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Insider trading sends mixed-up market signals

When company officials buy or sell their company's shares, they send important signals to outside investors. Or do they? Credible analysts of so-called insider trading data, as reported routinely to the Securities and Exchange Commission, have thrown a basic investment tool into doubt. In theory, top officers and directors know more than you do about the prospects for their company. Even if they are not trading illegally--exploiting material information that should be made public--their decisions must be better informed than yours.

Yet two widely quoted analysts using insider trading data disagree sharply on the outlook for 2005. "Insider selling at the current time, as for all of this year, is of a degree that suggests that the equity markets are not going to do well in 2005, relative to 2004 and 2003," said Michael Painchaud, research director at Market Profile Theorems. Insider trading is a key element in his analytical method, which recently led him to conclude, for example, that shares of Martha Stewart Living Omnimedia were due for a tumble. Painchaud tracks trades based on statistical norms for each company. Thomson Financial, another aggregator of insider trading data, has a different view.

Thomson analyst Mark LoPresti says the pickup in insider selling mostly reflects a greater amount of option-exercising by officers and directors. Individuals awarded option grants as part of a compensation package often sell part of the stock they obtain through those options. They may sell shares to pay the cost of the stock set at the time of the option award or to pay taxes on their gain. If you ignore selling associated with these acquisition costs, on balance "insiders are picking up shares as they go along," LoPresti said. In November 2003, as a stock market rally neared a peak, insiders were selling aggressively--unloading three times the amount of stock linked to option exercising, he said.

Currently, "insiders are increasing their positions overall. . . . There is nothing being indicated by insiders to suggest doom and gloom." There are differences among sectors, however. The telecommunications sector has been sending upbeat signals, but the energy sector is waving a warningflag, LoPresti said. Many studies indicate that insider buying and selling, as well as awards of stock options to top officials, send unmistakable market signals. "If a senior executive exercises an option and sells all or most of the stock, that tells you the stock may have reached a peak or there may be some bad news about to be released," said compensation consultant Don Delves. The dispute could resolve itself beginning June 15, when companies will be forced to account for stock option awards as a business expense. "Options will be granted much more judiciously since they will no longer be free," Delves said. The use of stock option awards as a gimmicky substitute for cash salaries should decline. Share ownership could resume its traditional role as a link between the long-term interests of management and outside shareholders. If that happens, insider trading will send a muted but clearer signal.