How Companies Profit From Our Mistakes

Alex Edmans
Mercers School Memorial Professor of Business
Gresham College

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The Dot.Com Bubble

- AppNet Systems filed for an IPO under the symbol APPN
  - Investors started buying Appian Technology, traded on Nasdaq OTC under APPN, even before AppNet's IPO
  - 200 shares were traded the day before filing
  - 7.3 million shares traded in the two days after
  - Stock price rose 142%

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The Dot.Com Bubble

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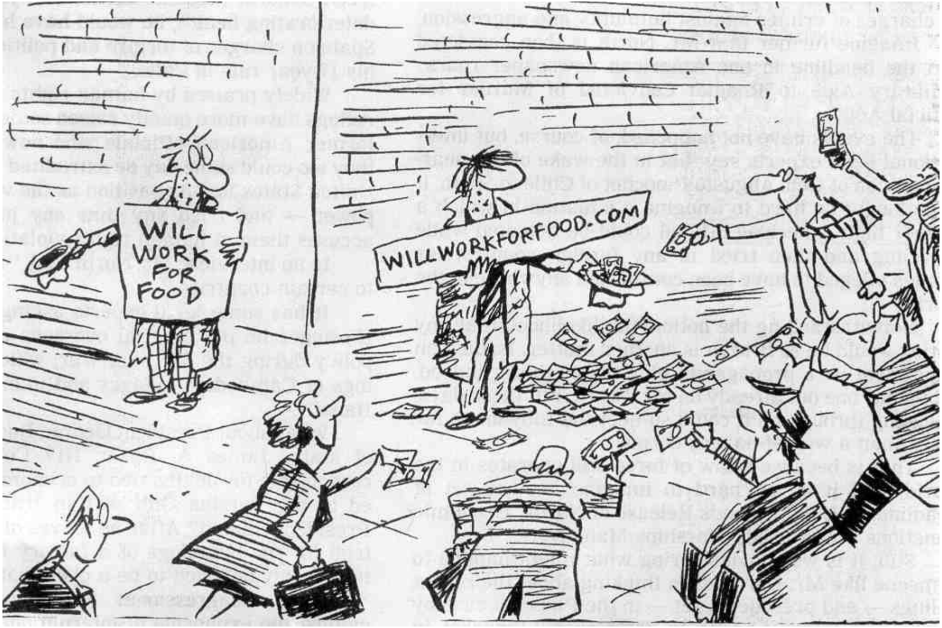
  - 200 shares were traded the day before filing
  - 7.3 million shares traded in the two days after
  - Stock price rose 142,757%
- Computer Literacy, Inc. changed its name because customers misspelled its URL computerliteracy.com
  - Changed its name to fatbrain.com, stock price rose 33%

Exploiting the Dot.Com Bubble

- Adding ".com" to your name between June 1998 and July 1999 yielded returns of 74%[1]
  - Even if firm had nothing to do with the internet
  - False value creation of $26b across 183 firms
- Halo effect, categorisation

1. Cooper, Dimitrov, and Rau (2001)


WILL WORK FOR FOOD
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Exploiting the Dot.Com Crash

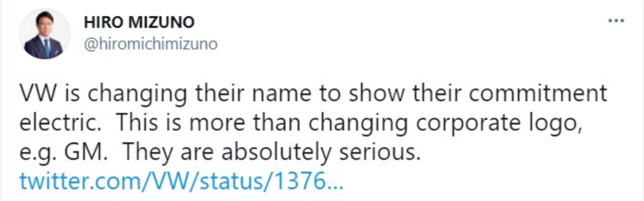
- Removing ".com" from your name between August 2000 and September 2001 yielded returns of 64%[1]
  - Even if you kept your Internet business focus
  - False value creation of $5.5b across 67 firms

1. Cooper et al. (2005)

The Coronavirus Pandemic

- Demand for Zoom video conferencing rose in the pandemic
- Zoom's ticker was ZM, but investors bought ZOOM
  - Zoom Technologies, a defunct Chinese wireless company
  - Shares rose 1,500%

The ESG Bandwagon



- Stock price jumped 12%
- But an April Fools' joke

Mutual Fund Names

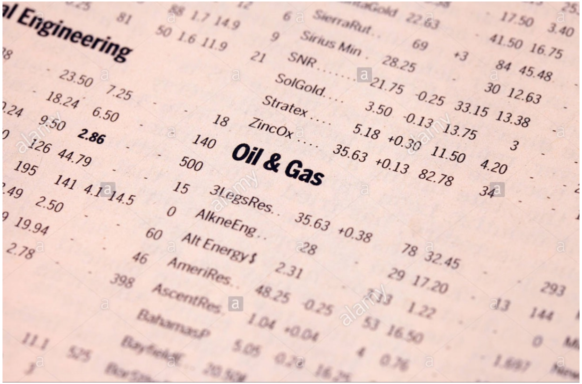
- Gabelli Global Interactive Couch Potato Fund
  - Earned 116% in 1999
  - But fewer inflows than other funds with similar returns
  - Changed name in 2000 to Gabelli Growth Fund
- A year changing name to reflect a current hot style
  - New flows increase by 28%
    - Regardless of whether holdings match style implied by new name
  - No improvement in performance
- Solution: look beyond the name to what the company / fund actually does

1. Cooper, Gulen, and Rau (2005)

I: Window Dressing

Industry Window Dressing

- Humans like labels, classifications
  - Stock are classified into an industry



Industry Window Dressing

- Industry choice matters
  - Some industries have higher valuations
  - Some mutual funds specialise in certain industries
  - Some industries have more analyst coverage
- Firms close to a 50-50 cutoff are disproportionately likely to tilt sales to favourable industry
  - No jumps anywhere else
  - Firms just above 50% cutoff have lower segment profit margins and inventory growth rates
    - No difference in investment – not a firm-wide shift to favourable industry
  - Future earnings restatements

1. Chen, Cohen, and Lou (2016)

Industry Window Dressing

- How the company benefits
  - Announcement returns of 1.4%
  - 41% more likely to issue equity
  - 20% more likely to undertake stock-financed M&A
  - CEOs are 42% more likely to exercise stock options

1. Chen, Cohen, and Lou (2016)

Industry Window Dressing In Reverse

- 3Com owned Palm, but was given little credit for it
- Floated 5% of Palm on the market; worth more than the whole of 3Com
- 3Com = Palm + Other Businesses

  -$22 billion

- Solution: look beyond the primary classification; do a sum-of-the-parts

1. Lamont and Thaler (2003)

II: Catering

Catering Through Investment

Catering Through Investment

- Companies invest more when stock price is overvalued[1]
  - Particularly if opaque (high R&D intensity)
  - High investment linked to low future returns
- When "high investment" firms trade at a premium to "low investment" firms, they overinvest even more and have even worse future returns

1. Polk and Sapienza (2009)

Catering Through Dividends

- Pay dividends when "payers" trade at a premium to "nonpayers"; stop dividends when "payers" trade at a discount"[1]
- Dividend premium rises in crashes (flight to safety), falls in booms

1. Baker and Wurgler (2004)

Juicing the Dividend Yield

- Investors like dividends
  - Potentially for irrational reasons[1]
- Mutual funds buy stocks just before they go ex-dividend, and selling after (even the next day)
  - Funds with dividends 1/3 higher than what long-term holdings would imply underperform by 2.1%
  - Saddle investors with 0.6% extra taxes

1. Hartzmark and Solomon (2019)
2. Harris, Hartzmark, and Solomon (2015)

Catering Through Focus

- In 1966-1968, conglomerates traded at a 36% premium to focused firms[1]
  - Conglomerate mergers peaked in 1968[2]
- Conglomerates started trading at a discount from the mid-1970s
  - Companies started divesting unrelated businesses[3]

1. Klein (2001)
2. Ravenscraft and Scherer (1987)
3. Kaplan and Weisbach (1992)

III: Exploiting Misvaluation

Issuing Equity

- If you know your firm is overvalued, sell shares
- 5 years out, the average IPO underperforms by 30%, SEO by 29%[1]
- Why don't investors realise this?
  - Irrational
  - Could be for innocuous reasons, e.g. to finance investment

1. Ritter (2003)

Creating Disguise

- "AOL stock was ridiculously overvalued ... Case … chose the moment, almost to the day, when his stock was most valuable and then used it as currency. He served his shareholders well. It was Time Warner that sold itself for wampum."[1]

1. Geoffrey Colvin, *Fortune*

Stock-Financed M&A

- Create disguise by issuing shares to buy other companies
- Cash acquirers earn positive returns; stock acquirers earn negative returns[1]
  - But negative returns don't mean that the deal was bad
  - Shares fall by less than they would have otherwise[2]
- Acquirers are more overvalued than targets; overvalued acquirers more likely to use stock[3]

1. Loughran and Vijh (1997); Rau and Vermaelen (1998)
2. Savor and Lu (2009)
3. Dong, Hirshleifer, Richardson and Teoh (2006)

IV: Exploiting Consumers: Pricing Schemes

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Shrouded Attributes

- If consumers are rational, they'll either look up add-on prices or take shrouding as a negative signal
  - But consumers are myopic or unaware
- Why don't competitors shine a light?[1]
- Costs a hotel £100 to provide a room
  - Opaque charges £80, plus £20 hidden add-ons
  - Transparent charges £100 with no add-ons; adverts with "Watch out for Opaque"
  - But then consumers will *prefer* Opaque and substitute away from add-ons (e.g. bring own alcohol)
  - Debiasing is good for the consumer and bad for both hotels, so neither has an incentive to do it

1. Gabaix and Laibson (2006)

Application: Mutual Funds

- Historically, fees were a shrouded attribute; now known that customers should consider them

  Laudus U.S. Large Cap Growth Fund **LGILX** NO LOAD NO FEE

- Initial charge ("load") and commission are salient
- Annual management charge less salient
- Negative relationship between fund flows and initial charge
  - Seasoned purchasers pay half the initial charges of first-time purchasers, suggesting learning
- Zero/positive relationship between fund flows and AMC
  - No difference between first-time and seasoned purchasers

1. Barber, Odean, and Zheng (2005)

Pricing To Exploit Biases

Experience goods
Immediate costs
Delayed benefits

Leisure goods
Immediate benefits
Delayed costs

Overconfidence About Self-Control

Experience goods
High fixed fee
Low variable fee

Leisure goods
Low (even negative) fixed fee
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Paying Not to Go to the Gym

- Members who pay a monthly fee of $70 attend 4.3 times per month = $17 per visit[1]
- Could pay $10 per visit with 10-visit pass
- Forgo savings of $600 per membership, out of $1,400 paid to the gym
- Solution: self-control devices, e.g. Gresham lecture on "Mental and Physical Wellness"

1. DellaVigna and Malmendier (2006)

Overconfidence About Cancellation

- Cancellation is costly; companies intentionally make it hard to cancel
  - E.g. call (and wait in line) rather than click
- Gym users with a monthly contract are 17% more likely to stay after a year than annual members
  - Monthly contract is more expensive due to option to cancel, but users overestimate ability to cancel
  - Annual users should be more dedicated to the gym, so results should be opposite

1. DellaVigna and Malmendier (2006)