

DOCTORAL THESIS

The performance of non-index individual stocks and stock portfolios relative to the index

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ABSTRACT

Extensive empirical evidence shows that passively managed index-tracking mutual funds and exchange-traded funds (ETFs) outperform actively managed portfolios. On the other hand, there are abundant findings that stocks admitted to an index outperform those deleted from the index. This study tests an issue that has been largely ignored in academic studies but is highly related to the above two seemingly disparate areas of researches. The paper examines the long-term performance of non-index individual stocks and stock portfolios relative to the index. The study proposes that the inclusion and maintenance criteria for index component stocks are long-term performance indicators. Therefore, an index can be regarded as a passively managed and highly diversified portfolio of expected outperformers. Using a complete set of H-shares listed on HKEx for the period 2001 to 2017, the study finds that 44.25% (55.75%) of individual stocks have positive alphas (negative alphas) relative to the index. The average alpha for the family of all non-index stock is negative but statistically insignificant, i.e., 77 positive alphas and 97 negative alphas. Most alphas are statistically insignificant, but only 5 are positive, and 2 are negative at 5% significance level. From the risk and return perspective, the index dominates two-third of the non-index H-shares. Regression analyses show that H-index outperforms non-index H-shares in general and the market capitalization and turnover ratio play an important role in determining the long-term performance of H-shares, which are the major factors for the admission and maintenance criteria of H-index. The findings strongly support our conjecture that the index admission and maintenance criteria are the quality assurance of individual constituent stocks of an index. The paper provides incremental evidence on the widely documented result that index trackers outperform actively managed portfolios. Nevertheless, the study extends the recent literature on the long-term performance of stocks that are admitted to (or excluded from) an index. The findings of the study have significant implications for securities markets participants, including index providers and ETF issuers.

TABLE OF CONTENTS

DECLARATION	i
ABSTRACT.....	ii
ACKNOWLEDGEMENTS.....	iii
TABLE OF CONTENTS.....	iv
LIST OF TABLES.....	vii
LIST OF FIGURES	ix
Chapter 1 Introduction	1
Chapter 2 Literature Review.....	3
2.1 Price Pressure Hypothesis	4
2.2 Imperfect Substitution Hypothesis	4
2.3 Information Hypothesis.....	5
2.4 Liquidity Hypothesis	6
2.5 Investor Awareness Hypothesis	7
2.6 Long-Term Performance of Added and Deleted Stocks	7
2.7 Performance of Index Funds and ETFs Versus Actively Managed Funds	9
2.8 Quality Factor Investing.....	10
2.8.1 Size	11
2.8.2 Liquidity	13
2.8.3 Profitability.....	16
2.8.4 Safety	17
Chapter 3 Research Gap and Major Hypotheses	18

3.1 Research Gap.....	18
3.2 Major Objectives	19
3.3 Hypotheses	19
Chapter 4 Data and Methodology.....	21
4.1 Data	21
4.1.1 H-shares	21
4.1.2 The Hang Seng China Enterprises Index.....	21
4.1.3 Eligibility and Maintenance Criteria of H-Index.....	27
4.1.4 Data Collection	27
4.2 Methodology	29
4.2.1 Non-index H-share Portfolios Construction.....	29
4.2.2 Correlation and Summary Statistics	30
4.2.3 Regression Analysis	32
Chapter 5 Empirical Findings and Interpretation	36
Chapter 6 Discussion	64
6.1 Theoretical Contributions.....	65
6.2 Managerial Implications.....	66
6.3 Limitations and Suggestions for Future Studies	67
Chapter 7 Conclusion.....	69
List of References	72
Appendix 1.....	77
Appendix 2.....	82
Appendix 3.....	93
Appendix 4.....	105

CURRICULUM VITAE..... 108