Bubble Investors: What Were They Thinking?

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Behavioral Finance...

- Cognition matters.
- Hard to get into the mind of the investor.
- Let’s ask them.
Polling Investor Thinking

- **Benefits**: Contextual, actual decisions.
- **Drawbacks**: depend on framing and recollection – retrospective biases.
- Bob Shiller’s Investor Confidence Surveys.
- Ivo Welch’s surveys of finance professors.
- MIT studies of investor physiology.
This Study

- A class-action lawsuit.
- Point of law: class definition hinged in part on whether investors *believed* the market was efficient.
- Also, whether they conditioned decision upon the stock price.
- Our role:
  - Assess beliefs about efficiency.
  - Assess motivations for trade.
  - Consider the general and the particular.
Results

- Evidence inconsistent with belief in the Efficient Market Theory.
- Strong belief in the value of personal and professional equity research.
- Price trends matter to valuation.
- Belief in *over*-reaction to news.
- Rational bubble beliefs.
Efficient Market Beliefs

- **Weak form:**
  - past price trends not useful.

- **Semi-strong:**
  - public news rapidly and fairly impounded in prices.
  - Stocks are not “over-valued” or “under-valued”
  - Personal research
Methodology

- Telephone questionnaire
  - Just before no-call lists
- Stock near its peak in 11/1999
Target America

- Affluent pool, philanthropic giving
- 156,319 called
  - (very expensive!)
- 16,733 spoke to us and qualified
  - (amazing number of buyers of the stock)
- 845 completed the survey
  - (5% response rate)
- High standards of monitoring, randomization of questions etc.
Sample Bias?

- Buyers of individual stocks. Speculators by definition?
- Buyers of telecom in late 1999-early 2000. Speculators by definition?
- Wealthy individuals – educated?
- Inference about broad population.
How likely is that the price of an individual stock is higher or lower than its true value?
Which factor that you rely on in determining whether the price of a stock differs from its intrinsic value is the single most important?

- The long term trend in the stock's price, say its price over the past 3 years
- The short term trend in the stock's price, say its price over the past 3 to 6 months
- The 52-week high and 52-week low price for the stock
- Opinion of my broker/financial advisor
- My own research on company's financial information
If the price of the stock is close to its 52-week high price, does it indicate to you that the stock is...
If the price of a stock is close to its 52-week low price, does it indicate to you that the stock is...
If the long term trend in the stock price, say its price over the past 3 years, shows an steady increase, does it indicate to you that the stock is...
If the long term trend in the stock price, say its price over the past 3 years, shows an steady decrease, does it indicate to you that the stock is...
From your own research on a company, how likely are you to identify stocks that are either undervalued or overvalued?
Thinking in general about stocks prices and how they change in response to the release of news and public announcements about a company, do you think the price of a stock tends to...

- Over react a good deal
- Over react somewhat
- React about the right amount
- Under-react somewhat
- Under-react a good deal
- Don't know/ it depends
How often have you purchased a stock that at the time seemed over valued but you purchased it any way because you thought that the price was likely to go even higher?
Thinking back to the FIRST time when you made your purchase, did you believe at the time of purchase that the price of stock X was ...
Which one reason that you rely on in determining that Stock X was overvalued at the time of the FIRST purchase was the single most important?

- The long term trend in the stock’s price, say its price over the past 3 years
- The short term trend in the stock’s price, say its price over the past 3 to 6 months
- The 52-week high and 52-week low price for the stock
- Opinion of my broker/financial advisor
- My own research on company's financial information
Did you purchase Stock X anyway because you expected the price to continue go higher, to diversify you portfolio or for some other reason?

- I expected the price to continue to go higher
- To diversify my portfolio
- Other
- Don't know/ No Answer
A "bubble" is defined as a time when stock prices are considerably above their true value. In your opinion, was the recent peak in telecom share prices...?
Conclusions

- This group holds beliefs contrary to EMH.
- Beliefs consistent with a model of personal research identifying under-valued and over-valued securities.
- Signs of contrarianism.
- Direct admission of bubble investing.