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Better safe than sorry

MUTUAL FUNDS
For a little bit more alpha

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The online trading war is declared

INVESTING
Marc Mayor: follow the insiders!

LONG/SHORT IN THE SWISS MARKET

Follow the insiders: they know what they're doing!

The added value of any investment strategy depends on making use of often overlooked information. When the insiders move, moving along with them can generate some very significant alpha, according to Marc Mayor, founder of Inside ALPHA. After eight years of spotless track record in the U.S. markets, he's applying his approach to the Swiss markets.

Véronique BÜHLMANN

American investors have been using insider signals for a long time now. Already since the 1930s, U.S. insiders have been required to report their own buy and sell transactions. The word "insider" is defined, in this case, as managers, directors and large shareholders who incur legal, declared trades pertaining to the listed company or companies they manage or own. In Switzerland, this type of strategy isn't yet widely used, as it wasn't until the 1st of July 2005 that insiders have been required to inform the Swiss exchange of their transactions. Executive and non-executive members of the management are only required to report their trades if the amount traded, per insider, is higher than CHF 100,000 per month (see "How to follow Swiss insiders in five clicks"). Fundamentally, do insider transactions by themselves provide enough information to construct an efficient investment strategy? To this question, the answers provided by the existing academic studies on the topic aren't unanimous. While buy transactions most systematically beat the markets, sell transactions have a more disputed usefulness. This can be easily explained: when an insider buys shares, the expected outcome is almost always a near-term rise in the stock price. On the other side, insiders might be selling for various reasons: the need to diversify one's holdings, to cash out of stock options (which have been increasingly used to remunerate the management of listed companies) or simply the need for cash. In other words, it's difficult for the investor to make sure that the selling has anything to do with an expectation, from the insider's point of view, that the value of his shares will go down as a result of future negative news about his company, or because he has the impression that his stock is grossly overvalued.

"My investment strategy has this 'hand-made' touch and after following insider transactions for years, I am finally able to identify those who, repeatedly, give profitable signals"

MARC MAYOR

How to follow Swiss insiders in five clicks

1. Go to www.swx.com
2. Click on "Admission"
3. Select "Quotes"
4. Then "Management transactions"
5. And finally "Published data"

But most of the academic studies which have concluded that there was too little informational value in the insiders' sell transactions have been only looking either at total or net numbers. As Marc Mayor puts it, it's quite useless to blindly follow such aggregated numbers; in order to generate a double-digit performance, it's necessary to go and have a look at what's happening on an individual level. For example, a study by Professor Carr Bettis[1] reveals the following: first, if you only follow the larger transactions (10,000 shares or more), you can be profitable both on the long and on the short side; second, after several insiders have gotten rid of a large percentage of their holdings, while no other insider has been buying, the company's shares tend to underperform the markets. Depending on the holding periods, the alpha generated can be as high as 11% per year.

Other selection criteria must also be taken into consideration, according to Marc Mayor. For example, a strong buy signal by a single insider can be weakened when other people in the management are selling. Signal quality also depends on the insider's function: a non-executive insider, such as a director, will usually have access to less confidential information than a Chief Executive Officer! Chief

Financial Officers, on the other side, deliver some of the most reliable buy and sell signals. In addition, there seems to be a "small cap" effect at work here: insider signals have more informational content in small and medium capitalizations than in large caps, because what happens in larger companies is scrutinized by dozens and dozens of financial analysts[2]. The conclusions of most of these academic studies are confirmed by Marc Mayor's experience, as some of his juiciest profits came from small and mid cap trades.

On the long side, there are two recipes which almost guarantee that a company's shares will overperform in the near future: when insiders buy despite their business appearing to be in a difficult or almost desperate situation, which might be the sign of a coming turnaround for the stock, and insider buying activity despite the fact that the company's shares have already doubled or tripled recently. On the other hand, the most profitable shorts are found when the management is dumping stock as it consistently beats new record highs, or when shares are liquidated despite having already lost 50% or more of their value over the recent months. As an example, Marc Mayor cites the case of the 4M stock which, after having already lost 99% of its value from its multi-year highs, was still liquidated by executive members of the management. Those who sold the stock short at this point could have made a 52% profit in the seven months that followed, as the shares plummeted further. Conversely, ABB saw an insider buying frenzy despite the stock's strong recent gains; in the eight months that followed the management's transactions, ABB shares gained an additional 83%. All these elements show that, in order to maximize the added value of such a strategy, a qualitative analysis is indispensable. Blindly following quantitative signals would cause an excessive rotation in the portfolio, and transaction costs would eat up most of the profits as a consequence.

Hand-made

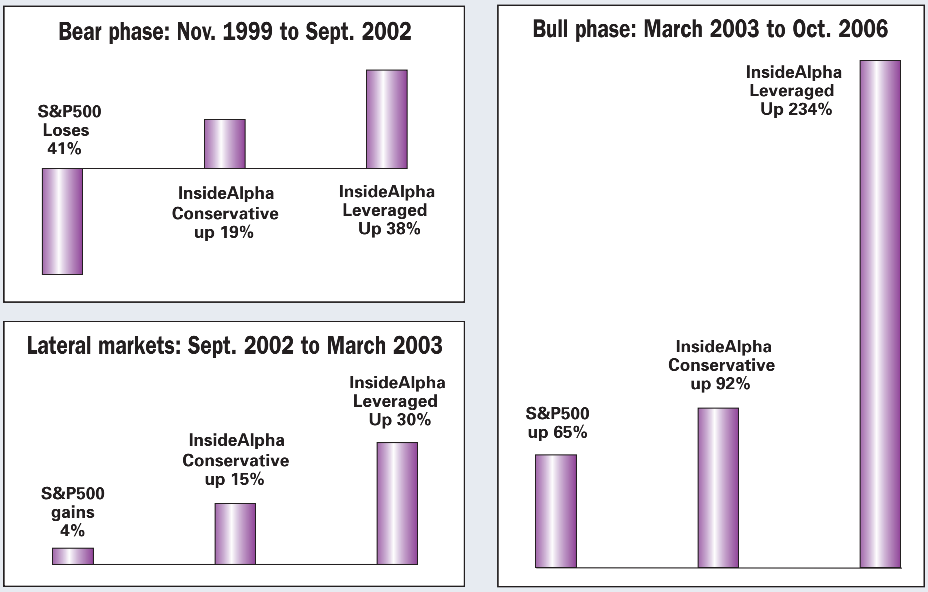
In the Swiss market, the potential for alpha is at least as important as in the U.S. market, according to Marc Mayor; his analysis is based on the trades observed since the insiders of SWX-listed companies have had to declare their larger transactions to the exchange in July of 2005. Nevertheless, he specifies that "a statistically significant analysis would require much more data; my estimates are based on the fact that I have observed that Swiss insiders have a virtually identical behavior to that of their U.S. peers". With the spectacular track record of this strategy since 1999 in the U.S. markets, it's curious that nobody has yet tried to take advantage of a similar approach on the Swiss market. Is it too thinly traded? Here's Marc Mayor's answer: "The first mover will probably choose to systematically exploit this free source of alpha, and gain an advantage to go on and dominate the market in terms of performance". For this, possessing the largest computer won't be enough; know-how and experience will also count, and that can only acquired by actually trading the market based on the signals. "My investment strategy has this "hand-made" touch ", Marc Mayor says, "and after following insider transactions for years, I am finally able to identify those who, repeatedly, give profitable signals". ■ *V.B.*

[1] *Carr Bettis is now the President of the Board of Directors, as well as the Chief Scientist of Gradient Analytics, a company that he founded with his wife and Dr. Donn Vickrey, who co-signed the academic study on insiders*

[2] *Study by Nejat Seyhun, University of Michigan*

A convincing track record

Marc Mayor is a specialist of insider-based signals and founder of Inside ALPHA. He started his career with American Express, then joined the asset management arm of Prudential Securities and was finally responsible for structured products and hedge fund strategies at Credit Suisse. Since 1999, he has successfully followed a market neutral strategy; the model portfolios have half of the money invested long stocks, and the other half short stocks. The approach uses a few quantitative and mostly qualitative criteria. His performance has been verified by ISFA (Information Systems for Analysts SA, owned by the Swiss Financial Analysts Association), and has yielded an annualized performance of 15% to 30%, for a risk twice to four times lower than conventional "buy and hold" investing (benchmark: S&P 500 index). As the following graphs show, the strategy's performance has been positive and double-digit in falling, lateral and bull markets. ■



The Inside ALPHA Conservative (IAC) portfolio uses no leverage, while the Inside ALPHA Leveraged (IAL) uses a leverage of 2x.

Insider strategy: The main principles

- Insider buying: only follow the larger transactions
- Insider selling: watch out for false signals!
- All insiders are not good indicators
- Small is beautiful
- Never neglect to do your homework

INSIDE ALPHA

MARKET NEUTRAL
INVESTMENT STRATEGY

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