
Investor Understanding and Risk Mispricing in Initial Public Offering Markets: A Behavioural Perspective on Investor Risk Perception

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ABSTRACT

Initial public offerings represent an important mechanism through which firms raise capital from public markets while providing investors with opportunities to participate in early stages of corporate growth. Despite extensive disclosure requirements designed to reduce information asymmetry, IPO markets continue to exhibit persistent patterns of mispricing and speculative investment behaviour. This paper examines how investors interpret and respond to risk disclosures contained in IPO prospectuses. Drawing on established research in corporate finance and behavioural finance, the analysis shifts attention from firm-level financial metrics toward investor cognition and behavioural response. The paper argues that investor awareness of risk does not necessarily translate into accurate risk assessment or rational pricing behaviour. Behavioural influences such as optimism, overconfidence, and herd behaviour shape how investors interpret prospectus information and evaluate investment opportunities. A conceptual framework is developed that explains how prospectus disclosures interact with investor cognition and market sentiment to produce risk mispricing. The paper contributes to research on IPO markets through a behavioural interpretation of investor awareness and highlights implications for disclosure design, investor education, and regulatory policy.

KEYWORDS

Initial public offerings; investor awareness; behavioural finance; risk perception; information asymmetry; investor

cognition.

INTRODUCTION

Initial public offerings are among the most significant events in corporate finance, enabling privately owned firms to access public capital markets while allowing investors to participate in the early stages of corporate growth (Pešterac, 2020; Megaravalli). The IPO process plays a crucial role in capital formation and financial market development, providing firms with access to funding that can support expansion, innovation, and strategic development.

Investment in IPOs, however, occurs within an environment characterised by considerable uncertainty. Newly listed firms often possess limited publicly available performance history, and investors must evaluate investment opportunities based largely on information contained in IPO prospectuses. These documents provide detailed disclosures regarding firm operations, financial performance, governance structures, and potential risk factors that may influence future outcomes.

Regulatory frameworks place significant emphasis on disclosure as a mechanism for reducing information asymmetry between issuing firms and investors. Disclosure theory suggests that transparent communication of firm information can improve market efficiency and enable investors to make informed decisions (Ammer & Sattarov, 2025). IPO prospectuses therefore function as the primary regulatory instrument through which firms communicate risk information to potential investors.

Empirical evidence suggests that investors do not simply ignore these disclosures. A recent multi-country study examining investor awareness across seventeen categories of IPO risk factors reported a strong degree of alignment between the risks disclosed in prospectuses and those recognised by investors (Puri et al., 2026).

Despite extensive disclosure requirements, IPO markets consistently display persistent patterns of mispricing. A substantial body of research documents systematic IPO underpricing, where shares are offered at prices below their potential market value, generating significant initial returns for investors (Mehmood et al., 2024; Rossovski, Lucey & Helbing, 2025; Rizvi & Nandan, 2026). This phenomenon has been observed across numerous global markets and remains one of the most widely studied features of IPO activity.

Traditional explanations for IPO mispricing focus largely on firm-level factors such as information asymmetry, signalling strategies, and the incentives of investment banks involved in underwriting offerings (Joshiyura, Mathur & Gwalani, 2023). These explanations provide valuable insight into pricing dynamics but devote relatively limited attention to the behavioural processes through which investors interpret available information.

Behavioural finance research suggests that investors do not always process financial information in a fully rational manner. Psychological biases and cognitive limitations frequently influence financial decision-making, particularly in environments characterised by uncertainty and limited information (Acciarini, Brunetta & Boccadelli, 2021; Sathya, & Gayathiri, 2024; Tansuchat & Thaicharo, 2025). Investors may therefore rely on simplified signals, such as market sentiment, anticipated listing gains, or other investors' behaviour, when evaluating IPO opportunities.

These behavioural tendencies have important implications for how investors interpret risk disclosures contained within IPO prospectuses. Although investors may recognise commonly disclosed risk factors, such recognition does not necessarily translate into accurate assessment of their implications for firm valuation. Optimism regarding potential returns, combined

with herd behaviour in financial markets, may lead investors to discount risk information when forming investment expectations.

Evidence indicates that investors often recognise many of the risks communicated during the IPO process. Survey based analysis of experienced investors shows that awareness levels across macroeconomic, regulatory, financial, and operational risk categories frequently exceed the neutral midpoint, suggesting meaningful engagement with disclosed information (Puri et al., 2026).

This paper examines investor understanding and risk perception in IPO markets through a behavioural finance perspective. The analysis shifts attention away from firm-level financial indicators toward the interpretive processes through which investors engage with prospectus disclosures. The central argument advanced in this study is that investor awareness of risk does not necessarily ensure accurate risk assessment or rational pricing behaviour.

The study contributes to research on IPO markets in three important ways. First, it reframes investor awareness as a cognitive process involving interpretation and judgement rather than simple recognition of disclosed risks. Second, it integrates insights from behavioural finance with disclosure research to explain how investor cognition influences pricing outcomes. Third, it proposes a conceptual framework that explains how interactions between disclosure systems and investor behaviour can contribute to persistent patterns of IPO risk mispricing.

INVESTOR COGNITION AND RISK INTERPRETATION IN IPO MARKETS

Investment decisions in financial markets require investors to evaluate uncertain outcomes and weigh potential returns against perceived risks. In IPO markets, this task becomes particularly complex because newly listed firms often lack extensive trading history, and investors must rely heavily on forward-looking information. Prospectus disclosures, therefore, play a central role in shaping investor expectations.

Empirical investigation of investor awareness supports this assumption. Structured survey analysis of IPO participants indicates that investors generally recognise the major categories of risk highlighted in prospectuses, including macroeconomic volatility, regulatory shifts, and firm specific operational constraints (Puri et al., 2026).

Although disclosure systems are designed to improve market transparency, the effectiveness of such mechanisms depends largely on how investors interpret the information provided. Investors differ significantly in terms of financial literacy, experience, and analytical capacity. These differences influence the degree to which prospectus disclosures are understood and incorporated into investment decisions.

Research in behavioural finance demonstrates that investors frequently rely on cognitive shortcuts when processing complex information (Gabhane, Sharma & Mukherjee, 2023; Ahmad & Wu, 2024). Such shortcuts allow individuals to simplify decision-making under conditions of uncertainty but may also lead to systematic errors in judgement. Within IPO markets, investors may focus on easily observable signals such as firm reputation, industry growth potential, or anticipated listing gains rather than conducting detailed evaluation of risk disclosures.

Overconfidence represents one behavioural influence that may affect IPO investment decisions. Investors who overestimate their ability to interpret financial information may place excessive confidence in their investment choices and underestimate potential risks. Studies have shown that overconfidence can lead investors to trade more aggressively and to place greater emphasis on optimistic expectations regarding firm performance (Guluma, 2021; Kunjal et al., 2021).

Another important behavioural influence involves investor optimism regarding growth opportunities. Newly listed firms often attract considerable attention due to expectations of rapid expansion or innovation. Positive narratives surrounding such firms can shape investor perceptions and contribute to elevated expectations of future performance. Under these conditions, investors may acknowledge the presence of risks while simultaneously discounting their importance when forming investment decisions.

Herd behaviour represents an additional factor that can shape IPO investment activity. Financial markets frequently display patterns in which investors follow the actions of others rather than relying solely on independent evaluation of available information (Mushinada & Veluri, 2019; Mutize, Tefera & Nkhalamba, 2020; Raut, Das & Mishra, 2020). When demand for IPO shares increases due to perceived market enthusiasm, additional investors may enter the market in response to this momentum. Such behaviour can amplify price movements and contribute to speculative trading patterns.

The interaction between these behavioural tendencies and the information environment of IPO markets creates conditions in which risk perception may diverge from objective risk exposure. Investors may recognise certain categories of risk disclosed in prospectus documents yet fail to integrate those risks fully into pricing expectations.

CONCEPTUAL FRAMEWORK: DISCLOSURE, COGNITION, AND RISK MISPRICING

The conceptual framework developed in this paper emphasises the relationship between prospectus disclosures, investor cognition, and market outcomes. Three interconnected components shape this relationship.

The first component involves the availability of information through prospectus disclosures. Regulatory authorities require issuing firms to disclose detailed information regarding potential risks that may affect future performance. These disclosures aim to provide investors with a comprehensive overview of the uncertainties associated with the investment opportunity.

Empirical findings suggest that investors do engage with these disclosures to a meaningful degree. Evidence indicates that investor awareness closely corresponds with the categories of risk typically communicated in IPO prospectuses, challenging the assumption that retail investors are consistently overwhelmed by disclosure complexity (Puri et al., 2026).

The second component concerns investor awareness and interpretation of disclosed risks. Awareness refers to the extent to which investors recognise the presence of risk factors described in prospectus documents. Interpretation refers to how investors evaluate the implications of those risks for future performance and investment returns.

The third component involves behavioural response within financial markets. After interpreting available information, investors must decide whether to participate in the IPO and how to value the shares offered. Behavioural influences such as optimism, herd behaviour, and expectations of short-term listing gains may shape these decisions.

The interaction between these components can produce situations in which risk disclosures are acknowledged but not fully reflected in pricing decisions. Under such conditions, investor behaviour may contribute to discrepancies between market prices and underlying risk exposure.

CONCEPTUAL PROPOSITIONS

The framework developed in this paper (Figure 1) supports several conceptual propositions regarding investor behaviour and IPO pricing outcomes.

Proposition 1: Greater exposure to prospectus disclosures increases investor awareness of IPO related risks.

Regulatory disclosure requirements ensure that investors receive extensive information regarding potential risks associated with newly listed firms. As investors review prospectus documents, they become aware of the categories of risks facing the firm.

Proposition 2: Investor awareness of risk does not necessarily lead to accurate assessment of risk implications.

Although investors may recognise disclosed risks, behavioural influences may shape how these risks are interpreted. Optimistic expectations regarding potential returns may lead investors to underestimate the significance of negative information.

Proposition 3: Behavioural biases influence how investors incorporate risk information into investment decisions.

Overconfidence, optimism, and herd behaviour may encourage investors to discount risk information when evaluating IPO opportunities. Under such conditions, investment decisions may reflect behavioural influences rather than detailed evaluation of firm fundamentals.

Proposition 4: Divergence between risk awareness and risk assessment contributes to IPO mispricing.

When investors recognise risks but fail to incorporate them fully into pricing expectations, market prices may deviate from valuations that reflect the true risk profile of the issuing firm.

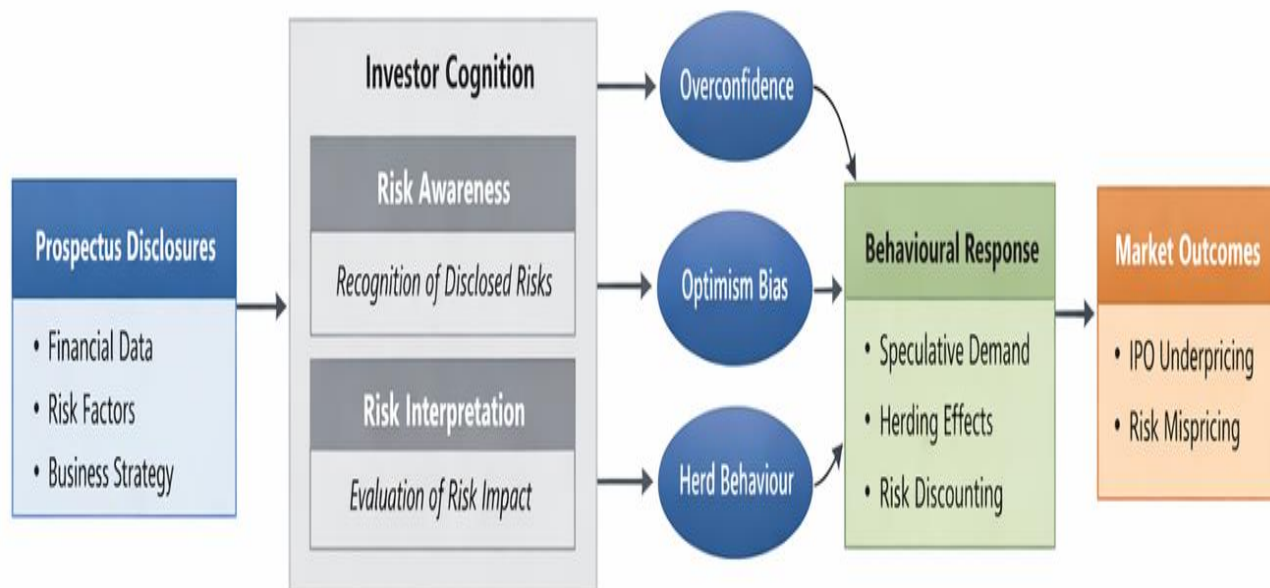


Figure 1: Conceptual Framework of Investor Cognition and Risk Pricing in IPO Markets

DISCUSSION

The conceptual analysis presented in this paper highlights the importance of considering investor cognition when evaluating the effectiveness of disclosure systems in IPO markets. Disclosure requirements represent a central pillar of modern financial regulation and are designed to reduce information asymmetry between issuing firms and prospective investors. Through prospectus documentation, firms communicate key financial indicators, operational characteristics, governance structures, and material risk exposures. These disclosures are intended to support informed investment decisions and to contribute to more efficient price discovery during the IPO process (Mangala & Dhanda, 2022; Wadha & Sahoo, 2024).

However, the availability of information does not necessarily ensure that investors interpret that information in a consistent or fully rational manner. Financial decision-making often occurs in environments characterised by uncertainty, time pressure, and incomplete knowledge. Investors approach such situations with varying levels of experience, financial literacy, and analytical capability. Some investors possess extensive expertise in evaluating financial disclosures, whereas others rely on simplified decision rules when assessing complex information. Behavioural finance research demonstrates that investors frequently employ cognitive shortcuts when processing financial data, particularly in settings where uncertainty is high and information is difficult to interpret (Sathya & Gayathiri, 2024; Reddy et al., 2025).

Psychological influences, therefore, play a significant role in shaping how investors interpret IPO prospectus disclosures. Expectations regarding firm growth, anticipated listing gains, and broader market sentiment can influence the way investors evaluate available information. Empirical research has shown that investors often exhibit overconfidence in their ability to interpret financial signals and forecast market performance (Bouteska & Regaieg, 2020). Such tendencies can lead investors to place greater emphasis on potential returns while assigning less weight to negative or uncertain information contained in disclosure documents.

The framework developed in this study, therefore, distinguishes between awareness of risk and interpretation of risk. Investors may recognise the categories of risk described in IPO prospectuses while simultaneously discounting the probability or severity of those risks when evaluating investment opportunities. This distinction aligns with behavioural explanations of financial market activity, which suggest that investors do not always integrate available information into pricing decisions in a fully rational manner (Khare & Kapoor, 2024).

Recent empirical evidence reinforces this distinction between awareness and interpretation. Survey-based analysis examining investor engagement with IPO risk disclosures indicates that investors frequently recognise the most economically significant risk categories presented in prospectuses, including macroeconomic volatility, regulatory intervention, and firm-specific operational uncertainties. These findings suggest that investors are capable of identifying the primary sources of risk associated with newly listed firms (Puri et al., 2026). Evidence that investor awareness aligns closely with disclosed risk categories challenges the assumption that retail investors are consistently overwhelmed by disclosure complexity.

This interpretation carries important implications for evaluating the effectiveness of disclosure frameworks. If investors already recognise many of the risks communicated in prospectus documents, simply expanding the quantity of disclosure may not significantly improve investment outcomes. Prior research suggests that excessively lengthy disclosures can reduce readability and limit the usefulness of financial documents for investors attempting to extract key information (Arora &

(Chauhan, 2023; Gangadharan & Padmakumari, 2024).

Understanding investor cognition, therefore, represents an important step toward improving the effectiveness of disclosure regulation. Regulatory strategies that focus on improving the clarity, organisation, and accessibility of risk information may enhance investor comprehension and support more accurate risk evaluation. Complementary initiatives aimed at strengthening financial literacy may also improve the ability of investors to interpret prospectus disclosures critically. When combined with existing disclosure requirements, such approaches may contribute to a more transparent and informed IPO market environment.

IMPLICATIONS FOR REGULATION AND INVESTOR EDUCATION

Several implications arise from the analysis presented in this paper. First, regulatory authorities may consider initiatives aimed at improving the clarity and accessibility of disclosure documents. Simplified presentation of key risk information may enhance investor comprehension and encourage more informed decision-making.

Second, investor education programmes may play an important role in strengthening market efficiency. Educational initiatives that enhance financial literacy and analytical skills may improve investors' ability to interpret prospectus disclosures.

Third, future research may explore how different categories of investors interpret risk disclosures. Institutional investors, experienced market participants, and retail investors may respond differently to the information environment of IPO markets. Understanding these differences can provide valuable insight into market behavior.

CONCLUSION

Initial public offerings represent a crucial mechanism through which firms access public capital markets, and investors gain exposure to emerging investment opportunities. Disclosure frameworks aim to reduce information asymmetry and support informed investment decisions by providing detailed information regarding firm operations and potential risks.

The present paper emphasises the importance of examining how investors interpret and respond to these disclosures. Behavioural influences such as optimism, overconfidence, and herd behaviour shape investor cognition and affect how risk information is incorporated into investment decisions.

A behavioural perspective, therefore, provides valuable insight into persistent patterns of mispricing observed in IPO markets. Investor awareness of risk does not necessarily guarantee accurate assessment of its implications. Greater attention to investor cognition and financial literacy may improve the effectiveness of disclosure systems and contribute to more informed investment decisions.

AUTHOR CONTRIBUTION

All authors contributed meaningfully to the development of this study and the preparation of the manuscript. The study was conceptualised and designed by T.P., who led the development of the research idea and overall study structure. The development of the theoretical framework was carried out by T.P., C.L.M. and K.O.O., who also contributed to the primary drafting of the manuscript. All authors contributed to the literature review, critical appraisal, interpretation of findings, and provided feedback on successive drafts. All authors approved the final version of the manuscript.

CONFLICT OF INTEREST

The authors declare no conflict of interest.

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