Social Media and Investing:

Misconceptions Mask Near-Term Stumbling Points and Long-Term Opportunities[1]

Chunka Mui and Paul B. Carroll[2]
Devil's Advocate Group

June 2010

Mesmerized by the explosion of use of Facebook, Twitter, LinkedIn and other forms of social media, many in the financial world believe that it will soon play a dominant role there, too. In fact, a study of 30 major financial Web sites and lengthy interviews with more than two dozen senior executives in financial services and the technology industry finds that numerous barriers will slow the adoption of social media in financial services.

The study found that many brokers, issuers and others are thinking hard about the issues raised by social media. Some have begun experiments that will shed light on how trends will develop and on how those conducting the tests can benefit. Still, the review of Web sites, the interviews and a look at the history of innovation suggest that many have what appear to be serious misconceptions.

Many brokers and issuers are assuming they can control the interaction that investors have with each other, even though social media will likely turn out to be an unstoppable force. Brokers and issuers, if they are astute, will be able to influence communication, but not limit it. Investors suffer from their own misperceptions. Some have come to think erroneously that social media will produce profitable tips; others, that "crowd-sourcing" will allow those who share their opinions to understand where the prices of assets are heading.

Our conclusion: Social media is potentially such a game-changer that brokers, issuers and all other parties in the financial services world should experiment with it, to understand how usage may take hold and to explore both for vulnerabilities and for opportunities.

---

[1] *This research was sponsored in part by Broadridge Financial Solutions, Inc. Broadridge views social media as a technological capability that could, if effectively leveraged, significantly promote industry dialog, transparency and good governance. The conclusions and recommendations are those of the authors, as are any mistakes or omissions.*

[2] *We would like to acknowledge the significant contributions of Chuck Callan, our working partner at Broadridge for this research effort. Bob Schifellite also participated in the interviews and Mike Mostransky contributed to the background research. Janey Place, Eric Siegmann and Tom Waite of the Devil's Advocate Group also contributed to the research described in this report.*

As has been the case with the Internet and with other breakthrough technologies, the impact of social media on investing seems to be overestimated for the short term and underestimated for the long term. In other words, everyone should be careful about how quickly they assume change will occur. But everyone should operate on the assumption that, at some point in the future, all investors will be able to communicate with each other on almost any venue on almost any topic. When this inevitability comes about, it will be much better to be at the center of such conversations, rather than on the periphery—or to be left out all together.

Dangerous Notions

The time is ripe for strategic missteps. Here are misconceptions that could contribute to ill-conceived initiatives, or to missed opportunities:

1. Control is possible.

Full-service brokers, in particular, seem to believe that they can limit how clients use social media. One executive nicely summed up the attitude of these brokers when he said:

—"My clients talking to other clients? Don't be silly."
—"My clients talking to another firm's clients? Are you insane?"

Big brokers can exercise some control for now. Clients are reasonably docile, especially when it comes to complex financial dealings, and investment discussions on forums like Motley Fool are unruly, unreliable affairs.

Corporate management and investor relations professionals seem to take a similarly controlling attitude toward shareholders, especially retail shareholders. One report on social media from an IR firm that describes itself as cutting-edge talked a lot about the "media" part—how to use Facebook and other new channels to broadcast messages. But the lengthy report said literally nothing about the "social" part; there was no acknowledgment of the fact that investors might talk to each other and not just listen to the issuer. Most issuers pay attention to the amorphous mass of individual shareholders only when there are fires to put out, and certainly not at the expense of large institutional holders. The reason is simple: Large institutions hold the most sway, so they capture most of the time and attention. Issuers worry that social media will serve as an organizing mechanism for activists and make it harder to "control the story." As such, issuers are doing little to engage shareholders using social media in general, and almost nothing to actively encourage shareholder-to-shareholder dialog.

But a guiding principle of the Internet has turned out to be that, in the words of a much-quoted line, "information yearns to be free," and investors who want to communicate on a topic will surely find a way to do so. Everything about the history of the diffusion of technological innovations suggests that, while it will take a while for things to fall into place and for people to become comfortable with social media, there will come a point after which those who fight the change will lose.

The best analogy here is AOL. Like the big brokers, AOL developed a great business based on what was known as a "walled garden"—through AOL, users got easy access to the Internet but were restricted to AOL sites for finance, email, etc. AOL wanted the walls to stay up forever, so it could control its customers and keep charging a monthly subscription fee. But AOL, which was basically the Internet with training wheels, found that people gradually learned to ride the bike without the help. AOL has been struggling ever since to reinvent itself.

As one technology executive said about the big brokers, "We've seen this movie before, and we know how it ends."

2. Social media is a product.

Because Facebook, for instance, is a site where people go to interact, many assume that there will be specialized sites where investors will go to discuss investment-related issues. But this sort of assumption has, historically, proved to be wrong. Bank One set up Wingspan as an Internet-only bank in the late 1990s, only to see it fail quickly because the Internet turned out to be a channel, not a product. People wanted banking capabilities on the Internet, but as an additional service channel along with branches, ATMs and telephone. Netscape saw the Internet browser as a separate product, then fell by the wayside as Microsoft incorporated the browser into the broader computing experience.

Instead of being a standalone product, social media will likely be a channel. It will turn out to be just a means of communication that will occur on numerous sites—whether operated by brokers, by sites devoted solely to social media, by issuers, by news providers or by any number of others.

3. Companies should build their own platforms.

This fallacy relates to the idea that social media is a product—people think they need to control the platform to make their product distinctive. People are also surely hoping that they can duplicate the breakthrough successes of Facebook, Twitter, etc.

It may be better to own a platform, but it's also really difficult to do so. Palm recently developed an operating system that it hoped would serve as a platform for smart phones and found that the world had already moved on. Motorola, meanwhile, decided to ride the platform that Google created with Android and had its first success in years. There is already plenty of technology that provides the backbone for any social media that people want to enable, and it's a much safer bet to use that technology rather than try to reinvent the wheel.

4. Crowd-sourcing is possible.

Social-media sites are trying to pull together large groups of people and get them to voice opinions about stocks, industries, the economy, etc., so that the "wisdom of the crowd" can lead to better investment decisions. The models here are online sites like the Hollywood Stock Exchange, which has done a good job of predicting ticket sales for movies and picking winners for the Academy Awards. But there is a crucial difference: The Hollywood exchange is setting up a market where none previously existed; the investor sites are setting up markets that have to compete with the public markets for stocks and other securities, which are far larger and more liquid. When the space shuttle Challenger exploded in 1986, within minutes the public markets had marked Morton Thiokol as the responsible party, out of all the contractors involved, and months of investigation showed that a part made by Morton Thiokol was, in fact, at fault. While investment sites can claim credit anecdotally for some insight, no one has yet demonstrated that its small crowd can come close to the level of accuracy that exists in public markets.

5. Tips are meaningful.

Related to crowd-sourcing is the commonly described dream that social media will bring more information to the surface so that it will be possible to know, for instance, whether Steve Jobs' health problems have recurred. This misconception has focused many social media efforts toward active traders. The problem with tips is that they are turning out to be like the index of leading indicators issued by the U.S. government, which, an economist once quipped, had predicted "nine out of the last three recessions." There are so many purported tips, accompanied by so much spam, that it's impossible to tell the reliable tips from the unreliable—or even fraudulent—ones. As the lack of reliability becomes clearer, the idea will fade that you can trust someone you don't know to provide important, truthful information.

Besides, if someone possesses that information, why share it? Why not just act on it alone and reap all the profits (if it's legal to do that without violating insider-trading laws)?

The Real Opportunities

If so many of the prevailing notions about the importance of social media are wrong, how will it, in fact, be so powerful in the long run?

1. Education

While social media won't deliver an endless stream of profitable trading tips, it will play an important role in educating investors. Already, people are going online and using pseudonyms to ask basic questions that they'd be embarrassed to pose to someone face to face. TradeKing, for instance, has found that people who trade stocks will ask each other for advice about how to start trading options. Branded providers of information, such as MarketWatch, are laying out trading strategies that have become the basis for thoughtful discussions.

The brokers that do the best job of providing education may increase client loyalty and may even be able to nudge customers into new types of activity, such as options trading. Issuers that add social media capabilities to their investor relations functions may be able to reach people not just as investors but as consumers and as members of communities where the issuers operate.

Change won't be simple. Brokers will have to offer increasingly sophisticated advice, to go beyond what investors are telling each other. Brokers will also have to contend with the fact that more information about their performance will be available online, where clients can easily compare the results against those from other firms and against those from brokers within the firm they're using. Issuers may have to do even more to protect their brands, so they have credibility when they're trying to swat down a dangerous rumor.

But complications are coming, no matter what, and creating a community where people educate each other may prove to be one of the best ways of deferring or even avoiding problems.

2. Customer service

By building a robust customer community, companies can enlist customers to help each other. This offloads work (and therefore costs) and frees customer-service agents to focus on the most complex issues. While there isn't yet much of this happening in the financial services world, computer companies such as Dell have shown that customers often enjoy helping others sort through problems, and forward-thinking companies will find ways to do similar things with investors (within regulatory constraints). The approach is a win-win for all involved.

3. Entertainment

Social media will contribute to the fun factor. People like competing, whether it's on the basis of investment portfolios or on their ability to outdo the experts at ESPN and Sports Illustrated when it comes to picking winners of football games. Many sites are generating interest by facilitating competitions and increasing users' loyalty through systems of rewards.

4. Competition

High-profile startups like KaChing and Covestor take the competition several steps further. They pit investment advisors against each other by giving potentially full transparency for the advisors' portfolios and trades. KaChing and Covestor also give spectators access to advisors through social media, fostering a robust discussion with advisors and other users about advisor strategies and performance. The advisors compete not only for bragging rights but for clients, as well, as the sites enable investors to pay for the privilege of trading in tandem with their preferred advisor.

This sort of competition will, obviously, hurt those whose results don't measure up. Over time, the competition may get to the point where firms and brokers that don't provide full information on results may lose to those that do. But competition will create opportunities for those savvy enough to gain attention and smart enough to then deliver superior results.

5. Bernie Madoff

There is even the possibility that social media could help spot fraud. Someone could post an informal, anonymous expression of doubt about the predictability of the returns and lack of information on the methods of the next Bernie Madoff, without having to have the kind of evidence that people generally feel they need when talking in person. The doubt would find a wide audience and, if enough others shared the concern, could lead the community to investigate.

Experts sometimes say that networks like Facebook and LinkedIn have succeeded because of the power of "weak links." In other words, people don't feel they have to have a strong link with someone before associating with them on, say, Twitter, a fact that has led to complicated and interesting networks of connections. Social media could provide the investing world with the power of "weak questions" and, in the process, help ferret out fraud.

More generally, open and honest dialog encourages transparency and a sense of trust. "Sunshine is the best disinfectant," to borrow a line from Justice Lewis Brandeis.

6. Community

Social media will also foster communities of like-minded people—though not necessarily around a particular stock or company. Schwab has generated great interest among retirees who share tips with each other on how to manage their IRAs, how to minimize expenses, etc. In a world where information is overflowing and increasingly commoditized, those hosting active communities will establish stronger relationships and higher barriers to exit. (This will be a double-edged sword. When communities become disenchanted with their hosts, they tend to leave all at once, as MySpace learned.)

Puzzlers

Even if one successfully skirts the misconceptions and focuses on the real drivers of social media, some significant questions remain. They are questions that won't have simple answers but instead need to be assessed from the standpoint of individual companies' particular strengths, weaknesses, and competitive context.

1. Timing

Tipping points are hard to predict. With social media, the timing will vary by industry segment. Brokers and issuers, for instance, will be affected differently. Even among brokers, the timing is likely to be different for discount brokers, which don't have advisers that they're trying to protect, than for full-service brokers. TradeKing, for one, will likely keep eating into the market share of brokers that haven't successfully adopted social media, but it's hard to know when those market-share losses will cause other brokers to overcome their concerns about social media and embrace it.

2. Reputation management

While there is universal agreement that there needs to be some way to understand the credibility of those participating in social media, the form that this will take is uncertain. Many said the most important thing is to be able to link a post to a real person, even if the post is under a pseudonym. The link not only gives authorities a way to police any fraud but also tends to make writers behave more responsibly. A rating system may also evolve for posters, along the lines of those Amazon uses for reviewers or that eBay uses for sellers. Various sites may also issue “badges” that will certify someone as a successful investor and that can be used on a variety of sites to provide credibility. In addition, brokers or others could certify that someone holds a stock that he’s writing about and could provide a general idea of the size of that holding.

3. Regulators

The general sense is that the Securities and Exchange Commission will react to social media rather than lead the way. But not necessarily.

The SEC seems likely to soon approve regulations referred to as Proxy Access, which would make it much possible for investors to promote alternative board of director candidates in a company’s own communications materials. A group would just have to demonstrate that it owns some small percentage of a company’s stock (proposals range from one to five percent) and has held the shares for a year. This change could encourage investors to use social media to find like-minded people so they could nominate directors sympathetic to their points of view. (The Wall Street Journal recently reported that Calpers, the $200 billion pension fund of the California Public Employees’ Retirement System, was already recruiting scores of executives whom it might nominate for corporate boards once proxy access changes are announced.)

The SEC could also decide to encourage shareholder communication as a way of reversing a precipitous decline in voting on proxies that has occurred in reaction to earlier regulation. The earlier change, known as the “notice and access rule,” let issuers save money by not sending all proxy materials to investors; instead, issuers could just send a postcard listing a site where investors could find those materials online. But retail investors who receive their proxy materials through the mail voted 20% of the time, whereas those who have to go through two steps to read the materials only vote about 4% of the time. The SEC has expressed concern about this decline and could see social media as part of a solution.

4. Compliance

While many advisers love the idea of communicating ideas to clients via Twitter, Facebook, blogs, etc., the uncertainty about rules for regulatory compliance is scary. Even once the regulations become clearer, companies will have to feel their way toward the right approach to vetting and logging all electronic communications. Companies will have to become much faster about deciding whether a communication is compliant—in a fast-moving market, what's the point of issuing advice 48 hours after a big move and countermoves have occurred? At the same time, companies can't afford to make mistakes.

5. Governance

Those who advocate for causes, such as limits on executive compensation, would love to rally people through social media. Issuers would love to damp such conversations.

So far, issuers have mostly controlled the conversations. But there have been flare-ups led by activists, such as one that occurred when some investors recently decided that Kraft was buying palm oil from an inappropriate supplier and organized a protest online.

Whether one side can prevail in the long run remains to be seen. Even if issuers lose some control, though, they may be able to mitigate problems by demonstrating that they are reaching out to communicate with investors—much as companies now take measures to earn good grades on governance from independent groups.

6. Security and Fraud

Each wave of Internet innovation has fed a dark side, and no doubt spammers, fraud artists, and other invaders of privacy will try to harness social media for their own gain. Some fear that creating electronic meeting places for retail investors might be herding the sheep for slaughter, which would not only harm investors but also open up organizers to liabilities.

One technology executive said that, while "www" sometimes seems like it stands for Wild, Wild West, there tends to be a tug of war between the good guys and the bad guys. He noted that spam once seemed like it would overwhelm email traffic but is now managed pretty well by filters. He said that, just because social media is chaotic for investors at the moment, doesn't mean solutions won't evolve. How fast such solutions do evolve will have a significant effect on adoption.

7. Privacy

It's amazing what users will share over social networks. Loopt enables users to share real-time location information with friends and, as the service trumpets, with people nearby whom they wished they knew. Through Blippy, users share and compare credit-card purchases. PatientsLikeMe encourages users with chronic illnesses to share and discuss health profiles and treatment experiences. Those who share draw in others, who pull in still more. But there will be many potential privacy landmines for those charged with organizing such capabilities. Even Facebook and Google stumbled when they took too much liberty with user-generated content.

What to Do?

Innovation is always a race, and this time will not be the exception. To beat the other guy to the punch—while not making any important mistakes—it's important to heed this reminder from Peter Drucker: "Contrary to popular belief, 'flashes of genius' are uncommonly rare. Purposeful innovation begins with the analysis of opportunities. The search has to be organized, and must be done on a regular, systematic basis."

Here are our recommendations about how to organize your social media efforts:

1. Understand Your Doomsday Scenario

Social media will bring a host of changes, but those changes will play out differently in each part of the industry. Some changes will be favorable, some not. Some changes will be favorable in the short run but unfavorable later, or vice versa. Getting a clear inventory of threats and how they might play out across your business lines and customer segments is necessary to steer the right course in a very complicated, emerging world. For example, how might social media change customer expectations or empower competitors and substitutes? How might issues like privacy, security, and compliance play in your favor, or against you? What regulatory wildcards or competitor moves might shift the landscape? What leading indicators might let you know that you are reaching the tipping point along various critical dimensions? Under what time frames would you be able to respond? Are there other time frames that would leave you flat-footed? At what point might your fixed assets become liabilities?

If you're a big broker, what would it take for you to lose out to competitors that embrace social media, like TradeKing? Might customers defect not just because such competitors offer a better price but because they offer better service through their online community? How long could you tolerate defections before you needed to do something? What happens to an adviser who has a bad year, in a world where returns will be increasingly transparent and where investors can compare notes?

If you're an issuer, what do you do if activists grab hold of the conversation about your company? What would make you want to change your approach to investor relations away from the current broadcast model, where you just focus on formulating key messages and disseminating them?

If you provide information or research, how could you be marginalized if someone builds a dominant community in which you have no role? At what point might a captivating community be valued more highly than your professionally generated content?

One exercise that is often useful is a "war game." Executives are given a proverbial blank sheet of paper and told to try to come up with a business plan that would put their company out of business—in this case, taking advantage of social media. While there may be no total killer, the exercise can point out weaknesses that can be addressed before it's too late.

2. Build a Common Perspective

While executive teams generally think they're on the same page, they often aren't. Everyone might say that a revenue stream is in imminent danger, but "imminent" can mean different things to different people. To one, it might mean the business will disappear within the year. Someone else might think 50% of the revenue will go away in three years. Yet, in general terms, both would paint the outlook in the same way. This unstated disconnect often results in executives working at cross-purposes, even though they think they have alignment on a key issue.

One way to resolve the ambiguity is to make sure your doomsday analysis looks at scenarios with precise measures of how much revenue would disappear by certain dates. Too often we find that what some think will happen in one year others believe wouldn't happen for five. By getting such scenarios on the table, management teams come to a real consensus on timing and can move forward in more unified fashion. It's also valuable to maintain a tracking mechanism so that, as the months and quarters go by, it's possible to see whether change is coming faster or more slowly than anticipated.

3. Win with a robust innovation process

Once you have identified your potential weaknesses and have everyone on the same page, you can start to think about ways to go on the offensive and take advantage of the changes that are in the offing because of social media.

To determine how to innovate, we recommend these fundamental steps: think big, start small, learn fast, and scale.

First, you have to think big. The social media technologies that are coming online are potential game changers, so there are lots of opportunities out there. But it's not enough to come up with one or two mesmerizing ideas. You have to force yourself to come up with a wide range of options, elaborate them enough to judge their worthiness, and stress test them enough so that key stakeholders develop a shared sense of understanding of the critical assumptions, potential risks and rewards, and likely competitive implications. From extensive research into the factors that influence strategic success and failure, we know that the challenge of this step will be to balance between coming to a decision prematurely, based perhaps on a senior executive's gut feeling, and not coming to a decision at all, because of analysis paralysis. Almost half of the big failures that we studied for our book "Billion-Dollar Lessons" stemmed from errors in forming strategy. So the stakes in this first stage are very high.

Second, though, you need to start small. The environment is unclear enough that nobody is going to nail every issue straight out of the gate. If the Internet bubble taught people anything, it should be that the first-mover advantage, while potentially useful, is no advantage at all if you get things sufficiently wrong. Look at Iridium, which took the Big Bang approach, trying to be the dominant wireless communications system almost right out of the gate. Iridium, backed by Motorola, launched dozens of satellites at a cost of $5 billion, only to find that technical obstacles severely limited demand. There is, in fact, a market for satellite phones, but Iridium didn't survive to take advantage of it. The company operated for less than a year before entering bankruptcy proceedings in 1999. The assets were auctioned off for $25 million.

Third, you have to learn fast because, after all, innovation is a race. If you learn too slowly, then the other guy will move ahead. Those that adapt the fastest will have a major advantage.

Finally, and most obviously, it's important to scale, once you've figured out how to develop an innovation and the market in which it sits. Scale is how you take advantage of your new idea.

* * *

There's a famous old story about a young Steve Jobs getting a tour of a plant where IBM was manufacturing matrix printers. His guide bragged about IBM's state-of-the-art manufacturing techniques and the edge that they gave IBM on cost. But, as Jobs said to a colleague later that day: "They're building the wrong printer." And, sure enough, laser printers soon rendered dot-matrix printers obsolescent.

That kind of mistake happens all the time—even to Steve Jobs, who had a dud of a computer called Next before returning to Apple.

The arrival of social media on the investing scene is going to create considerable disruption. Yet too many players are justifying doing nothing by thinking that they are taking a "wait-and-see attitude." Some will find themselves stuck in the equivalent of the dot-matrix world while more innovative companies are out there selling the investing equivalent of laser printers.

Chunka Mui and **Paul B. Carroll** are co-founders and managing directors of the Devil's Advocate Group, a consulting group that helps business leaders stress test their innovation strategies. They are also the co-authors of *Billion-Dollar Lessons: What You Can Learn from the Most Inexcusable Business Failures of the Last 25 Years*. (Portfolio, 2008) For more information, see the Devil's Advocate Group website at devilsadvocategroup.com.