

## Volume, Insider Trading, & Short Selling

*Using other people's trading as directional indicators*

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Price movements in the financial markets result from the collective decisions of millions of investors. There are a number of useful statistics and reports that tell you what those other market participants are doing. That information can easily be tracked and incorporated into your own trading decisions. The three indicators of what other people are doing that I will focus on in this article are daily trading volume, insider trading, and short interest.

On a day-to-day basis, trading volume can give you important insight about the strength of the current market direction. Volume is also an important consideration for individual companies, but an additional resource available to look at is insider trading. Insider trading reports can give you important clues about what those who know the company best think about the future prospects for the company. Finally, traders that bet against individual companies by short selling their stock provide useful information that can be incorporated in your decision making process.

### Daily Trading Volume: Up, Down, and All Around

Technical traders tend to focus almost exclusively on price action. Fundamental traders rely on company and stock valuation. But trading volume is an important indicator for understanding and forecasting price movements in the market. Everyday, millions of market participants from small individuals to large sophisticated trading firms, signal the direction they think the market is going. They do this by buying or selling shares. There are many statistics available that try to aggregate market information in a useful way, but I find volume both useful and easy to use.

Volume is an under-appreciated indicator. When people ask me how the market did today, they always mean price. How much did the Dow go up or down today? I've never (with the sole exception of our President, Len Yates ) had anyone ask me about today's volume. Yet volume tells as much about market strength as price movements in the Dow Jones or S&P 500. Volume, or *market breadth*, tells you how meaningful the price movement in the market is.

Advancing, declining, and unchanged volume are all simple market momentum indicators. They reflect the movement of stocks on an exchange in millions of shares. Advancing volume is the total volume for all stocks that have increased in price. Declining volume is the total volume for stocks that dropped in price today. And unchanged volume is the total volume for all securities that were unchanged in price. On a daily basis, I only follow the figures for the NYSE and NASDAQ. Below is an example of how they can be followed on your Quotes Display:

Symbol	Name	Last	Change	%Chg	High	Low	Volume	DiffX	TimeX	Time
Market Indexes										
\$INDU	Dow Industrial Avera	8393.85	-112.77	-1.3%	8508.77	8392.60	85.6M	+1.25	00:00	09:55
\$SPX	S&P 500 Index	871.96	-12.70	-1.4%	884.72	871.96		+0.00	00:00	09:55
\$COMPO	Nasdaq Composite	1258.26	-21.74	-1.7%	1282.06	1258.26		+0.00	00:00	09:55
\$NDX	Nasdaq 100 Index	896.84	-16.75	-1.8%	916.69	896.79		+0.05	00:01	09:55
\$OEX	S&P 100 Index	438.50	-5.82	-1.3%	444.18	438.49		+0.01	00:00	09:55
\$VIX	CBOE Volty Index	43.34	+1.85	+4.5%	43.34	40.90		-0.00	00:00	09:55
\$TRIN	Arms Index	1.32								09:55
Volume Indicators										
\$UVOL	NYSE Up Volume						107M			09:55
\$DVOL	NYSE Down Volume						310M			09:55
\$XVOL	NYSE Unchanged		0.00				2.31M			09:55
\$UVOLO	Nasdaq Up Volume						64.2M			09:55
\$DVOLO	Nasdaq Down Volume						348M			09:55
\$XVOLO	Nasdaq Unchanged		0.00				7.08M			09:55

Market volume is a relative term and needs to be compared to the average daily volume of the index or stock in question. A large percentage price change accompanied by larger than normal volume is a solid indication of market strength in that direction. But large percentage price increases accompanied by small volumes are less likely to indicate a market direction. In fact, it may indicate a reversal is likely in the near term.

### Insider Trading: What Those In The Know Think

Many think it isn't a coincidence that corporate executives always seem to buy and sell at the right times. After all, directors, CEOs, and CFOs have access to all the company information you could ever want. Luckily, individual investors are not left completely in the dark about what they are doing. Insider trading records are out there for all who want to see them. The two key documents used to compile insider trading information are Form 4 and Form 144. These are required to be filed with SEC and made available on their FreeEDGAR website.

In legal terms, the SEC considers "insiders" to be company directors, officials, or an individual with 10% or more ownership in a company. They are required to report any trades in the company stock within 10 days following the month the transaction occurred. For example, if an insider sold 10,000 shares today (August 2<sup>nd</sup>) they wouldn't have to report this until September 10<sup>th</sup>. Any changes in insider holdings must be sent to the SEC using Form 4.

Before they can be issued to the public, securities must be registered with the SEC. But there are numerous exemptions to these registration rules that give companies the ability to issue small amounts of shares directly to people as part of a stock bonus, pension or profit-sharing plan, as a private placement, plus a number of other reasons. These shares are "restricted", and there are rules that govern how they can be sold. Form 144 must be filed by insiders to announce their intention to sell these shares before they can actually be sold

to the public.

Form 144 is a notice that an insider would like to sell restricted shares, but it does not obligate them to do so. However, if the shares are not sold within three months, the Form 144 must be amended. Usually the shares designated on a Form 144 have already been sold by the time you see the document. They can even file Form 144 and Form 4 at the same time. That makes sense, because why would someone go through all the paperwork of a Form 144 unless they're ready to sell? Either way, Form 144 still indicates that someone has, or expects to, sell shares. That's useful information to keep in the back of your mind when researching a stock or possible trade.

Insider trading forms do not have to be filed electronically with EDGAR. More than 300,000 insider trading forms are filed annually with the SEC, and 95% of them still arrive via mail. Also, there is not always a Form 4 filed that matches the sale of the restricted shares shown by Form 144. That's because everyone with restricted shares are "insiders" by the SEC's definition. In this case, the relationship of the person filing Form 144 is indicated as "Unknown" or "None".

Are those insider trading records really useful if the information is likely to be so out-of-date? Certainly. It is always important to know what those with close links to the company are doing. Also, broad trends over time can become apparent using aggregate insider buying and selling as a possible indicator. One current example would be the telecom sector, which has been particularly hard hit this past year. For the 3 months up to June 30<sup>th</sup>, telecom executives have bought more shares than they sold. In contrast, insider sales have exceeded purchases by 15 to 1 across all American firms during that same period.

While you can go to the SEC's website and labor through all of a company's filings for these forms, most major financial websites give easy access to insider trading reports on individual stocks. You can also see the top ten companies with the largest insider purchases and sales for the last 30 days using the [MoneyCentral Top 10 Calendar / Insiders](#).

### Short Sellers: Are they Right or Wrong?

Short selling lets investors profit from a falling stock. An investor borrows shares of the stock from his broker at the current market price and immediately sells them. Sometime in the future, he will have to buy back those shares on the open market and repay his debt. If the stock has since dropped in value, he pockets the difference. If the stock price has gone up, the investor loses money. In fact, the possible losses from short selling stock are theoretically unlimited.

While there are individuals who short sell stock, it tends to be dominated by institutional traders. There are entire trading firms dedicated to selling stocks short. They scrutinize financial statements for weaknesses, looking for potential trouble spots. They may short sell the stock because a company is in trouble, or simply if they think the stock is currently priced too high.

All the stock exchanges track and report the short interest in each stock every month so investors can see what the short-sellers are up to. A high (or rising) level of short interest means that many people think the stock will go down. This is a sign you should check out the company and current news carefully before placing any trades in the opposite direction. But it doesn't necessarily mean you shouldn't bet against them. After all, the short sellers are often wrong. In fact, since stock prices have historically gone up, they are always betting against the long term market trend.

One interesting indicator that can be obtained from short interest reports is the short-interest ratio.

It is calculated by taking the short interest and dividing by the average trading volume. This tells you how many days it would take short sellers to cover their positions (i.e. buy back the stock) at the current trading volume. If too many shares of a given stock have been sold short, the days to cover can stretch past 8 or more. This can create difficulties for short sellers if there is good news that causes the stock price to increase suddenly. They will suddenly be scrambling to buy back the shares to prevent further losses. The higher the ratio, the more shares traders will have to buy, pushing the price up further. This phenomenon is often referred to as a "short squeeze".

Some bullish investors see high short interest as an opportunity. The reasoning goes that stocks with high short interest means they can see how much future demand there will be for the stock. After all, the short sellers are required to replace the shares they borrowed eventually, and any rise in price will force some short sellers to liquidate and cover their position by purchasing the stock. If a short squeeze occurs and enough short sellers buy back the stock it can push the price even higher. That's why short seller prefer large, liquid stocks.

While short squeezes tend to occur more often in smaller cap stocks, large-cap stocks are certainly not immune. However, this is a very difficult phenomenon to predict and execute. Buying a stock solely in the hope that a short squeeze will occur is not a good strategy. Betting on a short squeeze is just as risky as shorting the stock in the first place. And if you see a smaller cap stock with an extremely high short interest, chances are something is going on. My advice is to stick with using the short-interest ratio as an indicator of market sentiment – especially for volatile growth stocks.

The NYSE short ratio is often used to determine sentiment for the overall market. This ratio takes the monthly short interest on the entire exchange and divides it by the average daily volume of the NYSE for the last month. It therefore represents how many days of average volume it would take for all short positions to be repurchased.

As an indicator, it combines two market forces - sentiment and demand for stock. Its simplest interpretation is that the short interest level reflects the bearish sentiment among short sellers. Its effectiveness is enhanced by the need for short sellers to later cover (repurchase) those shares, making it a measure of future demand for stock as well. Again, many investors use this as a contrarian indicator, reasoning that a high short interest ratio helps support prices. In a market decline, short sellers become buyers to lock in their profits. In a rising market, they are forced to cover their positions, often propelling the market even higher in the attempt to limit losses.

While this short selling interest can be found by going to each of the individual stock exchanges, many websites aggregate it for all the stock exchanges in one place. Below is a recent list of stocks sorted by their monthly short interest volume, with the highest on top:

Rank	Symbol	Company	Average Daily Stock Volume	Monthly Option Volume	Monthly Call Volume	Monthly Put Volume	Monthly Short Interest Volume	Put/Call Ratio	Put/Option Volume Ratio	Put/Stock Volume Ratio	Short Interest Days to Cover	Speculation Index	VIX
1	LU	Lucent Technologies, Inc.	22158253	116294	67076	49218	115492857	0.73	0.42	0.0022	5.2	0.0052	58.9
2	KM	K Mart Corporation	17973189	193162	103282	89880	96546474	0.87	0.47	0.0050	5.4	0.0107	79
3	CPN	Calpine Corporation	19100263	182454	112220	70234	89009878	0.63	0.38	0.0037	4.7	0.0096	87.5
4	AWE	AT&T Wireless Services, Inc	21097637	33886	17876	16010	78970577	0.90	0.47	0.0008	3.7	0.0016	29.5
5	NT	Nortel Networks Corporation	13239505	46147	29470	16677	78179886	0.57	0.36	0.0013	5.9	0.0035	44.1
6	CD	Cendant Corporation	6558721	37431	23389	14042	77392469	0.60	0.38	0.0021	11.8	0.0057	18.1
7	MOT	Motorola, Inc.	10343268	39336	20843	18493	73693951	0.89	0.47	0.0018	7.1	0.0038	22.7
8	CSCO	Cisco Systems, Inc.	73641945	428383	288057	140326	67311503	0.49	0.33	0.0019	0.9	0.0058	37.7
9	INTC	Intel Corporation	48255243	300229	184675	115554	67129043	0.63	0.38	0.0024	1.4	0.0062	23.7
10	CNC	Conseco, Inc.	4466637	36503	24299	12204	66994963	0.50	0.33	0.0027	15.0	0.0082	71.5
11	AES	AES Corporation	13426747	54871	29962	24909	62219762	0.83	0.45	0.0019	4.6	0.0041	76.8
12	HWP	Hewlett-Packard Company	9827816	169004	124045	44959	60710646	0.36	0.27	0.0046	6.2	0.0172	15.2
13	AOL	AOL Time Warner, Inc	25489089	302978	188766	114212	59275569	0.61	0.38	0.0045	2.3	0.0119	21.1
14	F	Ford Motor Company	10433326	80060	60841	19219	58844526	0.32	0.24	0.0018	5.6	0.0077	22.6
15	NXTL	NEXTEL Communications, Inc. (Class A)	23563965	49779	37862	11917	54915031	0.31	0.24	0.0005	2.3	0.0021	70.4
16	T	AT&T Corporation	15072721	38356	23964	14392	53778057	0.60	0.38	0.0010	3.6	0.0025	18.3
17	JDSU	JDS Uniphase Corp.	30379975	57548	45933	11615	52772106	0.25	0.20	0.0004	1.7	0.0019	61.6

#### Conclusion: How to Begin Putting it all Together

You could easily look up this information yourself, and pick out any number of companies that might be worth some further research for a possible trade. For example, you might notice that in addition to the telecom sector having more buying than selling by insiders, the only recent insider trading on AT&T was a director who purchased 65,000 shares. That's a good sign. AT&T is also one of the top stocks in the short interest list (# 16). While that indicates bearish sentiment by short sellers, they will have to buy shares eventually. If further research shows attractive fundamental reasons to be bullish, and the stock to be fairly- or under-valued, then you would be prepared to take advantage when a good bullish technical entry point comes along.

No single one person can move the financial markets by themselves, no matter how much money they have. Trading does not occur in a vacuum. Indicators and reports that show you what other market participants are doing can be a valuable addition to your trading system. Daily trading volume, insider trading filings, and short selling reports can all be used to find trading ideas you might otherwise overlook.