Investors reap greater profits when trading stocks of firms with more connected boards

May 27 2016

A golfer, a banker and a gambler linked in an insider trading case make for a great headline and provocative news.

That was true last week when it was disclosed that as chairman of Dean Foods, Thomas C. Davis reportedly repaid gambling debts by feeding boardroom secrets to sports bettor William T. Walters. Throw in pro golfer Phil Mickelson—who was not accused of wrongdoing but was "unjustly enriched"—and you've got a sensational insider trading story.

Put it in perspective, though, as this case is the exception and not the rule, according to a University of Kansas researcher who studies insider trading and corporate governance. Realize that there are tens of thousands of board seats at publicly traded companies in the U.S., said Felix Meschke, associate professor of business.

"You can't conclude that all of those guys are tipping off their buddies," he said. "Many directors are taking their jobs very seriously."

Meschke and two KU School of Business colleagues are working to understand the magnitude of information sharing between corporate insiders and sophisticated investors.

Meschke, together with professors Ferhat Akbas and Jide Wintoki, authored the lead article in the August issue of the *Journal of Accounting and Economics* showing that these investors reap greater profits when trading stocks of firms with more connected boards.

What explains these profits? The professors discussed three ways information is shared. Deliberate tipping, which is alleged between Davis and Walters, garners the most attention and is illegal in the U.S.

The two other ways would be information that's inadvertently leaked, or disparate pieces of information that sophisticated traders can piece together.

These two ways are not illegal and probably more common, Meschke said.

"There's more gray area than is shown in the cases that usually make the headlines," he said.

It's difficult to pin down the exact channel, Meschke said, noting that people engaging in nefarious information sharing hide their tracks. For example, Davis and Walters used disposable cellphones and secret code words.

Yet the professors found that savvy traders are more informed when trading stocks of companies with more connected boards.

They uncovered this by sorting companies into portfolios based on the size of their boards' networks and the magnitude of informed trading. They measured the magnitude of informed trading as the monthly level of short interest, the ratio of monthly option volume to stock volume, and weekly order imbalances of institutional traders.

The professors found that the annualized return difference between the highest and lowest portfolio of informed trading is much larger for firms with highly connected boards when compared to that difference for firms with less connected boards.

This means that sophisticated traders obtain larger profits when they choose to trade in more connected firms. Annual trading profits depend on which measure of informed trading is used—short interest (4 percent), option to stock volume (5.4 percent) or institutional imbalances (7.2 percent).

The finding that savvy investors are more informed when trading in stocks of more connected boards does not necessarily imply that companies should avoid well-connected directors.

"If you think about why you like to have a highly connected person on your board, it's because that guy know a lot of things you and I can't just google," Meschke said.

Companies could benefit from director networks because connected directors might divulge information they heard as members on other boards. Of course, that also means things spoken of in your boardroom might be part of the human capital those directors can use on other boards.

"You have to rely on the integrity of directors to walk this very fine line," Meschke said.

The study also confirms recent findings by Stanford professor and University of Kansas alumnus David Larcker that companies with more connected boards perform better.

"It's entirely possible that the corporation that hires a highly connected director gets more benefit from that director than what it might lose in information leaking out and hitting the market a little bit early," Meschke said.

The full paper is available for download on SSRN and via Science Direct

.

Provided by University of Kansas