and short covering activity on Monday AND on Friday.

The rest of this paper is organized as follows. In section II, we discuss related literature. A discussion of institutional background is provided in section III. Section IV describes data and summary statistics. The cross-sectional differences in short-selling/short-covering activity by stock characteristics are also presented in this section. Section V discusses the relation between future returns and daily short-selling and short-covering activities. Section VI presents descriptive statistics by subsamples created based on the sign and magnitude of the weekend effect. Section VII presents empirical tests on the weekend effect and section VIII is our conclusion.

2. Literature Review

Short sellers are relatively sophisticated and informed. Their ability to predict future negative returns are evidenced in numerous papers. [Desai et al. \(2002\)](#) find that heavily shorted firms experience significant negative abnormal returns and these negative returns increase with the level of short interest, indicating that a higher level of short interest is a stronger bearish signal. [Boehmer et al. \(2008\)](#) illustrate that short sellers are well informed. Lightly shorted stocks perform better than heavily shorted stocks by an annualized return of 15.6%. [Diether et al. \(2009a\)](#) show that short sellers are contrarian traders and they increase their positions following positive returns. Furthermore, greater level of short sales predicts negative future abnormal returns. Overall, they conclude that short sellers take advantage of short-term overvaluation.

However, in contrast to the voluminous studies on short selling activity, few empirical studies examine when and why short sellers cover their positions. Short sellers cover their positions for a variety of reasons. They may want to take profits or cut losses; they may be squeezed or in need of liquidity; they may be forced to cover their positions due to regulations; or they may cover their positions, fearing the downside risk during non-trading hours. Using a proprietary database of stock lending contracts, [Diether \(2008\)](#) find that almost half of the securities lending contracts are closed out in two weeks. However, to our knowledge, no empirical studies directly investigate daily short covering activities.

The CS hypothesis on the well-known weekend effect explicitly links daily short-selling and short-covering activities to the day of the week. [Cross \(1973\)](#) and [French \(1980\)](#) are among the first to document that on average, Monday returns are significantly lower than returns on Friday. A number of studies have been conducted to investigate this effect. [Keim and Stambaugh \(1984\)](#)

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