THE AGONY OF VICTORY
AND THE THRILL OF DEFEAT

David Rosenthal, the Simon & Schuster publisher, and Tom Hicks, the Texas Rangers owner, have one thing in common: optimism. That’s what made Rosenthal outbid seven other publishers and agree to shell out an eight-million-dollar advance to Hillary Clinton for her forthcoming memoir, and it’s what made Hicks sign the shortstop Alex Rodriguez to a record two-hundred-and-fifty-two-million-dollar contract. Rosenthal is betting that Clinton’s book, expected in 2003, will sell more than a million copies. Hicks expects Rodriguez to spend the next decade piling up runs and profits for his Texas Rangers.

Rosenthal and Hicks have something else in common: they’re in businesses with slim profits. This is no coincidence. Book publishers and baseball owners tend to acquire their most valued commodities—high-profile books and star players—in auctions. Optimism helps them win those auctions. Unfortunately, it also guarantees that, most of the time, they overpay for talent, because whoever wins an auction generally pays more for what he’s won than it’s actually worth. This phenomenon is known as “the winner’s curse.”

The winner’s curse was documented in 1971 in an oil-industry journal, which examined the bidding by major companies on oil and gas drilling rights in the Gulf of Mexico. Although the Gulf was rich in oil and gas, the companies doing the pumping were reaping minuscule returns. Why? Well, in three-quarters of the auctions, the winner paid at least twice as much as the runner-up. But the rights weren’t worth anywhere near that much. Losers, it turns out, have a much better sense of value, and this is true in auctions of everything from ballplayers to Beanie Babies.

“I haven’t heard of the winner’s curse,” Rosenthal says. “But there’s an old publishing dictum—‘The only thing worse than not getting a book is getting a book.’ There’s a reason publishers tend not to like auctions.”

Auctions come in many guises (Dutch, classic ascending-bid auction, meaning that the publishers knew what the competing bids were and could revise their own bids accordingly. Rosenthal’s winning bid was only slightly higher than those of the runners-up, and he’s happy with the deal he got. “We would not have done it if there wasn’t an excellent chance of its being very profitable,” he says.

He would think that—it’s why he won the auction. Still, the chances are slim that Hillary’s memoir will generate the profits most companies would expect from an eight-million-dollar investment. Even if you assume that Simon & Schuster can get a hefty fee for the book’s foreign rights, to be profitable it will have to be one of the most successful nonfiction books in memory (and Hillary is no Mitch Albom). Simon & Schuster’s wager isn’t irrational, but it sure is optimistic.

The paradox of the winner’s curse, in fact, is that it comes into play even when all the bidders in an auction are rational. Yes, some auctions are emotional ($772,500 for J.F.K.’s golf clubs, anyone?), but auctions like those for Hillary’s memoir and Rodriguez’s services ultimately turn on one question: How much will these things be worth? Every bidder answers the question differently. In Hillary’s case, some compared her to other public figures who have written memoirs. Others compared her to people who have had their books endorsed by Oprah. And some even compared her to Paula Barbieri. Depending on what information bidders relied on, they came up with different estimates of how well the book would sell.

By definition, the company with the highest estimate won the auction. And it can safely be said that the highest estimate is probably too high. Charles Plotz, an economist and auction-theory expert at Caltech, says, “It’s a mechanical problem, not an emotional one. In any auction, the person who’s unlucky enough to place the highest value on an item is the person who’s going to win. No one’s being irrational. It’s just that the winner is likely to be wrong.” No wonder publishers and baseball owners have a hard time making money: even when they win, they lose.

—James Surowiecki