Should Investors Take Insider Trading Activities as Investment Signals?

Description

There has been a profound debate on whether or not individual investors should consider the buying or selling of stocks by corporate insiders as investment action signals to also sell or buy into the respective stocks.

Chief among the proponents of the theme is Professor Nejat Seyhun of the University of Michigan's discovery in 2000 of a strong correlation between insider activity and stock price performance in the long run.

The professor asserted that when executives bought shares in their company's stock, the shares tended to outperform the market by 8.9% over the next 12 months, and the stock would underperform by 5.4% if the senior insiders sold.

This evidence, among other theses, strongly supports the idea that investors should closely monitor and possibly follow corporate insiders' investing actions.

However, insider transactions can give muffled, unreliable, misleading, and somewhat confusing signals.

Take, for instance, the June 20, 2017, to July 4, 2017, trading activity on **Osisko Mining Corp**. (TSX:OSK) by John Burzynski, the president and CEO, who'd bought 380,000 shares at a cost of $1.675 million in 10 different transactions.

The CEO, however, went on to dispose 800,000 shares on the market on July 4; he exercised warrants for 834,000 shares at $1.44, then gifted 50,000 shares on the same day. While his purchases on June 20 and 21 could be bullish, his huge block disposal on July 4 was otherwise, but the warrant exercise nearly netted him back to his original shareholding before June 20.

What signal could investors have gleaned from this senior insider's actions? It's not clear, but his transactions could have been motivated by tax-management goals, among other possibilities not related to increasing his net shareholding in Osisko Mining.

However, the significant share purchases by **Osisko Gold Royalties** as well as by a director Robert Wares during the period could be bullish signs.

Warning!

The smart money is not always as smart, and there is a huge risk in following insider buy or sale signals.

Sometimes these senior insiders are under some employment contractual obligations to maintain some exposure in the company. They could also receive significant portions of their compensation in shares, share options, and warrants, such that their activity on the market is not as seriously investment motivated as non-related party investors.

Furthermore, some insider transactions may be solely motivated by personal circumstances and other matters outside their control.

One case in point was the early 2017 significant sale of stock by Terry Booth, the CEO of **Aurora Cannabis Inc.** (TSXV:ACB) to pay down the debt obligations he had accumulated while building the company.

Most importantly, investors should note that corporate insiders have an emotional attachment to their employer's stock, and not all their investment decisions are free of behavioural finance biases.

Senior executives may have an illusion of control bias, making them believe they have the power to alter the outcomes and fortunes of a company. Sometimes the broader economic forces and circumstances limit their efforts.

They may also suffer from overconfidence bias. This reminds me of **BlackBerry Ltd.** CEO John Chen, who was confident he could quickly turn around the tech giant's fortunes in a very short time when he got employed in November 2013 after successfully reviving Sybase.

Insiders may have an illusion of knowledge, thinking that they know much about the stock, when in actual fact, not all corporate insiders will have equal access to corporate financial and performance data.

Foolish bottom line

Following legal insider trading activity on a stock could provide some valuable investment signals as the corporate executives may know of something that the market doesn't.

However, insider transactions should be analysed closely and the "advice" taken with a grain of salt as the trades may be done for other personal and obligatory purposes or be influenced by behavioural finance biases. They may not be reliable buy or sell signals.

That said, I would worry about any repeated insider sales for "personal reasons," especially when several other insiders are selling, too.

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