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Insider trading and the long-run performance of new security issues

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Abstract

This paper uses insider trading around new security issues to provide evidence of managerial timing ability. I show that insider sales increase and purchases decrease prior to issues of information-sensitive securities (convertible debt and equity) by industrial firms. I then examine the relation between insider trading and subsequent stock returns. Although not all equity issues are motivated by overvaluation, those where managers sell prior to the issue are more likely to be. I find that industrial firms with abnormal insider selling underperform in the long run, whereas those with abnormal buying do not. There is no evidence of a relation between abnormal selling and future performance for utility offerings, however. Overall, the evidence is consistent with poor long-term performance being due to overvaluation. © 2000 Elsevier Science B.V. All rights reserved.

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1. Introduction

The information asymmetry arguments of Myers and Majluf (1984) and Stein (1992) imply that firms issue equity when managers' private information indicates the firm is overvalued. Empirical research is consistent with this hypothesis: stock prices decrease when new issues of common stock or convertible debt are

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announced. [1] This same private information presents opportunities for personal trading by these insiders. While we know a great deal about market reactions to a firm's issuance of new securities, we know little about related insider trading. Specifically, does managerial trading provide insights into the valuation of firms issuing new securities?

Consider the following scenario. Suppose a firm's securities are overvalued. According to the information asymmetry argument, management has an incentive to issue new securities. By the same token, overvaluation gives managers incentives to sell (or delay purchases of) personal holdings in the firm. Consequently, increases in insider sales and decreases in insider purchases should be associated with issues of information-sensitive securities, such as equity and convertible debt. Since straight debt is less sensitive to information asymmetries than equity, overvaluation is less of a problem. Therefore, I do not expect abnormal trading around debt issues.

Of course, not all equity issues are motivated by overvaluation. Firms issue equity-based securities for many other reasons (e.g., a need for cash to invest in positive NPV projects). Whereas managers of overvalued firms have incentive to sell, the motive for personal trading by managers disappears in the absence of overvaluation; an increase in insider selling or decrease in purchasing should not be observed in this case. Consequently, we should be able to separate firms where overvaluation is a motive from other firms by examining insider trading.

Recent evidence indicates that the negative 1–2% abnormal return on the announcement of seasoned equity issues is trivial relative to the long-run underperformance of the firm (Loughran and Ritter, 1995; Spiess and Affleck-Graves, 1995). This is consistent with the hypothesis that managers time new issues for periods of overvaluation and that the market underreacts to the information released in the announcement. If managers exploit this overvaluation not only by issuing new stock, but also by selling their own holdings, then insider selling prior to the issue should be related to the firm's future long-run performance rather than to the announcement day return. [2] Firms whose insiders exhibit abnormal trading patterns should perform worse in the long run than firms where managers do not trade on personal account.

Although the above hypotheses should hold generally, there are cases in which management cannot time securities issues easily. For example, utilities must have new issues approved by regulatory boards, decreasing the information asymmetry between insiders and the market and making timing more difficult. The nature of regulated utilities also gives rise to fewer information asymmetries (Smith and Watts, 1992). Further, knowledge of current regulatory policy and the tendency of

[1] See Smith (1986) for a thorough review of this literature.

[2] See John and Mishra (1990) for a further discussion of insider trading and announcement day returns around capital expenditures.