Money Stuff: 10-K tone

By Matt Levine
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If you read a company's annual report on Form 10-K, and it is pretty positive and upbeat — not, like, the numbers are big, but like the actual writing is full of positive sentiments — would that be a good sign, or a bad sign, or completely uninformative for your decision to invest in the company? On the one hand, good news is better than bad news, and you probably want a certain baseline level of optimism in your management team. On the other hand, you might imagine that good managers would be particularly focused on thinking about and communicating the possible downsides, while bad managers would remain upbeat by just ignoring existential risks. And then of course there is the realist-cynical view that 10-Ks are formulaic documents largely written by lawyers and their particular level of stylistic optimism or pessimism tells you almost nothing about the actual prospects of the company.

The answer is "good sign":

"Our results show that positive (negative) sentiment predicts higher (lower) abnormal return over days (0, +3) around the 10-K filing date, i.e., the filing period. Both sentiment measures also predict higher abnormal return over event windows of up to one month *after* the filing period. This finding suggests that the market underreacts to positive sentiment and overreacts to negative sentiment in the 10-K filing during the filing period. …

We next examine the relation between sentiment and future firm fundamentals. We find that positive sentiment predicts higher return on assets and higher operating cash flow over the next year, while negative sentiment predicts lower ROA and OCF. The economic significance of negative and positive sentiments are comparable to each other, suggesting that positive sentiment is nearly as informative regarding future profitability as negative sentiment."

That's from a blog post by Mehran Azimi and Anup Agrawal of the University of Alabama titled "Is Positive Sentiment in Corporate Annual Reports Informative?" (Here's the related paper.) The answer is yes, and I guess that sounds obvious, but if you are a believer in market efficiency it is a little surprising in two ways. One is that it suggests that you can get above-market returns just by reading a 10-K carefully. Not even "carefully," really; you can just read the 10-K, notice if it sounds happy, and if it is you can buy the stock and expect above-market returns in the short term. The other is that it suggests that corporate management teams have a level of self-knowledge, and a willingness to communicate that self-knowledge in print, that might surprise believers in strong-form efficiency.

Oh by the way the paper is largely about using machine-learning methods to read 10-Ks and notice if they sound happy, and of course if you are interested in applying these lessons at a large scale as part of a professional investing strategy you probably will want to get a computer to read the 10-Ks for you. But for me the answer to the much simpler question — if *you* read the 10-Ks and noticed they were happy, would that be meaningful? — was also interesting and a bit surprising.