Why Volkswagen share price slump goes beyond market logic

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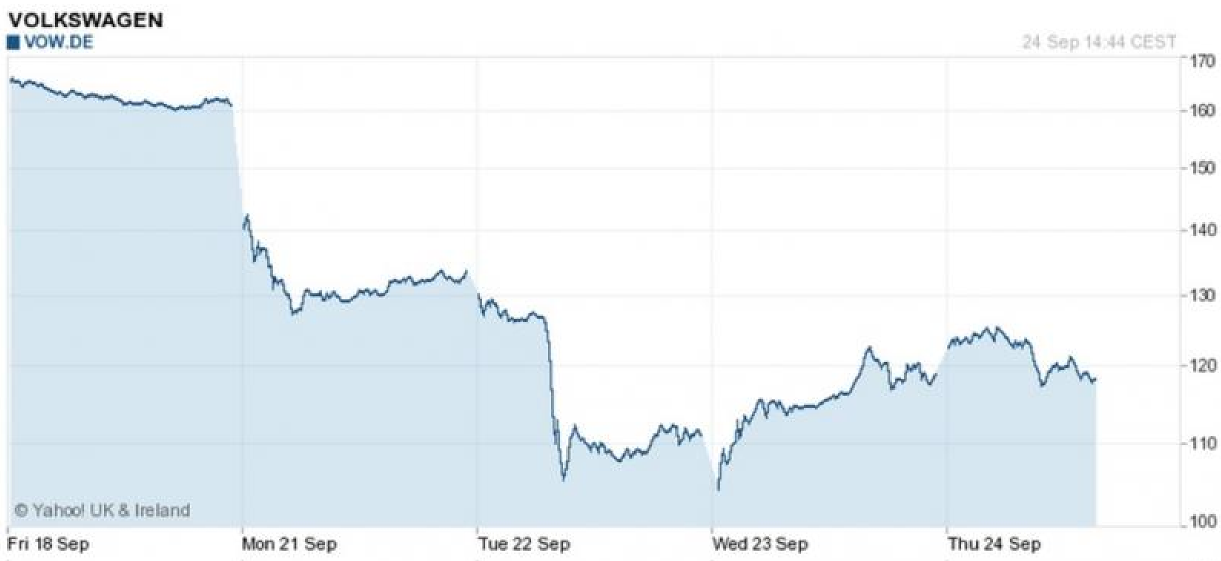

The share price slump. Credit: Yahoo Finance

It has been an extraordinary week for Volkswagen managers and investors alike as markets issued their punishment for the company's admission of emissions test cheating. Standard financial economics theory states that trading trends are based on rational investors' expectations of future cashflows, discounted back to wherever the stock had got to at that point. But has the VW share price reaction followed that rationale?

In the immediate aftermath of the news, when details were spare and traders at their most skittish, there was a sharp 25% wiped off of the VW share valuation. There has been a further drift downwards since: to date, approximately 30% has been wiped off of the share valuation.

But is this a pure assessment of economic fundamentals, or are there extra factors at play here? Behavioural economists may ask: how much of the negative reaction is based on emotions, such as disgust, despair, abhorrence, at such unethical behaviour? It has long been recognised that investors have complex motivations behind their stock purchase decisions.

Confidence is a preference

Investors are heterogeneous in their behaviour and preferences. Some are primarily focused on the pure economic fundamentals of companies. However, a growing proportion of investors focus on issues beyond the pure economics. They might look at issues such as a company's ethical behaviour, social impact, corporate social responsibility policies or its environmental behaviour. They might also consider the treatment of its other stakeholders (customers, employees, the surrounding community, the planet!).

A key issue for many investors is the confidence that they have in the trustworthiness of the company management. Thus, there is much evidence that many investors (sometimes termed ethical investors, "green" investors, social investors) are prepared to pay a price premium (and are thus prepared to take a hit on returns) for shares in companies that are committed to acting in a socially responsible, ethical, fair, environmentally and stakeholder-friendly, and trustworthy manner. One recent report suggests massive growth in ethical investing in the US alone, and the sector's success means that some of its priorities have started to bleed into mainstream investing.

On the other hand, companies who appear to act in the contrary manner (tending towards the unethical and untrustworthy, and with little regard for stakeholders, the environment, and the wider community) face the danger of extreme negative investor reaction, as VW has found to its cost. Evidence shows that trust is easy to destroy, but much harder to re-build.

Reputational cost

It has been argued that the sharp negative stock reaction to VW's unethical behaviour far exceeds the potential economic effects on its future cashflows. In other words, the negative reaction dwarfs the expected litigation costs. However, the situation is more complex than just examining the immediate negative costs. Such behaviour also damages both investor and consumer trust in VW's future integrity, and that means markets must factor in reputation costs to the share price discounted cashflow formula.

So, both litigation and reputation costs can be considered as economic factors in the price reaction of VW shares. It is interesting to consider whether, in addition to these factors, a large element of the 33% fall in share value is due to negative behavioural and emotional feelings towards the company (investor and consumer disgust and abhorrence at such unethical behaviour).

You might imagine the stock market trader as a calculating, implacable beast, buying and selling based on logic alone. However, a recent development in scholarly research, emotional finance, conceptualises how unconscious emotions may affect investor attitudes towards a stock. This approach focuses on the "love" that investors have when initially investing in a favourite and trusted company There then comes a tipping point (such as VW's unethical behaviour) where like a jilted lover, an investor switches sharply to hate of the company shares, sparking massselling, and massive share price reductions beyond the fundamentals.

Shareholder value

The economist, Milton Friedman, once famously argued that the only ethical and moral responsibility a company has is to its shareholders. He reckoned that the board should act to maximise shareholder wealth, even if that is at the expense of other stakeholders, and the planet.

VW may have even believed that it was following this mantra when it engaged in the emissions testing manipulation. It has been argued that the company was facing extreme competition from other car manufacturers, and emission -testing was extremely tough, so they may have believed that this justified their behaviour in terms of maintaining market share, and upholding shareholder value.

However, as we have witnessed this week, the financial markets have passed their crushing judgement on the emissions fiasco, and the slump in share value probably combines economic and emotional factors, as investors demonstrate their shock at the behaviour on show.

It is a useful reminder that for shareholder value to retain any relevance, you must imagine that the shareholder will still own the stock when the chickens come home to roost – or when a clean air NGO calls you out on some dodgy software. A failure to understand that simple fact has left VW facing a long battle to restore investor trust and confidence in its integrity.

Source: The Conversation

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