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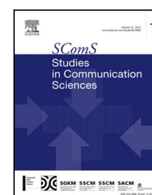

Insiders' incentives of using a specific disclosure tone when trading☆

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ABSTRACT

This study investigates the relations between disclosure tone, insider trading and returns. Using a dictionary-based approach to quantify the disclosure tone contained in the Management Discussion and Analysis of 10-Q and 10-K filings, I find that the net disclosure tone predicts the insider purchase ratio (purchases scaled by the sum of purchases and sales), even after controlling for past purchases, return volatility and firm characteristics. Constructing a buy-and-hold portfolio over a six months horizon, I find that insiders earn approximately 5.8% abnormal return per year. Both disclosure tone and insider purchase ratio are able to predict the buy-and-hold abnormal return.

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1. Introduction

Nowadays, the examination of the management behaviour is becoming increasingly important for a broad range of individuals and institutions. Investors face various issues when taking their decisions and understanding management incentives can help them to make the right call. The Security and Exchange Commission (SEC) requires each public company to disclose quarterly and annually comprehensive reports of their performance in the form of 10-Q and 10-K filings. Within this context, it is interesting to analyze whether managers act in the same way with what they disclose and which are their incentives to use a specific tone when preparing the 10-Q and 10-K forms.

Insiders, in the position of best-informed party about firm's fundamentals, boast a private advantage when compared with other traders. By complying with the SEC rules when preparing the 10-Q and 10-K forms, managers provide disclosure that is informative to investors. In fact, corporate disclosure represents the most important tool by which managers are communicating with both investors and analysts. Consequently, it is essential to understand and correctly assess the true meaning of its content.

Until now, investors have focused on analyzing the numbers contained in the financial statements; however, recent literature including Davis, Piger, and Sedor (2012) has documented that there is information content beyond numbers that proved to be very helpful. In this regard, examining 10-Q and 10-K forms, one can find additional information incorporated into other sections, such as the Management Discussion and Analysis (MD&A) of Financial Condition and Results of Operation, the CEO and Chairman's Letter to the Shareholders or the Notes to the Financial Statements. All these envisage their personal beliefs about the business description, the outlook of the company, the results of operations, critical accounting changes, the level of liquidity and capital resources, but also risks inherent to their business. By making extensive use of the MD&A, investors are able to assess the past and current performance of a company, but also to have an idea about the future prospects.

Insiders might strategically involve in trading activity prior to the disclosure of the news. Although there are clear rules restricting them to engage in trading, they can still take advantage of their superior information by choosing to postpone the trades, or even not to trade at all. This also classifies as trading on 'material non-public information', but it is not amendable, since it is difficult to be proved.

There is a large strand of literature that examines both insider trading and disclosure tone, but none is modelling specifically the relationship between the two. The principal finding is that they are informative, so we should expect a market reaction around the dates when they occur. Disclosure tone clearly influences the future performance of the company, but also its value. It means that managers can deliberately use a certain tone to push the price

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of the share in the wanted direction and then engage in opportunistic insider trading. The most probable scenario is that before issuing negative news of which they are perfectly aware, they sell in advance. Afterwards, while the negative tone is pushing down the prices, they can buy their shares at a lower price and then reverse the tone, to push up the prices and sell again. Basically, a sort of cycle develops that has in the centre the eager of insiders wanting to maximize their benefits. Having a closer look at the decision making process that happens before selling, insiders can also refrain from selling if they believe that the market has already formed the true expectations about the prospects of the company, i.e. that prices reflect the upcoming events. The reason behind this logic is that this would surely translate into lower abnormal returns. On the other hand, it can also be the case that insiders manipulating prices are an easy target under SEC's careful scrutiny and therefore they will not trade against what they disclose.

In this study, I examine the magnitude of the relationships between the disclosure tone, the (legal) insider trading activity and the corresponding 6 months buy-and-hold abnormal return (BHAR). The findings suggest that the disclosure tone contained in the MD&A section of the 10-Qs and 10-Ks filings is able to predict purchases made by insiders. Moreover, the tone also predicts the BHAR, even after controlling for past returns, the volatility of returns and other firm-performance variables.

In the initial phase of this study I checked whether the disclosure tone is able to predict the occurrence of an insider trade. Logistic regressions accounting for firm fixed effects strengthen the idea that disclosure predicts not only the trade, but also its direction, even after controlling for past returns and trades.

In a second further step, univariate and multivariate regression models suggested that corporate insiders are indeed contrarians who invest in value firms while selling the shares of growth firms. Their opportunistic behaviour lies in the fact that they reverse their strategy every six months, after securing their profits away from the short swing rule, which states that insiders have to disgorge any profit back to the company if made by shifting their position within less than six months. To provide further support to these findings, I constructed a purchase and a sale portfolio over a six months horizon. Under the Capital Asset Pricing Model (CAPM) and the Four-Factor Model, I find that only the purchase portfolio yields a positive abnormal return, whereas the sale portfolio does not exhibit any abnormal return. The intuition behind this result is that sales are driven by a variety of reasons, including liquidity or diversification since the management compensation consists also in firm's shares, whereas insiders engage in purchases mostly to make profits.

The final step of the analysis consisted in a robustness check of the previous findings by employing vector autoregressive models (VAR), which accounted for more complex dynamics between the variables. The results are consistent: disclosure tone predicts insider trading, both disclosure and insider trading predict BHAR and insiders reverse their strategy every half year.

The rest of the paper is organized as follows: Section 2 documents the literature review for disclosure tone and insider trading. Section 3 discusses the research design and methodology. Section 4 provides descriptive statistics and the correlation analysis for the data. Section 5 presents the main findings and also extends them using robustness tests. A brief summary with guidance for future research concludes the paper in Section 6.

2. Literature review

2.1. Disclosure tone

There is a substantial body of literature that examines the disclosure tone and its effects on firm performance and stock returns. This approach consists in analyzing rather the qualitative information (i.e. the so called soft information) included in corporate disclosures than the quantitative one. In so doing, one is able to better understand which are the drivers of the management's behaviour and of the corporate decisions. Furthermore, it is possible to examine if the decision making process takes place in a way that insiders can benefit in their own interest when choosing how to disclose.

This new area of interest was born when SEC, through the Electronic Data Gathering, Analysis and Retrieval (EDGAR) filing system, made available financial statements, conference calls and press releases. Usually, there is an endogeneity issue when examining the information contained in voluntary disclosures. Disclosures are supposed to be informative, but managers have significant discretion when preparing them and they can specifically choose what pieces of information to make public. However, in this research setting, we circumvent this issue, as 10-Q and 10-K filings represent mandatory disclosure required by SEC and thus are more reliable for investors. Even though managers still have a degree of discretion in preparing these forms, their disclosure is trustworthy, as they fear litigation costs and complaints under SEC's careful scrutiny.

As Li (2010) documents in his paper, there are different types of disclosure that present interest to researchers, such as the disclosure tone, the readability, or the length of the disclosure. While examining the length of disclosure is pretty straightforward and does not necessary imply that longer documents are also more complex (one should take into consideration other variables, such as the business environment), measuring the readability or disclosure tone seems to be more appealing. Following Li (2008), less readable financial statements translate into poorer current earnings. Analogously, firms with better performance (i.e. positive earnings) provide easier-to-read annual reports and also exhibit earnings persistence. He concludes that managers strategically obfuscate information when dealing with poor firm performance. His finding concerning the readability is supported also by the study of Subramanian, Insley, and Blackwell (1993). Moreover, Loughran and McDonald (2014) conclude that financial statements with fewer words exhibit less analyst dispersion.

Examining disclosure tone has proven more challenging, but also more interesting, both statistically and economically. Prior literature (Feldman, Govindaraj & Segal, 2010; Li, 2010; Loughran & McDonald, 2014; Rogers, Van Buskirk, & Zechman, 2011; Tetlock, Saar-Tsechansky, & Macskassy, 2008) has investigated the tone used by managers in disclosure and found that it influences both fundamentals and stock market prices.

When dealing with textual analysis, researchers can use two different approaches: a rule (dictionary) based approach and a statistical approach. The dictionary based approach consists in manually gathering the data and analyzing it by using built-in dictionaries, which have a predefined number of words and then aggregating the information in various categories. The most used dictionaries in content analysis are the General Inquirer, provided by Harvard University, the Diction software and the Linguistic Inquirer and Word Count (LIWC), distributed by the University of Texas (Austin).

The statistical approach employs computer programs to examine the information content and then classifies the text into a specific category according to some probability measures. Using a Naïve Bayesian machine learning algorithm to analyze the forward looking statements contained in MD&A, Li (2010) advances that using a positive tone contributes to a better future performance of a company, even after controlling for other predictors such as accruals or return volatility.

By testing the optimistic and pessimistic tone used by managers in earnings press releases, Davis et al. (2012) came up with two findings: on one hand, there is a direct relation between the tone and the future financial performance of the firm; on the other hand, the

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