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The Madness of Chat Room Crowds

by: *David Silverman*

Two heads may be better than one. But what about 20? Or 200?

***[Editor's note:** This article is important to anyone who, God forbid, wants to rely solely on the advice of someone else. The word "solely" is important here. There are market chat rooms that offer value to some traders and not to others. There are other chat rooms that perhaps sit on the edge of legality. In no way, however, can traders afford not to use their own common sense in these matters. Silverman's article is cautionary. Let the trader beware.]*

When I was a young trader on the floor of the Chicago Mercantile Exchange (CME) in the early 1980s, I spent most of my time searching for a quick and easy methodology to make money, not realizing that the only way to learn how to trade is, well, to trade. I spent endless hours creating hand-drawn bar charts – this was before the era of personal computers – practically lived in the exchange's library after the trading session ended each day and even bought a trading system that I saw advertised in the back of a magazine, next to an ad for pimple cream.

None of this was working for me, so I decided to seek out the advice of other floor traders who, unlike me, seemed to know what they were doing. I was not very discriminating either; in fact, any fellow exchange member who did not live in their parents' basement, as I did at that time, was fair game.

Mendacity and the Market

A decent fellow who stood in the same general area of the Japanese yen pit as I, took pity on me one day and invited me to Lou Mitchell's coffee shop across the street from the Merc. As he sopped up the largest sunny-side-up egg I had ever seen with an inch-thick piece of Greek toast, he ceremoniously instructed me to take out a pencil and trading card; he proceeded to dictate a list of cardinal rules that I must follow in order to succeed. I listened in rapt attention as if he were Moses on Mount Sinai and scribbled furiously, hoping I wasn't missing anything – Thou shalt not add to a losing position, Thou shalt not sell a quiet market, Honor thy order filler that thy days may be long – the list went on and on, and though these bromides seem quaint after the millions of contracts I've traded in my career, I remember everything he told me that day.

One of the things he said was that under no circumstances should I rely on anything another trader tells me, because no trader in history has ever been completely honest. To make a buck, a successful trader may

trash-talk, deceive, manipulate, confuse and lie as easily as a schoolboy in the locker room talking about last Saturday night's date. Until I understood this, he explained, the other traders would eat me alive, probably with some fava beans and a nice Chianti.

This insight so fascinated me – somehow it seemed to be much more valuable information than anything else he had told me – that I was willing to ignore the irony of taking seriously the words of someone who just told me he should not be trusted, and asked how the market can possibly function when its participants show such little respect for the rules.

He told me that one had to make a distinction between little lies and whoppers. Little lies didn't matter in the scheme of things, and the fact that everyone lied evened the playing field. As for "egregious lies," ones that caused severe economic damage, it was the exchange's job to enforce the stringent rules on its books. This was the way the world worked, and as long as the worst liars were held accountable, the system held up pretty well, notwithstanding its shaky foundation.

While no one likes to acknowledge their ethical shortcomings, and I have tried to set my own moral compass with the north and south poles exactly where they belong, after 25 years in the market I have to say my mentor's realpolitik view of the world is pretty accurate. While different people may define lying in different ways, and highly paid lawyers parse words for their clients to create reasonable doubt and avoid liability, in a world where so much money is at stake and the chance of being caught breaking the rules is relatively small, it becomes easy to see how "little" lies might not seem so awful. A trader may think, for example, if an investment banker can go on CNBC and talk up the prospects of a stock that his company's own traders may sell at an inflated price shortly thereafter, how awful is it, really, to spread a rumor about Martha Stewart on a Yahoo! message board?

Anonymous "Analysts"

In researching this article, I spent approximately 60 hours in various financial chat rooms, websites at which traders and trader-wannabes carry on discussions about the markets, presumably so that everyone in the room can benefit from the wisdom of the community. When I began my research I was not sure what I would find, and hoped to be rewarded with a new tool, courtesy of the electronic revolution in financial markets, that would help me become a better trader. Unfortunately, after reading thousands of online messages, I have concluded that, in the age of technology, it still pays to be a skeptic. Just as they did in the pits, traders continue to trash-talk, deceive, manipulate, confuse and lie. What I was told so many years ago remains fresh today, and anyone who does not understand this and totally relies on the information they read in chat rooms may get eaten alive.

That the Internet is being used to pass misleading information about the markets – and thousands of other things – comes as no great shock, but what I realized as I read one bogus posting after another, is that the anonymity the medium provides can make chat room lies far more insidious than any ever told in the pit. On the trading floor, market professionals, fully aware of the rules of the game, aware of the stakes involved, and able to look any trader in the eye to help determine the degree to which the truth might be shaded, needed protection only from the egregious lie.

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In chat rooms, by contrast, where the naïve and uninitiated congregate with the potential hustlers and con men, it is no fair fight. Anonymity fuels the liar's sense of invincibility, and often statements are so bold and outrageous it's amazing anyone takes this nonsense seriously. Think of it this way. If someone whom you've never met and cannot identify – whose credentials are unknown to you and impossible to discover – came to your office and insisted that you should enter into a financial transaction based on representations that you have no way to confirm, you'd probably call security to throw the bum out of the building. Why would you willingly enter into a chat room discussion with this guy, much less accept his opinions at face value? And, yet, seemingly, there is no shortage of individuals ready to look for new confidants among some of the shadowy charlatans of the Internet.

Arthur Levitt, former head of the Securities and Exchange Commission, put it nicely in a speech he gave to the National Press Club in 1999. "Chat rooms have been compared to a high-tech version of morning gossip or advice at the company water cooler," he said. "But at least you know your co-workers at the water cooler. For the future sake of this medium, I encourage investors to take what they see over chat rooms – not with a grain of salt – but with a rock of salt."

I suspect, however, that such admonitions make little impact, and that many individuals are making trading decisions as a direct result of some of the garbage they are reading online and then digesting it without much thought. By the way, if you think I'm overstating the case, I ought to tell you that shortly after I began my research, I established five different Yahoo! identities in less than ten minutes and stopped only because I got bored. Don't worry, I haven't actually posted anything yet. Or have I?

Stock Chat-Room Swindle

Consider the case of Jonathan Lebed. You may have heard of him. On 11 separate occasions between August 23, 1999, and February 4, 2000, Lebed engaged in a scheme on the Internet in which he purchased large blocks of thinly traded microcap stocks and, within hours of making such purchases, sent numerous false and/or misleading messages over the Internet, touting the stocks he had just purchased. Lebed then sold all of these shares, usually within 24 hours, profiting from the increased price his messages had caused. During the course of the scheme, Lebed realized a total net profit of $272,826. So reads the settlement between Lebed and the SEC, which accuses Lebed of violating Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, that prohibit acts, transactions, practices or courses of business that operate as a fraud or deceit in connection with the offer, purchase or sale of securities, including misrepresentations and omissions of material fact.

Jonathan Lebed, it should be mentioned, was 15 years old during the period of time when these transactions took place.

How did a tenth-grader making trades from the computers in his high school library dupe investors into his "pump-and-dump" scheme? In the settlement notice, the SEC highlights Lebed's trading in Man Sang Holdings (Symbol: MSHI) as a representative example of his fraudulent activity. On January 5, 2000, Lebed purchased 18,000 shares of MSHI at prices ranging from $1.375 to $2.00 per share. The trading volume on December 30, 1999, was 100 shares with a closing price of $1.125 per share. On January

5, 2000, the volume was 60,700 shares at a closing price of $1.8125. At 11:46 p.m. on January 5, 2000, Lebed posted messages on Yahoo! Finance message boards claiming that MSHI was "the most undervalued stock in history" and would be trading at more than $20 per share "very soon."

On January 6, 2000, in response to the messages posted by Lebed, the volume of trading skyrocketed to 1,074,900 shares at a high of $4.6875 per share. On that date, Lebed sold all 18,000 shares of MSHI at prices ranging from $3.8125 to $4.00 per share. His net profit was $34,959. MSHI issued no press releases, and there was no news in the marketplace during this time period to account for the rise in price and volume.

Three weeks later, Lebed again manipulated the price of MSHI stock. From January 27, 2000, the date he purchased MSHI and posted his messages touting the stock (again predicting a price of $20 "very soon"), until the following day, January 28, 2000, the date he liquidated his entire position, the volume of the stock increased from 71,500 to 1,879,000 shares, and the price jumped from $2.25 to a high of $5.125. Both the price and volume were 52-week highs. Lebed realized a net profit of $37,901.

Con of a Different Sort

There are a couple of interesting elements to this case that distinguish it from a traditional con game. First, Lebed believed he did nothing wrong – or at least that he was operating with the same degree of openness as the analysts he watched every day on CNBC – and was only caught because he made no serious effort to hide his identity from federal regulators and prosecutors. (However, it should be noted that in his thousands of postings, he did not divulge that he was only 15.) Had he been savvier about concealing his identity, one can only imagine the windfall profits he could have achieved.

Second, the regulators themselves were unsure how to treat this type of fraud, although they characterized it and Lebed in the most disparaging terms. Arthur Levitt, himself, said that Lebed was a "bad kid," that he'd "buy, lie and sell high." Yet, the SEC let Lebed keep more than $500,000 in trading profits that he achieved in dozens of other transactions, in part because they could not figure out exactly how Lebed's actions were fraudulent.

In fairness to the SEC, the Internet is so new and its power to affect the market so overwhelming – indeed, in a single week, Lebed's activities in MSHI caused the stock price to increase more than 400 percent – that the regulators simply don't know how to translate their righteous indignation into law that protects the investing public. Moreover, the SEC seems to be reluctant to address the inherent inconsistency between prohibiting free speech online and allowing similar questionable behavior on Wall Street itself.

In the end, Jonathan Lebed, now 21, apparently learned some lessons from his legal wrangling with the SEC, although not the lessons the regulators were hoping he'd learn. Today, Lebed provides Internet market commentary to more than 3,000 clients who pay him $50 per month for a market newsletter and to read his blog. It is also reported that in 2003 alone, approximately 30 small companies paid between $50,000 and $100,000 in consulting fees to Lebed's firm.

Apparently Lebed has hired some lawyers, because he points out on his

website (www.lebed.biz) that "Jonathan Lebed never receives any compensation from the companies profiled on Lebed.biz. Jonathan Lebed does run an investor relations firm, Lebed Biz, LLC, and occasionally will discuss clients in e-mail alerts. In the event that he discusses a client, he always fully discloses that the company is a client as well as the type and amount of compensation received." Actually, on Wall Street, and in cyberspace, this is about as honest a disclosure as one is likely to get.

Even with my deep reservations about the veracity of the material, as I read through message after message, the trader in me wondered whether there is any predictive value in the material. In other words, maybe it doesn't matter that people lie as long as I can figure out what their lies really mean.

Does the Chatter Matter?

Luckily for me, two economists from the University of British Columbia, Werner Antweiler and Murray Frank, looked at this issue in a paper that appeared in the June 2004 Journal of Finance, entitled "Is All the Talk Just Noise?" They reviewed a total of more than a million and a half messages from the Yahoo! Finance and Raging Bull websites and determined that the talk on message boards does have some predictive value. They found that the type and frequency of certain messages did tend to predict increased volume and volatility and impact on return. It is important to note that the effect on these variables was limited to the very short-run. So, for example, they would agree that Lebed could move the share price of PumpandDump Inc. for a few days or weeks, but no matter how many upbeat messages he posted, in the end, his efforts could not affect the company's long-term prognosis.

These findings offer no great surprises, but the question is, can one use the information that appears in chat rooms to make profitable trading decisions? There probably is no particular edge in doing so. Perhaps one could develop a gut feel about the short-term sentiment in a particular market by reading through messages over a few hours or days; however, the econometric analysis employed by Antweiler and Frank is so far beyond the capacity of the average trader, it would be unreasonable to think one could discern the significance of a series of messages with any degree of accuracy.

There are an endless number of better ways for traders to better understand the ebb and flow of market data, including trying out new trading software, developing systems, studying the newest research in financial journals, reading at least one book every month about the markets, reviewing trading charts or even just staring at a trading screen without trading. Also, if you're ever in my neighborhood, give me a call. I'll meet you at Lou's and we can discuss the markets over the biggest sunny-side-up egg you've ever seen.

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