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Insider trading and stock prices

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ABSTRACT

We examine the informational content of insider trades and its value to market investors using a US dataset. Overall, our results support the view that insider actions have positive predictive power for future returns. However, these results may come with some caveats. First, it is not the actions of all insiders (directors, officers and large shareholders) that have predictive power for future returns, but typically only those of directors and officers (senior management). Second, while director actions have predictive power for firm of all sizes, officers only have predictive power for small firms. The signal emanating from buys is stronger than the signal emanating from sells. Finally, the trading actions of directors, and to a lesser extent, officers have significant effects on the trading behaviour of other groups of insiders.
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1. Introduction

In this paper, we examine the informational content of insider trades and its value to market investors. The demand for credible yet lawful information that could assist investors in beating market averages is enormous, as typified by, for example, a number of data vendors, such as CDA/Investnet, who use insiders' trades to predict returns, for institutional and individual investors (Lakonishok & Lee, 2001). Moreover, one of the best known signalling theories is the insider trading of corporate management team.

However, there remains uncertainty as to the predictive content of insider trading. Thus, the motivations for this paper are several. First, it contributes to and extends the existing literature by re-considering the predictive content of insider buy and sells across four different categories of insider trader using a new dataset that covers a more recent time period than previously considered. In particular, the dataset considered here extends over the period from 2000 to 2007 and thus takes in the bear market of the early 2000s and the market recovery that extended from 2003. Previous studies have typically not included large bear market periods such as the early 1970s or in 1987 (one exception would be Lakonishok & Lee, 2001). Thus, at the very least, this paper will serve as a check on previous results, but also extends the weight of the information set in regard to whether insider information has predictive power by considering a sample that incorporates both bull and bear markets. Furthermore, the dataset covers periods marked by both economic expansion and contraction and thus implicitly considers whether insiders can predict the state of the economy, the future prospects of their firm and signal this ability through their own trading. Utilising such a data set, we believe, helps provide a robust conclusion.

Moreover, we consider the actions of four groups of insiders and, distinct from the majority of the literature, we split management into directors and senior management. In general we believe that the majority of meaningful insider trading will come from

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these groups and whereas the existing literature tends to have a single management category (e.g., Lakonishok & Lee, 2001), splitting them may provide greater insight. Hence, a second motivation is that while the management group may have the similar levels and type of information, their trading behaviour may not be the same indicating a hierarchy of information content. Additionally and third, we can examine whether insider actions are, in part, themselves conditioned by the actions of other insider groups. We also, and fourth, examine the effects based on firm size and whether the insider actions are buy or sell and whether the actions of insiders are affected by past returns. This latter issue has not been typically considered in the previous work (in partial exception Iqbal and Shetty, 2002 and Chowdhury, Howe, and Lin, 1993 consider VAR estimation to test for Granger causality between returns and insider actions).

The rationale for the use of insider information is that managers know more about their companies than any outsider, including Wall Street analysts and as such investors could benefit from observing the behaviour of insiders. Studies of managerial decisions suggest that insiders are better informed about their companies' prospects and that the market is slow in adjusting to managerial signals.[3] Prior US based research has examined the relationship between insider trading and the subsequent behaviour of share returns (Finnerty, 1976; Jaffe, 1974; Jeng, Metrick, & Zeckhauser, 2003; Lakonishok & Lee, 2001; Lin & Howe, 1990; Lorie & Niederhoffer, 1968; Penman, 1982; Rozeff & Zaman, 1998; Seyhun, 1986; Seyhun, 1988). Moreover, insider active trading could suggest features of over-confidence (Kumar, 2009), which in turn could provide confidence for others (Givoly & Palmon, 1985). Furthermore, given their privileged information the trading patterns of these individuals are considered to be different from the normal individual (noise) traders (Fidrmuc, Goergen, & Renneboog, 2006; Kaniel, Saar, & Titman, 2008; Kyle, 1985).

The evidence from this body of work appears to suggest that there is information content in corporate insider trading strategies using private information to earn abnormal returns (Carter, Mansi, & Reeb, 2003). Furthermore, it also suggests that the average investor can make an abnormal return by simply observing the trading behaviour of certain directors and managers of the firms they manage. In addition, it is argued that that nature of any link between insider activity and returns can depend on whether the insiders buy or sell. This is because while an insider buy can convey positive and thus favourable information on the firm's prospects, it is less clear about the information content of an insider sell as it may represent either unfavourable information about the firm's prospects or it could simply be to meet the liquidity needs of the insider (Fidrmuc et al., 2006). Nonetheless, this positive finding is not universal. Eckbo and Smith (1998) report that the insiders of firms listed on the Oslo Stock Exchange do not earn abnormal profits. While, Chakravarty and McConnell (1999) found that there were no distinguishable price effects between a confessed insider trader, Ivan Boesky, in Carnation's stock in 1984 prior to Nestlé's acquisition of Carnation and that of non-insider.

In line with previous studies (Iqbal & Shetty, 2002; Lakonishok & Lee, 2001) in order to address the issues outlined above, this paper examines whether there exists a time-series relationship, and in particular, whether there exists predictive power, between insider transactions and stock returns over the period 2000–2007. Moreover, as in Iqbal and Shetty (2002), it is assumed that the time series relationship between insider transactions and stock returns will reveal any firm-specific information without needing to examine any corporate events. Thus, we will test for the existence of a positive relationship between insider transactions and subsequent stock returns. Such a relationship will show that insiders purchase (sell) before stock prices rise (decrease). Moreover, we will consider whether there exists a negative association between stock returns and subsequent insider transactions, which would indicate that insiders sell (purchase) after stock prices rise (decrease).

In addition, as noted by Seyhun (1988), there is a belief that firm size is important, thus, we consider the effects of insider trades on return by size. Further, we consider the separate influence of buy and sell signals. As noted above, it is believed that buy signals may carry more information than sells. Finally, we consider whether the actions of one group of insiders affect the actions of another group of insiders. Of note, Fidrmuc et al. (2006) argued that the actions of directors and officers (senior managers) have predictive power for not only future returns, but also for the behaviour of other insiders.

2. Brief review of past literature and motivation

Several studies have shown that insiders can use privileged insider information for their personal gain. Seyhun and Bradley (1997) presented evidence that insiders sold shares of their firms before filing for bankruptcy and bought after prices had fallen. Other studies have presented evidence that insiders are able to strategically trade their own shares to earn abnormal returns around major corporate announcements or events such as new issue announcements (Karpoff & Lee, 1991), stock repurchases (Lee, Mikkelson, & Partch, 1992), dividend announcements (Cheng, Davidson, & Leung, 2011; John & Lang, 1991), listing and delisting (Lamba & Khan, 1999), takeover announcements (Seyhun, 1990), and the event itself (Ma, Sun, & Tang, 2009; Rozeff & Zaman, 1998; Seyhun, 1986; Seyhun, 1992). These studies observe positive returns following insider purchases and negative returns following sales. Also, negative returns precede purchases and positive returns precede sales.

It is also suggested that insiders, in aggregate, are able to predict market movements and thus able to time the market (Lakonishok & Lee, 2001; Seyhun, 1988). Hence, when insiders are optimistic, markets tend to do well and when they are pessimistic, markets tend to do poorly. Insiders also predict aggregate movements of small companies better than of large companies.

[3] For example, Ikenberry, Lakonishok, and Vermaelen (1995) found evidence of abnormal returns upon companies announcement of their share repurchases, as insiders perceive this as undervalued shares.

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