Directors' dealings database proves valuable

Investment

Inside Analytics has a wealth of information for sale, writes Sophia Grene

Genius is 1 per cent inspiration and 99 per cent perspiration, according to Oscar Wilde. This explains why it is so rare: plenty of people have good ideas, but few have the perseverance to make them work.

Two years ago, brothers Patrick and Robert Hable and Ruven Oberländer, founders of financial research company 2iQ, came up with one of the good ideas that many people have had, that of monitoring directors' dealings in equities and basing a trading strategy on it.

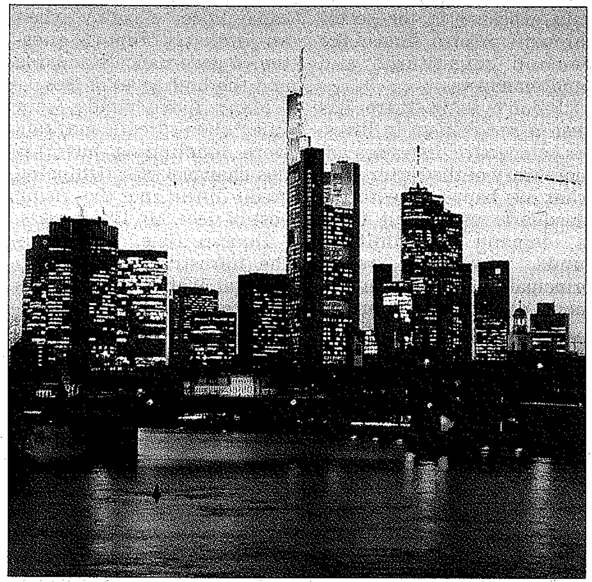
The thinking behind this is that directors of a company have more information about its fortunes than anyone else. Paying attention to their legitimate purchases and sales of stock in the company can provide investors with useful clues as to direction of its share price.

Research from Citigroup and others has shown that these insiders outperform the relevant benchmark and are particularly good at timing markets. Although it is only since 2003 that reporting such transactions has been mandatory across the European Union, many states have required it for much longer, while the US has demanded disclosure since 1934, so there is plenty of evidence to suggest this is a good strategy.

The problem is there are a lot of companies and even more transactions to monitor. Plus a single transaction is not going to give an enormous amount of useful information, since many are routine re-investments of dividends, maturing of options or the practice of a habitually bullish executive.

The three partners planned to put together a database and set up a hedge fund using its findings.

Unfortunately for them and their seed investor, before the fund was launched the latter lost large amounts of money due to the collapse of Absolute Capital. All was not lost, says Patrick Hable. "We had put so much work into the data, we had to decide what business model to use." Instead of looking for a replacement investor, they chose the "less stressful" option of packaging the database and selling it to others.



A thousand eyes: Inside Analytics is based in Frankfurt

Inside Analytics offers a "near real-time" database covering 2,000 stocks in 15 European countries. That is the 99 per cent perspiration: the regulations for disclosure of these deals vary in detail across the 15 countries, and the reporting comes in a variety of formats. The raw data is not always checked for quality and the depth of details, so a large part of the work done by Inside Analytics is in cleaning the data and surrounding it with useful context.

Hedge funds and investment banks are the main consumers of the data, although some of the latter run their own proprietary databases. Inside Analytics has nearly 20 clients, mostly hedge funds with between €100m (£79m, $146m) and €5bn under management. The data is available either directly from the providers, using FTP, a standard method of transferring information electronically, or via Deutsche Börse's CEF data feeds.

For hedge funds wanting to outsource even more of the perspiration, 2iQ has put together a model incorporating this information and using behavioural finance analysis.

Each company in the universe is given a score from one (strong sell) to 10 (strong buy); according to 2iQ's own backtested data, buying the top-rated companies and selling the bottom-rated generates an average return of 15.6 per cent over six months. The Frankfurt-based company offers another, more complex model, the "factors of pure alpha model" This combines the directors' dealings information with a raft of other information about each stock to generate scores from one to 100. The recommendation then is to buy the top 10 per cent of the universe and go short the bottom 10 per cent.

"The last three months were very good for our models," says Patrick Hable, "because we were short companies with poor earnings quality."

In the week when Lehman Brothers went bankrupt, following the 2iQ pure alpha strategy would have left investors down just 1 per cent.

Although restrictions on short selling would have a negative impact on this model, Mr Hable explains a ban limited to financial stocks is irrelevant, because they are not included in the analysis. "Our pure alpha model doesn't work on financials, because in order to get a meaningful picture, you have to get much more detail than our models have," he says.