

Decoding Leveraged Trading*

Zhuo Chen[†] Pengfei Li[‡] Zhengwei Wang[§] Bohui Zhang[¶]

First draft: March 2016

Abstract

We examine the informational role of leveraged trading. Using a unique Chinese sample of stock-level margin buying and short selling over the period from July 2010 to June 2015, we document that short selling predicts cross-sectional stock returns while margin buying has no cross-sectional prediction power. The time-series return prediction of margin buying is mechanically driven by the future increase in margin buying, which is not sustainable during the June 2015 Chinese stock market crash. Further evidence shows that margin buying activities are more likely to co-move across stocks, the intensity of margin buying is positively associated with contemporaneous investor sentiment, and the return predictability of margin buying is stronger during high-sentiment periods. Overall, the findings suggest that leverage is not a sufficient condition for informed trading.

JEL Classification: G10, G11, G23

Keywords: Leveraged trading, informed trading

*Preliminary and incomplete. Please do not circulate without permission. Comments welcomed.

[†]PBC School of Finance, Tsinghua University. Email: chenzh@pbcfs.tsinghua.edu.cn. Tel: +86-10-62781370.

[‡]School of Economics and Management, Tsinghua University. Email: lipf.13@sem.tsinghua.edu.cn.

[§]PBC School of Finance, Tsinghua University. Email: wangzhw@pbcfs.tsinghua.edu.cn. Tel: +86-10-62798760.

[¶]Australian School of Business, The University of New South Wales. Email: bohui.zhang@unsw.edu.au. Tel: +61-2-93855834. The authors thank Jianfeng Yu for helpful comments.