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The relationship between bid–ask spreads and holding periods: The case of Chinese A and B shares

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Abstract

The Chinese stock markets for A (domestic) shares and B (foreign) shares were completely separated. This study examines the relationship between spreads and holding periods across these segmented markets on the same set of firms. Our major findings are as follows. (1) There is a positive relationship between holding periods and bid–ask spreads in the Chinese stock market. (2) Investors' sensitivity toward liquidity is approximately the same in the A and B share markets, even though bid–ask spreads are substantially different across the two markets. These results provide strong support for the theoretical argument of Amihud and Mendelson [Amihud, Y., & Mendelson, H. (1986). Asset pricing and the bid–ask spread. *Journal of Financial Economics, 17*, 223–249.] that stocks with higher spreads tend to be held by long-term investors. Evidence also suggests that liquidity has a role in explaining the B share discount, although the results are less than conclusive.

JEL classification: G15; G19
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1. Introduction

The finance literature in general views that transaction costs have important effects on investors' trading behavior. In particular, Amihud and Mendelson (1986) theorize that

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stocks with large bid–ask spreads likely are held by long-term investors, since high transaction costs are affordable in the long term. An empirical testing of their theory is provided by Atkins and Dyl (1997). They find that, in the U.S. market, stocks with higher (lower) bid–ask spreads tend to have longer (shorter) holding periods. The result seems to confirm the theoretical argument of Amihud and Mendelson. However, in the U.S. market, institutional investors account for a large portion of stock holdings and they are fairly diversified; it is therefore not clear that Atkins and Dyl's study is in fact comparing different investors. This paper provides a cleaner test of Amihud and Mendelson by examining the relationship between spreads and holding periods across completely segmented markets on the same set of firms.

The Chinese stock market is ideal for this investigation in that there are separate markets for domestic and foreign investors. The A and B shares are restricted to domestic and foreign investors, respectively.[1] Although firms in a few other countries issue stocks similar to B shares, the B shares in those countries are convertible to A shares under certain conditions, whereas the A and B shares in China are completely separated. The B shares are traded in foreign currencies, and Chinese Yuan is not freely convertible into foreign currency. Moreover, short selling is prohibited in the Chinese stock market. These facts make arbitrage virtually impossible between the two markets. This complete division provides a unique setting to study the relationship between spreads and holding periods.

Specifically, the study attempts to address three potentially important issues. First, does the positive relationship between transaction costs and holding periods exist in a non-US market? Second, do investors' sensitivities toward liquidity vary across markets? More importantly, because A and B shares differ only in terms of investors, this investigation in effect controls for other relevant factors that are not suggested by extant theories. For instance, Atkins and Dyl (1997) document that, in 1989, the average holding periods of NYSE and NASDAQ are 4.6 years and 8.1 years, respectively. We are unaware of any existing theories capable of explaining this difference. Perhaps factors such as dividend payouts and ownership structures also affect holding periods. Examining two sets of stocks on the same set of firms provides a cleaner, more robust testing for the relationship between spreads and holding periods. We find strong evidence that the bid–ask spread is a significant factor explaining the length of holding period. This study also is among the first that utilize the bid–ask spread data in the Chinese stock market.

In late February 2001, Chinese government opened the B share market to domestic investors. On the day when the restriction was lifted, the B share market jumped 10%, which was exactly equal to the daily price limit (Wall Street Journal, February 28, 2001). Within a month, the B-share index more than doubled. This implies that liquidity has important effects on pricing. Indeed, we find evidence that prices are influenced by liquidity, although the results are not robust across sample periods. This is presented in the latter part of the paper. In December 2002, the Chinese government initiated the

[1] The purpose of issuing B shares is to attract foreign capital without giving up control to foreign investors. Wei, Varela, and Hassan (2003) suggest that most of the exchange-listed firms are neither the best nor the worst firms. The well-regarded firms probably sell foreign shares in the form of H shares (traded in Hong Kong) and N shares (traded in New York in the form of American Depository Receipts). The number of H and N shares is much smaller than that of B shares.