

*The Persistence of IPO Mispricing and
the Predictive Power of Flipping*

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Abstract

This paper examines underwriters' pricing errors and the information content of the first-day trading activity in IPOs. We show that, first-day 'winners' continue to be 'winners' over the first year, and first-day 'dogs' continue to be relative 'dogs'. Exceptions are 'extra-hot' IPOs (with first-day returns greater than 60 percent) which provide the worst future performance. We also demonstrate that large, supposedly 'informed,' traders 'flip' IPOs that perform the worst in the future. IPOs with low flipping generate abnormal returns of 1.5 percentage points per month over the first six months beginning on the third day. We show that flipping is predictable and conclude that underwriters' pricing errors are intentional.

The price setting process for initial public offerings (IPOs) is a multiround negotiation among the firm going public, the underwriter, and investors. Despite the presumed intention of underwriters to obtain the ‘best’ price for the issuing firm by balancing supply and demand, the evidence is less than convincing that they are able to accomplish this task consistently. In a sample of 1,232 large-capitalization IPOs in 1988-1995, 149, or 12 percent, provided a first day return of 30 percent or more. One might conclude that substantial money was left ‘on the table’ in these ‘hot’ deals. However, 25 percent of IPOs during the same period closed trading on the first day at or below the offer price. In these ‘cold’ deals, the issuing firms ostensibly received ‘top dollar’ for their shares, but possibly alienated new shareholders due to disappointing first-day performance.

We show that, despite this apparent mispricing, the market underreacts in choosing its initial trading price relative to both the offering price and the initial filing range. Hanley (1993) offers the first piece of the IPO pricing puzzle. She demonstrates that the relationship between the IPO offer price and the ‘price talk’ (the preliminary filing range) predicts the direction of initial stock returns. Stocks that are priced above the initial filing price range perform very well on the first day (in spite of being offered at the higher price), and stocks which are priced below the initial filing range, do poorly on the first day. Thus, the offer price represents a partial adjustment to the information about investor demand received subsequent to the ‘price talk.’

Affleck-Graves, Hegde, and Miller (1996) provide another piece of the puzzle. They examine the relationship between opening-day return and short-term after-market performance and find that three-month risk-adjusted returns are in the same direction as the original mispricing. We provide a finer opening-day partitioning and show that initial returns predict subsequent long-term (one-year) excess returns.¹ Hot IPOs outperform in

the first year, cold IPOs underperform, and extra-hot IPOs (those with first-day returns in excess of 60%) provide the worst future performance.

Prior literature gives us only modest evidence as to what information we should expect from one-day returns. There is pervasive evidence in behavioral decision research that decision-makers ‘anchor’ on an initial expected outcome and insufficiently adjust to new information.² The corresponding result, stock price drift, has been exhibited in investors’ responses to earnings announcements, dividend initiations and omissions, share repurchase announcements, seasoned equity offerings, and brokerage analysts’ buy and sell recommendations.³ In the case of IPOs, underwriters ‘anchor’ on the mid-point of the filing range and do not sufficiently adjust the offer price to fully reflect institutional indications of interest gathered during roadshows. We demonstrate that information about the quality of issues appears to be available since we observe large investors selling issues on the first day that have the worst future performance.

We focus on the information contained in this first-day trading. Flipping, which is defined as the immediate sale of IPO allocations back to the market or the underwriting syndicate, has been demonized by both underwriters and the financial press. “Flipping screws up the market,” and “they (flippers) are parasites who prey off a system that basically works,” say syndicate managers (Maher (1990) and Pratt (1994)). Underwriters aggressively attempt to discourage flippers by various penalty schemes such as threatened exclusion from future hot offerings.⁴ They, as well as academics (Carter and Dark (1993)), contend that flipping has a detrimental effect on the early price performance of IPOs. In contrast, we conclude that flipping is a rational response to underwriters’ mispricing. We demonstrate that heavily flipped IPOs significantly underperform IPOs with less flipping over future holding periods.⁵ If new issue prices adjust toward ‘fair value’ in the first year, then flipping is the appropriate *response* to unfavorable pricing. Flipping is not the *cause* of the poor price performance.

In order to capture information-based trading, we operationalize flipping as the percentage of first-day dollar volume ‘sold’ (traded on the bid side of the market) in block trades.⁶ Flipping accounts for 45 percent of trading volume on the first day in cold issues compared to only 22 percent in hot issues, despite significantly higher trading volume in hot issues. We demonstrate that flipping is a significant predictor of future stock performance. The difference in one-year size-adjusted returns (beginning on the third day) between the first and fourth flipping quartiles is 26.2 percentage points. Block traders appear to possess and use superior information; they flip issues that subsequently underperform the market. Thus, flipping provides valuable information (superior to the initial return) about the direction of the subsequent price adjustment to equilibrium ‘fair value.’

We show that flipping provides a link between the empirical findings of Hanley and Wilhelm (1995) and Field (1995) on institutional investment in IPOs and the theoretical underpricing literature. Rock (1986) argues that IPOs are underpriced to provide incentives for uninformed investors to bid for shares. Institutional investors bid for and gain a larger allocation of stronger IPOs, leaving a disproportionate share of weaker IPOs for the smaller investor. Underpricing exists to mitigate the impact of the lemons problem for small investors. The implication of Rock’s model is that, assuming institutions are proxies for informed investors, we should find lower institutional investment in cold issues relative to hot issues. Benvensite and Spindt (1989) argue that underpricing exists to compensate regular investors for revealing truthful information. They demonstrate that distributional priority for future IPOs is given to regular investors providing a motivation to take all IPO allocations. Hanley and Wilhelm (1995) show that the level of institutional buy-in to IPOs is constant at about 70 percent. Field (1995), however, demonstrates that the level of institutional investment in IPOs (measured approximately six months after the IPO) is highly variable. These findings appear to be at odds.

We demonstrate that flipping, a rational response to underwriters' mispricing, completes the story. Institutional investors may buy all issues equally. Based on either (i) superior information, or (ii) opening trade performance, however, institutions selectively flip IPOs that have the worst future performance, resulting in differential institutional investment levels across IPOs when measured at a later point in time. The cost of flipping is minimized by the underwriting syndicate's provision of aftermarket price support. By placing a stabilizing bid, underwriters effectively truncate the lower tail of the initial return distribution, minimizing the risk exposure of investors who have the ability to flip unwanted allocations (Ruud (1993)). Importantly, it is the industry practice of price support which 'supports' flipping as a profitable trading strategy (for those who have access to primary IPO offerings).

Finally, Fama (1997) asserts that much of the apparent overreaction and underreaction to information disappears when portfolios are value-weighted and common factors such as size and book-to-market effects are controlled for. Our results on flipping do not disappear. In a five-factor model (market, size, book-to-market, general market momentum, and IPO market momentum) using calendar-time value-weighted portfolio regressions, the level of flipping continues to differentiate good from poor first-year performers. The models 'load' significantly on the size and book-to-market factors that have been observed elsewhere for IPOs (Brav and Gompers (1997) and Loughran and Ritter (1995)), but the proxies for equity and IPO momentum have little (if any) explanatory power (see Table VII).

The remainder of the paper is summarized as follows. Section I provides a description of our IPO data and sample selection. Section II provides an analysis of the long-term performance of IPOs. Section III discusses the microstructure characteristics of the first day of trading. Section IV relates flipping to institutional investment and future performance. Section V examines the robustness of our results. Section VI addresses

methodological concerns and addresses IPO and general market momentum as explanations for IPO performance, and Section VII concludes.

I. Data and Sample Selection

The data used in this study come from three sources. Firms conducting initial public offerings between January 1988 and May 1995 (inclusive) are collected from the Securities Data Company (SDC) *New Issues Database*.⁷ We exclude financial corporations including banks, savings and loans, closed-end funds and real estate investment trusts, partnerships, and unit offerings. Our intention is to study IPOs that are reasonably large and important to institutional investors. Ritter (1991) establishes that on the whole, IPOs perform poorly in the aftermarket. However, Michaely and Shaw (1996) demonstrate that performance can be explained in part by institutional investment in an issue. IPOs during the 1984-1988 period with no institutional holdings significantly underperformed both the market and a portfolio of IPOs that had positive institutional presence. Thus, we exclude the smallest IPOs from our analysis and focus on issues with potential institutional interest. As such, we constrain our sample to IPOs with an offer price above \$8 per share and where the post-issue equity market capitalization, (based on the offer price and assuming no overallotment option exercise) of the firm is above \$50 million.⁸ Requiring prices and return data for all companies from the Center for Research in Security Prices (CRSP) Database further reduces the SDC sample by 38 (mostly foreign) companies.

Our final sample of IPOs, for which we have SDC variables such as offering date, number of shares offered, offer price, lead underwriter, and CRSP daily return and volume information, covers 1,232 IPOs. Two hundred forty-four began trading on the NYSE, 31 on the AMEX, and 957 (78 percent) on Nasdaq.

Finally, in order to examine trading patterns in IPOs, we collect trade and quote data from the *New York Stock Exchange TAQ Database (TAQ)*. This source permits examination of intraday price and volume results such as a firm's return from the offer price to the opening trade on the first day (see Table III). The TAQ Database begins in January 1993. We collect trade and quote data for the first five days of trading for the 611 firms in our sample that went public after January 1, 1993. This sample is used for our inquiry into flipping as a rational response to mispricing.

Table I provides descriptive statistics on the 1,232 IPOs examined in this paper. The median firm in our sample offers 3 million shares, garnering proceeds of about \$41 million. The mean and median market capitalization of the firms at their offering is \$325 million and \$120 million. Of course, these figures slightly understate the actual initial market capitalizations for most companies once they are trading since they do not consider the exercise of overallotment options or the underpricing of most IPOs.

[Table I about here]

II. First-Day and Longer-Term Returns

To evaluate the short- and long-term performance of IPOs, we calculate the first- and second-day raw returns and excess returns for longer buy-and-hold periods.⁹ We compare buy-and-hold returns with several benchmark portfolios: the Nasdaq Composite index, the CRSP equal-weighted index, and the appropriate CRSP market capitalization (size) decile index. While all indices provide similar results, we feel that the size-decile index is appropriate for several reasons. First, it is parsimonious and approximately reflects the benchmark that would be used by professional investors. Second, it explicitly accounts for the well-known size factor, and most IPOs are 'small-size' stocks. Third, the market-segment portfolios created by CRSP are value-weighted. Hence, potential bias from compounding an equal-weighted index has been reduced (see Canina, Michaely,

Thaler, and Womack (1998)). Fourth, it has been previously advocated in the literature for event studies (Dimson and Marsh (1986)). Thus, we use the size-adjusted benchmark in our preliminary analysis. In Section VI, we demonstrate that accounting for other factors such as price-to-book and momentum in calendar-time portfolios does not significantly affect our conclusions. As noted by other researchers, calendar-time portfolio regressions do not reflect either an investor's result or a typical benchmark, so we choose to use them in a diagnostic capacity.

The size-adjusted excess return is defined as the geometrically compounded (buy-and-hold) return on the stock minus the geometrically compounded return on the relevant CRSP market-cap decile portfolio:

$$ER_{3toM}^i = \left[\prod_{t=3}^M (1 + r_t^i) - \prod_{t=3}^M (1 + r_t^{size}) \right] \quad (1)$$

where r_t^i is the raw return on Stock i on Day t , and r_t^{size} is the return on the matching CRSP market capitalization size decile for day t . ER_{3toM}^i is the excess return for firm i beginning on the third trading day for the IPO, extending for M months (M periods of 21 trading days). If a firm is delisted during the period (four observations in the first twelve trading months, zero observations in the first six months), the mean return reflects fewer observations in subsequent periods. An analysis of the delisted firms shows that their returns at the time of delisting are not significant outliers and therefore do not bias our results.

The average excess return for each period, PER , (Portfolio Excess Return) is the mean of the ER^i :

$$PER = \frac{1}{n_M} \left(\sum_{i=1}^n ER^i \right) \quad (2)$$

where n_M equals the number of surviving firms in the event period with available returns. t -statistics are calculated using the cross-sectional variance of excess returns in the relevant period.

We partition all IPOs into one of four categories. ‘Cold’ IPOs are defined as offerings where the first-day unadjusted return is zero or negative (26 percent of IPOs). Cold issues are often price-supported. We expect to observe the ‘syndicate bid’ in many of these offerings, which demonstrates the willingness of the underwriter to repurchase shares, usually at the offer price, to support the stock. The remaining IPOs are classified as either ‘cool’, ‘hot’, or ‘extra-hot’. ‘Cool’ IPOs (35 percent of the sample) are defined as those which had a first day return above zero and less than 10 percent. We label IPOs with a first day return greater than or equal to 10 percent and less than 60 percent ‘hot’ (36 percent of the sample) and those with a first-day return above 60 percent ‘extra-hot’. Data suggest two significant regime shifts. First, cold IPOs appear to behave differently from non-cold IPOs. Asquith, Jones, and Kieschnick (1997) provide evidence that cold IPOs are drawn from a different distribution than other IPOs. Second, extra-hot IPOs perform worse than cool and hot IPOs. Our cutoff between cool and hot definitions is arbitrary; the relationship is locally monotonic, and other partitions yield similar results. We show a finer partition of the data in Figure 1, Panels B and C, allowing the reader to assess our cutoffs.

Tables I and II include return calculations using daily CRSP data for both short and long horizons. Table I contains return data for the entire sample and provides a partitioning by the subperiods 1988-1992 and 1993-1995 (the period with TAQ data). We find an average first day return of 12.3 percent overall, which is consistent with other studies using large IPOs during our time period. We also show that the initial and subsequent performance of IPOs in the most recent two and one half years (January 1993 – May 1995) is higher than in the earlier period. The 621 IPOs offered in 1988-1992 have one-year excess returns averaging 1.9 percent, compared to 11.2 percent for the 611 IPOs issued in January 1993 - May 1995. We believe this accounts for the differences between our mean and median returns and those of earlier studies.

[Table II about here]

Table II presents the return statistics partitioned by opening day performance. A majority of the offerings in the ‘cold’ category close trading on the first day unchanged from the offering price, not lower than the offering price. As mentioned previously, this is due to temporary price support from underwriters as described by Ruud (1993) and others. Hanley, Kumar, and Seguin (1993) find that prices fall following the hypothesized period of price support. Consistent with their findings, the cold IPOs in our sample decline 1.5 percent on average in the month following the offering.

[Figure 1 about here]

Table II and Figure 1 quantify and show the first main result of this paper, namely that partitioning the sample of IPOs by the first-day return gives an indication of future performance. However, the results are not monotonic. We find extra-hot IPOs do not outperform hot ones. No theoretical cutoff has been suggested between the cool/hot and the ‘overheated’ extra-hot groups. While we have chosen 60 percent for our presentation, one should recognize that a cutoff is making dichotomous what is essentially a continuous variable.

We find that the mean and median one-month excess returns for cold and extra-hot IPOs are negative while the same returns are positive for cool and hot IPOs. The relationship of cold and extra-hot to cool and hot IPOs continues at the six-month and one-year time frames as well. In parametric as well as nonparametric statistical tests, the differences between the four groups are significant at conventional levels.

III. Initial Trading Activity in IPOs

One aspect of IPOs often highlighted by the financial press is the heavy first day trading which puts many IPO firms on the list of the largest volume stocks for the day. From this point in the study, we focus on the 611 IPOs from the January 1993 through

May 1995 period for which TAQ data are available. TAQ data allow us to examine intraday trading activity. To provide a basic understanding of the magnitude of first-day trading, we calculate the total number of shares traded on the first day as a percentage of the number of shares offered in the IPO.¹⁰ We find a significant range of first-day adjusted trading volume within the sample with a minimum of 1 percent, a median of 33 percent, and a maximum of 209 percent of shares offered. However, volume quickly dissipates. The mean number of trades executed on the first day of public trading is 822, declining consistently over the next four days to an average level of only 93 trades by the fifth day. Figure 2 shows shares traded as a percent of shares offered over the first five days, partitioned by initial IPO performance. The heaviest trading activity takes place in extra-hot IPOs, with average first-day (adjusted) volume of about 1.9 million shares or 70 percent of shares offered. However, the relative level of trading quickly dissipates on days two through five across all IPOs regardless of first-day return.

[Figure 2 about here.]

A similar pattern of rapid trading decline also occurs within the first trading day. We construct this information by aligning trades in event time starting with the first hour of trading. The percentage of trades that occur during each of the first six hours of trading is shown in Figure 3.¹¹ The immediacy of the trading is dramatic. Approximately 52 percent of the day's trading activity takes place in the first hour of trading. The first two hours account for over 72 percent of the day's trading activity.

To provide some insight into who is trading during this time, we partition the trades into three groups; trades under 1,000 shares, trades between 1,000 and 9,999 shares, and trades of 10,000 shares and over. We find that 57 percent of the block trades (10,000 shares or more) on the opening day of trading take place within the first hour.

[Figure 3 about here]

Trading activity is much greater in hot issues than in cold ones. On the opening day of trading, there is an average of 2,886 trades in the extra-hot issues compared to only 345 trades in the cold issues. The number of block trades is significantly higher in the hot issues as well. Interestingly, however, block trades in the extra-hot issues account for only 39 percent of the shares transacted for the day compared to 68 percent in the cold issues. The difference is significant at the 0.0001 level and is indicative of heavier proportionate institutional trading in cold issues. Hanley, Lee, and Seguin (1996) examine order imbalance, defined as the $[(\text{shares sold} - \text{shares bought}) \div (\text{total shares issued})]$ as indicative of buyer versus seller initiated trading. In cold issues, we expect trading to be seller-initiated, whereas in hot issues we expect more volume to be buyer-initiated. Table III confirms this intuition. The order imbalance in cold issues is +0.22 versus +0.06 in hot issues. The difference is statistically significant at conventional levels.

[Table III about here]

While we find heavier trading in hot issues, block trades account for a significantly larger percentage of transactions in cold issues, 16.1 percent, compared to only 8.4 percent for hot issues. Thus, while we have shown in Section II that the first-day return predicts future performance, these statistics lead us to consider whether the first-day block trading activity is of incremental value in predicting longer-term ‘winners.’

IV. Flipping as a Predictor of Future Returns

We define flipping for our study as the immediate first-day selling of block allocations by institutional investors. Clearly, large investors are not the only ones capable of selling their shares in the aftermarket, but there are several reasons to examine block sales specifically. First, the academic literature often characterizes large traders as ‘informed’ (as opposed to naive or ‘noise’ traders). By focusing on large-trader behavior, we may be able to discern whether they in fact garner excess profits due to their

potentially ‘informed’ nature. Second, underwriters report that most IPO firms are vitally interested in placing large allocations of shares in the hands of ‘committed’ institutional investors. Presumably, this stems from a belief that trading volatility will be minimized and value maximized if they succeed. The absence of flipping, then, is a measure of whether their placement strategy has been successful.

First, we provide an operationalized definition of large traders. We define activity of large traders as transactions of 10,000 shares or more, although our results are not sensitive to this arbitrary, but institutionally accepted, cutoff.¹² While the frequency (count) of trades by large traders is small relative to other traders' activity, averaging 9.9 percent of first day trades, the effect of their trading is significant. On the first day of trading, block trades account for 59.8 percent of all shares traded.

We hypothesize that a measure of flipping may be valuable in detecting informed behavior by large traders. We define ‘flipping’ as the ratio of first-day sell-signed block-trade dollar volume to total dollar volume traded on the first day.¹³ Table III shows that the level of flipping is very different from cold IPOs to hot IPOs. For cold IPOs, flipping accounts for 45 percent of total dollar volume executed on the first day of trading. For hot and extra-hot IPOs, 22 percent and 14 percent respectively, of the first-day dollar volume is ‘flipped.’ The monotonic difference in flipping among the four first day return groups is significant at the 0.0001 level. Consequently, we rank and partition all IPOs into quartiles by this flipping metric. Figure 4 illustrates that the portfolio of lowest flipping quartile IPOs achieves the highest size-adjusted return over one-month, six-month, and one-year holding periods. An examination of the one-year excess return of IPOs partitioned by flipping group shows that the lowest flipping quartile has significantly higher returns than the interquartile range which has significantly higher returns than the high flipping quartile (F-value = 12.41, p -value = 0.0005).

[Figure 4 about here.]

Thus, the second main result of this study is that IPOs with lower flipping on the first day (especially the lowest quartile) significantly outperform those with high first-day flipping, over the next year. We have shown that first-day performance predicts one-year returns and that flipping also predicts one-year returns. Next, we ask the question: can we predict the amount of flipping from ex ante factors?

The offer-to-open return provides the market with the first indication of IPO performance. As such, institutional investors may condition flipping behavior on the first trade price. The offer-to-open return in our sample ranges from -4.5 percent to +127.5 percent with an average of 13.2 percent. We also control for the effects of firm size and underwriter and estimate the following regression (White's heteroskedasticity-adjusted t -statistics are reported in parentheses):

$$Flipping = -0.054 + 0.0001 Rank + 0.021 \ln(Mktcap) - 0.333 Return, \quad (3)$$

(-0.34)
(1.46)
(2.43)
(-9.88)

$$N = 611, \quad Adj. R^2 = 0.135 \quad F\text{-Value} = 32.74 \quad p\text{-value} = 0.0001,$$

where

Flipping = the percentage of sell-signed dollar volume executed in trades of 10,000 shares or more on the first day of trading;

Rank = a ranking of underwriters based on equity capital;

Mktcap = the total market capitalization of the firm at the time of the IPO;

Return = the percentage change from the offer price to the opening trade price.

The level of flipping is explained by the level of underpricing (*Return*), controlling for both firm size and the quality of the underwriter. The negative and significant coefficient of the *Return* variable indicates that large traders flip IPOs that open at a low price relative to the offer price. The positive and significant coefficient of the *Mktcap* variable is consistent with the argument in Michaely and Shaw (1994) that larger IPOs are

more difficult to market, holding other things constant. Thus, we see higher flipping in larger deals.

We have demonstrated that flipping is predictable and is related to the future performance of IPO stocks. We next examine whether first-day flipping partially explains the divergent results of Field (1995) (who finds significant variance in institutional holdings in the period subsequent to IPO) and Hanley and Wilhelm (1995) (who find a stable allocation of IPO shares to institutional investors of about 70 percent of shares offered).¹⁴ To do this, we collect institutional holdings as of the first quarterly 13F filing post-IPO for 552 of the 611 IPOs in our sample where data are available. The results of this analysis are presented in Table IV.

[Table IV about here]

We show that the percentage of shares offered held by institutions after three months is significantly different across flipping quartiles. IPO stocks that are heavily flipped on the first day have lower institutional holdings after three months. A Wilcoxon Rank Sum test rejects the equality of the distribution of the number of institutional investors across flipping quartiles ($\chi^2 = 10.59$, p -value = 0.005). Shares held by institutions, measured as a percent of shares offered, is also significantly different across flipping quartiles ($\chi^2 = 6.72$, p -value = 0.0347). Table IV documents that institutional investment is also related to the opening price performance of IPOs. We conclude that if institutional buy-in to IPOs is constant, as found by Hanley and Wilhelm (1995), flipping based on either superior information or opening day performance results in differential institutional investment profiles a few months later.

V. A Two Factor Trading Strategy and Robustness

We have shown that the first-day return and the level of flipping on the first day predict the performance of IPO stocks over the next year. With the exception of extra-hot

IPOs, the higher the first day return, the higher the one-year size-adjusted return; the lower the flipping (sell-side block activity), the higher the one-year size-adjusted return. For example, selecting a portfolio of the lowest flipping quartile produces a mean one-year size-adjusted return of 27.8 percent relative to 0.1 percent for the highest flipping quartile. Portfolio selection based on flipping yields a larger return differential than conditioning on opening day performance. A natural follow-on question is whether the two factors jointly can provide a more potent model for predicting returns, or whether they proxy for a single factor.

[Table V about here]

To address this issue, we partition the IPOs by flipping quartile within the opening-day performance categories. Again, low flipping is defined as the first quartile, medium contains the next 50 percent of the firms, and high contains firms in the highest quartile of firms ranked by flipping. The results shown in Table V and Figure 5 are consistent with first-day return and first-day trading activity having independent predictive power for future returns. Focusing on one-year returns, we find that average returns increase across the cold, cool, and hot classifications. Also, within each classification, the low flipping IPOs have substantially higher returns than the high flipping IPOs for both six-month and one-year horizons. For example, the low flipping quartile of hot IPOs has a one-year size-adjusted mean return of +29.2 percent compared with -0.1 percent for the high flipping quartile. The low flipping quartile provides the highest six-month and one-year return within each of the opening-day return categories.

[Figure 5 about here.]

An important question is whether these results hold consistently throughout our sample and in future periods. We address concerns of robustness in two ways. First, we provide results partitioned by shorter time periods. Second, we collect an additional 232

IPOs issued between June 1995 and December 1995 which meet the selection criteria outlined in Section I. This group of IPOs is used to perform an out-of-sample robustness check. We stop collecting observations at the end of 1995 so that we can calculate post-offer one-year performance.

Flipping is a significant predictor of future performance. The stability of its distribution across calendar years is presented in Table VI, Panel A. The median level of flipping ranges from 25.3 percent to 28.9 percent across time periods. (A Wilcoxon Rank Sum Test fails to reject the equality of the distributions across calendar years ($\chi^2 = 5.31$, p -value = 0.1500).) Importantly, the distribution of the flipping ratio for the 232 out-of-sample IPOs issued between June 1995 and December 1995, which meet the selection criteria discussed in Section I, is not significantly different from the original sample distribution.

[Table VI about here]

Next we present one-year size-adjusted returns for the out-of-sample period conditioned on first-day flipping. The flipping groups (low, medium, and high) are based on flipping quartiles during the period January 1993 through May 1995. We use the same quartile breaks for the June 1995 through December 1995 subset of data. As can be seen in Panel B of Table VI, the flipping-return relationship is robust across subsamples and the out-of-sample period.

On average, the low flip group provides the greatest average return over time and the high flip group provides the lowest one-year excess returns. For the original sample of 611 IPOs (January 1993 through May 1995), the low flipping quartile outperforms the high flipping quartile by 27.0 percentage points. For the out-of-sample period, the difference is 24.3 percentage points. We conclude that the results presented in the main body of the paper are reasonably robust over time and even predictive.

VI. Methodological Concerns and Momentum

We have demonstrated that IPOs with low levels of flipping outperform IPOs with higher levels of flipping. We have also demonstrated that cold IPOs continue to underperform and hot IPOs continue to do well in the following year. However, to this point, we have only controlled for size in our buy-and-hold return analysis.

Lyon, Barber, and Tsai (1997) support use of the Fama-French three-factor model using calendar time portfolios to estimate long run abnormal performance. This approach controls for the non-independence of returns over time, size and book-to-market effects, and avoids the problem associated with drawing inferences on skewed long-horizon returns. We estimate the following 3-factor model:

$$r_{it} - r_{ft} = \alpha_{iT} + \beta_{iT} RMRF_t + s_{iT} SMB_t + h_{iT} HML_t + e_{it} \quad t = 1, 2, \dots, T, \quad (4)$$

where r_{it} is the monthly return on a portfolio of IPOs, r_{ft} is the monthly return on three-month T-bills, $RMRF$ is the excess return on a value-weighted aggregate market proxy, SMB is the difference in the returns of a value weighted portfolio of small stocks and big stocks, HML is the difference in the returns of a value-weighted portfolio of high book-to-market stocks and low book-to-market stocks. The estimate of the intercept, α_{iT} provides a test of the null hypothesis that the mean monthly abnormal return on the calendar portfolio is zero. The number of IPOs is not constant from month to month, thus we use weighted least squares to account for the time varying number of observations used to create the calendar portfolios. The calendar portfolios are value-weighted to minimize the impact of ‘bad model’ problems.¹⁵ Loughran and Ritter (1998) argue that multi-factor model regressions may actually induce bias against finding abnormal returns when they are in fact present, especially when the target population comprises small stocks like typical IPOs.

Additionally, Jegadeesh and Titman (1993) and Carhart (1997), among others, have shown momentum in stock returns to be a significant factor in explaining performance. Therefore we include *PRIYR*, a factor-mimicking portfolio for return momentum.¹⁶ Finally, to control for the effect of hot versus cold IPO markets (IPO momentum), we construct a fifth factor. We define *IPOMOM* for a month as the median change from the midpoint of the initial filing range to the final offer price for all IPOs issued in the prior month. This variable is a proxy for the level of pre issue excess demand in IPO underwriting. We estimate the following five-factor model that controls for both general equity momentum and IPO momentum.

$$r_{it} - r_{ft} = \alpha_{iT} + \beta_{iT} RMRF_t + s_{iT} SMB_t + h_{iT} HML_t + p_{iT} PRIYR_t + m_{iT} IPOMOM_t + e_{it} \quad t = 1, 2, \dots, T. \quad (5)$$

For each calendar month, we calculate the value-weighted return (weighed by the offering proceeds) on a portfolio composed of all firms that went public during the previous twelve months (and, separately, during the last six months).¹⁷ For example, construction of the twelve-month portfolio for January 1994 includes the return on all IPOs issued between January 1993 and December 1993 inclusive. We calculate time series of monthly portfolio returns. The time series of monthly portfolio excess returns (portfolio return less the risk-free rate) is regressed on the five factors above. The model is calculated for the full sample of IPOs from January 1988 through December 1995 and for the subperiod January 1993 through December 1995 (the period with TAQ data available). We partition the portfolios based on flipping quartiles and opening day performance. Regression results are presented in Table VII.

[Table VII about here]

For the period 1988-1995, hot IPOs, those with first day returns greater than 10 percent and less than 60 percent generate small positive excess returns. The inclusion of

momentum terms in the regression, however, renders the abnormal performance of hot IPOs insignificant in value-weighted portfolios. (In equal-weighted portfolios, the abnormal performance is significant.) Thus, equity momentum appears to explain some of the performance of hot IPOs. However, the extra hot IPOs (those with first day returns greater than 60 percent) generate significantly negative abnormal returns. For the six-month and twelve-month portfolios, extra-hot IPOs underperform by two to three percentage points per month. The majority of this underperformance is not generated in the first six months but in months seven through twelve following the IPO.

Consistent with the results in Section IV, the low flipping quartile portfolio provides significant positive excess returns in the calendar time regressions. Interestingly, neither the general momentum, nor the IPO momentum factors are significant in the regressions. In the six-month portfolio, the low flipping group provides positive abnormal returns of 1.6 percent per month. In each model specification, the abnormal return or ‘alpha’ of the low flipping portfolio is statistically significantly higher than that of the medium flipping quartile portfolio. We conclude that informed institutional investors appear to execute a profitable trading strategy, flipping IPOs that perform the worst in the future.

VII. Discussion and Conclusion

We begin this paper with the observation that there is considerable variance in the first-day returns of IPOs. Furthermore, this variance and the associated trading activity predict returns for the next year. This begs an important question: are underwriters *intentionally* mispricing IPOs?

The partial adjustment phenomenon appears to be pervasive in the financial markets, as it is in most human behavior. As shown here and in Hanley’s (1993) study, underwriters fail to fully adjust their estimates of a firm’s value when they price a security

relative to the preliminary price range (the ‘price talk’). There are plausible explanations for this partial adjustment. In the case of cold IPOs, it is clear that underwriters have a difficult time ‘building the book’ of ‘committed’ investors. We observe substantial flipping by ‘uncommitted’ investors in these IPOs. We suggest that at least two factors are at work in cold IPOs. First, having overestimated the price associated with adequate demand in the preliminary price range, underwriters are unable to adjust completely to the new lower demand information because of their prior pricing ‘commitments.’ An important factor an IPO firm weighs in choosing an underwriter is: What price will the underwriter get for my stock? A cold IPO often results from an issuing firm’s unwillingness to accept a price lower than that ‘promised’ in the price talk. In these ‘cold’ deals, if the underwriting is consummated (and these are the only ones we observe), it is due to the marketing ‘muscle’ of the underwriting firm which ostensibly ‘drums up’ marginal buyers to complete the ‘book.’ Thus on average, the IPO firm and its original shareholders ‘win’ at the expense of new investors.

Capital markets specialists at investment banks suggest a second, less intuitive reason for the partial price adjustment to low demand signals. They suggest that lowering the price during the pricing process may actually *lower*, rather than attract, additional demand for shares.¹⁸ This counter-intuitive result is consistent with positive feedback investment strategies where investors form extrapolative expectations; they buy when prices rise and sell when prices fall (DeLong, Shleifer, Summers and Waldmann (1990)).

It is more puzzling why new issues are often *underpriced* by huge amounts. We report that 12 percent of IPOs open for trading up more than 30 percent from the offer price. It is clear that these ‘hot’ IPOs open at a premium considerably higher than is targeted for most underwritings and that the IPO firm and its previous shareholders receive substantially less (by selling at the offer price) than immediate ‘fair value’ for their shares. While the indications of interest from institutional investors are not publicly

disclosed by underwriters, the financial press regularly reports that these extra-hot IPOs are oversubscribed by ten or more times the shares being offered. We conjecture that the resulting (substantial) underpricing in these hot deals is intentional. Underwriters rarely raise the price enough in ‘extra-hot’ deals to lessen the excess demand. It is unclear why or if firms that are substantially underpriced (and ‘leave millions on the table’) do not find the means to ‘punish’ underwriters who insufficiently adjust the final offer price of their shares. Dunbar (1997) suggests that underwriters *are* punished by subsequent loss of underwriting market share. However, the loss of future market shares does not compensate the IPO firm for money ‘left on the table.’ This appears to be a fruitful topic for further research.

Again, investment banking professionals offer a more complex story for why they do not raise the offering prices of ‘obviously’ extra-hot deals. Price maximization (for the IPO firm) is important, but it is not the unique goal. A common goal of both the underwriter and the IPO firm is to attract well-known and informed institutions as buy-and-hold purchasers of the offering. Underwriters claim that by raising the offer price more than about 20 percent above the original price range, their ability to attract the desired set of investors is compromised. In fact, they claim that *ex post* extra-hot deals usually obtain from ‘irrational’ retail demand (by small investors) rather than institutional purchases (at levels of 50 percent or higher than the offer price). Conversations with portfolio managers at several well-known investment management firms confirm these claims and support our finding that extra-hot deals have the lowest proportion of block trades (as a percent of all trades on the first day).

Finally, we conclude that flipping of IPOs is a rational behavior. That is, ‘flippers’ quickly sell issues that perform the worst in the future (often with the benefit of underwriter price support that minimizes their exposure to losses), and they sell less in the best future performing issues. The evidence suggests that either (1) institutional investors

have superior information relative to the underwriter regarding IPO quality (since they collectively appear to execute a profitable trading strategy on the first day) or (2) underwriters intentionally under- and overprice IPOs without immediate measurable penalties. We conjecture that the latter is more likely.

This study also suggests a profitable trading strategy in IPOs. Namely, IPOs with positive (but not *too* positive) returns *and* with relatively low sell-motivated block trading activity on the first day outperform other IPOs over the next year.

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Endnotes

¹This result is not without controversy. Ritter (1991) and Carter and Dark (1993) find in studies of prior periods (1975-1984 and 1979-1984) that firms with the highest initial returns do not have higher aftermarket excess returns. There are two differences between our data sets. First, Ritter (1991) includes smaller firms not included in our sample. These smallest firms have the highest initial return, but the lowest three-year returns in his sample (Ritter (1991), Table IV). Second, market reactions are different in the more recent time period we examine. Levis (1993) finds, in U.K. data, a three-year return distribution conditional upon the first-day return consistent with our results.

²See Slovic and Lichtenstein (1971), or Kahneman, Slovic, and Tversky (1982).

³Post-earnings announcement drift has been shown by Bernard and Thomas (1989, 1990), among others. For dividends, see Michaely, Thaler, and Womack (1995), for share repurchases, see Ikenberry, Lakonishok, and Vermaelen (1995), and for brokerage recommendations, see Womack (1996).

⁴ On June 2, 1997 the Depository Trust Company (DTC) brought to full implementation its new IPO tracking system which ‘monitors’ flipping in an automated fashion. The system allows the lead underwriter to know within three days who has flipped shares. This enables the lead underwriter to punish syndicate members that place shares in the hands of flippers. It remains an empirical question whether this system will result in lower levels of flipping.

⁵Hanley, Lee, and Seguin (1996) show in a paper examining IPOs of closed-end funds that a selling imbalance (which is different from our flipping metric) in the first few days of trading predicts cumulative (negative) returns for the first three to four months of trading. Our paper differs in two important respects: first, we analyze large operating company IPOs where institutions have more long-term interest, and second, we find the return disparity (conditioned on price *and* trading activity) extends substantially beyond the underwriter’s stabilization period.

⁶ We use block trades as a proxy for institutional informed trading. Specifically, we use the Lee-Ready algorithm to ‘sign’ trades as ‘buys’ or ‘sells’ according to the bid and ask quote in place at the time of the trade.

⁷We stop our initial data collecting in May 1995 so that we have at least 6 months of post-IPO return for each company. These are critical to our analysis; return (CRSP) data are available only until December 1995, at the time of collection. Our results do not change significantly if we use December 1994 as our stopping point. In Section V, we verify our results out-of-sample, on 232 IPOs (which meet our selection criteria) issued between June 1995 and December 1995 (inclusive) using CRSP data through December 1996.

⁸SDC reports 3,331 IPO offerings in our time frame. Of those, 866 (26 percent) are financial corporations (including closed-end funds and REITs) and 479 (14 percent) are

unit offerings. One thousand nineteen (31 percent) of IPOs are excluded because they are below \$8 per share and 1,369 (41 percent) are excluded because of the \$50 million minimum capitalization constraint. With some overlap among these various constraints, 1,232 IPOs are included in our sample, representing a sizable proportion of all money raised by corporations through IPOs. Although the market roughly doubled during the time period we analyze, there is no indication that our fixed cutoffs of \$8 per share and \$50 million market capitalization have induced any bias. That is, the percentage of all IPOs we select in each year because of these cutoffs does not appear to increase or decrease over the eight-year period.

⁹Excess returns for the opening day and the second trading day for each firm ($t=1$ and 2) are negligibly different from the raw returns. None of our results qualitatively change if excess returns are used for calculations. We intentionally use raw first-day returns for separating our sample into cold, cool, hot and extra-hot deals. A large percentage of the firms classified as ‘cold’ have an opening (for the TAQ sample) or a close-of-first-day (for the CRSP sample) return of exactly zero percent, indicating possible underwriter support at the offer price.

¹⁰ To keep NYSE/AMEX and Nasdaq results comparable, we divide shares traded in the Nasdaq market by two and report these as ‘adjusted’ volume totals (Atkins and Dyl (1997)). Transaction specific measures of trading activity (flipping and order imbalance) are based on transactions as reported in the TAQ database. There is no known methodology that can be uniformly implemented to adjust volume at the transactions level. Krigman (1997) demonstrates that the level of volume inflation is highly variable from stock to stock and day to day for the same stock.

¹¹In Figure 3, we only include trading for the first six hours because the majority of IPOs in our sample open between 10:00 a.m. and 11:00 a.m., and thus do not have a full six and one-half hours of trading on the first day.

¹²We replicate our results using a 5,000 share cutoff for large trades. The results are substantially identical to those reported using the 10,000-share designation. The NYSE TAQ database does not provide information on exact trades. Prints are provided which sometimes are aggregates of trades executed at the same price and time on an exchange. All references to trades are prints as reported by TAQ. The aggregated trades are flagged with a ‘B’ code that indicates a bunched transaction. All results remain when we exclude the trades flagged ‘B’.

¹³We use the Lee and Ready (1991) algorithm to sign all transactions.

¹⁴ Field’s IPO sample contains 1,862 IPOs issued between the period 1984-1988. Our exclusion of small IPOs results in significantly higher levels of institutional holdings during the 1993-1995 period than she finds in her sample.

¹⁵ Fama and French (1993, 1996) document that three-factor models have systematic problems explaining the average returns on categories of small stocks. Value weighing is used to avoid giving more weight to small stocks.

¹⁶ PRIYR is defined as the equal-weight average of firms with the highest 30 percent returns lagged one month minus the equal-weight average of firms with the lowest 30 percent returns lagged one month. The four factors: *RMRF*, *SMB*, *HML*, and *PRIYR*, are provided by Mark Carhart.

¹⁷ The calendar-time regressions capture ‘excess’ return starting on the first day of the month *following* the month of the IPO. Returns between the offering date and the end of the first month are not incorporated in this analysis.

¹⁸ We acknowledge and greatly appreciate conversations with senior officials at Goldman Sachs and Morgan Stanley.

Table I: IPO Sample Description

Initial Public Offerings (IPOs) conducted in the US markets by non-financial operating companies from January 1988 to May 1995 with pro forma market capitalization above \$50 million, offering price of \$8 or greater, and with available CRSP and Securities Data Company data are included in the sample. Unit and partnership offerings are excluded. The sample is divided into roughly two equal halves, with a cutoff date of Dec. 31, 1992. (Intra-day trade and quote data (NYSE Transactions and Quotations Data) become available at the beginning of 1993.) One-year size-adjusted return is calculated from day 3 to day 368 after the IPO. Mean values are provided with medians in parentheses.

	All IPOs	IPOs 1988 - 1992	IPOs January 1993 - May 1995
Number of IPOs	1232	621	611
Pro Forma Market Capitalization (Million)	\$324.5 (120.3)	\$243.2 (121.4)	\$407.2 (119.0)
Offering Proceeds (Million)	76.5 (41.0)	74.3 (41.2)	78.8 (40.7)
Shares Offered (Million)	5.0 (3.1)	5.0 (3.1)	5.1 (3.0)
First-Day Return	12.3% (6.2%)	10.7% (5.3%)	13.9% (6.8%)
Second-Day Return	0.2% (0.0%)	0.4% (0.0%)	0.1% (0.0%)
One-Year Size-Adjusted Return	6.5% (-2.9%)	1.9% (-6.1%)	11.2% (2.1%)

Table II: Full IPO Sample Partitioned by Underpricing

IPOs conducted in January 1988 through May 1995 are partitioned into four groups using the raw return from the offer price to the first day closing price. Cold IPOs are defined as those with a first-day return of zero or less and Extra-Hot IPOs as those with a first-day return greater than 60 percent. The partitions of Cool and Hot are split at 10 percent. Medians are not reported when they are essentially the same as the means. Post offering excess returns beginning on the third day after the offering are buy-and-hold returns, using a capitalization-weighted size-decile benchmark. First-day volume as a percent of shares offered is presented unadjusted and adjusted by dividing Nasdaq volume by two to account for interdealer transactions.

	Cold IPOs First-Day <= 0% N=318	Cool IPOs 0% < First-Day <= 10% N=438	Hot IPOs 10% < First-Day <= 60% N=443	Extra-Hot IPOs First-Day > 60% N=33	Kruskal-Wallis Test Chi-sq p-value
First-Day Return (offer-to-close)					
Mean	-1.2%	4.6%	24.4%	80.3%	no meaning, defined as different
Median	0.0%	4.3%	21.1%	75.0%	
First-Day Volume as a Percent of Shares Offered					
Mean	42.3%	51.1%	81.3%	130.6%	359.3 (0.0001)
Adjusted Mean	24.0%	29.7%	43.7%	67.3%	366.6 (0.0001)
One-Month Excess Return from Day Three					
Mean	-1.5%	1.9%	5.7%	-0.9%	52.6 (0.0001)
Median	-2.7%	1.0%	4.1%	-5.2%	
Six-Month Excess Return from Day Three					
Mean	2.2%	6.4%	11.3%	-6.2%	12.7 (0.0052)
Median	-4.2%	3.2%	5.8%	-15.7%	
One-Year Excess Return from Day Three					
Mean	0.3%	5.1%	13.2%	-6.8%	11.0 (0.0117)
Median	-12.4%	-2.7%	4.7%	-21.3%	
Percentage Change from Midpoint of Filing Range to Offer Price					
Mean	-9.7%	-1.7%	12.6%	29.2%	442.7 (0.0001)
Overallotment Exercised (Mean) (15% Maximum)	2.8%	7.4%	12.1%	13.2%	323.6 (0.0001)
Second-Day Return (Mean)	-0.1%	0.1%	0.7%	-0.3%	4.4 (0.2217)
Proforma Market Capitalization (Millions)					
Mean	\$237.37	\$472.19	\$250.90	\$192.48	7.9 (0.0480)
Median	\$116.35	\$125.94	\$115.04	\$172.60	
Proceeds of Offering (Millions)					
Mean	\$77.15	\$85.98	\$68.88	\$48.19	5.9 (0.1155)
Median	\$39.00	\$42.00	\$40.25	\$43.01	

Table III: Trading Activity and Returns Partitioned on First-Day Underpricing

The 611 IPOs from January 1993 through May 1995 (where Transactions and Quotations data are available) are split based on the first-day offer-to-close return. Extra-Hot IPOs (24) are defined as those which have offer-to-first-day-close returns above 60%. Cold IPOs (136) are defined as those which close at or below their offer price. Cool IPOs (227) have offer-to-close returns greater than 0% and less than 10%, and Hot IPOs (224) have offer-to-close returns greater than 10% and less than 60%. The statistics included are the mean and median shares and prints transacted on day 1, the large trader activity, the day 1 order imbalance, defined as the sell-signed dollar volume minus the buy-signed dollar volume divided by total day 1 dollar volume, the offer-to-open return, the open-to-close-day-one return, the opening bid ask spread, the size of the offering, and the size-adjusted performance over several horizons. Trading volume is presented unadjusted and adjusted where Nasdaq volume is divided by two to account for interdealer transactions. Other partitions which distinguish the extremes (cold and extra-hot from warm and hot) (quartiles, quintiles, etc.) produce similar return differences.

	136 Cold IPOs		227 Cool IPOs		224 Hot IPOs		24 Extra-Hot IPOs		Kruskal-Wallis Test	
	First Day <= 0%		0% < First Day <= 10%		10% < First Day <= 60%		First Day > 60%		Chi-sq	p-value
	Mean	Median	Mean	Median	Mean	Median	Mean	Median		
Proceeds of Offering (\$ Millions)	\$75.43	\$37.09	\$82.78	\$41.13	\$80.16	\$40.75	\$47.75	\$42.15	1.2	(0.7413)
Day 1 Volume as % of Shares Offered	46.5%	39.3%	53.9%	46.9%	93.7%	98.1%	150.4%	135.9%	220.2	(0.0001)
Adjusted Volume as % of Offered [#]	27.5%	25.4%	31.9%	31.1%	46.6%	45.6%	69.6%	64.9%	167.8	(0.0001)
Day 1 Order Imbalance	21.8%	19.1%	9.3%	6.7%	6.0%	4.4%	6.7%	1.5%	88.3	(0.0001)
Opening Bid-Ask Spread	\$0.45	\$0.50	\$0.48	\$0.50	\$0.74	\$0.75	\$0.78	\$0.50	59.7	(0.0001)
# Shares Transacted Day 1	2,007,625	1,500,850	2,084,996	1,702,600	3,209,283	2,543,650	3,941,942	3,617,350	87.5	(0.0001)
Adjusted Shares Day 1 [#]	1,262,690	787,775	1,406,353	1,004,700	1,986,876	1,302,075	1,970,971	1,808,675	54.9	(0.0001)
# Trades Reported Day 1	345	284	504	430	1,216	1,001	2,886	2,137	270.0	(0.0001)
Block Trade (>10,000 Share) Activity Day 1										
As % of Shares	68.3%	69.4%	62.0%	64.1%	54.8%	55.0%	39.0%	40.4%	123.8	(0.0001)
As % of Trades	16.1%	14.7%	12.1%	11.4%	8.4%	7.6%	3.8%	3.8%	164.3	(0.0001)
Flipping Ratio Day 1	45.4%	44.7%	30.8%	29.1%	22.8%	20.9%	14.0%	13.5%	186.1	(0.0001)
Return Statistics:										
Offer-to-Open	2.3%	0.0%	5.3%	4.5%	21.6%	18.4%	71.1%	66.0%	372.5	(0.0001)
Open-to-Close-Day 1	-3.2%	-2.0%	-0.5%	0.0%	3.1%	2.9%	8.6%	7.2%	114.6	(0.0001)
Size Adjusted Performance:										
Day 3 to 1 Month	-0.83%	-1.30%	2.81%	1.00%	6.13%	3.55%	-0.02%	-5.85%	17.9	(0.0005)
Day 3 to 6 Months	0.98%	-9.75%	8.52%	4.40%	13.90%	10.30%	-3.21%	-17.25%	15.8	(0.0013)
Day 3 to 1 Year	-2.12%	-16.65%	11.54%	2.90%	20.12%	8.55%	-1.16%	-20.10%	13.6	(0.0035)

Table IV: Institutional Investment by Flipping Activity and First Day Performance

Institutional ownership from the first quarterly 13f filing that is at least one quarter post-IPO is provided for 552 of the 611 IPOs where data are available. We provide data on the number of institutions reporting holdings and institutional shares as a percent of shares offered in the IPO. We include a non-parametric Kruskal-Wallis test of the equality of the distribution across flipping and performance partitions. Panel A presents institutional ownership partitioned by flipping quartile. Flipping is defined as the sell-signed dollar volume executed in blocks of over 10,000 shares divided by the total day 1 dollar volume. The sample is split based on flipping levels; low flipping is the lowest quartile, medium flipping represents the interquartile range, and high flipping is the upper quartile. Panel B presents the data partitioned by opening day performance. Extra-Hot IPOs (23) are defined as those which have offer-to-first-day-close returns above 60%. Cold IPOs (115) are defined as those which close at or below their offer price. Cool IPOs (211) have offer-to-close returns greater than 0% and less than 10%, and Hot IPOs (203) have offer to close returns greater than 10%

Panel A	<u>Obs.</u>	# of Institutional Holders		Institutional Shares as % of Shares Offered	
		<u>Mean</u>	<u>Median</u>	<u>Mean</u>	<u>Median</u>
High Flipping	134	30	25	66%	64%
Medium Flipping	278	34	30	71%	68%
Low Flipping	140	33	31	82%	73%
χ^2 Kruskal-Wallis (<i>p</i> -value)		10.594 (0.0050)		6.721 (0.0347)	

Panel B	<u>Obs.</u>	# of Institutional Holders		Institutional Shares as % of Shares Offered	
		<u>Mean</u>	<u>Median</u>	<u>Mean</u>	<u>Median</u>
Cold IPOs	115	23	21	66%	62%
Cool IPOs	211	30	26	73%	67%
Hot IPOs	203	40	35	75%	73%
Extra Hot IPOs	23	42	39	82%	84%
χ^2 Kruskal-Wallis (<i>p</i> -value)		86.176 (0.0001)		16.049 (0.0011)	

Table V: Returns Partitioned by First Day Performance and Flipping Activity

The 611 IPOs from January 1993 through May 1995 have been split based on opening day offer-to-close performance and flipping activity. Flipping is defined as the sell-signed dollar volume executed in blocks of over 10,000 shares divided by the total day 1 dollar volume. The sample is split based on flipping levels; low flipping is the lowest quartile, medium flipping represents the interquartile range, and high flipping is the upper quartile. Mean and median size adjusted returns are provided for one-month, six-month, and one-year return horizons.

	136 Cold IPOs First Day <= 0%		227 Cool IPOs 0% < First Day => 10%		224 Hot IPOs 10% < First Day => 60%		24 Extra-Hot IPOs First Day > 60%		All IPOs (611)	
	Mean	Median	Mean	Median	Mean	Median	Mean	Median	Mean	Median
1-Month Size Adjusted Returns										
By Day 1 Flipping Activity										
Low	-1.9%	-1.5%	8.8%	9.5%	6.2%	4.8%	-0.9%	-6.5%	5.9%	3.5%
Medium	1.2%	-0.7%	2.0%	0.5%	6.3%	4.1%	3.2%	18.7%	3.7%	1.9%
High	-1.9%	-1.3%	-0.7%	-3.2%	3.7%	-0.2%	none	none	-1.0%	-1.6%
6-Month Size Adjusted Returns										
By Day 1 Flipping Activity										
Low	23.2%	15.3%	17.8%	13.1%	19.0%	14.8%	1.1%	-18.8%	16.6%	13.2%
Medium	8.3%	-1.2%	7.3%	6.4%	10.8%	7.4%	-19.5%	2.2%	8.5%	6.4%
High	-4.6%	-19.5%	3.0%	-1.2%	12.6%	6.9%	none	none	-0.3%	-7.5%
1-Year Size Adjusted Returns										
By Day 1 Flipping Activity										
Low	13.7%	9.3%	33.8%	10.1%	29.2%	20.2%	3.3%	-13.5%	27.1%	11.1%
Medium	5.6%	-8.3%	2.6%	-3.4%	16.4%	7.1%	-17.4%	-31.3%	8.6%	2.4%
High	-7.5%	-30.5%	11.7%	1.6%	-0.1%	4.7%	none	none	0.1%	-10.8%

Table VI: Robustness of Results Over Time

Results for the 843 IPOs issued during 1993 through 1995 are presented partitioned by calendar year to address robustness concerns. 1995a contains 82 IPOs issued between January and May (inclusive) 1995 which are contained in the original analysis. 1995b contains 232 IPOs issued between June and December (inclusive) 1995 which are added to the dataset to perform out-of-sample tests. Panel A provides information on the distribution of flipping by time period. Flipping is defined as the dollar volume of sell-motivated block trades as a percent of total day 1 dollar volume. Panel B presents mean and median one-year size-adjusted excess returns by flipping category. Low flipping contains the lowest quartile of flipping, medium flipping contains the interquartile range and high flipping contains IPOs which had the highest quartile of flipping. The high flipping category contains one IPO with a 360% one-year return which drives the group result. Excluding this IPO results in an average return of 6.4% for the remaining 13 IPOs in the category.

Panel A: Distribution of Flipping Ratio by Calendar Year

	1993	1994	1995a	(Out of Sample Period,1995b)	Full Sample
N	305	224	82	232	843
Mean	0.301	0.318	0.282	0.319	0.309
Quartile 1	0.178	0.184	0.179	0.208	0.185
Median	0.282	0.278	0.253	0.290	0.280
Quartile 3	0.406	0.441	0.356	0.403	0.406

Panel B: One-Year Excess Returns by Flipping Quartile and Calendar Year

	1993		1994		1995a		(Out of Sample Period,1995b)		Full Sample 1993 - 1995	
	Mean	Median	Mean	Median	Mean	Median	Mean	Median	Mean	Median
Low Flipping	12.2%	4.2%	52.8%	28.8%	19.5%	20.1%	29.0%	11.7%	27.5%	11.2%
Medium Flipping	5.4%	3.6%	12.5%	6.4%	9.5%	-16.5%	6.2%	-10.8%	7.8%	-3.8%
High Flipping	-2.0%	-8.9%	-4.6%	-13.7%	32.3%	-10.9%	4.7%	-7.5%	1.3%	-10.2%

Table VII: Calendar Time Portfolio Regressions

Weighted least squares regressions are run for all IPOs for the 1993-1995 and 1988-1995 horizons. Monthly return 'alphas' are calculated for 12-month calendar time portfolios. These are calculated by regressing the monthly return of all IPOs issued within the preceding 12 months on three and five factors. We also provide the 'alpha' intercept from identical regressions run on six-month calendar time portfolios which contain all IPOs issued within the preceding six months. Returns are included beginning in the first calendar month after the IPO. The dependent variable in the regressions is the portfolio return less the risk-free T-bill rate, the independent variables are the excess return on the market portfolio ($R_m - R_f$), SMB is the difference in returns of a value-weighted portfolio of big and small stocks, HML is the difference in returns of a value-weighted portfolio of high book-to-market and low book-to-market stocks, PR1YR is a factor mimicking portfolio for one year return momentum, and IPOMOM is the median change from the midpoint of the initial filing range to the offer price for all IPOs in the preceding month. Portfolios are then partitioned by flipping and opening-day performance groups. The low flip portfolio contains the first quartile, medium flip contains the interquartile range, and high flip contains IPOs in the highest quartile of flippers. Cold IPOs are defined as those with a first-day return of 0% or less and Extra-Hot IPOs as those with a first-day return greater than 60%. The partitions of Cool and Hot are split at 10%. t -statistics are contained in parentheses. F-tests for the equality of regression intercepts across models are presented in the bottom panel.

	12 Month Calendar Time Portfolios							6 Month Intercept
	Intercept	Rm - Rf	SMB	HML	PR1YR	IPOMOM	Adj. R2	
All IPOs 1993-1995	0.257 (0.91)	1.393 (11.90)	0.828 (5.24)	-0.553 (-2.91)			0.88	0.565 (1.34)
	0.252 (0.78)	1.389 (11.63)	0.818 (4.94)	-0.564 (-2.89)	-0.037 (-0.28)	0.025 (0.59)	0.89	0.491 (1.01)
Low Flip Portfolio	0.816 *** (2.23)	1.407 (9.20)	0.665 (3.17)	-0.909 (-0.36)			0.83	1.582 *** (2.78)
	0.858 ** (2.06)	1.403 (9.05)	0.633 (2.92)	-0.937 (-3.69)	-0.124 (-0.71)	0.039 (0.70)	0.84	1.502 *** (2.26)
Medium Flip Portfolio	-0.074 (-0.21)	1.426 (9.88)	1.024 (5.33)	-0.450 (-1.93)			0.85	0.146 (0.30)
	-0.008 (-0.02)	1.418 (9.70)	0.987 (4.93)	-0.473 (-2.00)	-0.126 (-0.77)	0.037 (0.70)	0.85	0.205 (0.37)
High Flip Portfolio	0.406 (0.88)	1.242 (6.45)	0.650 (2.45)	-0.596 (-1.90)			0.69	0.615 (0.95)
	0.247 (0.47)	1.244 (6.34)	0.696 (2.52)	-0.568 (-1.77)	0.165 (0.76)	0.000 (0.00)	0.69	0.389 (0.52)

Table VII Continued

	12 Month Calendar Time Portfolios							6 Month Intercept
	Intercept	Rm - Rf	SMB	HML	PR1YR	IPOMOM	Adj. R2	
All IPOs 1988-1995	0.305 (1.50)	1.336 (18.81)	1.007 (12.27)	-0.361 (-3.98)			0.88	0.736 *** (2.85)
	0.246 (1.10)	1.333 (18.55)	1.025 (10.87)	-0.361 (-3.68)	0.0333 (0.37)	0.018 (0.71)	0.88	0.711 *** (2.47)
Cold IPO Portfolio	0.170 (0.54)	1.244 (11.52)	1.098 (8.64)	-0.032 (-0.23)			0.72	0.906 ** (2.14)
	0.272 (0.79)	1.253 (11.46)	1.042 (7.14)	-0.069 (-0.46)	-0.112 (-0.80)	-0.002 (-0.05)	0.73	0.970 ** (2.09)
Cool IPO Portfolio	0.199 (0.68)	1.241 (12.19)	0.949 (7.75)	-0.212 (-1.60)			0.73	0.578 (1.60)
	0.168 (0.52)	1.239 (11.98)	0.961 (6.95)	-0.208 (-1.43)	0.024 (0.18)	0.007 (0.19)	0.73	0.746 * (1.90)
Hot IPO Portfolio	0.544 * (1.95)	1.474 (14.87)	1.054 (9.57)	-0.671 (-5.37)			0.85	1.049 *** (2.74)
	0.322 (1.05)	1.459 (14.73)	1.162 (9.10)	-0.612 (-4.57)	0.198 (1.63)	0.026 (0.72)	0.85	0.747 * (1.70)
Extra Hot IPO Portfolio	-1.917 * (-1.87)	1.896 (4.65)	0.988 (2.26)	-1.936 (-3.88)			0.60	-1.354 (-0.85)
	-2.423 ** (-2.02)	1.848 (4.45)	1.030 (2.17)	-1.977 (-3.82)	0.166 (0.36)	0.155 (0.99)	0.61	-2.492 (-1.34)

Tests for Equality of 12-Month Regression Intercepts

	3-Factor Model		5-Factor Model	
	F-value	p-value	F-value	p-value
H ₀ : Flipping: Low = Medium = High	2.649	(0.0745)	2.131	(0.1213)
H ₀ : Day 1 Return: Cold = Cool = Hot = Extra Hot	1.736	(0.1600)	2.456	(0.0636)

* Indicates significance at 10%. ** 5%, and *** 1% levels.

Figure 1: Size-Adjusted Performance (beginning on Day 3) Partitioned by Opening Day Return

Initial Public Offerings (IPOs) conducted in the US markets by operating companies from January 1988 to May 1995 with pro forma market capitalization above \$50 million, offering price of \$8 or greater, and with available CRSP and SDC data are included in the sample. Unit and partnership offerings are excluded. The IPOs are partitioned into four groups using the raw return from offer price to the first day closing price. Cold IPOs (318) are defined as those with a first-day return of 0% or less and Extra-Hot IPOs (33) as those with 60% or more. The partition of Cool (438) vs. Hot (443) is split at 10%. Panels B and C partition the IPOs into eleven groups using the raw return from offer price to the first-day closing price. Panel B contains mean size-adjusted one-year excess returns, and Panel C contains median one-year size-adjusted excess returns.

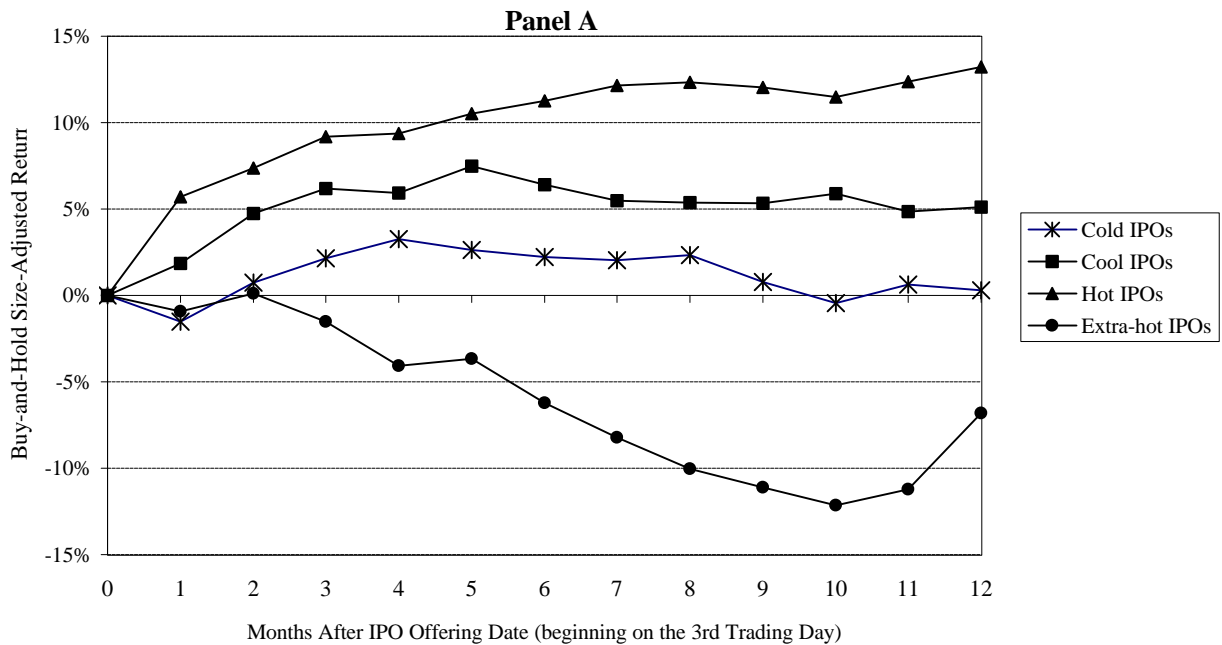
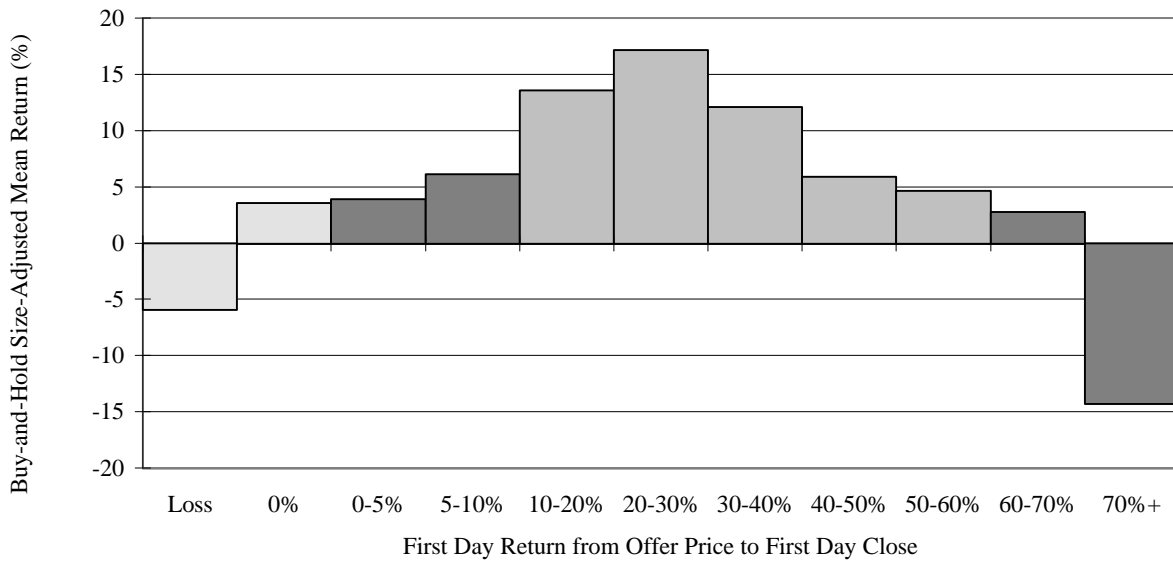


Figure 1 Continued

Panel B



Panel C

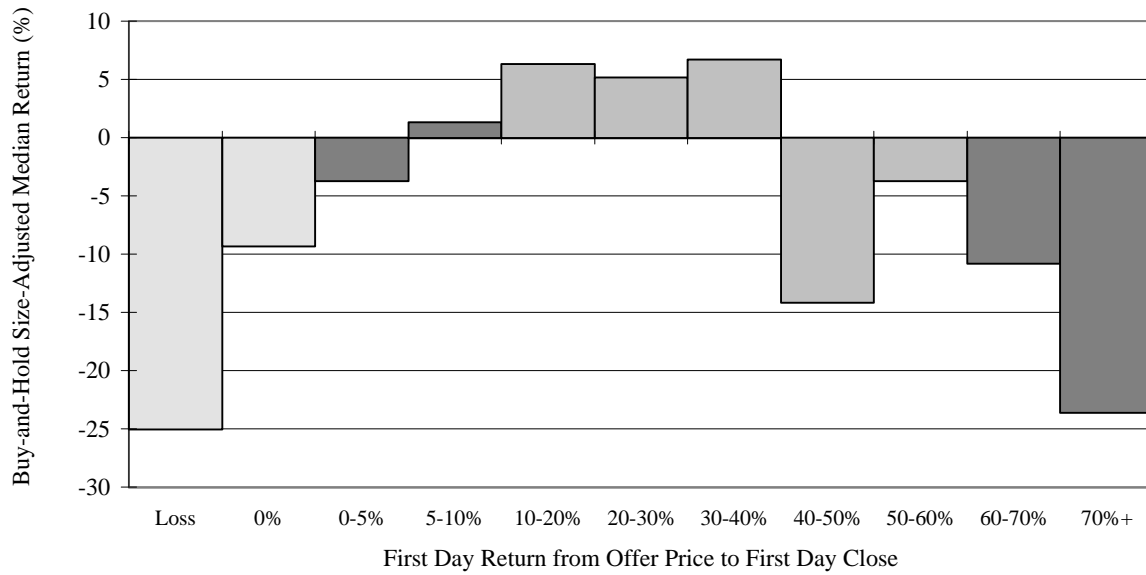


Figure 2: Daily Trading Activity by Day 1 Performance: January 1993 - May 1995

Daily trading volume is presented by day 1 offer-to-close return groups. 136 'cold' IPOs have first-day performance less than or equal to 0%, 227 IPOs' first-day return is between 0% and 10%, 224 IPOs' opening-day returns are between 10% and 60%, and 24 'extra-hot' IPOs have initial day returns greater than 60%. Nasdaq volume is divided by two to control for differences in trading protocol between the exchanges.

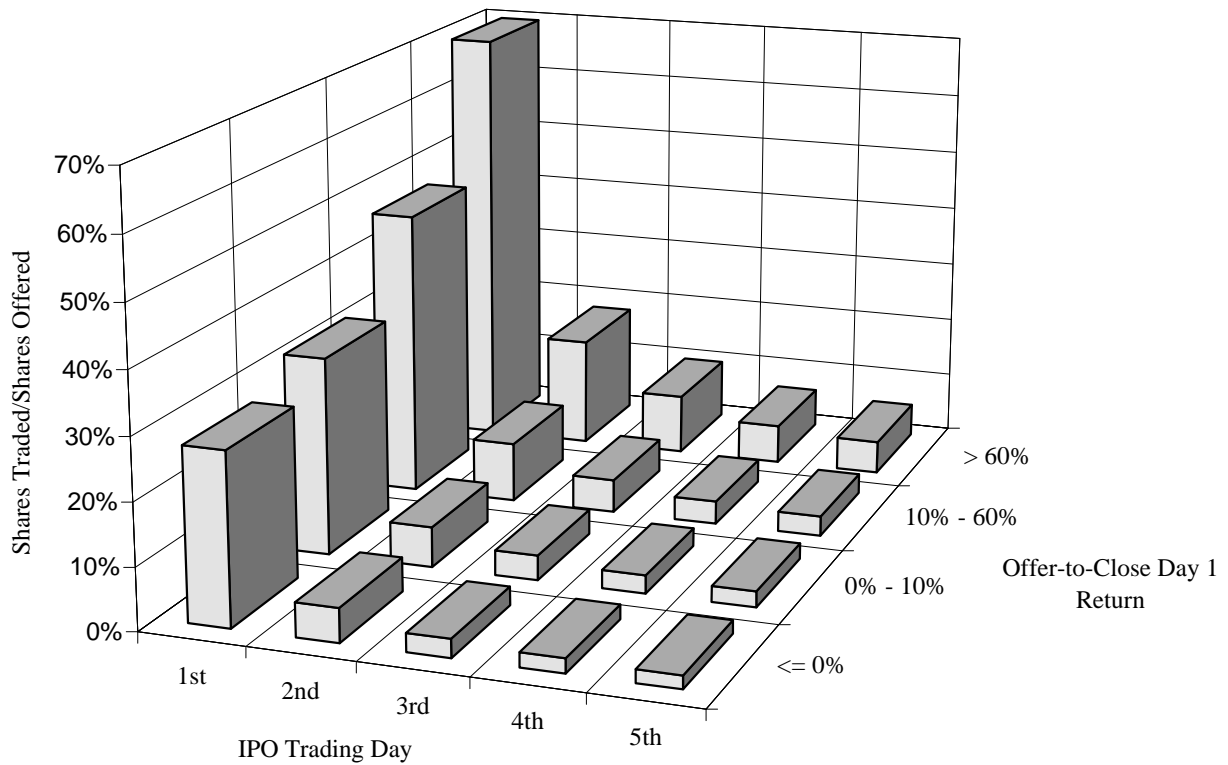


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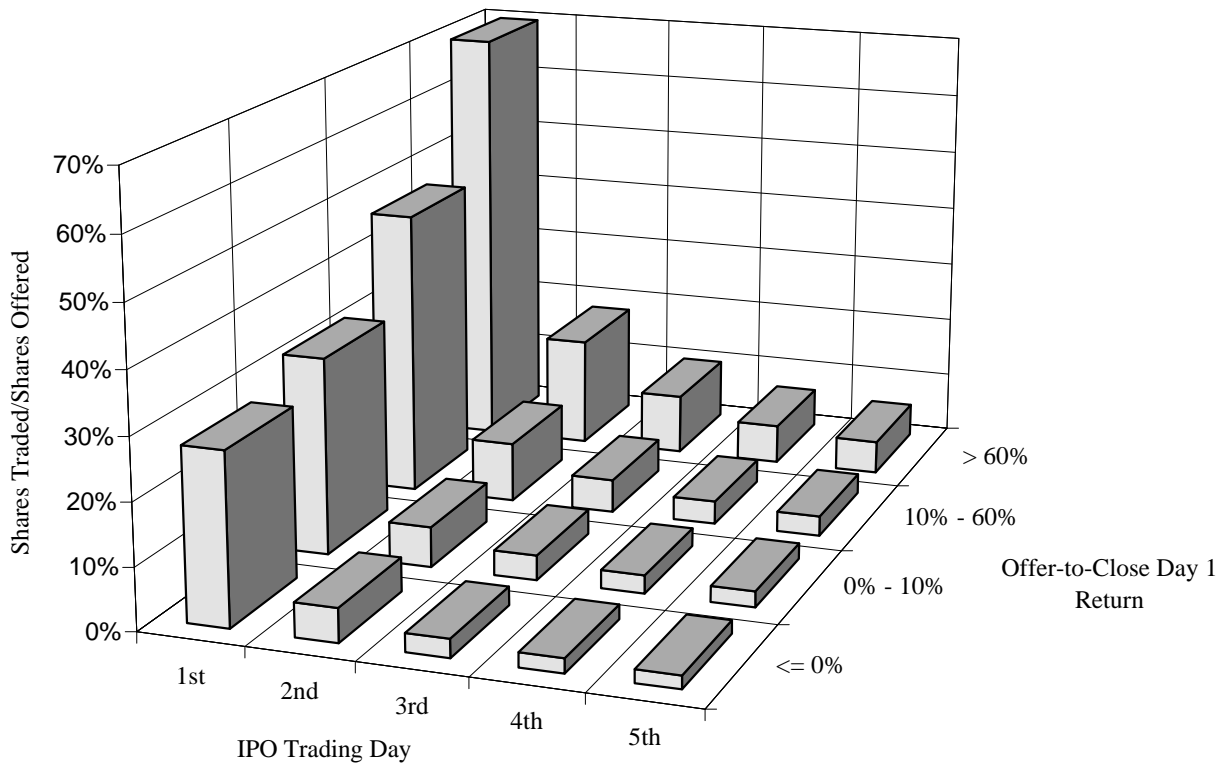


Figure 3: Day 1 Hourly Dollar Volume by Trade Size, January 1993 - May 1995

Opening day dollar volume transacted by trade size is presented as a percentage of opening day total dollar volume for IPOs issued between January 1993 and May 1995. Small Trades are defined as less than 1,000 shares, medium trades range from 1,000 to 9,999 shares, and big trades are defined as 10,000 shares or more. Over 50% of the opening day dollar volume is transacted in the first hour of trading in IPO stocks.

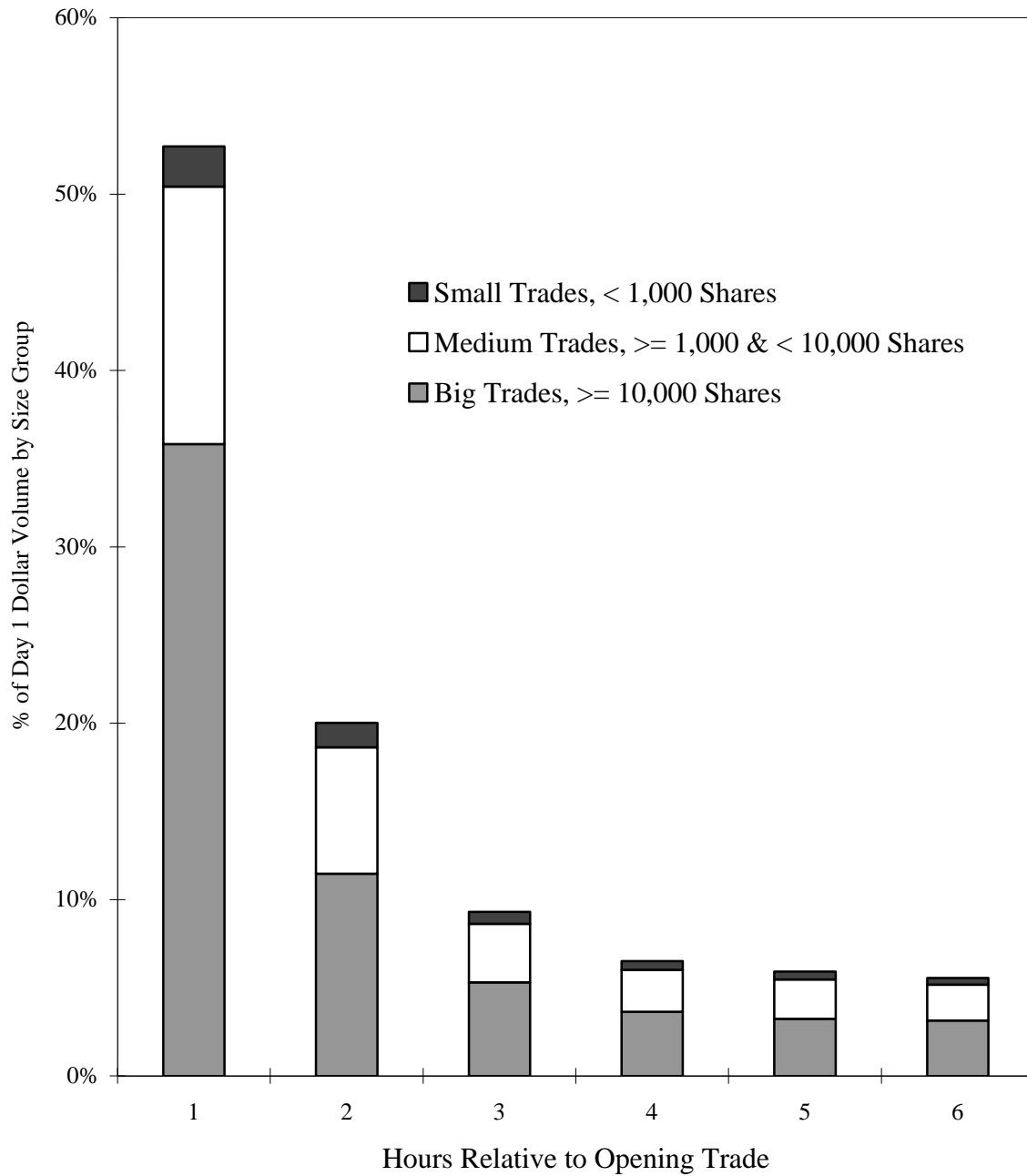


Figure 4: Size-Adjusted Performance by Flipping Quartile

One-month, six-month and one-year size-adjusted returns are presented for the 611 IPOs offered between January 1993 and May 1995. The sample is partitioned by the level of day 1 "flipping", defined as the percent of dollar volume executed in sell-signed trades over 10,000 shares. Low flipping is the lowest quartile, medium flipping represents the interquartile range, and high flipping is the upper quartile. The IPOs with the lowest level of "flipping" on the opening day perform the best over future trading periods.

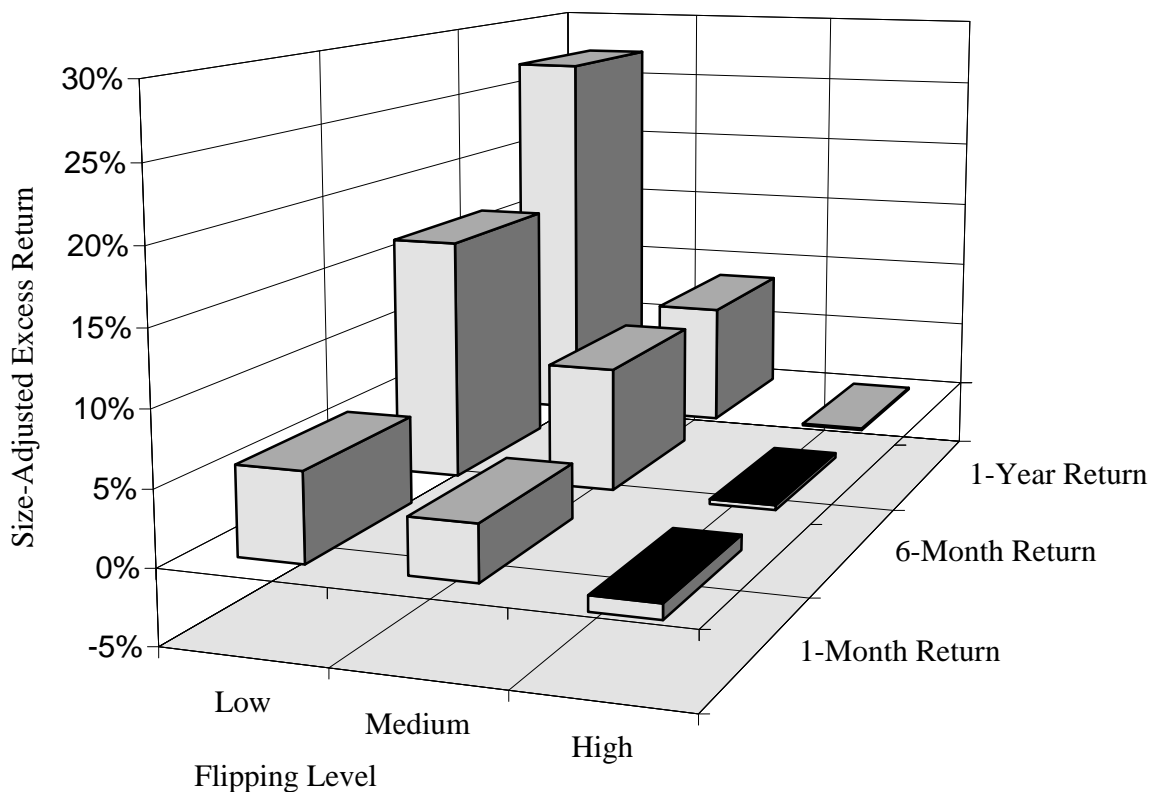


Figure 5: Mean Returns by Opening Day Performance and Flipping Group

One-year size-adjusted excess returns are presented partitioned by opening day offer-to-close performance and flipping group. Low flipping is the lowest quartile, medium flipping represents the interquartile range, and high flipping is the upper quartile. 611 IPOs offered between January 1993 and May 1995 (inclusive) are included in the analysis. The high flipping, extra-hot category contains no observations and the medium flipping, extra-hot category contains only 5 observations.

