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THE STUDY:

Three dozen case studies on the effects of stock recommendations of leading international business media were subjected to a meta-analysis. The long-term overview shows a stable pattern during different stages of the market cycle: Stock prices can move, but the usefulness of the investment advice remains questionable. This results

in an astonishingly clear picture of the possibilities and the limitations of investment advice published in the mass media.

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- The Information Content of the News
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Stock Recommendations and Stock Prices. Effects and Benefits of Investment Advice in the Business Media

by Thomas Schuster

With the stock market boom in the nineties, stock market coverage enjoyed a boom as well. The upswing of the financial markets was accompanied by a systematic expansion and a strategic reorientation of the business media.

In view of the importance attached to stock recommendations in the media, the lack of knowledge about this kind of business communication is surprising: Neither its effects nor its benefits have been studied systematically.

THE PUBLICITY-EFFECT. Our results demonstrate: In the print media, on television or the Internet, recommendations given by stock market commentators seem to be an incentive for investors to buy stocks.

Abrupt and significant price and volume increases of the stocks commented on can be the consequence. The experts' tips generate temporary

price pressure through investors who try to buy the advertised stocks.

Such reactions can sometimes be particularly strong for smaller stocks which are not so much in the spotlight. In these cases, the media can contribute to short-term overreactions among investors.

Trend stocks, which have shown a good performance in the past, can also provoke a marked response. Many recommendations relate to "hot" stocks which are already on the move - but which usually "cool down" quickly.

INFORMATION-ASYMMETRIES. The knowledge about future price surges induced by the media provides an excellent opportunity for front running: The insiders can buy before the recommendation is published and liquidate their positions while the general

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Abstract

The business media play an active role in influencing stock prices. Statistically significant excess returns at the time of the publication of stock recommendations have been documented many times. Frequently these abnormal gains begin to accumulate long *before* the publication date. In most cases they reach their highs on the day the recommendations are disseminated to the public.

With few exceptions a price reversal sets in shortly thereafter: Excess returns in recommended stocks are at least partially given up. Many stocks now enter a period of underperformance, earning significant negative returns. The return reversions indicate that such stock price reactions are due to price pressure from "naive" investors hoping to

profit from the experts. However, most media lack any real information that is not yet reflected in stock prices. In short: There is no evidence that stock recommendations published in the media offer any systematic opportunity to outperform the market. The evidence leads to the opposite conclusion: That investors who follow such advice will lose in the long run.

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Stock Recommendations and Stock Prices

public is still on the market. People with access to insider-information hardly have a reason to give up a potential advantage. The incentive to use the information before it is published is high.

Evidence of this is always visible when the prices of certain stocks increase immediately *before* they are recommended to the broad public. The lead provides a systematic information advantage and makes it possible to trade for a potential gain in the recommended securities. In fact, this has been observed repeatedly in practice.

INSIDERS VS. OUTSIDERS. The „classic“ case was already documented in the 1980s: The protagonist of the scandal was R. Foster Winans, author of the column "Heard on the Street" at the *Wall Street Journal*. Winans passed his information on to stock brokers of the investment company Kidder Peabody before they were published and later shared the illegal profits with them.

After the scandal was exposed, Winans and his contact persons were sentenced for fraud. A study of the stocks concerned later came to the conclusion that until the publication date, the insider tips facilitated an excess return of 6.25 per cent. In the more recent past, empirical studies repeatedly find evidence that insiders trade before the public gets into the game.

Sudden price surges before stock recommendations indicate that traders close to those giving the tips make use of their knowledge of the impending publication. After the publication, however, frequently only slight price increases are observed, in spite of the publicity effect. These imply for the outsiders at best

theoretical excess returns - most of which are very small. So how big are the chances for the public to profit from stock recommendations? The numbers don't give much cause for exuberance.

*„The numbers
don't give much cause
for exuberance.“*

INFORMATION, BUT NO NEWS. In many cases, statistical post-hoc analyses do not even indicate theoretical gains. It is hardly possible to earn excess returns with the help of business news in the financial press, such as take-

over rumors.

The market reacts efficiently to the published information: It is correct in less than 50 per cent of all cases. Thus it does not have any predictive value, since it does not cause any systematic effects in stock prices. In fact, it usually does not have any noticeable effect on the stock market at all. In other words: These pieces of information are no news for the market.

Studies on the information content of financial websites arrive at similar insights: Positive comments are followed by more positive comments. They result in a sharp increase in trading volumes. However, positive comments do not result in significant price gains. All things considered, the returns after the event day equal zero. This means that no reliable price forecast can be derived from the public response in

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these finance forums; the opinions expressed there do not provide forecasts that could be systematically used.

Opinions do not make the market, but the market determines opinions. Or to put it differently: For the market, information published on the message boards is not news.

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Surprising price changes in particular are hardly ever anticipated. The markets are ahead of the opinions. The discussants act reactively. In brief: Information published in internet forums does not have any predictive value.

PERFORMANCE-DISTURBANCES. Price reactions following recommendations can be statistically significant. For the private investor, however, it is impossible to benefit from these small and short-term price movements, which on average amount to 0.5 to 1.1 per cent.

Excess returns of this magnitude are easily exhausted by transaction fees, such as order and holding charges, and the bid-ask-spread (the difference between the buying and the selling price).

Already the attempt to benefit from these price surges will lead to a balanced result at best. The recommendations are of use only to those, if to anyone at all, who already own the stocks before the publication. Those who buy after the publication do not have any benefit – they have acquired an underperformer. The stocks commented on often begin to develop worse than the benchmark index from the second day after the recommendation was published onwards.

Study after study proves: Price movements after tips published in the media are followed by price reversals. As soon as public attention decreases, prices move into the opposite direction. Excess returns tend towards zero, or even below. The outperformance turns into its opposite, gains are reversed. And a loss is incurred.

This is always a sign for the fact that prices are not influenced by fundamental factors, but rather by publicity in the media. The price pressure after the recommendations is generated by reactions of uninformed investors.

The information content of the recommendations only plays a marginal role – if any role at all.

REFLEXIVE RETURN-REDUCTION. The increases in returns on the publication day are practically irrelevant, since they are in most cases already reflected in the opening prices. There is therefore no chance to participate in them. What is decisive is the price trend from the day after onwards. But the excess returns of various holding periods, from very short periods to time frames of several years, are close to zero or even lower.

Most tips are not only not better than the market, they even systematically fall behind. After taking

transaction fees into account, the equation turns negative. The quick initial price advance is of no use to the investor because he does not participate in it. However, he does participate in the decline in prices.

Instead of the profit he hoped for, he makes losses relative to the market, sometimes even considerable ones. The quick increase in returns is followed by an immediate price decline – and a continuous deterioration of prices afterwards. For the public, this return carousel is not neutral at all: Investors who follow the recommendations lose in the medium term.

Even a specific search for the economic benefits of the recommendations of finance commentators thus leads to disappointing results. No doubt, stock recommendations can also be correct. Successful streaks necessarily occur by chance.

What is decisive is their probability: It is certainly not a coincidence that out of all studies, those with the longest study periods come to the conclusion that it is impossible to outperform the market with the help of financial advice published in the media.

The longer the study period, that means, the lower the probability that periodic deviations from the norm are recorded, the clearer the result: The returns of the stock recommendations are not due to the know-how of their authors, but to a random distribution.

Whether the period considered is six months or one year, two or three years: The returns either almost equal zero or are clearly negative. There are hardly any positive exceptions. The losses in the available case studies were between -0.71 and -6.8 per cent after six months. After one year, negative returns come to up to -7.23 per cent.

THE (UN-)USEFULNESS OF THE NEWS. The numbers leave no doubt: The majority of stock recommendations in the media make a medium-term underperformance compared to a passive investment strategy highly probable. Those who fall for the tricks of the noise makers are systematically separated from their money.

Finance columnist Jane Bryant Quinn thus correctly remarks: The articles “make it sound like the journalist knows the right stocks or mutual funds to buy. And the fact is we do not.” Consequently, there is no reason to believe that journalists or their informants do have the ability to systematically make a superior stock selection. Under the pressure to comment on

„The quick increase in returns is followed by an immediate price decline.“

„Those who fall for the tricks of the noise makers are systematically separated from their money.“

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**Long-term Performance of Buy Recommendations
- Cumulative Excess Returns -**

Researcher	Publication	Period	6 Months	1 Year	2 Years	3 Years
Desai, Liang und Singh (2000)	<i>Wall Street Journal</i>	1993-96	1,77	4,02	6,04	n.a.
Liang (1999)	<i>Wall Street Journal</i>	1990-94	-3,80	n.a.	n.a.	n.a.
Beltz und Jennings (1997)	<i>PBS</i>	1990-92	-1,03	n.a.	n.a.	n.a.
Sant und Zaman (1996)	<i>Business Week</i>	1976-88	-6,80	n.a.	n.a.	n.a.
Desai und Jain (1995)	<i>Barron's</i>	1968-91	n.a.	0,21 ^{ab}	-0,38 ^{ab}	-0,71 ^{ab}
Mathur und Waheed (1995)	<i>Business Week</i>	1981-89	-5,33	n.a.	n.a.	n.a.
Trahan und Bolster (1995)	<i>Barron's</i>	1988	-2,30 ^a	-6,92 ^a	n.a.	n.a.
Benesh und Clark (1994)	<i>Barron's</i>	1987-88	-4,69	-1,65 ^a	n.a.	n.a.
Wijmenga (1990)	<i>Elseviers Magazine</i>	1978-83	-2,65	n.a.	n.a.	n.a.
	<i>Beleggers Belangen de Financieele Koerier</i>		0,16			
Pari (1987)	<i>PBS</i>	1984-84	-4,18	-7,23	n.a.	n.a.
Dimson und Marsh (1986)	<i>British Financial Press</i>	1975-82	n.a.	-0,4	-1,3	n.a.
	<i>Barron's</i>		2,92 ^a	3,41		-8,00
Shepard (1977)	<i>Forbes</i>	1966-71	1,08 ^a	-1,87	n.a.	-2,65 ^a
	<i>Wall Street Journal</i>		-0,71 ^a	-3,25		-7,86

This table gives an overview of the cumulative excess returns of stock recommendations published in the media (relative to the publication date) after 6 months, 1 year, 2 and 3 years.

^a statistically not significant ^b from the day after the publication date

short-term developments, journalists pretend to possess competence which they actually do not have.

In short: The business media's claim in their advertising that they provide a benefit by offering an advantage to the majority of investors does not stand up to systematic examination. Investors either do not benefit from the financial advice published in the media or are even adversely affected.

The opportunity to outperform the market systematically is only available to those insiders, analysts and journalists as well as people close to them who put the recommendations into action before their

publication. The logic behind this situation is that the potential systematic gain of the insiders is derived from the potential systematic loss of the outsiders.

Therefore, it would not be surprising if, in most cases, the private investor was left with a negative balance in the end. For him, the net effect equals zero at best. Most probably, however, his chances are even worse than fifty-fifty.

For the sake of honesty, financial advice in the business media should bear the following warning: "Attention: Profits obtained by following our stock recommendations are purely accidental." □

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