

CORE DISCUSSION PAPER
2005/8

**A MARKET MICROSTRUCTURE RATIONALE
FOR THE S&P GAME**

Paolo COLLA¹

February 2005

Abstract

We develop a dynamic trading game in which fundamental insiders co-exist with non-fundamental speculators. Non-fundamental speculators possess superior information about the future noise trades and are able to make sharper inference about the fundamental value with respect to the market maker. We show that non-fundamental speculators decrease market depth as well as the insider's ex-ante gains. We study inclusions in the S&P 500 after October 1989 as an example in which non-fundamental speculation may arise due to the preannouncement practice in index replacements. Evidence on the trading activity and the bid-ask spread pattern is consistent with our theoretical analysis.

¹CORE, Université catholique de Louvain, Belgium. E-mail: colla@core.ucl.ac.be

I thank Helena Beltran, Andrea Beltratti, Markus Brunnermeier, Antonio Mele, Jean-Charles Rochet, Paolo Vitale and seminar participants at the FMG and CORE for helpful comments. Financial support from the Bank of Italy, Ente 'L. Einaudi', FMG and LSE is gratefully acknowledged. All errors remain mine.

This paper presents research results of the Belgian Program on Interuniversity Poles of Attraction initiated by the Belgian State, Prime Minister's Office, Science Policy Programming. The scientific responsibility is assumed by the author.