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Bad news is better than good news

Good news can lead us into poor investment decisions. But bad news isn't so terrible (and there's been a lot of it recently). That's the bizarre conclusion of new research done at University of California, which looked at how investors choose the stocks they buy.

The US researchers wanted to discover whether individuals irrationally buy stocks that have been making headlines. The academics concluded that while investors don't buy every single stock in the news, individuals are indeed seduced by attention-grabbing stocks. If true, this behavior has the potential to influence prices, especially for stocks of small firms. Not only that, it is bad for the buyers themselves.

Traditionally, we view markets as a willing, informed buyer and an equally willing, informed seller. But for individuals, the decisions to buy and to sell are quite different in practice. When choosing a stock to buy, investors are faced with a daunting, even overwhelming, choice. There are hundreds, if not thousands, of stocks from which to choose, both on local and foreign exchanges. How can anyone possibly pick good stocks out of such a wide choice?

The answer is: they can't. So they buy research reports, ask an adviser, or browse the Internet for answers. Whichever approach they take, individuals narrow their choice to a shortlist of 10-30 stocks. More than that number is too many to handle. And according to the study, out of those 30, investors might pick just a handful to buy.

Critically, this final selection is influenced by recent news headlines: a company splashed all over the daily newspapers becomes too alluring for many investors. The researchers concluded that individual investors tend to be net buyers on "high attention" days. For example, retail investors at large US discount brokerages made nearly twice as many "buys" as "sells" of stocks experiencing unusually high trading volume. If markets were efficient this imbalance shouldn't happen, it suggests that retail investors are too optimistic on good news. Unfortunately, these same buyers live to regret their impulsive behaviour – attention-grabbing stocks often under-perform the market.

On the other side of the equation, individuals are not so prone to media persuasion when selling, because they usually hold relatively few counters in their portfolios (assuming they don't practise short-selling). With a naturally narrow focus, investors have more time to consider the merits of selling each stock they own, and are not swayed so much by bad headlines.

Fortunately for believers in mutual funds, the story is different when it comes to institutions. Professional investors devote more time to searching for stocks to buy and sell than do almost all individuals; attention is not as scarce a resource for institutional investors (since they get paid for their attention!). Institutions also use the discipline of an established investment process, usually highly-computerized, to narrow their search. Of course, individuals use computers or pre-selection criteria too, but they typically do so in a less disciplined and rigorous fashion.

Furthermore, professionals limit their search to stocks in a particular sector (for example, technology) or by meeting specific criteria (for example, low price-to-earnings ratios). Thus, buying behavior of professionals is less prejudiced by media hype, and therefore is likely to be more rational, and more profitable. This doesn't mean professionals always make the right selections, but at least they have an in-built advantage over the man in the street.

Small investors face another hazard, especially when doing their own research on the Internet. While it serves as an excellent tool for investors, allowing them to easily research investment opportunities, the

Internet places no quality controls on its information. Or in other words, free information comes with no warranty.

In particular, online bulletin boards and forums are a potential source of bad information. Bulletin boards typically feature “threads” made up of numerous messages on various investment opportunities or issues. On the surface, they are a good place for investors to share information. While some messages may be factually true and objective, some can turn out to be misleading – or even scams. Fraudsters can pump up a company or pretend to reveal "inside" information about upcoming announcements, new products, or lucrative contracts.

Another problem is that you never know for certain who is behind these postings, or whether they're credible, because most forums allow users to hide behind aliases. Posters claiming to be impartial, who've carefully researched a stock or product, may actually be company insiders, product sales people or just plain wrong.

In the worst case, one malicious person can create the illusion of widespread interest in a small, thinly traded stock by posting a series of bogus messages. And where forums are hosted by investment advisers, or well-known companies, users may get the false impression that advice posted there is verified, or at least moderated, by the firm running the forum.

Worryingly, investment forums like these have become increasingly popular in Singapore. Perhaps the best way to think about online forums is as a crowded room full of strangers. Basing your investment decisions on information there is no different from getting stock tips from a conversation you overhear on the MRT, or at a restaurant.

So what can you do with such a glut of investment information, some screaming in the headlines, some quietly dubious, and some excellent? A simplistic answer is to blot out headlines from your mind, and avoid investment forums like the plague when you come to making your investment decisions. But it's easier said than done. Perhaps the best remedy is for investors to recognize that investment information can be good, bad and sometimes thoroughly ugly.