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Do insider trades reflect both contrarian beliefs and superior knowledge about future cash flow realizations? ☆

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Abstract

This paper documents that insiders are both contrarians and possessors of superior information. We find that insider trades are positively related to the firm's future earnings performance (proxy for superior cash flow information), positively related to the firm's book-to-market ratio and inversely related to recent returns (proxies for trading against misvaluation). Each relation has incremental explanatory power, yet information about future cash flow changes explains a smaller portion of insider purchases than do proxies for security misvaluation. The relation between insider trades and future earnings performance is amplified (attenuated) as the benefits (costs) to trading on financial performance information increase.

JEL classification: M41; G14; G28

Keywords: Insider trading; Contrarian beliefs; Book-to-market ratios; Earnings; Capital markets

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1. Introduction

This paper documents that insider trades reflect both contrarian beliefs and superior information about future cash flow realizations. Prior research shows that insider trading activity generates abnormal returns (Jaffe, 1974; Givoly and Palmon, 1985; Seyhun, 1986; Rozeff and Zaman, 1988). Insiders can earn excess profit by either recognizing pricing errors made by outsiders or by having superior knowledge about future cash flow realizations. In the former case, insiders trade against current investor sentiment, recognizing that outsiders make valuation errors through the application of inferior valuation models and/or the incorporation of biased judgements. In the latter case, managers have private information about the pattern of future cash flows. Because prices respond to unexpected changes in cash flow, insiders trade when their private knowledge of future performance and payoffs differs from current market expectations. In both settings, insider trades help push prices towards fundamental value.

Prior research supports the hypothesis that insiders are contrarian traders. Seyhun (1992) shows that insiders are more likely to sell (purchase) shares following periods of significant price appreciation (declines), consistent with insiders trading in anticipation of subsequent price reversals. Rozeff and Zaman (1998) show that insiders predominantly buy (sell) shares in value (glamour) firms and interpret this as evidence of insiders trading against the market's over-reaction to past performance. Such trading behavior is consistent with insiders purchasing (selling) securities with high (low) expected returns or the greatest amount of undervaluation (over-valuation) (e.g., Fama and French, 1992; Lakonishok et al., 1994).

Past research, however, does not disentangle the source of insiders' superior trading performance. Rozeff and Zaman (1998)'s pattern of trading across book-to-market portfolios could reflect insiders trading on market pricing errors (e.g., over-reaction to past performance), but it could also reflect insiders' superior knowledge of future earnings performance. For example, LaPorta et al. (1997) show that, on average, value (growth) firms tend to have positive (negative) future earnings announcement period returns. Because earnings announcement returns tend to be correlated with actual changes in performance, Rozeff and Zaman's findings do not differentiate trading on the basis of contrarian beliefs from trading on the basis of superior information about future cash flows.

Prior research has also examined whether insiders trade on the basis of superior future cash flow information. The strongest evidence is found in Ke et al. (2003); they examine insider-trading patterns in advance of a break in quarterly earnings increases and find insider sales increase three to nine quarters before the earnings break. The authors conclude that insiders trade ahead of earnings breaks, but do so several quarters ahead of the break in order to avoid the appearance of trading on near-term, material news about earnings. Similarly, Elliot et al. (1984) find evidence that insiders increase (decrease) purchases (sales) in the 12 months before extreme earnings increases. However, the paper finds little evidence that insiders sell in advance of extreme earnings decreases, dividend changes or bond rating changes. In contrast, studies focusing on insider trading around short-window information