RMH Investment Management, LLC

Market Watch with RMH – Insider trading signals ?

I have always found that following what the "Insiders" of a company do is usually a good leading indicator. The reason is quite simple: **Insiders buy to make money.** They believe better times are ahead for the company, and statistically speaking, a more important indicator than Insider Selling.

The reasons for Insiders selling are a lot more complicated, this is a partial list of reasons to sell:

- Estate planning.
- Diversifying their assets.
- They could be wrong in their opinion of where the future stock price will go.
- It is not uncommon to negotiate to receive stock options in lieu of a higher pay package.
- Option sales are not important as they have a specific expiration date (expire worthless).
- How many insiders are selling?

The following commentary was published by Cumberland & Associates (Cumberland) on August 26, 2020, Insider Trading What Does It Tell Us?

Insider trading often refers to acting on material nonpublic information. However, when company employees buy and sell their own stocks, it is also called insider trading, which is permitted by the SEC. We will only discuss the second type of insider trading today. As many investors have wondered, is it a fair game for outsiders when insiders are allowed to trade their own stocks freely?

Insiders usually refer to corporate officers, directors, and large shareholders. Intuitively, these roles possess an informational advantage over outside investors. For example, the CEO of XYZ Co. must know more about XYZ than my retired mother-in-law who enjoys her beach life every day in FL.

In the U.S. equity market, a popular insider trading gauge is the Insider Buy/Sell ratio, which is the aggregate insider purchase over insider sale. Normally, the ratio stays between 0.4 and 0.5, indicating roughly twice as much insider sale volume as purchase. This is understandable given that many insiders receive stock compensations. There have been only 11 months when the ratio reaches above 1 since 2004, meaning there are more insiders buying than selling their stocks. Interestingly, each insider purchase spike coincides with a market drop. While the highest reading on the ratio came from the financial crisis in November 2008, the second highest reading was just March this year—both can be viewed as the entry signal of the decade. (See Chart 1 below)

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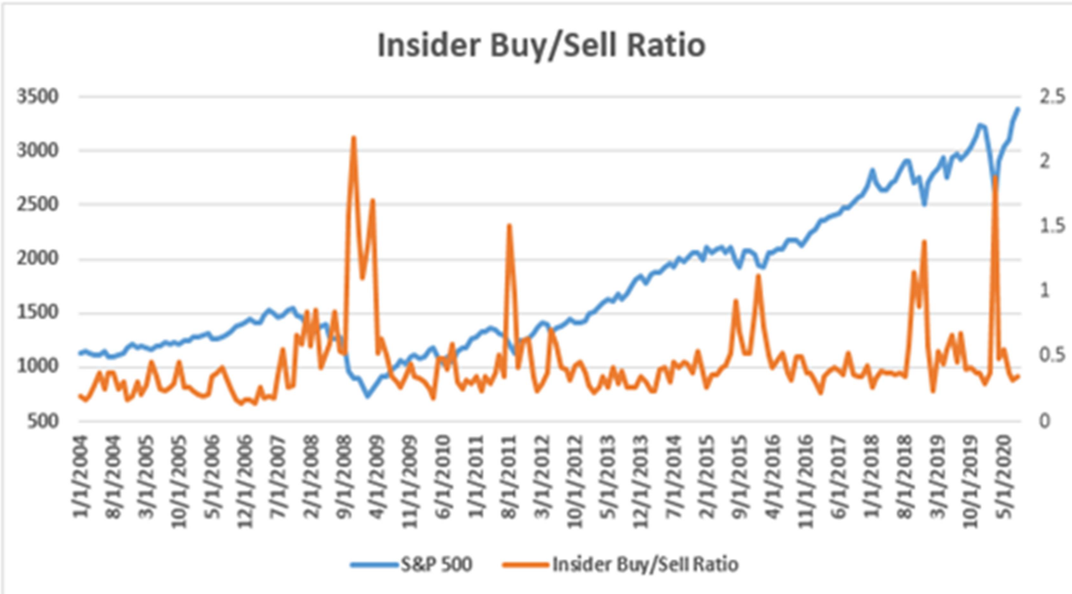


Chart 1. Monthly insider buy/sell ratio.

Digging further into the insider buying frenzies, we find that the stock market post-performance once Insider Buy/Sell ratio jumps above 1 is phenomenal. As Table 1 demonstrates, the U.S. equity market increases about 25% in 1 year and 54% in 3 years. Next time someone doesn't believe in market timing, maybe we should point them to the corporate insiders.

Time After Buy/Sell Reaches Above 1	S&P 500 Return
6-Month	13.54%
1-Year	25.33%
3-Year	54.09%

Table 1. S&P 500 performance after the Insider Buy/Sell Ratio reaches above 1.

**Data from Bloomberg as of August 20th, 2020.*

Cumberland followed up with a second article on insider buying, looking at the energy industry, as the data was easily observed. The following was from Cumberland on September 14, 2020 titled: "Insider Trading – The Case of Energy".

"Our last commentary on insider trading studied post-insider-purchase-spike (PIPS) market performance (https://www.cumber.com/cumberland-advisors-market-commentary-insider-trading-what-does-it-tell-us/). We found that the 6-month market return is 13.54% on average after the insider buy/sell ratio rises above 1. Today we will demonstrate the PIPS effect using the Energy sector as an example.

Undoubtedly, corporate insiders possess an informational advantage over outsiders. The advantage is negatively correlated with firm size. Although Energy made up 13% of the S&P 500 in 2008 when oil crossed above $100 per barrel, it accounts for only 3% by sector weight nowadays, which makes it an ideal candidate for a PIPS analysis, given its pronounced size. The insider buy/sell ratio rose to 1.88 in March, the highest reading since 2008. In the meantime, corporate insiders from the Energy sector purchased $471 million in their own stocks from late February, when the sell-off started, to the end of March – that's almost as much as the combined volume from April to August.

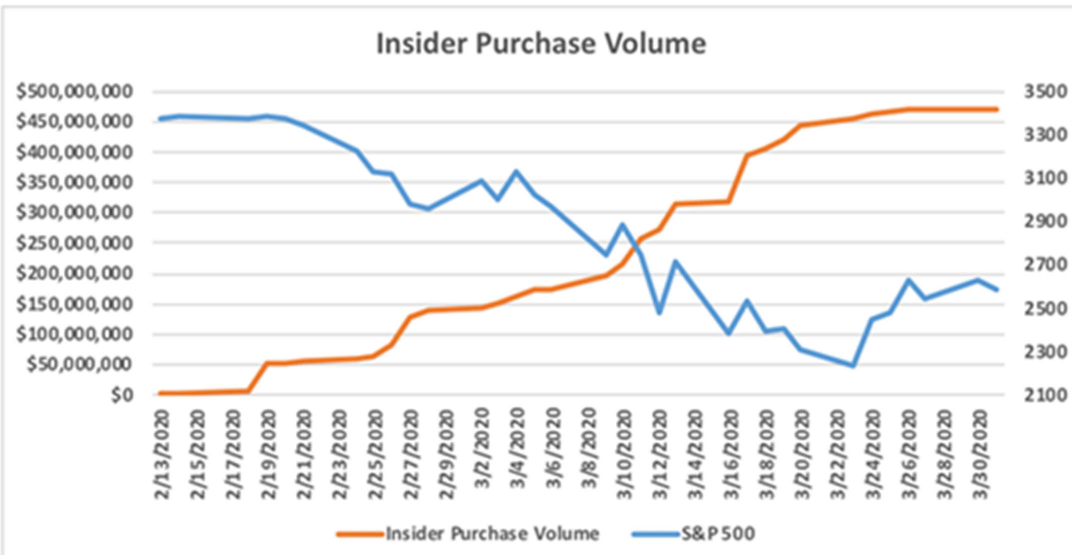


Chart 1. Insider purchase volume vs. S&P 500

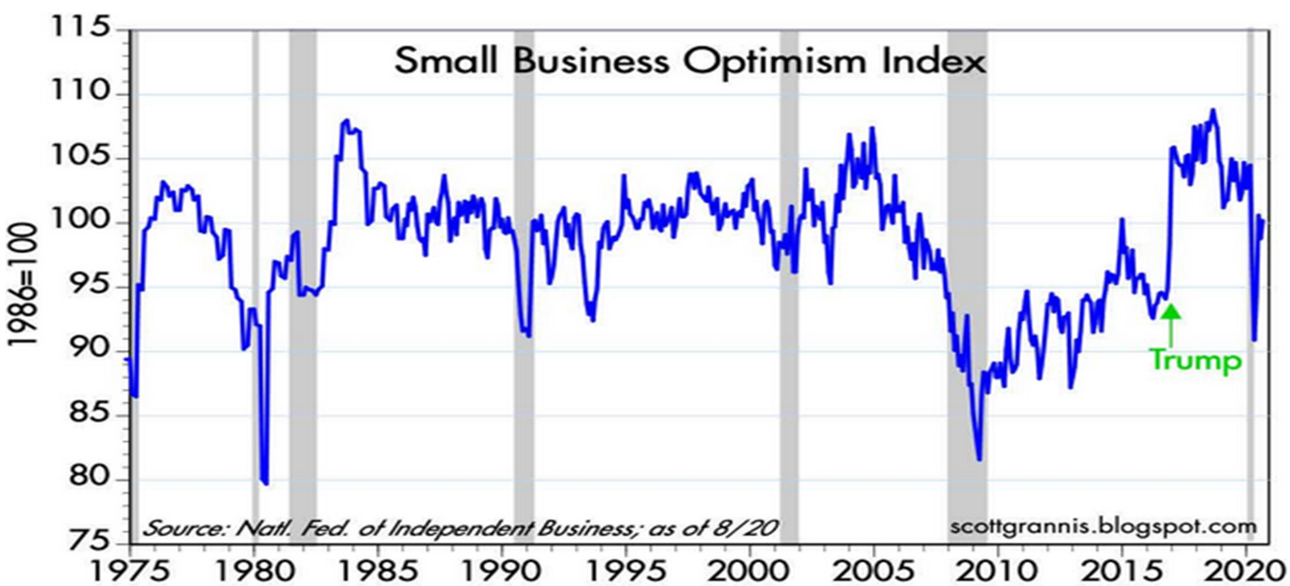
Now let's drill into Energy sector performance. Using the Energy sector ETF XLE as an example, we see that it is down about 33% since its peak back in February. But that is not the case for insiders. The $471 million in shares purchased by corporate insiders during the sell-off is worth roughly $900 million currently. In addition, insiders bought the most shares when the sell-off intensified, and almost stopped buying as soon as the market bottomed, as shown in Chart 1. The correlation between insider buying and the market drop during the period was 93%, an extremely high level. Interestingly, this finding is in line with academic research. For example, Biggerstaff et al. (2020) find that corporate insiders trade in short windows of time because their informational advantage is fleeting."

An RMH Market Watch would not be complete in these times without a commentary on the state of covid-19 (I would really like to stop doing so, and I expect this will stop in a few months as the virus runs its course). The following is from one of my CFA colleagues in Bermuda who shared the following post with me from YouTube. Ivor Cummins is from Ireland and has put forth a wonderful 37 minute summary of covid with just the facts (well over 1,111,883 views and counting). For those of you that drink whisky, (a little Jameson's), or a pint of Guinness, either will go well with the presentation, and the Irish brogue is soft on the ears as well.

https://www.youtube.com/watch?v=8UvFhIFzaac&app=desktop

Chance Encounters – leading to lower productivity and innovation?

What does this have to do with investing? A trend is currently underway that suggests migration from big cities to smaller less densely populated areas. The movement of working from home will have consequences, and one of those is the lack of spontaneous communication in the working world where ideas and productivity, are the key to success. Joachim Klement from his September 9th, 2020 article suggests that higher density cities, New York, Chicago, San Francisco, "Silicon Valley", etc…, have higher productivity and innovation due to the population density, i.e., more people working on similar issues. It is this lack of future productivity that concerns me, as the office was a common thread for several generations. The new working generations will need to find ways to innovate if the "office" of today goes away. There is more to this trend of working from home, **and,** will we need all of the same office space as before in the cities. Stay tuned. I think over time we will see the migration back to the offices, however not for the full 40 hour weeks. I am hoping we find a way to maintain productivity and innovation going forward, that has been the key to the U.S. success.



For those of you that have followed these reports you know that I am a big fan of finding out what small businesses are up to as over half of all workers in the U.S. work for firms with fewer than 500 employees.

Small businesses generate over 50% of the U.S.GDP, create jobs, and have more patents per 100 employees (26.5) versus large companies per 100 employees (1.7), finally provide more opportunities for women and minorities to achieve financial success and independence.

From the chart above, one can easily see where small businesses were crushed by covid lockdowns, however they are now rebounding. Optimism is lower than after the 2016 election, however higher than the years 2008 – 2016.

Hiring is trying to get back to the level of the first quarter of 2020, and businesses are reporting the difficulties in getting qualified workers. On a personal note, I am seeing more traffic in Tucson/Phoenix, and hearing from colleagues, that rush hours are getting busier.

The last chart of Stocks climbing a wall of worry is a favorite of mine, as when fear surges, stocks decline. Risk aversion is still strong as the 10 year U.S.Treasuries yield is still in the 0.70% range, an extremely low level rarely seen through the last 100 years.

Housing continues to lead the recovery, whether you have 33% first time home buyers, up 31% from last August, and there is no supply, certainly not in Tucson. Single family housing starts are 12.1% higher, and existing home sales are 10.5% higher year over year. Mortgage refinancing's are through the roof, with approved new loans at significantly lower rates going in excess of two months to close. To me what this all means is that a significant segment of the population has enough confidence in the economy, their jobs and prospects, **to go out and take a risk in the biggest purchase in their lives!**

What steps are we doing at RMH?

- We are looking at the portfolios and rebalancing where necessary.
- We are taking advantage of tax loss selling to lower future capital gains.
- We are looking at what insiders are doing with some of the stocks we have purchased.
- We are talking with portfolio managers on a one to one basis and participating in conference calls.

If there are ever any topics you wish us to explore, please let us know. ***We are here to help and guide you through these times.***

We thank you all for taking the time and reading "Market Watch." It is meant as an educational piece on the always evolving markets. It is something we plan on providing every month, and your feedback is very important to us.

On a personal note, RMH is now in the position to bring on new clients and please be sure to share this informational letter with whomever you wish. RMH's focus is on the customizable investment needs of individuals, families, and foundations. We enjoy working

with our clients to better understand their goals, values, and passions for what is important in their lives. In expanding our client base, we look forward to working with people who share these same desires

Richard Mundinger, CFA

Editing by Erica Mundinger

Sources

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Cumberland Advisors – September 14, 2020: Insider Trading – The Case of Energy
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