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Corruption? Caramba!

Academics find widespread insider trading in Mexico

By Barry Henderson

Mexico was supposed to have turned the corner on corruption. At least that's what investors who poured money into this bellwether emerging market thought in the early 1990s. It hasn't quite turned out that way. Just three weeks ago, Raul Salinas, the brother of former president Carlos Salinas, was convicted of murdering a political rival. In the financial markets, meanwhile, a less lethal but nonetheless prevalent form of corruption continues, according to a study by Utpal Bhattacharya, a professor of finance at the Kelley School of Business at Indiana University. He and his co-authors, Hazem Daouk, Brian Jorgenson and Carl-Heinrich Kehr, assert that insider trading is pervasive on the Mexican stock exchange, the Bolsa Mexicana de Valores. (The paper is posted on the Internet at http://ashem.bus.indiana.edu/finweb/UB.html.)

The evidence: Mexican shares -- at least the A shares, which are almost exclusively held by locals -- don't react to corporate news as they should, according to Bhattacharya and his colleagues. In fact, they don't react at all. But the B shares, which are owned primarily by foreigners, act like U.S. stocks whenever a company has news. For instance, a better-than-expected earnings number drives the stock price higher, while a disappointment tends to quickly deflate the shares.

[Corruption drawing] Bhattacharya and his colleagues examined a slew of corporate news announcements and their effect on stock prices from July 1994 through June 1997. On the day of a big event, they found nothing much happened to the company's A shares -- no pickup in volume or significant change in price. Their hypothesis: All the news already had been priced into the A shares because of insiders trading ahead of the news release.

For example, they compared the price moves in the A and B shares in Cemex before and after it announced a $200 million stock buyback in March of 1997. They also examined movements in the same stock before and after the company decided to terminate its tender offer to buy a company called Tolmex. Bhattacharya et al. looked at price change movements in both the A and B shares for 80 dayss before and 10 days after company news announcements. This 90-day period is what they called the "event window."

(In addition to Mexico, a number of other developing countries have similar share classes. See map.)

The researchers started by looking at 884 different securities over the three-year period. Then they refined their database, focusing on 73 examples involving what the researchers considered significant news, such as restructurings, privatizations, board of directors changes, as well as abnormal earnings and dividend announcements.

Bhattacharya and his colleagues also had to rule out alternate explanations to insider trading. Here

are three possibilities:

First, assume the stock market is "informationally inefficient," which means there's no link between corporate news and stock prices. Bhattacharya says that's clearly not the case here; before an announcement, there's a gradual change in price on the A shares that anticipates the move in the B shares. It's also possible that the information companies release isn't of much value to investors, and thus the share price wouldn't change. Bhattacharya eliminates this as well, noting again the gradual move in the A shares ahead of the news.

The third possibility is that investors fully anticipated the events. In this scenario, corporate news is just a badly kept secret, and insiders and public investors both get word of it before it's actually announced. In that case, you'd expect the A and B shares to move in tandem. But the fact that the A shares lead the B shares suggests that insider trading, not prescience on the part of all investors, explains why stock prices aren't sensitive to news events, according to Bhattacharya.

This controversial study -- its conclusions certainly aren't the kind you'll find in any Wall Street analyst's report touting Mexican stocks -- has just been accepted for publication by the Journal of Financial Economics. Last year, it won first prize for outstanding research in the International Investment Forum competition. This is a rather intense contest, judged by academically oriented buy-side firms like Barra.

That's not to say Bhattacharya and his colleagues don't have critics. Jorge Familiar, director general of the market supervision division of Mexico's National Banking & Securities Commission, contends they don't understand the real nature of the A shares. "The A shares are usually held by owner/managers and administrators that don't trade them very often," says Familiar.

What's more, he adds that the anecdotal evidence just doesn't support the authors' contentions. Familiar is investigating five insider trading cases right now and all of them have to do with the B shares, not the A shares.

Bhattacharya admits that A shares are much less liquid than their counterparts, but contends that's not relevant. He points out that price changes happen "on the margin," which means the prices depend on the most recent buyer and seller. Price trends, not liquidity, are really the issue here, Bhattacharya contends.

[Map of split-share countries] There's a surprisingly long list of countries where foreigners can't hold the same kind of shares in a company that natives do. All of the countries above have an A- and B-share split similar to the one in Mexico. Professor Bhattacharya suggests looking at insider trading as one gauge of "market integrity" in each of these countries.

Fund managers who invest in the Mexican market also don't seem to be terribly concerned with or surprised by Bhattacharya's results. "It's no great news flash that insider trading has been going on in Mexico," says Franklin Templeton's Mark Mobius. "We've got a lot more serious things to worry about [in emerging markets] right now," such as the treatment minority shareholders receive, the well-known global money manager adds. For example, he's recently sued a Polish bank that's selling out to a German bank for less than its exchange-listed share price.

Amit Khandwala, who runs the Wright EquiFunds Mexico portfolio, says that even if Bhattacharya & Co. are on the mark about insider trading, that's hardly a reason not to invest in the market. While he's interested in their conclusion, he doesn't see the immediate value to his investment strategy. For instance, if you believe the academics' argument that price movements in the A shares precede those in the B shares, you should be able to trade off this trend. It turns out, however, that the spread between the bid and asked price on the B shares is so great that you can't profit once you factor in the transaction cost.

Bhattacharya isn't fazed by this criticism. He says he's not surprised that foreign investors who already have a stake in the Mexican market aren't concerned about insider trading.

More importantly, without a credible effort to stamp out insider trading and other abuses, emerging markets won't attract as much foreign capital as they might, he says. Bhattacharya suggests that eventually, you should be able to construct a "market credibility index" that would give investors a gauge for market integrity. He hasn't done this yet, but he suggests that the first step should be an examination of trading patterns in A and B shares.

In the meantime, what's his advice to investors venturing abroad? "Find out what happens on the day of a corporate news announcement. If nothing happens, get suspicious. Check what happens before pre-announcement. If there is 100% leakage [of news], become more suspicious. If, further, there is a lead-lag relationship between shares segmented by ownership, become even more suspicious."