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Social Engineering: Capturing the Alpha in the Twittersphere

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Given the mass popularity of social media, many equity market participants are jumping on the bandwagon. But in the case of hedge funds and other trading firms, it is alpha that drives the interest, not entertainment.

Social media has become much more than a source of entertainment. In many cases, it is now the fastest and most reliable source for news and sentiment. Nowhere is this more relevant than in the financial sector, which generates a literal stockpile of data and messages for analysis and commentary.

Rifling through this mass of content to spot actionable trends, however, can be daunting. But there are now services that do it for you. These fledgling services represent the wave of the future, and hedge funds and other high-frequency trading firms already are jumping on the trend.

Nearly 62% of adults worldwide now use social media; and 22% of all users' time online is spent on social networking sites such as Twitter, Facebook, and Pinterest, according to thesocialskinny.com, a website that provides the inside scoop on social media. But with more than 250 million active users and 300,000 new users a day, Twitter is without a doubt the go-to source for trending news. Given the mass move to social media, it is only natural that many equity market participants are jumping on the bandwagon. But in the case of hedge funds and other trading firms, it is alpha that drives the interest, not entertainment. And the opening for entrepreneurs is clear.

[*Related:* "Twitter Just Crushed Wall Street After The Cyprus Bailout"]

Joe Gits founded Social Market Analytics (SMA) in 2012 because he recognized the importance of social media for the financial industry and how using the information could impact day-to-day trading decisions. "The key problem stemmed from the fact there was no way to quantify the data," says Gits. "Twitter users can't open up 100 different Twitter streams and accurately analyze the results."

SMA is partnering with NYSE Technologies to introduce to a wider audience a social media monitoring engine that gathers sentiment from Twitter and then evaluates the data in real time. This is one of the few times that social media sentiment has been collected and quantified in one location on a scientific basis, according to Gits. Currently, NYSE Technologies is the sole distributor of SMA sentiment data through NYSE Technologies' Secure Financial Transaction Infrastructure (SFTI) network.

SMA created its patent-pending framework to extract or digest all tweet messages from a qualified group of certified Twitter users based on topic, source, posting account and location to determine sentiment, Gits explains. He adds that these users tend to include stock analysts, legitimate news sources and other reputable commentators, not amateur pundits. The messages are then evaluated to remove spam and duplicates, and to assess the relevance. SMA reports that more than 90% of tweets are filtered out at this stage due to irrelevancy.

In recent months, however, the volume of actual tweets that pass the filtering process has increased by more than 10% per month, according to Gits. This is faster than the overall growth of Twitter and suggests that the financial community is catching up in its use of social media.

"Traders are replacing past methods of gathering stock market sentiment with electronic analytics since they give a more accurate view on short-term price movements," says Henry Chien, an analyst at TABB Group. Chien recently wrote a research piece embracing the 24/7 nature of the Internet and its effect on financial advisory and investments. He also concluded that social networks broadcast financial data much faster than traditional media outlets and promotes the obvious advantages of using these outlets.

According to Tom Watson, product manager of the US derivatives market data at NYSE Technologies, “The financial services industry has been watching and listening to social media for a while. Now they’re increasingly using and contributing to social media platforms, and trying out different trading strategies based on sentiment. This partnership between NYSE Technologies and SMA to provide a data feed of social media analytics is our first foray into social media as a product, but we fully intend to extend the product suite and offer access to other social media data sets in the future.”

SMA uses averages, change, volume, volatility, dispersion of tweets, and risk to produce “S-scores.” These scores provide rankings based on weighted normalized representations of sentiment over a pre-defined look-back period. Focusing purely on stock prices at this stage, the NYSE Technologies and SMA partnership looks to uncover the trading opportunities that arise from the quantitative social media data.

The big question is: Has there been a direct correlation between changes in sentiment and future stock price movement? Back-testing clearly suggests that this is the case, according to Gits.

Users of this data encompass a wide demographic but typically are proprietary trading firms, media outlets, and sell-side banks that are able to access the data from NYSE Technologies at a nominal monthly fee, according to Watson. Currently, NYSE Technologies isn’t feeling the squeeze of major competition, as the platform is relatively new. But this will likely change as social media adapts and expands.

Socially Acceptable

Twitter is not the only place that investors look to get valuable information on the stock market. For example, Stocktwits -- founded in 2008 as a social micro-blogging stock service -- provides a community-powered idea and information service for investors. Mirroring Twitter, Stocktwits users can post information on the markets and follow users or investors in real time.

Bypassing Facebook, LinkedIn is another favorite among financial advisors due to easy website navigation and few compliance issues for larger companies. A research study by LinkedIn and FTI Consulting in May 2012 found that nine out of 10 financial advisors who use social media for business purposes used LinkedIn, while less than 30% used Facebook. LinkedIn has become the professional-class alternative to Facebook.

While social media and sentiment evaluation holds countless opportunities for investors, there are risks. The increasing ease at which imposters can create fake Twitter names that mimic companies’ profiles and post tweets on their behalf is a concern. This has led to the involvement of the SEC and FBI in larger cases, and authorities are now constantly monitoring social media outlets for potential manipulation of stock prices.

The generation that grew up with the Internet and rode the social media wave is now entering the workforce, which makes the time perfect for integration between social media and the financial sector. For companies such as SMA, the wealth of material that social media provides is a godsend. But, the company’s Gits acknowledges, executives at SMA are aware as anyone that the old saying still holds true: “Don’t believe everything you read on the Internet.”
