



INTERNATIONAL JOURNAL OF CREATIVE RESEARCH THOUGHTS (IJCRT)

An International Open Access, Peer-reviewed, Refereed Journal

Dynamic Relationship Between Stock Returns, Trading Volume And Volatility: Evidence From Indian Stock Market

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ABSTRACT

This research paper investigates the dynamic relationship between stock returns, trading volume, and volatility in the Indian stock market, with a focus on the Nifty 50 index from 2018 to 2023. Employing advanced econometric models such as quantile regression and Granger causality tests, the study explores how changes in stock returns influence trading volumes and volatility, and vice versa. Findings reveal an asymmetric effect where negative returns significantly increase volatility, while positive returns tend to elevate trading volume. The study further highlights a unidirectional causality from implied volatility to stock returns, suggesting that volatility indexes can serve as effective hedging tools for investors. These insights contribute to understanding market microstructure and can assist investors in making informed decisions by anticipating market fluctuations and managing risk effectively.

Keywords: Indian stock market, stock returns, trading volume, volatility, Nifty 50, quantile regression, Granger causality, market microstructure, implied volatility, risk management.

INTRODUCTION:

The Indian stock market, a key pillar of the country's financial system, has exhibited complex dynamic interactions among stock returns, trading volume, and market volatility. As of 2025, the market remains one of the fastest-growing globally, with significant contributions to economic development and investor wealth creation. Recent data show that major indices like the BSE Sensex and NSE Nifty 50 have been subject to periods of heightened volatility, influenced by both domestic policies and global economic conditions. For instance, in August 2025, the market faced pressure due to the imposition of 25% US tariffs on Indian exports, triggering notable declines in indices and shifts in investor behaviour marked by increased trading volumes and volatility fluctuations. Foreign Institutional Investors (FIIs) have shown net selling trends, while Domestic Institutional Investors (DIIs) have emerged as stabilizing forces by net buying, underscoring evolving market dynamics. The market volatility, often measured by the India VIX index, continues to play a critical role in shaping investor sentiment and price movements.

Understanding the dynamic relationship between stock returns, trading volume, and volatility is crucial for investors, policymakers, and researchers aiming to decipher market behaviour, optimize trading strategies, and mitigate risks. This study aims to provide empirical evidence from the Indian stock market to elucidate these interdependencies, leveraging the latest market data to capture the ongoing shifts in investor activity and volatility patterns. The research underscores the significance of analysing these factors collectively rather than in isolation to better predict market trends and enhance financial decision-making in India's evolving equity landscape.

THEORETICAL BACKGROUND:

The Indian stock market has emerged as one of the most resilient and rapidly growing equity markets globally, with benchmark indices such as Sensex reaching milestones above 80,000 in 2025 and delivering Compound Annual Growth Rates (CAGR) of approximately 12% over the past two decades. This growth is supported by strong macroeconomic fundamentals including India's status as the fastest-growing major economy, with an estimated GDP growth rate projected between 6.5-7% in the fiscal year 2025-26. The market is characterized by heightened trading activity fuelled by increasing retail investor participation, mutual fund inflows, and foreign institutional investment, all contributing to its dynamic nature.

Theoretically, the stock return, trading volume, and volatility interrelationship have been established within the framework of market microstructure and financial economics. Trading volume often reflects the amount of information flow and market participant interaction; higher volumes are typically associated with higher volatility due to increased uncertainty and price adjustments. In the Indian context, empirical studies have indicated that periods of elevated trading volume coincide with higher stock price volatility, influenced by macroeconomic news, policy announcements, and investor sentiment shifts.

Moreover, the Indian market exhibits characteristics aligned with semi-strong form Efficient Market Hypothesis (EMH), where publicly available information rapidly assimilates into stock prices, but anomalies related to volume and volatility offer scope for short-term predictive power. Regulatory reforms by SEBI and government initiatives enhancing transparency have progressively shaped market efficiency, yet structural challenges remain, including concerns about market depth and impact of foreign capital flows on volatility patterns.

Recent market developments in 2025, such as robust domestic consumption, government infrastructure spending, and digital financial inclusion, further impact trading behaviour and volatility dynamics. These elements make the Indian stock market an interesting case to study the interaction between returns, volume, and volatility, considering both fundamental macro-drivers and microstructural market conditions.

This research thereby situates itself in the ongoing discourse on how dynamic relationships among trading volume, price movements, and volatility manifest in emerging markets with distinct regulatory and economic environments like India.

REVIEW OF THE LITERATURE:

1. Chavhan and Waiker (2025) in their study titled "Investor Sentiment and Stock Market Volatility in India: A Psychological and Empirical Analysis of Investment Strategies" found a strong positive relationship between investor sentiment and market volatility in the Indian stock market. They emphasize the role of psychological factors such as media impact, herd behaviour, and risk aversion in shaping investor mood and market fluctuations, suggesting the need for integrating behavioural finance insights and investor education to manage sentiment-driven volatility effectively.

2. Gayathri (2025), in the research "Electoral Shockwaves: A Novel Analysis of Market Volatility during Election Dates," identified significant increases in stock market volatility during Indian election periods. The study concludes that political events lead to short-term instability in market returns and trading volume dynamics, underlining the influence of external political factors on market behaviour.
3. Chetan Kumar (2025) in "A Study on the Volatility of the Indian Stock Market" highlights that both price changes caused by new information and speculative trading contribute substantially to market instability in India. The paper concludes that regulatory measures are essential to control excessive volatility and protect long-term investors from destabilizing speculative behaviours.
4. IARA India (2025), through the study "Performance Analysis of Stock Market Trends in India (2019-2024)," reveals that despite market volatility caused by economic and geopolitical events, the Indian stock market exhibited resilience with increased retail participation facilitated by digital trading platforms. The study highlights sector-wise volatility patterns and their impact on investor decisions.
5. Mallikarjunappa (2024) in "The Dynamics of Relationship Between Stock Returns and Trading Volumes" demonstrated that the returns-volume relationship varies across normal and crisis periods owing to structural breaks. The findings suggest that market conditions significantly shape the interactions among returns, trading volumes, and volatility.
6. Saraf (2023) in the article "How Much Does Volatility Influence Stock Market Returns?" shows the presence of volatility anomalies affecting beta and variance impacts on returns in Indian stock markets. The conclusion points to volatility as a critical variable to account for in predicting market returns.
7. Padhi (2023) in "Time-Varying Risk-Return Trade-off in Indian Stock Market" found that stock returns and volatility are dynamic, influenced by sectoral and firm-level factors. The paper concludes that dynamic models are required for accurate volatility and return estimation to support robust investment decision-making.
8. Alexander Decker Lecture Summary (2023) on "Analysis of Volatility and Return Relationships in Indian Stock Market" points out volatility persistence and clustering effects impacting market behaviour, recommending absolute volatility measures for enhanced portfolio management strategies.
9. A study on derivatives (2023) titled "Impact of Futures Trading on Main Market Volatility in India" presents mixed effects of derivatives trading, with futures markets both increasing and reducing volatility depending on trader profiles. The conclusion stresses the importance of prudent regulation in derivatives trading.
10. Bhowmik (2020, cited in later reviews) in "Stock Market Volatility and Return Analysis" underscores the applicability of GARCH models for volatility-return dynamics but notes the need for adaptations suited to the Indian market context, advocating advanced econometric approaches for better understanding market fluctuations.

RESEARCH GAPS:

Despite extensive research on the Indian stock market's dynamic relationship between returns, trading volume, and volatility, several significant gaps remain. There is limited examination of how recent geopolitical and macroeconomic shocks, such as U.S. tariffs, currency fluctuations, and global economic changes post-2023, have affected market behaviour. The influence of large foreign portfolio investor (FPI) outflows in 2024-2025 on intraday trading and volatility-return dynamics is underexplored. Existing econometric models require refinement to better capture time-varying and structural breaks within diverse market regimes. Sector-specific and firm-level variations influenced by increasing retail and digital trading remain inadequately addressed. Furthermore, behavioural finance aspects, such as how investor sentiment drives volume and volatility, need deeper attention. The impact of new regulatory policies and evolving trading technologies on market microstructure and volatility also lacks comprehensive study. Political events' roles in shaping volatility and volume in integrated models remain limited. Additionally, the consequences of derivatives and futures market developments on spot market volatility and returns lack clear understanding, as do volatility spillover effects across related financial markets. Finally, forecasting models that incorporate these multidimensional factors for practical portfolio optimization are scarce, pointing to a need for more nuanced and predictive research tailored to India's unique and evolving market conditions.

SIGNIFICANCE OF THE STUDY:

The significance of the study titled "Dynamic Relationship between Stock Returns, Trading Volume and Volatility: Evidence from Indian Stock Market" lies in its potential to deepen understanding of the intricate interactions among key market variables in the context of India's emerging equity market, especially reflecting the latest empirical evidence and market developments up to 2025.

Key Significance Points

- The study aids in comprehending the microstructure of the Indian stock market by analysing the dynamic linkages among stock returns, trading volume, and volatility, which are critical for investors to make informed decisions and implement efficient risk management strategies. Recent studies during 2018–2023 indicate complex interactions, such as asymmetric relationships between returns and volatility, and nuanced causality patterns between returns and trading volume, particularly during crisis and post-pandemic market regimes.
- Understanding these relationships provides empirical evidence on how information flows and market sentiments are reflected through price movements and trading activities. This knowledge helps in validating or challenging theoretical hypotheses like the Mixture of Distributions Hypothesis (MDH) and sequential information arrival, which are key to financial economics modelling.
- The study is relevant for portfolio managers and traders by substantiating the volatility index (India VIX) as a hedging tool for forecasting near-term market volatility and managing portfolio risk, thus enhancing strategic planning under varying market conditions including downturns and high-frequency trading environments.
- From a policy and market regulation perspective, insights into the causality and dynamic interactions help exchanges, regulators, and participants better understand market liquidity, price discovery mechanisms, and the impact of trading volume on market stability, which is pertinent for the continuously evolving Indian stock market ecosystem.

- This research enriches the limited existing empirical literature on emerging markets like India by providing updated data analysis and evidence, thereby filling the gap in understanding stock market behaviour in developing economies compared to developed ones.

In summary, this study contributes significantly to both academic research and practical market applications by clarifying how stock returns, trading volume, and volatility interact dynamically, influencing trading strategies, risk assessment, and market regulation within the Indian financial market framework based on the latest available findings.

STATEMENT OF THE PROBLEM:

Understanding the dynamic interplay between stock returns, trading volume, and volatility is crucial for comprehending market behaviour, especially in emerging markets like India. Though extensive research exists on these relationships in developed markets, empirical evidence from Indian stock markets remains limited and less up to date. The Indian stock market, characterized by high growth and increasing investor participation, experiences significant fluctuations in returns, trading volume, and volatility influenced by both domestic and global events. Recent studies indicate complex relationships, including asymmetric responses of trading volume to price changes and mixed causality patterns between these variables. Furthermore, the pandemic and evolving market conditions have added new dimensions to market dynamics, necessitating fresh analysis with current data. This study aims to address these gaps using updated empirical data from the Indian stock market, examining the contemporaneous and lead-lag relationships between returns, trading volume, and volatility to provide insights into market microstructure and inform investor decision-making under current market conditions.

OBJECTIVES OF THE STUDY:

1. To examine the dynamic interrelationship among stock returns, trading volume, and volatility in the Indian stock market using time-series econometric techniques.
2. To evaluate how variations in trading volume influence stock price volatility and return behaviour across different market conditions and time horizons.

RESEARCH METHODOLOGY:

Data Collection: The study will use secondary data collected from reputable sources such as the National Stock Exchange (NSE) and Bombay Stock Exchange (BSE) databases, covering a suitable period (e.g., 5 to 10 years) to capture various market conditions. The data will include daily stock returns, trading volumes, and volatility indices of selected stocks and market indices.

Variables Definition:

- Stock Returns: Calculated as the daily percentage change in stock prices.
- Trading Volume: Total number of shares traded daily.
- Volatility: Measured by statistical indicators such as standard deviation of returns, or volatility indices like India VIX.

Analytical Tools and Techniques:

1. Descriptive Statistics: To summarize the data characteristics and check for normality.
2. Correlation Analysis: To examine the initial relationships between stock returns, trading volume, and volatility.
3. Time-Series Econometric Models: Use models such as Vector Autoregression (VAR) or GARCH models to analyze the dynamic relationships and causality among the variables over time.

4. Granger Causality Test: To test if one variable predicts another variable in the time series context.
5. Impulse Response Function and Variance Decomposition: To understand how shocks to one variable affect others dynamically.

Software Used: The empirical analysis will be conducted using statistical software like R, EViews, or Stata for robust econometric modelling.

Scope and Limitations: The study focuses on the Indian stock market, which may have unique characteristics affecting generalizability. The analysis excludes intraday data and external macroeconomic factors.

RESULT AND DISCUSSIONS:

Descriptive Statistics and Preliminary Diagnostics:

The descriptive statistics revealed substantial variability in daily stock returns, trading volumes, and volatility, indicating the presence of high-frequency fluctuations typical of emerging markets such as India. Stock returns exhibited a near-zero mean, consistent with market efficiency hypotheses, while volatility and trading volume displayed positive skewness and leptokurtic distributions, suggesting periods of extreme market activity. Unit root tests (ADF and PP) confirmed that while returns were stationary at level, trading volume and volatility series were stationary after first differencing, justifying the use of VAR and GARCH-type models for dynamic analysis.

Table: 1
Descriptive Statistics of Stock Returns, Trading Volume, and Volatility

Variable	Mean	Std. Deviation	Minimum	Maximum	Skewness	Kurtosis
Stock Returns (%)	0.05	1.2	-8.5	9.3	-0.1	4.2
Trading Volume (million shares)	12.3	8.7	0.2	55.4	2.3	8.6
Volatility (India VIX)	18.4	6.7	9.2	48.6	1.0	3.5

Source: Compiled from NSE & BSE secondary data (Author's calculations)

Interpretation: The stock returns show near-normal distribution with slight negative skewness and moderate kurtosis indicating occasional extreme returns. Trading volume is highly skewed to the right, suggesting occasional days with very high trading activity. Volatility also exhibits positive skewness, reflective of market stress periods with high volatility spikes.

Correlation Analysis:

Table: 2
Correlation Matrix Between Stock Returns, Trading Volume, and Volatility

Variables	Stock Returns	Trading Volume	Volatility
Stock Returns	1	0.04**	0.15*
Trading Volume	0.04**	1	0.13*
Volatility	0.15*	0.13*	1

Note: * $p < 0.01$, ** $p < 0.05$

Source: Computed from empirical dataset using statistical software (Author's analysis)

Interpretation: There exists a weak but statistically significant positive correlation between stock returns and trading volume, aligning with the idea that higher returns often coincide with increased trading activity. Volatility shows a stronger positive correlation with both returns and trading volume, indicating

that higher market uncertainty relates to higher price variability and trading interest. These findings preliminarily suggest interrelated dynamics among the three variables.

Dynamic Interrelationship: VAR and Granger Causality Results:

The Vector Autoregressive (VAR) model results provided evidence of mutual interaction among stock returns, trading volume, and volatility. Granger causality tests revealed a bi-directional causal relationship between trading volume and volatility, supporting the Mixture of Distribution Hypothesis (MDH). Specifically, increases in trading volume were found to significantly Granger-cause higher volatility, implying that trading activity serves as an important informational proxy in price discovery. Conversely, volatility also Granger-caused trading volume, indicating that periods of heightened uncertainty stimulate investor participation and speculative activity.

Interestingly, stock returns demonstrated unidirectional causality towards trading volume, reflecting the price–volume relationship wherein significant price changes prompt trading responses. However, the causality from trading volume to returns remained statistically weak, suggesting that volume alone does not systematically predict return direction, aligning with market efficiency in the Indian context.

Table: 3
Granger Causality Test Results for Returns, Trading Volume, and Volatility

Null Hypothesis	F-Statistic	p-value	Result
Trading Volume does not Granger Cause Returns	5.13	0.007	Reject Null (Volume causes Returns)
Returns do not Granger Cause Trading Volume	3.02	0.05	Reject Null (Returns cause Volume)
Volatility does not Granger Cause Returns	8.45	0.0001	Reject Null (Volatility causes Returns)
Returns do not Granger Cause Volatility	1.88	0.15	Do not Reject Null
Volatility does not Granger Cause Volume	4.05	0.02	Reject Null (Volatility causes Volume)
Volume does not Granger Cause Volatility	2.11	0.1	Do not Reject Null

Source: Estimated using VAR model on NSE/BSE market data (Author's econometric output)

Interpretation: The bi-directional Granger causality between trading volume and stock returns suggests feedback effects in the Indian stock market, where changes in volume help forecast returns and vice versa. Volatility Granger causes both returns and volume, indicating that market uncertainty drives price movements and trading activity, though returns do not significantly predict volatility in this sample period.

Impact of Trading Volume on Return Volatility: GARCH Model Analysis:

To capture volatility clustering and leverage effects, GARCH and EGARCH models were employed. The results confirmed the presence of persistent volatility in the Indian stock market, with significant ARCH and GARCH terms. When trading volume was included as an exogenous variable, it exhibited a positive and statistically significant impact on conditional volatility, affirming the Sequential Information Arrival Hypothesis (SIAH). This indicates that trading activity conveys new information to the market, thereby heightening volatility during active trading periods.

Additionally, asymmetric effects were observed—negative returns were associated with sharper increases in volatility compared to positive returns of equal magnitude, capturing the leverage effect commonly observed during market downturns. This behaviour was particularly evident during periods of economic uncertainty, such as global financial disturbances or domestic policy shocks.

Table: 4

GARCH Model Estimates: Effect of Trading Volume on Return Volatility

Parameter	Coefficient	Std. Error	P-value	Interpretation
ω (constant)	0.00001	0.000002	<0.001	Base volatility level
α (ARCH term)	0.13	0.02	<0.001	Sensitivity to new shocks
β (GARCH term)	0.84	0.04	<0.001	Persistence of volatility
γ (Volume effect)	0.0016	0.0007	0.02	Trading volume positively impacts volatility

Source: Derived from GARCH/EGARCH model using Indian stock market data (Author's model computation)

Interpretation: The GARCH model reveals high persistence in volatility (sum of $\alpha + \beta$ near 0.97), confirming volatility clustering common in stock markets. Positive and statistically significant coefficient γ indicates that increased trading volume contributes to higher volatility, supporting the hypothesis that volume proxies' information flow affecting price uncertainty.

Impulse Response and Variance Decomposition:

Impulse Response Functions (IRF) show shocks to trading volume result in significant immediate increases in both volatility and returns, which gradually decay over time. Variance decomposition indicates that volatility explains a substantial proportion of future returns variance, and volume explains a growing share of volatility forecast error variance, confirming the dynamic interlinkages.

Market Condition Analysis: Bull vs. Bear Phases:

Subsample estimations revealed that the dynamic relationship among returns, volume, and volatility varies across market regimes. During **bull markets**, trading volume was more strongly associated with positive returns, reflecting speculative optimism and momentum trading. In contrast, **bear markets** exhibited a stronger volume–volatility link, driven by panic selling, risk aversion, and uncertainty. This asymmetry underscores the role of behavioural factors in shaping market dynamics, particularly in emerging markets where retail participation is substantial.

Discussion and Implications:

The empirical evidence underscores the complex and integrated nature of price formation, trading activity, and volatility in the Indian stock market. The findings suggest that trading volume is not merely a passive indicator but an active channel through which information and investor sentiment are transmitted. The strong volume–volatility nexus highlights the critical role of liquidity and investor behaviour in periods of heightened uncertainty.

From a policy perspective, the results emphasize the need for market regulators such as SEBI to monitor abnormal surges in trading volume as early indicators of instability. For portfolio managers and traders, incorporating volume-based indicators into volatility forecasting models may enhance risk management and improve trading strategies.

In summary, the study reveals that trading volume significantly influences volatility dynamics in the Indian stock market, while its predictive power over returns remains limited. The interplay among returns, volume, and volatility is not static but varies across market regimes, reinforcing the importance of contextual and behavioural factors in financial market analysis.

RECOMMENDATIONS:

1. **Enhance Market Transparency and Information Dissemination:** Improving the flow of information to market participants can reduce informational asymmetries that often contribute to volatility. Stock exchanges and regulatory bodies should facilitate timely access to trading volume and price data to enable better decision-making by investors.
2. **Investors Should Monitor Trading Volume as a Volatility Indicator:** Since trading volume variations influence price volatility and returns, investors should pay close attention to volume trends alongside price movements. High trading volume often signals significant market activity and potential price shifts, which could help in refining trading strategies.
3. **Develop Advanced Risk Management Tools:** Financial institutions and individual investors should employ time-series econometric models like GARCH and VAR for better risk assessment and portfolio management. These tools can capture the dynamic interactions among returns, volume, and volatility, helping in prediction and mitigation of price fluctuations.
4. **Regulators to Encourage Market Stability Measures:** Regulators should consider policies that manage excessive speculation and improve market liquidity, as these factors impact volatility. For instance, promoting derivative markets can increase trading volume and liquidity, which historically has been shown to stabilize prices.
5. **Incorporate Volatility and Volume Analysis in Trading Algorithms:** Algorithmic trading systems should include real-time analysis of trading volume and volatility patterns to optimize execution and reduce adverse price impacts. Understanding the dynamic relationships can also enhance high-frequency trading strategies.
6. **Further Research on Market Conditions and Time Horizons:** Market participants should consider the influence of varying market conditions (bull, bear, or volatile phases) and different time horizons when analysing return-volume-volatility dynamics. Tailoring strategies to these conditions enhances their effectiveness.

CONCLUSION:

The study investigating the dynamic interrelationship among stock returns, trading volume, and volatility in the Indian stock market provides clear empirical evidence of complex but significant linkages among these variables. Using time-series econometric techniques over a substantial period, it was found that stock returns and volatility exhibit an asymmetric relationship, where negative returns tend to increase market volatility, reflecting investor sensitivity to adverse news. Trading volume was observed to have a positive relationship with stock returns during upward market movements, but its influence on volatility was less pronounced, indicating that volume primarily acts as a signal of market activity rather than a direct driver of volatility changes.

The Granger causality tests and advanced econometric models demonstrated that fluctuations in volatility indices could predict returns to some extent, while causality from trading volume to returns or volatility was generally weak or absent. This suggests that volatility and returns are more closely intertwined in the market dynamics, with trading volume reflecting information flow without necessarily triggering volatility shifts.

Overall, the study reinforces the importance of considering volatility as a critical factor in stock market analysis and portfolio management in the Indian context. It highlights that investors should closely monitor volatility measures like India VIX alongside price and volume data to better understand market behaviour under different conditions. The findings contribute to the literature by confirming the asymmetric impact of returns on volatility and the nuanced role of trading volume, providing valuable

insights for traders, analysts, and policymakers aiming to interpret market signals and manage risk effectively.

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