Final Essay

Explanations for the IPO Underpricing from Behavioral Finance's Perspective

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June 2019

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The IPO underpricing refers to the phenomenon that the issued shares' offer price is lower than the closing price on the first trading day. China has a much higher degree of IPO underpricing compared to developed countries and other emerging countries.[1]

The issuers will suffer a loss (the number of shares multiplied by the difference between the offer price and the opening price on the first day) if the IPO underpricing exists. However, from EMH's angle, issuers should receive the market value for the shares and investors are not able to buy shares at a discount to their market value. This phenomenon appears to be an exception to the EMH, while the behavioral finance theory may be used to explain this "underpricing puzzle".

1. Possible Explanations

1.1 Investor's Overconfidence and Excessive Enthusiasm

The excessive confidence of investors may cause a huge price jump when the trading opens. After witnessing the price leap, investors react to price changes exaggeratedly and make over-optimistic judgements on the subsequent price movement. More investors are attracted to pour their money into rising stocks. Psychologically, people tend to pay attention to what others are paying attention to. The stock price keeps on going up after receiving a great deal of attention in such a short time.

Besides, news and social media amplify this market enthusiasm rapidly and

[1] 张晶. "中国 IPO 抑价研究综述." 现代管理科学 (2019): 85-87.

generate eye-catching stories that could explain the price increase, which continue to push up the stock price to an unreasonable level. Just as Shiller stated, "Feedback mechanisms include not only price-to-price feedback but also price-to-news-to-price feedback".[2]

1.2 Winner's Curse

Kevin Rock pointed out that the information asymmetry exists between informed investors and uninformed investors.[3] Both of them will purchase shares if the price is less than the actual value. However, informed investors will stop buying if the price exceeds the value, while uninformed investors lacking information advantage will continue to buy the overvalued stocks. Therefore, the information asymmetry leads to the adverse selection risks born by uninformed investors. In order to prevent uninformed investors from exiting the market, which might have an adverse impact on the market liquidity, the issuer will conduct the underpricing to compensate for uninformed investors' losses.

The winner's curse hypothesis is also valid for IPO underpricing in China according to Zhang and Lu's empirical research[4]. They also indicated that the IPO underpricing is closely related to the supply and demand relationship in the primary market.

1.3 Crowd Psychology

There is a time lag during the period of IPO subscription. In other words, investors "queue up" to subscribe for shares successively. The front investors' decisions are likely

[2] Shiller, Robert J. "Bubbles, human judgment, and expert opinion." *Financial Analysts Journal* 58.3 (2002): 18-26.
[3] Rock, Kevin. "Why new issues are underpriced." *Journal of financial economics* 15.1-2 (1986): 187-212.
[4] 张矢的, 卢月辉. ""赢者诅咒" 及风险假说对中国 A 股市场 IPO 抑价有效性的实证研究." 管理评论 8 (2014): 42-52.

to have an influence on those of subsequent investors who might mimic the actions of a larger group, especially when the accessibility of the issuer's information is not high.

A strong positive signal will be sent to the investors behind if front investors subscribe a lot, which will increase the subsequent subscription. Conversely, the subsequent investors might stop purchasing if the signal is not strong enough. Therefore, issuers and underwriters often take the initiative to discount the price to attract the initial investors to avoid the failure of the whole IPO issuance plan.

Different from the winner's curse caused by the information asymmetry between two groups of investors, the crowd psychology focuses on the information asymmetry between the issuers and investors. The issuers underprice the IPO to increase the subscription by taking advantage of investors' psychology.

It might also be inferred that the higher degree of IPO underpricing in China may be attributed to the lower degree of information transparency and accessibility.

2. Additional Thoughts

For investors (mutual funds, asset management companies, proprietary trading division of investment banks, individuals, etc.) in the secondary market, conducting the reverse investment strategy may be profitable if they realize there are overactions. In short, to sell stocks that are in an upward trend and to buy them when the price goes down. Besides, investors should make an effort to accurately assess the gap between the value and current price by reducing information asymmetry to beat the market.

For regulators, above all, improving the integrity and accuracy of the information disclosed by listed companies is crucial to reduce the underpricing caused by information asymmetry.

Another measure is to optimize the investor structure. At present, individual investors still account for the majority in China. Many of them generate a lot of “noise” in the market for lacking awareness of risk prevention and stop loss, and thus aggravate the market volatility. Restrictions on investments by institutions such as insurance companies, trust companies and qualified foreign institutional investors should be appropriately reduced under the premise of financial security.

Third, the common action of the imperfect market mechanism and supervision intensifies this phenomenon. In particular, the rigid P/E ratio, “window guidance” and favourable policies tilting towards state-owned enterprises have further distorted the pricing mechanism.

Overall, the reasons for IPO underpricing are depressed offer price in the primary market and excessive trading price in the secondary market. Therefore, the solutions should consist of two parts. First, information asymmetry should be reduced to improve capital allocation efficiency. Second, market sentiments should be rationally guided to reduce market bubbles.

Works Cited

1. Rock, Kevin. "Why new issues are underpriced." *Journal of financial economics* 15.1-2 (1986): 187-212.
2. Shiller, Robert J. "Bubbles, human judgment, and expert opinion." *Financial Analysts Journal* 58.3 (2002): 18-26.
3. 张晶. "中国 IPO 抑价研究综述." 现代管理科学 (2019): 85-87.
4. 张矢的, 卢月辉. "“赢者诅咒” 及风险假说对中国 A 股市场 IPO 抑价有效性的实证研究." 管理评论 8 (2014): 42-52.