Are All Individual Investors Created Equal? Evidence from Individual Investor Trading around Securities Litigation Events

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Abstract

This study examines the trading behavior of individual (retail) investors around securities litigation disclosure events. We hypothesize and find that less informed investors (low-income investors and investors in non-professional occupations) purchase earlier in the class period relative to more informed investors who tend to sell later in the class period. We also find that more informed investors achieve higher returns, or at least incur fewer losses, than less informed investors during the class period. Less informed investors are, therefore, more likely to suffer greater class action damages than more informed investors from their presumed reliance on allegedly false information.

JEL Classifications: G14, G15, K22, K41

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1. Introduction

This study examines the trading of individual investors in response to disclosures about securities class action litigation. We test hypotheses about the purchase and sale of stocks by individual (retail) investors around the start and end of the litigation class period.[1] In particular, we examine how different categories of individual investors trade when allegedly false information is introduced into the market and, later, corrected as a curative disclosure and, more specifically, whether some investors (e.g., more informed investors) are able to spot false information earlier than others (e.g., less informed investors), thereby potentially cutting their losses prior to the curative disclosure.

This topic is important for at least two reasons. First, we build upon a developing literature on variation in stock market response to litigation events across different categories of investors. This literature, thus far, has focused mostly on the responses of professionals such as securities analysts, short sellers and corporate insiders to litigation and related events. One result is that some groups (e.g., short sellers, certain institutional investors) are more astute than others (e.g., financial analysts) in predicting the accounting conditions that might lead to a restatement or an allegation of securities fraud (section 2 reviews the literature). Differences in incentives across these groups with respect to adverse information, however, may evince this result. This provides a second reason for our study, in that differences in incentives should have less influence within a retail investor sample than across different professional groups. By examining the trading responses of individuals to litigation events, we are able to ascertain whether some results that hold for professional investors also hold for individual investors.

We focus on a single class of disclosures, litigation disclosures and not disclosures in general, because litigation disclosures typically have reasonably similar and, mostly, significant adverse consequences for the named company. These can reflect claims of substantial out-of-pocket damages by investors who have allegedly suffered losses (e.g., *In re Cendant*, 2000). Yet, such consequences can be difficult to predict *ex ante*.[2] A litigation disclosure setting, in our view, increases the chances, relative to disclosures in general, that certain categories of individual investors, such as more informed or less informed investors, might respond differently. We focus on litigation disclosures, also, because by their nature they are infrequent events for a company not subject to regular forecasting or updating by analysts and managers as is the case with earnings.

Our study also pertains to the behavioral notion that some investors realize their losses reluctantly (the disposition effect) (Odean, 1998; Feng and Seasholes, 2005; Dhar and Zhu, 2006). Differences in the response of individual investors to the correction of heretofore allegedly false positive information may offer further clues about this behavioral effect.

[1] The class action litigation events in this study comprise only those that allege violations under Section 10b-5 of the Securities Exchange Act of 1934. These suits typically allege that certain false disclosures made by a company and/or its officers over a specified period, known as the litigation class period, misinformed those who purchased or sold the stock and caused them to incur financial damages.

[2] Such a prediction, for example, would involve judgments about whether certain prior disclosures were potentially false or misleading, whether a corrective disclosure would be made and whether such a corrective disclosure would trigger securities litigation leading to an adverse judicial outcome (e.g., settlement).