

DON'T END UP BEING ROAD KILL

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As an investor, I feel like I am being blown in two directions at once. Insiders are selling stock at record numbers¹. Management is repurchasing shares with shareholders' cash while many company managers and their boards are backdating option grants.

I can understand the lack of ethics on the part of management in regards to stock options, since it directly benefits the perpetrator. I find it more difficult to interpret the simultaneous crosswinds associated with the high volume of share repurchases coupled with record insider selling. Either there are a number of diverse opinions in respect to valuation, or else we should look for a more insidious reason for this seemingly contradictory behavior.

Insider Selling at Record Highs

Looking first at the insider selling issue, CFO.com pointed out that stock sales by insiders last month exceeded insider buying by the widest margin since 1987. In and of itself, this phenomenon is interesting, since there appears to be information associated with insider trading.² On balance, insider purchases/sales outperform the market after adjusting for size and book-to-market effects.

While I find it hard to believe that management is any better at timing the market than other investors, I find the following quote from Individual Investor best explains the view for outperformance.

"Company executives and directors know their business more intimately than any Wall Street analyst ever would. They know when a new product is flying out the door, when inventories are piling up, whether profit margins are expanding or whether production costs are rising...You always hear about the smart money. Generally, that is the smart money."³

Not only do investors receive the information in a less timely way, but oftentimes the information provided is misleading -- particularly if it's negative information. Given the large disparity in stock sales versus purchases, I think it reasonable to believe that company managers are voting with their pocketbooks having assessed that the market is overvaluing future results.

¹ "Report: CEOs Dumping Company Shares" – Stephen Taub, www.CFO.com, December 7, 2006, ©CFO Publishing Corporation 2006

² "Are Insider Trades Informative?" – Josef Lakonishok and Inmoo Lee, The Review of Financial Studies 2001, Vol. 14, No. 1, p. 79, ©2001 The Society for Financial Studies

³ Individual Investor, Feb. 1998, p. 54

Share Repurchases at Record Highs

Concurrently with record insider selling, we are witnessing the highest number of share repurchases in history⁴. This comes at a time when tax considerations between dividends and capital gains are no longer a factor. It is hard to swallow the typical argument that my stock is undervalued, in light of the fact that many companies' managements are repurchasing shares for the company while selling their own.

The strongest argument offered for share repurchase is that it is not dilutive. While this is true, the primary beneficiary of this lack of dilution is the manager himself, whose bonus payments are often tied to earnings-per-share performance. In fact managers get a double- barreled positive effect: increased bonus coupled with a hoped-for increase in stock price (or at least not a diminution in price) as they liquidate their holdings⁵. It's no surprise that we are also seeing an increase in the rate of management turnover.

The Risk to Shareholders

Dividend payments go directly to the shareholders, and managers are rarely meaningful shareholders. In effect, by incenting managers with stock options, investors have encouraged share repurchases in which they (the shareholders) participate to a far lesser degree than their option-leveraged managers.

So what's the story? Stocks may be overpriced and the shareholders have provided managers with a perfect exit strategy by willingly allowing management to repurchase shares at someone else's future expense. I would be very careful crossing this intersection of insider sales, share repurchases, opaque accounting, and management turnover. I think shareholders will end up being road kill.

The list below highlights some highly likely potential road kills. Not only is there substantial insider selling coupled with repurchases, but the accounting and governance practices of these companies (as measured by Audit Integrity AGR[®] scores) are opaque, suggesting that management may be less than entirely candid with shareholders .

With the exception of AFCE, GPX and WABC (all of whose revenue growths were far below peers), these companies have all outperformed their peers in respect to stock price performance over the last three years, reinforcing my argument that the high level of stock repurchases is unlikely to be due to undervaluation.

I strongly suggest you take a long look at these companies, and others whose patterns are similar, before investing.

⁴ "Can You Have Your Stock and Sell It, Too?" – Randy Myers, CFO Magazine, November 1, 2006

⁵ "Stock Repurchases and Incentive Compensation" – Christine Jolls, Working Paper 6467, NBER Working Paper Series, National Bureau of Economic Research, March 1998

POTENTIAL ROAD KILLS

Ticker	Name	Market Cap	AGR [®] Score	Stock	Insider	Peer
				Repurchase	Sales	Performance
				Rank %	Rank %	Last 3 Years
ASVI	A.S.V., Inc.	372.005	38	96	81	Neutral
AFCE	AFC Enterprises, Inc.	514.766	38	90	97	Underperform
FWRD	Forward Air Corporation	1,015.891	25	93	95	Neutral
GPX	GP Strategies Corporation	128.300	38	91	90	Underperform
GPI	Group 1 Automotive, Inc.	1,367.218	35	90	84	Neutral
HGRD	Health Grades, Inc.	139.853	37	91	82	Outperform
JKHY	Jack Henry & Associates, Inc.	2,036.022	41	91	85	Neutral
MTB	M&T Bank Corporation	13,374.420	36	91	86	Neutral
MVL	Marvel Entertainment, Inc.	2,113.853	41	94	89	Outperform
NTRI	NutriSystem Inc.	2,237.720	21	93	99	Neutral
PWEI	PW Eagle, Inc.	447.389	19	94	99	Outperform
STX	Seagate Technology	13,256.050	41	93	89	Outperform
WABC	WestAmerica Bancorp.	1,539.700	26	91	90	Underperform

Audit Integrity is an independent research and rating service that evaluates the risks associated with the accounting and governance practices of over 9,000 public corporations. Its industry-leading methodology, based on comprehensive data collection and proprietary analytics, produces statistically reliable measurements of the integrity of reported financial results and corporate governance practices.

Audit Integrity's flagship Accounting and Governance Risk (AGR[®]) rating system grades companies on a scale of 1 to 100, from Very Aggressive to Conservative. The company has established a direct correlation between its accounting and governance risk assessments and actual stock price performance, as well as the likelihood of such adverse events as class action litigation, financial restatements and SEC enforcement actions.

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