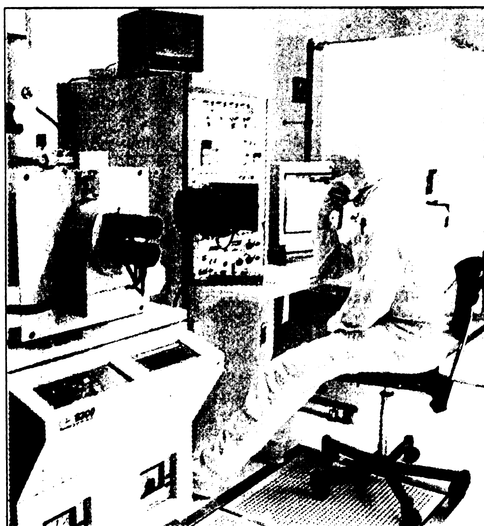
DIRECTORS' DEALINGS

Pros and cons of mimicking the board

The individual is at a clear disadvantage, say Sylvain Friederich and Ian Tonks



Under examination: directors' dealings between 1986-1994

Do directors know whether their company is under- or over-valued by the stock market? If they do, and if they trade on this information, then outside investors should be able to profit from an investment strategy that mimics directors' trades.

Judging by the information available on these trades, there are plenty of investors who believe that mimicking directors' trades is worthwhile. A number of data companies disseminate directors' trading data as soon as it is disclosed to the London Stock Exchange. FT Money carries a weekly table of directors' dealings (see page 3) which is followed closely by readers.

The internet is also making it easier for private investors to find out about directors' share trading activities. In the US, for instance, Bloomberg's internet site has an "Insider Focus" section. This means that share trading by company directors is scrutinised more closely than ever before.

CNN Financial News reported in September 1997 that, after it was disclosed that top executives at Chrysler Corporation had been selling unusually large quantities of stock for several weeks, Chrysler was forced to issue a public statement explaining why this was not to be interpreted as a bearish signal.

Are these directors' trades illegal? No. Directors' trade disclosure is strictly regulated in the UK: directors are prohibited from dealing in the securities of their own companies before the announcement of price-sensitive information. But there is nothing illegal about directors buying mis-valued shares.

It would be up to the courts to identify whether company information had been released at the same time, and then prove that directors had been acting on it.

The question remains, however: are directors' trades the basis for a sound investment strategy?

It seems likely that senior management are able to assess the prospects of their own companies better than anyone else. As David Coleman, manager of Watershed Investments (a US mutual fund that invests following insider signals), puts it: "Although you can't know what they know, knowing what they do is just as revealing."

To test this theory, we have been examining data on all directors' trades in UK companies from 1986 to 1994, and have focused on the stock price effects in both the short run (over a few days or weeks) and the long run (over a number of months and years).

We calculated the "abnormal returns" on a portfolio created by mimicking directors' trading behaviour to see whether it is possible to turn a profit. Abnormal returns are the differences between actual returns and those that might have been expected from general market movements and the relative risk of the shares.

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At first sight, our results from long-term investment strategies seemed ambiguous. But closer examination showed that high abnormal returns are largely observed in small-company shares, which are significantly more risky.

After a risk adjustment is made, excess returns stand at an average annualised rate of 5.5 per cent up to 24 months after director purchases, but a much smaller 2 per cent up to 24 months after sales.

The conclusion, therefore, seems to be that directors' "buy" signals carry more information than their share sales.

A caveat is that our calculation of long-term excess returns makes no allowance for transaction costs. Most of the directors' trades occur in small companies, which have notoriously wide bid-offer spreads. So investors' "real world" trading profits will be lower than this suggests.

Results on the short-term profitability of following directors' trades are more intriguing.

In the 20 days before a director's "buy" trade, stock prices fall by nearly 3 per cent on average. In the case of director "sell" signals, in the previous 20 days stock prices rise by just over 1 per cent. Over the next 20 days these abnormal price movements are reversed.

This indicates short-term "market timing" by directors, from which outsiders could also benefit. Directors seem to buy after an unusual price fall, when the shares have become relatively under-valued, and sell after a price rise, when the shares are over-valued.

From our results, it appears that the most profitable signals to imitate are the "clustered" directors' trades (with at least two trades by one or more directors in the same direction within 10 days). Perhaps surprisingly, however, the largest directors' trades are not followed by the largest returns.

The snag for investors is that trading costs again erode most of the short-term gains that can be made by following directors. Once adjustment has been made for the bid-offer spread, the only strategy that continues to yield significant abnormal returns are clustered buys, at 1.32 per cent over 20 trading days.

It is also worth bearing in mind that private investors usually face relatively high dealing charges (not to mention stamp duty) that make it difficult to capture even the excess returns available after taking account of the bid-offer spread.

The overall conclusion from our work is is that "buy" trades are more profitable to mimic than "sells", and the most bullish signals are sent by "clustered" trades by a number of directors.

Our results indicate that mimicking directors' trades does appear to be profitable in both the short and long run. But two conditions are crucial.

First, the immediate short-term price movements around insiders' trades mean that outsiders have to act as soon as possible to take advantage of them.

This is not easy unless you have access to day-by-day information, which until now has been either time-consuming or costly to collect.

Second, the trading costs incurred in implementing this strategy may reduce short- and long-term profitability to zero.

For these two reasons, individual investors, whose information is less timely and who do not have the negotiating power that fund managers have over trading costs, are clearly at a disadvantage.

Directors' dealings remain a source of endless fascination and can be revealing. But private investors should be sceptical about their chances of making a killing by following the board.

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