

(WallStraits.com, www.wallstraits.com, May 2002)

Investor Psychology Series
IPO Euphoria

Today's quiz...

1. What are the chances of tossing 10 straight heads with a fair coin?
2. What are the odds a fund manager will beat the index?
3. If a particular fund manager has beaten the index two-thirds of the time, which future performance record is most statistically probable (where B is beat the index, and M is missed benchmark)...
(a) BMBBB, (2) MBMBBB, or (3) MBBBBB?

Answers: (1) About 1 in 1000, (2) About 1 in 10, and (3) a.

These are interesting questions for behavioral finance psychologists. The first question shows how context is critical to conclusions. For example, if one person tossed 10 straight heads, with your newfound knowledge of the odds, you may ask to inspect the coin. However, if one fund manager among 5,000 created a track record of beating the index 10 straight years, you may consider it within the realm of probability...a rare combination of skill by the manager and a large dose of luck. The luck is usually underestimated by investors who read fund advertisement, as the second question confirms any given fund manager has a slim chance to beat the index this year regardless of their past track record.

The third question deals with the difference between *representativeness* and *probability*, which are not synonymous. While answer b is most representative of the past track record (two-thirds), answer a is actually more statistically probable. Investors often misjudge how often departures from one's own average performance occur.

IPOs: Short-term vs Long-term Stories

Behavioral finance psychologists usually focus their IPO market studies around three phenomena: (1) initial underpricing, (2) long-term underperformance, and (3) hot-issue markets.

Initial underpricing occurs when the offer price is too low, thus positioning the stock to soar on the first day of public trading. Of course, underpricing also all but eliminates the risk on the part of the underwriter to place or sell the new shares. The early euphoric rise in shares can often propel the stock price above fundamental values, thus leading to longer-term underperformance as it retreats back to reality.

Hot IPO markets come and go. One of the hottest ever was the United States in 1998. The biggest first-day gain ever was recorded by web page provider theglobe.com, which was offered at \$9/share and rose to an intra-day high of \$97 before closing at \$63.50, a first day gain of 606%! But the best performing IPO for 1998 was online auction service eBay, which rose from an offer price of \$18 in September to finish the year at \$241.25, a gain of 1,240%!

Longer-term there is data to show that IPOs underperform for many years. A study by Loughran and Ritter (1995) tells us that IPO issues underperform the general market by 7% per year for each of the first five years of trading. Commonsense tells this should be expected. After all, when does an underwriter and a private company get excited about developing an IPO? When the market and a particular sector is out-of-favor? Not hardly, but when investors are excited about the market and a particular sector--thus the share can be marketed while overvalued.

Final Words

As we wrap up this week's 5-part article on behavioral finance, and the psychology at work in the stock market, remember that recognizing behavior is the first step towards modifying behavior. Be on the lookout for personal qualities of yours,

especially the dangerous tendencies we all have towards gambler's fallacy, loss aversion, and lack of self-control. Most of all, try not to succumb to overconfidence.

While markets are occasionally inefficient and offer investors the opportunity to profit by exploiting such mispriced equities, behavioral finance emphasizes that smart money investors, who are free from overconfidence, do not try to exploit every mispricing opportunity they see. The smart money investor: (1) distinguishes luck from skill to stay humble, (2) recognizes that the mistakes of other traders produce an extra source of risk as well as a potential profit opportunity, and (3) knows that only some risks are worth taking. Don't take this lightly, remember, evidence shows that 90% of us are overconfident!

Sage@wallstraits.com

*The author, Curtis J Montgomery, is no psychologist, and thus has committed most of the illogical mistakes we will discuss this week. These ideas are gleaned from a book by Hersh Shefrin, *Beyond Greed and Fear*, published in 2000 by Harvard Business Press.*