Forbes

Bankrupt Stock Speculation Proves That Markets Aren’t Always Rational

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August 18, 2020

One of the key assumptions behind modern financial theory is that investors behave rationally – making choices which optimize their utility level. The efficient-market hypothesis (EMH) holds that this type of investor behavior causes stock prices to quickly trade to their fair value since all available information is taken into account by rational investors. Its primary proponent, Eugene Fama, won the Nobel Prize for his work on asset pricing. But, does the assumption of rationality hold true in the real world?

There’s still much debate about the validity of EMH since it implies that there are no under- or over-valued stocks and therefore no opportunities to generate alpha. Distressed investors, such as myself, have made a career out of finding and exploiting market inefficiencies. So, obviously I come down on the other side of the rationality proposal.

The market may act rationally as a whole, but it’s very obvious that not all market actors behave rationally. One merely has to observe what can happen with stocks of companies which file for Chapter 11 to see irrational behavior. Throughout my career as an investor, I’ve seen many instances where foolish investors bid up bankrupt stocks with the expectation that they can sell them to a greater fool. They usually ignore the high probability that the shareholders of bankrupt firms nearly always lose their entire investment.

That's just crazy.

Wall Street is littered with firms that went bankrupt and had their stock rally before collapsing…ever since COVID, that trend is increasing. You see big spikes in a stock right before—or even after—a firm files for bankruptcy. One reason this is happening is because there's just so much cash out there due to the massive money printing by the Fed: it's no surprise that there's speculative froth out there.

The story of our market could be called a tale of two markets. Bankruptcies are rising rapidly, the default rate is almost at 7%, and the YTD default total of $123 BN already represents the second highest annual total…and we still have five months left in 2020! We're seeing a lot of distress with lots of firms going bankrupt, along with turmoil for individuals (including high unemployment) while the population suffers from the virus. At the same time, there's so much money sloshing around the system that it's creating an unsustainable bubble in some bankrupt stocks because people buy them without any fundamental analysis whatsoever. These buyers must believe that bankrupt stocks might eventually get back up to where they once were or, occasionally, momentum traders bid them up for a few days before dumping them—it's really oddball stuff. I've seen that kind of rally in bankrupt stocks before during other bubble markets, particularly right before the tech bubble burst. It is clearly a sign of irrationality.

Hertz Corporation (ticker: HTZ) attempted a secondary public stock offering right after it filed for bankruptcy and even secured approval from a Federal Bankruptcy judge before the SEC stopped it. The firm's lawyers had disclosed in their offering prospectus that shareholders would be likely to get no recovery but, even so, the firm succeeded in selling some shares before the SEC's comments stopped this ploy.

This was a major sign of speculative froth…never in my career have I seen a bankrupt firm register to sell common shares to unwitting and irrational investors before first cleaning up its act. The fact that the market was willing to go along with this scheme was all the more surprising since any prospective investor who read the prospectus should have known that the outlook was a near certain loss.

The lesson to be learned from bankrupt stock speculation is that it historically harms unsophisticated retail investors the worst. Whether or not you agree that this form of speculation should be allowed, it certainly sets up for good potential trades where an astute distressed securities manager can short sell these stocks while irrational investors on the other side of the trade bid it up. Back in 2002, K-Mart had filed for bankruptcy, but its stock climbed over 100% before finally being cancelled. For investors who had read the company's SEC filings, it was clear that the prepetition stockholders would ultimately get nothing. Even so, on the day the stock was extinguished, news reports highlighted that investors were "shocked and dismayed" that the stock was now worthless.

What was really dismaying about K-Mart's post-bankruptcy stock price, as well as more recent examples of the same phenomenon (such as Whiting Petroleum, Chesapeake Energy CHK -2%, and many others), is that irrational investors appear to enter the market without doing any fundamental analysis at all. They seem to have a gambling mentality, where they do it for the thrill of it rather than doing any serious work and expect to make money. Clearly, they are not acting rationally in the normal sense of the term.

Given where we are in the business cycle, with the slowdown in the economy and continued slow pandemic recovery, second quarter results showed that it doesn't look too good for most firms. With record levels of junk-rated debt and default rates spiking, there's a growing and desperate need to restructure debt—but, when firms do file for bankruptcy, it's serious. The eventual reorganization almost always causes shareholders to lose their entire investment. Despite that outlook, you may see a stock climb, from $2 or $3 per share up to $5 or more, before finally plummeting to zero. It makes no rational sense, unless the bidder is perhaps buying involuntarily. For example, there may be a short squeeze causing a forced buy-in, or some other form of artificial demand. Sometimes, the debtor firm itself has a pension plan which automatically buys stock of the bankrupt firm on the open market. In that case, pension trustees may screw it up and continue buying the stock, even though it's headed into bankruptcy.

Against this somber economic backdrop, we recommend that investors consider new allocations to distressed debt strategies but also focus on "early cycle" distressed securities managers who can benefit by short-selling firms facing trouble. Those managers may have a clear edge in taking the other side of a trade where irrational market participants turn efficient market expectations totally upside down.