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Three Anomalies of Initial Public Offerings: A brief Literature Review ❖

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The literature on initial public offerings (IPOs) has questioned several anomalies relating to both the theoretical and empirical aspects of the pricing behaviour of equities to which they relate. The anomalies relate to the initial process of under pricing of stocks, the cyclical pattern of returns over time, and the long run issue of under performance of stocks. This paper brings much of this literature together and synthesizes their findings from, mostly, a US perspective. Important questions are raised in connection with the early optimism of investors participating in IPOs. **JEL: G14, G30.**

Introduction

A private company becomes a public concern, by issuing equity securities to the outside investors for the first time, in an initial public offering (IPO). In the past twenty years, there has been a large number of both theoretical and empirical studies on the IPOs. The still growing literature on this topic has been motivated by some puzzling empirical findings about the IPOs' stock returns after going public. Interesting empirical findings on the IPOs' abnormal stock returns, both in short-run and in long run, called for a great deal of theoretical work that tried to explain the puzzling phenomena and to postulate new hypotheses. These theoretical studies in turn motivated further empirical studies that tested the new implications.

This paper provides a brief literature review that concentrates on what may be the three most important anomalies found in the IPOs, the initial under pricing, the "hot issue" market phenomenon, and the long run under performance. This literature review is by no means comprehensive. Clearly, we will not discuss every study or issue that has been developed about the IPOs. Instead, we will try to provide a coherent summary of both theoretical and empirical studies on the three anomalies named above.

The initial under pricing of Initial Public Offerings

The initial under pricing phenomenon of IPOs refers to the positive average abnormal return found over a short period of time after the issue. The initial abnormal returns are typically measured between the offering price and the closing price at the end of the first day or the first week after the IPO. Since the initial return period is very short, the returns are generally not adjusted by any benchmark. The first major academic study reporting a positive mean initial return of the IPOs is Ibbotson (1975). On a sample of 120 IPOs during 1965-69 (one issue per month), he finds an average initial return of 11.4% from the date of issue to the end of the offering month. Most of the following studies measure initial returns during the first day of trading. Ibbotson and Jaffe (1975) report an average initial return of 16.8% using a much larger sample in a similar period. Ritter (1984) finds an initial return of 18.8% for a sample of 5,162 IPOs. A summary of the results from these and other studies can be found in Table 5 of Smith (1986).

Additional studies documenting positive initial returns are Miller and Reilly (1987), Carter and Manaster (1990), Tinic (1988), and Ibbotson, Sindelar and Ritter (1988) who find an 16.4% average initial return for a sample of 8,668 IPOs during 1960-87. The initial under pricing phenomenon is not limited to the U.S. IPOs. Various studies on IPOs in different countries have confirmed that the positive initial return is found virtually in all markets, although the size of under pricing varies substantially from country to country. For example, Aggarwal, Leal and Hernandez (1993) report that the IPOs in Brazil, Chile, and Mexico had average initial returns of 78.5%, 16.3%, and 33.0%, respectively. Dawson (1987) reports a 17.6% initial return for the IPOs in Hong Kong, and Kim, Krinsky and Lee (1991) find an initial return of 79.0% for the Korean IPOs. Among the European countries, initial returns ranging from 12.0% to 39% are found in Sweden, Switzerland, and United Kingdom by several studies including Rydqvist (1993), Kunz and Aggarwal (1994) and Levis (1993).

A number of theoretical explanations for the puzzling result of IPO under pricing have been formulated. Many of them rely on the assumption of information asymmetries: that there are differences in information known by the various parties that are involved in an IPO; namely, the issuer, the underwriter, and the investor. One of the most important explanations for the under pricing of IPOs is the adverse selection model presented by Rock (1986). Rock divides investors into two groups: the informed investors who will attempt to buy shares only when an issue is under priced and the uninformed investors who will buy shares in all IPOs, whether the issue is under priced or overpriced. As a result, when an issue is under priced and thus subscribed by both types of investors, the uninformed investors will be allocated only a fraction of the issue. On the other hand, when an issue is overpriced, the uninformed investors will “win” the entire issue. The partial allocation of the “bargain” issues and the complete “winning” of the “rip-off” offerings produces a “winner’s curse” problem. Recognizing this adverse selection problem, the uninformed investors are attracted to the IPO market only when they are compensated for their allocation bias problem in the form of the average under pricing of the issues. An implication of Rock’s model is that riskier issues should be under priced to a greater extent. This finding is supported by Beatty and Ritter (1986) as well.

While Rock (1986) considers an information asymmetry problem among investors, Baron and Holmstrom (1980) argue that it is the investment bankers who have superior knowledge about the

issues compared to the issuing companies. They deliberately under price the offerings expending less effort to market the new issues and to favour their buying clients. Although this argument may be conceivable, and is somewhat supported by the empirical findings in Baron (1982), Muscarella and Vetsuypens (1989) find that the investment banks under price themselves by as much as other IPOs when they go public. If the investment bankers were, in fact, informationally advantaged, we would not expect to find them under pricing their own shares at IPO.

Benveniste and Spindt (1989) offer a dynamic information acquisition explanation for the under pricing. In their model, IPO under pricing induces regular investors to reveal information about their valuations of the new issue during the preliminary prospectus stage. The revealed information is then used to determine the issue price. Empirical findings that support this argument are reported in Hanley (1993).

Welch (1992) argues that the IPO market is subject to information "cascades." In his model, an investor's demand for the issue not only depends on his/her valuation, but also on the demand by other investors. As a result, we may have a case where some investors who otherwise would subscribe for an issue may decide not to do so when they discover that the issue is not demanded strongly by other investors. In order to avoid this problem, issuing companies may under price their offerings to attract the first few buyers, thereby inducing a positive "cascade" effect in which all subsequent investors join their "instigators."

Some theoretical models involved a signalling equilibrium where the issuers under price the IPOs in order to charge a higher price in subsequent seasoned equity offerings (SEOs). In the signalling models developed by Allen and Faulhaber (1989), Grinblatt and Hwang (1989) and Welch (1989), high quality firms may under price their IPOs in order to signal their high valuations. The reduction in the IPO proceeds would then be recovered in subsequent seasoned offerings. Welch (1989) does find evidence that more IPO firms conduct a SEO within a few years after going public than an average firm. However, the signalling hypothesis is generally not supported in Jegadeesh, Weinstein and Welch (1993). Although, they find some relation between the IPO under pricing and favourable conditions for SEOs, the under pricing is not the uniquely necessary factor for the favourable conditions. In particular, they find that the aftermarket returns can predict successful SEOs, concluding that the issuers need not rely on the costly IPO under pricing to create better SEO conditions.

The "Hot Issue" Market Phenomenon

Over the past 30 to 40 years, a recurring pattern of cycles in both the volumes and the average initial returns of IPOs have been observed. This pattern is referred to as the "hot issue" market phenomenon. The "hot issue" markets, which are the periods with unusually high initial returns, are found to be associated with increasing volume of IPOs. On the other hand, the "cold issue" markets, with relatively low initial returns, tend to occur toward the end of the high IPO volume periods.

Ibbotson and Jaffe (1975) first documented the pattern for the 1960-70 period. Ritter (1984) confirmed the persistence of the pattern for the 1960-82 period. He finds an unusually high 48.4% average initial return during the "hot issue" market in 1980-1981 while reports a relatively low figure of 16.3% for the "cold issue" market in the remaining 1977-82 period. Ibbotson, Sindelar and Ritter (1988) extended the sample period to 1960-87 and reconfirmed the phenomenon. They also

found a clear relationship between the average initial return and the number of offerings: severe under pricing of IPOs appears to lead heavy volume periods of new offerings by approximately six to twelve months.

There have been few theoretical explanations for the "hot issue" market phenomenon. Based on the argument that riskier issues tend to be under priced to a greater extent, Ritter (1984) offers a hypothesis that the periods where more risky firms go public may have higher initial returns. This hypothesis, based on the "changing risk composition" of the IPO market, is not strongly supported by data. Ritter (1984) finds that although there is some evidence that the "hot issue" markets are associated with riskier offerings, the factor of changing risk composition explains only a little fraction of the amplitude in the average initial return cycles.

The Long-Run Underperformance of Initial Public Offerings

The third anomaly of IPOs is their poor long-run stock price performance first documented in Ritter (1991). Using a sample of 1,526 IPOs that went public in the U.S. during 1975-84, he finds that after 3 years of going public, these firms significantly under performed market indices and a set of comparable firms matched by industry and size. Excluding an average initial return of 14.32% as measured from the offering price to the market price at the end of the first day of public trading, the IPOs in his sample produced an average 3-year holding period return of 34.37%. However, a control sample of matching firms, paired by industry and market value, produced an average total return of 61.86% during the same 3-year holding period.

The long-run underperformance of IPOs is found to continue after the three-year period examined by Ritter (1991). Yi (1992), using the same IPO sample as in Ritter, finds that the underperformance continues until six years after going public. Loughran and Ritter (1995) use a larger sample of IPOs (4,753 issues between 1970 and 1990) and find that the poor stock performance extends to five years after issue, with no further underperformance in the sixth year.

Various studies with international data generally suggest that the long-run underperformance of IPOs is a global phenomenon. Lee, Taylor and Walter (1996) report a three-year abnormal return of –46.5% for Australian IPOs during 1976-89 period. Aggarwal, Leal and Hernandez (1993) find that the IPOs in Brazil and Chile under performed a benchmark by 47% and 24%, respectively, by the end of three years after issue.

Before these empirical studies were conducted, two theories that "predicted" the long-run underperformance of IPOs were advanced. Miller (1977) asserts that in an IPO, the main buyers are the investors that are most optimistic about future prospects of the IPO firm. Due to uncertainty about the valuation of an IPO, there will be a range of different valuations given by the optimistic and pessimistic investors. Since the shares will tend to be purchased by the optimistic investors, the offering price will be higher than the "fair" price. As time passes on and more information becomes available, the stock price will approach (will decrease to) the "fair" price. Thus, Miller (1977) predicts that IPOs, especially the riskier issues, will under perform in the long run.

Shiller (1990) provides another explanation for the poor long-run performance of IPOs. He argues that the IPO market is subject to fads and that investment banks act as the "impresarios" promoting the issue. One way to attract investors would be to under price the new issues. As with Miller's model, Shiller's "impresario" hypothesis predicts that IPOs will under perform in the long run. In particular, the size of under

performance is expected to be related, positively, to the size of under pricing. Although Ritter (1991) finds some evidence for this relation, results in Yi (2001) suggest that the initial return is generally not a significant factor in explaining the long-run returns.

The focus of the empirical studies discussed in the previous section has mainly been on the average long-run performance of IPOs. In an effort to shed some light on the puzzling finding with further empirical studies, some researchers have started to examine possible factors that may affect the cross-sectional variation in IPO long-run returns. Ritter (1991) reports that younger firms and firms that went public in the high volume years of the early 1980's had the most serious underperformance. He finds that older firms going public in light-volume years of mid- to late 1970's had performed as well as the benchmark. Teoh, Wong and Rao (1995) find that IPO firms that had high discretionary accounting accruals were associated with the largest negative abnormal stock returns. Brav and Gompers (1997) find that venture capital-backed IPOs outperform non-venture capital-backed IPOs when returns are computed on an equal-weighted basis. They also find that the difference in returns is largely due to severe underperformance of small firms.

There have been several studies that examined the reputation of the lead underwriter as a significant factor in explaining the long-run returns of IPOs. Carter, Dark and Singh (1998) report that the IPOs underwritten by the investment banks with the highest reputation do not under perform the NASDAQ index while those underwritten by less prestigious underwriters severely under perform the index during the first three years after issue. Furthermore, Beatty and Vetsuypens (1995) find evidence that the investment banks are penalized for underwriting the IPOs that had poor long-run performance.

Another factor that seems to be significantly related to the long-run performance of IPOs is the earnings before going public as evidenced in Yi (2001). Consistent with Ritter's (1991) results, Yi finds that IPOs as a whole under performed a market index and control firms over a three-year period after going public. However, the IPO firms that had positive earnings per share (EPS) at the time of offering seem to have fared better than the firms that went public with negative EPS.

As a concluding remark, based on the broad empirical findings discussed above, especially the high initial return and poor long-run performance of IPOs, one can argue that investors may have been too optimistic about future prospects of these new public firms. That is, the disappointing long-run returns are only the rational and inevitable results of the rather irrational run-up in prices in the initial period.

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❖ *The views expressed here are personal to the author and do not necessarily reflect those of the other staff, faculty or students of this or any other institution.*

IN MEMORY: James H. Gapinski

With the approaching of the third anniversary of Professor James Gapinski's death (*author of BNE Issue No. 21, March 1996*) the editor invited a close friend and colleague of his, Professor Ray Canterbery, to offer a few words. The following is an updated version of a piece Professor Canterbery wrote for the benefit of the Florida State University community some time ago.

… James H. Gapinski, long-time Professor of Economics at Florida State University (FSU), passed away on November 20, 2000. His ashes were sprinkled over the Gulf of Mexico at St. George Island where he loved to fly kites. He left behind Melissa and Susan, his two devoted daughters. Left behind too are the many fellow professors and students who respected him for his research, teaching, service, and sunny disposition. Truly a man for all seasons (sunny or not), everything that he chose to do, he did superbly. His friends knew him as "Jim" or "Gap."

Although a native of snowy Buffalo, N.Y., Jim had lived in the capital of the Sunshine State since 1970. His PhD was from the State University of New York at Buffalo where he was a member of Phi Beta Kappa. His career lofted quickly from the Buffalo tarmac: In his presence, you could almost sense his research and teaching soaring into the blue sky of high theory. But there was more, much more.
Jim authored six books and more than 70 articles, many in the top journals in economics. Still, the students who loved learning remember Professor Gapinski for his insightful, thoughtful and humorous teaching style—his entertaining balancing act between research and teaching. They also remember how patiently he listened to their questions and remained accessible. Although he was demanding, he motivated students to rise to his level of expectations. His judgments were fair. He radiated an upbeat attitude along with

an easy humour. In his direction of dissertations and theses, he brought out the best in candidates.

It is doubtful that anyone at any university has been nominated more often for or has received more, teaching awards. Deservedly, his awards included an Outstanding Faculty Award for Teaching and a University Teaching Award. In April 1999 Jim also was awarded by FSU a Professional Excellence Award that recognizes teaching and research excellence, as well as service to the university and to one's profession.

Gap's audience included many more than those at Florida State University. Within the academic community of economists in the United States he probably was best known for his work on a particular class of production functions, in which he was a noted pioneer. Outside the country—in the Asia-Pacific region—he was noted for his more recent publications on economic growth, international competitiveness, and financial crises. In between he developed an econometric model for Croatia (and the former Yugoslavia) and published research on the economic growth of the African nations.

Jim's career was distinguished by his courage to pursue those theories and policies that he considered most important, irrespective of current fads and fantasies in economics or within his academic home. Gapinski remained true to his inner voice and was a steadfast Keynesian or Post Keynesian. As an excellent swimmer, he was quite aware that he was swimming against the current, but his personal distaste for careerism and his strong preference to pursue the truth even when such a pursuit had, at least temporarily, fallen out of fashion is particularly admirable. The failures in the kind of economics and policies that he opposed vindicate his priorities. In the midst of these accomplishments he found time and energy to do clever, interesting, and unique research on the economics of performing Shakespeare (cultural economics) that appeared in the two top-ranked economics journals. He also had a keen appreciation for Shakespeare's use of humour, especially puns.

He accomplished much in too brief a life because of his great energy, still there in his final days. He was chosen by so many to serve so often because he was outwardly optimistic even when the odds were against him—even in his final struggle. Besides, he was skilled, smart, and amazingly efficient. Beyond, he felt that service to others was a natural (perhaps Catholic) obligation with inherent rewards.

Colleagues, family, friends, and students alike remember his essence—a ray of sunshine lighting up our lives.

Ray Canterbery

IN MEMORY: Franco Modigliani

Former Richmond conference delegate, Professor Franco Modigliani, died on Friday 26th September 2003, he was 85 years old. The editor had the pleasure of co-hosting a workshop on European Unemployment in the late 1990s at which Professor Modigliani provided the keynote speech. The following is an excerpt of a piece written to mark Professor Modigliani's death in September.

… Professor Franco Modigliani won the Nobel Prize in Economics in 1985 for his pioneering analyses of savings and financial markets. Professor Modigliani and an associate, Merton Miller, concluded that the market value of a company had no genuine relationship to the size and structure of its debt. Instead, they found, stock market values are determined mainly by what enterprises are expected to earn in the future.

MIT Institute Professor Paul Samuelson, a friend and fellow Nobel Prize winner in 1970, said, "Franco Modigliani could have been a multiple Nobel winner. When he died he was the greatest living macroeconomist …"

At the time of my meeting him at the workshop in April 1998, he would have been 80. Listening to his keynote address was, for me, an unforgettable experience. It was rich in quality and had incredible breadth. The speech had wit and charm in equal measure and filled with fresh insights into what was then a particularly uncomfortable period in European labour markets.

As an 80 year old academic, for whom the Nobel Prize had by then been a 13 year-old experience, my colleagues and I were expecting a little less passion and certainly much less combativeness. We were in for quite a surprise! During the discussion sessions that followed the key note address Professor Modigliani was giving as good as he got from the then deputy Chief Economist of the EBRD, Roberto Largo, and the Research Director for Employment at the OECD. The LSE economist, Professor Robin Jackman, was struggling to get a word in edgeways.

During one of the conference's quieter moments a colleague asked our illustrious guest about his remaining ambitions. Professor Modigliani said that he would very much like to win the Nobel Prize for a second time … so Professor Samuelson may have had a point after all!

Professor Samuelson noted that Wall Street was full of experts who had studied with Modigliani. His students also included Nobel laureate Robert Merton, the 1997 winner.

"On the day he won the Nobel, we played doubles," Professor Samuelson has recalled. "An intense tennis player, he never stopped moving. He was so intense, he once ran into a cement wall trying to get the ball." Samuelson's wish to collaborate with Modigliani came to fruition on a tennis court. "One day, between serves, he asked me what I thought of a new theory," Samuelson said. "I admitted I hadn't heard of it. He explained it. We kept playing. I responded. Our collaboration was born right there."

"His legendary enthusiasm and intensity never flagged. He inspired generations of students and colleagues with his passion for using economics to benefit society. Everyone who knew him will miss him."

Meeting him at Richmond was not just an honour but a real pleasure filled with deep admiration.

(Some of the less personal insights were taken from http://web.mit.edu/newsoffice/nr/2003/modigliani.html)

Parviz Dabir-Alai

Book Review:

Due to space restrictions the book review has been omitted from this issue of the BNE. This will return with the next issue.

Forthcoming Conferences:

December 10-12, 2003: The 12th international Tor Vergata conference on Banking and Finance to be held at the University of Rome, Italy. Further information available from Professor M. Bagella who may be reached via bagella@uniroma2.it and via www.economia.uniroma2.it/

January 3-5, 2004: The annual meetings of the American Economic Association will be held in San Diego, California, USA. Further information available via the AEA's website at www.aeaweb.org

February 20-22, 2004: The annual meetings of the Eastern Economic Association will be held in Washington, D.C., USA. Further information available from the conference organiser Dr Mary Lesser who may be reached by e-mail at

mlesser@iona.edu and via the conference website at www.iona.edu/eea/

Recently published papers:

* The June 2003 issue of the Journal of Economic Literature has papers by amongst others E. L. Glaeser and A. Shleifer on *The Rise of the Regulatory State*; S-H Poon and C.W.J. Cranger on *Forecasting Volatility in Financial Markets.*

* The June 2003 issue of the American Economic Review has papers by, amongst others, P. Francois and Huw Lloyd-Ellis on *Animal Spirits Through Creative Destruction*; Peter K. Schott on *One Size Fits All? Heckscher-Ohlin Specialization in Global Production;* Christophe Chamley on *Dynamic Speculative Attacks*; Paul Beaudry and David Green on *Wages and Employment in the United States and Germany: What Explains the Differences?*

* The July 2003 issue of the Economic Journal has papers by, amongst others, A. Barr on *Trust and Expected Trustworthiness: Experimental Evidence from Zimbabwean Villages;* R. Disney, et. al. on *Restructuring and Productivity Growth in UK Manufacturing*.

* The October 2003 issue of the Economic Journal has papers by, amongst others, A.J. Venables on *Winners and Losers from Regional Integration Agreements*; S. Nickell, et al. on *Nominal Wage Rigidity and the Rate of Inflation*; J. Ayuso, et al. on *A Model of the Open Market Operations of the European Central Bank*; T.P. Ballinger et al. on *Precautionary Saving and Social Learning Across Generation: an Experiment*.

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The following represents a sample of what has been published in previous issues. Those titles with an integral sign (∫) can be downloaded from the BNE web-site:

Hans Singer: 'The Bretton Woods Institutions and the UN'.

James Gapinski: 'Expectation Adjustment Time'.

William Boyes and Michael Marlow: 'Smoking Bans and the Coase Theorem'.

∫ **Andrew Henley**: 'What is the Role of Business Ethics in a Competitive Economy?'

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∫ **William R. DiPietro:** 'National Corruption and the Size of the Public Sector'.

∫ **Gert-Jan Hospers:** 'From Schumpeter to the Economics of Innovation'.

∫ **P. Kapopoulos, P. Papadimitriou and F. Siokis:** 'Identification problems on the causal relationship between minimum wage and employment?'

Sample of book reviews published since November 1999. Most of these are available on the BNE web-site:

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