The rationale behind voluntary underpricing of equity issuances

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1 Introduction

Many actors of the financial sector, including mutual funds, pension funds, fundamental hedge funds and retail investors use the link between a company's market capitalization and its fundamental value as a starting point for their investment decisions.In the 2010 decade, however, the well documented underperformance of value investing challenges the effectiveness of corporate valuation in predicting future stock returns.

With ever increasing information flows on prospective earnings, risks and growth outlooks, markets have arguably grown a lot more efficient than what they used to be. Having an edge on other market participants is harder to achieve, and that translates into a surge of passive investing through index funds and ETFs. Passive investment funds now account for north of 20% of aggregate investment fund assets, versus 10% just a decade ago. Furthermore, 16% of actively managed assets in the US are invested through quantitative strategies, which attempt to enhance portfolio return through a variety of statistical methods.

The paper presented here proposes a framework to account for the growing importance of those market participants in the field of equity valuation (I). We will focus more specifically on the IPO process, and offer a view on how it may be optimal for a company to issue shares below its alleged fundamental value rather than on par: dividing the investors into three categories (fundamental investors, noise traders/signal traders and passive investors), we will see that the dispersion of opinions among the first can be overcome by voluntarily setting a low price. As fundamental investors gradually plough in the under-priced company*(A)*, the positive trend attracts trend chasers who drive the stock even higher *(B)*. When a critical market capitalization is reached, the company enters an index and benefits from capital inflows of passive investors *(C)*.

In a second step, we will use data on members of the SP500 index and compare their current market capitalization with the level at which they were valued at IPO versus peers (II)