MarketPsych Newsletter

MarketPsych Report: Leadership Psychology and Investing - Buy the Accused, Sell the Acclaimed

December 07, 2014

Mutiny

They grumbled and complained of the long voyage, and I reproached them for their lack of spirit, telling them that, for better or worse, they had to complete the enterprise on which the Catholic Sovereigns had sent them. I cheered them on as best I could, telling them of all the honors and rewards they were about to receive. I also told the men that it was useless to complain, for I had started out to find the Indies and would continue until I had accomplished that mission, with the help of Our Lord.
~ Christopher Columbus, Wednesday, 10 October 1492

Christopher Columbus had set out 68 days earlier confident that he could reach Cathay (China), but a series of bad omens had spooked the crew, and by October 10th they were mutinous.

After setting out from Spain, they arrived in the Canary Islands to pick up supplies. There they received word that the Portuguese King had ordered the crew captured and imprisoned. Then after embarking from the Canaries, the rudder of the Pinta broke and they had to return to the islands for repairs. While on Tenerife, the island's volcano began to violently erupt - a new and frightening experience for the Spanish sailors.

They took to the seas again, and as the shores of the last of the Canary Islands faded out of sight, many sailors burst into tears, saying that "they were sailing off—off—off—upon the awful Sea of Darkness and would never see land any more" (Brooks, 1892).

The ships slowed in the Sargasso Sea - where there are few winds or currents - and drifted lazily through beds of seaweed and still waters for a week. The sailors became concerned that they would die, drift-less. Mirages of land raised hope and then dashed the crews' spirits.

Columbus soon realized that his calculations were incorrect - they had not found land where he thought they would. If Columbus returned to Spain without having reached land, he would face disgrace, imprisonment, or even death. **He began to doctor the distances traveled in his logs, keeping one log of the true distance and one for his crewmen which** showed less distance traveled. The sailors noticed that the magnetic compass no longer oriented itself properly to the North Star. To quiet their fears, Columbus lied and told the crew that the North Star had changed its position.

On October 10, 1492 the anxiety of the crew turned into mutinous fervor. To assuage his sailors' fears, Columbus took a gamble. He promised that if they did not sight land within three days, the ships would turn back to Spain.

The Emotional Value of Human Sacrifice

Scapegoat - Process in which the mechanisms of projection or displacement are utilized in focusing feelings of aggression, hostility, frustration, etc., upon another individual or group; the amount of blame being unwarranted.

Blaming a scapegoat is a common social process in times of unexpected distress. In many societies and cultures, the physical chanelling of this process was **human or animal sacrifice**. These sacrifices established a sense of control over uncertain circumstances (weather, crop yields, war, and other events). In honor of the value of the scapegoating process to stabilizing the society, the chosen victim was often first elevated as a near-god and - in the Aztec society - given a year of luxurious living before being destroyed.

Modern references to workplace scapegoats acknowledge the social-emotional benefits of scapegoating. See this Dilbert comic strip for a humorous example. Other examples include this poster.

Of course most societies do not organize ritualistic sacrifices as part of their calendar of psychological stabilization activities, rather they experience episodic paroxysms of social violence. Witch hunts, pogroms, or ethnic cleansing are often driven by the politically powerful, to maintain their power, and evidence of their economic link is seen in the following correlation of cotton prices with anti-black violence (lynchings) in the U.S. South:

Studies of anti-black violence in the southern US between 1882 and 1930 show a correlation between poor economic conditions and outbreaks of violence (e.g., lynchings) against blacks. The correlation between the price of cotton (the principal product of the area at that time) and the number of lynchings of black men by whites ranged from -0.63 to -0.72, suggesting that a poor economy induced white people to take out their frustrations by attacking an outgroup. (Hovland, 1940).

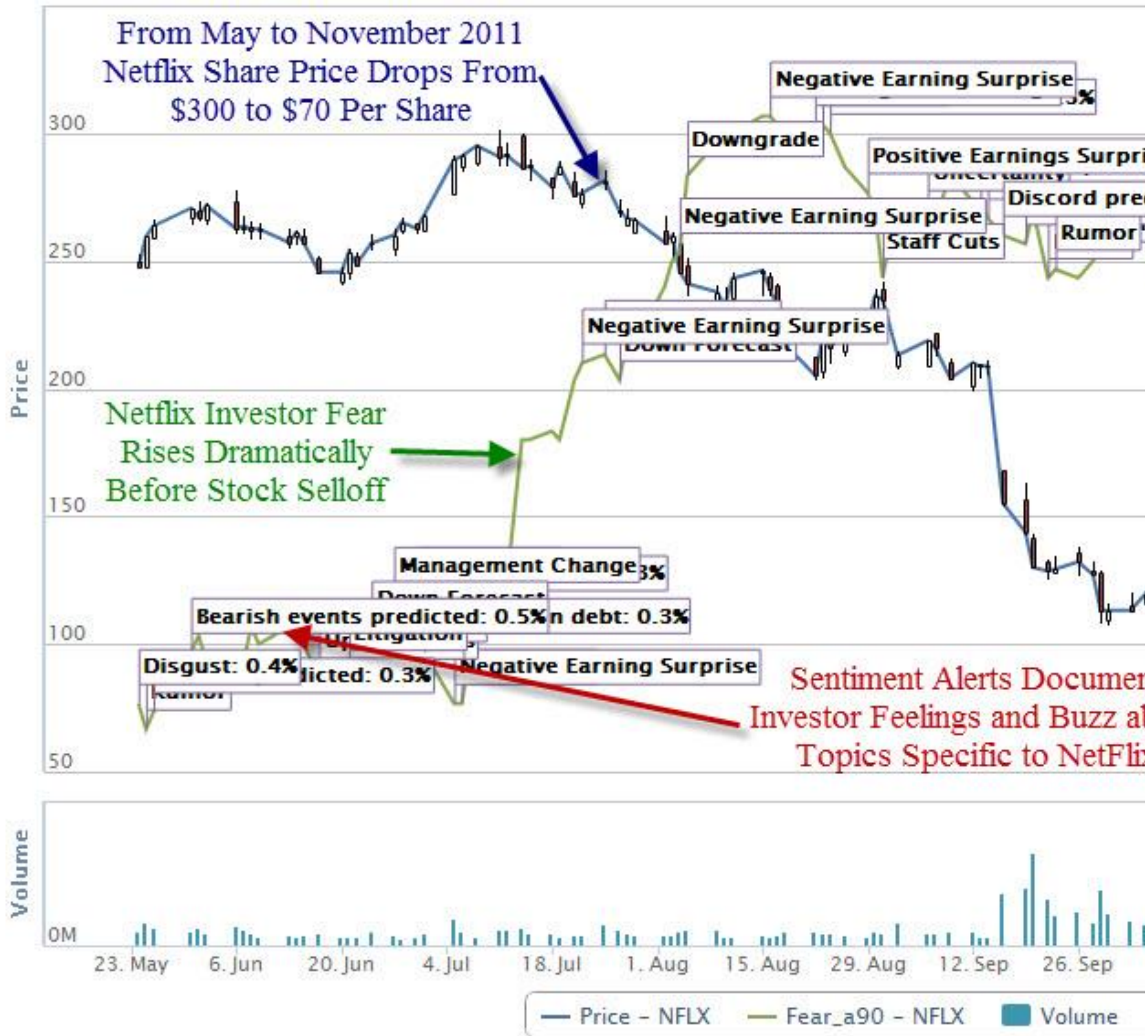
In the business world a peanut gallery of analysts and investors is watching for strategic blunders by management teams. **But the world is not so predictable. As a result, scapegoating of management teams is common and often inappropriately intense.**

Management Dysfunction

It's too easy to criticize a man when he's out of favour, and to make him shoulder the blame for everybody else's mistakes.
~ Leo Tolstoy, War and Peace

Reid Hastings' leadership was roundly criticized at Netflix (NFLX) after the DVD/streaming model was changed in 2011. The stock price plummeted from \$300 to \$70 per share over 6 months. Later Hastings' reputation (and stock price) recovered to new highs as his plan was vindicated.

Investor fear and anger drive accusations and innuendos about poor management quality. A chart depicting NFLX stock price, investor Fear, and frequently made comments about Netflix during 2011 is below: comments about Management Change, Misdeeds, and Litigation all occur with notable frequency.



Steve Jobs was famously ousted from Apple in 1985 under withering criticism of his leadership.   And as we know, he was invited back to run the company he had founded in 1997, where he led the creation of the world's most valuable company.

Fortunately, we now have evidence for how leadership scapegoating affects asset prices.

Buy Mistrusted Leadership

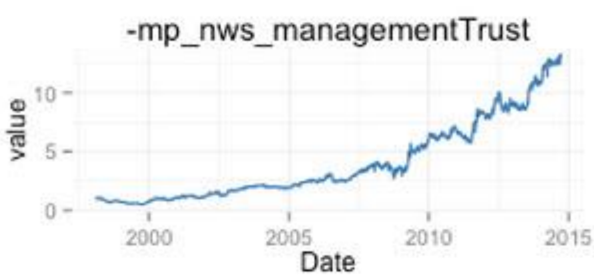
In our last newsletter we commented on another famous cases of scapegoating corporate management at Groupon and we demonstrated how a form of scapegoating against governments (Government Instability) creates excellent international buying opportunities. We saw such an opportunity in **Pakistan's massive past 3-year stock index gain. We may be seeing such an event in the "SuperBull" 21% stock market return in China over the past 2 weeks.** China had a high Government Instability score in September's newsletter due to the Hong Kong protests. And closest to home for many readers, despite intense criticism and disdain for American political leaders, the U.S. stock markets are rising robustly.

In studying our individual company data, we've found that one of our new indexes – **Management Trust** - has strong correlations with future stock returns. Management Trust is calculated by quantifying all of the references to a company's corporate management team (Board, CEO, etc...). Trust associations (reliable, trustworthy, etc...) versus mistrustful associations (scoundrels, criminals, etc...) were converted into a time series index for thousands of global stocks. Our software uses a sophisticated text analytics process to ferret out and quantify these verbal associations. The end result is the Thomson Reuters MarketPsych Indices (TRMI). The TRMI are quantitative indexes of business news and social media content from 1998 to the present.

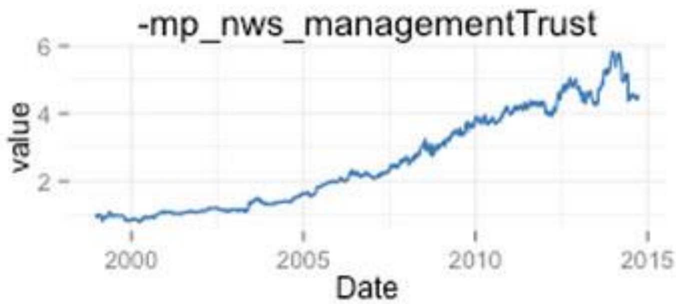
In order to study these indexes, our brilliant Head of Research CJ Liu creates simple rotational models. His software identifies the top 10 US companies with the highest Buzz in the news over the past 1 month. It then ranks those 10 companies by their average Management

Trust value for the past month. **To establish a broad effect, it simulates a portfolio that shorts the top 40% most-trusted-leadership-companies, and it goes long (buys) the bottom 40% least-trusted-leadership-companies. It then calculates the returns of this 4 long versus 4 short portfolio daily, and it re-ranks and re-enters positions monthly from 1998 to this summer. This model is performing emotional arbitrage.**

In the US investors should buy stocks with low Management Trust - the equity curve of a simple monthly rotation strategy with 10x returns is below. When a company's management team is in the news incompetent behavior, we should be buying that stock, and when they are praised for excellent work, we should be selling.



When expanding the sample to 20 stocks and looking back at the past year's ManagementTrust and holding each position for 12-months, the returns drop somewhat (4-fold), but are still interesting.



ManagementTrust fluctuates closer to a monthly than to a yearly frequency. As Warren Buffett famously said, "It takes 20 years to build a reputation and five minutes to ruin it." Ironically, what most risks ruining a reputation - for people who have a modicum of self-control - is not 5-minutes of indiscreet tweeting, **but rather resting on one's laurels.**

Superstar CEOs

The equity curves above are created by the excess returns of buying companies with mistrusted leadership and shorting companies with highly regarded leadership**. This finding aligns with breakthrough research performed by Ulrike Malmendier of Stanford and Geoffrey Tate of UCLA, using data collected by Stefano DellaVigna.**

In their 2009 paper "Superstar CEOs," the authors selected a sample of 283 companies whose CEOs had won prestigious nationwide awards from the business press. From 6 days following the award to three years later, they found that the stock of award winners underperformed those of predicted award winners (similar cohort in terms of business regard). In fact, the award-winners underperformed the predicted award winners by 20% over 3 years.

Difference in average cumulative abnormal returns between award winners and predicte
calculated using a market model with the CRSP value-weighted index as market retur
ending 23 trading days prior to the award date [-778,-23]. Windows are expressed in tr

	Event Window: [+6,+255]	Event Window: [+6,+510]
CAR Difference	-0.04	-0.14
	(1.24)	(2.04)**
Observations	283	283

The business press has coined the term "CEO disease" to refer to the tendency of CEOs to underperform after achieving the top position in their organization. Hubris is one of the most dangerous emotional states that CEOs (and investors) can experience, as it often precedes the greatest losses.

What To Do When You Are the Scapegoat

Our advice to leaders who find themselves unfairly scapegoated? Delineate clearly and concisely where the company's stress originates - express a clear understanding of the dangerous situation. Explain what must be further investigated and how exactly that will occur and on what timeline (then meet the timeline). Outline a clear plan for tackling the fundamental causes of the stress. Solicit feedback that addresses the problem, but do not tolerate feedback that is personal or unconstructive.

A while back we consulted with a Fortune 500 company to help the CEO improve his communication to investors. The CEO had an unfortunate habit of saying the wrong thing at the wrong time, especially during earnings conference calls, and the investing public was doubting his leadership. Using the Thomson Reuters Street Events database of earnings conference call transcripts, we quantified his comments over 30 past quarterly conference calls. We identified exactly what content was impacting the stock price in the three months after each call.

Naturally, negative accounting news and uncertainties expressed by the CEO led to stock price declines. But as a subset of those negative calls, we found that if he announced a definitive plan to restore earnings, the stock was not negatively impacted in the long term. If he announced no plan or waffled, the stock fell and continued to fall. If he discussed new innovations at the company, the stock rose, if he did not, the stock underperformed. If he praised his team, the stock outperformed, if he did not, it declined. Expressing appreciation for his team members was one of the most powerful independent factors driving the stock price in the 3 months after a call.

Housekeeping

The search for a scapegoat is the easiest of all hunting expeditions.
~ Dwight D. Eisenhower

On his third and fourth voyages to the New World, Columbus was evicted from the colony he founded on Santo Domingo by mutineers who despised him. He was later banned from landing at Santo Domingo to obtain badly needed supplies, and he was forced to weather a hurricane in a different harbor. He died with the Spanish crown having violated its commercial agreement with him (although it was later restored by his son).

Management of others is one of the most complex processes in business. As investors, it is crucial that we observe and use the cycles of blame and adoration of CEOs and management teams to our advantage.

Please contact us if you'd like to see into the mind of the market using our Thomson Reuters MarketPsych Indices to monitor market psychology and macroeconomic trends for 30 currencies, 50 commodities, 130 countries, 50 equity sectors and indexes, and 8,000 global equities extracted in real-time from millions of social and news media articles daily.

Please contact Derek Sweeney to book us for a talk or training at one of your events: Derek@thesweeneyagency.com, +1-866-727-7555.

We love to chat with our readers about their experience with psychology in the markets and with behavioral investing! Please send us feedback on what you'd like to hear more about in this area.

Remember: Mistrust Acclaim, and Don't Dismiss the Apparent Scoundrels
Richard L. Peterson, M.D. and the MarketPsych Team

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MarketPsych Report: Greek Tragedy, the Predictive Power of Scandal, and Rewriting an Investing Truth

June 14, 2015

Recent Press

June 02, 2015 - [Der Psychiater der Wall Street -- Tim Schäfer](#) Wirtschafts Blatt

June 01, 2015 - Thomson Reuters expands MarketPsych analysis service -- Automated Trader

[Animal Spirits] refers also to the sense of trust we have in each other, our sense of fairness in economic dealings, and our sense of the extent of corruption and bad faith. **When animal spirits are on ebb, consumers do not want to spend and businesses do not want to make capital expenditures or hire people.**
~ Robert Shiller, 2013 Nobel Laureate in Economics

Greek Tragedy

The question for the markets this month - will Greece default? In the media we hear a morally righteous tale that Greeks should shape up and pay back what they owe. We don't often hear the rationalizations of the Greek side - that other European banks were foolish to lend to a country with such a long history of default and unsustainable deficits.

Ultimately, the Greek situation is beyond repair. It has boiled down to a crisis of trust, and for that reason, it presents tremendous opportunity. With the mandate from Greek voters to spurn the austerity program, and the reticence of creditors to bend due to moral hazard, the only sensible way forward is default. Greece simply cannot pay what it owes. If default happens this month, would all be lost in "Europe's Lehman moment?" Would that shattered trust lead to plummeting stock markets and interest rates and a massive global flight to safety?

In an earlier newsletter we examined how mistrust in leadership is a contrarian predictor of stock prices. In today's newsletter we discuss shattered trust generally. Trust is more resilient than might be expected. And for investors, shattered trust presents tremendous opportunities.

A Culture of Scandal

William Andrews Clark was caught in a bribery scandal during a campaign for the U.S. Senate - he was said to describe the Montana legislators this way: 'I never bought a man who wasn't for sale.'
~ Bill Dedman

The United States has its fair share of ethical scandals. Alongside those is often moral self-righteousness and outrage in the media. Last week we had another high-level scandal - Dennis Hastert was the Speaker of the House of Representative (America's lower body of Congress) and thus third in line for the Presidency during the years 1999-2006.   Meantime he was allegedly paying "hush" money in cash to a boy he sexually abused decades prior.

Bill Clinton's Lewinsky cover-up involved lying under oath. Elliott Spitzer was attorney general and then governor of New York. Some thought he would become the U.S. President, but after a prostitution scandal and his resignation in 2008 (he charged his credit card for sexual liasons), public faith in him was shattered. Yet both he and Clinton returned to public life (Clinton much more successfully). Spitzer hosted a CNN television show and lectured on law at City College of New York. Clinton's wife is the lead contender for the Presidency.

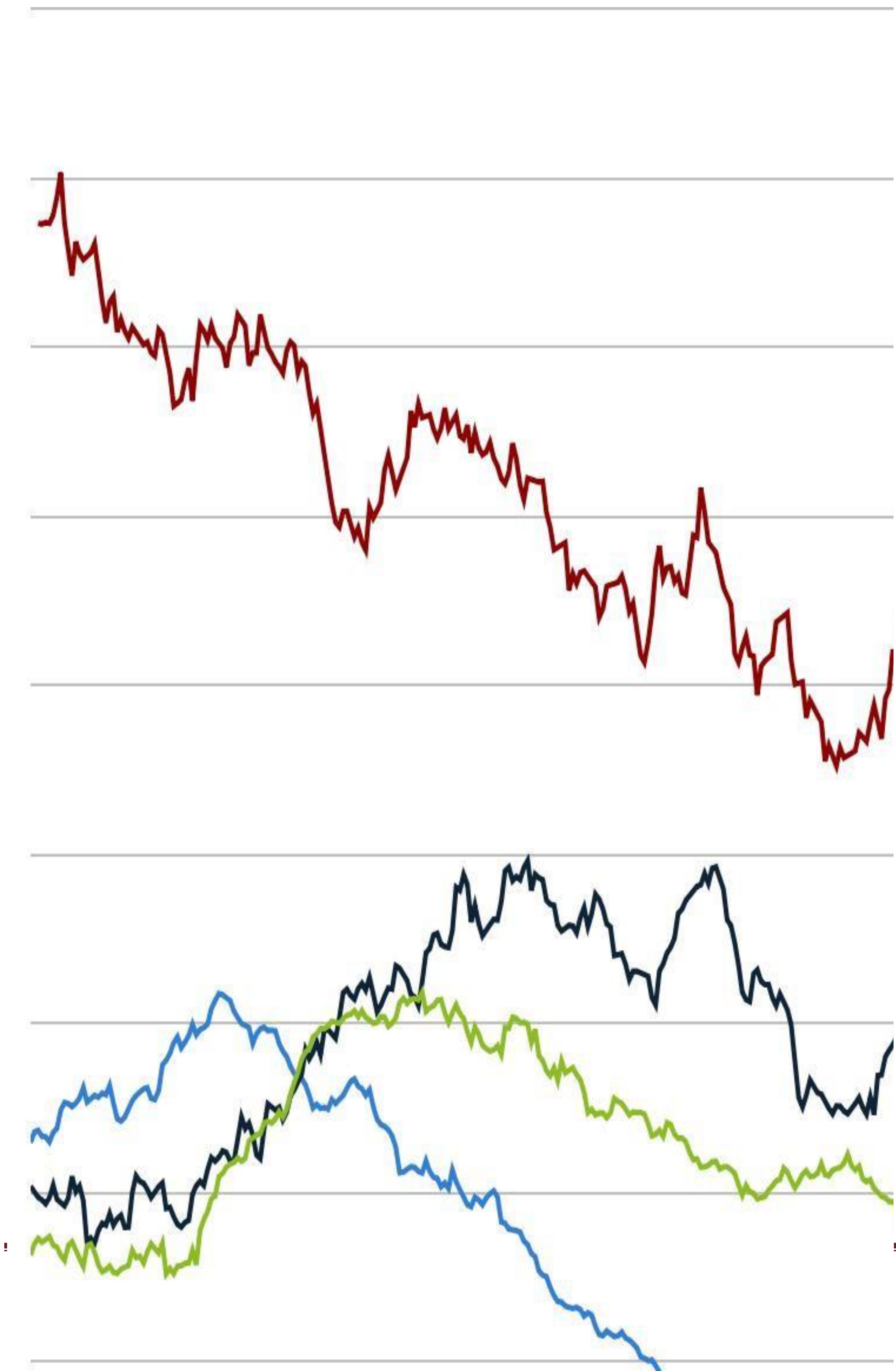
Bill Clinton, Hastert, and Spitzer did what they did. Clinton and Spitzer recovered public trust to some extent - much more so for Clinton, as he is much more personable (Hastert probably will too). When we see a moral violation like those that they committed, moral righteousness often blinds us to the fact that time will pass, and they probably recover to a substantial degree.   **Moral righteousness may feel good, but as investors it doesn't serve us to waste mental energy on it**. However some scandals present opportunity.

Corruption, Brazil, and Petrobras

Sometimes negative news does come out, but it is often exaggerated and manipulated to spread scandal. ~ Pope Francis

Corruption scandals bring to light a darker side of human nature, and it should be no surprise that they instill a particularly damaging and persistent brand of negative sentiment among investors - mistrust. When our Trust index is low, it represents such mistrust, often fueled by scandals and criminal behavior by companies or their management.

Sometimes sentiment can be used as a stock screening tool, and in exploring our data with sentiment screens, we often stumble upon evolving stories.   In the spring of 2015 we screened for the largest Latin American stocks by sentiment to better understand recent events in Brazil. Dilma Rouseff, Brazil’s President, was struggling at the polls due to a series of crises, and we were curious to compare her travails to those of individual companies. We compared four of the top companies in Brazil (and one from Mexico) from June 2014 through May 2015. Below is the chart of their 90-day average media sentiment - Petrobras (blue line), Vale (green line), America Movil (black line), and Brazilian Distribution Company (red line).

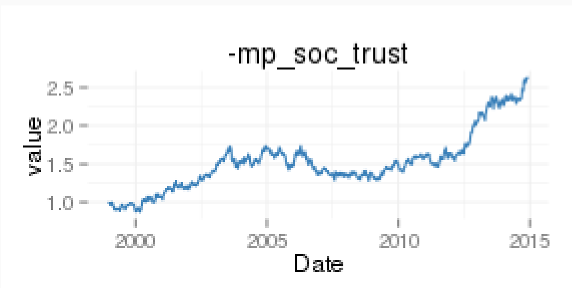


The Trust Factor

"A critical aspect of animal spirits is trust, an emotional state that dismisses doubts about others." ~ Robert Shiller

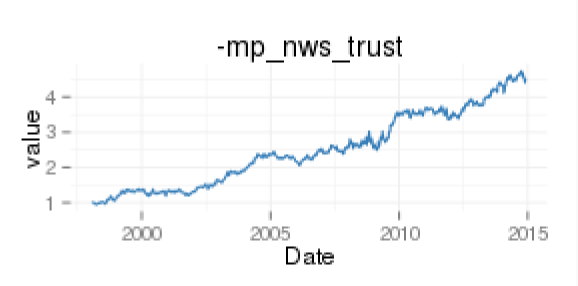
As Dr. Shiller suggests, trust is a key "animal spirit," and its effect on investor behavior is profound - **and surprisingly contrarian over the year following a trust-damaging event.** In this section we review the results of "trust arbitrage" across U.S. stocks and global stock markets to establish where trust is like to lead higher long-term returns.

MarketPsych's CJ Liu set up a cross-sectional study of the Trust TRMI for individual United States equities. His model first selected the 100 U.S. stocks with the most mentions in the news over the past one month. His model then ranked those stocks by their news Trust TRMI value. At the stock market open on the first day of the month, the model shorted the 20% of stocks with the highest trust (most trusted), and it bought the bottom quintile (lowest trust) stocks. Every month-end the model repeated the ranking and positions were exited and re-established based on the new ranking. The equity curve generated by this model was calculated, as seen below. Zero transaction costs were assumed in the model.

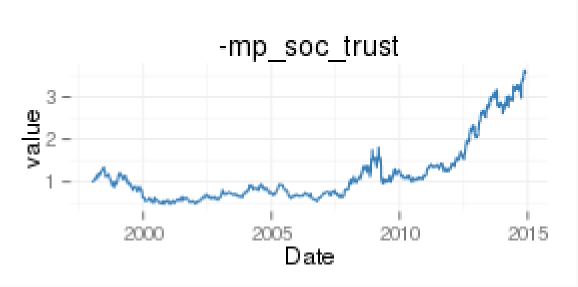


The equity curve above shows that it is advantageous to buy low trust stocks and short high trust stocks on a monthly rotation. This "trust arbitrage" is simple and does not account for timing considerations. Rather, it shows that trust is a useful predictor of prices regardless of what stage of scandal is underway.

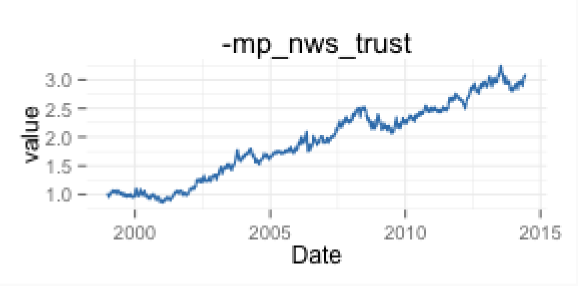
Furthermore, the impact of Trust is not only yearly, but also monthly and weekly among stocks. **Figure XX shows a monthly equity curve derived from arbitraging Trust in the news about the top 100 U.S. stocks by Buzz - going long the quintile (20) least trusted and shorting the quintile (20) most trusted.**



Scandals are likely less common on a rotating weekly basis, and the overall returns are less significant, as seen in Figure XX:



For both news and social media, this effect became significant only after 2012 on a weekly basis. So trust is influential on various time horizons across U.S. stocks, but is it also predictive across global stock markets? Yes, it appears that way in Figure XX, whose equity curve was derived using a yearly model that first obtains the top 20 “trade-able” countries in the news over the past year, and then arbitrages trust by shorting the top quintile (4) trust-ranked countries versus going long the bottom quintile (4) using each country’s major stock index.



Stock markets in the most trusted countries underperform those in the least trusted countries over time. It is easy to invest in a country whose government and business conditions are trustworthy, but it leads to a lower risk premium and lower overall returns.

Housekeeping and Closing

The stupid neither forgive nor forget; the naive forgive and forget; the wise forgive but do not.

~ Thomas Szasz

In these cases we see a specific corollary to Warren Buffett's assertion, "We buy when others are fearful, and we sell when others are greedy." We could rewrite that as, ***"We buy when others have lost faith, and we sell when trust is complete."*** As investors, we should learn from scandal - therein lie opportunities.

Greece will eventually default, byt necessity. This month is as good as any other for the event. The damage is likely to be significant to Greece, but short-lived. Greece will recover stronger from the event. The global ripples will likely be minor, as players have had time to prepare and have back-up plans.

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We love to chat with our readers about their experience with psychology in the markets. Please send us feedback on what you'd like to hear more about in this area.

Forgiveness is one key to happiness, both as an investor and in life.
Richard L. Peterson, M.D. and the MarketPsych Team

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