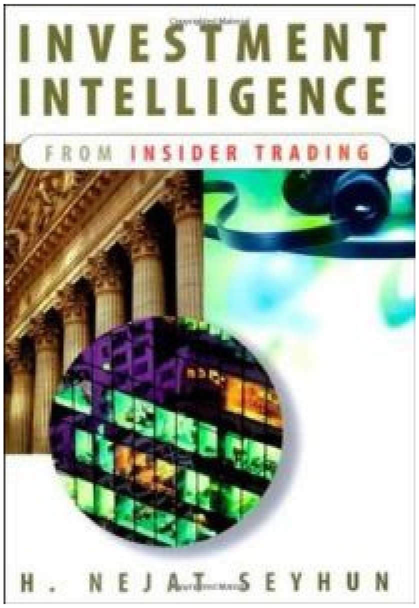

Book Investment Intelligence From Insider Trading

H. Nejat Seyhun
MIT Press, 1998

Recommendation

Are you ready to learn from the somewhat mythical, sometimes notorious and often misunderstood inside traders? H. Nejat Seyhun has compressed a gargantuan amount of information - 21 year's worth of reported insider trades, more than one million transactions - into a manual that debunks and reconfigures the wild world of insider trading. Since inside traders are bound by strict laws, their prowess comes from proximity to the action. As a farmer can predict the next big storm by watching his cattle, sophisticated traders can predict the next market windfall by watching the insiders. This isn't a late-night page-turner; after all, Seyhun is a noted academic expert. Yet flashier verbal energy might have sacrificed the book's most valuable quality: precision. This book (the opposite of the Investing for Illiterates-type) takes its readers and itself seriously - If you are serious about your portfolio, *BooksInShort* recommends that you put yourself through Seyhun's course. Dedicated investors, policy makers and scholars need this on their reference shelves.

Take-Aways

- Don't believe the hype about insider trading - It can be profitable and legal.
- Most inside traders obey a strict set of guidelines.
- The insider's advantage is an intimate knowledge of his or her business.
- Familiar investment styles bet on the past; insider trading bets on the future.
- If you decide to follow the insiders, be prepared for an avalanche - of information.
- You can't imitate the insiders move by move.
- However, a strategy based on insider-trading information can be lucrative.
- Insiders who are legitimate are interested in long-term gains, not quick fixes.
- When dealing with insider trading information, don't stop dealing in common sense.
- Watching inside traders produces information - What you do with it is up to you.

Summary

Eliminate Your Misconceptions

Chains of negative connotation bind the term "insider trader." People who misunderstand the term - the people who buy into the negative connotation - are missing out on a tremendous investment opportunity.

What springs to mind when you read the words "insider trading?" If you're like most people, you immediately think "insider trading is illegal." Don't be like most people. Be precise. Insider trading is sometimes, but not always, illegal. Insiders trade legally and profitably all the time. As long as they don't use material, nonpublic information they're in the clear. Most large firms are exceedingly clear on what, when and how their members can trade. Now, eliminate another misconception. The common assumption is that insider traders don't report their successful investments, because these investments are illegal. People reason, therefore, that insiders only release their throwaway investments; in other words, they only release the investments that didn't earn any money. Wrong. The insiders' reported legal transactions contain valuable information.

Why You Should Pay Attention

Insiders cannot move a single transaction without first consulting their compliance officers; insiders can only trade during a specific and rigidly determined timeframe. The list of regulations could go on and on. The point is simple, and knowing it sets up the key question you need to answer before using insider-trading information: If insiders are forced to comply with such a strict set of guidelines, how is their investment acuity any different from yours?

> "Understanding the motivation for a particular series of insider trading is no simple task."

To begin with, insiders can trade on any piece of information that is equally accessible to the public. As long as they don't know anything that would have a direct impact on their firms' stock prices, they are free to enter into transactions relating to their firms. Their advantage doesn't come from any special, secret information. It comes from their everyday experience.

> "Current insider-trading laws treat violations of insider trading almost as seriously as most violent crimes resulting in death or physical injury."

Henry David Thoreau said that he wrote about himself because he knew himself better than he knew anyone else. In the same way, an insider trades on his own firm because he knows its business better than he knows any other firm's business. If you were working in the typewriter business when the prices of computers started dropping, you would notice that fewer people were buying your product. You would witness the drop in demand. This is public information and you would be foolish not to act on it. Insiders don't benefit from covert information; they benefit from their expertise in a given industry. And, if you watch their moves closely, you, too, can benefit from the expertise of insiders.

Beyond Growth and Value

The two most familiar investment styles are the value-based approach and the growth-based approach. Investors using the value-based approach try to locate undervalued firms whose stock returns will beat the average. The growth-based approach is more interested in firms that investors support today than in firms that investors might support tomorrow. People who use a growth-based approach hope to get a piece of the firm's growth momentum.

> "Aggregate insider-trading activity follows rather slow cycles that are similar to business cycles."

These approaches are based on theories concerned with book-to-market ratios (B/M) or price-earnings ratios (P/E). Both depend on current stock prices and, therefore, are indicative of historical changes and risk premiums. In contrast, insider trading is concerned with firm value and the future. Its main concern is to identify profit opportunities. While the value-based and the growth-based approaches are determined by statistical inquiries, insider trading is based on real people investing their own money. If they lose, they lose immediately.

Are There Insider-Trading Patterns?

Yes. And the most basic pattern of insider trading is that there's a lot of it. Remarkably, too, the amount of insider trading has not decreased during the past few decades in spite of the ever-burgeoning sanctions against it. Thus, it's probably wise to start monitoring this phenomenon. If the insiders have persisted, in all probability, they're making money.

> "Despite the significant increases in insider-trading sanctions during the 1980's, there was no decline in the levels of insider trading."

More specific patterns include:

1. In large firms, insiders sell more than they buy.
2. In smaller firms, insiders buy more than they sell.
3. Insiders buy least during the summer months and most during the turn of the year.
4. If insiders have bought or sold in a firm in the past, they are likely to continue to buy or sell in that firm in the future.
5. The evidence shows that insiders are not manipulating stock prices.
6. Illegal insider trading is becoming less common as penalties become more severe.

Get a Strategy

Insider-trading signals can certainly give your portfolio a boost. In many cases, these signals are the best predictors of future markets. In theory, you might expect to be able to imitate the moves of insiders directly. You might expect to turn a profit just by selling when they sell and buying when they buy. One glaring problem exists with this theory: When you seek these signals and try to read them, you will find yourself in the midst of an information avalanche.

> "There is a strong positive correlation between past insider trading and future insider trading."

Insider transactions have been (and often still are) printed in The Wall Street Journal, The Financial Times, Value Line Investment Survey and several online services. The fact that these venues all take notice of insider information reinforces the claim that it is important; but this won't make your life any easier when you attempt to use insider information. In the last few years, insiders have been extremely active. You can't keep up with them. Direct imitation is time-consuming, expensive and, clearly, out of the question.

> "It is almost impossible to understand and interpret insider-trading patterns without a good understanding of insider-trading regulations."

Direct imitation is also a bad idea because you have no way of knowing exactly why an insider sells or buys stocks. He could be buying stock because he just got a raise and wants to gamble a little. He could be selling his stock because he has to liquidate to pay for a messy divorce.

Imitation is also a bad idea because the insiders can be very crafty. If they know many investors are interpreting every move as a good move, they can begin to manipulate the market. For example, their expertise might give them a hint that a certain stock soon will fall. If they know people are watching them, these investors might buy a few shares of it, so it becomes more valuable. Then, they can turn around and sell their new shares along with any old shares they might possess - at a huge profit at your (and other outsiders') expense. You can use inside traders' information to improve your portfolio, but you can't imitate their moves. You need a strategy, a way to read the information that works to your benefit.

Building a Framework

Over time, you'll have to develop your own strategy. No exact formula exists. But you can begin to erect a scaffolding right now. The following guidelines will assist you.

- Remember that the law creates four distinct classes of inside traders: top executives, officers, directors and large shareholders. On the average, the information hierarchy flows from the top down. Executives are the most informed, shareholders are the least, and officers and directors fall somewhere in the middle. This confirms the notion that the insiders' advantage doesn't come from something that they are keeping from the public; it comes from their experience and their dealings with the public.
- Based on the first guideline, you can determine that large shareholders are slightly 'out of the loop' when it comes to insider trading. Because they're not on the front line, they're not trading with the same level of probability as high-level executives.

When you're looking at large trades, therefore, don't pay attention to those made by large shareholders. When the top executives, officers and directors start making large trades, some alarms should start going off in your investment brain.

- Don't pay as much attention to insiders' sales as to their purchases.
- Percentage-wise, insiders who trade in small firms make more money than insiders who trade in large firms.
- Likewise, when you're dealing with small firms, you don't have to determine between the class of insiders. They all make money at relatively the same rate - but you still want to watch purchases more closely than you watch sales.

Does Insider Trading Predict Stock Returns?

Yes. Stock prices rise when insiders purchase them. At the same time, when insiders start selling, you may want to think about your holdings. Insider selling could be a signal that bad times are ahead. However, insiders do much better than the overall market in any given year. But don't get carried away. Most insider trade profit is small. Don't invest a large sum of money the first time you notice a small profit. Since the insiders you care about are the ones who are obeying the laws inside and outside of their firms, you can presume that insiders are interested in long-term gains rather than quick fixes. Since they can't legally manipulate their firms' stock value, they have to try to predict where their firms are headed. This is a slow process. If you're going to imitate the insiders, you don't have to rush.

The Way of the Outsider

If you want to be an outsider in an insiders' game - if you want to mimic the moves of inside traders - consider these points:

- There are always going to be delays in the reporting of insider-trading information. Chances are that you'll have to wait a month or two (at least) to gain access to insiders' trades. This delay occurs across the whole spectrum of insider trades. You won't necessarily hear about the small trades before you hear about the big trades, and vice-versa. At the same time, you won't necessarily hear about the trades of high-level investors before you hear about the trades of large shareholders. The results come in sporadically and in no specific order.
- You also need to be aware of transaction costs. If you're going to mimic the insiders you have to be ready for price adjustments - which means broker's fees. It usually takes up to three months of holding your shares to recoup your transaction costs.
- The basic risk factor is always there. Anytime you base your investment strategy on an insider, you risk losing over half of your funds. If you want to cut this risk, you have to be willing to mimic approximately 50 insider transactions.

> "The federal insider-trading regulations were passed in 1934 in response to the crash of 1929 with the aim of protecting small investors."

Following in the insiders' footsteps can be tricky at times, but if you can pull it off you will see a generous return on your expenditures. Of course, never break the rule of common sense. Anytime you're dealing with stock futures, you cannot depend on the past performance of those stocks. Also, just as you do when you download driving directions off the Internet, always do a reality check and make sure the road you want to travel down still exists. You never know when the federal government is going to change the game with a new set of laws. Take insider trading for what its worth: information. Rather than basing your whole investment strategy on the moves of insiders, use insider information to buoy your current strategies. Diversity is still the best policy when it comes to investing. Insider-trading information is a tool and not a panacea.

About the Author

H. Nejat Seyhun holds the Jerome B. and Eilene M. York professorship at the University of Michigan Business School, where he is chairman of the finance department. He is one of the leading academic experts on insider trading.
