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The Source of Information in Prices and Investment-Price Sensitivity*

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Abstract

This paper shows that real decisions depend not only on the *total* amount of information in prices, but the *source* of this information—a manager learns from prices when they contain information not possessed by him. We use the staggered enforcement of insider trading laws across 27 countries as a shock to the source of information that leaves total information unchanged: enforcement reduces (increases) managers' (outsiders') contribution to the stock price. Consistent with the predictions of our theoretical model, enforcement increases investment- q sensitivity, even when controlling for total price informativeness. The effect is larger in industries where learning is likely to be stronger, and in emerging countries where outsider information acquisition rises most post-enforcement. Enforcement does not increase the sensitivity of investment to cash flow, a non-price measure of investment opportunities. These findings suggest that extant measures of price efficiency should be rethought when evaluating real efficiency.

Keywords: Financial Efficiency; Real Efficiency; Real Effects of Financial Markets; Insider Trading

JEL Classification: G14, G15, G31

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