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Offering price clusters and underpricing in the US primary market

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Abstra

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We wish to thank Jay R. Ritter for providing the data used in this study and the participants of the seminar at the New Mexico State University.

Notes

A biological rationale for this pricing practice is that consumers have limited memory and tend to store the first digit of a price into memory (Brenner and Brenner, 1982). Thus, costs tend to be priced at odd prices, such as US$4.99 and US$99.99, and benefits, e.g., yields and salaries, tend to be priced at whole prices, such as 5.00% and US$100 000, in retail markets.

The well-documented price clustering in US secondary markets for securities is a result of a variety of economic reasons, including the reduction of negotiation costs (Harris, 1991), implicit collusion among market makers (Dutta and Madhavan, 1997), and explicit collusion among dealers (Christie and Schultz, 1994).

Furthermore, there are differences between the primary and secondary market microstructure in the USA Unlike in the secondary market where minimum tick sizes and spreads are almost always mandated, there are no mandated tick sizes or bid–ask spreads [illegible] are free to use odd [illegible]

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compete on price (Godek, 1996; Huang and Stoll, 1996). As these explanations are tailored to the NASDAQ market, they are not applicable to the IPO market.

In their study of gold price clustering, Ball et al. (1985) hypothesize that prices tend to cluster if the underlying value of the security is not well known (price resolution hypothesis). Harris (1991) adapts the price resolution hypothesis to the clustering in the secondary stock market and suggests that traders will use a fine set of prices when the underlying security values are well known, thereby leading to little price clustering. The competition theiry of Grossman et al. (1997) is largely an extension of the negotiation hypothesis.

Although there is currently no theiry predicting the shape of the distribution of IPO intrinsic values, except for the truncated component, the distribution of IPO intrinsic values should be somewhat smooth. In other words, a priori, there is no economic reason why a relative high frequency of intrinsic values at US$X with two relatively low frequencies of intrinsic values at US$X − 1 and US$X + 1. Harris (1991, Fig. 2) supports this presumption, in which the distribution of market prices is a rather smooth, χ^2-like one.

Harry (1991) documents clusters at whole 5s and 0s in secondary stock markets. These clusters, however, are far less intense than in IPO market.

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