



Insider trading returns and dividend signals

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ABSTRACT

The literature shows that insider trading activities and dividends contain information content and serve as signals to firm value. If insider return is a proxy for information asymmetry, we should expect a positive relation between dividends and insider returns. Using a sample of unambiguous (good and bad) news concerning earnings and dividend announcements from Hong Kong firms, we show that information asymmetry is stronger for bad news firms with insider sales than good news firms with insider purchases. In addition, we improve the methodology of Khang and King [Khang, K., & King, T. H. D. (2006). Does dividend policy relate to cross-sectional variation in information asymmetry? Evidence from returns to insider trades. *Financial Management*, 35, 71–94] and provide evidence that dividend is a credible signal for measuring information asymmetry.

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1. Theoretical background

The analysis of insider trading is important on many levels. For example, it conveys insights into the strong form of market efficiency. In addition, insider trading conveys information to the market and may help alleviate information asymmetry. In this role, it signals management and/or board opinions about the future profitability of the firm. Corporate insiders possess information on their firms' latest developments, expected performance, and ability to pay dividend. Insiders likely have information long before it is released to the public. Research has shown that firms often leak forthcoming good news prior to a formal announcement but shy away from leaking bad news until absolutely necessary (Begley & Fischer, 1998; Chambers & Penman, 1984; Givoly & Palmon, 1982).

According to the “information model theory”, insider trading should be profitable (Givoly & Palmon, 1985; Jaffe, 1974; Lin & Howe, 1990; Seyhun, 1986). Insiders are expected to possess private and price-sensitive information about firm value. As a result, insider purchases (sales) provide signals of future price increases (decreases), (Fishe & Robe, 2004; Jeng, Metrick, & Zeckhauser, 2003). Early insider trading studies on the US market document significant abnormal returns (Finnerty, 1976; Jaffe, 1974; Seyhun, 1986). More recent studies report a smaller market reaction (Lakonishok & Lee, 2001) which may be due to the imposition of stricter insider trading rules. Studies in other markets such as the UK (Gregory, Matatko, & Tonks, 1997; Pope, Morris, & Peel, 1990) and Canada (Lee & Bishara, 1989) also report varying degrees of profitability for insiders. However, Eckbo and Smith (1998) find zero (or negative) returns for insiders in the Oslo Stock Exchange but conclude that the performance of the insiders is conditional on the evaluation approach.

Recently, Daher and Mirman (2007) and Wang, Wang, and Ren (2009) extend the theoretical model from Jain and Mirman (2000) and examine the real and financial effects of insider trading with correlated signals. They find that insider trading is related to market structure. Furthermore, Wang et al. (2009) demonstrates that the manager's profits may decrease or increase depending on the variances in the real and financial sectors. Although there are some studies showing that the market reacts less to insider

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trading (e.g., Eckbo & Smith, 1998; Lakonishok & Lee, 2001), Ma, Sun, and Tang (2009) find evidence that the insiders (particularly the board chairmen) are information-motivated traders and the market tends to react to insider trading gradually in the filing and publication periods rather than immediately in the trading period.

In the Hong Kong stock market, Wong, Cheung, and Wu (2000) examine the abnormal returns associated with insider trading and conclude that prices increase (decrease) following insider purchases (sales) especially for small firms. Zhu, Chang, and Pinegar (2002) also report that inside buyers can earn significant abnormal returns. Cheng, Firth, Leung, and Rui (2006) show that increased insider trading impairs liquidity by increasing spread and reducing depth.

Cheng and Leung (2008) find that there are significant insider purchases before the announcements of good earnings and dividend news; and significant insider sales before bad earnings and dividend news. As insiders possess private information about the firm, insider trading activities before a corporate announcement should not be a rare phenomenon (Clarke, Dunbar, & Kahle, 2001; Fidrmuc, Goergen, & Renneboog, 2006). These studies document that insiders buy before favorable announcements and sell before unfavorable announcements.

It is well-documented that earnings (including earnings forecasts) and dividends provide signals about the future performance of firms (Asquith & Mullins, 1983; Bajaj & Vijh, 1995; Basyah & Hartigan, 2007; Brown, 1978; Nissim & Ziv, 2001; Rendleman, Jones, & Latane, 1982). Pre-disclosed earnings and dividend information is a price-sensitive information that insiders may use to time their trading for profits. Therefore, there are a number of studies examining the intensity of insider trading activities before the announcements of earnings (Allen & Ramanan, 1995; Park, Jang, & Loeb, 1995; Sivakumar & Vijayakumar, 2001; Sivakumar & Waymire, 1994; Udpa, 1996) and dividends (John & Lang, 1991). A recent study by Khang and King (2006) uses insider returns as a proxy for information asymmetry between insiders and outsiders to examine the relation between dividends and information asymmetry and finds a negative relation between dividends and returns to insider trades.

We hypothesize that insider returns serve as an effective measure to validate the signaling effect of dividend announcements. Khang and King (2006) use insider returns as a proxy for information asymmetry between insiders and outsiders to evaluate whether dividend payout serves as a credible signal for information asymmetry. They find a negative relation between dividends and insider returns and conclude that dividends may not be a credible signal for information asymmetry. We re-examine the signaling effect of dividend using insider returns as a validation tool with a modified methodology. These methodological enhancements include 1) providing alternative measurements of dividend changes; 2) controlling for earnings management; and 3) employing simultaneous earnings/dividend announcements to eliminate the potential confounding effects of earnings on dividends.

We find a positive correlation between insider returns and dividends when insiders trade firm securities. We, thus, find that insider returns are an effective measure validating the signaling effect of dividends. The rest of the paper is organized as follows: Section 2 discusses the data and methodology. Section 3 describes the results, and the conclusion is reported in Section 4.

2. Data and methodology

2.1. Earnings and dividend data

We obtain stock price data and financial statement data from the PACAP database, *Datastream*, and the *Securities Trading Record Journal* issued by the Hong Kong Exchanges. We limit our analysis to industrial companies in the PACAP database. During our sample period, 1993 through 2003, we find 6152 simultaneous annual earnings and dividend announcements.

In this study, we focus on the examination of the three unambiguous announcement signals with stronger information content of good and bad news rather than the three ambiguous signals which contain both good and bad news. We exclude the ambiguous announcements because the theoretical direction of the mixed effects is unclear, and the net effects on the market reaction may be weak as the effects of good and bad news cancel each other out. We have 653 simultaneous earnings and dividend announcements, and we are able to match them with 3329 insider trading events. We discuss the insider trades next.

2.2. Insider trading data

We obtain our insider trading data from the Inside Trade Asia database maintained by Primark (from 1993 to April 2000) and from the website of the Hong Kong Exchanges (from May 2000 to 2003). The Listing Rules of the Hong Kong Exchanges require directors to report their securities transactions within five business days (three business days from April 2003 onwards) from the day they place the transactions. The trading information would be disclosed on the Securities (Disclosure of Interest) Daily Summary – Directors'/ Chief Executives' Notification Report issued by the Hong Kong Exchanges. Although the changes in the share-holding of the directors can be the result of exercising options, warrants, bonus warrants and rights, the issue of bonus shares, the conversion of bonds and debentures, special and scrip dividends, stock splits as well as gifts, we only include those inside transactions which increase and decrease the shareholdings of the directors through open market purchase and sale of shares in our study (Lin & Howe, 1990).

Our focus is on the relation between insider trading returns and dividend signals. Therefore, we need to select the insider trades after the previous but prior to the current announcements of annual earnings and dividends. Based on this criterion, we initially identify 17,342 inside transactions. We apply two data-cleaning conditions to our sample. First, to avoid potential confounding effects on market reaction, we exclude those cases where the firms have made other corporate announcements such as seasoned equity offering, stock split, and consolidations during our -40 to $+40$ examination period, and we also eliminate cases with missing data. At this point, we have 8454 insider trading records remaining in the sample.

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