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Higher dividends help curb insider trading, industry study shows

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Investors get jittery when company insiders sell their stock, because it raises suspicions about what they know that average shareholders don't, even if nothing is going on.

That's why it's interesting to see how a company's dividend policy can affect insider trading.

Companies that pay higher dividends see executives and board members selling far less stock.

And when insider trading declines, that often leads to less volatility in the stock.

"Put very basically, I, as a shareholder, am more comfortable knowing that the managers are holding the stock and are net buyers of a stock," said Michael Painchaud, who tracks insider trading at his independent investment research firm Market Profile Theorems Inc.

Stock compensation, through stock options or other equity instruments, became a popular pay incentive during Wall Street's record climb in the 1990s.

The goal is to align the interests of executives and shareholders. So if profits grow and the stock goes up, everyone should walk away with their pockets lined.

Insiders often have legitimate reasons for selling their company stock, which, in most cases, must be reported to regulators and investors within two business days.

They may just want the money to cover personal expenses, or want to cash out after a big gain in the share price. And at many technology companies, stock compensation is often the bulk of executive pay, so they sell their stock for income.

But it is still sometimes difficult for investors to gauge what is considered routine selling or whether a sale signals something else.

And that uncertainty can lead to big swings in the stock price.

This nervousness is understandable given what happened in many of the recent corporate scandals. Stock compensation is blamed for enticing executives at companies like Enron and WorldCom to manipulate earnings to boost the stock price and then sell their lucrative holdings.

While dividends don't stop bad behavior, they appear to give insiders less reason to sell their stock because the payouts provide them with a regular flow of income.

A new study by Thomson Financial found that insiders at Standard & Poor's 500 firms with 4 percent or more in annual dividends sold an average of only $763,041 worth of stock each quarter over the last five years.

That contrasts with average quarterly sales of $8.4 million by insiders at firms that pay no dividends.

"This shows that a dividend changes the incentive structure for executives and encourages them to be more willing to hold their wealth in the one stock," said Craig Columbus, co-author of the study and a market strategist at Thomson Financial in Scottsdale, Ariz.

One example of this is cereal-maker Kellogg, where top managers and directors sold only $9.5 million in stock between 1998 and today, according to Thomson Financial.

Kellogg pays quarterly dividends of 25 cents a share, and its dividend yield, the amount of money per share paid to investors divided by the stock price, now stands above 3 percent.

That means chief executive Carlos Gutierrez, who holds about 114,000 shares of common stock according to Kellogg's latest regulatory filing in September, walks away with about $28,000 in dividend income every quarter.

At energy producer Marathon Oil, the executive team has sold about $700,000 in stock since 1998. Its quarterly dividend now is at 23 cents a share, just over a 4 percent yield.

And at J.C. Penney, insiders only sold a total of $2.3 million worth of stock over the last five years. In the last two years, during which revenues have started to improve thanks to efforts to turn the struggling retailer around, no executive or board member has sold any stock, even though the price has doubled.

Its quarterly dividend is 12.5 cents a share, putting its yield at about 2.6 percent.

"Dividends give executives a more longer-term view of the firm's value, and they begin to act more like long-term shareholders," Columbus said.

Still, the real test of whether dividends impact insider trading will come if more growth companies start issuing dividends in the wake of Microsoft's recent announcement to do so.

Microsoft's first annual dividend is 16 cents a share, which put about $99 million in dividend income in the hands of founder Bill Gates.

That, though, doesn't amount to much compared to the more than $2 billion in stock he sold over the last year, according to Thompson Financial.

There's no guarantee that dividends keep executives honest, but they appear to keep them from selling lots of their stock.

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