Limits to Arbitrage and Shareholder Gains in Corporate Acquisitions *

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Abstract

The literature on corporate acquisitions reports a persistent empirical regularity: acquisition announcements by small bidders greater shareholder value than those by large bidders. The evidence presented in this paper is consistent with the hypothesis that greater shareholder gains to small bidders' announcements reflect temporary mispricing arising from differential limits to arbitrage. Acquisitions announced by high-idiosyncratic volatility bidders generate significantly greater positive abnormal returns in value-creating acquisitions and significantly more negative abnormal returns in value-destroying acquisitions, regardless of firm size. Larger price movements are associated with greater abnormal trading volume indicating stronger temporary price pressure. Post-event return reversals show an asymmetric pattern: the market initially overreacts to the positive news in value-creating acquisitions, but underreacts to the negative news in value-destroying acquisitions. The evidence is inconsistent with the hypothesis that the size effect arises from overpayment for the target, or lower post-merger synergies.