Looking for a stock tip? Follow insiders at firms that spend on advertising

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(Phys.org)—It's a popular and successful strategy for many investors: Follow the trades made by corporate insiders, those high-level officials who often have informational advantages about their company. But two University of Kansas researchers suggest an even more precise version of that strategy: Follow the trades made by insiders specifically at companies engaged in advertising.

According to new research by KU School of Business professors Kissan Joseph and Jide Wintoki, company insiders at firms that advertise achieve higher portfolio gains than company insiders at firms that aren't advertising. These findings demonstrate that insiders' knowledge of their company's advertising expenditures is a strong informational advantage for them when it comes to trading, the researchers say. And for copycat investors, it means that insiders at firms that advertise are the best insiders to mimic.

"Investors often follow company insiders because insiders have informational advantages about their company," Wintoki said. "But until now, nobody had explored whether insiders' informational advantage includes knowledge of their companies' advertising expenditures. Our research says it does. So if you're an investor who likes to track insiders' moves, first research which companies have advertising expenditures, and then pay special attention to insiders at those firms."

Joseph and Wintoki detail their research in a paper titled "Advertising Investments, Information Asymmetry, and Insider Gains," which will appear in the upcoming issue of the *Journal of Empirical Finance*.

It's long been documented that insiders gain from trading in their firms' shares because of informational advantages. To date, the specific sources of information asymmetry that have been explored include firm size, analyst following, dividend payout policy, book-to-market ratio, and the presence or absence of R&D expenditures.

But surprisingly, virtually no research has examined the contribution of advertising investments to information asymmetry. This omission is particularly glaring since advertising investments constitute a significant fraction of many firms' expenditures. For example, between 2004 and 2008, aggregate advertising expenditure for all firms in the Compustat database was twice as large as R&D expenditure, which is a previously documented source of information asymmetry between insiders and outsiders. Joseph and Wintoki's research fills that gap.

In their study, Joseph and Wintoki analyze publically available advertising and transaction data from more than 12,000 firms between 1986 and 2011 and find that insider gains are significantly greater at firms that are making advertising investments. Specifically, a zero-cost portfolio that's long on firms with net insider purchases and advertising investments, and short on firms with net insider purchases and devoid of advertising investments, produces annual abnormal returns of 5.5 percent.

"I think most of us would agree that 5.5 percent is a pretty significant amount," Wintoki said.

In addition, Joseph and Wintoki find that investors' reaction to news of insider purchasing is significantly more pronounced at firms characterized by advertising investments – investors rationally recognize the greater information content associated with insider purchases at these firms.

"In the three days following disclosure of insider purchases at companies that advertise, their stock price rose by 0.3 percent more than those in companies where managers also bought their own company stock but do not advertise," Wintoki said. "This number translates to a 27 percent annualized

return."

Interestingly, Joseph and Wintoki find that the exact advertising level doesn't matter. In other words, the relationship between advertising and insider gains doesn't increase as advertising expenditures increase or vice versa. As long as companies demonstrate some non-trivial level of advertising expenditures, their insiders tend to have higher-than-average gains.

"So if Coke spends $100 million and Pepsi spends $50 million, that doesn't mean that Coke insiders do twice as well as Pepsi insiders," Joseph said. "What it means is, both Coke and Pepsi insiders on average will outperform by the same amount insiders at a third soda company that isn't advertising at all."

So are Joseph and Wintoki's findings the next big stock tip for the water cooler conversation?

"Investing is obviously complicated, and different people have different goals and strategies," Wintoki said. "But the take home-message from our research is this: If your investment strategy includes mimicking insiders, paying close attention to insiders at advertising firms may improve the profitability of that strategy."

More information:
www.sciencedirect.com/science/ … ii/S092753981300011X

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