Why do investors seek out stock swindles?

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Credit: University of Chicago

The chance to get rich quick by investing in a penny stock, even if it is widely suspected that the stock price is being manipulated, is too tempting for some investors to resist.

New research from the University of Chicago Booth School of Business finds that some investors actually seek out stocks suspected of "pump-and-dump" schemes, despite the risks and warnings from financial experts, in hopes of winning big, akin to the lottery.

In the working paper, "Who Falls Prey to the Wolf of Wall Street?

Investor Participation in Market Manipulation," from Chicago Booth Professor Christian Leuz, Leibniz University of Hanover's Steffen Meyer, Humboldt University of Berlin's Maximilian Muhn, Harvard's Eugene Soltes and Goethe University of Frankfurt's Andreas Hackehtal, the group of economists examine the German stock market, asking who invests in these schemes and how often.

Contrary to the popular understanding that people who invest in these stock schemes are duped into doing so, the researchers find evidence that some investors participate knowing the risks, taking a gamble that they will eventually win big.

"We identify several distinct types of investors, some of which should not be viewed as falling prey to these frauds," the researchers say in the paper. "For these investors, speculation or gambling are more likely to be the motive."

Few strategies for financial fraud are as broadly familiar as pump-and-dump schemes—in which promoters acquire a position in a cheap stock that is highly illiquid and artificially raise the price by disseminating false or misleading information. The limited liquidity leads to fast price increases when demand for the stock rises. Once the stock reaches a high enough price, the promoters sell their shares causing a rapid decline in the share price and significant losses for other investors.

The tactic is common in capital markets around the world, and have featured prominently in films such as The Wolf of Wall Street and Boiler Room. But little has been known about which investors take the bait.

The researchers examined 421 pump-and-dumps between 2002 and 2015, based on data from the Germany regulatory authority and the trading records of more than 110,000 individual investors in Germany.

Of these investors, 6,569 individuals—nearly 6 percent of the sample—took part in pump-and-dump schemes, investing an average 11.4 percent of their portfolio's overall value and sustaining an average loss of nearly 30 percent.

The average investor in these schemes was an older, married male not residing in a big city, who had a high self-assessed risk tolerance, the researchers find. Blue-collar workers, retirees, and the self-employed were also more likely to invest in these schemes.

While these characteristics describe investors who participate in touted stocks, they don't necessarily predict who participates. Past trading behavior is a better indicator, the researchers say. More than 35 percent of pump-and-dump investors were day-trading in penny stocks or were frequent traders with short-term horizons, taking substantial risks and trading aggressively before they participated in the schemes.

The research provides several insights that could help regulators design effective investor protection against pump-and-dump schemes. Interventions—such as prompts to take more time before making investment decisions and to think about whether funds look suspicious—could help protect some investors. But, the researchers warn that these techniques are less likely to work for the subset of investors who intentionally seek out such schemes for the sheer thrill of it and the possibility of big, quick gains.

More information: Christian Leuz et al. Who Falls Prey to the Wolf of Wall Street? Investor Participation in Market Manipulation, (2017). DOI: 10.3386/w24083

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