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Behavioural Biases in IPO Market

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ABSTRACT

Traditional finance models make many unrealistic assumptions about investors rationality, perfect competition, information asymmetry etc. These assumptions are not valid in real world market. Extant researches show that investors are not rational in their decisions and are biased in their investment behaviour. Researchers have identified several Behavioural Biases. There is lack of research available about Behavioural Bias for IPO Markets. The study identifies eleven Behaviour Biases and attempts to examine the them in IPO Market by conducting a primary study in the state of Gujarat. The study proves that the investors show Behaviour Bias in their investment decisions in IPO Market. Overall Investors exhibit Loss Aversion Bias, Stories to Facts Bias, Recency Bias, & Overconfidence Bias. While they are not biased for Confirmation, Self-Serving, Planning Fallacy, Choice Paralysis, Herding, Rule of Thumb and Disposition Effect. The investors are different when evaluated for association between location and Behavioural Biases. Surat is among the most biased Investors having nine biases. The Investors of Rajkot have five biases and for three they are unbiased. While Investors of Vadodara are just one bias and being unbiased to seven Behavioural Bias.

1. Introduction

Traditional finance uses different models like CAPM, Markowitz, and Sharpe. These models use all available information and these models considered that all investor have same optimal risk portfolio. Traditional finance theories assume investors are completely rational human beings. Sanfey, Rilling, Aronson, Nystrom, & Cohen, 2003 mentions that the traditional models ignore the impact of emotions of investor while making the investment decision. Behavioural finance rejects assumption such as perfect market and rational decision making. Behavioural finance takes a different view and emphasis on the emotional biases and their impact on investor's investment decision making.

De Bondt, Mayoral, & Vallelado, 2013 argues that the assumption of rational investors who aims and endeavours at maximizing their wealth does not stand true due to absence of empirical evidences. Further, Traditional finance assumes all investors to be homogeneous, which means that all the investors carry the same risk appetite and have the same risk return trade-off. Pompian, 2008 suggest that every investment decision should be based on systematic investor profile as every individual is different. Pompian, 2008 further suggested that investor profiling can serve as a base to effectively manage investor's behavioural biases.

Efficient Market Hypothesis (EMH) argues that all information will be quickly and correctly incorporated in prices. IPO market is primary market, where first-hand securities are traded. The securities traded in IPO are not yet listed in stock exchanges. The prices thus can't be incorporated in prices, as open market does not exist. All the information is processed by the investors and they decide whether to subscribe in IPO or not. Traditional finance also assumes a perfect market where information is freely & widely available to all. (Rock, 1986) proved why issues are underpriced and gave the concept of Winner's Curse. Winners curse refers to the phenomenon where uninformed investors are allotted only bad issues and they are not allotted good issues. It is worth nothing that Efficient Market Hypothesis (EMH) does not claim that the investors are rational, but the markets are. Thus, it is interesting to study the irrationality of investors while investing in IPO market. Ritter, 2003 proved through behavioural finance that markets are not efficient in terms of information.

Thus, Traditional finance has a lot of practical lacunas. To understand the real investment behaviour, it thus becomes important to study the behavioural aspect of invest. This behavioural decision of investment is not necessarily rational & sometimes not even informed. There are several biases which prevent investors taking rational decisions. This research attempts to study the investment biases of retail investors in Initial Public Offering (IPO).

2. Literature Review

Markowitz in his Noble-prize winning work on Portfolio Selection showed the world for the first time, how two risky securities can be combined to reduce risk. Markowitz, 1959 studied that the investors attempt to find the best combination from alternative choices by comparing them through risk return relationship in order to make superior return. On the other hand, Efficient Market Hypothesis argues one cannot make superior returns than the market. (Barberis & Thaler, 2003) observes "Efficient market is the market where average returns cannot be greater than what are warranted for its risk despite whatever investment strategy is applied".

It has been observed that investors in IPO market attempt to make superior profit in short run. Hayat & Anwar, 2016 suggests not all investors are well versed in investment and possess poor financial literacy as well as financial prudence. There is a need for investor training and education, which will in turn help reduce investment mistakes.

Seawright, 2012 identified 10 most common Behavioural Biases viz. confirmation bias, optimism bias, loss aversion, self-serving bias, the planning fallacy, choice paralysis, herding, preference to stories to analysis, recency bias, and blind spot bias. This study is an attempt to identify these behavioural biases in IPO Investors.

2.1 Confirmation Bias – Investors think they carefully collect the required information before investment. But, what investors really do is they perceive information which support their pre-conceived conclusion.

2.2 Optimism Bias – This refers to the investors bias where their subjective confidence in their own judgement outweighs the objective accuracy. Indeed, investors live in a Lake Wobegon World i.e. illusory superiority. It is also referred as Overconfidence. Larrick, Burson, & Soll, 2007 refer to overconfidence as "Another measure of risk is when people consider themselves better and superior relative to others". Further, Overconfidence is the investors overestimation of their own abilities which compel them to think that they can take better decisions than others (ibid). Shefrin & Statman, Behavioural Portfolio Theory, 2000 further mentions that this leads to two main implications, one is the failure to generalise the information and second to indulge in extra trading.

2.3 Loss Aversion – It is a tendency of investors to take investment decision which are loss averse. Kahneman & Tversky, 1979 in their noble prize-winning research in Behavioural Economics mentions about how investors gives more importance to loss than that to gains. Loss aversion leads to inaction and favours status quo.

2.4 Self-Serving Bias – It refers to investors tendency to attribute all the gains due to their own efforts, while the loss is due to someone else's fault. Investors never admit their mistake and consider their every decision to be true.

2.5 The Planning Fallacy – It is the investors mistake of underestimating the cost, time, and risk of their investment decisions and at the same time overestimating the benefits from their investment decision. In fact, the investors do not consider all the cost associated with the investment.

2.6 Choice Paralysis – In general choices are good to have, but in reality, too many choices for investors may lead to decision paralysis and inability to decide which stock to pick for investment.

2.7 Herding – Herding refers to investors following what others are doing. "Herd behavior describes how individuals in a group can act collectively without centralized direction" (Braha, Global Civil Unrest: Contagion, Self-Organization, and Prediction, 2012). In times of fear and uncertainty investors panic and dispose their investments just because others did the same. Persaud, 2000 identified that during the period of uncertainity their strategy is to simply copy others and rely on the information, that is why they would just buy when others buy and sell when others sell. Seawright, 2012 identifies that herding is not only found at institutional level but also that institutions herd even more than individuals. This leads to subscriptions of issues by most, or not opting for the issues by most.

2.8 Stories to Analysis – It is a tendency of investors to believe more in what is talked or discussed about an issue rather than what data speaks. This leads to taking decisions without considering the material data.

2.9 Recency Bias – It refers to giving more importance to recent events than the earlier ones, and further to extrapolate the recent events into future indefinitely. This leads to investors to subscribe relative more issues in hot market and subscribe relatively less issues in cold market.

2.10 Bias Blind-Spot – It refers to individual's inability to identify their own bias. They do identify other's bias, but fail to admit their own.

2.11 Disposition Effect - Boebel & Taylor, 2000 define disposition effect as "it is an anomaly discovered in behavioural finance. It relates to the tendency of investors to sell shares whose price has increased, while keeping assets that have dropped in value". Odean, 1998 opines it is a bias which can affect investor's profit. Frydman & Rangel, 20104 show that the effect of disposition effect is weak when the stock prices are displayed apparently. This leads to investors holding stock for long when prices go down, and do not sell them when prices go up because they are risk averse and want to generate gains quickly (Shefrin & Statman, The disposition to sell winners too early and ride losers too long: Theory and evidence, 1985). Summers & Duxbury, 2012 identify emotions especially regret which is responsible for such behaviour.

2.12 Rule of Thumb Bias – It is a tendency of investors to make rule of thumb and take decisions based on those rules, they ignore all other material facts and rely solely on that Rule of Thumb.

3. Research Methodology

3.1. Problem Statement:

1. To assess whether the IPO investors are homogeneous.
2. Does IPO investors have homogeneous expectations?

3.2 Research Objectives: The following are the objectives for this research –

1. To identify the investment biases of IPO investors in IPO.
2. To evaluate whether there is association of biases to different demographic variables.

3.3. Research Design: The paper uses Cross-Sectional Descriptive Research Design.

3.4. Scope:

1. The research is limited to the IPO Investors' Behavioural Biases.
2. There are three types of investors in IPO viz. High Net Worth Investors (HNI), Retail Individual Investors (RII), and Qualified Institutional Buyers (QIB). This research is limited to the Retail investors in IPO.

3.5. Data Collection Method: This study is based on Primary data.

3.6 Source of Data: The data are collected through Survey Method.

3.7. Data Collection Instrument: A structured questionnaire has been developed.

3.8. Sample Design: Non-probabilistic, Convenience & Snowball sampling is used.

3.9. Population: Retail investors in IPO market of Gujarat.

3.10. Sample Size: 500 respondents in three different cities viz. Rajkot (150), Surat (150) and Vadodara (200) are selected. The three cities represent North Gujarat, South Gujarat and Central Gujarat respectively.

3.11. Statistical Packages: The primary research data was processed using MS Excel 2010 & SPSS 21.0.

3.12. Statistical Tools Used: The research uses various statistical test viz. Reliability Test (to check the internal consistency of the questionnaire) and Anova (to assess the difference between responses of Investors of various cities).

3.13. Limitations:

1. The responses of this study may not be true and candid. The entire study is bases on the responses so received.
2. The selected cities might not be the true representative for Gujarat.
3. The study faces the inherent limitations of the sampling technique opted for. There are likely chances that the responses of the respondents surveyed by snowball sampling are similar and exhibit similar investment behaviour.

4. Data Analysis

1. **Reliability Test:** The reliability test using Cronbach's Alpha is 0.670, which indicates that the research instrument has good internal consistency (reliability).

2. **T-test**: Table 1 shows the summary of t-Test for Behavioural Biases statements tested at 95% confidence level.

Ho: There is no significant difference between the mean of all cities

Table-1
Summary Table of t-Test for Behaviour Biases

Sr. No.	Statement	Behavioural Bias	Mean	Test Value	t-value	Sig (2-tailed)	Interpretation
1	I have gut feelings for a particular IPO and thus I invest in that IPO.	Confirmation Bias	2.79	2	12.036	.000	Neutral
2	I think of loss more than the Return in an IPO	Loss Aversion	1.91	2	-1.983	.048	Strongly Agree
3	I have never made a wrong decision while investing in IPO.	Self-Serving Bias	2.88	2	18.315	.000	Neutral
4	I know all the cost associated with the IPO	Planning Fallacy	2.55	2	10.738	.000	Neutral
5	I am confused when there are many IPOs offered in short timing.	Choice Paralysis	2.84	2	14.685	.000	Neutral
6	I ask others and subscribe when all subscribe the IPO	Herding	2.52	2	9.578	.000	Neutral
7	For me what I hear about the company is more important than the data mentioned in the IPO Prospectus.	Stories to Facts	2.08	2	1.748	.081	Agree
8	IPO is more about getting in right market, than right stock. If the Capital Market if doing well, the IPO will do well (and vice versa)	Rule of Thumb 1	2.83	2	15.295	.000	Neutral
9	If the recent IPOs are successful, I would subscribe the next IPO	Recency Bias 1	2.55	2	10.942	.000	Neutral
10	If the recent IPOs are unsuccessful, I would not subscribe the next IPO	Recency Bias 2	1.99	2	-.129	.898*	Agree

Sr. No.	Statement	Behavioural Bias	Mean	Test Value	t-value	Sig (2-tailed)	Interpretation
11	Higher the Premium, better the Company	Rule of Thumb Bias 2	2.97	2	19.127	.000	Neutral
12	Discounted IPO are better than IPO issued at Premium	Rule of Thumb Bias 3	2.87	2	15.693	.000	Neutral
13	Do you feel you book profit too early when in profit	Disposition Effect 1	2.59	2	11.178	.000	Neutral
14	Do you feel you keep holding too long while in loss	Disposition Effect 2	2.10	2	2.024	.043	Neutral
15	I am among the Best 10% Investors in IPO market	Overconfidence 1	3.90	4		.069*	Disagree
16	I am among the Worst 20% Investors in IPO market	Overconfidence 2	2.01	2	0.136	. 892*	Agree

** t-Test significant p-value accepted at 95% confidence level*

Chi-Square for Investment Behavioural Biases and City. Chi-square test of association was applied to find out association between two categorical data. The responses of Behavioural Bias are converted into 3 categories viz Bias, Neutral & Unbiased and they are tested for association viz-a-viz City of Investor at 95% confidence level. The results of Chi-square test are summarised in Table – 2.

Table-2
Summary Table of Chi-square test between Behavioural Bias and Location of Investor

Sr. No.	Statement	Behavioural Bias	Pearson chi-square p-value	Cramer's V	Association
1	I have gut feelings for a particular IPO and thus I invest in that IPO.	Confirmation Bias	0.000	0.393	Strong
2	I think of loss more than the Return in an IPO	Loss Aversion	0.000	0.194	Moderate
3	I have never made a wrong decision while investing in IPO.	Self-Serving Bias	0.000	0.262	Moderate
4	I know all the cost associated with the IPO	Planning Fallacy	0.000	0.158	Moderate
5	I am confused when there are many IPOs offered in short timing.	Choice Paralysis	0.000	0.334	Strong
6	I ask others and subscribe when all subscribe the IPO	Herding	0.000	0.253	Moderate
7	For me what I hear about the company is more important than the data mentioned in the IPO Prospectus.	Stories to Facts	0.513	NA*	NO
8	IPO is more about getting in right market, than right stock. If the Capital Market if doing well, the IPO will do well (and vice versa)	Rule of Thumb 1	0.000	0.229	Moderate
9	If the recent IPOs are successful, I would subscribe the next IPO	Recency Bias 1	0.000	0.162	Moderate
10	If the recent IPOs are unsuccessful, I would not subscribe the next IPO	Recency Bias 2	0.000	0.158	Moderate
11	Higher the Premium, better the Company	Rule of Thumb Bias 2	0.000	0.260	Moderate
12	Discounted IPO are better than IPO issued at Premium	Rule of Thumb Bias 3	0.005	0.122	Moderate
13	Do you feel you book profit too early when in profit	Disposition Effect 1	0.000	0.276	Moderate
14	Do you feel you keep holding too long while in loss	Disposition Effect 2	0.000	0.272	Moderate
15	I am among the Best 10% Investors in IPO market	Overconfidence 1	0.000	0.143	Moderate
16	I am among the Worst 20% Investors in IPO market	Overconfidence 2	0.000	0.147	Moderate

NA – Caramer's V is not mentioned as Cramer's V is only referred if there is association.*

5. Findings

1. Cronbach's Alpha is 0.670 which suggest that the questionnaire has internal consistency and is reliable.
2. t-Test suggest that the overall investors are Biased for the following Behaviour Biases
   a. Investors think of loss more than return i.e. Loss Aversion
   b. Investors believe more in what they hear about an issue than to the IPO Prospectus i.e. Stories to fact bias.

c. Investors do not subscribe to IPOs if the recent IPOs are unsuccessful i.e. Recency Bias. It is worth noting that if the recent IPO are successful, it does not make the investors subscribe the coming IPOs.
d. Investors do not think they belong to the Best 10% Investors, but they do believe that they belong to the top 20% Worst investors i.e. negative Overconfidence bias.

3. t-Test suggest that the overall investors are Unbiased for the following biases
   a. Confirmation Bias
   b. Self-Serving Bias
   c. Planning Fallacy Bias
   d. Choice Paralysis Bias
   e. Herding Bias
   f. Rule of Thumb Bias
   g. Disposition Effect Bias

4. It is not only important to assess whether association exist or not, but it is also important to identify the association between the two variables. The cross-tab examination suggests the following Association between the Biases and the location of Investors. The results are summarised in Annexure 1.
5. Table 3 summarises the association of Behaviour Bias & Unbias with location of Investors

Table 3: Summary of Chi-Square association between Behavioural Bias and Location of Investor

Location of Investor	Surat	Rajkot	Vadodara
Bias	Confirmation, Loss Aversion, Self-Serving, Planning Fallacy, Choice Paralysis, Herding, Rule of Thumb, Recency, Negative Overconfidence	-	-
Unbias	Confirmation, Herding, Disposition Effect Bias, Negative Overconfidence	Loss Aversion, Choice Paralysis, Rule of Thumb,	Self-Serving, Planning Fallacy
No Association	Planning fallacy	Loss Aversion, Self-Serving, Herding, Recency, Rule of thumb, Disposition Effect, Overconfidence	Confirmation,

6. Conclusion

The study proves that the investors show Behaviour Bias in their investment decisions in IPO Market. Overall Investors exhibit Loss Aversion Bias, Stories to Facts Bias, Recency Bias, & Overconfidence Bias. While they are not biased for Confirmation, Self-Serving, Planning Fallacy, Choice Paralysis, Herding, Rule of Thumb and Disposition Effect. The investors are different when evaluated for association between location and Behavioural Biases. Surat is among the most biased Investors having nine biases. The Investors of Rajkot have five biases and for three they are unbiased. While Investors of Vadodara are just one bias and being unbiased to seven Behavioural Bias.

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Annexure 1
Interpretation of Chi-Square association between Behavioural Bias and Location of Investor

Statement	Behavioural Bias	Association	Interpretation for Surat	Interpretation for Rajkot	Interpretation for Vadodara
I have gut feelings for a particular IPO and thus I invest in that IPO.	Confirmation Bias	Strong	Surat is associated with Confirmation Bias	Rajkot is associated with Confirmation Unbias	-
I think of loss more than the Return in an IPO	**Loss Aversion**	Moderate	Surat is associated with Loss Aversion Bias	Rajkot is associated with Loss Aversion Bias	Vadodara is associated with Loss Aversion Unbias
I have never made a wrong decision while investing in IPO.	Self-Serving Bias	Moderate	Surat is associated with Self-Serving Bias	-	Vadodara is associated with Self-Serving Unbias
I know all the cost associated with the IPO	Planning Fallacy	Moderate	Surat is associated with Planning Fallacy Bias	-	Vadodara is associated with Planning Fallacy Bias

Statement	Behavioural Bias	Association	Interpretation for Surat	Interpretation for Rajkot	Interpretation for Vadodara
I am confused when there are many IPOs offered in short timing.	Choice Paralysis	Strong	Surat is associated with Choice Paralysis Bias	Rajkot is associated with Choice Paralysis Unbias	-
I ask others and subscribe when all subscribe the IPO	Herding	Moderate	Surat is associated with Herding Bias	Rajkot is associated with Herding Bias	Vadodara is associated with Herding Unbias
For me what I hear about the company is more important than the data mentioned in the IPO Prospectus.	**Stories to Facts**	NO	All are same	All are same	All are same
IPO is more about getting in right market, than right stock. If the Capital Market if doing well, the IPO will do well (and vice versa)	Rule of Thumb 1	Moderate	Surat is associated with Rule of Thumb 1 Bias	Rajkot is associated with Rule of Thumb 1 Unbias	-
If the recent IPOs are successful, I would subscribe the next IPO	Recency Bias 1	Moderate	Surat is associated with Recency Bias 1	Rajkot is associated with Recency Bias 1	-
If the recent IPOs are unsuccessful, I would not subscribe the next IPO	**Recency Bias 2**	Moderate	Surat is associated with Recency Bias 2	Rajkot is associated with Recency Bias 2	Vadodara is associated with Recency Unbias 2
Higher the Premium, better the Company	Rule of Thumb Bias 2	Moderate	Surat is associated with Rule of Thumb 2 Bias	Rajkot is associated with Rule of Thumb 2 Unbias	-
Discounted IPO are better than IPO issued at Premium	Rule of Thumb Bias 3	Moderate	Surat is associated with Rule of Thumb 3 Bias	-	Vadodara is associated with Rule of Thumb 3 Unbias
Do you feel you book profit too early when in profit	Disposition Effect 1	Moderate	-	Rajkot is associated with Disposition Effect 1 Bias	Vadodara is associated with Rule of Disposition Effect 1 Unbias
Do you feel you keep holding too long while in loss	Disposition Effect 2	Moderate	Surat is associated with Disposition Effect 2 Bias	Rajkot is associated with Disposition Effect 2 Bias	-
I am among the Best 10% Investors in IPO market	**Overconfidence 1**	Moderate	Surat is associated with Overconfidence 1 Unbias	Rajkot is associated with Overconfidence 1 Unbias	-
I am among the Worst 20% Investors in IPO market	**Overconfidence 2**	Moderate	Surat is associated with Overconfidence 2 Bias	Rajkot is associated with Overconfidence 2 Bias	Vadodara is associated with Overconfidence 2 Unbias