Want to make money with stocks? Never listen to analysts

January 10 2018, by Fabio Todesco

Credit: Bocconi University

Investors probably expect that following the suggestions of stock analysts would make them better off than doing the exact opposite. Nevertheless, recent research by Nicola Gennaioli and colleagues shows that the best way to gain excess returns would be to invest in the shares least favored by analysts. They compute that, during the last 35 years, investing in the

10 percent of U.S. stocks analysts were most optimistic about would have yielded on average 3 percent a year. By contrast, investing in the 10 percent of stocks analysts were most pessimistic about would have yielded a staggering 15 percent a year.

Gennaioli and colleagues shed light on this puzzle with the help of cognitive sciences and Kahneman and Tversky's concept of representativeness. Decision makers, according to this view, overweight the representative features of a group or a phenomenon. These are defined as the features that occur more frequently in that group than in a baseline reference group.

After observing strong earnings growth, the explanation goes, analysts think that the firm may be the next Google. "Googles" are, in fact, more frequent among firms experiencing strong growth, which makes them representative. The problem is that "Googles" are very rare in absolute terms. As a result, expectations become too optimistic, and future performance disappoints. A model of stock prices in which investor beliefs follow this logic can account both qualitatively and quantitatively for the beliefs of analysts and the dynamics of stock returns.

In related work, the authors show that the same model can account for boom-and-bust cycles in the volume of credit and interest rate spreads.

These works are part of a research project aimed at taking robust insights from cognitive sciences and at incorporating them into economic models. Kahneman and Tversky's concept of representativeness lies at the heart of this effort. "In a classical example, we tend to think of Irishmen as redheads because red hair is much more frequent among Irishmen than among the rest of the world," Prof. Gennaioli says. "Nevertheless, only 10 percent of Irishmen are redheads. In our work, we develop models of belief formation that embody this logic and study the implication of this important psychological force in

different domains."

Representativeness helps describe expectations and behavior in different domains, not only in financial markets. One such domain is the formation of stereotypes about social groups. In a recent experimental paper, Gennaioli and colleagues show that representativeness can explain self-confidence, and in particular the unwillingness of women to compete in traditionally male subjects, such as mathematics. A slight prevalence of exceptional male math ability in the data is enough to make math ability un-representative for women, driving their exaggerated under-confidence in this particular subject.

  More information: Pedro Bordalo, Nicola Gennaioli, Rafael La Porta, Andrei Shleifer, Diagnostic Expectations and Stock Returns. didattica.unibocconi.it/mypage … STOCKS_BGLS_NBER.PDF

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Provided by Bocconi University