- << Member Website

How hedge funds analyze your earnings calls

By Dominic Jones on August 13, 2010

NEWS this week from the *Wall Street Journal* that academics have found key language markers of executive deception on earnings calls won't come as a surprise to some of the world's biggest hedge funds.

That's because they have for years used advanced detection techniques devised by the US intelligence community and sophisticated voice analyzing software to tell if executives are lying on their earnings calls.

On Thursday, the Journal reported findings from a new academic paper (PDF 542 KB) by David Larcker of the Stanford Rock Center for Corporate Governance and Anastasia Zakolyukina at the Stanford Graduate School of Business who analyzed earnings call Q&A transcripts of companies that later had a substantial financial restatement, a change in auditor or a late filing.

Using a filter based on prior research into deceptive language, the accounting professors identified several features of deceptive CEO and CFO narratives, including:

- They use more references to general knowledge;
- They have fewer non-extreme positive emotions words;
- They refer less often to shareholder value and value creation;
- CEOs use fewer references to themselves and use more impersonal pronouns like we and team; and,
- CEOs use fewer extreme negative emotions words and more extreme positive emotions words.

The paper concludes that the "results suggest that it is worthwhile for researchers to consider linguistic cues when attempting to measure the quality of reported financial statements."

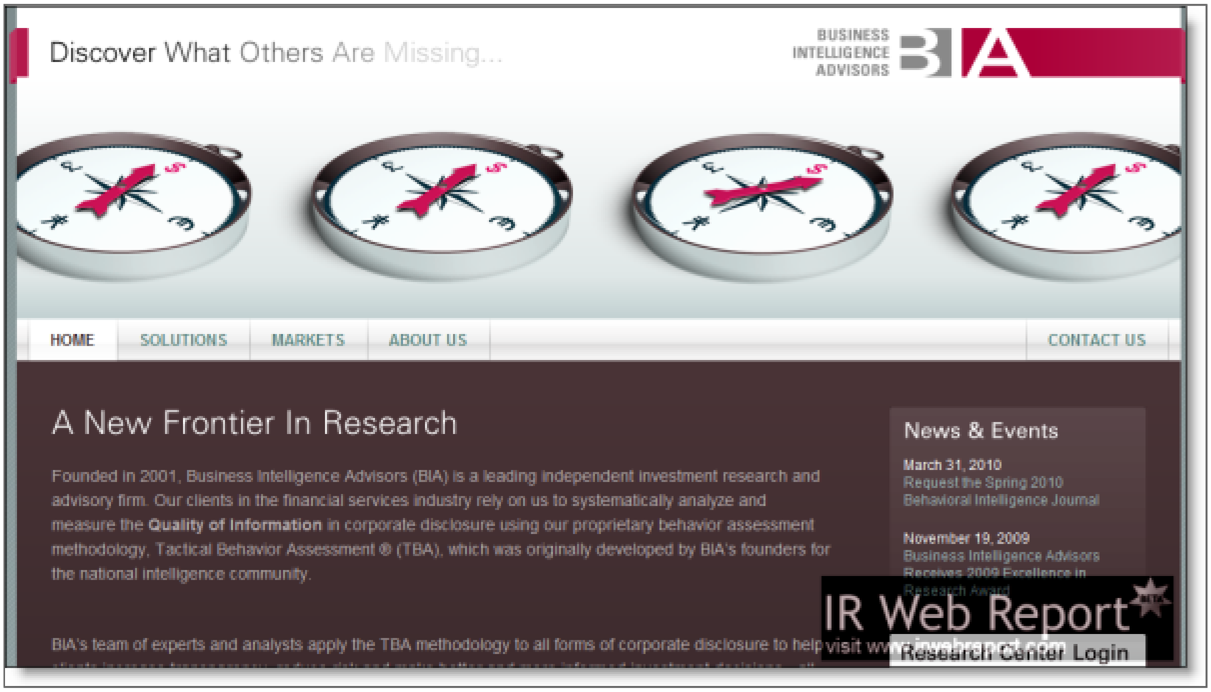
And that's exactly what firms like Goldman Sachs and S.A.C. Capital Advisors have done for years, using experts trained in CIA-style deception detection techniques and advanced software developed in Israel that analyzes executives' voices for signs of stress.

Ex-CIA agents analyze earnings calls for hedge funds

In his book Broker, Trader, Lawyer, Spy: The Secret World of Corporate Espionage CNBC reporter Eamon Javers explains how a firm called **Business Intelligence Advisors** (BIA) based in Boston is hired on a retainer for as much as $400,000 to $800,000 a year by some of the biggest names on Wall Street.

BIA was founded in 2001 and is staffed by retired CIA officers who specialize in deception detection using a technique called **Tactical Behavior Assessment** (TBA).

"TBA focuses on the verbal and nonverbal cues that people convey when they aren't telling the truth. Psychologists familiar with the method say it works because human beings just aren't hard-wired to lie well. Holding two opposing ideas in your brain at the same time — as you have to do in order to tell a lie — causes a phenomenon they term "cognitive dissonance," which creates actual physical discomfort. And when people are uncomfortable, they squirm. They fidget ever so slightly, they pick lint off their clothes, they shift their bodily positions," Javers explains in an except from his book published on Politico earlier this year.



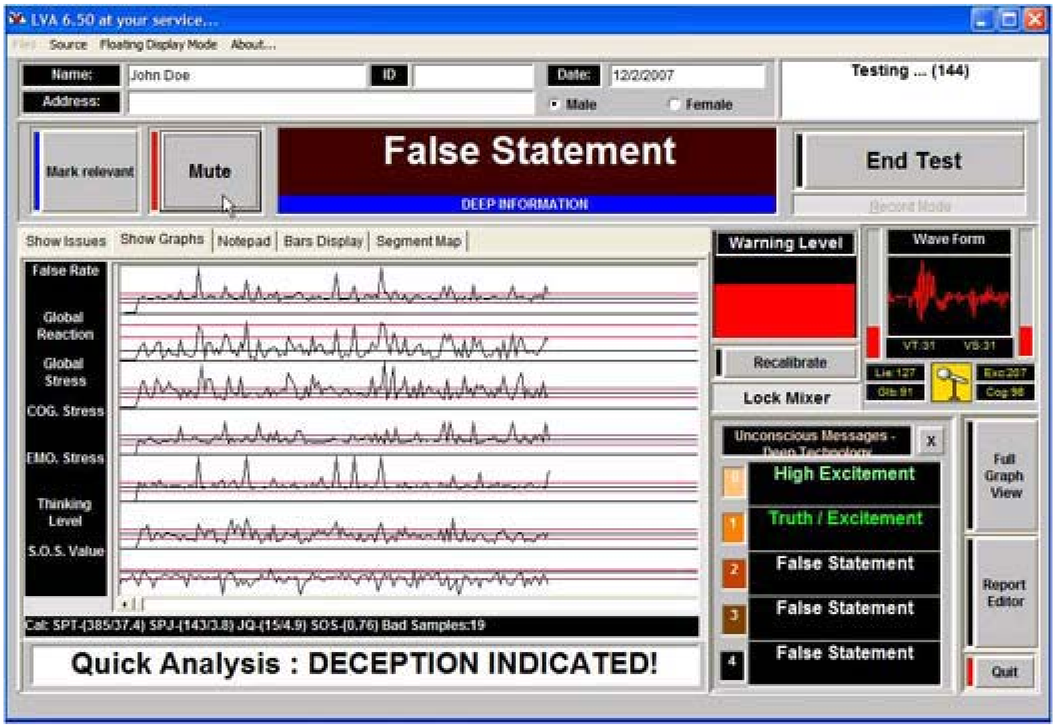
BIA's website says it offers a "new frontier in research."

BIA, which sports the tagline *"discover what others are missing,"* uses its CIA-trained operatives to analyze quarterly corporate-earnings calls for its investment management clients. They listen for qualifying answers like "honestly," "frankly" or "basically," detour phrases like "as I said before" or "in our last call," selective memory like "to the best of my knowledge," and overly courteous responses like "yes, sir."

In his book, Javers, recounts how BIA's agents identified potential problems at UTStarcom in 2005 by analyzing statements made by the then CFO about the company's revenue recognition practices. They provided a 27-page report to their client with the conclusion that management was worried about future results. In the next quarter, the company warned it would not meet its revenue targets and the stock fell to $5.64 from the $8.54 it had been when BIA compiled its report.

BIA's website doesn't list its clients, but it claims that since 2001, its behavioral experts have **analyzed over 50,000 Q&As**, over **4,000 earnings calls** across more than **1,500 companies** in more than 30 countries using the TBA model.

Software analyzes voice tone to detect lies



But it’s not just what executives say that investors are analyzing. They are using advanced software to analyze the tone in their voices as well.

An Israel-based firm Nemesysco Ltd. is the inventor of **Layered Voice Analysis Technology** (LVA), which uses 129 vocal parameters to detect small, involuntary changes in speech waves to identify excitement, which would be positive, and cognitive dissonance, which is negative.

Two accounting professors, **William Mayew** and **Mohan Venkatachalam** of **Duke University**, have used the software to analyze audio files of earnings calls held between January 1 and December 31, 2007 available on the Thomson Reuters StreetEvents database.

And they have published what they believe is the first study (PDF 341 KB) to show evidence that vocal cues can **predict a firm’s financial prospects**.

Their study found that negative emotions detected in executive’s voices predict that companies are more likely to miss consensus forecasts during the next three quarters than they did in the previous three.

They calculate that 27% of managers with lower levels of negative emotion missed their earnings target in the next quarter, while those with higher levels of negative emotion missed 38% of the time. Negative emotions predicted poor stock returns over the next nine months.

The professors say that **video** might offer the next “fruitful channel” of research as its allows “exploring facial expressions as yet another channel of nonverbal managerial communication in the context of financial markets.”

Dominic Jones

I founded IRWebReport.com in 2001 to promote best practices for online investor relations communications. I have also consulted for global large- and mega-cap companies and start-ups in the investor relations industry. I'm a former journalist and the author of several plain English investment books. View my bio and disclosures, join my network on LinkedIn, and follow me on Twitter @irwebreport.

Check Out These Related Articles

- CEO's online video mea culpa boosts investment — study A NEW study has found that when CEOs take responsibility for financial ...
- Weekly roundup: highlights for the week ending Aug. 13 This is a weekly feature at IR Web Report highlighting articles and ...
- Transcripts a sign of transparency WHY don't more companies provide transcripts of their earnings conference calls and ...

Share This Post

Posted in Articles | Tagged deception, earnings calls, voice analysis

Recommend Be the first of your friends to recommend this.