Seyhun, H. Nejat – Investment Intelligence From Insider Trading

The MIT Press, 2000, [Equity Investing] Grade ★★★

A central guidepost of finance is that an investor that is better informed than the others can generate returns higher than the less knowledgeable. The investor with the ultimate level of corporate specific knowledge is the corporate insider. The objective of this book is to determine if investors can use corporate management's legal insider trading in a profitable strategy and beat the market. The author's thesis is that this is the case. If fact, Nejat Seyhun who is a Professor of Business Administration at the University of Michigan, claims that this is so already in the introduction. The book is meant to be a comprehensive guide to the various signals and nuances that exist within insider trading. It's written to appeal to both academics and practitioners.

The book has got two main themes. Chapter one to four plus chapter fourteen investigate the profitability of insider trading plus describe how to build a strategy around the trading and then also how the profitability can be enhanced. Then the rest of the book is a number of chapters that partly validate a number of other financial so called anomalies such as value and momentum etc. and also look into how these strategies interact with insider trading. The short story to this second set of chapters is that the author finds that insider trading dominates most other investment styles. Further, there is a stray chapter that looks at using insider trading for market timing of the overall stock market.

So what is the evidence when it comes to insider trading? Following insider trading is profitable. This is despite that the probability of one single deal is profitable after trading costs is lower than 50/50. There is a positive skew where insiders outperform by more on their profitable trades than they underperform on their unprofitable trades. Insider's purchases are more profitable than their sales. However, when insiders sell shares that have underperformed this also contains price sensitive information. Insiders are in general contrarians, buying when stock prices have fallen and selling when they have risen. There is a hierarchy where the trading by the CEO is the most profitable and that of group management and group board members also show good results but trading by all others doesn't generate market-beating returns. Confirming trades by the same person previous months, by more insiders in the same company or by more insiders in the same industry raises the profitability. As does looking at insider trading in smaller companies rather than larger and looking at larger traded sums rather than smaller. About two thirds of the risk adjusted outperformance has occurred after 6 months and after 12 months the profitability of the signal is gone.

The text is relatively comprehensive when it comes to insider trading. But while I found it useful it isn't very entertaining. Even though much of the statistics performed is left out, the book is dry and repetitive – and readability counts. The book could actually be characterized as ten or so academic papers with some text tying it together. I also found the constantly recurring debate if a result depended on rational variations in risk aversion with subsequent variations in risk premiums or on irrational and faulty market pricing a bit nervous. Although the aim of the book by and large is fulfilled and the writing is very convincing and the quality of the research looks to be high, I'm hesitant to grade *Investment Intelligence From Insider Trading* higher than three stars.

If you are thinking of constructing a system for insider trading and look to complement your reading of academic papers with a book; this should be it. It you plan to read it out of general interest it might be a bit tough to digest.

Mats Larsson, January 2, 2015