
RESEARCH ELSEWHERE

Robert A. Olsen

Contrarian Investing in a Small Capitalization Market: Evidence From New Zealand

by Jim Y. F. Chin, Andrew K. Prevost and Aron A. Gottesman

The Financial Review, Vol. 37, 2002, pp. 421–446.

Evidence from large capitalization markets, such as the United States, suggests that value strategies tend to yield superior returns over longer time horizons. Some have suggested that these higher returns are caused by higher risk, although more recent evidence suggests otherwise. This study examines the hypothesis that in less competitive markets, where noise trading is more persistent, higher returns to buying undervalued stocks will take longer to materialize. Using data for approximately 650 New Zealand stocks for the period 1988 to 1998, the authors construct portfolios based on book to market, cash flow to price, earnings to price, and sales growth rate. They find that value stocks underperform glamour stocks for the first year following portfolio formation but significantly outperform glamour stocks in the second year following portfolio formation. This result holds true for most formation strategies, i.e. book to market, etc. The two year New Zealand market correction period is longer than that in larger, more competitive capital markets. The authors attribute this to expectations errors on the part of the more dominant New Zealand noise traders.

Are All Security Analysts Equal?

by Carl R. Chen, Kam C. Chan and Thomas L. Steiner

Journal of Financial Research, Vol. 25, No. 3, 2002, pp. 415–430.

Robert A. Olsen is Professor Emeritus from California State University, Chico and a Research Fellow with Decision Research in Eugene, Oregon. He holds graduate degrees in Finance from the University of Oregon and the University of Massachusetts. Professor Olsen has business experience as a Financial Analyst and consulting experience with small business start-ups. Professor Olsen's research interests are focused on Risk Perception and Behavioral Finance.

This paper examines the relative influence of coverage by different groups of security analysts on the value of firms' common stock. Based on a cross sectional sample of 808 firms and approximately 9400 analysts, the authors find that, in general, national brokerage analyst following has the greatest influence on stock value. This is followed by regional analyst following and non brokerage analyst following. Conversely, they report that Buy recommendations have the greatest stock price impact when made by non affiliated analysts. The authors attribute this later result to the reduced credibility of brokerage analysts, due to potential investment banking conflicts of interest. The greater overall influence of national and regional analysts appears to be due to their larger communication networks rather than the value of their advice.

When Is Bad News Really Bad News?

by Jennifer Conrad, Bradford Cornell and Wayne R. Landsman

Journal of Finance, Vol. 57, No. 6, December 2002, pp. 2507–2532.

This research examines whether the strength of firm-specific responses to new information is affected by the aggregate level of the market. In particular, the authors examine the effect of 24,097 earnings announcements over the period 1988–1998. Measuring the level of the market using relative P/E ratios (the difference between the current P/E ratio and its average value over the preceding 12 months), the authors find that stock prices respond most strongly to negative earnings surprises in good times (high relative P/E). The response strength of positive earnings surprises is generally less than that of negative earnings surprises. Also, the strength of the positive surprise effect decreases as the relative level of the market increases. Large and medium firm stocks tend to be more sensitive to market level effects than are small firm stocks. The authors do not empirically isolate a specific reason(s) for these market level effects, but they discuss a number of potential causes.

Who Blinks in Volatile Markets, Individuals or Institutions?

by Patrick Dennis and Deon Strickland

Journal of Finance, Vol. 57, No. 5, October 2002, pp. 1923–1949.

The results of this extensive research study supports the proposition that mutual funds, pension funds, and endowment funds tend to herd together and trade with the momentum of the market on days with large market price moves (greater than 2%). Thus in the short run, the portfolio management practices of these institutions tend to aggravate the situation during periods of substantial price instability. In addition, the appearance of subsequent positive abnormal stock returns after the event day suggests that these institutions drive stock prices below their fundamental values on days when the market declines by more than 2%. The authors conclude that because the performance of these institutions tends to be evaluated over a short time horizon, and relative to that of their peers, the institutions react more strongly than individuals to large market moves and have a greater propensity to “run with the herd.” In contrast, bank portfolio managers do not exhibit this herding tendency. The study covers the period 1988 thru 1996 and includes all domestic institutions with equity portfolios exceeding 100 million dollars.

Aspiration-Level Adaptation in an American Financial Services Organization: A Field Study

by Stephen J. Mezias, Ya-Ru Chen and Patrice Murphy

Management Science, Vol. 48, No. 10, October 2002, pp. 1285–1300.

Aspiration level has been shown to be a significant factor in financial decisions. For example, performance relative to an aspiration level has been shown to affect the level of risk that an investor will accept. Nevertheless, in spite of its importance, few studies have sought to empirically investigate the determinants of financial aspiration levels for either individuals or institutions. This empirical study is important because it focuses on the managerial aspiration level setting process in a large financial services company. The study reveals that the aspiration level is a function of three factors. First, the previous aspiration level serves as an anchor point or base upon which the setting process commences. Second, previous relative performance comes into play. In particular, if past performance was below par, the level is reduced. If above par, it is raised. Third, social (external) comparison influences the new aspiration level. In par-

ticular, the new level is set to minimize the difference between the set level and the performance of the external reference. The aspiration level tends to be reduced when past performance has been superior to the external reference, and raised when past performance has been inferior to the reference.

Rational Actors or Rational Fools: Implications of the Affect Heuristic for Behavioral Economics

by Paul Slovic, Melissa Finucane, Ellen Peters and Donald MacGregor

Journal of Socio-Economics, Vol. 31, 2002, pp. 329–342.

This article presents a concise summary of the potential influence of affect on the decision process. By affect the authors mean “goodness or badness experienced as a feeling state that inclines one toward or against something or someone”. The authors discuss psychological and neurological evidence suggesting that humans can be seen as embodying two separate decision systems that work simultaneously and interact with one another. The Experiential system is affectively focused and works more rapidly. The Analytic system is formally logical and works much slower. Using examples, the authors demonstrate the strengths and weaknesses of the experiential system and develop the position that it plays a necessary role in making sound economic decisions.

Judgments Under Uncertainty: Representativeness or Potential Surprise

by John E. Fisk

British Journal of Psychology, Vol. 93, 2002, pp. 431–449.

In 1969, Cambridge Economist G.L.S. Shackle presented a model of subjective probability that was based upon the potential for surprise. In particular, Shackle proposed that individuals assigned internal subjective probabilities to events based on their feeling that an event might turn out other than expected. For example, events with zero surprise potential would be seen as very likely. As an event increases in surprise potential it is perceived to be progressively more unlikely to occur. In this paper Fisk presents additional evidence to support Shackle’s model of subjective probability. First, he reports experiments demonstrating that subjective probability estimates are significantly correlated with judgments of potential surprise. Second, he provides experimental evidence that the conjunction fallacy, first

reported by Kahneman and Tversky in the "Linda" story, is more consistent with probability being derived from estimates of surprise than with probability being derived via representativeness heuristic. In particular he notes that, consistent with Shackle's model, conjunctive probabilities are more strongly associated with the surprise potential of the least likely event than they are with the representativeness of the most likely event (as the representativeness heuristic would suggest). Experiments aside, this article is valuable for the prospective it brings to the issue of how people may assign probabilities in complex and ambiguous situations.

The Price Dynamics of Common Trading Strategies

by J. Doyne Farmer and Shareen Josi

Journal of Economic Behavior and Organization, Vol. 49, 2002, pp. 149-171.

These researchers make use of simulation to model market price behavior resulting from the simultaneous action of value investors, momentum traders and market makers. Momentum traders or trend followers act as signal filters, amplifying noise and inducing short term positive correlation in prices. Value investors act as signal transducers, inducing negative short term autocorrelation in prices. The combination of these three trading behaviors creates measurable non linear structure in prices. However, past price behavior is virtually worthless for forecasting, without detailed knowledge of the underlying dynamics of each trading behavior. The authors also note that relatively simple models of the type investigated here tend to create periods of large fluctuations in trading volume and prices, as well as volatility bursts, which are reminiscent of real security markets. This paper offers readers a glimpse of the great potential value of Agent Based Simulation as a tool for investigating security market behavior.

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