"Giving Content to Investor Sentiment: the Role of Media in the Stock Market"

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Author: Paul Tetlock (McCombs School of Business, the University of Texas–Austin)

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Summary: Are the media just a sideshow to financial markets—or do the dire pronouncements of newshounds have any real effect on share prices? In a new study, an economist finds the tail really does wag the dog.

Paul Tetlock studies bad words. Not the schoolyard four-letter variety but those found in the Harvard psychosocial dictionary, which classifies words by the moods they convey. For example, the dictionary has hundreds of entries for words that communicate weakness and negativity.

He uses these pessimistic words to research how the media can affect the stock market. In a recent study to be published in the Journal of Finance, Tetlock, an associate professor of finance at the McCombs School of Business at the University of Texas – Austin, tests the daily "Abreast of the Market" column in the Wall Street Journal.

"First, the column provides one of the most widely read descriptions of the prior day's stock market activity. Second, the key insights in the column have more to do with investors' sentiments than their investments. This is why I suspected that the words in the column could be a useful indicator of overreaction."

And they were. Tetlock documents that a pessimistic Abreast column with many words that communicate weakness and negativity not only describes what happened in yesterday's trading but also foreshadows the next day's activity. He records an average fall of 0.081 percentage points in the Dow on the next trading day.

"Some of the words that we read in the financial news have greater entertainment value than information value," Tetlock says. "By the time news is printed in the WSJ, it is already known to most sophisticated institutional investors. Some WSJ readers may not realize this point, especially when a news column presents stale information in a compelling and colorful way. Thus, individuals may trade based on news that has already been incorporated in stock prices, leading the market to overreact to past information. Eventually, sophisticated investors restore order in the market, bringing prices back in line with fundamentals."

The lesson in the Wall Street Journal study and in others Tetlock is undertaking relates to the growing field of behavioral finance, which demonstrates how investors often act on imperfectly rational motives.

"Research in behavioral finance can teach ordinary investors which foibles they are most likely to commit and how to avoid them," Tetlock says. "There is a substantial body of work showing that individual investors are overconfident in their trading abilities. Increasing awareness of this common pitfall could help individuals curb their costly day trading. Of course, engaging in this sort of introspection and restraint is tough, even with the support of solid research."

Tetlock is currently broadening his research to assess whether words in news stories about specific firms can predict a firm's performance in the market. "Preliminary results suggest that the words in news stories seem to capture otherwise hard-to-quantify information about a company's future profits," he says. "Judging by the stock market's reactions to these words, investors seem to be aware of the importance of these subtle indicators of future performance. Within a day or two, market prices accurately reflect the impact of words on profits.

"These findings contrast somewhat with my Wall Street Journal study, where I find that media content may predict overreactions in market prices," Tetlock adds. "The key difference lies in the nature of the content: Some stories in the financial press convey real information, whereas other stories are written to entertain their readers."

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