

# Be wary when following insiders — they may be lost

**I**NSIDERS might sell their shares for any number of reasons, but they buy them for only one: they think the price will rise." — Peter Lynch

A US study published a few years ago showed top executives of companies beat the market on average by six percentage points a year. A Citibank study found that multiple purchases by several execs within a three-month period signalled big gains to come, especially purchases at small companies with limited analyst coverage.

The argument for shadowing insiders makes a lot of sense. Executives and directors have the most up-to-date information on their companies' prospects. Intimately acquainted with the critical success factors, they are way ahead of analysts and portfolio managers, not to mention individuals.

But individual investors need to be careful about reading positive messages into every insider buy. A



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big insider buy or sell might offer a hint of things to come, but it hardly translates into a sure-fire pointer for outperforming the market.

Joshua Brown, in an article for Forbes.com last week, argued that one of the dumbest syllogisms in all of investing goes like this: Insiders are buying their own stock; insiders know more about their companies' prospects than anyone else; you

should be buying the stock with them. "Do me a favour and trust me on this," says Brown, "in my retail broker days I used this syllogism to brutal effect — it is an utterly unstoppable weapon for those in the business of selling stocks, it cannot be disagreed with.

"Don't get me wrong, there is nothing negative about insider buying, but there is often very little meaning when it is used to spin some kind of narrative that 'so-and-so thinks their stock is cheap'."

A shareholder in a company hitting fresh lows every week is bound to be encouraged by management buying. But this could be precisely what it is aiming to accomplish by "showing a vote of confidence".

"It just may work," says Brown, "but don't confuse a 'vote of confidence' with a purchase made with the intention of making money. These are two different animals."

Are there CEOs who buy their own stock opportunistically?

Absolutely. But that doesn't change the fact that some open market purchases have more to do with publicity. As shown by the release on Sens of Robin Vela's share purchase earlier this year under the headline: "Management demonstrates confidence by increasing their interest in SacOil."

Another big problem with using insider data on specific companies is that executives sometimes misread company prospects. Anthony Cotterell bought millions of shares in King Consolidated Holdings in 2001 only to see them halve in price over the next two years. Ian Hewitt bought 10-million Lyons shares at 10c each when he took over as CEO in 2002, and sold 71-million at 5c in 2003. Some insiders may even end up buying as prices collapse — as in the single-stock futures debacle of 2007-08. When insiders do correctly assess their companies' share, it can be a matter of luck as much as anything else.

Ben McClure at Investopedia tells investors to consider these guidelines when analysing specific insider trading situations:

**Some insiders are better than others.** Directors know less about a company's outlook than executives. Key executives are the CEO and chief financial officer. People running the company know the most about where it is heading.

**A lot of trading is better than a little.** One or two insiders at a big corporation do not make a trend. Three or more provide a better indication something is happening. Generally speaking, solitary trades are unreliable.

**People at small companies know more.** At small and mid-sized companies, virtually all insiders are privy to financials. At big corporations, information is more dispersed and only the core management team has the big picture.

**Stay the course.** Insiders tend to act far in advance of expected news.

A study at Pennsylvania State and Michigan State universities contends insider activity precedes specific company news by as long as two years before the disclosure of the news.

For those who get it right, shadowing directors' buys can be lucrative. Insiders were big buyers of Advtech below 40c a share in 2001-02; the stock hit a high of R6,45 in April last year. Three Brimstone directors bought 12-million shares at 63c in March 2003; it hit a high of R13,20 last year.

Who's next? Well, who knows? But worth watching is Beige, where insiders have been big buyers at 5c a share over the past two years, and last week acquired another 47-million shares at 7c. Insiders have also been big buyers at Blue Financial Services, BSI Steel, Convergenet, Huge, MiX Telematics and RGT Smart. Last month Tradehold chairman Christoffel Wiese bought 5-million more shares at R6 each.