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Does Insider Trading Correct Mispricing?

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Abstract

The literature posits that insiders are contrarian, i.e., buy stocks when they are under-valued and sell stocks when they are over-valued. In addition, insider transactions contain information about future firm fundamentals. As such, insider trading helps improve stock price efficiency and promote stock price discovery. In this study, we test the implications of both hypotheses. First, we follow the literature and identify undervalued and overvalued stocks and examine whether insider trades help correct mispricing of these stocks. Second, we examine whether insider trades contain more information about future firm fundamentals for mispriced stocks and the extent to which insider trades incorporate future fundamental information into stock prices. Our findings indicate that insider transactions play a role in correcting mispricing. However, the effect is significant mainly for overvalued stocks over short-term and undervalued stocks over long-term. In addition, we find that insider transactions contain information about long-term future firm fundamentals mainly for overvalued stocks. Nevertheless, our analysis suggests that insider transactions only incorporate a small fraction of future firm fundamental information into stock prices. To sharpen our analysis, we exclude pre-scheduled or routine insider trades, which are believed to be less informed of stock valuation and replicate our empirical tests, and show that our main findings are consistent.

Conference Track

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