The New York Times ON THE WEB

September 25, 2005

The Analysts vs. the Insiders

By MARK HULBERT

INSIDERS are aggressively buying shares of their company's stock while Wall Street analysts are downgrading it. As a potential investor, what should you do?

Until recently, researchers had not tried to answer that question. To be sure, quite a few studies over the years have analyzed insiders' behavior, while others have focused on the ratings of Wall Street analysts. In general, the studies found that investors should pay attention to certain things that insiders do - or that analysts say.

But insiders and analysts often disagree. And in such situations, research provided no guidance for investors.

A new academic study fills that void - and concludes that when insiders and analysts directly disagree, the insiders are usually right. The study was written by three finance professors: James Hsieh of George Mason University and Lilian Ng and Qinghai Wang, both of the University of Wisconsin at Milwaukee. It has been circulating in academic circles over the past year; a copy is at papers.ssrn.com/sol3/papers.cfm?abstract-id=687584.

The professors focused on the 10 years through 2003. For each calendar quarter over that time, and for each stock, they first determined whether the consensus rating from Wall Street analysts had gone up or down. They also measured whether there had been net purchases or sales among that stock's insiders - the company's officers, directors and largest shareholders.

Consider first those calendar quarters when there were more insider purchases than sales of a company's stock, and when the Wall Street consensus about that stock had become more bearish. Such stocks, on average, outperformed the market over the next four quarters, according to the professors. In fact, these stocks performed almost as well, on average, as stocks for which both insiders and analysts were bullish.

According to the professors, this means that when insiders are bullish, the consensus of Wall Street's analysts is largely irrelevant to how a stock performs over the next year. In such cases, investors can safely ignore that consensus and rely on the insiders' behavior alone.

Consider next the situations in which the disagreement went the other way - when the insiders were net sellers and the analysts had become more bullish. In these cases, the researchers' findings were less favorable to the insiders, because these stocks, on average, did not lag behind the market over the next four quarters. But they did not outperform the market, either, so analysts still have little to brag about.

The only situations in which the analysts appeared to be more accurate than the insiders were those when a company's insiders were neither buying nor selling and the analysts had become more bearish. Such stocks, on average, significantly lagged behind the market over the next four quarters, the professors found.

They also found that stocks downgraded by analysts actually performed worse after periods when insiders were silent than they did after periods when insiders were net sellers. That would seem to paint an unflattering portrait of insiders' judgment, but the professors believe that even here, the insiders may get the last laugh.

The researchers argue that insider behavior should be interpreted in light of insider trading regulations, which discourage insiders from selling their companies' stock in the weeks and months before bad news becomes

public. Because of these regulations, aggressive insider selling "might even suggest that insiders do not have negative information" about their companies, according to the professors.

In fact, they reason, insider inaction may be a more bearish signal, because it may mean that insiders have bearish information about their companies but cannot trade on it. If that is the case, analysts may not deserve full credit for the market-lagging performance of stocks on which they are bearish and insiders are silent. In that event, credit would have to be shared with the insiders.

The bottom line, then, seems to heavily favor corporate insiders as guides to stocks that will do well - and maybe even to stocks that will be market laggards.

But does this conclusion need to be modified in light of Regulation Fair Disclosure, a rule that took effect in October 2000? It prohibits insiders from disclosing materially important information to analysts in private conversations, requiring them instead to disclose it either in a news release or a conference call that is simultaneously open to all investors. Does the greater transparency resulting from this regulation render the study's conclusion obsolete?

The professors don't think so. They analyzed the 1994-1999 and 2000-2003 periods separately, and found that their overall conclusion was even more pronounced in the second period. So even in the post-Regulation F. D. world, insiders appear more reliable than analysts as guides to stock performance.