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When to pay attention to insider buying

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Studying the actions of smart insiders has always been a valuable investment tool for us. Most of the time, insider activity is not very provocative, and insider selling typically means very little. But certain kinds of insider buying can mean a lot. We believe it often indicates an excellent entry point for a particular stock or group of stocks.

Consider the meaning of insider buying: the purchase of shares in a corporation by a director, officer, or executive within the company. If people are willing to invest a considerable amount of their own money in a company they know well as an insider, we should pay attention. When assessing insider buying action, we find a few criteria to be important, and some that can be ignored. First, we tend to ignore option-based insider buying. This is because the insider is paying, or has paid, a lower price to own more stock than we can pay at market. We also tend to ignore small purchases, as they may not demonstrate much conviction. Small purchases could simply be cosmetic moves by senior management to show they have confidence in their own leadership.

What gets our attention?

We view large insider purchases as a potential opportunity. We tend to consider purchases of $400,000 or more as a genuine commitment. One exception would be those of well-paid CEOs, like Jeff Immelt of GE, who routinely bought $1 million in stock each year. We generally viewed his purchases as cosmetic since he was paid 20 times this figure or more annually. We pay attention to purchases under $400,000 if we believe the buyer is smart but perhaps not as wealthy. In these cases, they may be middle-management insiders who have demonstrated a real feel for the stock with timely small purchases in the past. We research this timeliness by following SEC Form-4 filings, which must be completed by directors and officers of a company and by any shareholders who own 10% or more of the company's outstanding stock.

> In March 2020, we witnessed the highest level of insider buying versus selling we had ever seen in our investing careers.

Other smart insiders and cluster buying

Also on our radar for smart insider purchases are chief compliance officers. They tend to be knowledgeable about legal rules surrounding insider buying and are very careful in their purchasing actions. Chief financial officers also tend to be smart buyers. CFOs are very conscious of their company's stock price and tend to be strategic about entry points. We are very attentive to large purchases by CFOs.

We also pay attention to cluster buying. When we see a number of insiders buying, we view this as a strong signal to get involved, especially if the purchasers include those in middle management. Without acting illegally on inside information, these insiders can sense the beginning of a change in the company's fortunes — such as with an upcoming new product or a problem area that is finally being fixed.

When we notice any attractive insider activity, we do not react by impulsively buying the stock. However, it encourages us to begin our research process with immediacy. We (re)examine the fundamentals of the company, seeking to discern if the insiders are truly onto something. If we believe we have discovered an attractive opportunity, we won't hesitate to invest.

2020: A case study in insider buying cues

We can go many months without finding attractive insider activity. Then suddenly, activity can pick up and expand broadly. This was the case in March 2020, when we witnessed the highest level of insider buying versus selling we had ever seen in our investing careers. At the onset of the pandemic, record inside buying activity occurred in valuation-sensitive and cyclical sectors such as financials, energy, and materials, and also for the Russell 2000 Index overall, which tends to be cyclical.

The March 2020 "heads-up" from insider buyers

Insider buying data for the week ending March 13, 2020

Group	Unique buyers	Highest since
Entire market	1,347	11/25/2008
Wilshire 5000, excluding financials	320	8/17/2011
S&P 500	83	8/16/2011
Russell 2000	**778**	**New record**
Technology	56	11/1/2018
Healthcare	88	8/20/2019
Consumer discretionary	157	12/1/2008
Industrial goods	91	8/17/2011
Financials	**553**	**New record**
Materials	**81**	**New record**
Energy	**170**	**New record**

Source: InsiderScore, LLC.

This led to our strong conviction that the collapse in the overall market presented a buying opportunity. At that time, we compiled a list of names that made sense to research and distributed it to the analysts on our equity research team. Our list included stocks with increased activity from what we believed were smart inside buyers. One example we acted on was Freeport-McMoRan (FCX), a leading international mining company whose shares later surged with the recovery in global economic growth. Copper prices plummeted in March 2020 but rebounded considerably. Freeport-McMoRan owns an interest in one of the largest copper and gold mines in the world, and it ramped up its low-cost copper production in response to surging global demand. Another example was home improvement retailer Lowe's (LOW), which has experienced impressive same-store sales growth and stock price advances since the market's March 2020 lows.

Recently, with stocks generally advancing, we have not witnessed many attractive inside buying situations. However, we are always on alert, as we believe this is an alpha-enhancing strategy and discipline.

As of 7/31/21, Lowe's represented 1.98% and Freeport-McMoRan represented 0.67% of Putnam Multi-Cap Core Fund assets.

Alpha is a measure of performance on a risk-adjusted basis. Alpha takes the volatility of a mutual fund and compares its risk-adjusted performance to a benchmark index. The excess return of the fund relative to the return of the benchmark index is a fund's alpha.

The Russell 2000 Index is an unmanaged index comprised of approximately 2,000 of the smallest companies in the Russell 3000 Index as measured by their market capitalization.

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