

SCREENING FOR THE SMART MONEY: WHAT THE INSIDERS ARE DOING

By Wayne A. Thorp

Insiders tend to be long-term investors since insider trading laws prohibit them from being short-term traders. They are also good at identifying when stocks are over- or undervalued. Insiders have front-line knowledge of what is taking place at a company and, therefore, are the most informed about those things that will impact the cost of the company's stock.

Over the past several years, Wall Street and individual investors have been paying closer attention to the buying and selling activities of corporate insiders in the hopes of catching a glimpse of where a company's stock may be headed.

Such logic certainly makes sense—who else would better know the future prospects of the company and how this may impact future stock price movement? Insiders are privy to information regarding new products, competition, and operating environment—oftentimes long before the companies become large.

This article will discuss several of the issues surrounding insider trading—who insiders are, what requirements insiders must obey regarding the purchase and sale of company stock, why insider data is important, how it can be used in the investment decision-making process, and where you can find data regarding insider transactions.

WHO IS AN INSIDER?

In legal terms, the Securities Exchange Act of 1934 defines an insider as an officer or director of a public company, or an individual or an entity owning 10% or more of any class of a company's shares. Thus, the term "insider" refers to a wide-ranging number of groups including: large shareholders, directors, and officers.

Large shareholders, or "beneficial owners" as they are sometimes termed, are those persons or entities that own more than 10% of a class of a company's stock. Although they are insiders in a legal sense, they are not privy to the same kind of information that top-level employees of the company have access to.

Directors, as one may guess, are members of the board of directors of a company.

Officers are those individuals at a company occupying the highest positions—CEO, chief financial officer, president, vice president, and others.

INSIDER RESPONSIBILITIES

The term 'insider trading' also carries a negative connotation. Under the securities laws, it is illegal to buy or sell the stock of a company based on material, non-public information; this type of trading is often referred to as insider trading.

On the other hand, trading by insiders based on non-privileged information is legal, albeit highly regulated by the government.

The Securities and Exchange Commission (SEC) requires insiders to file several reports outlining their transaction histories. These reports include Forms 3, 4, 5, 144 and 13D.

- **Form 3** is the Initial Statement of Ownership, which must be filed by any insider, even if he or she does not own any shares in the company. Form 3 must be filed within 10 days of attaining insider status.

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- **Form 4** indicates a change in the ownership position in a certain security. A change in position takes place whenever an insider buys or sells stocks on the open market, exercises stock options, or is granted stock options. The insider is required to file a Form 4 with the SEC by the 10th day of the month following such a transaction.
- **Form 5** is the Annual Statement of Change in Beneficial Ownership. Activity listed on this report includes “exempt” transactions not required on a Form 4. This report must be filed within 90 days of the company’s fiscal year-end. Exempt transactions include gifts and dispositions by divorce decree.
- **Form 144** must be filed by anyone, whether or not they are an insider, who *intends* to sell restricted or unregistered stock within the next 90 days. Restricted stock is awarded or acquired from the issuing corporation and is usually granted as a form of compensation. Private investors may also receive restricted stock through a private placement. Recipients of restricted stock obtain it at a discount and are required to hold the stock for at least one year, after which they can sell it by filing a Form 144. A Form 144 must be filed on or before the actual sale date but does not indicate an actual transaction. If the stock is subsequently sold, a Form 4 must also be filed with the SEC. Oftentimes both the Form 144 and Form 4 are filed simultaneously.
- **Form 13D** outlines the activities of those persons or entities who hold 5% or more of the outstanding shares of a class of a company’s securities. If an individual or entity acquires more than 5%, a 13D must be filed within 10 days. Besides illustrating the buying and selling activities, the 13D also shows the reason for the action—such as

investment purposes or intent to gain controlling interest in the company. Once a 13D has been filed, all subsequent transactions require an amendment to the original 13D as long as the position does not fall below the 5% level.

Beyond having to report their activities to the SEC, insiders are typically limited as to *when* they may buy or sell the stock of a given company. In addition, the SEC has initiated “short-swing profit rules” that prevent insiders from entering and exiting positions quickly to capitalize on short-term price movements. These rules stipulate that if an insider sells a stock, he or she cannot buy it back at a lower price for the next six months. Likewise, if an insider buys a stock, he or she cannot sell it at a higher price for at least six months. When viewing the buying and selling behavior of a company’s insiders, be sure you are aware of the company’s own trading rules.

WHY THE DATA IS IMPORTANT

How can knowledge concerning insider transactions help you in your own transactions?

Insiders have frontline knowledge of what is taking place at a company. Consequently, they should be most informed about those things that will impact the cost of the company’s stock.

To give you an idea of just how prescient insiders can be, let’s see how insiders have performed as compared to the market as a whole. Research has shown that portfolios of insider buy transactions that were created on a rolling 12-month basis, outperformed the market by over 7% *a year* during the 10-year period ending in 1996. Furthermore, two-thirds of these extra returns were earned once a 30-day period had passed since the transaction, indicating that the lag in reporting of insider transactions may not prevent outside investors from benefiting

from the knowledge about the transactions. On the flip side, however, studies have shown that data concerning sell transactions tends not to be useful in garnering extra investment returns.

These studies indicate an important concept: Most insiders buy the company stock to make money, but they tend to sell company stock for any number of reasons. Insiders will probably not put up their own money unless they believe the investment will make them a profit. Often, however, stock-purchase loan programs require executives to purchase shares of the company or allow them to purchase shares without having to risk their own money up front.

INTERPRETING THE DATA

If insiders have the edge in making their buy decisions, how can you use the data to judge investment opportunities? There are several ways to analyze insider data to get the most out of it.

When you examine the insider trading data for a given company, here are some key points to keep in mind:

- The size of the trade
- The type of transaction
- Insider activity within the firm
- The insider’s role within the company
- The price paid/received for the stock

When looking at the size of an insider transaction, you should look at it from several different angles—the number of shares transacted, the dollar value, and/or the shares transacted relative to existing holdings. Obviously, you should place greater emphasis on transactions involving several thousand shares as compared to one with only a couple hundred shares.

The dollar value of a buy transaction can be very significant. You probably wouldn’t think twice if Bill Gates bought \$1 million worth of Microsoft, whereas a vice president

TABLE 1. TOP 25 FIRMS PASSING THE INSIDER BUY SCREEN

Company (Exchange: Ticker)	Insiders		Net Insider Buys as a % of		Price as % of		P/E Ratio (X)	5-Yr. EPS Growth (%)	EPS Growth Est. (%)	Market Cap. (\$Mil.)	Description
	No. of Buy Trades	Net Shares Purch. (000s)	Shares Outstg. (%)	52-Wk. High (%)	52-Wk. Price (\$)						
					Low	High					
FirstWorld Commun. (M: FWIS)	5	6,502	18.1	8	2.75	38.75	nmf	-62.4	71.5	155.4	Internet, data & comm servs
Aviation Sales Co. (N: AVS)	3	966	6.4	15	3.50	39.75	nmf	-53.4	25.0	89.2	Aviation maint & parts redist
NTN Commun. (A: NTN)	3	1,087	3.5	30	1.06	7.75	nmf	-45.4	—	77.3	Interactive programs
Acceptance Ins. Cos. (N: AIF)	4	518	3.6	31	2.75	15.38	nmf	-28.2	10.0	67.9	Property & casualty insurance
Metrocall (M: MCLL)	5	3,371	6.9	31	1.13	17.22	nmf	-102.9	16.0	448.8	Wireless messaging services
Global Sports (M: GSPT)	3	7,500	40.5	34	4.31	25.25	nmf	-104.3	50.0	184.5	E-commerce sporting goods
Alpha Microsystems (M: ALMI)	3	2,057	17.4	37	2.00	11.38	nmf	-5.0	—	58.8	Consulting & solutions
Vitech America (M: VTCH)	6	1,720	10.5	37	3.81	12.50	41.5	-135.9	15.0	88.3	Computer equipment
Bluegreen Corp. (N: BXG)	6	5,278	22.2	42	2.50	6.38	11.2	0.0	—	65.3	Resort & golf businesses
Mac-Gray Corp. (N: TUC)	5	511	4.0	42	2.75	9.50	nmf	-20.3	10.0	50.5	Card & coin-op laundry servs
Bell & Howell Co. (N: BHW)	4	925	3.9	50	19.50	39.13	140.6	25.8	18.0	466.9	Information solutions & servs
Phosphate Resource PLP (N: PLP)	9	3,605	3.4	56	5.38	11.25	nmf	-40.6	5.0	653.4	Crop nutrients & feed ingred
Cell Therapeutics (M: CTIC)	3	660	3.4	57	1.31	52.00	nmf	8.4	—	713.1	Biopharmaceuticals, cancer res
Data Race (M: RACE)	5	967	4.2	57	0.88	8.88	nmf	26.0	—	116.1	Prods for telecommuting
Gymboree Corp. (M: GYMB)	6	1,722	7.0	66	2.25	7.63	nmf	-20.0	14.4	138.9	Newborn to preteen apparel
Paradigm Genetics (M: PDGM)	12	1,774	32.8	68	9.00	22.00	nmf	—	—	385.7	Gene research for crops
Pennaco Energy (A: PN)	16	630	3.3	68	6.88	17.75	nmf	—	35.0	235.1	Natural gas
Gentek (N: GK)	10	2,114	9.2	72	7.19	16.50	6.6	—	—	295.1	Industrial & chemical prods
Thomas Nelson (N: TNM)	8	495	3.4	72	6.25	11.19	11.3	-1.6	—	113.8	Christian-oriented books
OSCA (M: OSCA)	10	39	3.9	78	13.19	18.88	8.7	—	—	205.6	Oil & gas well prods
Chart House Enterprises (N: CHT)	9	885	7.5	82	4.00	6.38	nmf	-20.8	—	61.9	Restaurants
Annuity & Life RE Holding (M: ALRE)	10	1,436	5.6	84	16.00	29.13	19.5	—	25.0	625.5	Annuity & life reinsurance
Cole National Corp. (N: CNJ)	7	771	4.9	88	3.88	8.63	nmf	-44.3	20.0	118.3	Eyewear & optometric servs
LodgeNet Entertainment (M: LNET)	6	1,169	9.7	95	11.88	27.75	nmf	-46.6	—	322.3	Broadband interactive servs
Allergan Specialty Therap (M: ASTI)	7	136	4.1	97	11.00	18.50	nmf	—	—	58.9	Pharmaceutical prods
Median for Passing Cos.	6	1,087	5.6	57			11.3	-28.2	18.0	138.9	
Median for All Cos.	0	0	0.0	57			13.7	7.6	18.0	88.2	

nmf = no meaningful figure

Statistics are based on figures as of July 28, 2000

Data Source: AAI's Stock Investor/Market Guide, Inc.

Exchange Key: N = New York Stock Exchange

A = American Stock Exchange

M = Nasdaq

Sources of Insider Trading Data

EDGAR Online

www.edgar-online.com

Information on Form 144 filings and other insider transactions. Users can specify stocks and receive E-mail alerts when companies file with the SEC.

InsiderSCORES.com

www.insiderscores.com

Insider transactions that can be broken down by buy or sell transactions, option exercise, or planned sales. Ranks insiders according to their trading success.

InsiderTrader

www.insidertrader.com

Source of free Form 4 and Form 144 data covering the last two years. Premium service includes a searchable database of Form 3, 4, 13G, and Schedule 13D data that is updated daily.

Quicken.com Insider Trading

www.quicken.com/investments/insider

Free listing of insider buy and sell transactions over the last year. Dollar value of shares transacted also provided.

SEC Info

www.secinfo.com

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

Thomson Investment

www.thomsoninvest.net

Insider trading activity for the last year and corresponding chart that shows prices at which transactions were made.

of a firm spending a year's salary on his company's stock could be viewed as a significant transaction.

The same can be said when viewing how many shares are transacted in comparison to the size of the insider's holdings. Selling 10,000 shares from a portfolio of one million shares is probably not as significant as someone selling 5,000 shares from their holdings of 10,000. Overall, you need to view the transactions in a relative fashion.

The type of transaction can be important as well. 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.

When you are examining the insider trading activity of a company, you should 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. Several insiders buying stock would look more favorable than only one. If you find insiders buying and selling simultaneously, you will want to examine the net effect, both in terms of the number of transactions as well as the number of shares. It is a more bullish indicator if insiders are net buyers rather than net sellers.

An insider's track record can be helpful when viewing buy and sell transactions. Insiders who buy and sell indiscriminately are of little use, while insiders who have a history of selling at the high and buying at the low are worth watching.

The insider's position within the firm can also be an important consideration. The closer the insider is to the day-to-day operations of the firm, the stronger the signal is.

Lastly, you should pay close attention to the prices at which insiders are buying and selling. You would expect to see insiders selling their stock near its high and buying

near the lows. You should take note, however, if the price has been trading in a sideways manner and insiders begin buying or selling: Something besides price has probably triggered this activity.

Since there is a lag between when an insider buys or sells and when he or she files a report with the SEC, you also want to 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.

One item to keep in mind is that 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.

THE INSIDERS SCREEN

It would be foolish to base your buy and sell decisions solely on insider data. However, before you buy or sell a stock, it may be useful to see what the inside money is up to.

For the insider screen here, we use AAI's *Stock Investor* database program. *Stock Investor* covers over 9,500 NYSE, Amex, Nasdaq National Market, Nasdaq Small Cap and over-the-counter stocks. Table 1 shows the 25 companies that passed our final insider buy screen. This screen is solely concerned with insider buying activity, since studies have shown that insiders have been able to outperform the market on their buys, but not on their sells. Therefore, we first search out those companies that have had a "signifi-

cant" level of insider buying—in this case those companies with at least three insider buys. The insider buy and sell data in the *Stock Investor* program comes from Market Guide, which covers those transactions in the last six months. Using month-end data as of July 28, 2000, this first screen reduces the original database of 9,518 companies down to 1,321. Table 1 indicates that the median number of insider buy trades for the passing companies was six, while the median for the entire database was zero. Pennaco Energy led all companies that passed the screen, with 16 insider buys over the last six months.

The second screen concerns net buying. The screen here seeks companies that have had more shares of stock purchased by insiders than have been sold. This further reduces the number of companies passing this screen thus far to 1,068. The passing companies have a median net purchase size of 1.087 million shares. Compare this to the database as a whole, where there was actually a median net *sale* of over 71,000 shares. Using these figures as well as the number of buy trades, we can come up with an average net number of shares bought per company. Pennaco Energy falls to the rear of the pack when viewing the net number of shares bought. On the flip side, Global Sports had the minimum number of insider buys required to pass the screen—three—but led all companies with a net of 7.5 million shares purchased by insiders.

The next set of criteria limits the market capitalization of the passing companies to a range of \$50 million to \$1 billion. These companies tend to have less of a following than large-cap companies such as Microsoft, and companies that garner less market attention offer a greater potential for "surprises" that could allow them to offer returns greater than the overall market. In fact, research has shown that the insider buy transactions of small-

and mid-cap companies have outperformed similar transactions by insiders of large-cap companies.

In the *Stock Investor* database, 3,931 companies have a market capitalization within this range and, overall, this requirement lowers the total number of passing companies to 554. For the passing companies, the median market capitalization was well below our \$1 billion ceiling at \$138.9 million, yet was above the database median of \$88.2 million.

The next screen eliminates over-the-counter (OTC) stocks. Exchanges have listing requirements that establish minimums for company size, share availability, and financial strength. There are 7,629 companies in the *Stock Investor* database on the listed exchanges. This screen reduces the number of passing companies to 543.

The next two screens exclude companies categorized as part of the Miscellaneous Financial Services and Real Estate Operations industries, which eliminates closed-end mutual funds and real-estate investment trusts (REITs). Collectively, these screens leave behind 9,014 companies of the overall database, and added to the other screening criteria leave 509 companies.

The last screen measures the number of net shares of stock purchased (shares purchased by insiders minus shares sold by insiders) as a percentage of the overall number of shares outstanding. The top 25 companies passing this screen are listed in Table 1; these companies had net insider purchases of 3.3% or more of their shares outstanding. The median net insider purchase as a percentage of shares outstanding for these 25 companies was 5.63%. Among the top 25, Pennaco Energy brings up the rear with 3.3% of its shares

outstanding being bought (net of shares sold), compared to Global Sports with 40.5%.

THE CAST OF CHARACTERS

Other investment characteristics in Table 1 provide some interesting details about these companies. Perhaps the most striking item is the 8% of 52-Week High" column. Eleven of these companies were, as of the end of July, 50% or more below their 52-week high price. FirstWorld Communications was at the "top" of the list at only 8% of its 52-week high! At the other end of the spectrum, Allergan Specialty Therapeutics was at 97% of its 52-week high. Overall, the median level for all the passing companies was 57%.

The median price-earnings ratio (calculated by dividing earnings over the trailing 12 months by the current price) of these companies was 11.3, just slightly below the median of 13.7 for the entire database. However, only seven of the 25 companies had a price-earnings ratio that was calculable; the other 18 companies all had negative earnings for the trailing 12-months. This gives further indication as to the riskiness of this group of companies.

Two other data columns included in this table are the five-year annualized growth rate for earnings from continuing operations, and the five-year estimated growth rate in earnings. These growth rates provide a glimpse into how the company has operated in the past, as well as a window to the company's potential future. For the 19 companies that had an historical earnings growth rate, only three had figures that were positive, with Data Race topping them all at 26% per year. Vitech America was at the other end of the

spectrum with a five-year earnings growth rate of -135.9% per year (a growth rate of -100% or less per year is possible because the company has gone from positive earnings to negative). The median growth rate for all 25 was -28.2%, while the median growth rate for all the companies in the database stands at 7.6%.

Since we are dealing with companies with low market capitalizations, we would expect a few to have no analyst following. This proves to be the case here, with 12 of the 25 not having an estimated earnings growth rate. With a median estimated growth rate of 18%, the final group of companies matched that of the entire database. Phosphate Resource PLP has a 5% estimated earnings growth rate, while FirstWorld Communications is estimated to grow at 71.5% per year for the next five years.

CONCLUSION

The insider screen here is not meant to independently generate a list of investment candidates. Instead, these are 25 small-cap companies that are experiencing above-average insider buying activity—a signal that they may warrant further analysis.

To buy or sell strictly on what the insiders are doing is not a wise investment strategy. However, to ignore what the insiders are doing may be an investment mistake.

Remember, insiders can sell their shares for a multitude of reasons. For the most part, however, insiders only buy because they expect to make money. By keeping on eye on what the insiders are doing, you have one more piece of the investment puzzle that may help aid your investment approach. ♦