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Insider Buying Trends
Show 'Cautious Optimism'

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Corporate insider trading activity can provide a useful hint of about the market's direction. While insiders aren't gobbling up shares right now, the lack of selling may indicate that corporate executives think their share prices are bottoming.

Executives' decisions about buying or selling their own stocks can tip off smaller investors as to where the market's headed. After all, corporate types are nothing if not vigilant about the fatness of their own wallets. And in the last month, insider buying rose modestly while selling rates remained unusually low.

This pattern stands in stark contrast to insider activity in early 2000. As the market bubble peaked, corporate insiders -- who have to disclose trades in their company's shares to the Securities and Exchange Administration -- were unloading expensive shares like mad, and smaller investors were snapping them up in a move that would very soon come back to haunt them.

In February of 2000, monthly insider selling was up around \$10 billion, according to Thomson Financial, more than three times the average monthly sales volume for the last five years. At a market's bottom, of course, the opposite is usually true and selling is light. In the last four months, Thomson's records show that selling has been under \$1.5 billion each month, about half the normal rate. The relative dearth of selling could presage a better market in the months ahead.

"Insiders do not behave with short-term time horizons in mind," says Michael Painchaud, director of research at Market Profile Theorems, a Seattle company that tracks insider trades. "They're not looking at a short-term pop like a day trader or hedge fund might. They're looking at buying a stock of a company they're very, very closely affiliated with, where they've had a good experience of understanding the company."

Mr. Painchaud points out that insiders must hold their shares for at least six months if they buy, and that other laws limit trading around times when earnings news is released.

While the lack of selling is bullish, the positive outlook is clouded by equally light insider buying of late. Insider buying had risen sharply following a brutal July. But the bullish mood was short-lived, with buying dropping off sharply in September.

David Coleman, editor of Argus Research's Vickers Weekly Insider report, says its benchmark index of an 8-week sell-buy ratio (which measures number of insider shares sold to shares bought), stands at 1.58 sold to one bought, safely below the 2.25 break between neutral and bearish.

Mr. Coleman's model is considered bullish when the ratio of shares sold falls below 2.25 for each share bought, meaning more than the usual number of insiders are buying their own stocks. Any number above 2.25 means more insiders than usual are selling their stocks, likely a bad sign for the market.

"I'm cautiously optimistic right now," Mr. Coleman says.

In September of this year just before the market's most recent bottom, the index tumbled to 1.06 sells for every buy, which he calls an "extremely bullish" level. But the rise back to 1.58 was swift, he said, which he considers a caution flag.

"The overall story is that insiders are cautious and not doing much of anything," says Lon Gerber, director of insider research for Thomson Financial.

In September, insider buys amounted to about \$158 million, only half August's level, according to Thomson. Buying increased by 10% in October, to \$173 million, though the rise was somewhat inflated up by the lifting of corporate trading restrictions as earnings-reporting season came to a close.

The buying rates are below last year's levels, though September last year saw unusually heavy insider buying as stock prices swooned in the wake of the Sept. 11 terrorist attacks.

Insider selling, despite a recent rise, has been lighter than usual, an indication that corporate insiders see their shares as too cheap to sell. In September insider selling fell more than 50% to \$690 million, compared with August, according to Thomson Financial. October selling picked up by 75% to \$1.2 billion. But even with that rise, Thomson termed insider sales as "anemic." The monthly average is usually about \$3.2 billion, according to Thomson.

"The fact that the selling is so light indicates that we've hit a bottom," Mr. Gerber says, adding that for the past four months the number of executives buying has been greater than those selling, a bullish trend Thomson hasn't seen in about three years.

The dollar amount of selling normally outpaces buying, primarily because executives are often compensated in shares of their company's stock. When it comes time to pay Junior's private-school tuition or buy a second helicopter, the shares get palmed off.

Among sectors that are seeing unusual activity right now, Thomson said buying in the department-store sector was "encouraging" over the past two months, with the sell-to-buy ratio remaining in bullish territory, something that's a rarity in that industry. Executives from Sears, Dillard's, and Saks all added to their holdings.

Other big companies that saw an impressive amount of buying last month included McDonald's, whose shares hit a 7-year low in early October, Gillette, whose shares hit a 52-week low in late October, and General Electric, who, whose shares hit a five-year low on October 10, according to Thomson.

Executives' faith in their own companies is something investors can

take to heart -- after all, no one has a better understanding of where a company might be headed than the men and women who run it.

"At the bubble's peak, insiders were selling. Today, insiders are buying cheap stocks from us," says Mr. Painchaud. "We're in the vicinity [of a bottom] and investors should begin buying along with them."

Of course, keep in mind that executives are only human.

McDonald's Director Roger Stone purchased 10,000 shares of common stock on Oct. 24. Friday, the company was downgraded by a number of analysts after the fast-food company said it was falling short of performance goals⁴ and wouldn't fulfill full-year predictions.

Lehman Brothers analyst Mitchell Speiser said weak sales and likely lower same-store sales in the U.S. "will make it tough to grow operating earnings." He told clients he remains cautious on McDonald's stock, "as [earnings] power and fundamentals keep deteriorating."

McDonald's shares dropped 7.9% Friday. Sorry, Mr. Speiser.
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