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Predicting Contemporary Volume with Historic Volume at Differential Price Levels: Evidence Supporting the Disposition Effect: Discussion

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DISCUSSION

LAWRENCE HARRIS*: Ferris, Haugen, and Makhija present some important innovations to the methodology of testing for tax-loss selling and/or disposition effects. Their analysis of the timing of volume at different price levels will be most useful because the two hypotheses have different predictions conditional on the prices at which previous trades were made. Using these conditional predictions, the authors increase the power of their tests to discriminate between the specified alternatives, and, as is further discussed below, provide greater strength against unspecified alternative hypotheses. This work therefore shows great promise.

Aside from usual concerns related to the presentation of preliminary work, there are some substantive points about the experimental design that should be discussed. The most important concerns an alternative explanation for the results that does not depend on either hypothesis under consideration.

This alternative explanation involves the bid/ask spread and the determinants of the demand for trade. When the percentage spread is large, trade is expensive and simple demand theory predicts that less will occur. Since the goal of this paper is to test trading hypotheses that are independent of the cost of trading, the empirical methodology must hold these costs constant. Failure to do so may result in spurious conclusions.

This criticism is of special concern in this paper. Many theoretical and empirical studies show that the percentage spread decreases with firm value and price level and increases with volatility. When prices and values fall (rise), volatilities typically rise (fall). All three effects cause transaction costs to increase (decrease) so that less (more) volume will be observed. This prediction is identical to that of the disposition hypothesis, which is supported by the results.

Since the authors focus their attention on small firms for which price volatility is greatest, and for which the spread may already be a significant determinant of total transaction volume, the transaction-cost explanation for volume may be especially important. Note also that a sample-selection bias further reinforces this effect. Since only the smallest 30 firms are analyzed, many of the sample firms are likely to be losers for which prices have changed by more than would be expected given a random sample.

Fortunately, a simple change in the experimental design can eliminate biases that may be associated with changing transaction costs. The transaction-cost effect can be modeled in the time-series regressions designed to determine abnormal trading volume. This can be accomplished by introducing a proxy for transaction costs into the set of independent variables. The best proxy would be the quoted percentage bid/ask spread, although this may be expensive to acquire. An inexpensive alternative would be the inverse price level, which is closely correlated with the percentage bid/ask spread.

Underlying all tests of tax-loss trading and of the disposition effect is an implicit assumption that frequently goes unmentioned. The assumption is that all volume explained by the model is initiated by sellers. In reality, however, we

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know that much volume is buyer-initiated. It is therefore interesting to ask whether theories of buyer-initiated volume might explain the results. For example, does buyer-initiated trade increase after a stock experiences an increase in price? If so, the increase in volume might be mistaken for the disposition effect. Is buyer-initiated volume seasonal? If so, seasonal volume might be mistaken for tax-loss selling.

Although I will not suggest alternative models of buyer-initiated volume, I would like to note that analyses of seller-motivated volume are best protected from these unspecified criticisms when their models provide very specific predictions for volume. The conditional predictions explored in this paper provide a good example of this principle. Even if buyer-initiated trade increases after an increase in stock price, the increase in volume will only be mistaken for the disposition effect if there was a lot of volume at lower prices. An acceptable buyer-initiated theory would have to provide a similar conditional prediction. Similarly, even if buyer-initiated volume is seasonal, a theory relating it to previous volume would be needed before the results of this paper could be challenged.

In summary, I found the approach used in the paper to be very promising. I look forward to the polished product.