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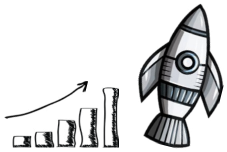

INSIDER OWNERSHIP AND FIRM PERFORMANCE

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> ***"Never, ever, think about something else when you should be thinking about the power of incentives."***
>
> ***"Show me the incentives and I will show you the outcome."***
>
> *- Charlie Munger*

When we set out to write a paper on insider ownership, our intent was to put together a short piece on the positives and negatives of large quantities of equity owned by individual insiders. Our answer was... *well, it's complicated*. Two distinct and competing effects simultaneously work to determine a firm's value. First is the Alignment Effect, where the managers of a firm who own large portions of equity are incentivized to make strong, long-term managerial decisions to increase shareholder value. The second is more ominous and less obvious in the Entrenchment Effect, where a manager's large ownership stake can complicate any attempts to mitigate or replace managerial decision making.

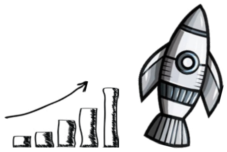
What Is Insider Ownership

Insider Ownership is a measure of the amount of a firm owned by officers, directors, and other large, influential shareholders. Generally, these individuals have better information on the outlook of the company than the average investor or any outsider. Paying attention to these executives and their buying/selling patterns can provide valuable insights into a firm's long-term outlook. Further, their level of aggregate ownership can be an important tool for analyzing managerial conviction, incentives, and decision making.

Alignment Effect

Amazon and Berkshire Hathaway are two of the biggest success stories in the history of business, and both were built into what they are today by CEOs—Jeff Bezos and Warren Buffett—whose incentives were perfectly aligned with other shareholders. While Bezos and Buffett own less than they used to of their respective companies as they've sold shares to pay for other things and give away to charity, they still remain big holders of the companies they run. This sort of alignment in the incentives of the decision makers and shareholders has led directly to the enrichment of both them and the shareholders who went along for the ride. It has been present in these examples, and present in past examples such as Sam Walton with Wal-Mart, Ray Kroc with McDonald's, or Bill Gates with Microsoft. And it has also been present in more recent examples, such as with Ryan Pape at XPEL (see in one of our previous white papers) or Elliot Noss at Tucows, among the many other examples in the technology industry over the last couple of decades.

From alignment emerges the type of long-term decision making that delivers outsized value to shareholders. Insider ownership percentage does not necessarily need to be enormous for this effect to take hold, so long as the dollar amount held in shares is much more important to the manager than his or her salary. But in the small and micro-cap space, it is almost exclusively the case that, for there to be sufficient Alignment Effect, insider ownership needs to surpass 5%. This Alignment Effect usually exists with positive impacts from 5% to 50%, before other effects risk taking hold and need to be given more consideration.



Entrenchment Effect

Collectors Universe (CLCT) was public company that was a darling of deep value microcap investors for several years. It had a fortress of a balance sheet, a deep moat, and strong cash flows. However, the stock did not earn a good investment return, potentially because of an ineffective management that failed to advance the company's core, cash-producing businesses. This was due to a legacy board of executives that maintained very high ownership positions and were incredibly difficult to influence, due to this entrenched position. This is what caused Alta Fox Capital to engage in an activist campaign that ended with rapid price increases and CLCT going private at a premium price. CLCT could easily have been classified as a "private company that happened to be public" (from the CM Microcaps Podcast) that ended up actually going private. The Entrenchment Effect occurs when a CEO or management own enough of a firm that they're difficult to depose and replace, or their decision making becomes difficult to question. This effect begins to dominate both anecdotally and empirically with ownership levels over 50% (or even earlier if there is a dual class voting structure). The Entrenchment Effect begins here largely because once insiders own, or control, over 50% of a firm's voting power, they become impossible to depose for outsiders. Therefore, they effectively control the firm and are "Entrenched" in their executive role. This leads to excess autonomy and reduced accountability in decision making and can lead to negative outcomes for the firm.

Insider Buying and Selling

One of the more valuable tools available to investors is the ability to monitor insider transactions. These transactions can be a signal for the overall sentiment of a company's management, particularly when they signal significant departures from norms. This can be particularly important in the microcap space as the presence of insider buying is a direct reflection of an executive's willingness to invest personal capital in a firm's future. Further, insider buys often go unnoticed in these smaller companies due to the lack of coverage they receive and the limited flow of institutional dollars into these illiquid stocks.

Not all insider selling is a signal of weakness. Often, selling can be done for other reasons or to increase public float. In companies where an insider is holding a large percentage of the company, this increased supply allows for increased liquidity which can often bring in institutional investors that might not otherwise be willing to become shareholders. Take Joe Mansueto of Morningstar as an example. In 2005, he owned over 70% of the company which was valued at over $1 Billion. He was keenly aware of the fact that the company's limited float (around 20% of shares) was likely suppressing the stock price as multiple institutions made it clear that they would have bought if the stock were more liquid.

Further, anomalous selling patterns by individual insiders may not signal an overvaluation or weakness in stock price. It is important to remember that these executives are still humans who like to reward themselves and spend their earnings on occasion, so try not to fault a guy or gal who just really wants a condo in Tampa. Personal needs can necessitate selling as well. Events like divorces, college expenses, or medical bills can all necessitate a need to sell some stock for cash expenses. Proper tracking of these managerial maneuvers can be accomplished by monitoring Form 4 filings published on the SEC's EDGAR site.

Final Thoughts

There is an oft-cited conclusion from academic studies that insider ownership is not a significant predictor of a firm's performance. While this may be true of the meta data or a quantitative approach to investing, it does not account for an individual investor's ability to evaluate the quality, or lack thereof, of a firm's executive suite. The important underpinning of this entire point of evaluation is the ability of a manager to make effective decisions on capital allocation. If a manager is not a strong capital allocator, they are not likely to miraculously become one with a higher ownership stake. Conversely, managers who are effective will likely have this amplified by having the proper incentives to maximize their own wealth through the maximization of shareholder value.