

**Information and noise in stock markets:  
Evidence on the determinants and  
effects using new empirical measures**

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Doctor of Philosophy in Finance

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## Statement of originality

I certify that work in this thesis has not previously been submitted for a degree nor has it been submitted as part of requirements for a degree except as fully acknowledged within the text.

I also certify that the thesis has been written by me. Any help that I have received in my research and the preparation of the thesis itself has been acknowledged. In addition, I certify that all information sources and literature used are indicated in the thesis.

This research is supported by the Australian Government Research Training Program.

A handwritten signature in blue ink, appearing to read 'Thanh', with a horizontal line extending to the right.

Thanh Huong Nguyen

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# Preface

Some of the research presented in this thesis has also been incorporated in four working papers co-authored with Prof. Talis Putnins, Assoc. Prof. Eliza Wu, and Prof. Jonathan Brogaard. The four papers are titled:

1. “What moves stock prices? The role of news, noise, and information”;
2. “Noisy prices and capital allocation efficiency”;
3. “Time-varying gambling in stock markets and its effect on asset prices”;
4. “Stock markets as casinos: International evidence on the drivers and effects of gambling in stock markets”.

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# Table of Contents

|                                                                                                |           |
|------------------------------------------------------------------------------------------------|-----------|
| Statement of originality.....                                                                  | i         |
| Acknowledgements.....                                                                          | ii        |
| Preface.....                                                                                   | iii       |
| Table of Contents.....                                                                         | iv        |
| List of Figures.....                                                                           | vii       |
| List of Tables.....                                                                            | viii      |
| List of Abbreviations.....                                                                     | ix        |
| Abstract.....                                                                                  | x         |
| <b>Chapter 1: Introduction.....</b>                                                            | <b>1</b>  |
| 1.1 Research background and motivation.....                                                    | 1         |
| 1.1.1 Definition and forms of market efficiency.....                                           | 1         |
| 1.1.2 Tests for market efficiency: contentious evidence.....                                   | 2         |
| 1.1.3 Challenges to measuring stock market efficiency.....                                     | 4         |
| 1.1.4 The presence of noise in stock prices.....                                               | 6         |
| 1.1.5 Implications/effects of informational efficiency.....                                    | 6         |
| 1.2 Research scope and contributions.....                                                      | 7         |
| 1.3 Thesis outline.....                                                                        | 9         |
| <b>Chapter 2: Measuring the information and noise in prices.....</b>                           | <b>10</b> |
| 2.1 Introduction.....                                                                          | 10        |
| 2.2 Related literature.....                                                                    | 16        |
| 2.3 Empirical model for variance decomposition.....                                            | 17        |
| 2.3.1 Baseline variance decomposition model.....                                               | 18        |
| 2.3.2 Full sample estimates of variance components.....                                        | 27        |
| 2.3.3 Variance components through time.....                                                    | 30        |
| 2.3.4 Variance components in the cross-section of stocks.....                                  | 33        |
| 2.4 Further validation tests.....                                                              | 38        |
| 2.4.1 Exogenous shocks to tick sizes.....                                                      | 38        |
| 2.4.2 Exogenous shocks to analyst coverage.....                                                | 42        |
| 2.4.3 Relation between variance components and other measures of<br>information and noise..... | 45        |
| 2.5 Conclusion.....                                                                            | 48        |
| Appendix 2.A. Variable definitions.....                                                        | 50        |

|                                                                                     |           |
|-------------------------------------------------------------------------------------|-----------|
| Appendix 2.B. Effect of including the covariance between noise and information..... | 51        |
| <b>Chapter 3: The effects of noise on existing empirical models .....</b>           | <b>53</b> |
| 3.1 Introduction .....                                                              | 53        |
| 3.2 Related literature .....                                                        | 56        |
| 3.3 Theoretical model .....                                                         | 57        |
| 3.4 Extensions incorporating cash flow and discount rate news .....                 | 60        |
| 3.4.1 The standard approach to separating cash flow and discount rate news.....     | 61        |
| 3.4.2 Accounting for noise when separating cash flow and discount rate news.....    | 62        |
| 3.4.3 Extended variance decomposition.....                                          | 70        |
| 3.5 The empirical relation between R2 and the variance components .....             | 73        |
| 3.6 Conclusion.....                                                                 | 76        |
| Appendix 3.A. Variable definitions .....                                            | 78        |
| Appendix 3.B. Proofs.....                                                           | 80        |
| Appendix 3.C. Effect of including the covariance between noise and information..... | 84        |
| <b>Chapter 4: Noisy stock prices and capital allocation efficiency .....</b>        | <b>86</b> |
| 4.1 Introduction .....                                                              | 86        |
| 4.2 Related literature.....                                                         | 90        |
| 4.3 Sample, data, and key measures.....                                             | 91        |
| 4.3.1 Country sample selection .....                                                | 91        |
| 4.3.2 Data description.....                                                         | 91        |
| 4.3.3 Measures of noise and information in prices .....                             | 92        |
| 4.4 The impact of noise on firm-level investment efficiency .....                   | 92        |
| 4.4.1 Measuring firm-level investment efficiency.....                               | 93        |
| 4.4.2 Evidence from a long time-series of US data .....                             | 99        |
| 4.4.3 Evidence from the cross-section of countries .....                            | 103       |
| 4.5 The impact of noise on industry-level capital allocation efficiency .....       | 106       |
| 4.5.1 Measuring industry-level capital allocation efficiency .....                  | 106       |
| 4.5.2 Evidence from the cross-section of countries .....                            | 111       |
| 4.6 Robustness tests .....                                                          | 112       |
| 4.7 Conclusion.....                                                                 | 120       |
| Appendix 4.A. Data description.....                                                 | 122       |
| Appendix 4.B. Measures of information and noise in stock prices .....               | 124       |

|                                                                                                                                                                                                        |            |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------|
| Appendix 4.C. Variable definitions.....                                                                                                                                                                | 127        |
| <b>Chapter 5: How gambling in stock markets affects information and noise.....</b>                                                                                                                     | <b>129</b> |
| 5.1 Introduction .....                                                                                                                                                                                 | 129        |
| 5.2 Related literature.....                                                                                                                                                                            | 131        |
| 5.3 Data and measures .....                                                                                                                                                                            | 133        |
| 5.3.1 Sample and data sources .....                                                                                                                                                                    | 133        |
| 5.3.2 Measures of “casino” gambling.....                                                                                                                                                               | 134        |
| 5.3.3 Measures of stock market gambling .....                                                                                                                                                          | 135        |
| 5.4 How much gambling occurs in stock markets around the world?.....                                                                                                                                   | 145        |
| 5.5 What drives the level of gambling in stock markets and casinos? .....                                                                                                                              | 152        |
| 5.5.1 Country-level variables and hypotheses.....                                                                                                                                                      | 152        |
| 5.5.2 Estimating the determinants of gambling.....                                                                                                                                                     | 153        |
| 5.6 Are stock markets substitutes for casinos? .....                                                                                                                                                   | 157        |
| 5.7 How does gambling impact stock markets?.....                                                                                                                                                       | 163        |
| 5.8 Conclusion.....                                                                                                                                                                                    | 169        |
| Appendix 5.A. Data description .....                                                                                                                                                                   | 171        |
| Appendix 5.B. Variable construction.....                                                                                                                                                               | 173        |
| Appendix 5.C. Summary of variable definitions (further details are<br>provided in Appendix 5.B).....                                                                                                   | 178        |
| <b>Chapter 6: Conclusions.....</b>                                                                                                                                                                     | <b>179</b> |
| 6.1 What do the new measures of noise and information in stock prices<br>tell us about what drives stock price movements? .....                                                                        | 179        |
| 6.2 How have the levels of noise and information that are reflected in stock prices<br>changed through time as the structure of stock markets has evolved? .....                                       | 180        |
| 6.3 How does noise in stock prices affect inference in existing empirical<br>models? .....                                                                                                             | 181        |
| 6.4 What are the real effects of informational efficiency: how does noise in<br>stock prices affect the efficiency of corporate investment and capital<br>allocation across firms and industries?..... | 182        |
| 6.5 How does gambling in stock markets affect their liquidity, informational<br>efficiency, and noise?.....                                                                                            | 183        |
| 6.6 How much gambling occurs in stock markets and what drives the amount<br>of gambling?.....                                                                                                          | 183        |
| 6.7 Future research.....                                                                                                                                                                               | 184        |
| <b>References .....</b>                                                                                                                                                                                | <b>186</b> |

# List of Figures

|                                                                                                                      |     |
|----------------------------------------------------------------------------------------------------------------------|-----|
| Figure 2.1. R2 through time.....                                                                                     | 11  |
| Figure 2.2. Stock return components.....                                                                             | 19  |
| Figure 2.3. Stock return variance components for US stocks through time.....                                         | 31  |
| Figure 2.4. Variance components in size groups through time.....                                                     | 36  |
| Figure 2.5. Variance components in major industry groups through time.....                                           | 37  |
| Figure 3.1. Extension of variance decomposition to cash flow and<br>discount rate information .....                  | 64  |
| Figure 3.2. Cash flow news, discount rate news, and noise through time .....                                         | 68  |
| Figure 4.1. Investment- <i>Q</i> sensitivity by country.....                                                         | 97  |
| Figure 4.2. Investment- <i>Q</i> sensitivity by year.....                                                            | 98  |
| Figure 4.3. Elasticity of industry investment to value added by country.....                                         | 110 |
| Figure 5.1. Correlation between stock gambling and return of lottery-like stocks. ...                                | 140 |
| Figure 5.2. Relation between stock gambling and MAX-premium .....                                                    | 141 |
| Figure 5.3. Relation between quarterly stock gambling and HiTech Index<br>during the dot-com bubble (1997-2002)..... | 142 |
| Figure 5.4. Relation between changes in stock gambling and ASVI during<br>the period from 2004 to 2015. ....         | 144 |
| Figure 5.5. Gambling activity by country.....                                                                        | 148 |
| Figure 5.6. Gambling activity over time .....                                                                        | 151 |



# List of Tables

|                                                                                                                           |     |
|---------------------------------------------------------------------------------------------------------------------------|-----|
| Table 2.1. VAR coefficient estimates.....                                                                                 | 24  |
| Table 2.2. Stock return variance components in the baseline model.....                                                    | 28  |
| Table 2.3. Determinants of stock return variance components. ....                                                         | 34  |
| Table 2.4. Effect of the tick size on noise.....                                                                          | 40  |
| Table 2.5. Effect of analyst coverage on variance components. ....                                                        | 44  |
| Table 2.6. Relation between variance components and other measures of<br>information in prices. ....                      | 47  |
| Table 3.1. Stock return variance components in the extended decomposition model                                           | 72  |
| Table 3.2. Drivers of the trend in $R^2$ through time.....                                                                | 76  |
| Table 4.1. Summary statistics for the US sample .....                                                                     | 94  |
| Table 4.2. Investment- $Q$ sensitivity, information, and noise by country.....                                            | 95  |
| Table 4.3. US evidence on the relation between noise and firm-level<br>investment efficiency.....                         | 101 |
| Table 4.4. Cross-country evidence on the relation between noise and firm-level<br>investment efficiency.....              | 105 |
| Table 4.5. Industry investment growth, value added growth, and<br>investment-to-value-added elasticity .....              | 108 |
| Table 4.6. Cross-country evidence on the relation between noise and<br>industry-level capital allocation efficiency.....  | 112 |
| Table 4.7. Robustness tests for the US evidence on how noise impacts<br>firm-level investment efficiency.....             | 114 |
| Table 4.8. Robustness tests for the cross-country evidence on how noise<br>impacts firm-level investment efficiency ..... | 116 |
| Table 4.9. Robustness tests for the evidence of how noise impacts industry-level<br>capital allocation efficiency.....    | 118 |
| Table 5.1. Gambling and other country-level variables by country .....                                                    | 146 |
| Table 5.2. Determinants of “casino” gambling activity.....                                                                | 155 |
| Table 5.3. Determinants of stock market gambling activity .....                                                           | 156 |
| Table 5.4. Relation between “casino” gambling and stock market gambling (OLS<br>regressions).....                         | 159 |
| Table 5.5. Substitution between “casino” gambling and stock market gambling .....                                         | 162 |
| Table 5.6. Impact of stock market gambling on stock market liquidity and<br>efficiency.....                               | 166 |
| Table 5.7. Robustness tests for the impact of stock market gambling .....                                                 | 168 |

# List of Abbreviations

|       |                                                     |
|-------|-----------------------------------------------------|
| 2SLS  | Two-Stage Least Squares                             |
| AMEX  | American Stock Exchange                             |
| CRSP  | Center for Research in Security Prices              |
| ETF   | Exchange traded fund                                |
| EU    | European Union                                      |
| GBGC  | Global Betting Gaming Consultants                   |
| GDP   | Gross Domestic Product                              |
| IDV   | Individualism versus Collectivism                   |
| IV    | Instrumental Variable                               |
| IVR   | Indulgence versus Restraint                         |
| NYSE  | New York Stock Exchange                             |
| OLS   | Ordinary Least Squares                              |
| SEC   | Securities and Exchange Commission                  |
| SIC   | Standard Industrial Classification                  |
| SIRCA | Securities Industry Research Centre of Asia-Pacific |
| VAR   | Vector Auto-Regression                              |
| VMA   | Vector Moving Average                               |
| UAI   | Uncertainty Avoidance Index                         |
| US    | United States of America                            |

# Abstract

This thesis comprises four studies relating to stock market efficiency, its measurement, its effects, and its determinants.

The first study proposes novel empirical measures that separate different types of information and noise as drivers of stock return variance. Specifically, the new methods disentangle four components: market-wide information, private firm-specific information revealed through trading, firm-specific information revealed through public sources, and noise. Overall, in US stocks, 31% of the return variance is attributable to noise, 37% to public firm-specific information, 24% to private firm-specific information, and 8% to market-wide information. Since the mid-1990s, there has been a dramatic decline in noise and an increase in firm-specific information, consistent with increasing market efficiency.

The second study examines how noise affects inference in existing empirical measures, such as idiosyncratic volatility (one minus the  $R^2$  of a market model) and decompositions of cash flow and discount rate news. This thesis finds that after accounting for noise, cash flow information plays a considerably larger role in driving individual stock returns than previously believed and discount rate information plays a smaller role. Furthermore, the decrease in idiosyncratic volatility (increase of market model  $R^2$ ) since 1997 is the result of a decrease in noise during this recent period. The evidence indicates that the market has become more efficient in the past two decades, contrary to what is implied by standard interpretations of  $R^2$  as an inverse measure of efficiency.

In the third study, this thesis examines the real effects of stock market efficiency by analysing the relation between noise in stock prices and the efficiency of corporate investment and capital allocation at both the firm and industry levels. The analysis uses a long time-series of data from 1963, as well as a cross-section of 42 countries. Consistent with the notion that noise decreases investment efficiency, this research finds strong evidence that noise is negatively associated with the sensitivity of corporate investment to firms' growth opportunities and the sensitivity of industry-level investment to value added. These findings highlight the important real effects of

secondary market quality in determining firms' investment behaviour and the efficiency with which capital is allocated.

The fourth essay provides evidence on how individual investors' behaviour, in particular investors' gambling activity in stocks, affects stock market efficiency. We develop novel measures of the amount of gambling in stock markets based on the turnover differences between lottery stocks and non-lottery stocks, and validate the measure. Using a global sample, we examine how much gambling occurs in different countries, what determines these levels, and how the gambling that occurs on stock markets affects a country's capital markets. We find that culture and economic factors are all significant drivers of a country's gambling propensity in both traditional venues and stock markets. Interestingly, we find a substitution effect—restrictions/bans on traditional gambling lead to a spillover of gambling onto stock market(s). Exploiting regulation of traditional gambling as an instrument, we find that increased gambling on stock markets makes them more liquid and efficient. Our findings have implications for using gambling regulation as a policy instrument to affect financial market quality.

Collectively, these studies contribute to our understanding of market efficiency, how to measure it, what drives its variation through time and across stocks, and how it affects resource allocation across companies and sectors.