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# Structural change and the bid-ask spread: evidence from the Johannesburg Stock Exchange (JSE)

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## Abstract

This article quantifies the size of the implicit bid-ask spread and examines the impact of three structural changes on the relationship between the bid-ask spread and its determinants on the Johannesburg Stock Exchange (JSE). A sample of 135 firms was analyzed using a time series over the period from January 1991 to February 1996. It was found that the size of the spread is substantially larger on the JSE and that the independent variables (price, volatility and trading volume) explain a smaller proportion of variation in the spread than on developed exchanges. The evidence shows that the spread decreased after tax structural change, but increased after both political and economic structural changes. The size of the spread decreased on average from 1.71% to 1.24% following tax structural change and increased from 1.67% to 1.83% and from 1.10% to 1.24% following political and economic structural changes, respectively. The evidence also shows that the impact of tax, political and economic structural changes on the relationship between the spread and its determinants is not statistically significant. The results show that while the independent variables explain from 23.45 to 48.2% of the variation in the spread, there is no statistically significant change in the coefficients of the independent variables between before and after structural change regressions. © 2001 Elsevier Science B.V. All rights reserved.

*Keywords:* Bid-ask spread; Economic structural change; Independent variables

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## **1. Introduction**

Does structural change affect the size of the bid-ask spread and its relationship with its determinant variables on the JSE? Anecdotal evidence suggests that it does because of its impact on the stock price, volatility and volume, determinants of the spread. The measurement and analysis of trading costs has considerable practical and academic interest. The spread represents an important trading cost that clearly imposes a drag on the performance of an investment to an individual or institutional investor thus reducing significantly the benefits to diversification. The bid-ask spread is determined by competition among dealers, dealer costs and adverse selection, and the hidden costs of trading. While some investors may operate under the misconception that the only trading cost is the brokerage commission that they pay when they buy or sell, there are other costs that they incur in the course of trading that generally dwarf the commission cost. For any traded asset, there are three components that go into the trading costs. The first is the spread between the price at which you can buy an asset and the price at which you can sell the same asset at the same point in time. The second is the price impact that an investor can create by trading on an asset, pushing the price up when buying the asset and pushing it down while selling. The third component of the trading cost is the opportunity cost associated with waiting to trade. It is the sum of these costs, in conjunction with the commission cost that makes up the trading costs on any investment strategy. Knowledge of these costs is not only useful but is necessary for investors to make informed investment decisions in new equity markets that have emerged around the world. In developed markets in the US and Europe, trading costs are well documented. Unfortunately, in markets where there are no market makers, and hence no quoted spreads such as the JSE, the spread is unknown and has to be estimated from transaction returns. This article presents estimates of the spread as a percentage of the transaction price and provides evidence of the impact of structural changes on the relationship between the spread and its determinants.

Tests of structural change are important because they capture the effects of significant events on the spread and on its relationship with determinant variables. First, I document evidence that tax, political and economic structural changes in South Africa had little and insignificant impact on the size of the spread. The changes in the spread following each structural change are statistically not significant. The spread decreased on average from 1.71 to 1.24% following tax structural change. Following both political and economic structural changes, the spread increased on average from 1.67 to 1.83% and from 1.10 to 1.24%, respectively. Although these results are not statistically significant, they nonetheless provide portfolio managers and investors in JSE securities with a reasonable estimate of trading costs that they must take into account when computing expected returns. This is important since investment performance reflects not only the underlying investment strategies of portfolio managers, but the execution costs incurred in realizing those objectives as well. In certain instances, trading costs can be large enough to substantially reduce or even eliminate the paper return to an investment. Besides its immediate practical value to investors and portfolio managers,

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