Look Out Below?

In certain sectors, insiders historically have been smart sellers. Well, they're at it again

BY VITO J. RACANELLI

EVERY INVESTOR WOULD LOVE TO HAVE INside information. Trouble is, trading on it is illegal and can land you some serious hard time. Certain types of inside dope, however, are perfectly legit, and available to all who bother to look. We're talking about the buying and selling of company shares by so-called insiders, the firm's own executives and directors, who must report such activity in filings with the Securities and Exchange Commission shortly after such purchases and sales take place.

There are various ways to interpret this data, and an entire industry, catering largely to institutional money managers, has grown up around parsing insider buys and sales. Insider selling typically is far more prevalent than buying, because for most executives, stock is a key component of compensation. But heavier-than-usual selling by insiders can and should wave a red flag for outside investors.

Insider buying, on the other hand, suggests that the executive in question thinks the stock is undervalued. And more often than not, such buyers are right. "Insiders are closest to the company, and probably understand it better than anyone else," says Michael Painchaud, a founder and research director at Market Profile Theorems, a Seattle-based firm that keeps tabs on insider behavior.

While studying a company's insider activity often gives useful clues to the stock's subsequent performance, the exercise also works well on an industry level. Likewise, insider behavior has been a good barometer for the broad market, Painchaud says. In the past few months, aggregate insider selling relative to buying has been at its highest level in the 14 years in which MPT has been keeping tabs. "This market should be sold," he declares.

Lon Gerber, director of insider research at Thomson Financial, also is worried by the truckloads of stock that America's executives have been dumping lately. September will mark the fifth consecutive month of significantly higher sales versus buys, he says. In the past 11 years, there has been only one stretch of as much as three consecutive months in which selling predominated: July to September 2000, shortly after the stock market's peak. "We're in uncharted territory," he notes.

As the charts nearby illustrate, insiders in many industries that have enjoyed strong stock-market gains are selling into the rally. And some of these folks have been good, though not perfect, market timers over the past five years.

Studying insider activity in the semiconductor industry, which has just seen a burst of insider sales, can be tricky, says Carr Bettis, who runs the **Reserve Informed Investors Growth** Fund. Given that stock options are a major form of compensation for technology-firm execs, "we expect them to be rampant sellers," he says. Even so, he observes, the heavy and increasing selling by those supposedly in the know is reason for caution. Painchaud sees significant selling in **Novellus Systems**, **Fairchild Semiconductor** and **International Rectifier**.

And while this selling is going on, the chip stocks are fetching multi-year highs. Perhaps those attempting to exit sense that the vaunted rebound in tech revenues is destined to disappoint. As the semiconductor chart shows, increased selling by industry executives in the past five years often preceded big retreats in the shares by a couple of quarters. Once again, Painchaud doesn't mince his words: "The tech sector should be sold."

In the advertising business, the trend is troubling, too. "The rate of selling is greater than we would anticipate and continues to accelerate, while buying at these firms has essentially dried up," Bettis says. Adds Gerber: "You'd have to go back to May of 2000 to find selling at this high a level." We don't have to tell you what happened to these stocks after that.

Indeed, advertising shares spent the next three years in retreat, and insiders kept selling nearly all the way down. These days the group is rallying in anticipation of a rebound in ad spending, but industry executives are showing a notable lack of faith.

For Painchaud, insider selling at **Southwest Airlines**, **Alaska Air Group**, and **America West Airlines** "most clearly demonstrates an inflection point." Airline managers were bullish early in the year, buying shares in March and April, just as the stocks started to rally. Now they are dumping their shares, and pocketing 50% gains in some cases. Ironically, Wall Street analysts generally were bearish on the airlines early in the year, but started raising their ratings in August and September—just as the pros were heading out the door. Sure, summer traffic picked up, but the business traveller, who's crucial to industry profitability, shows no sign of returning.

In the metals and mining sector, Bettis says, insiders are selling furiously, and buying has disappeared. That, too, calls for caution, the more so because industry executives have been keen timers in the past.

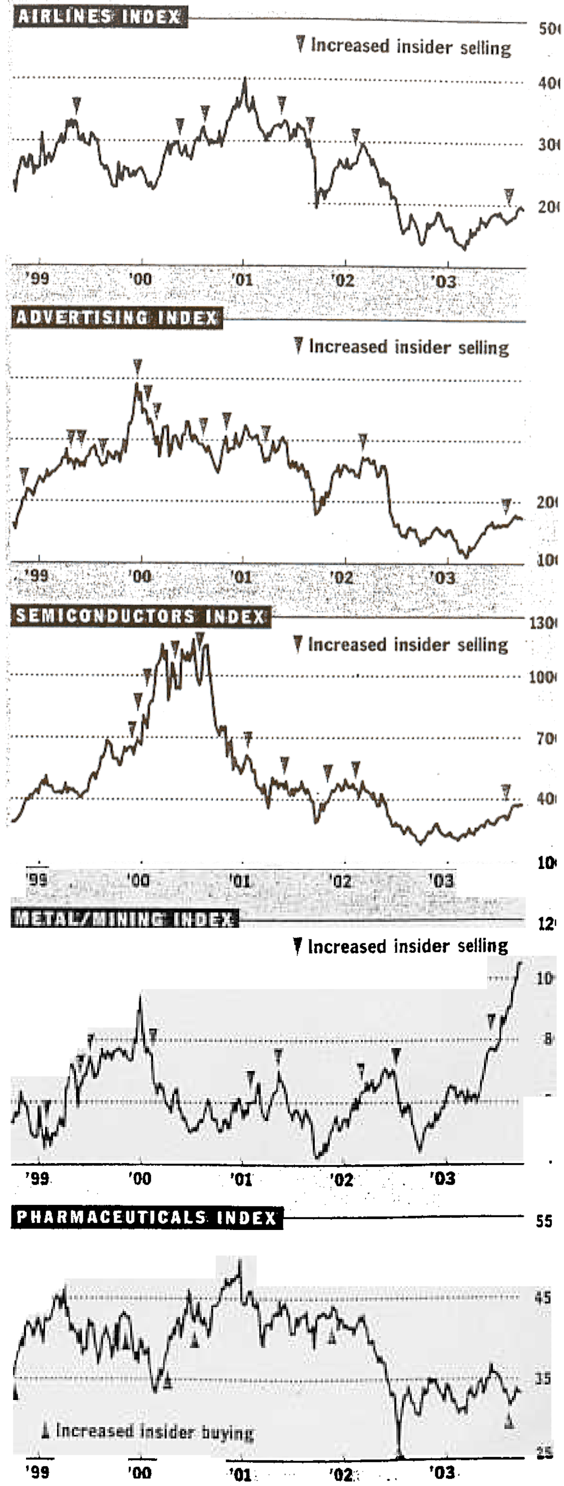
So, who's buying disproportionately in this market? Insiders in consumer non-cyclicals such as gas, electric and water utilities, and beverage and pharmaceutical companies, Painchaud says. Buying is especially heavy at drug firms such as **Abbott Laboratories**, **Bristol-Myers Squibb**, **Merck**, **Pfizer**, and **ICN Pharmaceuticals**, he adds. The group is up a puny 7% from its March low, compared with the broad market's 25% rally. Often, it has paid to follow the insiders into these stocks. Among utilities, insiders are buying **DQE**, parent of Duquesne Light, and **PG&E**.

Those who track insider activity for a living agree that buying is a more useful indicator than selling, because executives sell for myriad reasons, some of them quite personal. Consequently, insider activity should not be followed slavishly, and needs to be evaluated within the context of a company's fundamentals and industry trends.

But, as our grandmother always told us, watch what people do, not what they say. If the chief executive officer is talking up the company to a investor conference, even as he's selling shares hand over fist, something is amiss. ■

TAKE THE PROFITS AND RUN

▸In recent months, insiders across the board have taken advantage of the market's 25% rise by selling their shares into the rally. In particular, executives at airlines, semiconductor makers, advertising, and metals and mining have been good market timers and are now unloading stock. Meanwhile, insiders are snapping up shares of drug stocks.



Sources: Thomson Financial/Baseline; Market Profile Theor