EQUITIES

Economic Links and Predictable Returns

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This paper provides evidence that investors often fail to consider economic links between companies when making investment decisions and this phenomenon can have a substantial effect on asset prices. The links examined in the paper are publicly available and sometimes represent long-standing relationships between firms, with the given customer on average accounting for 20% of the supplier's sales.

We contend that it is possible to harvest large and predictable returns by buying (or selling) the supplier firm after a positive (or negative) shock to its customer. This customer momentum strategy is largely unaffected in both magnitude and significance by controlling for the three-factor model, liquidity, own-firm momentum, industry momentum, within-industry lead-lag relationships, and across-industry momentum.

We believe the customer–supplier link provides a natural framework to test investor inattention. Not only is the link publicly available to all investors, but given our results on real effects of the link, it is difficult to argue that this link should not be taken into account when forming expectations about suppliers' future cash flows. More generally, customer–supplier limited attention poses a roadblock for standard asset pricing models.

What we document is not an isolated situation that is constrained to a few firms, but instead is a systematic violation across firms that has a material effect on prices. If it is true that investors ignore even these blatant links, then the informational efficiency of prices to reflect more complex pieces of information is potentially less likely.

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