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Facebook for Finance

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Blogs, online networks and other social media web sites are creating new opportunities for investment research. Social media sites are supplementing, and in some cases supplanting, the traditional Wall Street information ecosystem that transmits sell-side investment research and stock calls to the buy side.

If information "wants to be free," as one half of the famous aphorism goes, somebody forgot to tell Wall Street. This fall a federal appeals court in New York will weigh in on a long-running and widely watched legal dispute pitting Barclays Capital, Bank of America Merrill Lynch and Morgan Stanley against Theflyonthewall.com, a New Jersey–based web site that publishes sell-side analyst recommendations before the market opens — and often before the firms can distribute their own research to clients. The firms contend this hurts their commission revenue. This past spring a lower court judge ordered Theflyonthewall.com to delay publication of the firms' stock calls until one half hour after the opening of the New York Stock Exchange, among other restrictions. The web site countered with an appeal and won a temporary stay.

Even if the brokerage firms prevail in their battle against Theflyonthewall.com, winning the war to preserve the primacy of their investment research won't be easy. Bolstered by the low cost of online publishing and the rising popularity of blogs, discussion forums and commenting, a growing number of niche web sites are creating opportunities for new forms of investment analysis to emerge — and for buy-side professionals, even those at rival firms, to collaborate and learn directly from one another. These social media web sites are supplementing, and in some cases supplanting, the traditional Wall Street information ecosystem that transmits sell-side investment research and stock calls to the buy side. The sites' popularity has been fueled by the limitations and shrinking coverage universe of sell-side research and the failure of establishment experts — from Wall Street analysts and strategists to the credit ratings agencies to the financial news media — to call the credit crisis.

"The sell side can often be slow to twist and turn with where the market is going," says David Jackson, a former Morgan Stanley technology analyst and the founder and CEO of Seeking Alpha, a leading investment blog backed by blue-chip venture capital firms Accel Partners, Benchmark Capital and DAG Ventures. But crowd-sourcing investment ideas, he says, has its benefits: Throughout the rise and crash in the price of oil in 2007 and 2008, the unraveling of the housing market and the implosion of Bear Stearns Cos. and Lehman Brothers Holdings, Jackson's more than 3,000 handpicked contributors and vocal readers were "uncannily on topic in terms of what was driving the market — at a macro level and an individual stock level."

In mid-August, as part of the U.S. Treasury Department's ongoing outreach to the financial blogosphere, seven bloggers were invited to a private meeting with a small group of senior officials, including Treasury Secretary Timothy Geithner, to discuss financial reform. As four of the seven bloggers regularly contribute to Seeking Alpha, the meeting was a nod to the site's growing influence.

Finance pros have taken notice. According to audience tracker Nielsen Co., Seeking Alpha, which launched in 2004, now attracts more financial professionals than any other major financial web site. The site recently hit 540,000 registered users, and its opinion and analysis pieces, which are free, are read by more than 2.8 million people a month. Nielsen data suggest that more than 385,000 of these individuals are professionals: money managers, sell-side analysts, investment bankers, financial advisers, business leaders, entrepreneurs and sophisticated retail investors. Morgan Stanley's sell-side research, by comparison, goes out to roughly 250,000 institutional investors, though the firm's reach is much broader when you factor in its retail network of 18,000 financial advisers and their clients.

"Blogging is absolutely democratizing the investment business," says Barry Ritholtz, who is CEO and director of equity research at independent quant research firm FusionIQ, and who writes The Big Picture, a well-regarded blog about macro investing themes. A Wall Street veteran and the former chief market strategist at New York boutique investment bank Maxim Group, Ritholtz says that 20 years ago the typical Wall Street strategist had an economics degree, went to one of a half dozen leading MBA programs and came up through the ranks at a big firm: "You're talking about members of the same club — similar schools, similar background, working at the big Wall Street firms, quoted in the major media." But these days, he contends, "that model is totally broken."

For every form of investing, to tweak Apple's catchphrase, "there's a blog for that." Naked Capitalism, which specializes in financial and economic commentary, is overseen by Yves Smith, the nom de plume of a former Goldman, Sachs & Co. and McKinsey & Co. executive, and is widely read by hedge funds. Footnoted.org, launched by journalist Michelle Leder, reports on the things that companies try to bury in their Securities and Exchange Commission filings and was recently acquired by Morningstar. And Jeff Matthews Is Not Making This Up, written by the founder of Greenwich, Connecticut–based hedge fund RAM Partners, delivers blunt analysis of everything from the sources of revenue growth at Hewlett-Packard Co. under former CEO Mark Hurd to Wall Street's earnings coverage.

The explosion in socially generated investment analysis is both a blessing and a curse, especially when you consider the volume of short messages containing financial content that are transmitted every day via Twitter, the microblogging service that is especially popular among active traders (see sidebar, opposite). To manage what traders might call the high "signal-to-noise ratio" of public web sites, at least three private online communities now cater specifically to professional investors: Value Investors Club and Distressed Debt Investors Club, which were founded in 2000 and 2009, respectively, and each cap their membership at 250 investors, who are anonymous to fellow users; and SumZero, which launched in 2008, combines user-generated investment research with social networking features and now boasts a membership of more than 4,000 buy-side analysts and portfolio managers.

All three sites are rivals of sorts but share some members. Generally speaking, they screen applicants based on the quality of a sample investment thesis and require members to post write-ups on securities and regularly rate other community members' ideas. The sites may also offer incentives to encourage participation; Value Investors Club, for example, awards a weekly prize of $5,000 for the best idea.

SumZero is betting that scale, transparency and Facebook-style networking features will set the site apart from its two smaller rivals. “The dynamic is that the bigger the idea database gets, the more compelling it becomes to contribute to,” says co-founder and CEO Divya Narendra, a 28-year-old former analyst at Boston-based hedge fund Sowood Capital Management who is running the site while pursuing law and business degrees at Northwestern University.

Networks are something that Narendra has spent a lot of time thinking about. As an undergraduate at Harvard University, he co-founded social network ConnectU, and he remains locked in a long-running legal battle with Facebook and its co-founder Mark Zuckerberg, a Harvard classmate whom Narendra accuses of stealing his idea. SumZero’s name and tagline, “The opposite of zero sum,” suggest a Facebook-like zeitgeist. It’s a cheeky riff on the idea — which seems out of place in the cutthroat world of money management — that investors can create value for one another by openly collaborating and sharing ideas.

And they are. James Kilroy, a portfolio manager at Gainesville, Georgia–based Willis Investment Counsel, which oversees about $1 billion in institutional and high-net-worth assets, joined SumZero when it was a third of its current size. He says that he often posts a detailed investment thesis to the site after completing his research and building a position. His goal is to stress-test his ideas — “I want to understand how I can be wrong,” he says — and to share them with an influential community that is prepared to act on a persuasive argument.

“You want to be early and first,” explains Kilroy, a former Bear Stearns analyst who covered multi-industrials, “but ultimately you need other investors to share your point of view for the stock to go up.” Kilroy likes the fact that SumZero members must disclose whom they work for and the type of funds they manage. “It forces you to a higher level of accountability,” he adds.

Access to contrarian investment thinking is also a key driver of investor interest in these social media sites. Jackson credits Seeking Alpha’s success to the diversity of viewpoints expressed by the site’s writers and commentators, who create a wide-angle view of a stock that he says is unmatched by traditional Wall Street research. SumZero’s Narendra agrees. “Somebody might put up a thesis [on SumZero] where a stock trades at $2 and the target is $10,” he says. “That’s the kind of stuff that the investment community needs — a divergence of viewpoints, as opposed to herd thinking.”

Still, investors must proceed with caution. In a 2007 study of 340 buy and 160 sell recommendations posted on Seeking Alpha, Veljko Fotak, a Ph.D. student in finance at the University of Oklahoma, found that the stock picks exhibited some value and market impact, as measured by returns in the 20 trading days after publication, but that the quality of the investment advice varied. He found scant evidence of any factors that could predict the quality of a blogger’s recommendations.

Size may be the enemy of the good. Wesley Gray, an assistant professor of finance at Drexel University in Philadelphia and a co-founder of Empirical Finance, a recently seeded $50 million quantitative hedge fund, has studied the investment write-ups posted to Value Investors Club, whose founders, Joel Greenblatt and John Petry — longtime partners at New York hedge fund firm Gotham Capital — strictly enforce the 250-member cap. Gray’s analysis, which formed the basis of his Ph.D. dissertation at the University of Chicago Booth School of Business, found that stocks recommended on the site delivered an average one-year buy-and-hold return of 9.52 percentage points above the predicted return, after controlling for risk. Gray and his colleagues performed a similar, unpublished analysis of recommendations on the SumZero web site, which has a much larger user base and a shorter track record, and found no statistical evidence that the ideas posted there were, on average, market-beating.

That comes as no surprise to the Value Investors Club founders, who admit just one in 15 applicants. “If every member of the buy side joins SumZero, over time you’re going to have the aggregate return of the market,” says Petry.

Blogs, online communities and crowd-sourcing platforms like Twitter may hold promise for investors, but their reach is still limited, especially among more-seasoned professionals. “Most portfolio managers over 35 are ignoring this stuff,” says Steven Goldstein, co-founder and CEO of Alacra, a New York–based content aggregator that helps investment firms track information published on blogs, social media sites and other online sources.

Tapping into the right networks can be a Herculean task. “Yes, there is a proliferation of information and a lot of debates happening on social networking sites, but I think if anything it obfuscates the issues,” says Barry Hurewitz, chief operating officer of investment research at Morgan Stanley. He contends that good sell-side analysts, thanks to their own professional networks, are better equipped to define the debate and understand market expectations. “They tend to have the conversations with investors that matter the most,” says Hurewitz.

The proponents of online communities and social networking have no delusions of grandeur, but they are firm in their belief that these new online tools will ultimately change the way investors conduct research and vet new ideas. “I don’t want to sound ridiculous,” says SumZero’s Narendra, who positions his site as an alternative source of information that complements existing sources, such as sell-side research, 10-Ks and investors’ own proprietary models. Still, the entrepreneur can’t help but ponder the possibilities. “If we get to the stage where there are 10,000 to 20,000 buy-side analysts all in one community,” he says, “I think that’s really, really powerful.”

THE FACT THAT professional money managers share investment ideas online is perplexing to academic economists. After all, in an efficient and competitive market, money managers should be inclined to keep valuable insights private so that they can exploit the information advantage to outperform their rivals and attract greater sums of investment capital.

In practice, though, sharing has long been one of the most important ways that fund managers discover new investment ideas. Private “idea” dinners and gatherings like the twice-annual Value Investing Congress, launched by Whitney Tilson and John Schwartz, have long been a staple of the business. In a 1988 academic paper, written back when social networking meant working the cocktail party circuit rather than friending somebody on Facebook, Yale University economist Robert Shiller and then–Harvard economist John Pound found that roughly 53 percent of the institutional investors they surveyed attributed their initial interest in a stock to another investment professional. When the inquiry was limited to a small sample of stocks that had experienced rapid price increases, 75 percent of the investors traced the origins of their ideas to fellow fund managers.

Sharing good ideas with competitors, it turns out, is an entirely rational undertaking. Drexel’s Gray cites three reasons: the collaboration argument (originally put forward by another academic, Harvard economist Jeremy Stein), which holds that managers will share information if doing so provides access to constructive feedback; the diversification argument, which holds that sharing is rational when it gives managers access to a wider pool of high-quality ideas; and the awareness argument, known more pejoratively as “talking your book,” in which a manager profits by persuading other investors to buy, thus bidding up the price.

The speed and scope of information sharing among investment professionals got a big boost in the late 1990s with the rapid adoption of instant messaging on Wall Street. With IM, brokers and traders — much like the teenagers who popularized the technology — found that they could share information with multiple individuals simultaneously and that sending an IM was more real-time than e-mail and more convenient than the telephone.

Sensing an opportunity, Reuters and Bloomberg introduced their own instant messaging platforms in 2002 and 2003, respectively, marking an important turning point. Unlike most consumer IM platforms at the time, both companies offered investment firms security, auditing and privacy controls, helping compliance officers get comfortable with the technology amid growing scrutiny by the SEC and other regulators that oversee brokerage firms.

As Reuters and Bloomberg terminals became ubiquitous in the investment business, they emerged as linchpins in what might be deemed Wall Street's formal network for the distribution of research and stock calls to the buy side. Today, once an analyst releases a research report, it is typically published to the firm's password-protected web site for clients and distributed simultaneously to entitled customers via Thomson Reuters (as the company is now known), Bloomberg or other third-party distributors, such as Capital IQ. Brokers and traders also e-mail research to clients, disseminate the substance via IM and host private conference calls or webcasts to discuss the investment opinions.

Thomson Reuters and Bloomberg are themselves working to build on strengths in instant messaging to create new opportunities for investment professionals to share and collaborate online — but in a way that affords firms ample control over who can see their content and how their employees share research and other proprietary information. Both companies' flagship data products allows users to create profiles, follow updates from individual users and share charts and data, along with comments. "Bloomberg built systems to meet our customers' networking needs before the concept of social media even existed," says Jean-Paul Zammitt, Bloomberg's head of core terminal products and services.

Even a Wall Street lawyer could love this kind of networking: As Eran Barak, Thomson Reuters's global head of community strategy, puts it, the goal is to "bring the power of community and collaboration into financial professionals' work flow," while giving IT departments and compliance officers "all the tools to be compliant with regulation and perform risk management."

Outside of this formal distribution network, socially generated investment opinion is for now less heavily regulated, but potentially very lucrative, for those who can tap into the right source. Value Investors Club, the most exclusive of the online venues aimed at pros, is seen as a particularly fertile source of high-quality ideas. In early May, for example, user "cxix" recommended shares of NBTY, the world's largest maker of vitamins and supplements, then trading at $39 a share. The company, cxix wrote, was "a better business than it's generally given credit for" and prone to "blow-ups" — such as the one in the previous week, when shares fell 20 percent intraday — because management "doesn't play the earnings guidance/smoothing game." With the stock trading at $54 in mid-September, investors who bought on the dip were up nearly 40 percent.

"When you submit a good idea to Value Investors Club or SumZero, others get on board," says Alan Axelrod, a member of both sites and a former managing director at Ziff Brothers Investments, who now oversees $50 million in separately managed long-short domestic equity accounts. “You can immediately see some volume change plus the stock going up on a long you might suggest or down on a short.”

THERE is NO DOUBT that investment recommendations posted to social networks, however exclusive they may be, can be subject to biases. The 2007 paper by Fotak of the University of Oklahoma found that the stock picks from bloggers on Seeking Alpha tended to focus on large-cap names with recent abnormal returns and trading volumes. Long picks were consistent with contrarian strategies, he found, while shorts reflected momentum strategies.

Conversely, stock picks posted to Value Investors Club and SumZero are more likely to be small-cap stocks or special-situations opportunities, according to Drexel’s Gray. He noted in his Ph.D. thesis that the median market cap of long ideas, which make up the vast majority of recommendations on both sites, was $393 million for Value Investors Club and $559 million for SumZero. Most users of both sites are themselves employed by small and midsize firms. Based on an analysis of SumZero’s membership, Gray found evidence that larger fund managers were less willing to share new ideas than smaller managers were. (His interest isn’t just academic: Gray’s hedge fund trades in part on quantitative models that analyze the flow of information through social networks like SumZero and Value Investors Club.)

Apart from discovering and vetting new investment ideas, these specialized social media sites — the ones that don’t permit anonymity, at least — also provide crucial networking opportunities. Narendra says that SumZero is in many ways an extension of the information provided by services like Bloomberg. He points out that a Bloomberg terminal can be used to find out the names of firms that are 5 percent holders of a company’s stock, but not the names of the analysts at those firms who actually cover the company. On SumZero, however, users can search for a 5 percent holder and find out which of its analysts is covering the company. Users can also figure out who they know in common, whether they both used to work at Goldman Sachs or even whether they attended the same business school. “We’ve taken elements from social networking and [online encyclopedia] Wikipedia and applied them to the buy side in a way that nobody really has in the past,” says Narendra.

Over time, social networking may reduce the advantage that more-sophisticated asset managers with deeper pockets enjoy over smaller firms. “You’re gaining an extension of your own staff of smart people to render an opinion,” says money manager Axelrod. Although he generally prefers anonymity when connecting with peers online, he hasn’t hesitated to take advantage of the networking opportunities afforded by SumZero, using the site to identify fellow investors with whom to strategize. “It provides avenues for what social media is all about: relationships,” says Axelrod. “Not frivolous relationships but very valuable points of access.”

Alexander Rubalcava, founder of Los Angeles–based wealth management firm Rubalcava Capital Management, agrees. He recently posted on SumZero an analysis of offshore oil exploration and production company ATP Oil & Gas Corp., which has substantial operations in the Gulf of Mexico. As the BP oil spill dragged on, the web site “helped me keep track of all the changes proposed by the government,” says Rubalcava, a former analyst at Santa Monica, California–based venture capital firm Anthem Venture Partners. “Keeping up with that was beyond any one firm, but a lot of people were exchanging their findings on SumZero.”

The market for online investment opinion is helping some firms reach new clients. Chicago-based independent equity research firm Applied Finance Group, which typically serves institutional investors and large bank trust departments, publishes a daily investment thesis on a proprietary blog called Value Expectations and regularly contributes ideas and analysis to

Seeking Alpha. Co-founder Rafael Resendes says the exposure has helped introduce his firm to registered investment advisers and brokerage teams that haven't typically been big buyers of independent research. "Who knows how this will change the client landscape," he says.

The Big Picture's Ritholtz also attributes business wins to his blog. His firm, Fusion IQ, runs an asset management business that has attracted more than $300 million in assets, primarily through word-of-mouth referrals. "I suspect there's a comfort level thanks to my blog," says Ritholtz. "It makes the process of someone validating you that much easier."

Networking and information exchange may be especially valuable in niche areas of the market. A case in point is Distressed Debt Investors Club, the brainchild of a credit analyst who goes by the handle "Hunter" and has eight years of experience on the buy side. Hunter, who declines to reveal his real name or the name of his employer, says that about three quarters of the roughly 200 investment ideas on the web site are distressed-debt and event-driven plays, with the remainder split between equity and special-situations opportunities.

"A lot of people on the site have either formal credit training or a leveraged finance background, so people understand the bankruptcy and restructuring process," explains Hunter, who says his site marries the best of Value Investors Club and SumZero. (He is a member of both.) "On other sites or in sell-side reports, you might not have people well versed enough to understand the implications of, say, a fraudulent conveyance ruling."

Still, money managers trolling for new investment ideas must proceed with caution. Academic studies of retail investors have found strong evidence that stock message boards lead to confirmation bias. Studies of professional investors' offline behavior suggest that they are prone to the same temptations. With the balkanization of online information sources and the rise of the number of networking sites for professionals, myopia is a hazard. "You run the risk of reading just the people who agree with you," says Ritholtz.

Conflicts of interest are another danger. Seeking Alpha differentiates itself with a contributor policy that requires its bloggers, who range from hobbyist investors to professionals, to provide the site's editors with their real names for verification purposes, even if they blog anonymously, and to disclose positions in the securities they write about. Still, compliance with the policy is not policed by the site and thus depends on contributors acting in good faith.

The founders of private buy-side communities that permit anonymity say that they too know everyone's identity, even if fellow users don't, and that their sophisticated, highly vetted user bases assume that people are writing about positions they already own. "It's preselected for people who will see through pump-and-dump," says Value Investors Club's Greenblatt.

Will these nascent social networking sites for financiers flourish — or will they remain a pursuit for just a narrow slice of the investment community? There are challenges to growth. For starters, regulators and compliance departments alike are still trying to figure out how to adapt existing rules on disclosure, supervision and recordkeeping to the unruly world of social media communications. Many firms are ordering employees to steer clear, and in some cases they are simply blocking social media sites from office computers.

"The new technology keeps morphing," says Margaret Paradis, a partner in the investment fund and asset management practice at law firm Baker & McKenzie in New York. "That's the challenge on the regulatory side."

Making money is another hurdle. Some sites, like Value Investors Club, will no doubt continue to be run as quiet side projects for a select few. But other sites, such as Seeking Alpha and SumZero, aim to become profitable businesses. Seeking Alpha relies primarily on advertising, but in October the site will launch a platform featuring more than 20 applications for stock and exchange-traded-fund research as well as screening and charting tools, says CEO Jackson. SumZero is contemplating a different model. Rather than pursuing advertising, Narendra and his partners are considering strategies for selling or licensing to third parties the investment selections and recommendations that are featured on the site.

Back on Wall Street, many of the major brokerage firms say they aren't yet ready to discuss how they might deploy social media tools to extend the reach of their investment research. But at least one firm is taking a page from the digital media playbook. In August, Morgan Stanley became the first Wall Street firm to launch iPad and iPhone apps allowing institutional clients to search and browse its research. According to research COO Hurewitz, the firm has already begun streaming research presentations on video.

And in a world awash in information, Morgan Stanley is helping its analysts validate their investment theses by leveraging a three-year-old internal custom research group called AlphaWise, which uses tools like quantitative market research and data mining to uncover primary evidence on any topic, from casual dining trends in the U.S. to equity issuance in India. By strengthening its research with proprietary data sources and delivering the content through new digital channels, such as apps that enable the firm to control access with a log-in, these initiatives are consistent with the firm's protective stance in its case against Theflyonthewall.com, but at odds with the open, collaborative and freewheeling nature of the social web. Whether these two approaches to creating professional-quality investment opinion can coexist in the information age, or whether they will ultimately converge as they have in other industries, remains to be seen.

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