

The Cynical Wisdom of Crowds: Implications of Behavioral Research for ICT Company Financing

Or, why Warren Buffett doesn't invest in tech stocks
(but maybe should)

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A cynic is a man who knows the
price of everything and the
value of nothing

- Oscar Wilde



In the short run the market is a
voting machine, in the long run
it is a weighing machine

- Benjamin Graham

Value investors agree with efficient market theorists that value is a function of cash flows

$$\text{Value} = \sum_t \text{Cash Flow}_t / (1 + r)^t$$

They simply disagree on whether this determines the price

EMT: market dynamic drives price to value



Graham-Dodd: investors buy when value > price



Market prices, information cascades and the value of future cash flows

- Falling market prices might trigger bank runs
- Customers want to choose popular technologies that will continue to be supported (e.g. network effects)
- Stock-based compensation affects employees
- High-valued equity can be used as a strategic weapon

Feedback effects in theory*

- Greater when complementarities are high, but relationships between firm and stakeholders are not well established (Subrahmanyam & Titman, 2001)
- Affected by liquidity and the availability of information (Ozdorenen & Yuan, 2008)
- Might result in higher expected returns for speculators using *complementary* strategies than for investors using *substitution* strategies (Hirshleifer, Subrahmanyam & Titman, 2003)

* Warning: inappropriate use of theoretical models has been linked to the occurrence of highly contagious cancers in financial institutions

Complementary strategies are rational in coordination games

- Coordination is aided by psychologically salient focal points (aka sunspots)
- The tendency to “chase experts” suggests that investors use behavior of “smart money” as one type of focal point
 - Venture capitalists
 - Board members and senior management
 - Underwriters
 - Informed investors

Feedback effects in practice

- Securities offered by firms can (and often should) be marketed as a product line
 - Branding represents a psychological premium in price relative to “value” that is related to the “representativeness” heuristic
- Focal points and equity brand equity
 - Complementarity Part I: the dominance of the dumb and the debate over option expensing
 - Complementarity Part II: the Matthew effect