
RESEARCH ELSEWHERE

Robert A. Olsen

How Do Earnings Numbers Relate to Stock Returns? A Review of Classic Accounting Research With Updated Evidence

By D. Craig Nichols and James Wahlen

Accounting Horizons, Vol. 18, No. 4, 2004, pp. 263-286.

The literature dealing with the relationship of earnings numbers to stock prices has now become so large that it deserves its own internet search engine! However, in this concise and well focused literature review the authors update and extend three classic studies detailing the historical relationship of stock prices and earnings. First, they summarize new research relating earnings changes to stock returns. Second, they investigate the impact of earnings persistence on stock returns. Third, they update evidence as to the efficiency with which quarterly earnings changes are impounded into share prices. The authors begin with a brief conceptual model describing the theoretical links between earnings and stock prices and then utilize new stock market data from 1988 to 2002 to update classic studies by Ball and Brown, Kormendi and Lipe, and Bernard and Thomas. The authors conclude that annual stock returns are significantly related to the sign of annual earnings changes; that returns are disproportionately greater (lesser) for firms exhibiting greater positive (negative) earnings continuity; that share prices react very quickly the quarterly earnings changes with most of the adjustment occurring before earnings announcement dates.

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When Good Decisions Have Bad Outcomes: The Impact of Affect on Switching Behavior

By Rebecca K. Ratner and Kenneth C. Herbst

Organizational Behavior and Human Decision Processes, Vol. 96, 2005, pp. 23-37.

This paper presents evidence obtained from laboratory studies describing how an emotional reaction to a single negative outcome can lead decision makers to abandon strategies that they believe are actually most likely to be more successful in the future. More specifically, the authors present evidence that the negative affect generated by one's initial unfavorable outcome often leads people to abandon the very decision that has the best chance of meeting their future needs. Four different studies indicated that the source of the switching behavior was the desire to avoid the potential regret associated with selecting an option that had previously led to an undesirable outcome. It was found that switching behavior was reduced when the decision maker was required to focus on the cognitive aspects of the decision task. These results add to the growing literature in which emotions can dominate when reason and emotions are at odds with one another.

Does Stock Return Momentum Explain the "Smart Money Effect"?

By Travis Sapp and Ashish Tiwari

Journal of Finance, Vol. 59, No. 6, 2004, pp. 2605-2621.

Previous studies have suggested that the future short-term performance of mutual funds experiencing new money inflows has been superior to those experiencing money outflows. This has led to the hypothesis of a "smart money effect" wherein some investors appear to be able to identify those funds that are most likely to achieve superior future performance. This study, using market data on all U.S. mutual funds for the period 1970–2000, suggests that the "smart money effect" is best explained by stock market momentum and that investors simply "chase" funds experiencing

recent above average returns. More specifically, the apparent excess returns realized by funds that receive new funds evaporate when the effect of “herding toward profitability” is statistically controlled. Thus there appears to be no substantial evidence that from this market data that investors are able to identify superior investment fund managers and invest accordingly.

Reasoning About Emotional and Neutral Materials

By Isabelle Blanchette and Anne Richards

Psychological Science, Vol.15, No 11, 2004, pp. 745-751.

There is substantial evidence that one’s emotional or affective state has an effect on one’s reasoning. However, this laboratory study investigates whether people reason differently about emotional and neutral decision content. More specifically, this research investigates whether people reason differently about emotional and neutral content, irrespective of their affective state. In two experiments, where the emotional content of conditional statements was manipulated, the authors found that emotional content influenced the manner in which subjects responded logically. In particular, these investigators found that subjects were less likely to draw logical inferences when reasoning about emotional material. They suggest that emotional material may influence logical reasoning thru working memory and the way in which conditional statements are interpreted.

Trust, Risk and Betrayal

By Iris Bohnet and Richard Zeckhauser

Journal of Economic Behavior and Organization, Vol. 55, 2004, pp. 467-484.

Recent investigations have suggested that trust appears to be a significant risk attribute. In particular, many studies have suggested that perceptions of risk are enhanced by personal distrust. In this set of experimental game studies the authors investigate whether prospects for betrayal influence a decision maker’s decision, beyond mere probabilities. The experimental results suggest that the decision to trust is not simply treated by people as another form of probabilistic risk. That is, people care not only about a payoff outcome but also how the outcome came to be. In particular, they act as if there is a betrayal cost associated with distrust that requires a return premium over and above that which would be due simply to chance. In effect, people

are more willing to take risks when the outcome is due to chance as opposed to when the outcome depends upon some other party proving to be trustworthy.

What Valuation Models Do Analysts Use?

By Efthimios Demirakos, Norman Strong, Martin Walker

Accounting Horizons, Vol. 18, No. 4, 2004, pp. 221-240.

Previous studies have indicated that analysts tend not to rely heavily on complex stock valuation models. Also, much of the existing evidence on model usage has come from self-report questionnaires. In contrast, these researchers use structured content analysis of 104 analyst reports for 26 firms in the beverage, electronics and pharmaceuticals industries. These sectors were chosen because they pose varying levels of complexity and difficulty for analysts.

The paper’s primary conclusion is that analysts appear to tailor their valuation methodology to the circumstances of the industry. Nevertheless, simple single period P/E type methods appear to be the mainstay of analysts, as other studies have found. However, multi period models were also used as complimentary methods in the more complex analyses associated with electronics and pharmaceutical firms. In no case did analysts primarily rely on a discounted cash flow model as their primary valuation tool. In general, comparative valuation models are favored in the more stable industries where accounting numbers have more utility. However, where future uncertainty is greater and firm value is more dependent on accounting intangibles, greater weight and attention is given to information about firm strategy, managerial competence, R and D expenditures, etc. Residual Income Analysis (RIA) is very little used in comparison to discounted cash flow analysis.

Effective Leadership and Decision Making in Animal Groups on the Move

By Iain Couzin, Jens Krause, Nigel Franks, Simon Levin

Nature, Vol. 433, 2005, pp. 513-516.

Recently, herd behavior has become an important topic in the study of financial markets. This elegant study of herding among “virtual animals”, by a group of mathematical biologists, has interesting implications for the interpretation of investor behavior. Finan-

cial herding models usually assume that some market participants possess superior information and that this situation is signaled to the rest of the group, who then key on and mimic these knowledgeable individuals. This study demonstrates that virtually no assumptions about cognitive analysis and complex signaling are necessary for herd behavior to dominate a system. All that is necessary is that individuals wish to maintain some constant degree of “social distance” and that individuals favor a slight majority. It also suggests that accurate group behavior (getting to the desired objective) does not depend upon widespread information dissemination or complex signaling. In fact, the larger the group, the fewer the knowledgeable parties the better. Surprisingly, the best social outcome for the group may be obtained where few individuals have superior information and merely herd, oblivious to the degree of superior knowledge of their leader.

Financial Analysts Reports: An Extended Institutional Theory Evaluation

By Timothy J. Fogarty and Rodney K. Rogers

Accounting, Organizations and Society, Vol. 30, 2005, pp. 331-356.

This conceptual paper is premised on the assertion that the output of financial analysts (recommendations) cannot be understood except as part of the social and institutional fabric that makes up their work environment. After a review of the analyst’s work environment the authors identify four propositions relevant to analyst output.

1. Analysts are heavily dependent upon corporate management and reflect this dependency in their reports.
2. Analysts depend considerably on the past repeating itself and they act accordingly.
3. Analysts are more influenced by good than by bad news.
4. Analysts generally comment favorably on future corporate plans involving change.

The authors conclude the article by summarizing a very large body of existing empirical research that tends to substantiate the four research propositions.

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