

AN INVESTOR'S GUIDE TO CORPORATE INSIDER TRADING ACTIVITY

By John Deysher

Insider buying is much more significant than insider selling. Insiders may sell their shares for a variety of reasons. But typically insiders buy their shares on the open market for one reason—the stock is cheap!

Are the corporate insiders buying or selling? That's a relevant question for every serious student of the stock market.

One of the most important tools of fundamental security analysis is knowing how the insiders feel about their own shares.

Over time, insider purchases and sales have been fairly good predictors of future stock performance. Since insiders have access to crucial information not generally available to the public, it makes sense to monitor how they act toward their own shares. While not foolproof, studies have shown that insiders have fairly good results in buying and selling their own shares.

WHO IS AN INSIDER?

An insider is defined by the Securities and Exchange Commission (SEC) as an officer or director of a public company or an individual or entity owning more than 10% of a company's stock. Take a look at the firm's annual report, 10K or proxy to identify the insiders.

Insiders are required to report their transactions in the company's shares to the SEC. These filings are usually done electronically via the SEC's EDGAR (Electronic Data Gathering, Analysis, and Retrieval) system. And now, thanks to the 2002 passage of the Sarbanes-Oxley Act, relevant filings are much more timely. The most relevant SEC forms are Forms 3, 4, 5 and 144. They become public information and are available on the Web at www.sec.gov.

Form 3

This form is filed when an individual initially becomes an insider. It is an initial Statement of Ownership showing all holdings and must be filed immediately upon attaining insider status, even if no shares are owned initially.

Form 4

This form is filed whenever there is an actual change in share ownership. This may include open market purchases or sales, granting of stock options or the exercise of stock options. Previously, Form 4 had to be filed with the SEC by the 10th day of the month following the actual transaction. In practice, however, sometimes it was filed months late or not at all. Under the Sarbanes-Oxley Act of 2002, a Form 4 must now be filed electronically via EDGAR within two business days of each transaction. This makes following the trades easier and the information contained therein more timely.

Form 5

This is an Annual Statement of Changes in Beneficial Ownership showing the insider's holdings as of a specific date. It must be filed within 90 days of a firm's fiscal year-end.

Form 144

This must be filed by *anyone* (insider or not) intending to sell restricted,

John Deysher, CFA, is president and portfolio manager of the Pinnacle Value Fund, a newly formed (April 2003) diversified mutual fund specializing in small companies. He is based in New York City and can be reached at deysher@pinnaclevaluefund.com.

TABLE 1. INSIDER TRADING: ON-LINE SOURCES**Securities & Exchange Commission (SEC)**

www.sec.gov

For the following sites, if there is no link to insider data on the home page, type a ticker in the quote function and look for an insider hyperlink or tab at the quote page.

CBS MarketWatch

cbs.marketwatch.com

Insider Trading search

Search by company name or ticker. Provides listing of recent insider transactions, including the number of shares, price and type of transaction. Free.

EDGAR Online

www.edgar-online.com

Under Latest News/Insider Filings

Listings of new (daily or weekly) insider transaction filings are free. Subscription: \$44.85 quarterly.

MSN Money Central

moneycentral.msn.com

Under Stocks/Research/Insider Trading search

Search by company name or ticker. Provides listing of recent insider buy and sell transactions. Free.

SEC Info

www.secinfo.com

Form 3, 4, 5, and 144 filings. Can sort by company, insider, form, and filing date. Free.

SmartMoney.com

www.smartmoney.com

Comprehensive stock data site includes insider trading activity for individual stocks; also provides a price chart with detailed insider buy and sell transactions, insider gain/loss data and an insider timing grade. Free.

Thomson Financial Network Insider Reports

www.thomsonfn.com

First Call Insider alerts

Listings of the day's most notable insider trading activities; historical insider transactions for companies including shares, price and type of transaction, as well as ratings on insider activity. Also includes commentary on particular insider transactions. Free.

Vickers Stock Research

www.vickers-stock.com

Limited access to free insider transaction reports, as well as listings based on insider ratings, such as the top 25 stocks most actively bought by insiders.

Wall Street City

www.wallstreetcity.com

Comprehensive stock data Web site includes detailed insider trading activity for individual stocks; also provides a price chart with buying and selling activity. Free.

unregistered securities. It provides notice of an intent to sell more than 500 shares or \$10,000 worth of securities within the next 90 days. Form 144 shows intent only and does not obligate the seller to complete the sale.

Restricted securities are usually provided as part of an executive's compensation package or in exchange for seed capital. Such securities are generally unregistered, meaning the shares have not been approved by the SEC for sale on the open market. Filing a Form 144 is part of the process of removing this restriction. It must be filed on or before the actual sale date, but does not show the actual transaction. When the security is actually sold, a Form 4 must be filed with the SEC. In practice, Form 144 and Form 4 are often filed at the same time.

HOW DO YOU TRACK FILINGS?

The forms that tell you the most about an insider's intentions are Forms 4 and 144, which reflect actual purchases and sales (Form 4) and intentions to sell (Form 144).

The key data contained in these forms is generally available through several types of sources:

- The SEC Web site (www.sec.gov) for individual company filings or the most recent insider trading form filings;
- Financial newspapers including Barron's (Insider Transactions, SEC Form 144 Filings), the Wall Street Journal (Insider Trading Spotlight), and most regional dailies (local insider transactions); and
- On-line resources (see Table 1).

WHAT SHOULD YOU LOOK FOR?

Once you've identified an insider transaction, how do you interpret it? Here are some general rules to point you in the right direction:

- Insider buying is much more significant than insider selling. Sellers do so for a variety of reasons including estate planning, portfolio diversification, paying taxes, or funding a college education or a new roof. Insider sales occur routinely—insiders normally sell two to three shares for each share purchased. Sales are not normally a sign of trouble unless multiple insiders are unloading large portions of their holdings at a rapid pace. That can be a red flag. But insiders typically buy their shares on the open

market for one reason—the stock's cheap!

- Open market purchases are more significant than those made at discounts to the market via the exercise of stock options. Insiders buying on the open market have usually exhausted their option opportunities but still have an appetite for additional shares, even at higher prices. Normally the Form 4 disclosure will detail whether the shares purchased or sold were option-related or open market transactions.
- Who's doing the buying? While the chairman, chief executive officer and directors should be monitored for insider activity, don't ignore buying by those further down in the organization hierarchy. Line managers and divisional vice presidents are often closer to the action and their open market purchases signal a meaningful vote of confidence. An executive adding

1,500 or 2,500 shares to an existing 5,000-share position is making a commitment. These are funds typically earmarked for a college education or new car, but instead he is putting the money into shares of his own company—a bullish sign! There were once several lower level insiders buying shares of their firm at a rapid clip while the head executives bought none (they were already large owners). The shares doubled in quick order.

- Similarly, the size of the purchase relative to the total holdings speaks volumes. Many insiders add regularly to their positions via modest open market purchases. But when an insider owning 500,000 shares buys another 250,000 shares, that's normally bullish. An executive owning 10,000 shares who triples his holdings to 30,000 is also a bullish signal.

Purchases made by multiple insiders are more significant than purchases made by a single insider.

- Finally, don't chase shares selling significantly above what the insiders paid unless your analysis shows the shares continue to be undervalued. Frequently, the higher price already reflects the good news that originally triggered the insider purchase.

THE FUNDAMENTALS

Tracking insiders is just one of many tools used in fundamental analysis. Remember, insiders are human and just like the rest of us they make mistakes.

However, actions speak louder than words, and there's no better way to observe the behavior of corporate America than through stock ownership activity, especially by the insiders. ♦

Insider Trades: What to Look For

The size of the trade

The dollar value of a buy transaction can be very significant. Bill Gates' purchase of \$1 million worth of Microsoft isn't nearly as significant as a vice president of a firm spending a year's salary on his company's stock. Also examine the trade in relation to the insider's holdings—selling 10,000 shares from a portfolio of one million shares is not as significant as someone selling 5,000 shares from their holdings of 10,000.

The type of transaction

Buying is more significant than selling, because sellers often have cash flow needs that prompt sales. Purchases made on the open market tend to be more significant than options-related transactions. This is because options allow the holder to purchase stock at a discount to the current market price. An insider willing to buy the stock at full price is a positive sign.

Number of insider transactions

Pay attention to the number of insiders either buying or selling. Ideally, you would like to see several insiders acting in a similar fashion within the same relative time period.

The insider's position

The closer the insider is to the day-to-day operations of the firm, the stronger the signal is.

The price paid for or received for the stock

You would expect to see insiders selling their stock near the high and buying near the lows. However, note where the price currently is in relation to when the transactions actually took place. If the price is significantly different from the insider's buy or sell transaction, you may wish to hold off on entering the trade until you see confirming behavior—more buys or sells from insiders.

Timing

Insiders tend to be early in their activity, especially when it comes to buys. Studies have shown that the majority of the extra returns insiders generate on their buy trades come after 30 days of making the buy. Just because insiders are snatching up their company's stock does not mean that the price will rise immediately, or at all. "Significant" insider activity—both in number of shares and number of insiders—is more a sign of long-term value.