

Buy Me Now ?

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Avoiding the Wrong Side of "Pump and Dump"

You walk down a dark street. The houses are unlit. There's nothing of interest to see. For lack of anything better to do, you look at the street in front of you, even though it's not that interesting.

On another night, you walk down the same street. It's different on this evening. One of the houses is brightly lit, cars are parked outside and people milling around. You notice it among all the other pitch-black homes. Its illumination and activity draw you in. The novelty stimulates your nervous system so you pay attention.

Our reaction to media is similar. We are engaged by the fresh, the unusual, the extraordinary and the unexpected. For example, an e-mail like this is meant to catch people's attention:

"Stocks Ready to Explode"

Professors Jonathan Zittrain from Oxford University and Laura Frieder from Purdue University examined this type of Internet hype in their working paper entitled [Spam Works: Evidence from Stock Touts and Corresponding Market Activity](#). They reached a startling conclusion. People actually do sink their teeth into the bait and buy the stock. After a few days, when the price is elevated, the spammers sell and can make up to a 6% return. The unsophisticated that bought the stock, however, lose money, up to 7% of their investment. Those selling last lose the most.

This maneuver is called "pump and dump." It benefits the spammers who purchased the stock before they pumped up the price through their e-mails. Then, when the stock price/share increases, they sell.

Why would anybody buy stock on the recommendation of a stranger? It's because emotion is overpowering common sense. The person who takes the bait is overly hopeful and optimistic. These feelings overpower caution and any realistic understanding of the stock market.

Warren Buffet says: "You don't know who's swimming naked until the tide goes out." Indeed, unwary individuals play the "pump and dump" stock without clothes. They didn't do research themselves, and thusly, deserve to be caught naked when the smarter bathers emerged wearing their swimming suits.

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