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Do sophisticated investors interpret earnings conference call tone differently than investors at large? Evidence from short sales

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ABSTRACT

Recent research finds that investors, broadly defined, react to the linguistic tone of quarterly earnings conference calls; there is a positive relation between firms' stock returns and call tone (a measure of "sentiment" related word tabulations). However, this type of soft information can be subtle, context-specific, and difficult to interpret. Moreover, the literature suggests cross-sectional variation in information processing skills among investors. Thus, we test whether sophisticated investors interpret earnings conference call tone differently than investors at large by examining short selling activity and its relation to earnings conference call tone. We find that short sellers target firms with simultaneous high earnings surprise and abnormally high management tone. The combination of positive earnings surprise and unusually positive tone strengthens short sellers' return predictability. This result indicates that short sellers interpret revealed "inflated" call language by managers more completely than naïve investors. The incomplete stock price reaction by naïve investors due to the lack of reliability that they place on this soft information results in overpricing of the stock. However, it also suggests that managers are unable to maintain prolonged overvaluation of their stock by striking an overly optimistic posture in the interactive conference call disclosure forum since short sellers' trades provide additional price discovery.

1. Introduction

"There is no greater impediment to the advancement of knowledge than the ambiguity of words."
[Thomas Reid, Scottish philosopher]

The efficient markets hypothesis suggests that market participants react to newly available firm-specific information. Historically, empirical work in this area has focused on "hard" information such as earnings surprises, equity offerings, repurchases, or insider trades. Signals of this sort are easily quantified. Nonetheless, as technology and regulation have evolved, it has become increasingly common for managers to engage in an ongoing dialogue with the investment community; most notably, managers use quarterly earnings conference calls where additional qualitative, or "soft", information is revealed to the market place (Bethel, 2007; Bowen et al.,

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2002; Bushee et al., 2004; Frankel et al., 1999; Gomes et al., 2007; Kimbrough, 2005; Kimbrough and Louis, 2011; Matsumoto et al., 2011; NIRI, 2004). A unique feature of conference call signals is that they can be more subtle in how they are conveyed and, thus, more difficult to interpret. Indeed, the word choices of call participants may be highly nuanced as managers seek to wave the company flag without overstepping and exposing themselves to potentially negative repercussions.

Consequently, recent research finds that the linguistic tone (a measure of "sentiment" related word tabulations) of the call matters to investors, as there is a positive relation between firms' stock returns and this type of soft information (Larcker and Zakolyukina, 2012; Price et al., 2012; Rogers et al., 2011). However, to date, these relations have only been examined using data which capture the general market reaction, without differentiating by investor ability. To our knowledge, no study has investigated the extent to which soft information is heterogeneously processed among investors with differing prowess, even though theoretical and empirical analyses suggest that this should be the case (Kandel and Pearson, 1995; Malmendier and Shanthikumar, 2007). Such an inquiry is particularly important following the implementation of Regulation Fair Disclosure (Regulation FD) given literature which finds lower average firm-specific information quality, and greater informational complexity, in an environment where disclosures are simultaneously available to all investors (Ahmed and Schneible, 2007; Gomes et al., 2007).[3]

Sophisticated investors may be better skilled at interpreting soft information and value the firms more correctly than unsophisticated traders. If conference call tone is better understood by sophisticated investors, we should observe trades by these investors that assist in the price discovery process. This paper investigates the relation between the tone of earnings conference calls and the trades of short sellers, a group of investors regularly identified as sophisticated (e.g., Asquith and Meulbroek, 1995; Boehmer et al., 2008; Dechow et al., 2001; Desai et al., 2002; Diether et al., 2009b; Drake et al., 2011). Specifically, we examine the extent to which call tone impacts the daily volume of short selling activity while controlling for the hard information in the earnings releases.

Profitable short sellers borrow shares from lenders and trade in anticipation of declines in stock prices; a position that arguably requires more investing skill as short positions are exposed to unlimited losses and high equity borrowing costs. Consequently, the majority of short sales are generally believed to be informed trades (Diamond and Verrecchia, 1987). Supporting this notion, Dechow et al. (2001) and Drake et al. (2011) find that short sellers are proficient at using financial accounting-related fundamental information to identify and target overpriced stocks that experience negative future returns. We posit that short sellers are also proficient at processing qualitative information, and will base their trading decisions on both the hard and the soft information associated with quarterly results and the corresponding conference calls.

Furthermore, we hypothesize that short sellers will interpret abnormally high call tone as a signal of poor future performance and more heavily short such firms. Our logic stems from the Kartik et al. (2007) model of strategic communication which suggests that, in equilibrium, managerial language is inflated and naïve receivers are deceived. Thus, management may either knowingly or unknowingly use overly-positive linguistic tone that mitigates negative news or over-emphasizes good news.

An anecdotal example describing such a scenario with inflated talk can be seen in a *Fortune Magazine* article recounting the first quarter 2008 Lehman Brothers earnings conference call and a corresponding short seller analysis:

> … sitting in a conference room with just a speakerphone and one colleague … [Lehman Brothers CFO Erin Callan] fielded two dozen questions and assuaged suspicions that Lehman's assets were worth billions less than the firm claimed. Callan succeeded, and Lehman's stock price jumped 15% in an hour, lifting the firm's market value by more than $4 billion. … [Immediately following the call, Lehman CEO Dick Fuld] said, 'The only complaint I have is that [Callan] shouldn't have hung up on the call. Because as long as [she was] on there, the stock kept coming up.'Patricia Sellers, Editor at Large, Fortune Magazine[4]I'd like to review Lehman Brothers' last quarter. Presently, Greenlight is short Lehman …. Lehman announced a $489 million profit in the quarter. On the conference call that day, Lehman CFO Erin Callan used the word 'great' 14 times, 'challenging' 6 times; 'strong' 24 times, and 'tough' once. She used the word 'incredibly' 8 times. I would use "incredible" in a different way to describe the report.David Einhorn, Short Seller, Greenlight Capital[5]

Kartik et al. (2007) show that inflated talk (and therefore, unusually high call tone) should be considered "bad news." Unlike situations where management is unchallenged, such as with paper filings and press releases, the question and answer portion of earnings calls allows for a more appropriate level of tone since analysts and other stakeholders can dispute or corroborate statements made in the introduction portion of the call. We identify the change in tone from the introduction to the questions and answer session as the revealed inflated talk, or the abnormal tone. Conference calls are unique in that they provide a setting for the amount of inflated talk to become public knowledge. Therefore, if short sellers are indeed sophisticated and possess superior information processing skill, then their trades corresponding to calls with inflated talk will provide incremental information about the true prices of the stocks.

Using a sample of roughly 1300 conference calls from 2005 to 2006, we find short seller target earnings conference calls with high abnormal linguistic tone. This result establishes the abnormal tone of conference calls as a channel of information that short sellers consider. Moreover, in further analysis we show that abnormal tone affects short selling only when there is a positive earnings surprise. Yet, Price et al. (2012) find positive two-day cumulative abnormal returns (CARs) for firms with positive earnings surprises

[3] See Bethel (2007) for an overview of historical changes in disclosure regulation including the adoption of Regulation FD in 2000.

[4] http://money.cnn.com/2010/03/08/news/companies/erin_callan_lehman.fortune/index.htm. This example is also referenced by Larcker and Tayan (2010) and Tan et al. (2014).

[5] From Mr. Einhorn's May 21, 2008 address at the Ira W. Sohn Investment Research Conference while commenting on his short position in Lehman Brothers. http://www.foolingsomepeople.com/main/TCF%202008%20Speech.pdf.