Buy-sell orders can predict market's performance

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Investors may have access to a process similar to one used by racetrack bettors that could make playing the financial markets substantially less risky.

Serious racetrack bettors have "a system," poring over the Daily Racing Form to examine past race results, workout times, even a horse's lineage, all in an effort to predict a horse's performance.

New research from Duke University, Cass Business School in London and the University of Wisconsin indicates that a broad look at the buy-and-sell orders submitted by investors and traders -- called "sector orderflow" -- can predict the performance of stock and bond markets and the economy as a whole. The research will be published in an upcoming edition of the journal *Review of Financial Studies*.

"Market participants are continually digesting news about the macro economy, and as they process this news, it impacts their preferences, expectations and risk tolerances," said Michael Brandt of Duke's Fuqua School of Business. "These are some of the important factors that influence trading. Collectively, investors possess a huge amount of knowledge about the state of the economy and where it's headed."

The researchers reviewed equity orderflow data contained in the Trades and Quotes (TAQ) and Center for Research in Security Prices (CRSP) datasets from 1993 through 2005. By aggregating this information into broad sectors of the stock market, such as industrial companies versus utilities, the researchers were able to gauge the sentiment of the market.

"When economic conditions are perceived to be worsening or investors become more risk averse, they tend to shift their portfolio toward defensive, less cyclical stocks," Brandt said. "That is what we are trying to measure."

"Our methodology differs significantly from previous studies on price formation in trading markets," said Alessandro Beber from Cass Business School. "Orderflow reflects the actions of investors and contains information that is not revealed by examining returns, which reflect the consequences of investors' actions."

The study found the orderflow portfolio outperforms the traditional market portfolio by about 40 percent.

"If you'd invested $1 in the orderflow portfolio and $1 in the market portfolio over our sample period, the return on the orderflow portfolio would be $3.50 versus $2.50 with the traditional market portfolio," Brandt said.

More information: A copy of the report can be found online at faculty.fuqua.duke.edu/~mbrand … blished/secflows.pdf

Provided by Duke University

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