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Informed or speculative trading? Evidence from short selling before star and non-star analysts' downgrade announcements in an emerging market[☆]

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ABSTRACT

We examine informed vs. speculative trading among short sellers prior to analyst downgrades in China from March 2010 to August 2014. We do not find abnormal short selling in the days before downgrade announcements in the full sample. For the star (non-star) analyst subsample, however, we find significant (insignificant) abnormal short selling beginning 10 days prior to downgrade announcements. In addition, short sellers cut back their short positions when star analysts incorrectly upgrade. Hence, short sellers do not seem to know more than star analysts. With the timing of the short selling, our evidence indicates that star analysts might leak their research to certain short sellers before their downgrade announcements. Furthermore, we demonstrate that broker reputation and institutional investor ownership mitigate the relation between star analysts' downgrades and abnormal short selling. Our results are robust to different measures of abnormal short selling, abnormal returns, event windows, star analysts' impact, and endogeneity. Our overall findings suggest that short sellers are informed.

1. Introduction

Diamond and Verrecchia (1987) theorize that due to additional restrictions (e.g., margin and uptick rules), short sellers possess more information regarding the future downward stock price movements than do typical investors. The related literatures (e.g., Senchack and Starks, 1993; Desai et al., 2002; Christophe et al., 2010) report that short sellers are informed traders and thus offer support to Diamond and Verrecchia's model prediction. Specifically, Christophe et al. (2010) documents abnormal short selling in the three days prior to analyst downgrade announcements using NASDAQ data in 2000–2001, suggesting that some investors are informed traders in the context of short selling.

In contrast, Daske et al. (2005), Blau and Wade (2012), and Blau and Pinegar (2013) document that short sellers engage only in speculative trading and find no evidence of incrementally informed trading by short sellers. Specifically, Blau and Wade (2012)

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report that abnormal short selling occurs during both analyst downgrade and upgrade announcements using samples in NYSE and NASDAQ in 2005–2006. Obviously, abnormal short selling before analyst upgrade announcements is not consistent with the informed trading argument. Blau and Wade (2012) contends that short sellers engage in speculative trading only, not informed trading. Given the mixed evidence in the literature, it is unclear if short sellers engage in informed or speculative trading.

However, both groups of literature (e.g., Christophe et al., 2010; Blau and Wade, 2012) do not consider the heterogeneous nature of analysts. That is, the literature assumes analysts not different from each other. A parallel strand of literature (e.g., Loh and Stulz, 2011; Xu et al., 2013; Fang and Yasuda, 2014), shows that recommendations made by star analysts earn better returns and produce more firm-specific information than those of non-star analysts. Naturally, some analysts (e.g., star analysts) are endowed with better human capital than other analysts (e.g., non-star analysts). It is unclear how star analysts contribute to the relation between short seller informed vs. speculative trading and analyst downgrades.

The objective of this paper is to examine short seller informed vs. speculative trading and analyst downgrades in the emerging market of China. Specifically, we examine how star vs. non-star analysts moderate the relation. We contend that if speculative trading is the case, the abnormal short selling between star and non-star downgrade announcements will not be significantly different because short sellers' speculative trading will not rely on analysts' information. Hence, irrespective of star or non-star analyst downgrade announcements, the abnormal short selling should not be significantly different. In contrast, if short sellers engage in informed trading, we expect abnormal short selling to be significantly higher when star analysts make downgrade announcements than when non-star analysts do so. Given short sellers' informed trading and that the ability of star analysts is better than those of non-star analysts, the information provided by star analysts is more valuable to short sellers, resulting in higher abnormal short selling when star analysts make downgrade announcements than when non-star analysts do so.

To examine informed vs. speculative trading among short sellers, we follow the framework of Christophe et al. (2010) using the recent deregulation of short sales in China to study abnormal short selling prior to star and non-star analysts' downgrades from March 2010 to August 2014. Our new findings in China can help to settle the informed vs. speculative trading motivation behind short sellers. In addition, the literature focuses more on the US markets. With the exception of Choi et al. (2013, 2016) on the long side of stock trading, few studies examine informed vs. speculative trading in emerging markets, which generally have higher information opaqueness and poorer country-level governance than mature markets. We complement Choi et al. (2013, 2016) by studying short selling in an emerging market. Our results provide a reference for other emerging markets pursuing regulatory reforms (e.g., short selling deregulation) and analyst monitoring in a heterogeneous analyst labor market. If short sellers engage more in informed (speculative) trading, there is a need (no need) for regulatory reforms and analyst monitoring related to short selling.

In addition to its emerging market characteristics, the Chinese environment offers several unique features for our study. First, Chinese daily short selling data are publicly available. In the US, detailed short selling data are seldom available to the public and, when they are available, it is only for a short period. For instance, Christophe et al. (2010), through a special arrangement with NASDAQ, were able to use detailed short selling data from September 13, 2000 to July 10, 2001 (less than 10 months). In contrast, we are able to capture daily abnormal short selling data from when short selling was first permitted (March 31, 2010) to the most recent data available, with more than four years of data. Thus, our research offers a longer-term perspective than many of the studies that use US data.

Second, the cost of short selling is high in China. In addition to the typical uptick rule and minimum balances in trading accounts, short sellers in China must pay their brokers a sizable administrative fee on a relatively high percent of the value on the borrowed stocks. The high cost of short selling motivates short sellers to make short sales only after acquiring information from star analysts about downgrades. Thus, the Chinese environment fits the model of Diamond and Verrecchia (1987).

Third, China exhibits the characteristics of opaque markets with a poor information environment. Hence, different investors may engage in speculative and/or informed trading. There are demands for the services of star analysts in the information production process. We contend that star analysts, with superior human capital, are able to produce more firm-specific information (Xu et al., 2013). Accordingly, star analysts are more likely to move stock prices with their downgrades than non-star analysts. Thus, if short sellers engage in informed trading, they leverage star analysts' downgrades more than non-star analysts. In contrast, if short sellers only speculate, they are indifferent to star and non-star analyst downgrades. Thus, we can use the star vs. non-star analyst perspective to offer new insights into the informed vs. speculative trading among short sellers.

Our findings suggest that, if we do not consider the heterogeneous nature of analysts, analyst downgrades are not related to abnormal short selling in China. The findings of insignificant informed trading in China appear to be consistent with those of Blau and Wade (2012). However, after we partition the sample into star and non-star analyst subsamples, abnormal short selling in the 10 days before a star (non-star) analyst's downgrade announcement is negatively (not) correlated with stock price reactions on the announcement day. Our results are robust to alternative measures of variables and endogeneity and are not related to short sellers' stock picking ability. Further, we document that broker reputation and the presence of institutional investors as shareholders can mitigate the relation between star analyst downgrade announcements and abnormal short selling. Therefore, the results from the star vs. non-star analyst research design show support to the informed trading of short sellers in Diamond and Verrecchia (1987) and Christophe et al. (2010). Given that abnormal short selling occurs 10 days before star analysts' downgrade announcements, our findings seems to be consistent with the conjecture that star analysts might leak their information to some short sellers before their downgrade announcements.

We make three contributions to the literature. First, our findings complement the literature on informed trading by reporting results consistent with the literature in the star analyst downgrade subsample. Without distinguishing the star vs. non-star analyst downgrades, the findings are consistent with speculative trading. Hence, it is imperative to distinguish the impact of star vs. non-star

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