

Market Liquidity, Capitalization and the Random Walk Behavior of Stock Prices

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Abstract

Variance ratio based tests are applied to moving windows of weekly NYSE-AMEX market indices and the capitalization-based decile indices from July 1962 to September 2003. The graphical and regression analysis of test statistics and market indicators demonstrate that serial correlation in returns is inversely related to liquidity and size throughout most of the sample. Stock prices tend to converge towards random walk as market capitalization and liquidity increase. However, this relationship between market indicators and serial correlation in returns has weakened or, as in the case of large-capitalization deciles, been reversed during the internet bubble of late 1990s and 2000.

JEL classification: G10, G14.

Key words: Serial correlation in stock returns; Joint variance ratio tests; Market development; Market indicators.

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