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Return Predictability and Complicated Countries

125.899 Research Report

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Requirements for the Degree of Master of Finance

Massey University, Albany, Auckland,
New Zealand

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Return Predictability and Complicated Countries

Abstract

Prices should instantly reflect information according to the efficient markets hypothesis (EMH). Hong and Stein (1999), however, suggest that the information processing environment will affect price discovery because of the gradual diffusion of information. This paper investigates the roles of information processing complexity in the price discovery process across countries. We hypothesise that the same piece of relevant macroeconomic information can be incorporated into stock prices at different speeds, depending on the complication of information environment in each country. The results show that returns for less complicated countries can predict future returns for more complicated countries with the out-of-sample R^2 's ranging from 3% to 14%. We find that the predictability induced by the complications in information processing is consistent at both group level and country level. Moreover, our results prevail after we control for regional effects.

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