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MONEYBEAT BLOG

# The Stock-Market Price Can Be Wrong. Very Wrong.

Researchers have caught investors in the act of wildly--and unnecessarily--overpaying for a stock

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If you could buy the same stock in two different ways, one of which cost up to nine times as much as the other, you would pick the cheaper way.

Wouldn't you?

Perhaps you shouldn't be too sure.

In a new study, finance researchers have caught investors in the act of wildly -- and unnecessarily -- overpaying for a stock. In effect, investors paid as much as \$9.07 for shares that they could have bought at the exact same time for \$1 instead. That casts some doubt on the idea that financial markets are efficient. It should cast more doubt on whether all investors, including you and me, are as shrewd as we think.

The study is based on a peculiar transaction that occurred on the Euronext stock exchange in Amsterdam in 2014. That October, Dutch engineering-services firm Royal Imtech NV was struggling to survive. To raise capital, Royal Imtech announced a rights offering, enabling investors to buy new shares at a discount to the market price.

The rights offering worked like this: For each share they owned, stockholders who subscribed to the offering got the right to buy another 131 shares at only 0.01 euro apiece.

Yet, during the offering period, Royal Imtech stock closed as high as 0.1 euro per share. By purchasing shares on the market instead of buying them through the rights offering,

investors were paying up to nine times more than they needed to. (Even if you didn't already own the stock, you could obtain rights by buying them on the exchange from a Royal Imtech investor.)

Rights offerings are rare among operating companies in the U.S., with none since the beginning of 2017 and a total of only 11 since 2009, according to Dealogic. They are less unusual among closed-end funds in the U.S. and more common in Europe.

Shareholders often fail to participate in rights offerings, presumably because stocks are much more familiar and it takes a little effort to figure out what rights are worth.

As a result, many investors seem to have overlooked the Royal Imtech deal entirely; 48% of the rights offering went unsold, according to Martijn van den Assem, a finance professor at Vrije Universiteit Amsterdam and co-author of the study. Investors kept buying the stock the same way they always had, oblivious to the opportunity the rights gave them to buy it at a fraction of the market price.

That turned out to be costly; by late October 2014, investors who had paid up to 0.1 euro per share were left with stock trading at only 0.017 euro. Royal Imtech declared bankruptcy in 2015.

“If people avoid the unfamiliar and the uncommon and they aren't perfectly attentive,” says Prof. van den Assem, then what happened with the Royal Imtech offering “isn't super-puzzling.”

So are investors stupid or irrational? Neither: We are human. We have many demands on our time and attention, we hate thinking harder than we need to, and we chronically take mental shortcuts and leap to conclusions. A slightly more complicated way to buy a stock feels like a worse way. So we don't bother with it.

Royal Imtech is only the latest violation of what economists call “the law of one price,” which holds that identical assets shouldn't trade simultaneously at different prices, regardless of where they change hands.

In 1999, for example, 3Com Corp. spun off Palm Inc. You could buy Palm shares directly in the open market, or you could buy them indirectly by purchasing 3Com stock. For

each share of 3Com, you would get 1.5 shares of Palm.

Yet on the offering date, you could get one share of 3Com for \$82, with 1.5 shares of Palm thrown in for free -- at the very same time as other investors were willing to pay \$95 for a single share of Palm. (The risk that the deal might not have gone through, and the costs of betting against it, might explain part of the oddity.)

Likewise, in the roaring stock market that preceded the great crash of 1929, it was common for closed-end funds to trade for double or even triple the per-share value of the stocks and bonds they held. Investors acted as if such leading stocks as Radio Corp. of America, Studebaker Corp. and Wright Aeronautical Corp. were worth two or three times as much inside a fund than outside it -- on the illusory belief that skilled stock pickers could make diversification and high returns easier to achieve than investors could on their own.

All this is a reminder that market prices are shaped by the tension between sophisticated, informed and attentive investors, on the one hand, and naive, unknowing and uninterested investors on the other.

The same mechanism that overpriced Royal Imtech by nine-fold also fostered the internet-stock bubble that burst in 2000 and the crisis that nearly destroyed the global financial system a decade ago.

Markets are mostly efficient most of the time. They aren't perfectly efficient all the time.

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