Market Price and Value Can Diverge

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Abstract
There seems to be a misconception in some domain name circles that the value of an asset is what the buyer is willing to pay for it, rather than value based on fundamentals. Below, I distinguish between these two concepts of values and outline general reasons for their dispersion and implications.

Introduction
The market price is the monetary value at which a buyer and a seller agree to exchange a domain name before any commissions are paid. Domain names are sold through specialized marketplaces and popular auction sites such as eBay. However, unlike markets for other assets, not all domain name marketplaces make all their sales transactions public. Nevertheless, some of the medium and high-end sales information are publicly available.

An asset's value, on the other hand, refers to what the market price should be based on the asset's fundamentals.

Since domain name markets[1] are relatively new, one should not be surprised to find disparity between these two values.

Market Factors
Disparity between an asset's value and its market price can occur even in highly developed and liquid markets such as the U.S. equity market.

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[1] For an introduction to domain name markets, see Alex Tajirian (2004), "Domain Name Markets," DomainMart.

a. Observed Characteristics
Probably the most analyzed prices are those of the U.S. equity markets. There is empirical evidence of periods of disparity between the market price and fundamentals. The common characteristics of seemingly abnormal disparities in various markets – including the tulip mania - between these two values is that prices initially diverge in a systematic and increasing fashion. The rate of disparity increases until market participants take notice. When market participants realize that the market price levels cannot be sustained, there is an abrupt market collapse with a sharp reversal of market prices to fundamental values.[2]

b. Why Disparity Exists?[3]
There are three prominent explanations:
   1. During certain periods, the relationship between market prices and fundamentals becomes nonlinear.

   2. Self-fulfilling expectations and speculative bubbles. Various rational bubble models have been developed to explain and test divergence.[4]

   3. Practical or institutional constraints on the ability of market participants to arbitrage price differences. Examples are constrains on short selling and limited supply of equity in IPO markets.

c. Evidence From Other Markets:
There is empirical evidence that art masterpieces – expensive paintings – under-perform the art market index.[5] There is also empirical evidence that domain name markets are not price efficient.[6]

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[2] See C. Kindleberger (1989), *Manias, Panics and Crashes: A History of Financial Crises*, London, Macmillan.

[3] For a relatively non-technical survey of the various research models and findings, see R. Shiller (2000), *Irrational Exuberance*, Princeton: Princeton University Press.

[4] See J. Chen, et al. (2001), "Forecasting crashes: trading volume, past returns and conditional skewness in stock prices," *Journal of Financial Economics*, vol. 61, pp. 345-81.

[5] See J. Mei, and M. Moses (2002), "Art as an Investment and the Underperformance of Masterpieces," *American Economic Review*, vol. 92, 2, pp.1656-68.

[6] See Alex Tajirian (2006), "Price Inefficiencies in Domain Name Markets: An Empirical Investigation," DomainMart.

d. Implications
    1. By specifying the bubble-generating model, one can, in principal, test whether markets are rational, efficient, and whether such patterns can be exploited for excess returns.

    2. When markets are inefficient, one side of an exchange is at a disadvantage.

    3. Appraisers need to be explicit as to whether they are estimating the fundamental value, the market value based on comparables, or the liquidation value of a domain name.

Winner's Curse
In addition to the above market-based price discrepancies, individuals can over react in auction betting situations, and thus, an auction winner can end up paying a premium over the asset's fundamental value.

A winner's curse is defined as a bidder feeling regret after winning an auction because of overpaying for an item.

There are two types of information associated with the Winner's Curse that have been studied: certainty of value by bidders and experience of bidders. Bidders are less likely to submit high bids when they are uncertain about the true value of the item and are more aggressive when bidding on an item when they are more certain of its value.[7]

[7] For more information, see Alex Tajirian (2004), "Auctions, Haggling, and Fixed Prices: A Survey of Recent Literature," DomainMart.