The Journal of Behavioral Finance
2006, Vol. 7, No. 3, 126–127

EDITORIAL

Did Investor Sentiment Foretell the Fall of ENRON?

Harry F. Griffin

In the aftermath of the ENRON Corporation failure, we acknowledge that many investors experienced a financial loss when their ENRON equity holdings lost market value. Our research centers upon the loss of that market value, and when the capital market first signaled the positive potential of that loss. An examination of ENRON option open interest from January 1, 2000 through December 31, 2001 reveals that such information was available, observable, and inferential a year earlier.

The rise and fall of ENRON has generated a plethora of literature in the academic, accounting, investment, legal, and news media. McLean and Elkin (2003) wrote that as ENRON matured, the stock price matured as well. In an effort to prevent the increasing stock price from stalling, ENRON's management engaged in several financial deceptions; burying their tactics in confusing and misleading financial reports. ENRON believed that the deceptions would not be discernible by the investing public.

Testing Method of Behavioral Reaction

Using daily data, we compared the stock's daily closing price and the stock's 10 day price volatility to the daily option open interest for all option strike prices from January 1, 2000 to December 31, 2001 in order to ascertain whether there existed any information which may have signaled ENRON stakeholders and stockholders concerning a potential decline of ENRON's stock price. Standardization through the use of Z-scores resolved the problem of numerical magnitude. Figure 1 presents the stock price, volatility, and put and call open interest z-scores plotted across time in order to observe their tendencies. The Y axis is the z-score integer value.

From January to November of year 2000, ENRON stock price, stock price volatility, and option open interest behaved as expected. Call open interest dominates put open interest. When the call option open interest dominates the put option open interest, the market expectation is that the option contract owners hold as opinion that the underlying security will increase in value. The opposite is also held as true.

On Wednesday December 13, 2000 it was announced that Mr. Jeffrey Skilling, then ENRON's President and Chief Operating Officer, would take over as the Chief Executive Officer on February 12, 2001. According to Figure 1, several events occurred subsequent to that December announcement:

A) The stock price volatility increased.
B) Call and put option open interest reversed, indicating a reversal in investor sentiment.

Three months later, McLean (2001) authored an article asking exactly how ENRON earned its revenues. Also occurring in March 2001, we see both the stock price volatility and the call and put open interest (investor sentiment) increase as the decline in stock price accelerates.

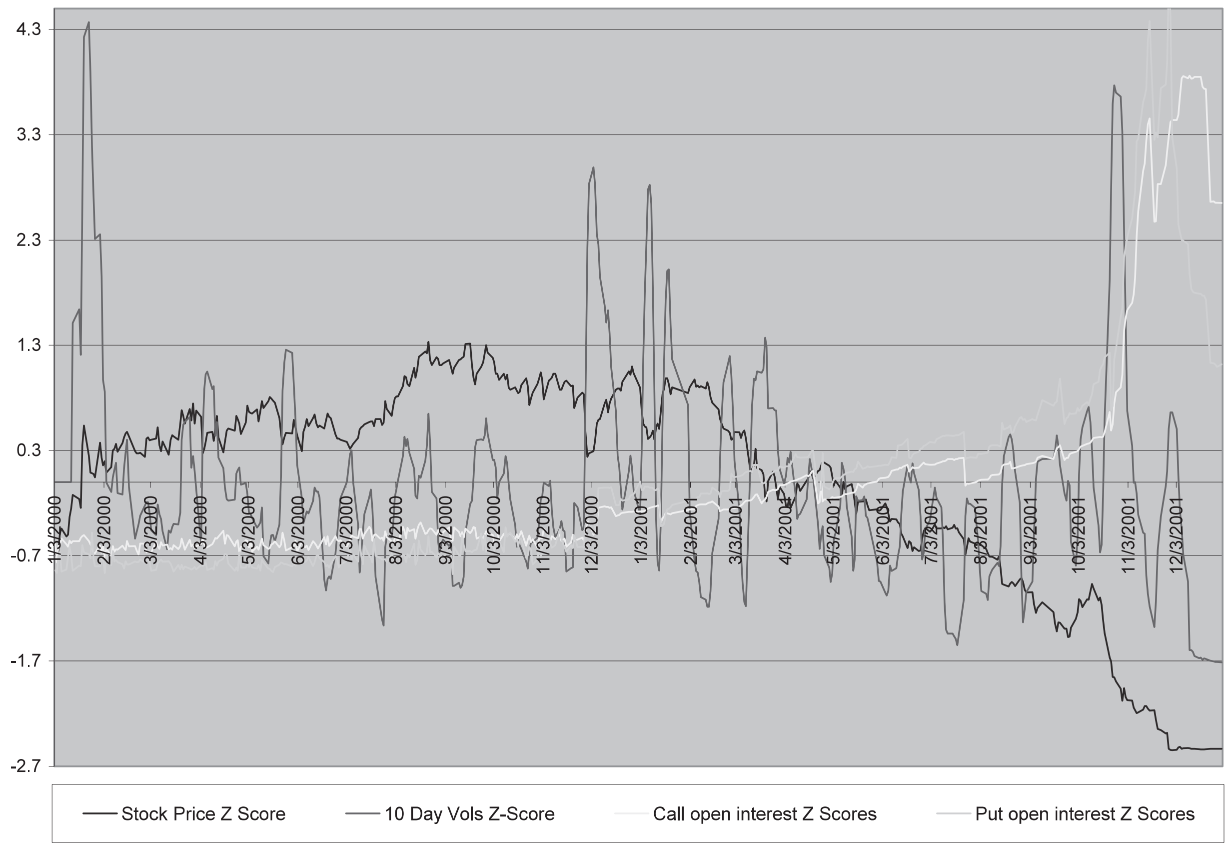
Results

The correlation between stock price and option open interest is well documented. Furthermore, the option open interest reversal offers a powerful market commentary. We see a sharp rise in the ten day volatility of the stock price and a reversal of put/call open interest domination, and yet the majority of ENRON equity holders maintain their positions in the face of investor sentiment that is overwhelmingly bearish.

Harry F. Griffin is a professor in the Stephens College of Business at the The University of Montevallo.

Requests for reprints should be sent to: Harry Griffin, Stephens College of Business, The University of Montevallo, Station 6557, Montevallo, AL 35115. Email: griffinhf@montevallo.edu

FIGURE 1
Stock Price, 10-Day Stock Price Volatility, Call and Put Open Interest



While several explanations are possible, the most likely reason why the stockholder held on to their ENRON positions long after the erosion of firm value became evident is that senior management made several strong endorsements and recommendations as to the holding of ENRON common equity. Management insistence to maintain and even to increase the size of their positions temporarily assuaged investor's fears and protected their ego.

Acknowledgments

I wish to thank the editors for their helpful and constructive comments and Terry Liberman for his insights and suggestions.

References

McLean, Bethany. "Is ENRON Overpriced." *Fortune, Vol. 143*, No. 5, (2001), pp. 122–126.

McLean, Bethany, Peter Elkin, *The Smartest Guys in the Room,* New York, NY: The Penguin Group Publishing, 2003.