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THE VARIABILITY OF IPO INITIAL RETURNS

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### **ABSTRACT**

The monthly volatility of IPO initial returns is substantial and fluctuates dramatically over time and is considerably larger during "hot" IPO markets. Consistent with IPO theory, the volatility of initial returns is higher among firms whose value is more difficult to estimate, i.e. among firms with higher information asymmetry. Interpreting initial return volatility (or dispersion) as a measure of pricing (or forecast) errors made by underwriters, we conclude that underwriters have considerable difficulty pricing new issues accurately. Moreover, the complexity of the valuation problem is greater during "hot" IPO markets and for firms with high information asymmetry. One implication of our results is that the bookbuilding process may be inferior to alternate price discovery mechanisms in the pre-IPO period and that alternate mechanisms, such as auctions may be beneficial to firms that value price discovery.

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## **1. Introduction**

Initial public offerings (IPOs) are underpriced on average: the secondary market trading price of the stock is on average much higher than the IPO price. A number of academic papers note that the equity in private companies with uncertain prospects is inherently difficult to value, and they posit that underpricing is an efficient response to the complexity of this valuation problem (see, e.g., Rock (1986), Beatty and Ritter (1986), Welch (1986), and Benveniste and Spindt (1989), among others.) In contrast, others have questioned whether the IPO price-setting process results in excess underpricing of IPO stocks.

This paper proposes a new metric for evaluating the pricing of IPOs in traditional firm commitment underwritten offerings: the volatility, or dispersion, of initial returns to IPO stocks. We find that there is considerable volatility in initial returns. To the extent that the IPO price is a forecast of the secondary market price for the stock, these forecasts are not only biased downward (underpricing), but the dispersion of the forecast (or pricing) errors is huge. While underpricing averages 22% between 1965 and 2005, a relatively small portion of offerings have underpricing that is close to this average: only about five percent of the initial returns are between 20% and 25%. Moreover, nearly one-third of the initial returns are negative. The standard deviation of these initial returns is 55 percent from 1965–2005.

Our findings suggest that underwriters have limited ability to accurately value IPOs. This is consistent with Derrien and Womack (2003) and Degeorge, Derrien, and Womack (2005), who compare the pricing of auction versus firm-commitment offerings in the French market. However, to the best of our knowledge, there exists no evidence on this issue for the U.S. market. In contrast, there is a large literature on the accuracy of earnings forecasts. Notably, it seems that the earnings forecasting problem is relatively easy compared with setting IPO prices, in the sense that the dispersion of forecast errors is much larger for IPO prices.<sup>1</sup>

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<sup>1</sup> For example, Gu and Wu (2003) find that the standard deviation of the errors in analysts' forecasts of quarterly earnings, scaled by the prior stock price, is 2.7 percent.

The wide dispersion of initial returns suggests that underwriters have great difficulty in pricing, and limited ability to accurately value, IPOs. If one considers IPO initial return dispersion to be a metric for the difficulty of pricing IPOs, then one could reasonably expect that the variability of IPO initial returns would change over time with changes in complexity of the pricing problem. Consistent with this intuition, we find that the volatility of initial returns fluctuates greatly over time. While prior literature has shown the existence of hot IPO markets characterized by extremely high initial returns (see, e.g., Ibbotson, Sindelar, and Ritter (1988, 1994)), we find that these hot markets are also characterized by an extraordinarily high variability of initial returns. That is, there is a strong positive correlation between the mean and the variability of initial returns over time.

These descriptive statistics suggest that the level of uncertainty surrounding IPO firms and, correspondingly, underwriters' ability to value these firms, varies over time. As a first step toward understanding this changing uncertainty, we examine changes in the types of firms going public over time. To the extent that the complexity of the pricing problem is greater for certain types of firms than others, one would expect greater pricing errors when a larger fraction of highly uncertain firms is going public. A number of theories support this intuition and predict that an investment bank's pricing of an offering should be related to the level of information asymmetry surrounding the company.

For example, Beatty and Ritter's (1986) extension of Rock (1986) predicts that companies characterized by higher information asymmetry will tend to be more underpriced on average, a prediction that has received considerable empirical support (see, e.g., Michaely and Shaw (1994)). As noted by Ritter (1984a) and Sherman and Titman (2002), information asymmetry should also affect the precision of the price-setting process. Specifically, it should be more difficult to precisely estimate the value of a firm that is characterized by high information asymmetry: firms with higher uncertainty should have a higher volatility of initial returns. Our results are consistent with these models: we find that IPO initial return variability is considerably higher when the fraction of difficult-to-value companies going public (young, small, and technology firms) is higher. Given that these types of firms will also have higher

underpricing on average, this result is also consistent with the positive relation between the mean and volatility of underpricing noted above.

Our results raise serious questions about the efficacy of the traditional firm commitment underwritten IPO process, in the sense that the volatility of the pricing errors reflected in initial IPO returns is extremely large, especially for certain types of firms and during “hot market” periods. We conjecture that alternative price-discovery methods, such as auction methods, might result in much less uncertainty. An examination of the limited sample of auctions in the U.S. indicates that these offerings tend to have lower average underpricing and a lower dispersion of underpricing, compared to traditional firm commitment offerings. Moreover, our comparison of auction versus firm commitment IPOs reveals little difference in either the number of market makers or the number of analysts following companies subsequent to the IPO. In sum, our results suggest that auctions potentially offer many advantages to companies considering an IPO, while the purported advantages of the bookbuilding process (e.g., market makers, analyst coverage) are perhaps overstated.

The remainder of this paper proceeds as follows. Section 2 analyzes the unconditional dispersion of IPO initial returns and the time-variation in the dispersion of IPO returns. Section 3 examines various firm- and deal-specific factors that are likely to influence initial IPO returns to see how much of the dispersion of IPO returns is attributable to the characteristics of the issuing firms. Section 4 discusses other possible influences on the variation of initial returns. Based on the findings in sections 3 and 4, section 5 comments on the current debate over firm-commitment versus auction methods of going public. Finally, section 6 synthesizes the results from the preceding sections and presents concluding remarks.

## 2. IPO Return Data

### 2.1 Data Sources and Definitions

To assemble our dataset of IPOs between 1965 and 2005, we combine data from several sources. We begin with a sample of IPOs between 1965 and 1973 (excluding 1968) that were used by Downes and Heinkel (1982) and Ritter (1984b).<sup>2</sup> We fill in data for 1968 by identifying company names and offer dates for IPOs listed in the *Wall Street Journal Index* and then collecting after-market prices from *The Bank and Quotation Record*. For the 1975-1984 period, we use Jay Ritter's (1991) hand-collected data. Finally, we use data from Securities Data Company (SDC) and from the Securities and Exchange Commission (S.E.C.) Registered Offering Statistics (ROS) database. We examine all of the offerings to ensure that none are double-counted because they were listed in multiple databases. In cases where offerings are in multiple databases (e.g., a 1980 IPO in the Ritter 1975-1984 database, the SDC database, and/or the ROS database), we rely first on hand-collected data, second on the SDC data, and last on the ROS data. Finally, from these samples we exclude unit IPOs, closed-end funds, real estate investment trusts (REITs), and American Depositary Receipts (ADRs).

As described in Table 1, these datasets provide us with a total of 11,734 offerings. For the offerings included in the Center for Research in Securities Prices (CRSP) database, we obtain the aftermarket price on the first and 21<sup>st</sup> day of trading, and the initial returns (first-day and first-month) equal the percent differences between these aftermarket prices and the offer price. For those IPOs not included in CRSP, we calculate the initial return using the closing price at the end of the first month of trading (as we do not have price data on the twenty-first trading day). To ensure that our results are not disproportionately affected by extremely small firms, our main analyses restrict the sample to firms with an offer price of at least \$5. After requiring that firms have both initial return data and an offer price of at least \$5, our dataset consists of 8,781 IPOs: 576 from the 1965-1973 Ritter data, 369 from the 1968 *Wall Street Journal Index* data, 1,199 from the 1975-1984 Ritter data, 17 from ROS, and 6,620 from SDC.

## *2.2 Descriptive Statistics*

The first question we address is how best to measure the initial return to IPO investors or, equivalently, the pricing error realized by the issuing firm as measured by the percent difference between the IPO price and the subsequent secondary trading market price. To address this issue, we focus on the sample of 7,669 IPOs for which we can measure both first-day and first-month initial returns. Fig. 1a shows the histogram of first-day initial returns to IPOs from 1970-2005. The average initial return is 17% from the IPO price to the closing price in the secondary trading market on the first day after the IPO. The standard deviation is 39%, and the distribution is both skewed and fat-tailed, with many extreme positive values (for example, the median initial return is only 6%).

There is an obvious pattern in Fig. 1a that has been noted in the prior literature (see, e.g., Ruud (1993)). There are a large number of initial returns that equal exactly 0% (11.9% of the sample, shown by the solid bar in Fig. 1a) and a very small number of initial returns that are negative. It is well-known that underwriters can provide after-market price support by posting bid prices in the secondary trading market at, or just below, the IPO price. Such price support is allowed by securities market regulators for brief periods after a securities offering.

Fig. 1b shows the histogram of first-month initial returns to IPOs from 1970-2005. The average initial return is 22% and the standard deviation is 55%. The distribution of first-month returns is both skewed and fat-tailed, with many extreme positive values (for example, the median initial return is only 8%). Most important, though, the proportion of initial returns exactly equal to 0% is much smaller (4.4% of the sample, shown by the solid bar in Fig. 1b) and the histogram of returns shows much less truncation of negative values. This reflects the fact that price support does not extend 21 trading days after the IPO, so that the secondary market trading price after one month reflects market forces, not support by the underwriter. To avoid the effects of secondary-market price support on our tests, we use first-month initial returns in the remainder of the paper.

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<sup>2</sup> The 1968 data are missing from the original Downes and Heinkel (1982) dataset.

Figure 2 shows the distribution of first-month initial returns to IPOs over a 41-year time period. The 8,762 IPOs between 1965 and 2005 have an average monthly initial return of 22% and a large standard deviation of over 55%. Figure 2a shows the histogram of these 8,762 initial returns, along with a Normal distribution with the same mean and standard deviation as this sample. In addition to having a high standard deviation, the initial return distribution is highly positively skewed and fat-tailed.

Lowry and Schwert (2002, 2004) and Loughran and Ritter (2004) note that the 1998-2000 period exhibits unusual dispersion of IPO returns. A closer inspection of the chronology of firms going public in 1998-2000 shows that the first very high IPO initial return is for eBay, which went public on September 24, 1998 (the one-day IPO return was 163% and the 21-day return was 81%). The end of the hot IPO market seems to have occurred in September 2000, as the number of IPOs fell to 21 from 59 in August, while the average IPO initial return fell to 33.1% from 66.2% in August. Thus, throughout the paper we define the Internet-NASDAQ bubble period as September 1998 – August 2000.

Figure 2b shows the histogram of IPO initial returns after omitting the IPOs that occurred during this Internet-NASDAQ bubble period. While the histogram is still skewed and fat-tailed, it is more Normal looking than the all-inclusive 1965-2005 sample, because there are so many very high IPO returns in the September 1998-August 2000 period. The average IPO return in Fig. 2b is only 15%, about two-thirds the size of the corresponding statistic in Fig. 2a, and the standard deviation is also about one-third lower at 34%.

Figure 3 shows the monthly mean and standard deviation of first-month initial returns, as well as the number of IPOs per month, from 1965-2005. It is clear from this graph that both the level and the dispersion of IPO initial returns follow persistent cycles, with high average IPO initial returns and high standard deviations within a month occurring at roughly the same time. Ibbotson and Jaffe (1975), Ibbotson, Sindelar, and Ritter (1988, 1994), and Lowry and Schwert (2002) have noted this ‘hot issues’ phenomenon in the number of new issues per month and also in the average initial return per month, but the strong and similar pattern in the dispersion of initial returns is one of the contributions of this paper.



Table 2 contains the descriptive statistics underlying Figure 3. Each month we calculate the mean and standard deviation of initial returns for all IPOs during the month.<sup>3</sup> Columns 2, 3, and 4 show the time-series mean, median, and standard deviation of these two monthly statistics. Column 5 shows the correlation between the monthly mean and standard deviation. Finally, the last six columns show autocorrelations (up to six lags) of the initial return mean and standard deviation measures.

The cross-sectional standard deviation of IPO initial returns is about twice as large as the average IPO initial return, the two statistics are strongly positively correlated (0.864 in the 1965-2005 period), and the autocorrelations of the initial return dispersion are generally similar to those of the initial return mean.<sup>4</sup> Table 2 also contains these same summary statistics for the 1965-1980, 1981-1990, and 1991-2005 subperiods, as well as for the 1991–2005 subperiod after excluding the September 1998-August 2000 Internet-NASDAQ bubble period. Omitting the data from September 1998-August 2000 makes the remainder of the 1991-2005 period look very similar to the earlier sample periods in terms of the mean, dispersion, and autocorrelations of both initial return means and initial return standard deviations.

The evidence in Table 2 strongly suggests that the conditional distribution of IPO initial returns changes substantially over time, that some of these changes are predictable, and that the average initial return is strongly positively associated with the cross-sectional dispersion of IPO initial returns. The subsequent sections of this paper examine these findings in greater detail, relating the dispersion of IPO initial returns to IPO market conditions, to the characteristics of the types of firms that go public at different points in time, and to secondary-market volatility.

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<sup>3</sup> The standard deviation of initial returns is only calculated in months with at least three IPOs. As a result, in Table 2 the number of observations for mean initial returns (i.e., the number of months in which we can calculate this statistic) exceeds the number of observations for the standard deviation of initial returns.

<sup>4</sup> The positive relation between average IPO returns and cross-sectional standard deviations within months partially explains the strong positive skewness and kurtosis shown in the frequency distribution in Fig. 1b and Fig. 2a. (see, for example, Clark (1973)).

### **3. Why Are Average IPO Initial Returns and IPO Initial Return Volatility Related?**

There is considerable variation in the types of firms that go public. Some firms are over 100 years old, are from well-established industries, and are broadly covered in the media before even filing an IPO. In contrast, other firms are less than one year old, are from new industries that are not well-understood by the market, and have received little or no media coverage prior to the IPO. Underwriters presumably find it more difficult to value firms about which less information is available, i.e., for which information asymmetry is higher. Investment banks may overvalue some and drastically undervalue others, suggesting that the dispersion of underpricing across these types of firms will be quite substantial. In contrast, the greater amount of information available about more established firms should enable underwriters to more precisely value these companies, meaning the dispersion of initial returns across these firms will be relatively low.

The idea that the dispersion of initial returns would be related to the amount of information available about the firm was first suggested by Ritter (1984a), in an extension of Rock (1986) and Beatty and Ritter (1986). Specifically, Ritter (1984a) notes that IPO firms that are characterized by greater information asymmetry should have both greater average initial returns and a greater variability of initial returns.

Extending these ideas to a time-series context, clustering in the types of firms going public will cause time-series patterns in both the mean and the variability of initial returns. Suppose that during certain periods there is greater ex-ante information asymmetry about companies going public. We would expect initial returns during such periods to have a high mean (to compensate investors for the greater costs of becoming informed) and a high dispersion (because the underwriters will find it especially difficult to estimate the value of such issues). Consistent with these ideas, Figure 3 and Table 2 depict a positive relation between the mean and standard deviation. The remainder of this section more directly examines the extent to which the fluctuations in initial return volatility reflect underwriters' ability to value the types of firms going public at various points in time, i.e., during some periods a greater portion

of the IPOs are relatively easy to value, while in other periods more of the firms are quite difficult to value.

Section 3.1 examines whether the average characteristics of firms going public each month are correlated with the mean and standard deviation of initial returns during the month. Section 3.2 investigates whether these characteristics contribute to the positive correlation between the mean and standard deviation of monthly initial IPO returns. Finally, section 3.3 directly examines the extent to which both the level and the uncertainty regarding individual firm initial returns are related to firm-specific sources of information asymmetry.

### *3.1 Descriptive Evidence*

Our measures of firm- and offer-specific characteristics, which proxy for underwriters' ability to accurately estimate firm value, include:

- (1) **Rank** is the underwriter rank, from Carter and Manaster (1990), as updated by Carter, Dark, and Singh (1998) and Loughran and Ritter (2004). If highly ranked underwriters are better able to estimate firm value, then we should observe a negative relation between rank and underpricing. However, Loughran and Ritter (2004) note that, in recent years, issuers' increased focus on analyst coverage rather than pricing implies that issuers may accept lower offer prices (i.e., greater underpricing) to obtain the best analyst coverage. Because the highly ranked underwriters tend to have the best analysts, this suggests a positive relation between underpricing and rank.
- (2) **Log(Shares)** equals the logarithm of the number of shares (in millions) offered in the IPO. Less information tends to be available about smaller offerings, suggesting that underwriters will have more difficulty valuing such issues.
- (3) **Tech** equals one if the firm is in a high tech industry [biotech, computer equipment, electronics, communications, and general technology (as defined by SDC)], and zero otherwise. The value of technology firms tends to be much harder to estimate precisely.
- (4) **VC** equals one if the firm received financing from venture capitalists prior to the IPO (as defined by SDC), and zero otherwise. If venture capitalists share

information about the firm with underwriters, then underwriters may be better able to estimate firm value for such issues.

- (5) **NASDAQ** equals one if the IPO is listed on NASDAQ, and zero otherwise. The Small, young, high-tech firms tend to list on NASDAQ, suggesting underwriters will find it more difficult to value these firms.
- (6) **NYSE** equals one if the IPO is listed on the New York Stock Exchange, and zero otherwise. In contrast to NASDAQ, more established firms tend to go public on the NYSE, suggesting that underwriters will be better able to value these firms.
- (7) **Log(Firm Age + 1)** equals the logarithm of (1 plus) the number of years since the firm was founded, measured at the time of the IPO. There is likely to be more uncertainty regarding the secondary-market pricing of the stocks of young firms. We use the Field-Ritter dataset of founding dates (see Field and Karpoff (2002) and Loughran and Ritter (2004)).
- (8) **lPrice Update** is the absolute value of the percentage change between the offer price and the middle of the range of prices in the prospectus. This represents a proxy for the amount of learning that occurs during the registration period when the IPO is first marketed to investors. Substantial learning (i.e., a higher absolute value of price update) is more likely for firms whose value is more uncertain.

Table 3 shows correlations between the monthly average characteristics of firms going public and the monthly means and standard deviations of initial returns. In the first two columns, correlations are computed using the full sample from 1981–2005, the sample period with sufficient IPO characteristic data from SDC. The final two columns contain the same correlations after omitting the Internet-NASDAQ bubble period.

Months in which a greater proportion of firms are subject to higher levels of information asymmetry should exhibit both higher mean and a higher standard deviation of initial returns. Specifically, we expect initial returns to be high and more volatile in months when a lower fraction of offerings is backed by venture capital, months when the average offering is smaller and by a younger firm, months when more companies list on NASDAQ rather than the NYSE, and months when the average absolute value of the price update is higher.

Consistent with our predictions, both average initial returns and the dispersion of initial returns are substantially higher in months when the firms offering stock are (on average) younger, and when a greater proportion of IPO firms are in high-tech industries. Also, months with more firms listing on NASDAQ tend to have a higher mean and standard deviation of initial returns, while months with more firms listing on the NYSE tend to have lower initial returns. To the extent that the absolute price update reflects the amount of learning that occurs during the registration period when the IPO is first marketed to investors, the strong positive correlations between this variable and both average initial returns and the dispersion of initial returns are similarly consistent with our predictions.

The positive correlation of the average and standard deviation of initial returns with underwriter rank suggests that issuers' focus on analyst coverage dominates any incremental skill that highly ranked underwriters have in accurately valuing companies – perhaps issuers' focus on analyst coverage rather than pricing leads highly ranked underwriters to exert less effort on accurately pricing the issue. Finally, the positive correlations of the average and standard deviation of initial returns with venture capital backing and shares offered are not consistent with our predictions.

When the Internet-NASDAQ bubble period is excluded from the sample, the correlations become smaller, and several are not reliably different from zero. Looking at the last two columns, the strongest effects are for the technology and firm age variables: months in which more firms are from high technology industries and months in which the average firm is younger exhibit a higher average and a higher standard deviation of initial returns. In addition, the correlation between average underwriter rank and the standard deviation of IPO initial returns changes sign in this sub-sample, and the coefficient (although insignificant) is now consistent with highly ranked underwriters having more skill in valuing companies: months in which more IPO firms are advised by higher ranked advisors have lower variability of initial returns.

In sum, results in Table 3 provide suggestive evidence regarding the factors underlying the positive relation between the average and standard deviation of initial returns: when a greater fraction of

the IPOs represent firms that are more difficult for underwriters to value, both average initial returns and the standard deviation of initial returns tend to be higher.

### 3.2 Regression Analysis

Evidence in the previous section indicates that the portion of firms that is especially difficult to value (for example because relatively little information is available about them) in a month contributes positively to both the mean and the standard deviation of initial returns in that month. This suggests that the positive correlation between the mean and standard deviation of monthly initial returns is driven, at least partly, by fluctuations in the types of firms going public over time. Tables 4 and 5 investigate this proposition more directly.

Table 4 contains cross-sectional regressions of initial returns on various firm- and offer-specific characteristics, where these characteristics are intended to proxy for the level of uncertainty regarding the secondary-market pricing of the issue (and thus the uncertainty regarding the initial return). Specifically, Table 4 contains estimates of several variants of the following regression:

$$\begin{aligned} IR_i = & \alpha + \beta_1 \text{Rank}_i + \beta_2 \text{Log}(\text{Shares}_i) + \beta_3 \text{Tech}_i + \beta_4 \text{VC}_i + \beta_5 \text{NYSE}_i + \beta_6 \text{NASDAQ}_i \\ & + \beta_7 \text{Log}(\text{Firm Age}_i + 1) + \beta_8 |\text{Price Update}_i| + \beta_9 \text{Bubble}_i + \varepsilon_i. \end{aligned} \quad (1)$$

IR is the IPO initial return, defined as the percent difference between the offer price and the closing price on the 21<sup>st</sup> day of trading (as described in section 2.1). Bubble equals one if the IPO occurs between September 1998 and August 2000, and zero otherwise. All other variables are defined above.

The primary purpose of the cross-sectional regressions shown in Table 4 is to identify firm and deal characteristics that are likely to be systematically related to initial returns so that we can aggregate the predictions and the prediction errors from these models (at the monthly level) to learn more about the role that information asymmetry plays in explaining the cycles in IPO initial return volatility. While these cross-sectional regressions have many potential statistical problems (for example, correlations in

regression errors arising from the time clustering of IPOs), these problems are unlikely to bias the aggregation of predictions and prediction errors.

Our objective in this table is to assess the importance of firm-specific measures of uncertainty, rather than the recent state of the IPO market. Consistent with this objective, the regression in column (1) of Table 4 includes only firm-specific measures (i.e., excluding the Internet-NASDAQ bubble indicator variable). To examine the extent to which the extreme conditions during the Internet-NASDAQ IPO bubble of the late 1990s affect our regression estimates, columns (2) and (3) in Table 4 account for this period in two different ways. Column (2) includes an indicator variable that allows the average IPO return to be different between September 1998 and August 2000. Column (3) omits all of the observations between September 1998 and August 2000.

The regressions in Table 4 highlight the importance of the bubble period to the overall 1981-2005 sample. In column (2), the coefficient on the Internet-NASDAQ bubble indicator variable implies that average IPO returns were 62% higher during these 24 months, holding other characteristics of the deals constant. Moreover, in both columns (2) and (3), many of the coefficients on the firm- and deal-characteristic variables are different than those in column (1). This indicates that restricting coefficients on all explanatory variables to be constant throughout the entire sample period (including the Internet-NASDAQ bubble period) causes misspecification and biased inferences, a conclusion that is consistent with the findings of Loughran and Ritter (2004) and Lowry and Schwert (2004). As a result, we focus on the regressions shown in columns (2) and (3).

Looking at column (2) of Table 4, results are broadly consistent with those reported in prior literature. Consistent with Loughran and Ritter (2002), Megginson and Weiss (1991), Lowry and Schwert (2004), Ritter (1991), and Beatty and Ritter (1986) we find that smaller offerings, technology firms, firms with venture capital backing, NASDAQ firms, and younger firms have the most underpricing. The finding that higher ranked underwriters tend to have higher initial returns is inconsistent with Carter and Manaster's (1990) reputation hypothesis, but consistent with the findings of Cooney, Singh, Carter, and Dark (2001) and Loughran and Ritter (2004). In addition, we also find a

positive coefficient on the NYSE dummy, a result that is inconsistent with predictions. Finally, we find that the absolute value of the price update has a large, positive effect on the initial return. This is consistent with the effect of learning about unexpected investor demand during the book-building period. An absolute price update of 10% is associated with a 7.39% higher initial return (t-statistic = 7.32).

As mentioned above, the primary purpose of Table 4 is to obtain estimates of the ways in which firm- and deal-specific characteristics affect the pricing of each IPO. The fitted values from these regressions should represent the portion of initial returns that is attributable to underwriters' uncertainty regarding true firm value (e.g., Beatty and Ritter (1986) suggest that initial returns will be greater for high-uncertainty issues). If the positive correlation between the monthly mean and standard deviation of initial returns is driven by clustering in the types of firms that underwriters can value less precisely, then we should observe similar correlations in the fitted values. To examine this, we aggregate at the monthly level the predicted and residual values of each observation from the Table 4 regressions. We then calculate the mean and standard deviation, across all IPOs in each month, of both these predicted and residual values. Table 5 shows these means, standard deviations, and most importantly the correlations between the means and standard deviations across the raw data, fitted values, and residuals.

Specifically, in each of the three panels of Table 5, the first row represents the sample average of the monthly mean initial return measures (i.e., raw initial returns in the first column, predicted initial returns in the second column, and residual initial returns in the third column). The second row shows the sample average of the monthly standard deviations of the initial return measures. Finally, the third row shows the correlation between the mean and standard deviation, at the monthly interval.

Looking at the top panel in Table 5, we see that the fitted values from the column (2) regression in Table 4 (which employs the entire sample period and includes a dummy variable for the Internet-NASDAQ bubble period) capture many of the features of the raw initial returns. Although the Table 4 regression only explains 24% of the variation in initial returns, the characteristics of the fitted values are similar to those of the raw data. Most importantly, the correlation between the mean and standard deviation of the fitted values is 0.63, compared to 0.91 in the raw data. In contrast, the analogous



correlation for the residuals is only 0.35. Consistent with our predictions, this suggests that the time variation in uncertainty regarding firm value results in a significantly positive correlation between the mean and volatility of initial returns. When the types of firms going public are especially difficult to value, both the mean and the variability of initial returns are relatively high. In contrast, when the types of firms going public are easier to value, both the mean and the variability of initial returns are substantially lower.

The second panel in Table 5 is similar, with the exception that the cross-sectional regression of initial returns is estimated on a rolling sample of the previous 500 IPOs. This estimation method accounts more generally for the fact that many determinants of initial returns are not constant over time (see, e.g., Lowry and Schwert (2004)). After accounting for such fluctuations, the importance of information asymmetry as a determinant of the positive correlation between the mean and volatility of initial returns appears even stronger. The correlation between the mean and standard deviation of the fitted values is 0.84, which is very close to the correlation of 0.92 observed in the raw data for the same sample period.

Finally, the last panel shows similar results after omitting the Internet-NASDAQ bubble period. Due to the unique characteristics of this period, we want to ensure that results are robust to excluding it. While the correlation between the mean and standard deviation in the raw data is weaker (0.52), the predicted values from the cross-sectional regressions continue to explain a substantial portion of this relation (correlation = 0.44).

In sum, certain IPOs are characterized by greater uncertainty and it will be more difficult for underwriters to precisely estimate the value of such issues. In periods when a greater portion of issues is characterized by high uncertainty, underpricing should be higher on average and more dispersed. Our results are consistent with this prediction. Specifically, our findings suggest that the strong patterns in both the mean and volatility of IPO initial returns reflect two phenomena: underwriters can more precisely value some types of firms than others, and the type of firms going public changes over time.

### 3.3 *The Effects of Firm-specific Information Asymmetry on IPO Initial Return Dispersion*

This section continues to examine the idea that issues characterized by greater uncertainty (i.e., issues that are more difficult for underwriters to value) will be characterized by higher average initial returns and a higher dispersion of initial returns. While the previous section provided strong support for this hypothesis in an aggregated time-series framework, this section tests the same concept on a firm-specific basis, by treating the sequence of IPOs in our sample period as a time-series process. As discussed earlier, many prior papers have employed cross-sectional regressions of initial returns on firm- and offer-specific variables to show that the level of initial returns is positively related to measures of information asymmetry. Table 6 increases our understanding of the pricing of IPOs by capturing not only the cross-sectional characteristics of initial returns, but also the time-series dynamics. Second, in addition to examining the determinants of the *level* of initial returns, our specifications enable us to also investigate the factors that affect the *volatility* of initial returns.

Treating this sample of IPO initial returns as the realization of a time series process is somewhat unusual, because the individual observations represent different firms. The observations are ordered so that they are sequential, but they are not equally spaced in calendar time.<sup>5</sup> Nonetheless, the use of Box-Jenkins (1976) ARMA models to account for residual autocorrelation and the use of Nelson's (1991) EGARCH models to account for residual heteroskedasticity allow us to substantially improve the statistical specification of our models. The EGARCH specification allows us to directly test whether our information asymmetry variables are related to both the level of and the variability of IPO initial returns in similar ways.<sup>6</sup>

Column (1) in Table 6 replicates the regression shown in column (1) of Table 4. As described above, this regression restricts the coefficient estimates to be the same across the entire 1981–2005 period. This serves as a baseline regression against which to compare the alternative specifications that

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<sup>5</sup> In cases where there are multiple IPOs on a single calendar day we randomly order the offerings.

<sup>6</sup> We use Eviews version 5.1 to estimate all of the ARMA and EGARCH models.

capture the time-variation in both the level and the volatility of initial returns. Column (2) adds an ARMA(1,1) process to the baseline regression in column (1). The coefficient on the AR(1) term is close to 1, and the MA term is slightly lower, but also highly significant. As discussed in Schwert (1987), ARMA(1,1) models similar to this occur frequently in financial and economic data, including CPI inflation and measures of stock volatility. The relative magnitude of the AR and MA terms indicates that the residual autocorrelations for the model in column (1) are small but very persistent. After adding these time-series terms in column (2), the Ljung-Box (1979) Q-statistic, which measures the joint significance for the first 20 lags of the residual autocorrelation function, drops from 4,318 to 64, suggesting that the specification has improved dramatically.

While the ARMA terms control for autocorrelation in the level of initial returns, Figure 3 and Table 2 showed that there also exists strong cycles in the volatility of initial returns. Thus, for each regression we also calculate the Ljung-Box Q-statistic for the squared residuals, which is used to identify persistent residual heteroskedasticity. Not surprisingly, we find substantial time-varying heteroskedasticity (Q-statistic equals 1,194, p-value=0.000 in column (2)). This implies the need for some form of autoregressive conditional heteroskedasticity (ARCH) model of the type introduced by Engle (1982).

To address this conditional heteroskedasticity issue, column (3) adds an EGARCH(1,1) process to the ARMA(1,1) model in column (2). The first thing to note is that the coefficients on several of the explanatory variables change substantially. For example, underwriter rank, which was significantly positive in column (2), is now insignificantly different from zero. These changes are driven by the fact that the EGARCH specification essentially produces weighted least squares estimates, thereby reducing the influence of the Internet-NASDAQ bubble period (which had very high variability). Thus, the estimates of the parameters of the regression model look more like the estimates in columns (2) or (3) of Table 4, which adjusted for the Internet-NASDAQ bubble period by either adding a differential intercept (column (2)) or by completely omitting that data (column (3)). Finally, consistent with the patterns in raw

initial returns shown in Figure 3, the EGARCH parameters indicate that the residual variance is very persistent (the GARCH parameter is 0.997).

Moreover, the asymmetric ARCH coefficient in column (3) is positive (0.029, with an asymptotic  $t$ -statistic of 2.52), indicating that unusually large IPO initial returns are associated with a higher variability of subsequent residuals, while unusually low initial returns are associated with a lower variability of subsequent residuals. In light of the very persistent nature of both the level and variance of initial returns, this is broadly consistent with the strong positive correlation between the level and standard deviation of initial returns, as shown in Table 2. Notably, this contrasts sharply with what we have come to expect from studies of the variability of secondary-market returns, where positive shocks to returns are followed by low subsequent volatility (see, e.g., French, Schwert, and Stambaugh (1987)). Finally, the Ljung-Box  $Q$ -statistic for the squared residuals is much smaller in column (3), a value of 21, with a  $p$ -value of 0.257, implying that the conditional heteroskedasticity has been modeled adequately.

Column (4) of Table 6 adds the firm- and offer-specific variables to the EGARCH(1,1) process in column (3). This specification allows us to simultaneously examine whether these firm-specific factors affect both the level and variability of IPO initial returns, as suggested by our earlier evidence. As discussed above, prior literature has shown these factors to significantly affect the level of initial returns. If underwriters have more difficulty in valuing certain types of issues, we expect that they will also be significantly related to the variability of initial returns.

Consistent with our expectations, several of the proxies are significantly related to both the mean and the variance of initial returns in the predicted direction. For example, the coefficients on the technology indicator variables imply that the level of the IPO initial return and also its variability are reliably larger for technology firms ( $t$ -statistics of 2.22 and 4.45, respectively). Venture-backed IPOs have marginally lower initial return variability ( $t$ -statistic of -1.73), and firms with large absolute price updates (suggesting more learning during the book building process) have reliably larger IPO initial returns and variability of initial returns ( $t$ -statistics of 5.39 and 5.02, respectively). Finally, consistent with older firms being subject to less information asymmetry, firm age is significantly negatively related

to both the level of initial returns ( $t$ -statistic of -3.28) and the dispersion of IPO initial returns ( $t$ -statistic of -2.59).

The evidence presented here supports the conclusion that firm characteristics that one could naturally expect to be associated with greater uncertainty about the aftermarket price of the IPO stock are reliably associated with higher, and more variable, initial returns. Technology companies, companies not backed by a venture capitalist, young firms, and companies about which there is greater price discovery during the IPO registration period have significantly higher dispersion of initial returns than the remainder of the sample. Our tests are also more powerful than those offered previously in this literature: the combined ARMA/EGARCH models in Table 6 jointly model the time-dependence of the data that makes the simpler statistical analysis typically used in the IPO literature problematic, particularly for any sample that includes the Internet bubble period.

#### **4. Other Factors that Might Affect the Volatility of IPO Initial Returns**

##### *4.1 The Relation between the Dispersion of IPO Initial Returns and Market Volatility*

One obvious additional factor that could explain the strong cycles in the dispersion of IPO returns is the well-known persistence in the volatility of stock market returns. In particular, the peak in both the average level and the standard deviation of the initial returns to IPOs during the Internet-NASDAQ bubble period is reminiscent of the high volatility of NASDAQ stock returns during this period (e.g., Schwert (2002)). It seems plausible that underwriters would have greater difficulty valuing IPO firms when the level of market-wide uncertainty is especially high.

Fig. 4a shows the implied volatility of the Standard & Poor's composite index (VIX) and the NASDAQ composite index (VXN), both from the Chicago Board Options Exchange (CBOE), and there does seem to be a pronounced jump in market volatility in late August 1998. However, the biggest increases in market volatility on NASDAQ occurred starting in early 2000 and continued through the end of 2001. Fig. 4b shows the ratio of these measures of volatility from 1995-2005. To the extent that the volatility of the NASDAQ index reflects uncertainty about the valuation of growth options, this ratio

should mimic the uncertainty seen in IPO pricing. The September 1998-August 2000 period is identified by the dashed line. It is clear from Fig. 4b that market uncertainty about the value of NASDAQ stocks began to rise from a historically low level relative to S&P volatility in September 1998 and it continued to rise throughout the booming IPO period. However, NASDAQ market volatility remained high until July 2002, long after the IPO market had been very quiet in terms of average initial returns, the volatility of initial returns, and the number of IPOs. Thus, this figure provides preliminary evidence against the idea that market uncertainty explains a large portion of the volatility of IPO initial returns.

To more rigorously investigate the link between market-wide volatility and our measures of the monthly volatility of IPO initial returns, we first must determine the appropriate measure(s) of market-wide volatility. Monthly initial returns have both time-series and cross-sectional dimensions: the IPOs (by definition) are for different firms, implying a cross-sectional component, and the IPOs occur at different points in the month, implying a time-series component. Therefore, we examine market volatility measures computed in both the time-series and cross-section. The time-series metrics are the traditional monthly standard deviations of daily returns (e.g. Schwert (1989)), computed using equal-weighted portfolios of all firms on CRSP, and also for the sub-sample of firms listed on NASDAQ.<sup>7</sup> The cross-section measures are the standard deviations of firm-specific monthly cumulative returns, again estimated using all firms on CRSP and for the sub-sample of firms listed on NASDAQ.

To compute a time-series standard deviation for a given month, we determine the index returns on each day within a month, and then take the standard deviation across these daily index returns. In contrast, to compute a cross-sectional standard deviation for a given month, we first determine the monthly return of each firm in the market, and then take the standard deviation across these N monthly returns.

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<sup>7</sup> We also used value-weighted (by market capitalization) portfolios, but focus on the equal-weighted market portfolios since they are most comparable to our equal-weighted portfolios of IPO returns.

These time-series and cross-sectional return volatility measures capture significantly different aspects of aggregate return variance.<sup>8</sup> Time-series volatility measures, as traditionally employed in the literature on return volatility, reflect aggregate market return volatility – the extent of movements in stock indices within the month. On the other hand, our cross-sectional return dispersion measures capture aggregate firm-specific volatility – the extent to which firm-specific information flows cause stock prices to move in different directions, or change by different magnitudes, within the month (see, e.g., Bessembinder, Chan, and Seguin (1996) and Stivers (2003)). In this sense, the cross-sectional volatility measures reflect ‘market-wide’ firm-specific information flows: months with lots of firm-specific news are characterized by greater cross-sectional return dispersion, while months in which most of the news that moves stock prices is related to systematic factors affecting all firms are characterized by lower cross-sectional return dispersion.

Table 7 examines whether initial return volatility covaries with either of these measures of market volatility over time, where both initial return volatility and market volatility are measured at the monthly interval. The top panel shows significant correlations between the cross-sectional volatility measures and IPO volatility. Correlations between IPO volatility and the-time-series market volatility measures are only significant when the market is restricted to the Nasdaq index, i.e., to firms that are more similar to the IPO firms. In sum, Panel A suggests that the dispersion in initial returns is related to market-wide volatility measures, in particular to firm-specific information flows and to the price movements of firms that are most similar to the IPO firms.

However, the bottom panel of Table 7 indicates that the importance of both cross-sectional and time-series volatility measures is driven by the Internet-NASDAQ bubble period.<sup>9</sup> Removing the bubble

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<sup>8</sup> Our time-series and cross-sectional volatility measures are closely related to the disaggregated volatility measures in Campbell, Lettau, Malkiel, and Xu (2001) [CLMX]. Specifically, our time-series volatility measure is highly correlated with CLMX’s market volatility component, and our cross-sectional measure is strongly related to CLMX’s firm-specific volatility component.

<sup>9</sup> This is consistent with the evidence in Schwert (2002), who shows that technology firms’ volatility was unusually high during this period.

period from the sample reduces the correlations between IPO initial return dispersion and both time-series and cross-sectional measures of volatility considerably; outside the bubble period we observe no positive correlations between IPO initial return volatility and the various measures of market volatility. This is consistent with the evidence in Figure 4. In sum, across the vast majority of our sample period, there is no significant positive association between IPO initial return variability and measures of market-wide volatility, whether measured in the time-series or cross-section and whether measured for all firms on the CRSP database or for NASDAQ firms only.

#### *4.2 Other Possible Explanations for Underpricing*

Loughran and Ritter (2002) argue that prospect theory can explain part of the underpricing seen in IPO markets. In effect, equity owners who see their wealth increase due to large increases in the secondary market stock price after an IPO do not feel too bad about the fact that they could have raised more money in the IPO by setting a higher IPO price. Of course, unless the after-IPO market price of the stock is higher than it would be if the IPO had not been underpriced, there is no connection between the high value of the stock and the loss associated with underpricing, so prospect theory implies irrational behavior by the decision-makers of issuing firms.

Ljungqvist and Wilhelm (2003) argue that lower CEO ownership and smaller secondary components of IPOs in the late 1990s led to less sensitivity to IPO underpricing. They find some evidence that this factor explains part of the variation in underpricing in the 1999-2000 period. They also argue that directed allocations of underpriced IPOs to “friends and family” led to a desire for underpricing by the executives of firms undergoing IPOs.<sup>10</sup>

Loughran and Ritter (2004) argue that during the Internet-NASDAQ bubble period many issuers had objective functions that focused on things other than maximizing the proceeds from the IPO. In particular, they argue that decision-makers in the issuing firms sought pay-offs from investment bankers

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<sup>10</sup> However, Lowry and Murphy (2007) suggest that the high levels of underpricing may lead more firms to adopt friends and family programs, rather than friends and family programs leading to more underpricing.



in the form of allocations in the underpriced IPOs of other firms (“spinning”), so when their own firm went public they accepted underpricing as part of the quid pro quo exchange for the private benefits they received as investors in the underpriced IPOs of other firms. They also argue that issuing firms became very interested in coverage of their firms by securities analysts during this period, and perceived that an underpriced IPO would provide incentives for the underwriting firms to provide such analyst coverage.

We have been unable to find data that would allow us to test whether these factors can explain the level and variability of underpricing over longer sample periods before and after the Internet-NASDAQ bubble period. While many hypotheses have been proposed for the unusual underpricing behavior during the 1998-2000 period, as shown in Figure 3, there have been several other hot issues episodes in the IPO market before 1998, and most of the institutional factors that have been identified as being unusual in the 1998-2000 period were not present in the earlier episodes (to the best of our knowledge).

## **5. Implications of the High Volatility of IPO Initial Returns**

The evidence in this paper strongly suggests that the bookbuilding process (the conventional pricing mechanism for IPOs in the United States) has a difficult time setting IPO prices that come close to equating demand and supply. Across our 1965–2005 sample period, nearly one-third of IPOs have negative initial returns and another one-third have initial returns of 25% or more. This phenomenon is particularly pronounced in “hot issues markets”: the standard deviation of initial returns was 126% during the September 1998–August 2000 internet bubble period, compared to 30% during the remainder of our sample period.

At least a portion of this volatility in initial returns is driven by underwriters’ tendency to incorporate only a portion of the information learned during the bookbuilding period into the final offer price. While there is much evidence (e.g., Hanley (1993), and recently Lowry and Schwert (2004)) that price updates that occur during the bookbuilding period reflect some information about demand, there is also much evidence that underwriters and/or issuing firms are reluctant to adjust the IPO price upward sufficiently when they learn that there is substantial excess demand at the proposed IPO price. In fact, the

results in this paper suggest that IPOs in which underwriters revised the price by greater amounts (regardless of whether the revision was positive or negative) have larger pricing errors (as reflected in higher volatility of initial returns).

From underwriters' perspective, it is arguably easy to see that a proposed IPO price is too low if the indications of interest are many multiples of the shares for sale in the IPO. However, it may be difficult to estimate the market-clearing price (i.e., the price that would equate the supply of shares for sale with demand) if one only observes excess demand at the proposed IPO price. Even if underwriters can confidently predict a "large" price increase after the IPO, they may remain quite uncertain about what the actual secondary market price will be.

In recent years, auctions have emerged as a credible alternative to the conventional bookbuilding process for the pricing and distribution of shares in IPOs. In contrast to bookbuilding methods, auction methods allow the overall market to determine the price at which demand equals supply. Consequently, there is little reason to expect large price changes or high trading volume in the secondary market for stocks that are marketed using an auction mechanism.

Table 8 contains a sample of 16 auction IPOs in the U.S. that were managed (or co-managed) by W. R. Hambrecht & Co.<sup>11</sup> All the IPOs in this sample are for firms that went public in the 1999 – 2005 time period and listed on NASDAQ. With the notable exception of Google, the auctions are by small firms: the average pre-IPO assets for these firms (excluding Google) are \$68 million, compared to average pre-IPO assets of \$1,118 million for conventional IPOs over the same period.

As shown in Table 8, initial returns for auction IPOs look quite different than those of traditional IPOs. For example, initial returns for the majority of auction IPOs are not very large, particularly given that many of these offerings occurred during the Internet Bubble period, a time when traditional IPOs were underpriced by exorbitant amounts. Average first-day returns across all 16 auction IPOs equal

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<sup>11</sup> [http://www.wrhambrecht.com/comp/corpfm/completed\\_recent.html](http://www.wrhambrecht.com/comp/corpfm/completed_recent.html). This sample contains all auction IPOs managed by W.R. Hambrecht, with the exception of the Instinet IPO for which only a small fraction of the shares offered in the IPO (2.4m out of 12.2m) were sold using the auction process.

17.1%, compared to an average of 41.8% for traditional IPOs over the same period. Looking at the auction initial returns, we observe that there is one extreme outlier: Andover.net had a one-day initial return of 252%. Because the number of auctions is so small, this has a substantial effect on sample-wide statistics. We therefore calculate average initial returns after excluding this one outlier from the auction sample, and, for consistency, also excluding a similar portion of outliers from the traditional IPO sample.<sup>12</sup> After excluding outliers from both samples, the average first-day initial return is 1.5% for the auctions, compared to 34.6% for traditional IPOs.

In addition to being lower on average, initial returns of the auction IPOs are also less disperse. After excluding Andover.net from the auction sample (and also removing outliers from the traditional IPO sample for consistency), the standard deviation of first-day initial returns for the auction sample is 10.1%, compared to 50.8% for traditional IPOs. These same patterns are evident in first-month (21-day) initial returns, which we rely on in this paper to circumvent the effects of immediate post-offer price support by IPO advisors. Both the average and the standard deviation of initial returns are substantially lower for auctions.

As an additional estimate of the difference between auctions and firm-commitment offerings, we add an auction dummy to the GARCH model shown in column 4 of Table 6, where the auction dummy equals one for each of the 16 auctions, zero otherwise. Consistent with the descriptive statistics shown in Table 8, this GARCH specification (not shown in the table) indicates that auctions have significantly lower underpricing than the firm-commitment offerings. However, the coefficient on the auction dummy is not significant in the volatility equation. Given the small sample of auctions, we similarly interpret this evidence as suggestive of the benefits of auctions, but certainly not conclusive.

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<sup>12</sup> Specifically, we truncate the traditional IPO sample at the 3% and 97% levels. Excluding 6% of the traditional IPOs is approximately equivalent to excluding 1 out of 16 auctions ( $1/16 = 6.25\%$ ).

It is important to note that many of these auctions were “dirty” auctions, meaning their offer prices were set below the market clearing price.<sup>13</sup> The fact that W. R. Hambrecht chooses to run their auctions in this manner is consistent with Sherman (2005) and Jagannathan and Sherman (2006), who argue that the optimal IPO auction would give the auctioneer discretion in setting the offer price. As an example, Andover.net chose to price its offer at \$18.00, considerably below the clearing price of \$24.00. In the case of Andover, the fact that the offer price was set below the market clearing price does not explain all of the initial return (first-day return of 252%). However, the extent to which such practices are common throughout the sample potentially causes initial returns of the auctions to be higher than they otherwise would be.

Derrien and Womack (2003) compare the pricing of auction versus firm-commitment offerings in the French market. Similar to the results presented here, they conclude that auctions are much better at identifying an IPO price that is close to the subsequent secondary market price.<sup>14</sup> Also consistent with our conclusions, they find that bookbuilding is at the biggest disadvantage during “hot issues” markets, when underpricing is largest and most uncertain. Nevertheless, they confirm the conclusions of Jagannathan and Sherman (2006) that the market share of auction mechanisms has diminished, despite the apparent improvement in setting IPO prices.

DeGeorge, Derrien, and Womack (2005) suggest that the auxiliary services offered in conjunction with firm commitment offerings may contribute to their growing popularity. Specifically, their study of the French market suggests that companies may choose the bookbuilding method over auctions because of a higher likelihood of receiving favorable analyst coverage (though they find no evidence that this more favorable coverage translates into any valuation differentials).

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<sup>13</sup> W. R. Hambrecht specifically states on its website that the issuing company and the underwriters take “a number of economic and business factors into account in addition to the clearing price. The company may choose to sell shares at the clearing price, or it may offer the shares at a lower offering price.”

<sup>14</sup> At least a portion of the difference between auctions and bookbuilding methods potentially reflects the fact that the offer price was set farther in advance for the bookbuilding offers (see, e.g., Jagannathan and Sherman (2005)).

Table 8 provides descriptive statistics on two auxiliary services that generally accompany firm commitment offerings: analyst following (the number of analysts providing a price recommendation within six months of listing) and the number of market makers (measured on the 21<sup>st</sup> trading day following listing). Notably, there is little evidence that those companies choosing to go public via the auction method are disadvantaged on either of these dimensions. Across all 16 auctions, the average number of analysts is 3.6, compared to 4.4 for the firm commitment sample. Moreover, the auctions actually have a higher average number of market makers than the firm commitment offerings: 22.6 versus 18.7. Like the other figures in Table 8, these comparisons are suggestive rather than conclusive. For example, if we eliminate Google from the auction sample, the average number of market makers is similar across the two groups (18.5 for auctions and 18.7 for firm-commitments), but analyst following is greater for the firm commitment offerings (average of 2.0 for auctions, vs. 4.4 for firm commitments). Notably, however, the firm commitment sample includes many large offerings (similar to Google), and both analyst following and the number of market makers are positively related to firm size. Unfortunately, the limited sample of auctions prevents us from controlling for such issues using more robust statistical analyses.

In sum, the descriptive statistics in Table 8 provide little support for the idea that companies obtain non-price related benefits when they choose the firm commitment method of underwriting. While there are other services that underwriters provide, for example price support and discriminatory allocation, we do not have data to examine such issues. Certainly, we cannot rule out the relevance of such auxiliary services in a firm's decision between the auction and firm-commitment form of going public. However, at a minimum, the extreme difficulties that underwriters appear to have in pricing IPOs suggests that many firms would benefit from an auction mechanism.

## **6. Conclusion**

This paper documents the monthly dispersion of IPO initial returns, and demonstrates that the volatility of initial returns is large on average and varies considerably over time. The dispersion of initial IPO returns each month has a strong positive correlation with average initial returns each month (underpricing) over the 1965–2005 period. This relation is stronger in data from the Internet-NASDAQ bubble period (September 1998 to August 2000), but persistently positive across all sub-periods analyzed, and contrasts markedly with the negative correlation between the volatility and mean of secondary-market returns.

The large and time-varying volatility of IPO initial returns documented in this study suggests that underwriters have great difficulty in accurately valuing the shares of companies going public through IPOs. The process of marketing an issue to institutional investors, for example during the road show, appears unable to resolve much of the uncertainty about aggregate market demand for the stock of IPO firms. If anything, we find the opposite: issues for which the most learning occurs during the registration period (large absolute price updates) also have higher volatility of initial returns (i.e. pricing errors). Furthermore, consistent with the notion that the complexity of the pricing problem in traditional firm-commitment offerings contributes to IPO initial return volatility, we report greater pricing errors (dispersion of initial returns) when a larger fraction of high information asymmetry firms (young, technology firms) go public and during hot markets, particularly the internet-NASDAQ bubble of the late 1990s.

Our results raise serious questions about the efficacy of the firm-commitment underwritten IPO process, as the volatility of the pricing errors reflected in initial IPO returns is extremely large, especially for firms with high information asymmetry and during “hot market” periods. We conjecture that alternative price-discovery mechanisms, such as auction methods, might result in much more accurate price discovery in the pre-trading period for IPO companies.

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Table 1  
Sources of IPO Data, 1965-2005

Data Source	Sample Period	Number of IPOs	First-month Initial Return Available	and IPO Price $\geq$ \$5.00
Downes and Heinkel (1982) and Ritter (1984b) <sup>a</sup>	1965-1973 (not 1968)	635	604	576
<i>Wall Street Journal Index</i> <sup>a</sup>	1968	395	395	369
Ritter (1991) <sup>b</sup>	1975-1984	1,524	1,510	1,199
S.E.C. Registered Offering Statistics (ROS) Database <sup>c</sup>	1977-1988	1,394	46	17
Securities Data Corporation (SDC) Database <sup>d</sup>	1970-2005	7,786	6,917	6,620
Total	1965-2005	11,734	9,477	8,781

<sup>a</sup> <http://schwert.ssb.rochester.edu/DownesHeinkelRitter.xls>

<sup>b</sup> <http://bear.cba.ufl.edu/ritter/IPO2609.xls>

<sup>c</sup> <http://www.archives.gov/research/electronic-records/sec.html#ros>

<sup>d</sup> <http://www.thomsonib.com/sp.asp>

Initial returns are measured as the percent difference between the aftermarket price on the twenty-first day of trading and the offer price.

Table 2  
Descriptive Statistics on the Monthly Volatility of Initial Returns

	N	Avg	Median	Std Dev	Corr	Autocorrelations: Lags					
						1	2	3	4	5	6
<b>1965 – 2005</b>											
Mean IPO Return	456	0.166	0.119	0.256		0.64	0.58	0.58	0.50	0.46	0.45
Std Dev of IPO Returns	398	0.314	0.239	0.280	0.864	0.70	0.64	0.65	0.60	0.57	0.56
<b>1965 – 1980</b>											
Mean IPO Return	162	0.121	0.053	0.237		0.49	0.46	0.46	0.46	0.42	0.35
Std Dev of IPO Returns	111	0.307	0.240	0.229	0.754	0.34	0.22	0.35	0.33	0.29	0.35
<b>1981 – 1990</b>											
Mean IPO Return	120	0.092	0.084	0.121		0.48	0.28	0.16	0.12	0.00	0.05
Std Dev of IPO Returns	117	0.215	0.202	0.098	0.543	0.23	0.22	0.09	0.22	0.14	0.13
<b>1991 – 2005</b>											
Mean IPO Return	174	0.258	0.184	0.310		0.69	0.62	0.64	0.50	0.47	0.47
Std Dev of IPO Returns	170	0.387	0.266	0.362	0.923	0.79	0.73	0.73	0.65	0.62	0.59
<b>1991 – 2005 (omitting September 1998 – August 2000)</b>											
Mean IPO Return	150	0.162	0.164	0.113		0.30	0.14	0.01	0.00	0.03	-0.03
Std Dev of IPO Returns	147	0.264	0.245	0.098	0.498	0.27	0.10	0.10	0.05	0.17	0.24

Each month, the mean and standard deviation of initial returns is measured across all firms that went public during that month. Initial returns are measured as the percent difference between the aftermarket price on the twenty-first day of trading and the offer price. Price updates are measured as the percent difference between the IPO price and the midpoint of the filing range specified in the earliest prospectus. Corr represents the correlation between the means and standard deviations through time. Months for which there is only one IPO yield an estimate of the mean IPO return, but not an estimate of the standard deviation. Months with three or more IPO's yield an estimate of the standard deviation.

Table 3

Correlations between the moments of IPO initial returns  
and IPO market characteristics  
(p-values in parentheses)

	1981-2005		1981-2005 (omitting bubble)	
	Average IPO Initial Return	Std Dev of IPO Initial Returns	Average IPO Initial Return	Std Dev of IPO Initial Returns
Average Underwriter Rank	0.14 (0.010)	0.18 (0.002)	-0.04 (0.755)	-0.10 (0.234)
Average Log(Shares)	0.22 (0.000)	0.24 (0.000)	0.15 (0.003)	0.13 (0.020)
Percent Technology	0.48 (0.000)	0.51 (0.000)	0.26 (0.000)	0.27 (0.000)
Percent Venture Capital	0.30 (0.000)	0.32 (0.000)	0.15 (0.031)	0.12 (0.089)
Percent NYSE	-0.12 (0.017)	-0.08 (0.159)	-0.04 (0.699)	0.00 (0.767)
Percent NASDAQ	0.17 (0.000)	0.13 (0.011)	0.08 (0.236)	0.04 (0.773)
Average Log(Firm Age + 1)	-0.29 (0.000)	-0.33 (0.000)	-0.11 (0.071)	-0.27 (0.000)
Average  Price Update	0.50 (0.000)	0.58 (0.000)	0.07 (0.256)	0.15 (0.043)

This shows correlations between the monthly average and standard deviation of IPO initial returns and monthly average IPO market characteristics. The sample consists of all IPO's with an offer price of at least \$5 that went public between 1981 and 2005. Initial returns are defined as the percent difference between the closing price on the twenty-first day of trading and the offer price. Underwriter Rank is the average Carter-Manaster (1990) underwriter ranking score, as updated by Carter, Dark, and Singh (1998) and Loughran and Ritter (2004). Log(Shares) is the logarithm of the number of shares (in millions) offered in the IPO. Percent Tech is the average of a Technology Dummy equals one if the firm is in a high tech industry [biotech, computer equipment, electronics, communications, and general technology (as defined by SDC)], and zero otherwise. Percent Venture Capital is the average of a Venture Capital Dummy equals one if the firm received financing from venture capitalists prior to the IPO (as defined by SDC), and zero otherwise. Percent NYSE is the average of a NYSE Dummy equals one if the IPO firm will be listed on the New York Stock Exchange, and zero otherwise. Percent NASDAQ is the average of a NASDAQ Dummy equals one if the IPO firm will be listed on NASDAQ, and zero otherwise. Log(Firm Age+1) is the logarithm of the number of years since the firm was founded at the time of the IPO plus one. |Price Update| is the absolute value of the percentage change between middle of the range of prices in the initial registration statement and the offer price. The "bubble" period is defined to be between September 1998 and August 2000. The p-values, use White's (1980) heteroskedasticity-consistent standard errors.

Table 4  
 Relation between Initial Returns and  
 Firm-Specific Proxies for Information Asymmetry

	(1) 1981-2005	(2) 1981-2005	(3) 1981-2005 Omitting Bubble
Intercept	-0.654 (-5.87)	0.181 (1.75)	-0.117 (-1.71)
Underwriter Rank	0.010 (3.06)	0.011 (3.50)	-0.001 (-0.48)
Log(Shares)	0.038 (4.77)	-0.020 (-2.64)	0.011 (2.43)
Technology Dummy	0.123 (9.61)	0.060 (5.13)	0.048 (5.44)
Venture Capital Dummy	0.037 (2.41)	0.041 (2.84)	0.012 (1.35)
NYSE Dummy	0.039 (1.31)	0.078 (2.68)	0.059 (2.33)
NASDAQ Dummy	0.138 (5.16)	0.099 (3.77)	0.078 (3.30)
Log(Firm Age + 1)	-0.033 (-6.81)	-0.021 (-4.69)	-0.013 (-4.16)
lPrice Updatel	0.969 (8.89)	0.739 (7.32)	0.241 (6.02)
Bubble Dummy (9/1998-8/2000)		0.620 (14.78)	
R <sup>2</sup>	0.142	0.240	0.030
Sample Size	6,840	6,840	6,103

This shows cross-sectional regressions of IPO initial returns on firm- and offer-specific characteristics. The sample consists of all IPO's with an offer price of at least \$5 that went public between 1981 and 2005. Underwriter Rank is the average Carter-Manaster (1990) underwriter ranking score, as updated by Carter, Dark, and Singh (1998) and Loughran and Ritter (2004). Log(Shares) is the logarithm of the number of shares (in millions) offered in the IPO. The Technology Dummy equals one if the firm is in a high tech industry [biotech, computer equipment, electronics, communications, and general technology (as defined by SDC)], and zero otherwise. The Venture Capital Dummy equals one if the firm received financing from venture capitalists prior to the IPO (as defined by SDC)], and zero otherwise. The NYSE Dummy equals one if the IPO firm will be listed on the New York Stock Exchange, and zero otherwise. The NASDAQ Dummy equals one if the IPO firm will be listed on NASDAQ, and zero otherwise. Log(Firm Age+1) is the logarithm of the number of years since the firm was founded at the time of the IPO plus one. lPrice Updatel is the absolute value of the percentage change between middle of the range of prices in the initial registration statement and the offer price. Bubble equals one if the IPO occurs between September 1998 and August 2000, and zero otherwise. The t-statistics, in parentheses, use White's (1980) heteroskedasticity-consistent standard errors. R<sup>2</sup> is the coefficient of determination, adjusted for degrees of freedom.

Table 5  
 Monthly means and standard deviations of predicted  
 and residual initial returns, 1981 - 2005

	<i>Whole Time Period: Column 2, Table 4 regression</i>		
	<u>Raw Data</u>	<u>Fitted Values</u>	<u>Residuals</u>
Average Monthly Value	0.20	0.20	0.00
Std dev of values within each month, averaged across all months	0.31	0.12	0.32
Correlation between mean and standard deviation, monthly interval	0.91	0.63	0.35
	<i>Whole Time Period: Column 1, Table 4 regression estimated on Rolling Sample of last 500 IPOs</i>		
	<u>Raw Data</u>	<u>Fitted Values</u>	<u>Residuals</u>
Average Monthly Value	0.20	0.21	-0.01
Std dev of values within each month, averaged across all months	0.32	0.14	0.34
Correlation between mean and standard deviation, monthly interval	0.92	0.84	0.25
	<i>Omitting Bubble Period (September 1998 – August 2000): Column 3, Table 4 regression</i>		
	<u>Raw Data</u>	<u>Fitted Values</u>	<u>Residuals</u>
Average Monthly Value	0.13	0.14	-0.01
Std dev of values within each month, averaged across all months	0.24	0.05	0.24
Correlation between mean and standard deviation, monthly interval	0.52	0.44	0.44

To compute Average Monthly Value, we calculate the average initial return each month, and then average this value across all months. For the standard deviation, we compute the standard deviation of initial returns across all IPOs each month, and then average this value across all months. The correlation represents the correlation between this mean and standard deviation at the monthly interval. Fitted values and residuals come from regressions in Table 4. In the second panel, the regression is continuously re-estimated, based on the previous 500 observations.

Table 6  
 Relation between Initial Returns and Firm-Specific Proxies  
 for Information Asymmetry, with ARMA(1,1) Errors  
 and EGARCH(1,1) Conditional Volatility, 1981-2005

	(1)	(2)	(3)	(4)
Intercept	-0.654 (-5.87)	0.607 (4.23)	0.261 (3.12)	0.292 (3.62)
Underwriter Rank	0.010 (3.06)	0.014 (4.36)	0.001 (0.64)	0.003 (1.25)
Log(Shares Offered)	0.038 (4.77)	-0.047 (-4.87)	-0.011 (-1.88)	-0.015 (-2.47)
Technology Dummy	0.123 (9.61)	0.052 (4.35)	0.023 (2.37)	0.020 (2.22)
Venture Capital Dummy	0.037 (2.41)	0.042 (3.03)	0.018 (1.87)	0.018 (1.96)
NYSE Dummy	0.039 (1.31)	0.103 (3.65)	0.048 (1.71)	0.039 (0.94)
Nasdaq Dummy	0.138 (5.16)	0.103 (4.09)	0.056 (2.09)	0.041 (1.08)
Log(Firm Age + 1)	-0.033 (-6.81)	-0.017 (-3.87)	-0.011 (-2.78)	-0.011 (-3.28)
lPrice Update <sub>it</sub>	0.969 (8.89)	0.774 (8.08)	0.206 (5.86)	0.191 (5.39)
AR(1)		0.991 (219.85)	0.988 (303.67)	0.986 (267.04)
MA(1)		0.925 (78.24)	0.920 (122.15)	0.923 (110.83)

$$\text{EGARCH model: } \log(\sigma_t^2) = \omega + \alpha |\varepsilon_{t-1}|/\sigma_{t-1} + \gamma \varepsilon_{t-1}/\sigma_{t-1} + \beta \log(\sigma_{t-1}^2) + \sum_{i=1}^8 c_k X_{kt}$$

Variance intercept, $\omega$		-0.052 (-3.80)	-0.135 (-0.60)
ARCH, $\alpha$		0.064 (3.43)	0.153 (3.44)
Asymmetric ARCH, $\gamma$		0.029 (2.52)	0.022 (1.04)
GARCH, $\beta$		0.997 (729.36)	0.939 (84.42)
Underwriter Rank			0.005 (0.70)

Table 6 (continued)

	(1)	(2)	(3)	(4)
Log(Shares)				0.004 (0.23)
Technology Dummy				0.157 (4.45)
Venture Capital Dummy				-0.058 (-1.73)
NYSE Dummy				-0.289 (-0.92)
Nasdaq Dummy				-0.204 (-0.79)
Log(Firm Age + 1)				-0.047 (-2.59)
lPrice Updatel				0.448 (5.02)
Ljung-Box Q-statistic (20 lags) (p-value)	4318 (0.000)	64 (0.000)	30 (0.035)	27 (0.083)
Ljung-Box Q-statistic (20 lags, squared residuals) (p-value)	1461 (0.000)	1194 (0.000)	21 (0.257)	12 (0.841)
R <sup>2</sup>	0.142	0.283	0.249	0.246
Sample Size	6,840	6,839	6,839	6,839

This shows regressions of IPO initial returns on firm- and offer-specific characteristics. The sample consists of all IPO's with an offer price of at least \$5 that went public between 1981 and 2005, ordered by the date of the offer. The model in column (1) is the same as the model in column (3) of Table 4. Underwriter Rank is the average Carter-Manaster (1990) underwriter ranking score, as updated by Carter, Dark, and Singh (1998) and Loughran and Ritter (2004). Log(Shares) is the logarithm of the number of shares (in millions) offered in the IPO. The Technology Dummy equals one if the firm is in a high tech industry [biotech, computer equipment, electronics, communications, and general technology (as defined by SDC)], and zero otherwise. The Venture Capital Dummy equals one if the firm received financing from venture capitalists prior to the IPO (as defined by SDC), and zero otherwise. The NYSE Dummy equals one if the IPO firm will be listed on the New York Stock Exchange, and zero otherwise. The NASDAQ Dummy equals one if the IPO firm will be listed on NASDAQ, and zero otherwise. Log(Firm Age+1) is the logarithm of the number of years since the firm was founded at the time of the IPO plus one. lPrice Updatel is the absolute value of the percentage change between middle of the range of prices in the initial registration statement and the offer price. The t-statistics, in parentheses, use heteroskedasticity-consistent standard errors. The Ljung-Box (1979) Q-statistic is based on the first 20 lags of the residual autocorrelation function and has an asymptotic  $\chi^2$  distribution under the hypothesis of no autocorrelation. For the EGARCH models in columns (3) and (4), the Ljung-Box Q-statistic is based on the autocorrelations of the standardized residuals. R<sup>2</sup> is the coefficient of determination, adjusted for degrees of freedom.

The data are ordered according to the offer date of the IPO, but they are not equally spaced in time. The models in columns (2)-(4) estimate ARMA(1,1) models [Box and Jenkins(1976)] for the residuals from the model to correct for the autocorrelation of the residuals in column (1), as reflected in the lower Ljung-Box Q-statistics. The Ljung-Box Q-statistics for squared residuals suggest substantial autocorrelation of the conditional variance of the residuals, so the model in column (3) includes an EGARCH(1,1) model for the conditional variance of IPO returns. The model in column (4) also includes the information asymmetry variables that are in the return equation in the conditional variance equation, represented by the summation  $\sum c_k X_{kt}$ .



Table 7

Correlations between volatility of initial returns and  
the time-series and cross-sectional volatility of market indices  
(p-values in parentheses)

	Time-series market volatility measure	Cross-sectional market volatility measure
January 1965 – December 2005		
Market-wide Index	0.07 (0.153)	0.26 (0.002)
NASDAQ Index	0.17 (0.009)	0.25 (0.003)
January 1965 – December 2005, omitting September 1998 – August 2000		
Market-wide Index	-0.00 (0.948)	-0.11 (0.033)
NASDAQ Index	0.05 (0.400)	-0.12 (0.036)

Initial Returns are defined as the percent difference between the closing price on the twenty-first day of trading and the offer price. All IPO's between 1965 and 2005 with an offer price of at least \$5 are included in the sample. To compute monthly volatility, we compute the daily return on the given portfolio (market-wide index or NASDAQ index). We then calculate the standard deviation of daily portfolio returns for all days in the month. To compute monthly cross-sectional volatility, we compute the monthly return on each stock in the given portfolio (market-wide index or NASDAQ index). We then calculate the standard deviation of these monthly returns across all firms in the portfolio. All portfolios use equal-weights.

Table 8  
Descriptive Statistics on U.S. Auction IPOs between 1999 and 2005

Name	Issue date	Pre-IPO assets (\$m)	Offer price	First-day initial return	First-month initial return	Number of analysts	Number of market makers
Ravenswood Winery Inc	4/8/1999	\$16.0	\$10.50	3.6%	0.6%	1	12
Salon.com	6/22/1999	4.6	10.50	-4.8%	8.3%	1	15
Andover.net Inc	12/8/1999	14.4	18.00	252.1%	116.7%	2	17
Nogatech Inc	5/18/2000	51.7	12.00	-21.6%	-42.4%	2	17
Peet's Coffee & Tea	1/25/2001	47.4	8.00	17.2%	6.3%	2	27
Briazz Inc	5/2/2001	14.2	8.00	0.4%	-37.6%	0	18
Overstock.com Inc	5/29/2002	47.2	13.00	0.2%	3.8%	2	24
RedEnvelope Inc	9/24/2003	48.8	14.00	3.9%	-4.0%	3	15
Genitope Corp	10/29/2003	12.0	9.00	11.1%	36.1%	4	17
New River Pharmaceuticals	8/5/2004	3.1	8.00	-6.3%	-5.3%	3	15
Google Inc	8/18/2004	1,328.0	85.00	18.0%	34.1%	27	83
Boff Holding Inc	3/14/2005	512.6	11.50	0.0%	-4.3%	1	20
Morningstar Inc	5/2/2005	190.7	18.50	8.4%	18.6%	1	28
CryoCor Inc	7/13/2005	5.8	11.00	-1.2%	-23.9%	3	21
Avalon Pharmaceuticals Inc	9/29/2005	24.4	10.50	-9.6%	-46.4%	3	17
Dover Saddlery Inc	11/17/2005	30.7	10.00	2.5%	0.0%	2	15
Average		\$147.0	\$16.09	17.1%	3.8%	3.6	22.6
Standard deviation				63.4%	38.6%		
Average (excluding Andover.net)				1.5%	-3.7%		
Standard deviation (excluding Andover.net)				10.1%	25.0%		
Average for firm-commitment IPOs, 1999-2005		\$1,117.8	\$14.67	41.8%	54.5%	4.4	18.7
Standard deviation for firm-commitment IPOs, 1999-2005				73.4%	101.3%		
Average for firm-commitment IPOs, 1999-2005, excluding outliers				34.6%	44.7%		
Standard deviation for firm-commitment IPOs, 1999-2005, excluding outliers				50.8%	70.1%		

\* This sample of auctions is from W. R. Hambrecht's OpenIPO process ([http://www.wrhambrecht.com/comp/corpfm/completed\\_recent.html](http://www.wrhambrecht.com/comp/corpfm/completed_recent.html)), excluding Instinet (for which only a fraction of the IPO shares were sold in an auction format). The number of market makers is measured on the 21<sup>st</sup> trading day following listing. The number of analysts represents those analysts providing a price recommendation within 6 months following listing.

**Frequency Distribution of First-day IPO Returns,  
1970-2005, IPO Price > \$5, N = 7,669**  
 Mean = 17%, Std Dev = 39%, Skewness = 5.92, Excess Kurtosis = 54.8

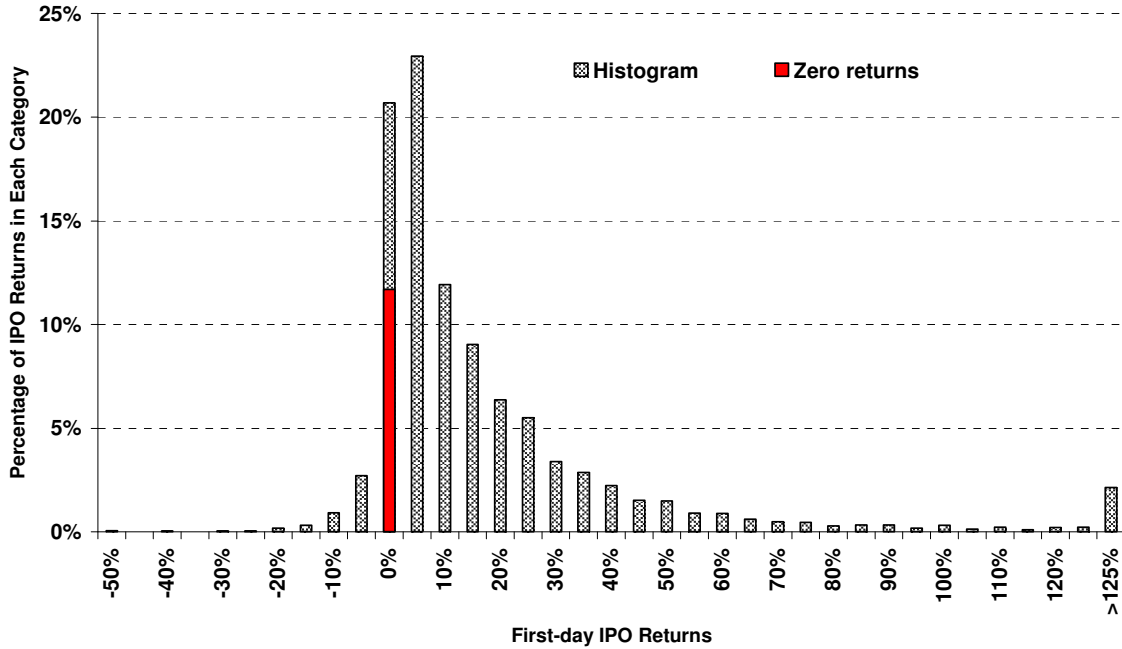


Fig. 1a. Distribution of first-day initial returns to IPO investments, defined as the percent difference between the aftermarket price on the first day of trading and the offer price. The solid red bar shows that 11.9% of the one-day returns equal exactly 0%.

**Frequency Distribution of First-month IPO Returns,  
1970-2005, IPO Price > \$5, N = 7,669**  
 Mean = 22%, Std Dev = 55%, Skewness = 5.10, Excess Kurtosis = 41.5

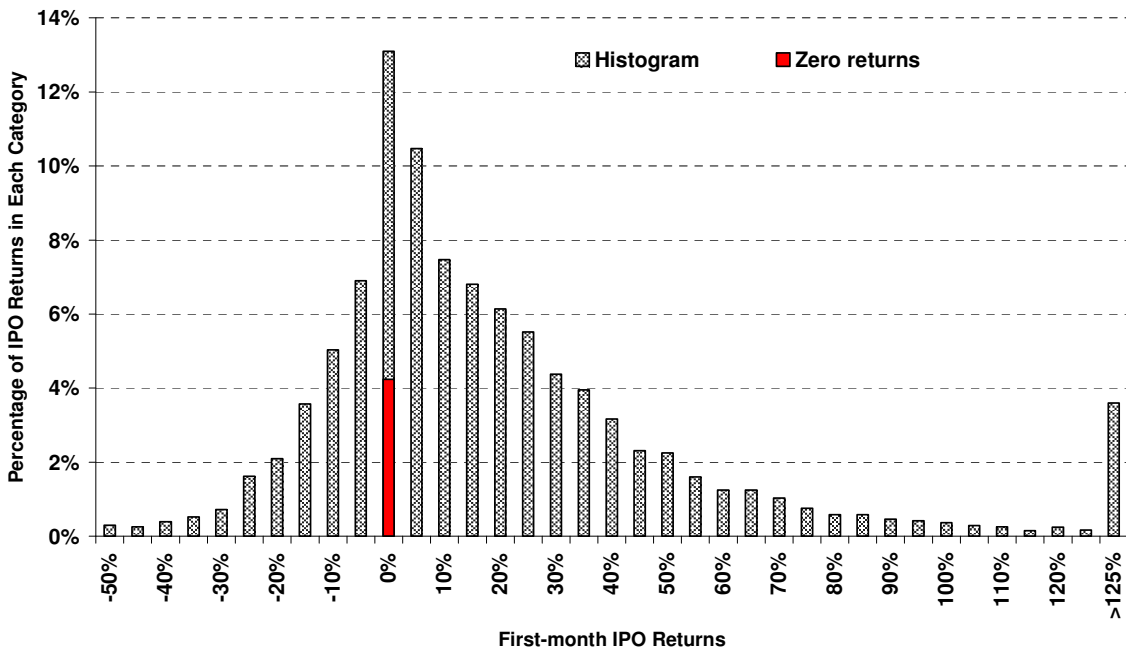


Fig. 1b. Distribution of initial returns to IPO investments, defined as the percent difference between the aftermarket price on the 21<sup>st</sup> day of trading and the offer price. The solid red bar shows that 4.4% of the one-day returns equal exactly 0%.

**Frequency Distribution of First-month IPO Returns,  
1965-2005, IPO Price > \$5, N = 8,762**  
**Mean = 22%, Std Dev = 55%, Skewness = 4.73, Excess Kurtosis = 37.0**

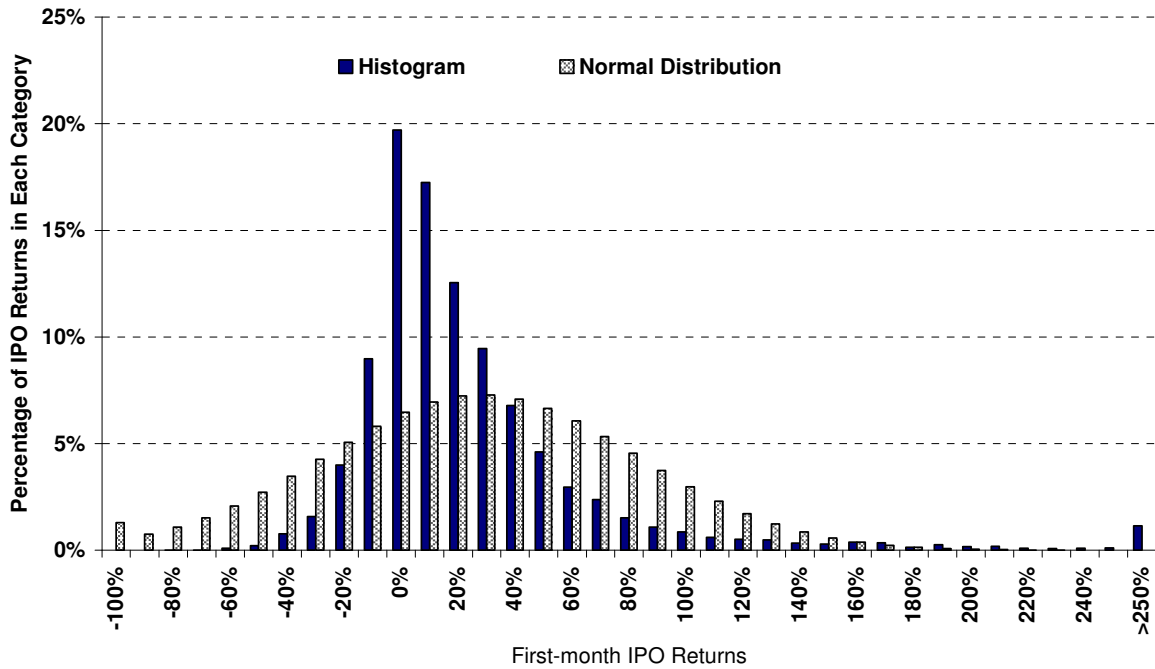


Fig. 2a. Distribution of initial returns to IPO investments, defined as the percent difference between the aftermarket price on the 21<sup>st</sup> day of trading and the offer price.

**Frequency Distribution of First-month IPO Returns,  
1965-2005, Omitting September 1998-August 2000, IPO Price > \$5, N = 7,949**  
**Mean = 15%, Std Dev = 34%, Skewness = 2.61, Excess Kurtosis = 13.5**

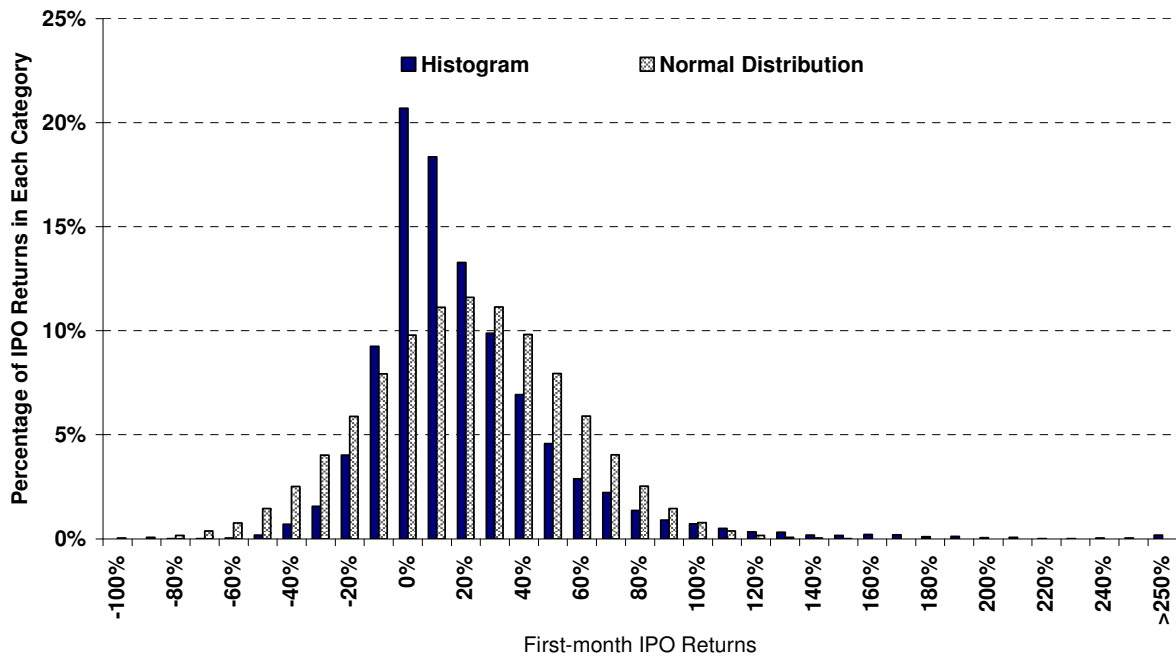


Fig. 2b. Distribution of initial returns to IPO investments, defined as the percent difference between the aftermarket price on the 21<sup>st</sup> day of trading and the offer price. Observations during the Nasdaq-Internet bubble period, September 1998 – August 2000, are omitted.

**Mean and Standard Deviation of Initial Returns to IPOs and  
the Number of IPOs by Month, 1965-2005**

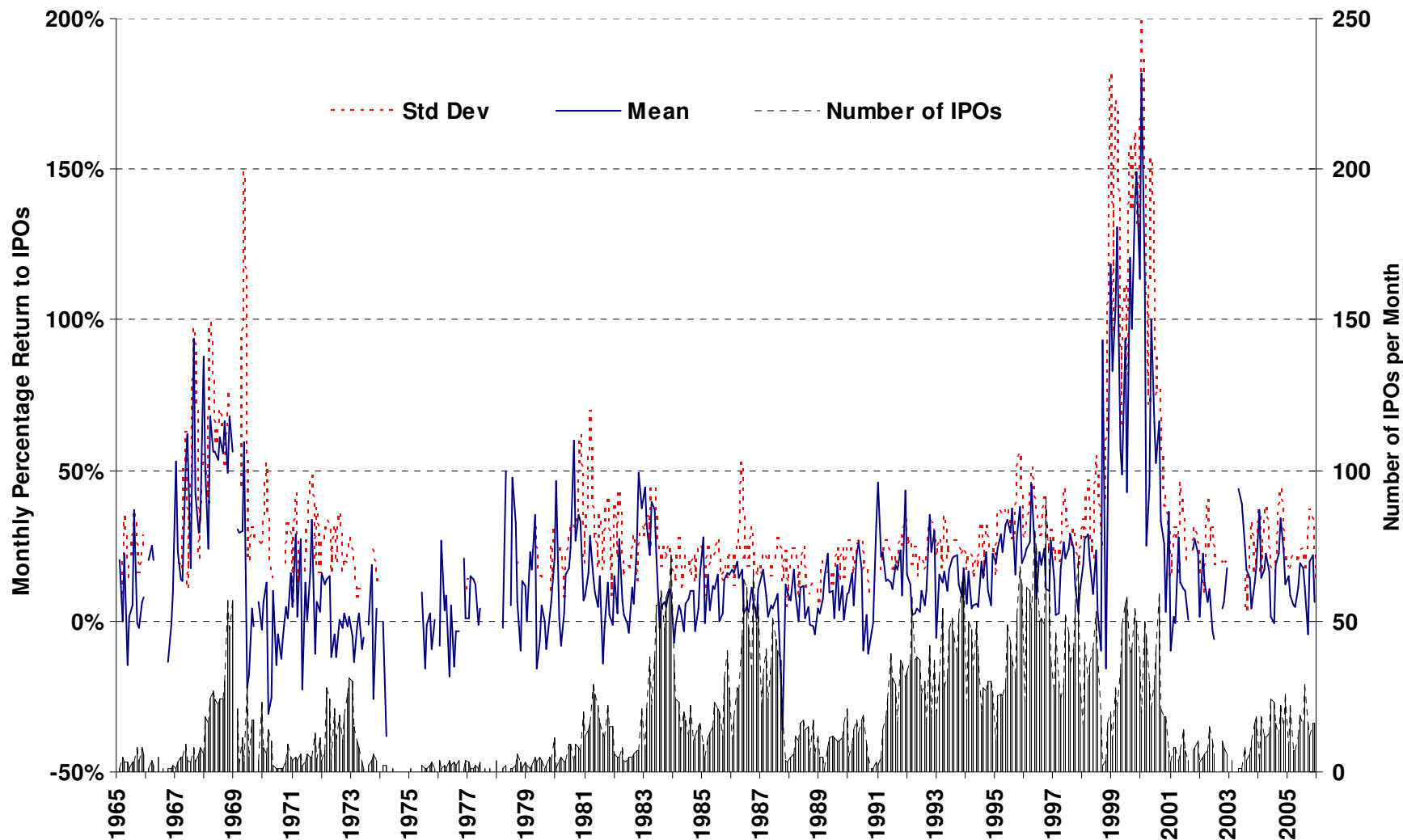


Fig. 3. Initial returns are defined as the percent difference between the aftermarket price on the 21<sup>st</sup> day of trading and the offer price. Each month, the initial returns of each IPO during that month are calculated. The sample consists of IPOs with an offer price of at least \$5. The solid line represents average initial returns during the month, and the dotted line represents the standard deviation of these initial returns. The bars represent the number of IPOs per month.

