SFB/Transregio 266

ACCOUNTING FOR TRANSPARENCY

Research on Corporate Transparency

Element 4: Why theory?

Joachim Gassen

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A fuzzy but interesting question

Is social media good or bad for corporate transparency?

One (out of many) derived more precise question

Does social media disclosure cause mispricing on stock markets?

The ‘Cathy question’

What do you believe is going on?

An empiricist's ad hoc answer

Well... people are misled by influential people on social media, leading to herding behavior, leading to mispricing.

Can you be more explicit?

- Does the influencer deliberately mislead people?
- Are her followers rational?
- What makes them believe the influencer?
- Why is the firm not reacting to this by voluntarily disclosing information?
- Why is there no arbitrage?
- A tip: There is a theoretical literature on herding. Can you build you argument on it?

Some answers (again ad hoc)

- Maybe the influencer has some some private stake in the stock
- The followers are over-trusting and over-confident in their stock-picking abilities
- The firm is unable to adjust its disclosure routines on short notice
- Arbitrage costs are too high for institutional investors until mispricing is brutally obvious

Meet Occam’s razor

- These are many assumptions, making your theory virtually impossible to test (and thus pretty useless)
- Can you come up with a more parsimonious argument that fleshes out the core mechanism that you want to predict?
- The more parsimonious a model is, the easier it is to test it in the lab and in the field, and
- the more likely it is to contribute to the advancement of knowledge

Research needs theory

Read (and understand) theoretical work on …

- (rational) herding in financial markets,
- the interaction of liquidity and asset prices and on
- voluntary disclosure!