



Contents lists available at ScienceDirect

Pacific-Basin Finance Journal

journal homepage: www.elsevier.com/locate/pacfin



Liquidity provision and informed trading by individual investors



Xiao Tian^{a,1}, Binh Do^{a,2}, Huu Nhan Duong^{a,*}, Petko S. Kalev^{b,3}

^a Department of Banking and Finance, Faculty of Business and Economics, 900 Dandenong Road, Caulfield East 3145, Australia

^b School of Commerce, Division of Business, University of South Australia, City West Campus, GPO Box 2471, Adelaide, South Australia 5001, Australia

ARTICLE INFO

Article history:

Received 7 June 2014

Accepted 19 November 2014

Available online 26 November 2014

JEL classification:

G10

G20

G24

Keywords:

Individual investors

Future stock returns

Algorithmic trading

Liquidity provision

Informed trading

ABSTRACT

This study examines the relation between individual investor trading and future stock returns in the Australian equity market. We find that the net trading of Australian individual investors is positively related to future returns. We show that this association is driven by individual investors who play the role as liquidity providers. We further document that the proliferation of algorithmic trading in recent years dampens the relation between individual trading and future returns. Finally, we present evidence that the net individual trading prior to earnings announcements predicts post-announcement returns. This prediction, however, is only observed for individual investors using full-service brokers.

© 2014 Elsevier B.V. All rights reserved.

1. Introduction

A large body of literature documents that individual investors, as a whole, are unsophisticated and uninformed. They underperform the market index (Barber and Odean, 2000); trade actively, aggressively and speculatively, often to their detriment (Barber and Odean, 2000; Barber et al., 2009a, 2009b); hold undiversified portfolios (Dorn and Huberman, 2005); and suffer from behavioural biases such as holding

* Corresponding author. Tel.: +61 3 9903 2032.

E-mail addresses: jason.tian@monash.edu (X. Tian), binh.do@monash.edu (B. Do), huu.duong@monash.edu (H.N. Duong), Petko.Kalev@unisa.edu.au (P.S. Kalev).

¹ Tel.: +61 3 9903 2043.

² Tel.: +61 3 9903 1399.

³ Tel.: +61 8 8302 7122.

losers too long and selling winners too early (Grinblatt and Keloharju, 2000, 2001).⁴ However, recent studies by Kaniel et al. (2008) and Kaniel et al. (2012) portray individual investors in a very different light. Kaniel et al. (2008) find that over the short horizon, intense buying by individuals predicts positive abnormal future returns whilst intense selling by individuals is associated with negative abnormal future returns. They show that this predictability is consistent with individual investors providing liquidity to institutional investors who require immediacy.⁵ Kaniel et al. (2012) document that intense aggregate individual buying (selling) predicts large positive (negative) abnormal returns on and after earnings announcement dates. They show that although liquidity provision continues to play a role in explaining this predictability, about half of the abnormal returns can be attributed to individual investors acting on private information.

Motivated from the seemingly contradictory findings in the prior literature, in this paper, we investigate the relation between individual investor trading and future stock returns both unconditionally and around earnings announcements. In doing so, we examine whether the liquidity provision role played by individual investors explains the relation between individual investor trading and future stock returns. In addition, we consider how the changes in liquidity provision affect this relation. Finally, we investigate whether the relation between individual trading and future returns arises as a result of informed trading by individual investors.

There are at least two reasons why an independent, out-of-sample verification of the liquidity provision role and informed trading by individual investors is warranted. First, whereas Kaniel et al. (2008) examine a sample period from 2000 to 2003, the proliferation of algorithmic trading (hereafter, AT) over the last decade may have a potential effect on the return predictability of individual investor trading. Hendershott et al. (2011) define AT as the use of computer algorithms to automatically make certain trading decisions, submit orders, and manage those orders after submission. AT accounts for 73% of the trading volume in the U.S. in 2009 (Hendershott et al., 2011) and 30–40% of total volumes traded on the Australian Securities Exchange (ASX) (ASX, 2010a).

The fast-pace growth of algorithmic trading is often thought to benefit large institutional traders at the expense of other traders (O'Hara, 2007). More importantly, Ait-Sahalia and Saglam (2014) emphasize that high frequency traders (HFTs), a subset of algorithmic traders, have become the modern-day market makers, or providers of liquidity to the markets. They show theoretically that faster or better technology translate into higher profits and higher liquidity provision for HFTs. Hoffmann (2014) presents a theoretical model trading in a limit order book market with fast and slow traders. He shows that fast traders (HFTs) are more likely to act as makers rather than takers of liquidity. Prior empirical studies also highlight the role of algorithmic traders or high frequency traders as liquidity providers (see, for example, Menkveld (2013); Hendershott and Riordan (2013); Hagströmer and Nordén (2013); Carrion (2013); Jarnecic and Snape (2014)).

Building from these findings, one can conjecture that as algorithmic traders have been competing against individual investors in supplying liquidity in recent years, the return predictability by individual trading may have weakened accordingly. We test this conjecture by focusing on stocks with different levels of AT. We also analyse a sample period that includes the establishment of the Australian Liquidity Centre – the collocation service on the ASX. This natural experiment will enable us to draw insights into the dynamic nature of the informativeness of individual trading against the backdrop of algorithmic trading.

Second, Kaniel et al. (2012) document evidence of informed trading by individual investors around earnings announcement periods. They, however, establish this result for individual investors as a whole group. Fong et al. (2014) emphasize that “we should be cautious about generalizing the results of a study if we do not know the composition of individual investors' trades across broker types in the data relative to the population”. Motivated from the findings of Kaniel et al. (2012) and Fong et al. (2014), we investigate the information content of individual trading prior to earnings announcements, differentiating between individuals using full-service versus discount retail brokers.

We investigate the relation between individual trading and future stock returns for the constituent stocks of the S&P/ASX 200 index over the period between 2005 and 2013. The Australian market is particularly suitable for the purpose of investigating the individual investor trading–future stock returns relation. According

⁴ See Hvidkjaer (2008) and Barber et al., 2009a, 2009b for further evidence on the underperformance of individual investors over the long horizon.

⁵ Evidence on the positive return predictability of individual trading over the short horizon can also be found in Dorn and Huberman (2005), Barber et al., 2009a, 2009b and Kelley and Tetlock (2013).

Download English Version:

<https://daneshyari.com/en/article/975204>

Download Persian Version:

<https://daneshyari.com/article/975204>

[Daneshyari.com](https://daneshyari.com)