Textual Disclosures and Retail Investors

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Prior evidence suggests that textual disclosures provide incremental information to investors as all value-relevant information cannot be presented in financial statements. However, in the absence of a formal external auditing requirement for such disclosures, regulation is difficult. Thus, managers often mislead investors by increasing the complexity of the annual reports when the performance is poor or engaging in tone management around important corporate events.

Most of the early evidence show that retail investors are unsophisticated, behaviorally biased and uninformed, and hence are more prone to misinterpreting textual disclosures. However, this view has been challenged by recent findings, signaling the possibility of some retail investors being not prone to framing effects of language. As such, it is not clear ex-ante if retail investors are influenced by textual disclosures. The purpose of this study by Jain, Khizer and Thirmalai (2019) is to empirically examine how less-sophisticated investors interpret textual information.

The study has used a sample of 3,172 quarterly earnings conference call transcripts from 201 unique firms forming part of the S&P BSE 200 Index between 2005 and 2017. It then captured the sentiment of the management by calculating *TONE* as the difference in the frequency of optimistic and pessimistic words, scaled by the total number of words. The study then examines how different classes of investors interpret *TONE* using a rich tick-by-tick transaction-level data from the Bombay Stock Exchange in India during the same period.

The study shows a positive and economically meaningful association between cumulative abnormal returns (calculated as cumulative difference between daily stock and market returns), suggesting a positive market reaction to *TONE* over the short-term windows around the earnings announcement date. However, the study shows that market corrects these mistakes in the long-run as witnessed from a significant negative association between *TONE* and cumulative abnormal returns in the long-run. This suggests that management employs tone management to mislead investors, but investors are only misled in the short-term as stock prices revert in the long-term. The results of a separate examination of the market reaction to two different components of TONE—one capturing the underlying fundamentals of the firm and the other capturing the discretionary part—further strengthens the argument that management employs tone management to mislead investors.

The second part of the study that is currently under progress aims to examine the reaction of retail and institutional investors separately to textual information using the tick-by-tick transaction-level data that allows easy identification of different categories of investors. The study aims to investigate if retail investors consider the credibility of management when interpreting textual information and learn from their past trading activities.