Director Dealings

By Michael Kemp

What are director's trades telling us?

As shareholders we look to the company reports to get a handle on how our companies are traveling. Not a bad idea but it's wise to recall the words of 17th Century philosopher, John Locke:

"I have always thought the actions of men the best interpreters of their thoughts."

Or in the common vernacular: "Actions speak louder than words." With this in mind let's consider what it means when directors deal in the shares of the companies they run. After all who has better insight into what is really going on?

This concept was enthusiastically embraced by US fund manager Peter Lynch when he said:

"There's no better tip-off to the probable success of a stock than when people in the company are putting their own money into it….. When insiders are buying like crazy, you can be certain that, at a minimum, the company will not go bankrupt in the next 6 months."

Termed "director dealings" they should be distinguished from the illegal practice of insider trading which seeks to profit from the use of confidential information. This article explores whether keeping an eye on these trades provides useful information for the share investor.

ASX listing rules governing director dealings

Both the Australian Securities and Investments Commission (ASIC) and the Australian Securities Exchange (ASX) govern the trading activities of company directors. Prior to 2011 the securities trading policies of the ASX were covered by non-mandatory corporate governance recommendations. However, on the 1st January 2011, new ASX listing rules covering this activity came into effect. All listed entities are now required to define and disclose a Securities Trading Policy which complies with the minimum content requirements spelt out in ASX listing rule 12.12. Rather than being prescriptive the new rules require a company to define the trading limitations most appropriate to its own circumstances.

Companies are required to define closed or blackout periods when directors are prohibited from trading in the company's securities. This is typically the time between the closing of the company's books and the public disclosure of its financial results. However any period, if seen as appropriate, can be specified by the company.

Where can you find the information?

Both the Corporations Act (2001) and the ASX Listing Rules require full disclosure of the trades made by directors in the securities of their own companies. ASX Listing Rule 3.19A provides that a listed entity must advise the ASX of any notifiable interest of a director no more than 5 days after the date of change in the director's interest. This information is available to the public in the company announcements section of the ASX website (www.asx.com.au). Specific director dealings are disclosed under the title "Notice of Directors Change of Interests". Other sources of this information are The Australian Investor Information Service website (www.australianinvestor.com.au) or via your preferred internet broker website. This is provided as raw data requiring interpretation. Some investment newsletters collate and interpret this information for their subscribers. Examples are the Intelligent Investor and Business Spectator newsletters.

How to interpret the information

Director dealings should not be used by investors as a mechanical buy or sell signal. The information needs to be interpreted within a wider analytical framework. To assist in this interpretation it is useful to consider the following:

Share purchases made by a director with his or her own money send a stronger signal than allocations through executive share schemes or the exercise of company granted options. The ASX notice will indicate this. An even stronger indicator is the purchase of shares with borrowed money. However this information is less readily available.

Buying carries a stronger message than selling. To quote Peter Lynch again:

"There is only one reason that directors buy: They think the stock price is undervalued and will eventually go up."

Whilst buying is undertaken with a profit motive selling can be undertaken for a variety of reasons. In analysing selling look for the pattern of selling. The sale of a sizeable parcel of securities by a single director might not indicate much in itself. A share sale might be made to diversify holdings, finance a new house, settle a divorce, pay down debt or fund retirement. Looking at the pattern of selling can assist in differentiating between financial and non-financial motives. For example repeated selling by several directors sends a stronger signal than an isolated sale.

It is also useful to compare the size of the trades in relation to the size of each existing holding and whether it is the directors at the core of the business, such as the CEO, who are undertaking the trading.

Consider the trades in relation to recent movements in the share price. Has the share price been falling? Value investors are constantly on the lookout for "Fallen Angels" – previously well regarded companies whose share price has fallen – in particular those which have become undervalued as a result of the fall. Under these circumstances the signal given by directors buying or selling might provide additional information in determining whether value is on offer or if the fall is justified.

Research-based findings

The important question is whether this is all supposition or whether observing director dealings actually provides useful information. Who is to say a director's judgment is superior? Researchers have investigated this question.

UK research company Director Deals looked at share price changes following directors' transactions between 1999 and 2003. They found significant buying by directors was followed by an average rise of 23.5% in the year after the purchase whilst significant selling was followed by an average drop of 15.5%. European Business School academics Dardas and Guttler analysed short term announcement effects for 2,782 companies from 8 European countries between 2003 and 2009. In keeping with the intuitive hypotheses proposed in this article they found the magnitude of the announcement effect depended upon the transaction size and was more significant when there were multiple trades by different directors on the same trading day. They also found the results were stronger for purchases than sales and the corporate position of the director was positively correlated to the size of the announcement effect.

Disclaimer

A study of director dealings should not be used as the sole basis for making investment decisions. They represent but one piece of information and must be interpreted within the context of all available information. They don't represent a substitute for a full analysis of a company's fundamentals.

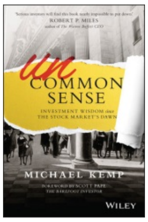
To read more of Michael Kemp's work

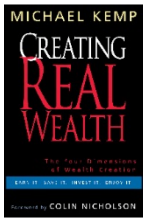
Previous Articles

All Michael's previous articles for the website are now on the *Michael Kemp Articles* page on the Free Resources menu. They are now listed by title with a brief description of their contents.

Books

Michael has written two books, both of which are available for purchase from the ***Buy Books*** menu:





CREATING REAL WEALTH - The four dimensions of wealth creation

UNCOMMON SENSE - Demystify the complex world of investments and make your own investment calls

Michael Kemp is the chief analyst for the Barefoot Blueprint and author of "Uncommon Sense". Published under the Wiley label "Uncommon Sense" delivers a deeply considered and logical approach to the otherwise complex world of investing.