A $3.5m Gift From Foolish Retail Punters

A nice little gift turned up at the Intelligent Investor Funds office this week. We were given 366,160 Vision Eye Institute (VEI) shares for $0.34 each. Given the current market price is $0.58, the instantaneous profit on these shares represents $87,878 straight to the bottom line.

While I should be happy and probably keep mum, I'm not. The money we made – and the $3.4m made by other institutional investors – is a direct transfer from retail punters. Their behaviour exasperates me.

Vision undertook a 2 for 3 rights issue in December. In addition to a $4.5m placement, each VEI shareholder was entitled to buy two new shares at $0.34 each for each three they already held. II Funds and other institutional shareholders guaranteed that we would take up our own rights, and also agreed to buy any shares not taken up by retail investors ('sub-underwriting' the offer).

This is not a risk-free game. We get paid a small fee (1% of the amount underwritten) and a portion of the attractively priced placement. But underwriting – from a shareholder's perspective – is usually a one-sided game. In this case retail investors had a month to watch how the share price performs and make their decision late in the piece.

If the share price trades below the offer price, they ignore the rights issue and we get lumped with a pile of shares for which we have to pay a premium to the market price. If the market price is higher than the rights price, everyone takes up their rights and you don't get anything. Heads we lose a lot, tails we get a 1% fee.

In Vision's case we formed the view that the capital raising was going to create value by reducing the company's debt and allowing it to get back to paying fully-franked dividends. We also wanted as much of the placement as we could get, so agreed to our share of the underwriting.

What we ended up with was a free gift, thanks to retail investor slothfulness. By the time the retail component of the rights issue closed, Vision shares were trading at $0.57. Even if you didn't want to own more shares, you could sell your existing VEI shares on market at $0.57 and buy them back for $0.34.

Yet rights were not taken up on 35% of the retail shares. Fourteen and a half million 34-cent gifts gone begging, and $3.5m of profit into the bad guys' pockets.

This is going to sound harsh, but if you were one of the gift givers, you shouldn't be investing in the stock market. If you don't get the arithmetic behind these trades, or you don't check your mail, or you're away on holidays for six months a year, you're better off in an index fund.

Sorry, but making money on the stockmarket is hard enough begin with. Throwing away guaranteed profits makes it nigh on impossible.

PS. If you are Ten shareholder, you have approximately eight hours to avoid being the patsy in next week’s blog piece.