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Insider trading, tax-loss selling, and the turn-of-the-year effect

David Hillier[1], Andrew Marshall*

Department of Accounting and Finance, University of Strathclyde, Curran Building, 100 Cathedral Street, Glasgow, Scotland G4 0LN, UK

Abstract

We examine the turn-of-the-year effect (January effect) in UK listed securities and find that it is significant but not persistent through time. In contrast to the US studies, equities of all sizes are affected. Although important, we reject the hypothesis that seasonalities in insider trading are the main determinant of the turn-of-the-year effect. In addition, the tax-loss selling hypothesis, which is commonly thought to be a cause of the January effect in the US, is tested with the April year-end for UK investors. We find evidence of excess abnormal share price returns. However, this does not impact upon excess abnormal share price returns in January. Our results are important because they provide an insight into stock return seasonality in the UK and reject some widely held beliefs on this issue.
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1. Introduction

The purpose of this study is to examine the turn-of-the-year effect (also known as the January effect), well documented for US stocks, on equities listed in the UK. Two main hypotheses have been tested with respect to this anomaly in the US. The most common is the

* Corresponding author. Tel.: +44-141-548-3894; fax: +44-141-552-3547.
E-mail addresses: a.marshall@strath.ac.uk (A. Marshall), d.j.hillier@strath.ac.uk (D. Hillier).
[1] Tel.: +44-141-548-3889; fax: +44-141-552-3547.

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tax-loss selling hypothesis where traders reduce their holdings prior to the tax year-end in poorly performing firms in order to reduce taxes from their capital loss.[2] As Keim argues, this reduction in holdings is only achieved through the sale of those equities deemed to have performed badly in the previous year, resulting in a consequent increase in the number of transactions at the bid price prior to the tax year-end.[3] When the new tax year begins, the excess supply is reduced with the effect that prices revert to their equilibrium levels, causing positive abnormal share price returns in the period. Unfortunately, because of the coincidental clustering of the calendar year-end and the tax year-end in the US, all tests are joint tests of the two year-ends. In the UK, the tax year-end for investors is April 5. Thus, the confounding problem that is present in tests of US data can be circumvented and the calendar year-end effect can be separated from the tax year-end effect.

Another explanation for the turn-of-the-year anomaly in the US is the increase in bid–ask spreads of smaller companies caused by a higher level of insider trading in January.[4] Insider trading forces market makers to widen the spreads they quote on securities. Consequently, this action would result in an increase in transaction costs for investors. Conflicting evidence on the return, bid–ask spread relationship in January has been reported. Whereas Stoll and Whaley concluded that there was an implied correlation between security returns and bid–ask spreads (and thus increased insider trading), many other studies do not (Schultz and Clark et al. are examples).

We propose another possible factor for the January effect that is driven by findings in many insider trading studies. Corporate insiders in both the UK and US are known to outperform other market participants in their trades.[5] Various amounts have been reported on the abnormal share price returns insiders earn on their trades and all, with the exception of Lin and Howe (1990) and Seyhun (1988b), who find that before a trade, abnormal share price returns are significantly negative, whereas after the trade they are abnormally positive.[6] In addition, abnormal returns can persist for up to one working month after the trade. As a result, it is possible that the turn-of-the-year effect may be due to increased net insider buying activity (buy trades minus sell trades) in December. If this has occurred, many stocks would exhibit an abnormally high return in January of each year.[7]

[2] Brailsford and Easton (1991), Griffiths and White (1993), Keim (1989), and Lakonishok and Smidt (1984) have tested this hypothesis and found a significant turn-of-the-year effect for US stocks.

[3] Due to a lack of data availability on other investor trades, we are unable to verify whether this occurs in the UK.

[4] See Bhardwaj and Brooks (1992), Clark, McConnell, and Singh (1992), Schultz (1983), Seyhun (1988a), and Stoll and Whaley (1983).

[5] See, for example, Finnerty (1976a, 1976b), Givoly and Palmon (1985), Hillier and Marshall (2001), Lin and Howe (1990), Lorie and Niederhoffer (1968), Nunn, Madden, and Gombola (1983), Petit and Venkatesh (1995), Pratt and DeVere (1970), Seyhun (1988b), and Sivakumar and Waymire (1994).

[6] Lin and Howe (1990) and Seyhun (1988b) find that insiders earn positive abnormal returns but that they are insignificant.

[7] This return pattern is similar to that which would prevail in the tax-loss selling hypothesis especially if insiders trade in the month before the year-end.

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