Irrational Markets

For the past several decades, an interesting question that causes an ongoing debate, both between academics and practitioners, is whether or not stock markets are efficient. Proponents of the Efficient Market Hypothesis (EMH) claim that stock prices incorporate all available information as soon as it becomes publicly available, and hence it is not possible to outperform the market by active management since all stocks are fairly priced. On the other hand, there are also people who claim that this is not how markets work, and that there are plenty of indications that markets can at times structurally misprice assets with the consequence that stock prices are not reflecting the fair value of a company anymore. In the light of this question, there is an interesting discussion on the Chicago Booth Review website between Eugene Fama and Richard Thaler about this very question, representing two expert views of opposing sides. Thaler, who debates against the EMH, uses the price of a closed-end mutual fund with the ticker symbol “CUBA” as an example of a bubble. This fund had a valuation of around 85%-90% of its NAV for a long time, when suddenly its price rose to 170%. Unsurprisingly, this was the same day that President Obama announced his plans to improve the US’s relationship with Cuba, although the fund had of course no exposure to the country. The only link with the country was the ticker symbol. Fama, who developed the EMH, defends his position against Thaler’s example by noting that it is just an anecdote or a curiosity in the market, which does not imply that anything is structurally wrong. So in any case, there seems to be a consensus that occasional irrationalities or curiosities do exist in the market. Knowing this, it becomes interesting to question to what extent these examples are exceptional and, even if they are, whether they could be predictable.

A paper zooming in on a whole category of these examples is written by Cooper, Dimitrov & Rau (2001). They investigated the stock price reaction for companies when they announce the change of their name to an internet-related dotcom name and found a cumulative abnormal return of around 74% for the 10 days around the day of the announcement. Furthermore, they did not see any sign of this effect being only temporary, and more interestingly, the effect was similar for companies regardless of the extent to which they were actually engaged in internet-related activities. Based on these findings, they noted that price effects do suggest some irrational behaviour from investors. The crash of the markets after the spring of 2000 does indeed point in that direction, although it is dangerous to make such statements in hindsight.

An interesting detail about this study is that they found no less than 147 companies changing their name in an internet-related way over the course of 14 months. Although this is still a small number compared to the total amount of public companies, it does become a bit more difficult to speak of an isolated anecdote in the market. When talking about the dotcom name changes in the ‘90s, comparisons with the current blockchain popularity are never far away. It is not too hard to find examples of companies that more recently changed their name into something blockchain-related and witnessed a big surge in stock price. On-line Plc, for example, announced plans to change its name into On-line Blockchain Plc during the past October, and subsequently gained 394% in one day. It is important to note that they were unable to say much more than that their blockchain-related product was still in a very early stage. In short, it seems that just mentioning that you are considering to jump on the wagon is enough to almost quadruple the market value of a company.
Another example could be found in Bioptix Inc, which also nearly obtained a triple-digit rise after announcing to change its name into Riot Blockchain Inc. More broadly, Quartz published a list on their website of 12 stocks of companies that changed their names into something blockchain-related in 2017 and traded over 300% higher than their 2017 low. The most spectacular example is Bitcoin Services Inc, where they report a whopping 42,500% difference between the 2017 high and low. The frequency of these occurrences paints a similar picture to that of the dotcom case, meaning that when explaining how an overall market behaves, you could potentially regard the examples as anecdotes, but when looking for market opportunities, they do occur often enough to be worthwhile investigating.

That brings us to the second question of whether there can be some predictability in the price patterns that could make it possible to take advantage of such dynamics. Zooming in on the Bitcoin Services example for this purpose, it is interesting to see that while the company changed its name as early as March 2016, its stock price only surged more than a year later. This large time lag might not occur in the majority of these cases, but it certainly is possible and helps to make the point below.

Given the nature of the company, its website provides little to no information about what they actually do, and in its 20-year history, it has already changed its name into Direct Music Group, Cell Bio-Systems and Tulip Biomed, etc. It seems hard to believe that investors actually picked up some underlying value in the company. A more plausible explanation is that the price of the stock might just have profited from the bitcoin hype that has characterized 2017. This is of course just one example, but there are similar cases to be found of companies that do not really have concrete results to show for and also experienced this surge in stock price after loosely affiliating themselves with blockchain somehow. However, there are companies that do have some very concrete projects that provide the opportunity to create value with the blockchain technology, and what is said here does not encompass these latter ones.

So, when you see the hype taking off, is it irrational to buy these type of stocks since it is not based on fundamental underlying value? After all, it may be reasonable to assume that others will buy it just because of the hype and don’t care about fundamental underlying value, driving up the price regardless. To answer this question, we have to point out the paradox...
here, because it can be argued that you might rationally expect others to buy the stock in the future, but your expectation is based on the irrational behaviour of others, which in turn makes your own actions somewhat irrational. This situation is the exact definition of a bubble, and the fact that there inevitably has to be someone who buys last before the bubble bursts makes the whole system quite dangerous to join. But that does not necessarily make it impossible to profit from these dynamics, you just have to be good at recognizing trends before the big masses do and have the discipline to get out in time, which might be the hardest of the two conditions.

This is not really how markets are supposed to work according to the EMH. In the aforementioned cases, there is no particularly new information available that can greatly impact the value of the company. However, it is a good example of the law in finance that says the greater the risk you take, the higher your expected reward will be. What should always be remembered is that you run the big risks of being the last to buy, or that the hype will not take off the way you expected it to after all. On the other hand, since some of the returns can run so high, it is acceptable to also lose a sizeable portion of your bets. Investing in companies like Bitcoin Services or buying stocks from other companies that change their name into something related to the latest hype, will undoubtedly have paid off very well for some investors, while others will have lost a lot of money on it as well. But in a sense, because of the lack of link to fundamental underlying value, strategies trying to take advantage of these dynamics start to look more like pure gambling. Although there will always be uncertainty about the future, this is not what you would expect to be happening on the stock market.

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Sources

Chicago Booth Review, Bloomberg, Quartz, Investing.com

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