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Influential investors in online stock forums☆

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ABSTRACT

This paper uses data from an online stock forum to examine the behavior of influential investors, posters who are popular among forum members. Unlike prior research, we find that influential investors post messages based on information and target actively traded large firms. Their predictions are more likely to indicate subsequent returns, as compared to other investors. Influential investors exhibit a preference for local investments and, furthermore, their predictions for local firms are more likely to be correct, suggesting a true information advantage. Thus, these investors contribute to the overall functioning of the market by providing insight into targeted companies.

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1. Introduction

The Internet is an important source of information for investors around the world, but particularly so in rapidly growing financial markets such as China. Every day, millions of people spend time online to express ideas and collect information on the topics that matter to them, which for many users include investment tips. Instead of relying strictly on corporate financial reports and management disclosures, investors search for information from alternative sources including the Internet. In this paper, we examine postings on a widely used online stock forum (guba.eastmoney.com), which allows its members to view and post information without limitation.

A stock forum's members are mostly individual investors, and the quality of their opinions varies. In the absence of an editorial process, investors must discriminate the source, truthfulness of a message, and intent of the poster. Researchers have devoted significant effort to discerning whether stock forum messages are informative or noise without content (e.g., Tumarkin and Whitelaw (2001), Das, Martinez-Jerez, and Tufano (2005), Clarkson, Joyce and Tutticci (2006), Sabherwal, Sarkar and Zhang (2008)). While important insights have been provided, conclusions are often conflicting, with some finding that messages have information content and predict market volatility (Antweiler and Frank (2004)), whereas others conclude that no information is exchanged in Internet forums (Dewally (2003)). Yet, still others find that posters can influence trading in the absence of fundamental information (Sabherwal, Sarkar, and Zhang (2011)).

This paper focuses on influential investors, a particular group of message posters in the forum who actively participate in forum discussions and enjoy popularity among message board members. It is difficult to identify influential investors in naturally occurring settings, though some empirical evidence suggests that market influence can be used by unscrupulous traders to generate profits (e.g., Allen, Litov, Mei (2006)). Theoretical research on influential investors has provided insight into the power of influential investors to manipulate markets (e.g., Allen and Gale (1992), Benabou and Laroque (1992), Grorud and Pontier (2005)), but many questions remain unresolved concerning the source of investors' power and their strategies. With our stock forum data, we observe actual forum activity related to a discussed stock and identify key attributes of influential message posters including their location. Importantly, we find that influential posters in the stock forum promote the efficiency of the market by disseminating information, rather than actively seeking to manipulate the market by spreading false information.

We identify influential investors in the online stock forum from 2008 to 2012 and examine their location, attributes of the stocks they target, and whether their up-or-down predictions were accurate. In their recent examination of online message board activity, Sabherwal, Sarkar, and Zhang (2011) conclude that influential investors manipulate the market with a "pump and dump" trading strategy. In theory, an unscrupulous poster could take a long position in a given asset, generate market enthusiasm through false rumors to "pump" up the price, then suddenly "dump" the stock at elevated prices, profiting at the expense of unwary outsiders. In contrast, we find that influential investors are more likely to trade based on their information rather than against it.

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We also explore whether influential investors fall prey to home equity bias, a widely documented behavioral tendency. French and Poterba (1991) document that domestic investors hold primarily domestic securities. Despite the well-known benefits to international diversification, this phenomenon persists across time. People simply do not hold diversified portfolios. Home bias may persist if local investors have a true information advantage. Researchers have documented a significant return to local investing consistent with an information advantage (Coval and Moskowitz (1999, 2001)). We also find that influential investors are more interested in local stocks than other message posters, and they tend to fare better in predicting the performance of local stocks.

In the course of our investigation, we discovered the novel result that these influential investors prefer making predictions for large firms. This finding suggests that influential investors are not targeting small, obscure firms for easy market manipulation, but rather providing insight into large companies. This contrasts with existing research suggesting that small investors focus their interest on small firms (Kumar and Lee (2006), Sabherwal, Sarkar, and Zhang (2011)).

The rest of the paper is organized as follows. In Section 2, we review related literature. In Section 3, we present our hypothesis on the behavior and characteristics of influential investors. We discuss our data sources and sample construction in Section 4. Empirical methodology and results are in Section 5. Summary and concluding remarks are in Section 6.

2. Prior literature

As is recognized in the finance literature, the Internet plays an important role in investment decision-making because it provides a venue for collecting and sharing information. Rubin and Rubin (2010) argue that when the general population is engaged in processing company-related information, investors become better informed. Even professional financial analysts benefit from easy access to information as indicated by lower analyst forecast errors for firms who receive more Internet attention. In addition, managers realize that the Internet is helpful when they seek to disclose information and win trust from investors. Orens, Aerts, and Cormier (2010) find that firms with higher levels of web-based non-financial disclosure benefit from a lower cost of equity capital.

It seems that firms and managers benefit from a richer information environment, and even regulators recognize that the accessibility of the Internet has the potential to enhance market efficiency. For example, in a U.S. Security and Exchange Commission Report to Congress on the impact of technology, the SEC argued that the Internet promotes more informed decisions by allowing investors to receive information faster, promoting communication, and leveling the playing field between large and small investors.[1] Much attention has been paid by researchers and investors to the accuracy and efficiency of information contained in online messages. For example, Tumarkin and Whitelaw (2001) examine the relationship between Internet message board activity and abnormal stock returns and trading volume for the Internet service sector. They conclude that their results support market efficiency because they find no causal link between message board postings and subsequent stock returns and volume. Similarly, Tumarkin (2002) concludes that stock returns are not predictable using message board posts, a result also in support of market efficiency. In contrast, Antweiler and Frank (2004) find that messages on stock forums are not just noise. Instead, the magnitude of message postings predicts trading volume and volatility. In addition, in a recent study of microbloggings (i.e., tweets) Sprenger, Tumasjan, Sandler, and Welpe (2013) report that stock microblogs contain useful information that is not already incorporated in stock prices.

Taken as a whole, the conflicting evidence suggests that investors' opinions expressed through the Internet are followed by a significant number of market participants, whether or not there is information content. Regulators are concerned that some who post opinions intend to manipulate naïve investors, rather than promote efficient dissemination of information. In the U.S. the SEC's concern is exemplified on its web site, which cautions investors that it is easy for fraudsters to spread information on the Internet but very difficult to differentiate fact from fiction. Investors are specifically warned about so-called "pump and dump" schemes.[2] Individuals may spread false information on the Internet to temporarily drive up a stock's price and generate trading profits. A manipulator who builds a position in advance can earn profits at the expense of other investors by pumping up the price with false rumors, and dumping the stock before the market adjusts. Sabherwal, Sarkar, and Zhang (2011) observe that the stock price increases as an influential investor "pumps" the market with posts of online messages and falls as the investor "dumps" the stock later on.

Van Bommel (2003) models an equilibrium in which liquidity traders follow rumors, allowing both rumormongers and their followers to accrue profit at the expense of uninformed traders. In this model, a trader with limited market power can impact market outcomes by spreading rumors. The trading capacity of these influential investors is too small for them to profitably derive benefits through trading even when they have true information. Van Bommel considers three variations of his model. A rumormonger may bluff when he actually has no information, spread false information, or spread honest information. In each case, followers trade on the rumor, whether true or false, moving price and actually causing it to overshoot the informed price. The influential investor reverses his position when he sees the price moving too far. Thus, it is profitable for even honest rumormongers to share information.

In addition to examining their posting behavior, we explore whether influential investors fall prey to home equity bias, first documented by French and Poterba (1991). Investors show a preference for firms that are close to home so that domestic investors hold primarily domestic securities. Despite the well-known benefits to international diversification, this phenomenon persists across time, holds across nations, and extends to localities and cultures with people showing a comfort for the familiar (Grinblatt and Keloharju (2001), Huberman (2001), Coeurdacier and Rey (2012)). Familiarity refers to a feeling of knowing, whether or not there is true information. A potential rational explanation of the tendency to invest close to home is a local informational advantage. Coval and Moskowitz (1999, 2001) report that mutual fund managers tend to invest in firms that are headquartered locally. Interestingly, Coval and Moskowitz document a significant return to local investing consistent with an information advantage. Similarly, Baik, Kang, and Kim (2010) report that institutional investors earn excess returns on proximate firms. Skill at identifying superior local investments is not limited to finance professionals. Ivkoviĉ and Weisbenner (2005) report that households exhibit a strong preference for investments that are close to home with households generating an annualized return premium of 3.2% from local holdings, relative to non-local holdings. Overall, the literature suggests that investors may overweight local investments in their portfolios because local knowledge can be exploited to generate superior returns.

In addition to finding that investors do not fully diversify their portfolios, the literature reports that small investors gravitate toward firms with certain characteristics. In particular, small investors focus their interest on small firms (Kumar and Lee (2006), Sabherwal, Sarkar, and Zhang (2011)). The theoretical model developed by van Bommel (2003) predicts that small investors with limited ability to influence a market target small stocks when they seek to generate trading profits. The target small stock is more likely to have weak financials and small

[1] See the SEC's "Report to the Congress: Impact of Technology on Securities Markets" at http://www.sec.gov/news/studies/techrp97.htm.

[2] See http://www.sec.gov/answers/internet.htm and http://www.sec.gov/investor/pubs/cyberfraud.htm.

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