Journal of Behavioral Finance ›
Volume 5, 2004 - Issue 2

Original Articles

The Influence of Affect on Investor Decision-Making

David Dreman

Pages 70-74 | Published online: 07 Jun 2010

Cite this article https://doi.org/10.1207/s15427579jpfm0502_1

The Journal of Behavioral Finance
2004, Vol. 5, No. 2, 70–74

EDITORIAL COMMENTARY

The Influence of Affect on Investor Decision-Making

In the editorial in Volume 4, Number 4 (2003) issue of this Journal, the writer attempted to link some of the more recent affect research to specific investor decision-making that seemed pertinent to the disconnect between prices and values of high-tech and dot.com stock during the1997–2000 bubble, and again in the current mini-bubble. These affect findings appeared to provide some good answers to consistent, but to date unexplained, investor behavioral patterns. The current piece will attempt to provide further insight into other characteristics of the affect heuristic which also appear to impact investor decision-making. The analysis will first examine a number of well documented investment anomalies, and then attempt to explain what part affect played in investor decision-making in each case.

Investor Behavior to Initial Public Offerings

The first case is a look at investor behavior to initial public offerings in four separate market periods since the late nineteen fifties. While the first three bubbles were not of the magnitude of the 1997–2000 Bubble, investor behavior seemed very similar, if not identical.

Conventional Financial Theory holds that IPO's should be offered at a small discount to their actual value, in order to ensure the successful salability to investors. Figure 1 demonstrates the significant overpricing of IPOs during the 1998–March 2000 Bubble. As Figure 1 indicates, the average IPO was priced at a premium of 10% or under the first day's closing price for the eight years from 1987 through 1994, in line with the small discount expected for IPOs. As Figure 1 indicates, during the years 1987–1994, the average IPO's offering price was 10% at most below the first trading day's close, in line with the small discount expected for IPO's. Over the next four years, premiums expanded significantly, averaging somewhat under 20%. This significant appreciation is by itself enough to steer many investors away from more conventional investment returns into the far more speculative arena of IPOs. Speculation dominated 1999 and the first three months of 2000 with the average IPO rising by a staggering 90% and 95% respectively at the close of the first day's trading. Moreover, for the first three months of 2000, the peak of the Bubble, the average closing price of IPOs of dot.com stocks (not shown in the figure) increased 135% from the original offering price, to the close of the first day's trading.

One of the most notable characteristics of a bubble is that the normal guidelines used to evaluate a company's value are bypassed or short-circuited by analysts, money managers and other professional investors. The premiums on IPOs in the late 1990s, as noted above increased to as much as ten to twelve times the average premiums over the longer term. The fundamentals of this group of IPOs were certainly no better, and judging by the high rates of failures, likely a good deal worse than IPOs of earlier time periods.

Since the late 1950's, no fewer than four major IPO bubbles have occurred, with the 1990's surpassing any in the past in terms of both its magnitude and its price appreciation. In all four bubbles, each new issue had some cutting edge product or service investors believed was absolutely guaranteed to make money. In the IPO market of the early eighties, one of the captivating images was that of new pharmaceuticals and other products that would come from genetic engineering, along with major breakthroughs in computer technology, including the introduction of the PC. In the 1966–69 IPO Bubble the image was of unlimited growth in the semi-conductors, computer peripherals, computer service companies and health-care issues. All in all, the concepts that captivated investors in the Bubble of the late sixties were not very different from the IPO Bubble that began in the mid-1990's. Back then as in the 1990s, technology ruled supreme. The U.S. was soon to put a man on the moon and the possibilities of various forms of technology growth seemed unlimited.

People do not appear to accurately gauge the risk of IPOs during periods of significant appreciation, or the enormous dilution of their capital when they purchase IPO's. Caginalp, Porter and Smith [2002] for example noted that the prospectuses of many high-tech IPO's stated that the initial shareholder equity would be diluted by a factor of 20 due to the ownership of 95% of the shares by the founders of the company. In other words, shareholders paying $ 10 per share would see an immediate drop of the book value to 50 cents minus expenses!

Related Research

People also read | Recommended articles | Cited by 8

Factors Influencing Individual Investor Behavior

Robert A. Nagy et al.
Financial Analysts Journal
Published online: 31 Dec 2018