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The price, liquidity and information asymmetry changes associated with new S&P 500 additions

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Abstract

Purpose – Using S&P 500 additions, the purpose of this paper is to test the permanence of abnormal returns around the index inclusion announcement and effective implementation dates to differentiate among competing explanations for the index inclusion premia puzzle.

Design/methodology/approach – The event study methodology is used to examine abnormal returns and volume effects around the announcement dates (ADs) and implementation dates of index additions.

Findings – This study documents a twofold increase in trading volume and significant permanent abnormal returns at the ADs that are correlated with subsequent decreases in bid-ask spreads. There is a fivefold increase in trading volume, but only temporary abnormal returns, around the effective dates (EDs). Taken collectively, the evidence indicates that the permanent return at announcement is best explained by liquidity/information cost explanation, but the temporary return and large trading increases at the ED can best be attributed to the price pressure hypothesis.

Research limitations/implications – These results do not support the well documented long-run downward-sloping demand curve as the primary explanation for the abnormal returns observed on these dates.

Originality/value – This study contributes to the body of literature on the index inclusion effect by providing supporting evidence for the liquidity/information cost explanation, and by extending the previously analyzed index additions with an additional five-year period from 2000-2004.

Keywords Stocks, Liquidity, Financial information, United States of America

Paper type Research paper

1. Introduction

Over the past three decades, studies in leading finance journals documented significant and permanent positive abnormal returns associated with inclusion announcements to the Standard and Poor's (S&P) 500 index (e.g. Dhillon and Johnson, 1991; Lynch and Mendenhall, 1997; Chen *et al.*, 2004). This "index inclusion effect" is controversial because prices in efficient markets should reflect all publicly available information and should not react to changes in a security's supply that are not accompanied by news concerning the security's fundamental value. Assuming that the S&P 500 inclusions are information-free events, the most frequently supported explanation for the index inclusion effect has been the downward-sloping demand curve (e.g. Shleifer, 1986; Wurgler and Zhuravskaya, 2002; Petajisto, 2007). Over time, the information-free

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