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Information environment, market-wide sentiment and IPO initial returns: Evidence from analyst forecasts before listing

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ABSTRACT

Measuring the information environment of firms using analyst (price) forecast bias and forecast dispersion before listing, we empirically examine the interactive influence of the information environment and market-wide sentiment on the initial returns of initial public offerings (IPOs). We find the smaller the analyst forecast bias/dispersion, the lower the effect market-wide sentiment has on IPO initial returns. This finding indicates that information asymmetry is a basic reason for noise trading occurs and demonstrates the positive effect of financial analysts during IPOs. In addition, the effect of analyst forecasts is more pronounced during periods of rising markets and when IPO prices are not regulated.

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1. Introduction

In modern finance theory, stock prices are not only influenced by value-relevant information, but also significantly affected by investor sentiment. Real-world investors are not always as rational as traditional theory assumes. Cognitive bias and emotional behavior influence investors to form biased expectations or judgments during valuation and incur price fluctuations through noise trading. Noise trading leads to valuation errors in the capital market and harms the efficiency and stability of the capital market (Brown and Cliff, 2004, 2005; Baker and Wurgler, 2006; Wang and Sun, 2004).

The influence of investor sentiment on stock prices is more pronounced during initial public offerings (IPOs). The serious information asymmetry that investors face during IPOs makes them more susceptible to emotional factors and causes false investment decisions. However, short-selling constraints during IPOs make stock prices reflect only the expectations of optimistic investors and exaggerate the influence of sentiment. Foreign studies of IPO initial returns have found that rational factors such as information asymmetry, controlling rights and litigation risk are insufficient in explaining IPO initial returns and that investor sentiment plays a prominent role (Ljungqvist et al., 2006; Derrien, 2005; Cornelli et al., 2006). These studies have proposed that the over-optimism of investors in the secondary market pushes stock prices above their intrinsic value and leads to irrational initial returns.

The Chinese stock market has a shorter history than mature capital markets and its market mechanisms remain imperfect (China Securities Regulatory Commission, 2008). IPO initial returns in China were once the most anomalous returns around the world and have drawn a great deal of attention from researchers, practitioners and regulators. Meanwhile, the high offering prices, high price-to-earnings ratios and enormous funds raised during IPOs have attracted a great deal of attention from Chinese investors. One report from the Shenzhen Stock Exchange shows that most of the traders involved on the initial offering date are individuals and cover 90% of the total trading amount on the buy side. As a result of this individual majority, stock prices are highly affected by sentiment in China. Much evidence has shown that IPO initial returns are highly affected by investor sentiment from the secondary market and that price premiums on initial offering dates are caused by over-optimistic behavior (Song and Liang, 2001; Cao and Dong, 2006; Jiang, 2007).

Trading activity caused by investor sentiment constitutes noise trading in the capital market. Based on Black's (1986) definition of noise trading, information insufficiency and asymmetry are the basic premises of noise trading. In other words, investors are not priori irrational, but are rather forced to make investment decisions based on sentiment because information asymmetry makes information lack relevance and reliability. As a result, sentiment factors affect trading behavior and make stock prices deviate from their intrinsic value. Consequently, this paper tries to determine whether improving the information environment and decreasing the information asymmetry between companies and investors can decrease noise trading and hence decrease the effect of investor sentiment on stock prices.

Sell-side financial analysts are an important part of the information environment. Taking advantage of their privileged information sources and professional analysis, analysts produce earnings forecasts and investment ratings for investors. Analyst reports are especially important information sources for individuals, who suffer from information asymmetry. As Chinese analysts continue developing, they are playing an increasingly important role in market pricing (Huang and Ding, 2011). Numerous studies have confirmed that analyst forecasts reduce information asymmetry between companies and investors (Zhu et al., 2007). However, studies have focused only on listed firms and the information role of analyst forecasts for pre-listing firms remains unknown. Contrary to the constraints placed on analyst forecasts for pre-listing firms in foreign countries, there is no such prohibition in the Chinese stock market. Analysts can follow pre-listing firms and forecast offering prices. This paper examines whether analyst during the pre-IPO period can improve pricing efficiency and stabilize the market.

Based on the actual conditions of the Chinese stock market, this paper follows classic theories related to IPO initial returns in behavioral finance, uses analyst (price) forecast bias and forecast dispersion to measure the quality of the information environment, and examines the interactive influence of the information environment and market-wide sentiment on IPO initial returns. To verify the influence of market sentiment on IPO initial returns, this paper finds that the smaller the analyst forecast bias or dispersion, the lower the effect market-wide sentiment has on IPO initial returns. These findings indicate that information asymmetry is a basic