

Cheap Initial Public Offering and Its “True” Value

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Abstract

It can be argued that a cheaply priced IPO will attract more potential buyers, especially retail investors, which can result in more speculative trading activities due to it being perceived as “cheap” by these investors. A fixed-price IPO serves a unique situation in which the price of an IPO is fixed prior to its offering to the potential buyers, and it gives the opportunity to test the hypothesis that a cheaply priced IPO can attract more potential buyers, especially retail investors, which in turn can result in more speculative trading activities, hence, higher initial return and price spread. Malaysian IPOs are mostly fixed-price IPOs which gives us a unique opportunity to test the hypothesis. This study examines a sample of 104 Malaysian fixed-price IPOs from January 2009 to December 2014. In general, the results show that low-priced IPOs and those IPOs listed on the ACE Market (proxy for low-priced IPOs) produced higher initial returns and higher price spreads compared to the more expensive IPOs and IPOs listed on the Main Market (proxy for high-priced IPOs).

1.0 INTRODUCTION

Under-pricing in initial public offerings (IPOs) is a well-documented phenomenon in both the developed and the developing markets. This paper explores the possibilities of exploiting the under-pricing situation in Malaysian IPOs by forming portfolios, based on offer price and also on listing board of IPOs.

In Malaysia, low offer prices are often associated with IPOs listed on the ACE market of Bursa Malaysia, which caters for small, young technological companies. Lowry et al. (2010) noted that IPOs of small, young and technological firms are more difficult to value due to a higher information asymmetry between the issuers and the investors. As a result of this situation, these IPOs are subject to speculation by investors, especially the retail or small investors. Small investors are also attracted to companies with low offer price due to their understandably limited funds to invest.

The higher level of uncertainty regarding the “true” value of an IPO will arguably further increase the level of underpricing due to the existence of information asymmetry between the issuer and

the investors, where the “true” value of the IPO firm is “perceived” to be known only to the issuer but not to the investors. Thus, according to Beatty and Ritter (1986), investors require a lower offer price in order to compensate for their information uncertainty risk. On the other hand, the issuer needs to set a lower offer price in order to attract these perceivably “uninformed” investors. Based on this line of argument, it can be hypothesized that an IPO with a higher level of value uncertainty, especially the one that has low offer price, will have a higher level of underpricing. Furthermore, Baker and Wurgler (2007) suggested that IPOs with a higher level of value uncertainty will be more likely to be affected by investor speculative behaviour. It can be argued that investor speculative behavior will result in higher volatility of initial returns or higher price spread. Based on this line of argument, it can be hypothesized that the lower the offer price, the higher the level of under-pricing and also price volatility or price spread will be.

Falkenstein (1996) suggested that institutional investors seem to avoid investing in low-priced stocks due to higher transaction costs and the negative image of the so-called “penny stocks”. As a result, low-priced stocks are left to the retail investors. It can be argued, due to the nature of human-beings who are usually attracted to something considered cheap (based on “value for money” argument), the same situation can also occur in the case of low offer price IPOs. Retail investors are assumed to be less knowledgeable about the value of an IPO, as compared to institutional investors who are perceived to be informed investors, and as such, these retail investors will be more likely to indulge in speculative activities. With the participation of more retail investors, who are mostly considered to be uninformed investors, more speculative trading activities will occur, and we would expect that prices will be pushed higher and be more volatile.

Fixed pricing is the most common IPO pricing mechanism in Malaysia, unlike book-built offer which is quite common in the United States. With a fixed-price offer, the offer price is set prior its allocation to successful subscribers. Malaysian IPOs, with mostly fixed-price pricing mechanism, serve a unique scenario in testing the relationship between cheaply priced IPOs and their initial returns and also their price spreads during the first day of trading. I hypothesize that in the case of a fixed-price IPO, a cheaply priced IPO will attract more potential investors, especially the retail investors, which in turn will result in higher level of speculative trading activities. Increased speculative trading activities will result in higher prices, and thus higher initial returns, and also higher price spreads.

The remainder of this paper is organized as follows. Following the introduction section, Section 2 reviews some related past studies and Section 3 discusses the data and methodology used. Section 4 presents the results, whilst Section 5 concludes and discusses the implications of the findings.

2.0 LITERATURE REVIEW

Studies that report the existence of under-pricing in initial public offerings (IPOs) are voluminous, both in the developed market (Ritter, 2003), and in the developing markets (Yong, 2007a). Many past studies on Malaysian IPOs dealt with issues that could be linked to the under-pricing phenomenon of Malaysian IPOs. Among the issues studied were underwriters' reputation and management earnings forecast (Jelice et al., 2001), earnings management (Ahmad-Zaluki et al., 2011), owner's participation and lock-up provision (Wan-Hussin, 2005), proportion of IPO shares allocated to Bumiputra investors (How et al., 2007), privatization IPOs versus other IPOs (Paudyal et al., 1998), firm size (Yong, 1996), over-subscription ratio (Yong & Isa, 2003), over-subscription ratio and firm size (Yong, 2007b), investor's opportunity cost of fund and over-subscription ratio (Low & Yong, 2011), board structure (Yatim, 2011), intellectual capital (IC) disclosures in IPO prospectuses (Rashid et al., 2012), government public policy and regulatory intervention (Prasad et al., 2006), shariah-compliant IPOs (Abdul Rahim & Yong, 2010), and investor heterogeneity regarding the value of an IPO (Low & Yong, 2013). An exception, Annuar and Shamsher (1998), tested the Grinblatt-Hwang (1989)'s signaling hypothesis on Malaysian IPOs and concluded that this model was *not* able to explain the under-pricing in Malaysian IPOs. In another study, Chong (2009), tested the Shefrin and Statmen (1985)'s disposition effect and concluded that disposition effect exists among Malaysian IPO investors, namely investors who are more than willing to flip winning IPOs compared to losing IPOs. Yong (2011) suggested that bandwagon effect may explain the under-pricing phenomenon in Malaysian IPOs, and he also concluded that the winner's curse exists in Malaysian IPOs.

The higher level of uncertainty regarding the true value of an IPO can increase the level of under-pricing due to the existence of information asymmetry between the issuer and the investors, where it is assumed that the "true" value of an IPO is known only to the issuer but not to the investors. Therefore, Beatty and Ritter (1986) argued that investors require a lower offer price in order to compensate for their information uncertainty risk, while at the same time, the issuer needs to set a lower offer price in order to attract these "so-called" uninformed investors. Furthermore, Baker and Wurgler (2007) suggested that IPOs with higher level of value uncertainty will be more likely to be affected by investor speculative behaviour, which will result in higher level of initial return (or higher level of under-pricing) and larger price spread.

Unlike previous studies on Malaysian IPOs, the objective of this paper is to explore the possibility of investors benefitting from the under-pricing situation in Malaysian IPOs through portfolio formation. I propose that investors could form specific portfolios, based on offer price of IPOs, and also based on listing board, in order to take advantage of the possible higher levels of return produced by lowly-priced IPOs and IPOs listed on the ACE Market of Bursa Malaysia. In Malaysia, there are two listing boards, namely the Main market and the ACE market. Low offer prices are often associated with IPOs listed on the ACE which caters for small, young and technological companies. As noted by Lowry et al. (2010), IPOs of small, young and technological firms are more difficult to value (due to higher information asymmetry) and as such

the volatility of their initial returns is higher. In addition, these companies exhibit a positive relationship between the mean initial return (or under-pricing) and the volatility of under-pricing. This is based on the idea suggested by Beatty and Ritter (1986), and supported by Michaely and Shaw (1994) who noted that companies characterized by higher information asymmetry will tend to be more under-priced. Beatty and Ritter (1986) also showed that there is a positive relationship between ex ante uncertainty about an IPO's value and its expected initial return. This means that a firm with higher ex ante uncertainty should experience higher initial return. Furthermore, past studies such as Chalk and Peavy (1987) and Ibbotson et al. (1988), reported an inverse relationship between offer price and under-pricing, namely, the lower the offer price, the higher the level of under-pricing will be. In addition, as noted by Ritter (1984) and Sherman and Titman (2002), firms with higher uncertainty have higher volatility of initial returns (or under-pricing).

Falkenstein (1996) observed that institutional investors seem to avoid investing in low-priced stocks due to higher transaction costs associated with low-priced stocks, and perhaps due to the negative image of low-priced stocks perceived as being "penny stocks". Even though this study relates to seasoned stocks, it is not quite clear whether the similar situation is true in the case of IPOs. Assuming that institutional investors (also considered to be informed investors) are mostly interested in high-priced IPOs, then low-priced IPOs are left for retail investors (considered to be uninformed investors). Retail investors are assumed to be less knowledgeable about the value of an IPO, and as such, they will indulge in speculative activities, that will result in higher mean initial return and higher volatility.

Before this, I argued that a low offer price IPO will attract attention of retail investors due to its perceived "cheap" price. In a related study, Corhay et al. (2002) reported that there is a negative relationship between the size of offer (defined as total amount of shares floated in a particular offering) and the initial return of Malaysian IPOs. This means that the bigger the offer size the lower the initial return is, or the smaller the offer size the bigger the initial return will be. This result is in line with the suggestion made by Ritter (1984), that smaller issues are more likely to be subjected to speculative forces and as a result, ex ante uncertainty is expected to be greater for smaller firms. Just like the case of smaller issues, low offer price IPOs are also subject to speculative forces, especially when there are many retail investors participating in the speculative trading activities.

3.0 METHODOLOGY

This study examines a sample of 104 fixed-price IPOs listed on Bursa Malaysia from January 2009 to December 2014. The focus of this study is on the fixed-price IPOs, and book-built IPOs are excluded from the study as the number of book-built IPOs during the sample period is less than ten. In fact, there are seven of them, namely Maxis, listed in 2009; Shin Yan Shipping, listed in 2010; Eversendai and MSM Malaysia Holdings, both listed in 2011; AirAsia X, and UMW Oil and Gas, both listed in 2013; and Boustead Plantations, listed in 2014. IPOs that are classified as REITs are also excluded.

January 2009 was chosen as the beginning period of this study because it is in line with the new classification of listing board of Bursa Malaysia which started in 2009, when stocks were listed into the Main Market and the ACE Market. Prior to 2009, there were three listing boards, namely, the Main Board, the Second Board and MESDAQ. With the new classification, IPOs are either listed on the Main Market (also for stocks that were previously listed on either Second Board or Main Board) or listed on the ACE Market (also for stocks that were previously listed on MESDAQ market). Another reason is to exclude the negative effect of the 2008 financial crisis that hit most global stock markets, including the Malaysian stock market.

The basic information on IPOs used in this study is compiled from Bursa Malaysia website (<http://www.bursamalaysia.com/market/listed-companies/initial-public-offerings/ipo-summary/>). Information on prices during the first trading day is extracted from a website named “KLSE Info” (<http://www.klse.info/counters/historical-prices/>). Under-pricing or initial return referred to the percentage change in price from the offer price to the closing price of the first day of trading.

In this study, I argued that low offer prices will attract more potential buyers, especially the retail investors (or small investors), and thus, will result in a higher level of under-pricing or initial return, and also a higher level of price volatility or price spread. In order to evaluate the impact of offer price on the level of initial returns, and the level of price spread, I grouped these 104 IPOs into three equally-weighted portfolios based on the offer price, namely the low offer price IPOs, the medium offer price IPOs and the high offer price IPOs. I also formed portfolios of these IPOs based on their listing board, in order to capture the size effect on the initial return and the price spread that may exist.

Mann-Whitney U test, which is a non-parametric test for the difference in mean, is employed to test the difference in mean initial returns, between portfolios formed based on offer price, and also based on listing board. Mann-Whitney U test is an alternative test to the commonly used independent t -test, which is a parametric test. With a non-parametric test, the distribution of the data used for the study does not have to be normal, as required under a parametric test.

4.0 FINDINGS

Table 1 presents a summary of the characteristics of the 104 IPOs used in this study, for the period between January 2009 and December 2014. The average initial return (offer-to-close) is 15.93 percent, with a median of 5.80 percent, a minimum of -65.44 percent and a maximum of 404.17 percent. This average initial return (offer-to-close) is less than half of the figure 36.38 percent reported by Yong (2007b) for the period 1999-2003, and substantially lower than the figure 26.54 percent reported by Low and Yong (2013) for the period 2004-2007. The average offer price is RM1.00, median of RM0.75, minimum of RM0.12 and maximum offer price of RM5.05.

Table 1. Descriptive statistics of initial return, number of shares issued, offer price and size of offer, for the period 2009-2019

	Mean	Median	Std. Dev.	Min.	Max.
Initial return (%)	15.93	5.80	49.00	-65.44	404.17
Number of shares issued (million)	327.00	87.95	764.40	15.32	5273.65
Offer price (RM)	1.00	0.75	0.88	0.12	5.05
Size of offer (RM million)	581.85	50.33	1973.91	8.10	12520.00

Note: Sample size, n=104.

Table 2 presents the descriptive statistics of the portfolios formed based on offer price and also based on listing board. As shown in Panel A, low offer price portfolio has an average initial return of 29.42 percent, with a median of 17.25 percent. High offer price portfolio has an average initial return of 9.52 percent, with a median of 7.21 percent, whereas the medium offer price portfolio has an average initial return of 9.23 percent with a median of 3.26 percent. Panel B of Table 2 shows the descriptive statistics of initial return of portfolios formed based on the listing board. The Main Market portfolio has an average initial return of 9.51 percent with a median of 4.26 percent, whereas the ACE Market portfolio has an average of 35.17 percent with a median of 20.78 percent. These figures clearly indicated that cheaply-priced IPOs exhibit higher levels of initial return compared to the more expensive ones.

Table 2. Descriptive statistics of initial return (in percent) for portfolios formed based on offer price and on listing board

	Mean	Median	Std. Dev.	Minimum	Maximum
<i>Panel A: Initial return (in percent) for portfolio formed based on offer price</i>					
Low (n=34)	29.42	17.25	73.71	-39.21	404.17
Medium (n=36)	9.23	3.26	32.77	-35.00	160.00
High (n=34)	9.52	7.21	25.40	-65.44	78.98
<i>Panel B: Initial return (in percent) for portfolio formed based on listing board</i>					
Main Market (n=78)	9.51	4.26	27.65	-65.44	160.00
ACE Market (n=26)	35.17	20.78	83.82	-39.21	404.17

Note: Low offer price IPOs refer to IPOs priced RM0.57 and below; medium offer price IPOs refer to IPOs priced between RM0.58 and RM.97; and high offer price IPOs refer to IPOs priced RM1.00 and above.

As noted by Ritter (1984) and Sherman and Titman (2002), firms with higher uncertainty should have a higher volatility of initial returns. In Panel A of Table 2, low offer price IPOs were shown to have higher mean initial return and higher standard deviation, which is consistent with the findings of Lowry et al. (2010) who found that IPO initial return variability (i.e. initial return standard deviation) is considerably higher in IPOs of young, small technological companies.

This result is also consistent with Lowry et al.'s (2010) observation that for these types of firms, which have higher under-pricing (i.e. higher level of initial return) on average, there is a positive relation between the mean and the volatility (i.e. standard deviation) of under-pricing. These results were shown in Panel B are also consistent with Lowry et al.'s (2010) findings, where IPOs listed on the ACE Market, which are considered to be young, small technological firms, have higher mean initial return and higher standard deviation.

Table 3 shows the results of the Mann-Whitney U test for the difference in mean initial returns between portfolios formed based on offer price and also based on listing board. The z -value of -2.007 and its corresponding p -value of 0.045 indicated that mean initial return of low offer price portfolio is significantly higher than the mean initial return of the medium offer price portfolio, at the 5 percent level of significance. The z -value of -2.087 and its corresponding p -value of 0.037 indicated that mean initial return of the IPOs listed on the ACE Market is significantly higher than the mean initial return of the IPOs listed on the Main Market, at the 5 percent level of significance.

Table 3. Results (z -statistics) of the Mann-Whitney U test for the differences in mean initial returns, between portfolios formed based on offer price and on listing board

Portfolios compared	z -value	p -value
Low Offer Price <i>versus</i> Medium Offer Price	-2.007*	0.045
Low Offer Price <i>versus</i> High Offer Price	-1.357	0.175
Medium Offer Price <i>versus</i> High Offer Price	-0.447	0.655
Main Market <i>versus</i> ACE Market	-2.087*	0.037

Notes:

1. The Mann-Whitney U test is a nonparametric alternative for the t -test for the difference between two independent means.
2. * Significant at the 5 percent level.

Table 4 shows the descriptive statistics of price spread for portfolios formed based on offer price, and also based on listing board. Consistent with results on initial return, low offer price portfolio exhibits the highest mean price spread, with a mean of 42.92 percent, compared to a mean of 19.63 percent for medium offer price portfolio, and a mean of 12.26 percent for the high offer price portfolio. Again, in the case of listing board, IPOs listed on the ACE Market exhibit a significantly higher mean price spread than the mean of those listed on the Main Market. Our contention earlier that low-priced IPOs are subject to speculative trading activities is supported by these findings, as shown by the higher level of price spread for these IPOs compared to the more expensive ones.

Table 4. Descriptive statistics of price spread* (in percent) for portfolios formed based on offer price and on listing board

	Mean	Median	Std. Dev.	Minimum	Maximum
<i>Panel A: Initial return (in percent) for portfolio formed based on offer price</i>					
Low (n=34)	42.92	18.65	61.20	5.56	279.17
Medium (n=36)	19.63	13.81	19.78	2.06	95.71
High (n=34)	12.26	10.07	8.50	0.93	34.45
<i>Panel B: Initial return (in percent) for portfolio formed based on listing board</i>					
Main Market (n=78)	15.58	10.92	14.97	0.93	95.71
ACE Market (n=26)	52.58	25.63	67.29	8.70	279.17
Overall (n=104)	24.83	14.92	39.06	0.93	279.17

Note: Price spread is defined as the difference between the highest price and the lowest price, over offer price, in percent.

Table 5 shows the results of the Mann-Whitney *U* test for the differences in mean price spread between portfolios formed based on offer price, and also based on listing board. As we can see, low offer price portfolio has a significantly higher mean price spread compared to that of the medium offer price portfolio (*z*-value equals -2.703 with its corresponding *p*-value of 0.000) or the high offer price portfolio (*z*-value equals -4.128 with its corresponding *p*-value of 0.000). In line with these results, IPOs listed on the ACE Market also record a significantly higher mean price spread than the mean of those listed on the Main Market (*z*-value equals -4.989 with its corresponding *p*-value of 0.000). These findings supported the contention made earlier that low priced IPOs are subject to speculative trading activities and thus, have higher level of volatility, as suggested by Ritter (1984), Sherman and Titman (2002) and Lowry et al. (2010).

Table 5. Results (*z*-statistics) of the Mann-Whitney *U* test for the differences in mean price spread, between portfolios formed based on offer price and on listing board

Portfolios compared	<i>z</i> -value	<i>p</i> -value
Low Offer Price <i>versus</i> Medium Offer Price	-2.703**	0.007
Low Offer Price <i>versus</i> High Offer Price	-4.128**	0.000
Medium Offer Price <i>versus</i> High Offer Price	-1.739	0.082
Main Market <i>versus</i> ACE Market	-4.989**	0.000

Notes:

1. The Mann-Whitney *U* test is a nonparametric alternative for the *t*-test for the difference between two independent means.
2. ** Significant at the 1 percent level.

5.0 CONCLUSION AND IMPLICATION

It can be argued that a cheaply priced IPO will attract more potential buyers, especially retail investors, and it can also result in more speculative trading activities during their early trading due to it being perceived as “cheap” by these investors. A fixed-price IPO serves a unique situation in which the price of an IPO is fixed prior to its offering to the potential buyers. This allows us the opportunity to test whether or not a cheaply price IPO can attract more potential buyers, which could result in more speculative trading activities, resulting in higher initial return and price spread. Malaysian IPOs, with mostly fixed-price pricing mechanism, serve a unique scenario in testing the relationship between cheaply priced IPOs and their initial returns and also their price spreads during the first day of trading.

This study examines a sample of 104 Malaysian fixed-price IPOs from January 2009 to December 2014. I hypothesize that a cheaply priced IPO will attract more potential investors that will result in a more speculative trading activity which will later push the IPO price higher in the secondary market, and will result in higher price spread. The same situation occurs with regard to trading board, where investors are more attracted to cheaply priced IPO associated with IPOs listed on the ACE Market. In general, it is found that low priced IPOs and those IPOs listed on the ACE Market have higher initial returns and higher price spreads compared to the more expensive IPOs and IPOs listed on the Main Market. The results of this study implies that investors can benefit significantly from investing in IPOs with low offer price, especially those IPOs listed on the ACE Market, which is associated with low priced IPOs. The implication to the regulatory bodies of Bursa Malaysia is that they should pay closer attention to those low price IPOs and IPOs listed on the ACE Market because these IPOs are subject to speculation or speculative trading activities.

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