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ETFs for IPOs: Worth Buying?

BY ALEXANDER EULE

Alibaba Group Holding might have broken new ground for the size of initial public offerings, but it did little to change cynical views about IPOs. Investment bankers priced the shares just low enough to give their best customers an easy one-day gain. By the time trading commenced, Alibaba had jumped 36%. Anyone who bought on the open market didn't fare nearly as well. Alibaba (ticker: BABA) closed its first full week at \$90.46, 2.4% below the opening trade. And it might not get much better; the typical IPO delivers a negative return to investors over its first four years.

ETF investors may have a better way. In 2004, Josef Shuster, a London School of Economics–trained Ph.D., launched a benchmark to track U.S. IPOs. (The index also includes spinoffs, because they're similarly infused with new capital.) He concedes that the data show that individual IPOs are usually poor investments, but in aggregate they actually do fairly well. In fact, the top 10% of IPO performers do so well that they carry the laggards with them. For the roughly 1,200 U.S. IPOs from 2000 through 2013, the average first-year gain was 6%. But take out the top 10% of performers and that gain becomes a loss of 8.2%. (The performance excludes opening-day trading.)

"Nobody knows who's going to be the next Google or CME or Facebook," Shuster says. "There is no better place to apply indexing than the IPO market." For his U.S. index, Shuster picks the 100 largest new issues. Over 30 years, size—bigger is better—has been predictive of success according to research by Jay Ritter, an IPO expert at the University of Florida.

FIRST TRUST HAS PUT THE THEORY into practice. In 2006, the Wheaton, Ill.–based fund manager launched the first IPO-focused ETF, licensing the U.S. IPO index from IPOX-Shuster. The First Trust U.S. IPO Index ETF (ticker: FPX) has a five-year annual return of 22%, versus 16% for the Standard & Poor's 500. Morningstar rates it five stars. And though still relatively small, First Trust's ETF has exploded in the past two years, with assets under management of \$528 million, up from \$25 million at the end of 2012.

The exchange-traded fund brings some discipline to the hyped IPO world. Its IPOX-Shuster index permanently excludes any stock that jumps more than 73% on its first trading day, an attempt to eliminate stocks brought to market at artificially low prices. The index is rebalanced once a quarter. The latest rebalancing—on the third Friday of September—coincided with Alibaba's listing, so the Chinese e-commerce giant was added. Shuster said that was a rare exception permitted by the index's rule book; usually, the index has a six-day waiting period before adding stocks. The average holding period is 2½ years.

Alibaba is now 2.8% of the First Trust fund, its eighth-largest position. Facebook (FB) is the top holding at 10%, but despite the emphasis on technology IPOs, the rest of the top 10 is decidedly non-tech. In fact, First Trust IPO is a surprisingly diverse mix of companies, including car maker General Motors (GM), refiner Phillips 66 (PSX), and hotelier Hilton Worldwide (HLT).

For all of First Trust's success, there's strangely only one other IPO-related exchange-traded fund: IPO-specialist Renaissance Capital launched the Renaissance IPO ETF (IPO) last October, though it has garnered just \$33 million in assets. The fund buys stocks on their fifth day of trading. By then, it seems, the initial public offerings have become yesterday's news.

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