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## Emerging Markets Review

journal homepage: [www.elsevier.com/locate/emr](http://www.elsevier.com/locate/emr)

## Is individual trading priced in the preferred stock discount?

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## ARTICLE INFO

## JEL classification:

G12  
G15  
G32

## Keywords:

Preferred stock discount  
Noise trader risk  
Individual trading weight

## ABSTRACT

Individuals have long been blamed for noise trader risk. Moreover, the literature suggests that the discount of preferred shares against comparable common equities is due to dual-class differences in dividend yield, voting rights, management control, and turnover. In this paper, we argue and present evidence that noise trader risk, as proxied by the individual trading weight, explains the preferred stock discount observed in the Korean stock market after controlling for the conventional determinants. This main result and additional considerations empirically support the presence of noise trader risk.

## 1. Introduction

The overall discount of preferred shares against their comparable common stocks is a persistent phenomenon found ubiquitously and globally. The cross-country difference in the discount corresponds to the premium of voting rights for common shareholders that varies across the borders. In this study, we look at the time-variation of the preferred stock discount (PSD) in an advanced emerging market, controlling for the conventional determinants known in the literature. The literature theoretically predicts that noise trader risk (NTR) diverges asset prices from their fundamental values. In the light of this, we specifically use the individual trading weights (ITWs) of pairs of common and preferred stocks as a proxy for NTR associated with PSD.<sup>2</sup> Our proxy well explains PSD and shows that NTR is present in the stock market.

Individual investors have long been suspected as noise traders in the stock market because of their limited access to firms' inside and fundamental information. Jensen (1968) and Lease et al. (1974) show that individuals often tend to trade single stocks on erroneous noise or invest in mutual funds at high fees rather than construct or hold a market portfolio. Kyle (1985) and Black (1986) also labeled uninformed individuals noise traders for their suboptimal trading behavior in the market. Although many studies have shown evidence of noise trading by uninformed individuals, an extensive discussion of the effect of noise trading seems to have begun after the theoretical predictions of De Long et al. (1990). In their study, they show that when the proportion of uninformed individual

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<sup>1</sup> Special thanks are due to Jonathan Batten (the Editor), Mark Seasholes (Associate Editor), an anonymous referee, Warren Bailey, and Andrew Karolyi. We also appreciate Jae Man Chung, Seth H. Huang, Sung Wook Joh, Bong-Chan Kho, Woojin Kim, Kuan-Hui Lee, Rae Soo Park and seminar participants at Seoul National University and the Korea Securities Association (2017). This research is based on a chapter of the Ph.D. dissertation of J.H. Choi at Seoul National University (Choi, 2015). Part of this research was conducted while P.M.S. Choi and J.H. Choi were visiting scholars at the Samuel Curtis Johnson Graduate School of Management, Cornell University, and were funded by the grants provided by the Fulbright Scholarship Program, Ewha Womans University, and the Korea Securities Association. Hyeik Kim, Ye Jun Kim and Francis Joonsung Won provided excellent research assistance. Standard disclaimer rules apply and all errors are our own.

<sup>2</sup> As the relative price deviation of a preferred stock issue from its comparable common stock listing, PSD is measured by the excess of the common share price over the preferred stock price and divided by the common share price.

<https://doi.org/10.1016/j.ememar.2018.03.006>

Received 13 July 2017; Received in revised form 27 February 2018; Accepted 25 March 2018

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traders in stocks increases, the transaction risk generated by the uninformed traders can limit the entrance of short-term, risk averse and rational arbitrageurs. In this case, arbitrageurs are deterred from exploiting price deviations, which causes stocks to be traded at persistent discounts, even when there is no fundamental risk in the stock market. [Choi and Choi \(2018\)](#) argue that ITW—defined as the proportion of individual traders-initiated buys and sells out of the total trading volume of a given stock listing—can proxy for NTR and explain the returns of common stocks. They further construct an excess return factor of sorted portfolios that are dense (high in ITW) and scarce (low in ITW) in terms of individual traders (dense-minus-scarce, DMS). The NTR factor (DMS) is then shown to significantly account for the returns of sorted portfolios in the stock markets of Korea and Taiwan, which cogently shows that NTR is priced in common stock returns in Asia.

In the corporate finance literature, in addition to the dual-class differences in dividend payout, the cause of PSD has been largely explained by the absence of voting rights following [Zingales' \(1994, 1995\)](#) seminal works. First, private benefits with management control accompanied by voting rights can make common stocks with voting rights more valuable than preferred stock ([Zingales, 1994](#)). Second, the price deviations between common and preferred shares are not substantial in countries with well-separated corporate ownership and management and a highly diversified composition of shareholders, such as the U.S. ([Zingales, 1995](#)). Various country cases for Israel ([Levy, 1983](#)), the U.K. ([Megginson, 1990](#)), Switzerland ([Horner, 1988](#)), Korea ([Chung and Kim, 1999](#); [Kim et al., 1996](#)) and 18 countries ([Nenova, 2003](#)) also show the cross-sectional variation of PSD along with deviations in the premium of voting rights due to the cross-border stratification of corporate governance.<sup>3</sup> Generally speaking, a country under the civil law system with inferior shareholder protection ([La Porta et al., 1998, 2002](#)) in the emerging markets is likely to show a large premium of voting rights. However, even after accounting for largely non-volatile voting rights, PSD has shown large time variations. Further, [Muravyev \(2004\)](#) suggested turnover in addition to voting rights as an additional factor of the common stock premium (PSD) in Russia. The turnover factor complements the time-varying characteristic of PSD, which cannot be explained by non-volatile voting rights.

In Korea, institutional changes that affect the private benefits of large shareholders in tandem with their ownership ([Chung and Kim, 1999](#); [Kim et al., 1996](#)) and that occur in the market for corporate control ([Kook and Jung, 1996](#)), and the turnover of preferred shares ([Chay and Moon, 2005](#); [Han, 2010](#)) appear to matter in evaluating voting rights and determining PSD. However, considering largely static dual-class differences in dividends, voting rights and time-varying turnover still leave much room for the unexplained dynamics of the discount of Korean preferred shares. In the Korean stock market, preferred stocks, on average, exhibit heavier individual trades than their comparable common listings do. Because the creation of NTR depends on the volume of uninformed individual traders ([De Long et al., 1990](#)), following [Choi and Choi's \(2018\)](#) suggestion of ITW as a proxy for NTR, we expect that the discount of a preferred stock will enlarge corresponding to an increase of ITW relative to that of the comparable common share. A given pair of common and preferred equities, which share the identical firm-level characteristics, can be contrasted by ITW after controlling for fundamental and systematic risks and dual-class differences in dividend yield, voting rights and turnover.

Given 185 pairs of “old-type” preferred<sup>4</sup> and common shares listed on the Korea Stock Exchange (KSE, 169) and the Kosdaq (16) from January 2000 until October 2014,<sup>5</sup> we find that the excess of ITW of preferred shares over that of comparable common listings (relative ITW) economically and statistically significantly explains the time variation of PSD after controlling for firm-level characteristics and the aforementioned dual-class factors. Individuals in the Korean stock market turn out to deter the parity-convergence of common-preferred equity pairs, which is evidence of NTR that impedes the enforcement of price discovery. While existing studies in the literature since [De Long et al. \(1990\)](#) have focused on the systematic patterns of individual traders and on the dynamic relationship between investor sentiment and stock returns, this study sheds light on how a subset of investment strategies, i.e., “long-preferred, short-common”, can be priced by a parsimonious measure of NTR–ITW in our case. Our approach is made feasible due to a peculiar feature of the database (DataGuide) of our sample that identifies the ratios of investor types for every stock listing. Moreover, our choice of Korean data is motivated by several aspects. The Korea Exchange is the holding company of KSE (main board), the Kosdaq (dominantly listed with growth stocks) and the Options and Futures Exchange. These are considered some of the most active and liquid securities trading venues in the emerging (MSCI) and developed (FTSI) markets. This is a valid reflection of the Korean economy given its size and influence on global commercial transactions. The representativeness of our data implies that the implications of this empirical research can be emulated in other markets.

We additionally consider several aspects surrounding the findings herein. First, we show that the source of the risk that mutually diverges the prices of common-preferred share pairs tends to systematically affect the relative pricing of preferred stocks. Specifically, statistically significantly positive correlations among factor-orthogonal relative ITWs and residual PSDs, respectively, and their substantial principal components attest that. Second, the discount of preferred shares at issuance is noticeably less than the time-average discount, reflecting the market-timing incentive of issuers based on the cost of capital. Third, our main finding continues to hold for relatively invariant PSDs and for the premiums of preferred shares, and under various market conditions. Lastly, while this study is primarily regarding an advanced emerging market, we find a preliminary, corresponding corroboration of NTR-priced PSD in another emerging market economy, Taiwan.

The rest of this research is organized as follows. [Section 2](#) describes data sources, defines key variables, and presents the preliminary results. [Section 3](#) investigates the main thesis of this paper—the pricing of NTR on the discount of preferred shares. [Section 4](#)

<sup>3</sup> PSDs in various economies are as follows: 81.5% in Italy, 45.5% in Israel, 20% in Switzerland, 13.3% in the U.K., 3% ([Zingales, 1994](#)) or 5.4% ([Lease et al., 1983](#)) in the U.S., and 10% ([Chung and Kim, 1999](#)) or 48% ([Nenova, 2003](#)) in Korea.

<sup>4</sup> The “new type” preferred shares are introduced and tested for the robustness of our main finding in [Section 4.3](#).

<sup>5</sup> In the Korean stock market, trade-level investor group identification was made available since 2000.

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