Trading activity and stock price volatility: evidence from the London Stock Exchange

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Abstract

Analysis of transactions data for the Financial Times Stock Exchange (FTSE-100) stock index on the London Stock Exchange (LSE) shows that trade frequency and average trade size impact price volatility for small trades (i.e. trades of one normal market size (NMS) or less). For large trades, only trade frequency affects price volatility. In further splitting small trades by relative size, trade frequency and average trade size are found to affect price volatility only for trades close to stocks’ maximum-guaranteed quoted depth. This evidence is consistent with microstructure models of dealer inventory adjustment and strategic behavior by informed traders, where dealers and uninformed traders face adverse selection costs.

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1. Introduction

\textit{Jones et al. (1994)} (JKL) reports a startling result concerning stock price volatility. After decomposing trading volume into two components, they find that the number of trades (trade frequency) is much more important than trade size in affecting stock price volatility. Their evidence is based on an examination of a large sample of Nasdaq stocks using daily data over the 1986–1991 period, and aggregated into equity capitalization quintiles. This evidence appears to run counter to the dominant market microstructure theories of stock price determination, which emphasize the role of trade size as a means of...