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ETF Shows New Stocks Can Pop After Debuts

By Chris Dieterich

The sprawling reach of exchange-traded funds has so far left initial public offerings virtually untouched, but the performance of the sole fund to focus on new stocks has proven worthy of investors' attention—and could well encourage imitators.

The pioneering fund, First Trust US IPO Index ETF (trading symbol FPX), tracks an index of 100 U.S. IPOs and spinoffs developed by Josef Schuster, founder of IPOX Schuster LLC, an IPO research-and-investment firm based in Chicago. It climbed to an all-time high earlier in December, and has risen 26% in 2012 through Friday, towering over a 12% gain for the Standard & Poor's 500. Over three years, the fund has returned 16% on an annualized basis, topping 10% for the S&P 500.

The fund's year-to-date return is markedly better than if an investor was able to buy every IPO in the U.S. this year at the offer price and hold it, a strategy that would have notched a 17% return through Friday, according to Renaissance Capital, an IPO research-and-investment firm.

The methodologies underpinning IPOX Schuster's suite of indexes are, essentially, to focus on the biggest, brightest stars, skip the noise of first-day jumps or nosedives, and let the companies put their newly raised cash to work for a few years.

Data have shown the market performance of IPOs tends to trail shares of publicly traded companies with the same size by market capitalization. In an April analysis, Jay Ritter, a finance professor at the University of Florida, found between 1970 and 2010, IPOs trailed peers by an average of 3.3% during five years after issuing shares, excluding the first-day gain.

But Mr. Schuster has found much of the lagging performance comes from a large chunk of small- and middle-capitalization companies. "A few do extremely well, and the rest really underperform," he said.

The fund is selective, only buys after a given stock has been trading for at least a week and then holds on to shares for several years.

Many of its top holdings, which include spinoffs like Phillips 66—up more than 50% since trading began in May—hardly resemble cash-hungry startups. Among the fund's largest positions for most of the year: Visa Inc., which went public in 2008, and General Motors Co., which went public in 2010 after the federal government bailed out the auto maker a year earlier. Visa, which this month was dropped from the fund after more than four years, has gained 46% this year, while General Motors added 37%.

Big holdings also include the likes of Facebook Inc., which commands nearly 10% of the weight. Mr. Schuster added Facebook in late September, according to Morningstar Inc., when shares prices hovered at roughly half of their May offer price. Shares have since climbed 20%.

The fund also holds stocks like luxury retailer Michael Kors Holdings Ltd., which went public in December 2011. Its shares have soared 80% this year.

Given its success, First Trust US IPO likely won't be the only kid on the block forever.

Nearly 1,000 domestic and international equity ETFs dotted the investment landscape at the end of November, collectively valued at more than $1 trillion, according to recent data from the Investment Company Institute, a mutual-fund trade association. Yet only First Trust currently fits under the IPO category of ETFs tracked by IndexUniverse, a research firm.

Renaissance Capital, however, has documents on file with the Securities and Exchange Commission to launch an ETF based on its one of its own IPO indexes.

ETFs, which trade like stocks, can provide investors simple ways to gain exposure to a risky IPO market, and tend to carry lower fees than mutual funds. But since its inception in 2006, the First Trust US IPO Index ETF has collected only about $21.4 million in assets.

Mr. Schuster speculated investors aren't beating down the doors to buy the IPO ETF with the urgency of other stock ETFs because the market is perceived by some to be too risky. But he said the fund's track record shows IPOs and spinoffs are a "solid asset-allocation proposal."

Smaller, infrequently traded funds can make quick bouts of buying and selling more expensive, said Todd Rosenbluth, an ETF analyst at S&P Capital IQ. But "if the strategy makes sense, assets shouldn't be a deal breaker," he said.

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