

# LGC&D Wealth Management, LLC

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### Is it Wise to Follow “Mad Money”?

**Overview:** Following is a discussion of the findings of a paper that looked at the stock recommendations of the cable television show “Mad Money,” a lively and entertaining take on the typical format of a show that dispenses financial advice/information. However, as with all such “hot” news, by the time the information has been disseminated, it is already incorporated into stock pricing within our highly efficient markets, and thus no longer useful information on which to base decisions about trading. Instead, we would suggest that, rather than following recommendations that may or may not match an individual’s ability, need and willingness to take risk, prudent investors continue to adhere to their well-developed plan based on their long-term financial objectives.

In their book, *The Great Mutual Fund Trap*, authors Gregory Baer and Gary Gensler wrote, “If you’re having fun investing, then there’s a good chance that you’re not properly diversified, you’re trading too much, and you’re taking too much risk.”<sup>1</sup> We are reminded of the cable television show “Mad Money.”

Jim Cramer, ex-hedge fund manager and co-founder of TheStreet.com, has become one of the most recognizable faces in the investment world (or at least on the cable channel CNBC). He dispenses rapid-fire investment advice on the show “Mad Money.” Since it premiered in March 2005, it has been one of CNBC’s most watched shows. In September 2005, *Variety* reported that, “The freewheeling investor show hosted by Jim Cramer, increased the net’s 6 p.m. [performance] by 141% in the third quarter and became the financial net’s highest-rated show in primetime.”<sup>2</sup>

But has it been as successful for the investors who follow his advice? Three PhD students at Northwestern University’s Kellogg School of Management sought the answer to this question in their 2006 paper, “Is the Market Mad? Evidence from Mad Money.”<sup>3</sup>

At first glance, the answer would appear to be yes. Typically, after Cramer recommended a stock, its volume soared. For example, the authors found that on the smallest quartile of stocks, volume was almost nine times more than on the day after his recommendation (and stays above normal for about three days, with the effect decreasing with time). The increased demand led to an overnight rise in prices of about 5 percent for the smallest stocks (where they can have the greatest impact) and about 2 percent for the entire sample of the 246 unconditional recommendations examined between July 28, 2005 and October 14, 2005.

Those gains turned out to be temporary. For example, price gains for stocks in the smallest quartile completely reversed within 12 trading days. The original gains turned into nothing more than market impact costs. In other words, after costs, Cramer’s picks typically had negative value to naïve investors who reacted to the buy recommendations.

However, because the market is so efficient, a different category of investors may have benefited from Cramer's picks. For example, while the demand for Cramer's stock picks increased, there was also an increase in the volume of short selling (bets that the stock will fall). In the opening minutes of the day following one of his recommendations, short sales increased to almost seven times their normal levels, and they remained elevated for three days.

Besides individuals who followed Cramer's show, the authors identified two main players: "the market makers who supply liquidity to these investors, and the arbitrageurs who attempt to profit from the mispricing following the recommendations."<sup>4</sup>

The authors also found that the stocks that Cramer recommended had excess returns for the three days prior to his actual recommendation. They provided two explanations for this behavior. Their first explanation was that Cramer was recommending stocks with short-term momentum (of which there is some evidence, although after trading costs the positive momentum would be difficult, if not impossible, to exploit). Their second explanation was that information pertaining to some of the stocks he recommended was released before the television show aired each day (during market hours), which the authors attributed to either Cramer's daily radio show or Web columns.

We would suggest that instead of following pied pipers such as Cramer, investors adhere to a prudent investment plan based on their long-term financial goals and risk tolerance. Cramer might be providing entertainment for those who enjoy screaming, chair throwing, ringing cash registers and shouting "Booyah." While this might make for enjoyable television, it also falls into the category of active management (market timing and individual stock selection). Copious academic research has indicated active management is unlikely to offer consistent premium returns, particularly after accounting for the cost of implementation.

Cramer and CNBC attempt to make investing entertaining. After all, the goal of any television show is to attract the greatest number of viewers. But investing should not be considered a form of entertainment. Instead, investing should be about taking the appropriate amount of risk (with commensurate expected returns) to achieve well-defined long-term financial goals. It should be about forming a careful plan for achieving those goals, and remaining adherent to it in a highly disciplined manner. Research shows that, on average, investors harm themselves with too-frequent trading — often a result of paying attention to what they believe is valuable information but is really nothing more than Cramer-style "noise."

<sup>1</sup> Gregory Baer and Gary Gensler, **The Great Mutual Fund Trap**. Broadway Publishers, September 2002.

<sup>2</sup> Michael Learmonth, **Ratings Flood for Fox, CNN**. *Variety*, September 27, 2005.

<sup>3</sup> Joseph Engelberg, Caroline Sasseville and Jared Williams, **Is the Market Mad? Evidence from *Mad Money***. Working Paper, Kellogg School of Management, Northwestern University, March 22, 2006.

<sup>4</sup> Ibid.

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