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The Inside Scoop

By Lisa Scherzer
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AS A BIOLOGY AND STATISTICS major at Michigan State University, Michael Painchaud found the predictability of scientific questions and answers a bit tedious. After awhile, he wanted to examine a part of the world that was less predictable. The stock market seemed a natural fit.

But Painchaud didn't abandon the quantitative methodologies he'd learned in school. Rather, he combined them with behavioral approaches to predict price changes in equities. Insider corporate behavior proved an especially valuable tool to Painchaud, founder and research director of Market Profile Theorems, a Seattle firm that provides research on more than 5,000 companies. By gauging insider buying and selling as well as other key factors such as earnings surprises and analysts' profit estimates — Market Profile Theorems employs four models in all — Painchaud discovered that it was possible to pick out promising stocks much of the time.

"We have a very realistic batting average," says Painchaud. "No one consistently hits home runs in our business. The game is about singles and doubles."

Right now, those models are indicating a bearish market — an environment along the lines of 1973 or 1980. Painchaud even goes so far as to call for a possible recession in late 2005 or early 2006. That prediction is based on the premise that the U.S. economy is finding itself dramatically slowed by an unanticipated rise in inflation, which has triggered a sharp increase in long-term rates.

SmartMoney.com: A lot is involved in the research process at Market Profile Theorems. You have four different models on which you base your findings. One of them is insider behavior. Why is this an important element when analyzing stocks?

Michael Painchaud: We're thinking of this as a pyramid. There's an information hierarchy that begins at the company level. Corporate insiders, on balance, understand companies better than almost anyone else. By dint of their training, their risk-control education, they're able to appreciate and understand risks — business risks — as well as, if not better than, anyone else; and regarding their own companies, better than anyone else. They're in a position to buy or sell their company's stock.

SM: How long have you been using insider behavior in your research?

MP: We've been doing this for some 16 years. The model we employ at MPT was finalized in 1989. Our insider model is one of best on the Street; it weights several factors, and aggregates those factors upward into industries, sectors, and then creates a broad market view. This approach has been invaluable in certain turning points in the market.

SM: What about the rest of the research process?

MP: The second level of the pyramid is the earnings model. It consists of the analysts who work for Wall Street and large brokerage firms who report their opinions through Zacks, Thomson First Call... We look at earnings and earnings surprises. With earnings surprise, we rely largely on the work of three professors at Duke and the University of North Carolina, who struck a dagger in the Efficient Market Hypothesis. They showed that a company that beats market estimates (positive surprise) tends to persist. And one positive surprise for a quarter tends to beget a second. There's a trending. This flew in the face of the Efficient Market Hypothesis. Our model is a compilation of two aspects of earnings: surprise and looking at the direction of where analysts are moving their estimates.

An interesting wrinkle in all this is a human wrinkle. To get an analyst to move away from the crowd in the investment community is difficult. They're investment-driven and it doesn't pay for them to move away; to go outside of the norm tends to be an event which is unusual. So what you see happening in this information hierarchy is that invariably insiders tend to be ahead of analysts at important turning points. When everyone is looking at a company as being unpalatable for a long period of time and that company has underperformed, and news is full of bad reports about the company, insiders tend to be the canary in the coal mine and be amongst the first to suggest change.

Very often when that first signal is given — it's like a light switch when insiders change their attitude — you can still have analysts' estimates trending lower for a month or two. But you see a beginning of change in their attitude, and a tendency in that model to begin to look better relative to where it was trending in the past.

SM: Which details of insiders' transactions are significant to your model?

MP: Our insider model has seven different factors, some of which are whether the transaction is a buy or sell; is it an options-related transaction; how many shares are traded; what is the history of the company relative to the open market's buying and selling; at what level are they transacting in the company, meaning who's doing the buying or selling; how long ago was transaction, etc. What we're saying is, things have changed for the positive or negative at the company on the basis of insider behavior. **SM: What's MPT's ideal stock?**

MP: Our ideal stock is if insiders change behavior from selling to buying; analysts change outlook on the stock; the company is starting to outperform on a relative strength basis; and it has characteristics favored by the current market. This is different from a valuation approach. This is a behavioral approach — a tag that didn't exist 16 years ago. There is a lot to be gained for investors when they're analyzing research to incorporate this approach alongside others.

SM: So yours should not be exclusive to other methods of stock picking?

MP: No, it should not be exclusive, it should be complementary... We're not data-mining. But we know this has produced excess returns for managers who've used it. We have a very realistic batting average. No one consistently hits home runs in our business. The game is about singles and doubles.

SM: What is your outlook on the market now?

MP: All four of our models, from the top-down perspective, are currently bearish. Such a profile has occurred on two occasions in the past 13 months: in February 2004, and Jan. 1, 2005. Both of these periods were followed by weaker overall market pricing structures. February 2004 was the market peak until December 2004, and the Jan. 1, 2005, reading was followed by a large, broad market selloff in the month of January. Therefore, history suggests that these are signals that should not be ignored. As to whether the current signal will continue beyond March, our back-testing of these signals back through 1996 suggests that they are of at least a three-month duration. Beyond that, we do not know. The models will have to tell us and either reinforce or reverse the signals. I can tell you this, that the turn in signal from all-out bearish as it was at the start of March to all-out bullish has never happened in the 16 years that we've been providing our research to professional investors... Should the waterfall continue, we are probably looking at a signal which endures for the next 12 to 15 months.

SM: MPT's March research report characterizes the market now as driven by value over growth. What are the implications of that?

MP: What we found is when the market is described as a risk-averse or value market, that tends to be accompanied by stock market price levels that are sideways to lower. This market currently is a value market... If we look at insider behavior — if we look at all insider transactions and look at them for the whole market — insiders are net sellers now relative to their activity in the past. There's a high level of selling relative to buying. What we have found over time is that insiders tend to be correct, not only about their own companies, but they tend to be correct at the industry, sector and at market levels. When there's more selling than buying, that's a bearish sign for the market.

SM: MPT's best stock ideas for 2005 points to a list of more than 40 companies. Kerr-McGee got the best overall score from the list. Why is this stock, at least according to MPT models, so attractive?

MP: To select companies that we believe will outperform the market, we look at many factors, but one of the most important is: How do they score on our overall Summary model (combining insider, earnings, style and technical models)? The second most important factor we look at is: What is top-down outlook for the year, and how would a given company profile fit into that outlook? On March 1, 2005, **Kerr-McGee** (SYM">KMG[1]) sold at about $77 per share, and had the top score on the MPT summary model. Insiders tended to be positive on the company in terms of their buying and selling activity. Wall Street analysts were raising their forward earnings estimates, and the company had consistently beaten even those elevated analyst numbers for the past two quarters. In terms of style the company reflected more of a value bias, with a beta below that of the market at 0.92; a below-market price-to-book of 2.21; a market dividend yield of 2.37%; and below-market trailing 12-month price/earnings ratio of 16; 11.45 (fiscal 2005 P/E); and 14.3 (fiscal 2006 P/E). Finally, on a simple relative price strength basis, the company scored in the upper 20% of all companies covered by our technical model. In our opinion, these are the elements that tend to contribute to a winning profile. Kerr-McGee was our top-ranked stock at the start of March 2005, and was ranked in the top 5% of all companies at the start of the year with a price at that time of about $57. It currently has a value of $78.46 (as of Wednesday). Over the same period the equity markets have fallen over 3%.

SM: Which industries have your models indicated are looking good for investors?

MP: Our recommendation to own utilities is a continuation of the same recommendation we had at the start of 2004. The reason we would continue to recommend them in 2005 would be for reasons of risk control as opposed to a bet on interest rates. The style characteristics of utilities in general are more conservative in nature, and would be in keeping with our expectation that value will be the style winner over growth in 2005. A rising-interest-rate environment would, of course, work against an overweight in utilities as they're interest-rate sensitive; however, the game will be about risk control in 2005. As to a favorite industry or two within the utilities sector, we would point to water and natural-gas industries.

SM: What sectors look overvalued to you now?

MP: The canary in the coal mine at this point is energy. There have been some insider services suggesting selling. That area should be sold. Those stocks are up between 15% and 35% from the start of 2005 through February. **ExxonMobil** (XOM[2]) and **Apache** (APA[3]) had robust performance. In our March 1 issue, for the first time in at least 12 months, MPT, driven by the data in its insider model, recommended moving to an underweight in energy. The manager who over the next month or two trims his holdings in energy will look very smart a year from now. Insider behavior is like a first chink in the armor — the first sign something needs to be done.

[1]http://www.smartmoney.com/cfscripts/Director.cfm?searchString=
[2]http://www.smartmoney.com/cfscripts/Director.cfm?searchString=XOM
[3]http://www.smartmoney.com/cfscripts/Director.cfm?searchString=APA