

CORPORATE INSIDERS'

Big Block Transactions

The Leuthold Group

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SUMMARY

- *The Leuthold Group has been compiling corporate insiders' big block transactions since 1982, in order to gauge the sentiment of the "smart money".*

..."Big Block" transactions defined as those involving more than 100,000 shares or have a total transaction value greater than \$1,000,000.

- *Corporate insiders have been selling at levels approaching historical extremes recently. The short-term outlook for the stock market is beginning to look negative by this measure.*

...Increased levels partially due to SEC's 1997 code revision, which shortens holding period of restricted shares. Additionally, a lower long-term maximum capital gains tax rate (20%) was effected in '97, and has likely resulted in increased selling by insiders.

- *Since 1983, when net selling measured in dollars has reached historically high levels the stock market has performed poorly over the next 12 months.*

...Normalizing the data allows a better historical perspective by adjusting for the growth of the stock market over time. When normalized, the current high level of dollar volume of net selling, while still high, is significantly below levels of 1983, 1989, and the selling extremes of mid-1998.

- *When net selling (measured in dollars) reaches historically low levels, the stock market has demonstrated significant above average performance over the next 12 months.*

...The 10 week moving average is particularly useful to signal bear market bottoms. This measure has signaled "net buying" from corporate insiders a total of 3 times in the last 15 years, all were within weeks of bear market bottoms.

- *The number of net buy/sell transactions is also currently near historic highs. Even when the data is normalized, the number of selling transactions have been increasing since 1991.*

- ***Conclusion: Quantitatively testing the normalized historical data for insiders net transaction levels measured in dollars confirms that when historically high or low extreme levels are hit, they offer excellent trigger points for asset allocators and market timers.***

Introduction

The efficient market hypothesis holds that the market discounts information as soon as it is made public. While the degree of efficiency in the U.S. stock market is debatable, most would agree that corporate insiders possess superior knowledge about their own company's prospects for the future. Clearly insider trading laws prohibit using "material, non-public information" for financial gain, but hunches about the success or failure of a new product line, for instance, can come into play when a corporate insider decides whether to accumulate or sell company stock.

Consequently, monitoring the significant buying and selling of company insiders should lend some insight concerning a firm's financial health and growth prospects...insight that might not be gleaned from the latest quarterly statements. It then follows, that since the stock market is the sum of all public firms, the aggregate buying and selling patterns of all insiders from these firms should lend insight about the future prospects of the stock market. This study examines the merits of this assumption.

Since 1982, the Leuthold Group has been tracking **corporate insiders big block transactions** on a weekly basis. It is one of the components that we use in the weekly Major Trend Index's "Sentiment" category. We are the only research firm that we are aware of that compiles this type of data. The SEC makes information on insider's transactions available weekly. By law, all corporate insiders (and beneficial owners who hold 10% or more of outstanding shares) are required to file **Form 4** by the 10th day of the month following a transaction. Each week the latest filings are compiled and published in *Vicker's Weekly Insider*. This is where we begin.

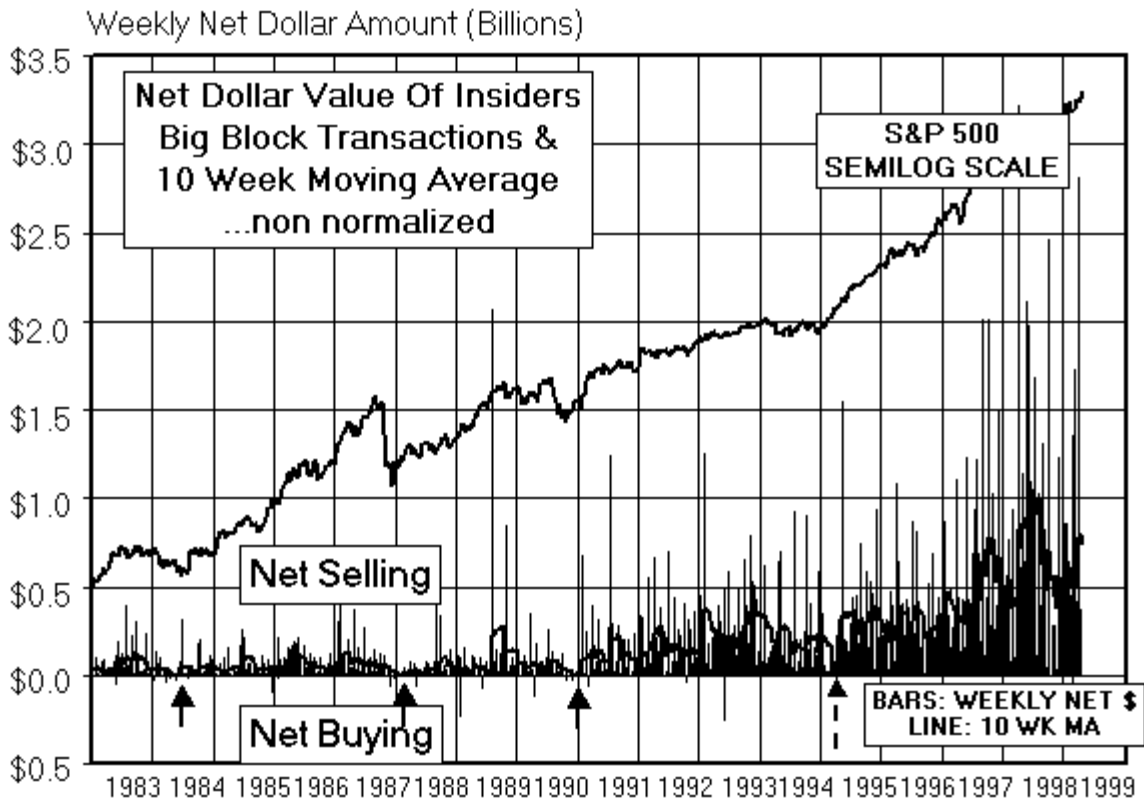
Compiling The Insiders Big Block Data

For our purposes of gauging insiders' sentiment, we ignore small transactions – focusing only on big block transactions involving buying/selling more than 100,000 shares or those transactions with a total value of \$1 million or more. We ignore the transactions of corporations, foundations, trusts and other institutional shareholders, since these transactions are often motivated by factors that have nothing to do with the financial prospects of a company.

The resulting list of buy and sell transactions are logged, and then summed up to yield a weekly **aggregate net dollar amount** of buys vs. sells. Most of the time the net selling is much greater than the net buying, but this is not always the case. We then tabulate the **aggregate net number** (frequency) of buys vs. sells meeting the above criteria. An example of a recent week's list of qualifying transactions appears in the appendix to illustrate the individual transactions that we look at in deriving a weekly reading.

Part A: The Raw Data

Net Weekly Dollar Amount & 10 Week Average



The preceding chart depicts the weekly net dollar amount of insiders' buying and selling activity (vertical bars) and the 10 week average (lower line) vs. the S&P 500 on semilog scale. **Note: on this chart and all that follow, points above the zero axis represent net selling and the very infrequent points below the axis represent net buying.**

Observations

- Over the course of the last sixteen years, the weekly data (represented by the bars) shows that weeks of net selling outnumber weeks of net buying by about 12:1. This is primarily because insiders' sell transactions include the sale of stock resulting from the exercise of options, although no corresponding buy transaction occurs when options are issued. In the last seven years, the sell/buy ratio has climbed even higher (about 50:1), partly due to increasing use of options to compensate corporate insiders.
- The 10-week average (lower line) passes below the zero axis into net buying territory on only three occasions within the last 16 years (marked with arrows). **Each time this occurred, a bear market bottom had occurred within a short period, sometimes within weeks.** Intermittent weeks of strong net buying and low net selling accompanied these bear market lows, which has made this measure an excellent "buy" signal at the lows of the three significant down markets since 1983.
- Since the late 1990 signal, the 10-week average has not been in net buying territory, but there haven't been any bear markets either. The closest the average came to net insider buying was in early 1995 (indicated by the dashed arrow). This four-year low in net selling could not have been better timed, coming right at the end of an 18 month consolidating market.

- On the sell side, this non-normalized series is more difficult to interpret. Because the collective wisdom of all corporate insiders is thought to be a forward-looking stock market indicator, high levels of selling should theoretically precede stock market corrections. However, as option issuance and market capitalization has increased, the 10 week average and weekly data has shown a strong tendency to drift upward. Fixed "sell" trigger levels that worked ten years ago are commonplace today. Normalizing the data avoids this problem (see part B of this study).
- For now, let it suffice to observe the market's behavior subsequent to sharp upward "spikes" in the 10-week average. As indicated on the chart, a rapid increase in insider net selling often precedes or coincides with market weakness and price volatility, but generally the signals have been 6 to 12 months early for the "major" corrections of 1987 and 1990. For example, insider net selling peaked in March 1987, but the market did not crash until October. Also, the spike in the fall of 1989 was immediately followed by a choppy market, (which many investors would have been happy to avoid), but the S&P 500 did not collapse until August 1990. A more comprehensive look at this indicator as a sell signal appears in part B where this series is normalized.
- **The latest reading through April 7, 1999 shows the 10 week average is now in a rising trend, but is still 33% below the all time high recorded in late-May 1998. Also note that the week of 3/24/99 net aggregate insider selling posted the second highest single week reading ever (\$2.8 billion).**

Weekly Number Of Net Buy/Sell Transactions & 10 Week Average

While the dollar amount measures the *magnitude* of insider's transactions, the net number of transactions measures the *breadth* of net sells/buys. Normally the two data series move together (e.g. when the dollar amount of net selling rises, the number of net "sells" also rise). But this is not always the case. Occasionally the weekly net **dollar amount** of net selling surges, but the net **number** of sell transactions remains flat. This indicates that there were one or more very large transactions during that particular week. For instance:

...In July 1989, weekly dollar volume soared to \$2.1 billion while net number of sells actually fell from the preceding week. This was the result of insider Carl Icahn liquidating \$1.3 billion worth of Texaco shares, a company for which he had served as an officer.

...During a weekly reporting period in May 1995, two significant insiders at Duracell sold big blocks of shares, accounting for 90% of the soaring \$1.5 billion volume that week. But the number of net insider sales that week was down from the levels of previous weeks.

...In March of 1998, Bill Gates and Paul Allen sold shares of Microsoft totaling over \$1.6 billion during a two week period, accounting for about half of the all-time record dollar volume of insiders sales reported that week (\$3.2 billion). But unlike the previous two cases, net number of sells also hit a record high. What are insiders transactions revealing about the stock market when you have high levels of conviction (indicated by record dollar amount) and broad consensus (record number of net sells)? ...Historically it has meant that a market peak may soon be at hand.

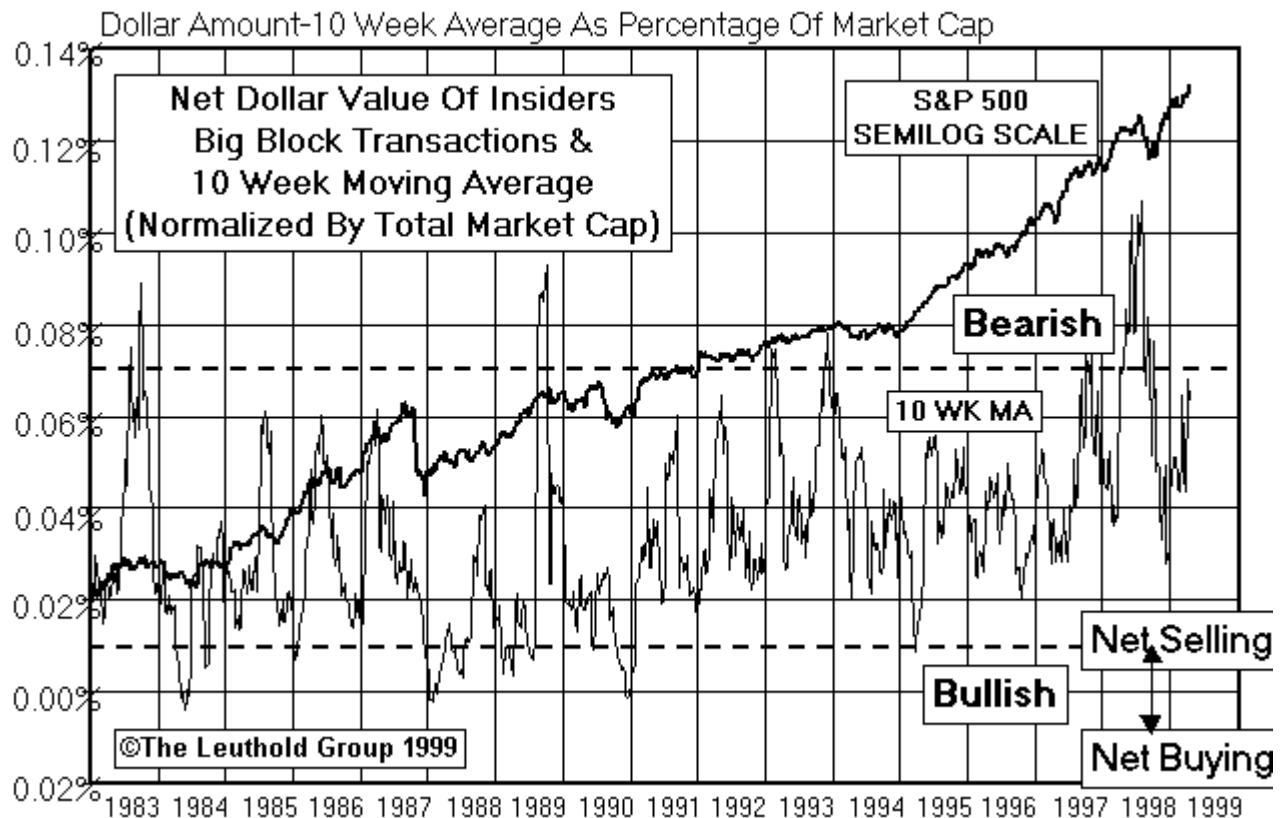
The current 10 week moving average is also in a rising trend. In terms of weekly number of net sells, the all time high was nearly beat on the week ending March 24th, when a net 406 individual

corporate insiders were selling big blocks of their company's stock (previous 1998 record stillstands at 410 net sells).

...Because non-normalized data has a tendency to drift upward as market capitalization and total number of traded issues increases, it is necessary to normalize the data if any comparisons are to be made between today and sixteen years ago. In part B we normalize the dollar volume data in order to provide a better historical perspective.

Part B: The Normalized Data

Net Weekly Dollar Amount & 10 Week Average (Normalized By Total Stock Market Capitalization)

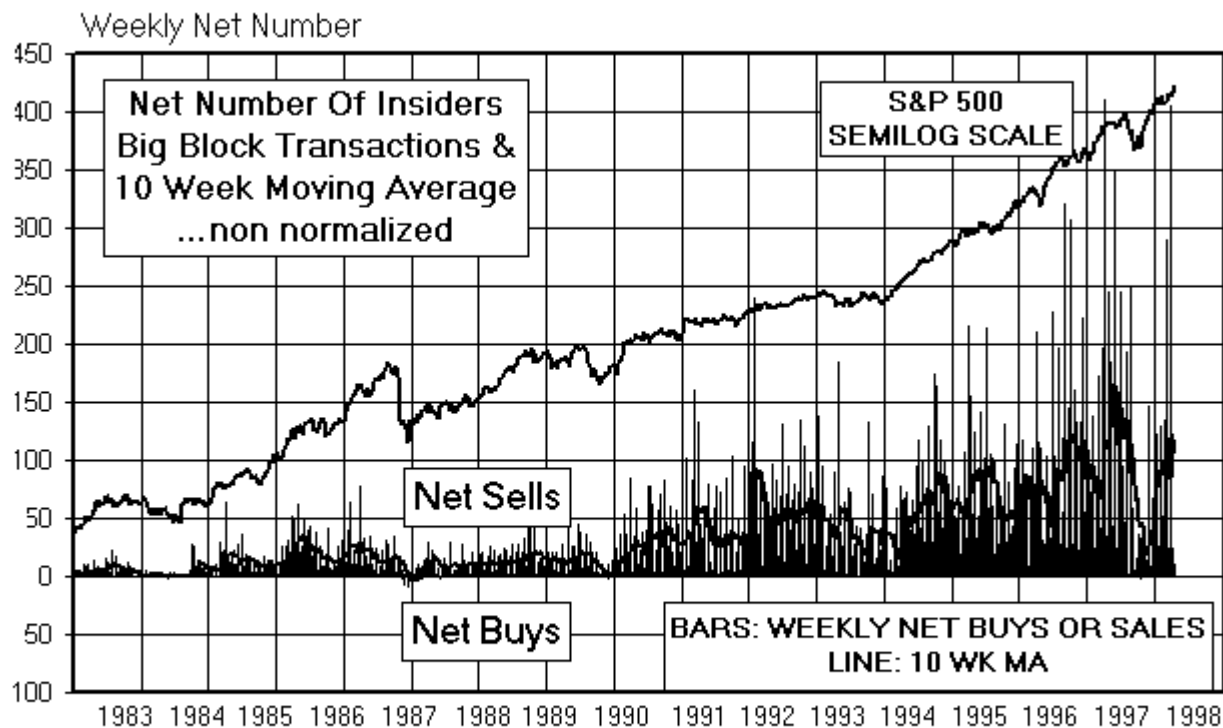


The chart above is similar to the first chart we presented except that the data is normalized as a percentage total equity market capitalization. This will allow more meaningful comparison over time, and keep the tendency for the data to drift upward held in check.

- On the buy side, normalization does not significantly change the original conclusions. No amount of normalization will change net selling to net buying. Since late 1990, the 10-week average has not returned into net buying (positive) territory, but it still came fairly close in early 1995.
- However the net selling peaks of the 1980s now prominently stand out. In fact, when normalized, the current nominal reading for the 10 week average now falls short of peaks recorded in 1983, 1989, 1993 and 1997. But the rapid increase of net selling so far in 1999 is approaching historical extremes through the most recent reading. **The normalized data still indicates that the recent**

high levels of insiders' big block selling may have negative implications for the stock market .

- Since 1983, upward surges in insiders net selling appear to precede periods of market weakness, however the chart above shows that the results are not entirely consistent. In 1983, 1987, 1993 and late 1989 (1990 bear market), surges in net selling did foreshadow intermediate corrections that were quickly followed by a longer term rallying market. But the three other peaks that occurred during the 1990s were soon followed by periods of market consolidation. The most recent set of sell signals occurred during Q2 of 1998, and provided a timely exit signal for the market declines that occurred the following quarter.
- The dashed horizontal lines on the chart at -0.07% (seven hundredths of a percent) and -0.01% (one hundredth of a percent) represent points at which selling reached historically high and low extremes. Since 1983, the 10-week average has moved outside this range only about 14% of the time.
- The normalized data on the chart seems to provide some strong evidence (at least visually) between high levels of net selling (above the $.07\%$ line) and subsequent inferior market performance. On the other side of the coin, the few instances of insider net buying have demonstrated a record of signaling bear market lows. Even when net selling falls to historically low levels (below the dashed $.01\%$ line) it was a good time to start buying stocks.



These two extremes can be viewed as action signals. Do some selling at $.07\%$ and above, and be a buyer at $.01\%$ and below.

This study wouldn't be complete without some quantitative evidence to support the visual

evidence. In part C we test the relationship between high and low levels of net selling and subsequent market performance.

Part C: Testing The Data

The table below shows subsequent market performance for different levels of dollar volume of insider net selling. We show the price performance of the S&P 500 in 3, 6, 9 and 12 month time periods when the insider selling 10 week average reaches historical extremes on a normalized basis (refer to previous chart). As the dashed lines on the normalized 10 week average dollar chart indicates, extremes are signaled when net selling falls below one-hundredth of a percent of total market capitalization (bullish) and when net selling reaches seven-hundredths of a percent of total market capitalization (bearish). **The 10-week average is now within 10% of the bearish line and in a rising trend. Only time will tell where the market goes from here, but the current high level of net selling gives rise for concern about what insiders are collectively revealing about the outlook for the stock market in the coming year.**

- Performance subsequent to high levels of net selling was below "normal range" in all time frames. **Average 3 month subsequent performance when in "bearish" range was a loss of 0.6% compared to 3.7% average gain when in "normal" range.**
- **At low net selling levels, subsequent market performance better than "normal range" in all time frames. Outperformance optimized at 3-month horizon, but consistently outperforms by 280-320 b.p.'s over longer time horizons.**
- This study covers 1983 to date covering roughly 848 weeks. During this time, the normalized 10 week average dollar amount has spent a total of 74 weeks in the historically low selling (bullish) range or 8.7% of the time. The average has spent 48 weeks in the historically high selling (bearish) range, representing 5.7% of the time. Following insiders buying and selling cues over this sixteen-year time span would have been profitable for the market timer or asset allocator.
- Recent periods of high net selling include the mid 1998 signals that occurred as the market was in decline. Not enough time has elapsed to evaluate the longer term merits of these latest readings, but the preliminary data shows the mid 1998 signals were followed by below average performance in the 3 month range, but not over the longer time frames. But what occurs in the next 3-6 months will determine if these latest signals were indeed as productive as they have been in the past.

PART D: Conclusions

- The 10 week average of dollar volume of net insider sells seems to work extremely well in identifying bear market bottoms. When net selling has hit historical lows; it has identified the market bottoms of 1984, 1987 and 1990 within several weeks.
- The 10 week dollar average also has a proven track record of signaling periods of impending market weakness when insider net selling reaches historically high levels (like now).

...Normalizing the data to reflect the growth of the stock market over time is necessary to identify the key selling triggers on a historical basis.

- Testing the data confirms the value of tracking trends of insiders' aggregate buying/selling behavior. Using the historical extremes as action points to increase or decrease equity holdings has worked well.
- Net dollar volume and net number of transactions often move together, but occasionally an unusually large single transaction can swell dollar volume without causing the number of net sells to rise. When this occurs, the number of net sells becomes significant as a confirming indicator.
- **Our measure of insider buys/sells is indicating that since mid-1997, insiders have been selling their stock at historically high levels in both nominal and normalized terms. Based on the historical relationship between levels of net selling and subsequent market performance, insiders may be signaling that the road ahead for the stock market may be rocky in the coming year.**

...However, part of the increase in insider net selling is due to recent changes in SEC restrictions about the length of holding periods for restricted shares. This has encouraged insiders to sell more freely than before. Additionally, reductions in the maximum capital gains rate may have resulted in increased selling by corporate insiders. At this point, it is difficult to tell how much this is contributing to current high levels of net selling.