Catalyst Funds
Intelligent Alternatives

Top Executives Insider Buying Credit Review

Insiders versus Credit Rating Agencies for Evaluating Credit Worthiness

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KEY TAKEAWAYS

- On the heels of the financial crisis of 2007-2008 and the associated sub-prime mortgage meltdown, there has been much scrutiny of the CRAs and concerns over the accuracy of their credit ratings and information that they supply to investors.
- Since CRAs are competing with one another for business, their business model can conflict with the interest of investors.
- Insider transactions are an accurate predictor of both stock and bond movements, and empirical data suggests a lower likelihood of default among firms with heavy insider buying.

When it comes to investing in fixed income securities, many investors have traditionally relied on the evaluations of Credit Ratings Agencies (CRAs), and especially those of the "Big Three" (Moody's Investors Service, Standard & Poor's, and Fitch's Ratings, Ltd.) in helping them in decision-making relating to the purchase of corporate and government bonds and structured finance debt. These agencies provide evaluative services culminating in the publication of ratings of the creditworthiness of debt securities and their issuers, with investors using the information (credit rating) to determine the risk associated with their investments. A higher credit rating implies lower risk and a higher likelihood that the debt will be repaid.

On the heels of the financial crisis of 2007-2008 and the associated sub-prime mortgage meltdown, there has been much scrutiny of the CRAs and concerns over the accuracy of their credit ratings and information that they supply to investors. Following the financial crisis, the CRAs were accused of giving higher ratings to sub-prime mortgages and misrepresenting the risks associated with them.

The big question now is whether the ratings business has changed much since the financial crisis. We believe that the simple answer is not really. Congressional oversight and accountability measures have proven to be ineffective.

Problems with the CRA Business Model

One of the main problems is the way CRA revenues are derived and the business model behind it all. CRAs mainly generate revenues from issuers of debt who are seeking a credit rating. They also generate additional earnings from subscribers who receive published ratings and related credit reports. Corporate and government bonds must have a credit rating to be issued. However, here is the rub. If an issuer receives a rating from a CRA and doesn't like the rating they receive, then they can shop around for a better one.

Since CRAs are competing with one another for business, their business model can conflict with the interest of investors. More specifically, it means that credit ratings agencies no longer have incentives that are closely aligned with those of their customers. In other words, CRAs have an incentive to offer lenient ratings in order to get business from large customers who issue debt (Levich, Majnoni, & Reinhart, 2012). Even though credit ratings agencies ratings have been proven time and time again to be inaccurate (e.g., in their assessment of subprime mortgage securities in 2007-2008), there is a continued demand for their services because institutional investors need summary statistics on the creditworthiness of their debt holdings.

According to a report by Gary Burtless, Senior Fellow-Economic Studies at the Brookings Institute, "Some investors must use a flawed and discredited product because no other alternative is readily available…Their ratings may be flawed, but for a wide range of investors the agencies' ratings are better than no ratings at all." There is therefore the need to identify alternative sources of information that investment professionals can use to evaluate credit quality and risk.

Insider Buying as an Alternative Source of Information

Several researchers have pointed out that insider transactions reveal insightful information about future changes in the prices of stocks. Using a variety of different methodologies and undertaking research in different geographical contexts, it has been shown that insider transactions reveal private information that outsiders can use to reap better returns. Top executives in firms use inside information to make predictions about future cash flows and to support their trading activity. A research paper by H. Nejat Seyhun (Seyhun 1992) shows that as soon as outsiders observe and react to insider trading, stock prices adjust, making insider trading an effective predictor of stock returns.

Based on these observations, researchers began to look at how insider trading impacts the bond market. Studies support the hypothesis that insider trading represents an accurate estimate of changes in the bond market, with insider trading actually exerting a stronger impact upon bond returns than stock returns (Datta and Iskandar-Datta, 1996). In addition, an analysis of bankruptcy data among firms with insider buying from the dates December 2004 to November 2017 shows that while on average, 0.375% of stocks go bankrupt in the next year, only 0.08% of stocks with insider buying default .

Based on his analysis of S&P 500 Index Firms, Kiwia (2016, p. 29) concludes that “corporate insiders in firms with higher credit risks may trade opportunistically in advance to capture the opportunities that may no longer be available once ratings have been disclosed to the public.” Hable & Launhardt’s (2016) work confirms this finding. Their work reveals a negative relationship between aggregate net buying and future changes in credit spreads through the mechanism of stock prices. This is because bond yields and stock prices move in diametrically opposing directions. Therefore, a positive stock market signal in one period will induce lower credit spreads in the future period. Furthermore, this effect is larger during periods of crisis, because insiders have greater informational advantages during crises (Hable & Launhardt, 2016). This increases the predictive power of heavy insider trading during downswings – an important point, if the next financial crisis is already looming, as analysts predict (Phillips & Russell, 2018).

Given the enormous heterogeneity of insiders, institutional investors looking to use their activity as predictors of bond performance would benefit from information as to the specific type of insider to observe. On this particular point, there is a little less consensus. On the one hand, Tavakoli et al (2012) and Seyhun (1986) both find that the trades of top executives (i.e., CEOs) have larger effects on returns than the trades of officers. This seems to make sense as one would expect insiders higher in the firm to have access to more accurate information about the firm. However, in their empirical analysis, Hable & Launhardt (2016) find that the transactions of level B insiders (that is vice chairmen, vice presidents, and executive vice presidents) have the greatest predictive power. This is because the actions of top executives are subjected to more intense scrutiny. This means that their transactions are well anticipated and portray less valuable information to the market.

Conclusions and Recommendations

This paper has discussed the merits of buying the corporate bonds of companies that have experienced heavy insider buying by their top executives. Based on the discussion, professional investors should heed the following recommendations. First, they should be wary when using CRAs to evaluate the credit quality of bonds. These ratings have been proven to be inaccurate, and this is likely caused by structural inefficiencies of the industry and government regulations. Second, when choosing bonds, investors should look to firms that have experienced heavy insider buying. Research demonstrates that insider transactions are an accurate predictor of both stock and bond movements, and empirical data suggests a lower likelihood of default among firms with heavy insider buying.

Data collected from Bloomberg and merged into FactSet. Only stocks with a market cap over 100 million are included in the dataset. Lionshares data used to indicate stocks with insider buying.

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