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SUMMER SESSIONS

Refresh your knowledge of essential topics in investing

How Media Narratives and Individual Investors Drive Markets

Presented by Professor Ronnie Sadka

Key Points

- Behavioral finance studies the psychological biases of investors and how they can help explain some of the price movements in the market.
- Media narratives can shape the behavior of investors, particularly retail investors.
- Since the pandemic began, additional participation from retail investors has increased both liquidity and the frequency of black swan events in the market.

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In its strongest form, market efficiency is defined as the state when prices reflect all public and private information. Inefficient pricing can arise as a result of psychological biases inherent in investors. Behavioral finance examines both these biases and other investor behaviors to discover how they affect market prices. In this presentation, Ronnie Sadka introduces behavioral finance as a topic and examines how media narratives and individual investors influence markets and prices.

Media narratives can potentially shape the behaviors of consumers. As an example, Ronnie highlights the toilet paper shortage when Covid-19 began making news in March 2020. He shows that before there was an actual shortage in food and supplies, local media outlets began reporting there might be a potential shortage. When people were told there was a shortage, they reacted by buying up as much as they could (milk, eggs, bread, and even toilet paper!), causing a negative feedback loop exacerbating the shortage. This same dynamic may appear in markets where media narratives influence investors, especially retail investors, who can affect asset prices.

Retail, or individual investors, are seen as more susceptible to behavioral biases than their institutional counterparts, and their influence is on the rise. Historically, retail participation in the US has been low, but due to evolutions such as new fintech platforms (e.g. Robinhood), more free time, and social media, retail participation has dramatically increased over the last few years. The impact of these new investors has improved liquidity for some stocks, but also created new risks, such as the coordinated buying of GameStop (GME) and AMC Entertainment (AMC) resulting in the now infamous short squeezes. Sentiments spurring these retail investor events have been cultivated in social media websites such as Reddit.

It may be possible to capture some of the idiosyncratic risk created by these new investors, using natural language processing to track the sentiment surrounding specific tickers on social media and creating an index of companies with the most bullish sentiment. Although the historical performance of such a strategy is limited (Oct 2020 through Mar 2021), it shows positive abnormal returns. It is clear that additional retail participation has had significant effects on the market. Investors can look to adapt to these new pressures by including information on trends from social media into their analysis.

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