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"Swimming Ducks Forecast the Coming of Spring"—The predictability of aggregate insider trading on future market returns in the Chinese market

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ABSTRACT

This study systematically examines the ability of aggregate insider trading to predict future market returns in the Chinese A-share market. After controlling for the contrarian investment strategy, aggregate executive (large shareholder) trading conducted over the past six months can predict 66% (72.7%) of market returns twelve months in advance. Aggregate insider trading predicts future market returns very accurately and is stronger for insiders who have a greater information advantage (e.g., executives and controlling shareholders). Corporate governance also affects the predictability of insider trading. The predictability of executive trading is weakest in central state-owned companies, probably because the "quasi-official" status of the executives in those companies effectively curbs their incentives to benefit from insider trading. The predictive power of large shareholder trading in private-owned companies is higher than that in state-owned companies, probably due to their stronger profit motivation and higher involvement in business operations. This study complements the literature by examining an emerging market and investigating how the institutional context and corporate governance affect insider trading.
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1. Introduction

Insiders include a company's corporate officers, directors, supervisors (all referred to as "executives" hereafter) and large shareholders (those with ownership of 5% or more of the company's stock). Insider trading based on a superior information advantage can influence the efficiency and fairness of the financial market, and thus presents a thorny regulatory challenge.

When the Chinese A-share market was initially established, it had a dual share structure comprising tradable and non-tradable shares. Shares owned by large shareholders and executives were basically non-tradable as they were prohibited from being traded on the secondary stock market. As such, insider trading was very rare at that time. Since the end of 2005, with the market reform of non-tradable shares, market segmentation between tradable and non-tradable shares has been gradually removed. To mitigate the supply pressure on the secondary market, the reform prevented non-tradable shares from being sold immediately, and instituted a lock-up period of one to three years. Some locked-up shares have been "lifted" since the beginning of 2007. By the end of 2011, almost all of the non-tradable shares became tradable and insiders began to trade their stocks more frequently, a new occurrence that has attracted a lot of attention. The A-share market is still emerging and its efficiency requires improvement. The quality of its corporate information disclosure is generally not high, its information intermediaries (analysts) have yet to mature and the information asymmetry between insiders and outsiders is still relatively large. These limitations have undoubtedly provided insiders with more trading opportunities. Furthermore, a regulatory system has not yet been developed, making insider trading a potentially serious and complicated challenge.

Based on media reports, insiders from different companies often trade in the same direction during the same period. When the market index is high or rapidly rising, insiders often consistently decrease their holdings. When the market index is in a slump, insiders often uniformly increase their holdings. The "mainstream" aggregate insider trading matches "cleverly" with market movements, suggesting that it is ideal in terms of market timing.

Using A-share market insider transaction data from January 2007 to August 2011, we empirically examine the predictability of aggregate insider trading on market returns. We find that after controlling for contrarian trading, the past six months of aggregate executive (large shareholder) trading can predict 66% (72.7%) of market returns twelve months in advance. We also examine the effect of information hierarchy on predictive power and find that the predicative power of aggregate trading is significantly higher for insiders with more business operation involvement and a higher position in the information hierarchy (e.g., executives and controlling shareholders) than for insiders with a lower position (e.g., supervisors and important shareholders). This evidence strongly supports that an information advantage, beyond being a simple contrarian trading strategy, is the root cause of the strong predictive power of aggregate insider trading. Stemming from their high involvement in business operations, insiders can aggregately form a stronger ability to predict macroeconomic trends and detect deviations in systematic valuation in the stock market (referred to as the "macro information advantage") and use this advantage when trading.

As a typical form of agency conflict, insider trading behavior is affected systematically by corporate governance (Gunny et al., 2008). Corporate governance affects the information content of insider transactions in two ways. First, the ownership structure affects the distribution of control rights and decision-making power between shareholders and executives, thus affecting the information distribution and advantages of specific insiders. Second, insider trading behavior is monitored differently under different corporate governance structures, and corporate governance affects the motives of insiders and thus the possibility that insiders will use their information advantage in trading.

In this study, we examine the effect of corporate governance on the predictive power of aggregate insider trading. Depending on the nature of the largest shareholder's ownership, companies can be divided into three categories: private, local state-owned and central state-owned. Local state-owned companies are controlled by the local State-owned Assets Supervision and Administration Commission (SASAC). Central state-owned companies are controlled by either the central SASAC or central government departments. These three types of companies have systematically different agency problems and governance structures. As investor protection is weak in the A-share stock market, the largest shareholder in most privately owned companies has highly concentrated ownership and even controlling ownership for self-protection purposes. Because these large

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