DO SMALL TRADES INFLUENCE THE INDIAN ADR PREMIUMS?

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dx.doi.org/10.18374/JABE-23-1.7

ABSTRACT

This paper explores the Indian ADRs that trade at a premium. The premiums, on average, have been significant during the sample period. Therefore, this paper examines whether the ADR premium is related to small trades. The findings suggest that small trade order imbalance, a proxy for small trades, significantly and positively influences the premiums. Small buy order imbalance continues to be associated with more significant Indian ADR premiums. The results hold on to the alternative set of premium and order imbalance. Consistent with the prior study, the ADR premium has a positive and significant relationship with S&P 500 and a negative association with VIX. However, currency risk and changes in liquidity cannot explain the ADR premiums.

Keywords: American Depositary Receipts (ADR), Premium, Small Trades, Order Imbalance

1. INTRODUCTION

The law of one price is the bedrock of financial economics that requires the price of identical goods or securities in different markets to be identical. The law principally works in an efficient market and applies to a wide range of securities. However, financial literature documents several violations of the law in financial markets. American Depositary Receipts (ADRs) often trade at premiums or discounts to their underlying shares is one the examples. Indian ADRs have shown to be trading at premiums during the first decade of the 2000s.

No arbitrage theory requires that ADRs and their underlying shares must trade at parity after adjustment of exchange rate and transaction cost if any. However, in the case of the Indian ADRs, Indian government regulations restrict arbitrage activities for ADRs, resulting in no arbitrage away for observed premiums. Poor correlation with home markets and price distortions can also create inefficiencies and arbitrage opportunities.

This paper examines the Indian ADRs to disentangle the premiums or discounts from the price of underlying shares. Specifically, it investigates whether small trades, as measured by small trade order imbalances in the ADRs, generate the observed price divergence between ADRs and their underlying shares. The primary motivation for this paper is to analyze small traders' behavior in the ADR markets. U.S. retail traders can diversify their portfolios via depositary receipts with international holdings that would otherwise be unavailable. Further, the increasing role of institutional investors in the financial markets has diminished the attraction for retail traders / investors.

A considerable body of literature on ADRs and their underlying shares addresses the price divergence issues. Aquino and Poshakwale (2006) note that ADR prices are affected by domestic and U.S. indices, innovations in the underlying security, and the exchange rate change. Gagnon and Karolyi (2010) find that the home country's economic development influences the ADR premiums or discounts, suggesting a higher price disparity between ADRs and underlying shares for less advanced economies. Further, The ADRs often contain home country inflation, interest, currency, political, and sovereign credit risks. U.S. investors likely have fewer concerns about the corporate governance of the ADRs issuing firms.

The ADR premium/discount issue is also related to another significant stream of research on the closed-end fund discount/premium puzzle. Several rational explanations have been offered in the literature to