Available online at www.sciencedirect.com
SCIENCE DIRECT®

Journal of Financial Intermediation 14 (2005) 1–31

Journal of Financial Intermediation

www.elsevier.com/locate/jfi

Talking up liquidity: insider trading and investor relations

Harrison Hong [a,*] and Ming Huang [b,*]

[a] *Department of Economics, Princeton University, Princeton, NJ 08544, USA*
[b] *Graduate School of Business, Stanford University, Stanford, CA 94305, USA*

Received 28 May 2001

Available online 23 December 2003

Abstract

Managements (“insiders”) of many corporations, especially small or newly-public firms, invest considerable resources in investor relations. We develop a model to explore the incentives of insiders to undertake such costly investments. We point out that insiders may undertake such investments not necessarily to improve the share price, but to enhance the liquidity of their block of shares. This leads to a divergence of interest between insiders and dispersed outside shareholders regarding investor relations. Our model predicts that the demographics of insiders (e.g. liquidity needs, size of equity stakes) are important determinants of the extent of investor relations across firms.

JEL classification: G0; G3

Keywords: Investor relations; Information disclosure; Insider trading; Liquidity; Newly-public firms

1. Introduction

Investor relations are a set of activities that firms engage in with investors and analysts. Such activities include voluntary information disclosures, competition for analyst coverages, and interactions with investors for the purpose of expanding the shareholder base.[1] Investor relations are costly; voluntary disclosures involve costs in producing and disseminating the information, and both courting analysts and attracting institutional investors

* Corresponding authors.
E-mail addresses: hhong@princeton.edu (H. Hong), mhuang@stanford.edu (M. Huang).

[1] See, for example, Brennan and Tamarowski (2000) for a history and overview of investor relations.

1042-9573/$ – see front matter
doi:10.1016/j.jfi.2003.08.004

require a lot of time and effort from top executives, particularly for small or newly-public firms.[2] Yet despite such costs, many corporations, especially small or newly-public firms, are heavily engaged in investor relations. The purpose of this paper is to explore the reason behind such costly investor relations activities.

There are a number of theories for why firms invest considerable resources in investor relations. Broadly speaking, these theories argue that investor relations can boost the mean level of a firm's stock price because certain key assumptions of (strictly) efficient markets may not always hold. The proposed mechanisms for the positive effects of investor relations on stock prices include correction of mis-valuations by costly selective disclosures (Verrecchia, 1983, 1990), limited investor familiarity with firms (Merton, 1987), increased efficiency in firms' real investment (Fishman and Hagerty, 1989), reduced information asymmetry and cost of capital (Diamond and Verrecchia, 1991), and incomplete information and short-selling restrictions (Trueman, 1996). In these models, investments in investor relations benefit all existing shareholders and there is typically unanimity among them regarding a firm's investor relations policy.

Existing empirical studies on investor relations, however, have generated some findings that cannot be easily explained by these theories. First, the empirical literature has not convincingly established a strong causal relationship between investor relations and the long-term mean level of stock prices; the results in Byrd et al. (1993) and Botosan (1997), for example, are mixed at best. Secondly, there is strong evidence that demographics of insiders may be important determinants of the extent of investor relations across firms; Richardson et al. (2001), for example, found that earnings-guidance (a form of investor relations) is more prominent for firms whose insiders sell stocks from their personal accounts after earnings announcements.

Motivated in part by the above empirical evidence, we propose in this paper an alternative role of investor relations. From our perspective, it is interesting to look at the insiders' incentives to undertake such costly investments since insiders typically have discretion over the investor relations policy. In contrast to existing theories, we point out that insiders may undertake such investments not necessarily to improve share price, but to enhance the liquidity of their own block of shares in case they have to sell their equity stakes for liquidity (such as life cycle or diversification) reasons. In fact, insiders may engage in investor relations even absent any positive effects on the share price. Furthermore, there may exist a divergence of interests between the insider and dispersed outside shareholders regarding the investor relations policy. While the costs of investor relations are shared by all shareholders, the insider benefits from increased liquidity disproportionally since dispersed shareholders—with their small holdings—care little about market liquidity.

[2] For many small and newly-public firms, most of the costs of investor relations is due to the time and attention spent by top executives who are normally pressured to provide direct access to stock analysts and institutional investors. Although we are not aware of any formal study that documents such costs, a few senior stock analysts whom we interviewed estimated that, for the average small and newly-public firm (with a market capitalization less than $1.5 billion) that decides to engage in investor relations with analysts and institutional investors, investor relations activities account for about 20–25% of its CEO's time and about 50% of its CFO's time. Given that the time and attention of top executives are especially important for such young firms, investor relations activities are indeed quite costly for these firms. (See also Nocera (1997) for more details on corporate competition for coverage by top analysts.)