BARRON'S Online

WEDNESDAY, DECEMBER 5, 2007

Judging the Financial-Stock Insiders

By NAUREEN S. MALIK

AMID THIS YEAR'S HEIGHTENED STOCK-MARKET volatility, insiders have increasingly emerged as bullish buyers of beaten-down shares across the financial sector.

But the extent of the subprime breakdown caught even the savviest executives and directors unaware.

For example, insiders at Citigroup, Thornburg Mortgage and IndyMac Bancorp bought shares during earlier corrections this year. The stocks then rallied only to drop again.

And last month, financial insiders made their largest open-market purchases in years as valuations continue to contract, particularly in the banking industry.

These cases of bad bullish calls by the so-called smart-money crowd serve as a cautionary lesson that even investors on the inside don't always get it right. It's clear that they didn't fully appreciate the depth of the credit-related problems originally tied to bad mortgages.

While following insiders into stocks can be treacherous in a market when some financials have been both gaining and losing 10% to 20% within days, the aggregate bullish activity across the sector should be reassuring. (See Electronic Q&A, "What's Next for Credit Markets?," Dec. 3, 2007.)

Insiders "are going to be correct more often than not, and if you consistently bet with insiders you are going to be correct with your investment," says Michael Painchaud, managing director of research for Market Profile Theorems.

So when is it the right time to buy financials again?

Regarding the sector's insider buying, Jonathan Moreland, an adviser to Ladenburg Thalmann Asset Management on insider strategies, says, "I'm definitely putting long-term faith in it, and I expect [financials] to turn around, but it still doesn't mean that I'm buying."

What keeps him on the sidelines? The technicals. "As a money manager, I get judged on a quarterly if not monthly basis, and frankly I can't afford to commit a lot of capital to this extremely volatile sector right now," says Moreland.

Even so, he says that those willing to cast a blind eye toward near-term volatility would make out well picking fundamentally strong financial companies with limited subprime exposure over the next three to five years.

Market Profile Theorem's Painchaud says it's a bullish sign that insiders stepped up purchases in November following a dramatic rally and tumble in August.

Painchaud's models weigh the strength of insider sales against buys to form a ratio, generally giving higher scores to executives and directors over outside major shareholders. He also gives more weight to open-market transactions over the more routine exercising of options.

Over the past 18 years, the historic sell-to-buy ratio, using Painchaud's weighted methodology, is 0.6-0.8. That ratio is currently at a very bullish level of 0.45 and was at 0.37 when the Dow Jones Industrial Average touched an intraday low of 12,455.90 on Aug. 16. (A lower ratio is more bullish than a higher one.)

Thus insider buying in August preceded the Dow's rally to a record high of

14,280 on Nov. 11 before the index tumbled more than 1,500 points to test that August low but not reaching it.

Insiders' willingness to repeatedly step up during these pullbacks "is supportive of a strong advance" in the market and point to good entry points when the Dow is trading at 12,500 to 13,000 points, says Painchaud. "I can't imagine (a market rally) taking place without the financials."

Bullish insiders in financials are emerging at a time when analysts' estimates are falling and stocks lack technical support. At these times, cumulative insider behavior in the financial sector has been pretty prescient in pointing to turns, says Mark LoPresti, vice president of Thomson Financial's proprietary research group.

And financial insiders have been making some hefty purchases in November, tallying $91.7 million, says LoPresti. That is the largest for any month since February 2003, ahead of what turned out to be a 30% rally by year end.

Big commercial banks and smaller regional banks were responsible for more than 50% of all financial-services sector buying this November. Overall, these industries, plus asset management, and thrifts and mortgage finance, were all ranked in the top 10 buying industries in November across the broader market.

LoPresti says insiders are pulling out less cash-per-dollar purchased. Take large banks, such as Wachovia, where insiders sold just four cents of stock for every $1 purchased. The monthly average dating back to 1996 is $9.75 in sales. The sell/buy ratio for regional banks was $1.06 versus the historical monthly average of $3.50.

The current buying emerges as the financial stocks in the Standard & Poor's 500 trade at the low end of their historical price-to-earnings range at 11.4 times. The multiples peaked at 13.5 times in 2004.

In a research report Tuesday, Goldman Sachs analyst Michael A. Moran noted that the earnings per share in the financial sector represented in the S&P 500 index declined 40% in the third quarter of 2007 with several companies indicating further write-downs and higher loan-loss provisions in the fourth quarter.

These "could lead to easier comparisons for the sector in 2008," he said. The firm estimates that the S&P 500 could end 2008 at 1,675.

Amid this continued uncertainty around credit losses, the pullback has created buying opportunities for long-term and patient value players, says LoPresti. Goldman Sachs, which has said it will not make write-downs, is trading at 9.7 times forward earnings, its lowest level since 1999, he adds.

When looking at individual stocks, however, insiders often get it wrong -- at least when it comes to timing.

A slew of Thornburg Mortgage insiders purchased nearly $13 million shares this summer in the $20-range. Days later the stock lost half of its value due to concerns about the company's ability to make loans. Insiders emerged as buyers again in late October. (See Inside Scoop, "Thornburg's Mini-Drama of Buying," Aug. 16, 2007.)

Similarly, Citigroup and IndyMac insiders purchasing stock in February and March did not anticipate the sudden subprime breakdown shortly thereafter.

Based on limited subprime exposure and strong business models, insiders say the most bullish signals are coming from companies like American Express, Wachovia and MF Global, the futures and options broker. Fannie Mae has had some positive insider buying. Prescient insiders at American International Group have been snapping up shares again, and the stock is one of Goldman's top picks in the sector.

But Ben Silverman, director of research at InsiderScore.com, says he is hesitant to make a positive call on Fannie because of the credit-market uncertainty.

While insider buying is tempting outsiders to jump back into the financial sector, it might be wise for investors to take their cues from the fundamentals as well as from the insiders.