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MARKETS | HEARD ON THE STREET

Investors Should Beware When Good Managers Make Great Traders

New research suggests heightened risks at firms where insiders make great returns on trading their own company's stock.

By **JUSTIN LAHART**

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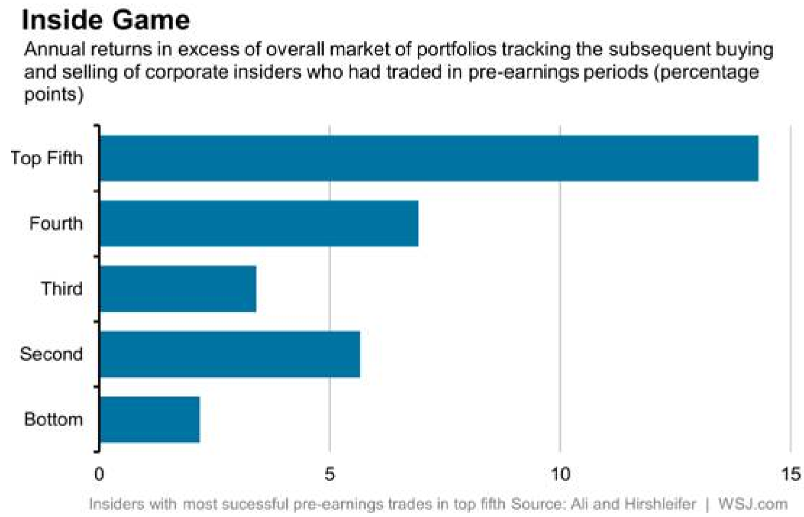
Investors rightly prize clever managers. But they should rethink that when such cleverness extends to trading in the company's shares.

Chief executives and other top managers count as corporate insiders, routinely holding private information that could move their firms' stock. They aren't allowed to trade on that, and the Securities and Exchange Commission has put in a variety of measures aimed at making it more difficult. Insiders must report a trade within two days of the end of the month the trade occurred, for example. And they are blocked from trading in and out of their firms' stock for a quick profit.

Many firms also limit trading in the run-up to earnings announcements because executives regularly hold material information at such times. But these restrictions aren't legally required; even firms that have them sometimes waive them.

And new research suggests adept trading by managers at such times can be a red flag for investors.

From 1986 through 2014, about 16% of trades by corporate insiders occurred in the 21 trading days before quarterly earnings announcements, according to research conducted by Usman Ali, a portfolio manager with Newport Beach, Calif.-based investment firm MIG Capital, and David Hirshleifer, a finance professor at the University of California, Irvine.



As a next step, they divided the insider trades made by CEOs and CFOs during pre-earnings periods into five groups based on profitability. Executives in the top quintile—whose trades ahead of earnings made or saved the most—got labeled as opportunistic traders. The two researchers then looked at how well this group did in later periods, constructing portfolios that each month bought the stocks the insiders bought, and shorted the stocks the insiders sold.

How did this approach do? Extremely well. On a value-weighted basis that adjusts for risk and other factors, a strategy of trading with the high-performing opportunistic insiders would have yielded an annual return that was 14 percentage points in excess of the overall market. In contrast, a strategy of trading alongside the executives in the bottom quintile would have done about two percentage points better than the overall market.

The performance exhibited by the opportunistic traders suggests there may be something more than luck involved, and that at least some of those executives may be trading on private, material information.

And that may not be all they are doing. Messrs. Ali and Hirshleifer found that the probability of earnings restatements at companies with opportunistic CEOs or CFOs was about 15% higher than at other companies. They were also more likely to undergo investigations by the SEC for alleged accounting and auditing misconduct. Executive compensation at these companies was also apt to be higher than at similar companies.

Discretionary accruals—setting aside funds for future liabilities—can be a sign of a company smoothing earnings. These were about 5% higher at opportunistic executives' companies. Finally, the stock options received by executives at the opportunistic insiders' companies were more likely to have well-timed grant dates—a red flag for options backdating—particularly prior to the 2002 Sarbanes-Oxley law.

Some of the opportunistic insiders may be just plain lucky, but not all of them. Investors who run a across an executive whose stock trades have been unusually profitable may want to run the other way.

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