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Market microstructure and corporate finance

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Abstract

This article provides a brief overview of the importance of market microstructure research and identifies existing areas of research that focus on links between microstructure and corporate finance. Each of the special issue articles is then summarized with particular attention given to the research contribution of the article and to the links explored between microstructure and corporate finance.

Keywords: Market microstructure; Stock; Corporate finance

These trees are magnificent, but even more magnificent is the sublime and moving space between them. Rainer Rilke.[1]

While the growing complexity of both theoretical constructs and empirical methodologies leads to ever more specialized research, a healthy preoccupation with the meaning and relevance of our research still ensures we never loose sight of the forest for the trees.[2] Furthermore, an honest fascination with the myriad details and nuances of our work ensures that every tree gets more than a passing glance. What Rilke so elegantly reminds us, is to devote at least some of our attention to those topics that lie between established lines of inquiry. This special issue explores just such a set of topics—those that combine corporate finance with market microstructure.[3]

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[1] This quote appeared in a letter to Claire Goll and appears in Goll (1995, pp. 63–64).

[2] This proverb was first documented by John Heywood in 1546 and the first use in print was by Christoph Martin Weiland, a German poet, who wrote "Too much light often blinds gentlemen of this sort. They cannot see the forest for the trees."

[3] This is not to say there has been no research in this area. There has been substantial activity in some areas and these are discussed below. The focus of this special issue might best be described as bringing to light some new or less explored areas.

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While the articles collected here are by no means exhaustive, they do suggest two paths down which one might proceed. First, there are empirical methods in market microstructure that can be used to evaluate theories in corporate finance. For example, there are measures of the degree to which some individuals are better informed than others and these can be used to evaluate links between asymmetric information and corporate decisions. The second path is to examine the influence of microstructure outcomes on corporate decisions. In this case, the microstructure of markets may influence corporate strategy.[4]

The goal of this introduction is twofold. First, to place microstructure research itself into a broad context. Specifically, I will briefly address the general relevance of microstructure issues and discuss some existing research that links microstructure and corporate finance. Second, to introduce each of the articles in this collection and highlight the contribution of the work in light of both microstructure and corporate finance literatures.

1. Microstructure: does it matter?

Market microstructure is the study of the organization and function of markets. Most of the literature focuses on the two central roles of markets—the transfer of ownership and price discovery. Research on the former role emphasizes the costs of trading (liquidity), while research on the latter emphasizes the process by which private information is incorporated into prices.

Given the centrality of liquidity, it is not surprising that one of the first papers to assess the importance of microstructure examined the relation between asset value and liquidity.[5] Amihud and Mendeson (1986) looked at the relation between the bid-ask spread and expected returns. In their conclusion, they write

> Applying our empirical results, consider an asset which yields \$1 per month, has a bid-ask spread of 3.2% (as in our high-spread portfolio group) and its proper opportunity cost of capital is 2% per month, yielding a value of \$50. If the spread is reduced to 0.486% (as in our low-spread portfolio group), our estimates imply that the value of the asset would increase to \$75.8...(pg. 246).

While this analysis has its weaknesses (see O'Hara, 1999 for a complete discussion), the magnitude of the results is striking. An improvement in liquidity that spanned their sample implied an increase in value of about 50%.

More recently, these two authors, with Beni Lauterbach, provided corroborating evidence of a different sort.[6] They examined a change in the trading mechanism of the Tel Aviv Stock

[4] Which is not to say that microstructure issues are necessarily dominant or deciding factors. In some cases, they will be of secondary importance, while in others they may be central.

[5] O'Hara (1999) discusses the importance of market microstructure in an engaging short article entitled "Making Market Microstructure Matter."

[6] Amihud et al. (1997).