

Does the market react to buy and sell recommendations of personal finance magazines?

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Abstract

By definition, private investors are not members of the financial community itself, since they have to spend most of their time making a living outside of Wall Street. Nevertheless, they invest substantial amounts of their wealth in direct stock holdings. Since this is a crucial decision as it affects their standard of living in the future, they consult so-called financial experts to come up with reasonable advice for investment decisions. Private investors usually find this kind of advice at brokerage houses, investment newsletters, 'financial gurus' and journalists. Whereas the market reaction to the information provided by the first three groups of financial experts has been analyzed extensively by academics, investment advice published by journalists has not been very thoroughly researched so far.

To close this gap, our study analyzes 2,860 explicit buy recommendations for stocks published by five different German *Personal Finance Magazines* from 1995 to 2003. Analyzing the investment value of financial advice by journalists in the context of the German market is particularly suitable since this type of advice is of high importance to private investors. One reason for this is that the German brokerage business refrained from issuing direct buy and sell recommendations for specific stocks since they feared legal actions for damages if a stock investment were to fail. Hence, other sources for information like *Personal Finance Magazines* are consulted by private investors.

To answer the question if the event, the publication of a stock recommendation, influences the stock price, I convert calendar time into event time when applying standard event-study methodology. For the calculation of abnormal returns around the

day of publication, I use the market model. To test for significance, both parametric and non-parametric tests are used. Within five days around the publication day, the recommended stocks earn significant abnormal returns of 2.58 percent. Results are mainly driven by high abnormal returns for small stocks and value stocks. However, price reactions, although smaller in magnitude, are also significantly positive for big stocks and glamour stocks. On the publication day, excess trading volumes rise to 161 percent of the normal level giving an indication that readers of the analyzed magazines as a group do significantly impact trading volumes.

Traditionally, research on the market reaction to financial experts' recommendations accepted the semi-strong form of the efficient market hypothesis. Consequently, observed increases in prices were routinely attributed to new, unknown information comprised in buy recommendations. However, two competing hypotheses emerged in more recent research: first, the price-pressure hypothesis which assumes that recommendations do not have information value; hence, stock price increases are only temporary since they are triggered by naïve buying-pressure. And second, the information hypothesis which assumes recommendations to have information value; hence, stock price increases are of permanent nature. The market response of stock recommendations in the context of these two competing hypotheses has only been analyzed by a very limited number of studies. With the data I can confirm both the price-pressure effect and the information effect. However, the main contribution is to evaluate the effects of both hypotheses according to companies' characteristics like firm size and price-to-book ratios, a procedure which has to the best of my knowledge not been done before. Within the study, I can confirm that the price-pressure effect is most extreme for small stocks and glamour stocks. However, whereas the initial price reaction to small stocks is additionally driven by permanent information value, this does not hold true for glamour stocks. In contrast, value stocks are associated with high cumulative abnormal returns that are solely driven by information value.