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Why can managers time the market in issuing new equity? The global evidence

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ABSTRACT

Recent studies find that aggregate equity issues predict market returns in the U.S. market. In this research, I examine whether such predictive effect exists in the global stock market. I use an aggregate approach across 41 countries with diverse legal regimes. The results confirm the presence of predictability of aggregate equity issues in the global market. In addition to aggregate equity shares, the annual frequency of equity issues also appears to be a strong predictor of market stock returns. Furthermore, I find that the predictive power is related to the level of information asymmetry in a country due to cross country differences in legal protections and accounting disclosure standards.

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1. Introduction

This study empirically examines the global predictive effects of aggregate equity issues using a broad cross-section data of 41 countries. It extends the literature by offering explanations for managerial market timing ability in equity issues within the asymmetric information framework.

Numerous studies have documented empirical evidence on the predictive power of various financial variables for stock market returns. Among these variables are book-to-market ratio (Kothari and Shanken, 1997), aggregate insider trading (Seyhun, 1988), aggregate analyst recommendations (Howe et al., 2009), dividend-price ratio (Campbell, 1987; Campbell and Shiller, 1988a), earnings-price ratio (Campbell and Shiller, 1988b; Fama and French, 1988), short and long-term interest rates (Campbell, 1987; Hodrick, 1992; Ang and Bekaert, 2007). Most of these authors conclude that their findings are suggestive of market inefficiency. The finding of these predictive variables raises the question of

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why public investors cannot recognize the economic value of these predictive factors and exploit the arbitrage opportunity they provide.

Baker and Wurgler (2000) introduce a new variable "equity share". They find that the share of equity issues in total new equity and debt issues is a strong predictor of the U.S. stock market returns. U.S. corporate managers aggregately are more likely to issue new equity prior to market downturns and issue more bonds prior to hot markets. Their results suggest that managers are able to take advantage of favorable stock prices and can systematically time aggregate stock market returns in their financing decisions. They do not find support for efficient market explanation of the results. They believe that the fact that market is predictable conflicts with the semi-strong market efficiency.

Henderson et al. (2006) extend Baker and Wurgler (2000)'s study and examine how firms raise external capital in G7 countries. They find the predictive power of aggregate equity share in these seven developed countries. They believe that market timing considerations are important in security issuance decisions.

In this paper, I examine whether corporate managers' market timing ability is a global phenomenon. I further investigate whether information asymmetry between managers and public investors explains the managers' market timing ability. I use the strength of legal protection and accounting disclosure standards as proxy for measuring the information asymmetry of a country.

The results from this study provide evidence complementing the findings of Henderson et al. (2006). Although both studies address a similar issue in the international market, Henderson et al. (2006) mainly focus on exploring the evidence of the predictability effect and they do not offer explanations behind the managerial market timing ability, whereas I explore the reasons behind the predictive effects in the asymmetric information framework. They use a sample of seven countries with the same legal regime and similar accounting standards. The G7 countries in their study share similar economic climate. It is widely known that markets behave differently across different investment environments. My research focuses on 41 countries under five different legal regimes and with various degrees of accounting disclosure standards. The analysis from this study helps us understand the linkage between information asymmetry and the predictive effect of aggregate equity issuance.

The main findings of this study are as follows: first, the predictive effect of aggregate equity issues is a global phenomenon. In addition to aggregate equity share and the ratio of new equity share to GDP, the number of new aggregate equity issues within a given year also appears to be a strong predictor of stock returns. Second, the predictive power is related to the level of information asymmetry in a country due to cross country differences in legal protection and accounting disclosure standards. For countries with higher degree of information asymmetry, corporate managers are more successful in timing the market returns in equity issues; while for countries with lower degree of information asymmetry, managers have less market timing ability. This evidence suggests that managers' market timing ability comes from their informational advantage over public investors. Since managers in countries with more asymmetric information possess more insider information, they are able to have better estimation of their stock value in comparison to stock market price, therefore can take advantage of the windows of opportunity in issuing equities. The empirical evidence from this study does not support the strong-form market efficiency, but it still supports the semi-strong market efficiency.

The remainder of this paper is organized as follows. Section 2 presents the model and hypotheses development. Section 3 describes data and methodology. Section 4 explains the empirical results. Section 5 concludes.

2. Hypothesis development and model

2.1. The predictive effect of aggregate equity issuance

To examine whether aggregate equity issuance predicts stock market returns in the global market, I use the univariate regression model for the pooled sample. The specific construction of this measure is shown in Eq. (1):

$$R_{i,t+j} = \alpha + \beta \left\{ \frac{E_{i,t}}{E_{i,t} + D_{i,t}} \right\} + u_{i,t} \quad \{j = 1, 2, 3, \text{and} \quad 4\} \tag{1}$$

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