Winton Centre for Financial History

IDIOTS EVERYWHERE? OR NOT SO FAST?

9/11/10

Comments on 'Individual investors and volatility'

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Overview

- Mature, well-developed paper
  - May 2008 -> July 2010 version
- Impressive theoretical framework
- Ingenious ‘panel matching’ respects the data
- Convincing robustness checks
- Hard to quibble at this stage with the econometric results (nor am I the one to do so)
- So what can a financial historian add?

Theoretical Framework

- Noise traders versus smart money (De Long, et al, 1990, 1991), Schleifer and Vishny (1997), etc.
- Strategy to preserve 'rational expectations'
- Policy Implications are obvious
  - Make retail trading more expensive; annoys online brokerages, but perhaps desirable anyway.
- Caveats about the use of the model here
  - Danger of circularity. Retail trading volume ↓, concurrent volatility ↓, therefore 'noise trader traits' causing volatility, but what about independent factors? 23% estimate.
  - Confirmation bias against other endogenous explanations

Convincing empirical results

- Volume of trades in treated stocks declines
- Decrease in volatility measures (especially Volatility2)
- Decrease in return reversals
- Decrease in price impact
- But are there other explanations to be found in the market microstructure?

Historical Markets

- 1888-1983: bifurcated markets. Stocks that traded on RM also traded in a spot market.
- 1983-2000: stocks traded either on the RM list or in a spot market. Limited options market mostly accessible to institutional investors. RM (blue-chip French stocks).
- 2000-: stocks trade on spot market, but former RM stocks are SRD eligible (plus government bonds, corporate bonds, and foreign stocks nominated by Euronext, as well as ETFs eventually)
- But whereas RM was historically restricted to French investors, foreign investors get access to the spot market

What is SRD?

- Deferred settlement service
  - Apparently no one much uses it, but the authors' tests do not discriminate against types of settlement. Assumption is that most of the transactions were spot post-2000.
  - Also unclear how much of settlement is handled internally by the brokerage houses for small retail investors. 2007 reform; regulations governing reporting, but apparently almost no one remembers how this actually worked from 2000 to 2007?
- Tougher margin requirements
  - Minimum of 20% for gov't securities, 25% corporate bonds, 40% stocks, but amount set by broker. Also subject to daily margin calls whereas RM was not.
- Tougher listing requirements for domestic vs. foreign stocks
- Not equivalent to the RM, which functioned more like a futures market (or at least an exchange-traded forward market)
- Collateral requirements for RM were very low (20%) with no margin calls. High leverage, few(er) liquidity constraints.

Several questions

- Is the RM inherently a more volatile market?
  - Settlement system would suggest as much.
  - Authors' measure: 'standard deviation of the daily difference between the raw return of a given stock and the market return' might magnify the result.
- Literature on the volatility of futures markets, both in themselves, and how they stabilise prices in spot markets.
- After 2000, institutional investors have access to spot and equities-index futures markets. Expect decreased volatility.
- If we accept contrarion trading is price-stabilising in spot markets and momentum trading price-destabilising, how does this play out in the RM, with the additional leverage? Authors conclude that retail traders simply introduce disproportionate idiosyncratic risk, but is this convincing?

Conclusions/Possible extensions?

- Authors should explain explicitly the relatively low uptake of the SRD (141 stocks eligible in 2010) and also what the 2007 reform tells about the retrospective operation of SRD
- Explore the role of foreign investors after 2000 in French spot markets. Intuition? Comparatively smart(er) money. Also role of retail access to foreign stocks.
- Authors argue French stock market decline does not account for much of the drop in volatility, but was it sector-driven (Dotcom crash)?
- How much volatility is endogenous to RM? Possibly explore with reference to before/after 1983?
- Is this mostly a liquidity constraint/de-leverate story? Or is the RM a different kind of market from the spot market?