FORTUNE.com

JULY 8, 2021 CUSTOM REPRINT

FINANCE / QUARTERLY INVESTMENT GUIDE

The definitive data-driven guide to buying the best performing IPOs

By Shawn Tully

It's practically investing gospel that the way to score big on IPOs is getting shares before trading starts on opening day. The reason is simple: Wall Street banks typically underprice the stock they sell in the "offering" phase, and reserve those prize servings mostly for their big, fee-paying clients such as mutual and hedge funds and family offices. The privileged players jockey hard for those goodies and for good reason—over the past 40 years, the newcomers' shares jumped an average of 17.9% by the end of the first day of trading. And in last year's hot IPO market, the prevailing "pop" was an incredible 41.6%.

IPOs aren't just for insiders

Hence, you might think that investing in IPOs is strictly a game for powerful money managers and the ultrawealthy. Not so. Once the bell has rung on some of this summer's hottest upcoming IPOs, don't despair if you didn't get in with the insiders. There may still be plenty of upside left to capture.

For the average investor, however, winning in IPOs is tricky. Buying a mix of all new listings is a loser, since the majority of IPOs underperform both the market as a whole, and other value or growth stocks of similar size. The key is choosing the sweet spot, the blend of sectors, revenue categories, and holding periods that, over time, have generated the best returns, and are likely to deliver outsize gains in the future.

Here's a quick summary: Tech is best; big beats small; profits or losses early on don't matter much; and holding for just a few years captures youthful enterprises in their most dynamic phase. "If investors had had perfect foresight 40 years ago, they would have bought tech IPOs year after year, because so many of them turned into Amazons, Alphabets, and Teslas," says Jay Ritter, a professor at the University of Florida who is the nation's leading expert on IPOs and provided *Fortune* with the market data for this story.

IPO investing is getting democratized. Folks can get in on the action via funds that post strong returns holding shares of new offerings that they buy exclusively in the aftermarket. "We don't go to Wall Street banks and say, 'Give us 10,000 shares to flip,'" says Josef Schuster, CEO of IPOX Schuster, the firm that designs strategies for the $2.8 billion **First Trust U.S. Equity Opportunities ETF** (symbol: FPX). "The allocations the insiders get are small. We're free to purchase all the shares good diversification requires. And we don't charge '2 and 20' fees to our clients using the gimmick of selling them underpriced shares," says Schuster.

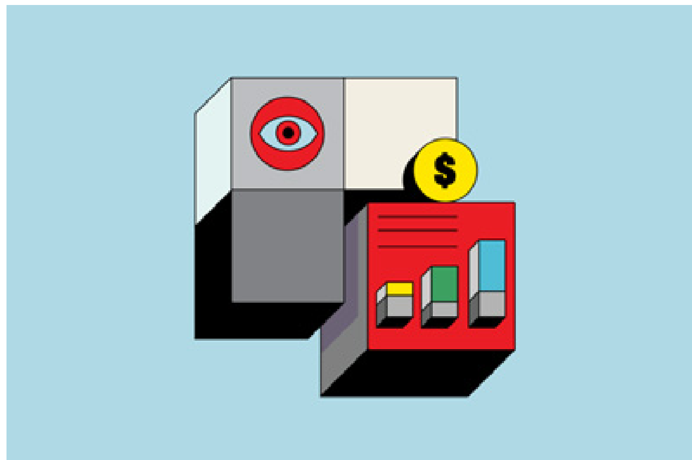

ILLUSTRATION BY JAMIE CULLEN

The rub is that today, investors are paying far higher prices for future superstars than in the past. That's likely to hold returns below the terrific levels of previous periods for a while. But those sizzling valuations will inevitably cool. If investors follow the rules and roll over their IPO holdings on a disciplined schedule, either on their own or via the specialized funds, they're likely to pocket market-beating gains.

Here's why "IPOs for everyone"—one of the most overlooked corners of the investment world—is also one of the most potentially profitable.

Forty years of IPO data spotlight areas that generate big returns

Ritter assembled numbers from 1980 to the close of 2019 showing how all of the 8,610 IPOs combined, and sliced in different categories, fared over time. He measures returns for the IPOs in those four decades that by the end of 2020 had traded for three years, long enough to post a medium-term track record. His data also includes IPOs from 2017 to 2019 that traded for shorter periods, but no companies that went public after December of 2019. So since he's measuring returns to the end of 2020, every company in his sample has at least one of year of data.

Ritter measures from the end of the first trading session to the three-year mark—in other words, what investors would make if they bought at the opening day's closing price and then sold after 36 months. Or in the case of IPOs from 2017 to 2019, shorter periods. Leaving out day one, he says, makes little difference.

"After the big pop that goes to insiders, the trading that happens within the first day shows no pattern," says Ritter.

Obviously, virtually every IPO covers a different three-year span. So Ritter compares the performance of each stock over its 36-month "holding period" to two benchmarks measured for exactly the same intervals.

The first is the overall market, as represented by how each company's shares performed versus the CRSP index of all publicly traded stocks on the major exchanges. The second shows each IPO's record over its individual, three-year time in the "portfolio" against a basket of companies of similar market cap that also fit the same profile as "value" or "growth" stocks, as measured by price-to-book value. He calls the two yardsticks the "market" and "style" metrics.

Ritter then combines that data to arrive at the average of the three-year returns for all IPOs since 1980. He shows how that overall record compares with first, the CRSP total return, and second, the gains of stocks in the same value and growth classes over each three-year period for which the IPOs are measured, rolled into an average.

Ritter also gets granular, and that makes his data especially revealing. He divides all of the IPO stocks into batches according to sales, profitability, and sector, and tracks the three-year gains for each category. That breakdown reveals the characteristics that make for high-return IPOs.

Big beats small by a wide margin

The first notable point: Buying all IPOs is a bad strategy. Over the past four decades, that approach would have delivered average gains for each company over the three year buy-and-hold period of 8% a year. That number trails the market gains of 12% by a wide margin. "The numbers show that the majority of IPOs are losers, so don't put all your eggs in the big IPO basket," says Ritter. "IPOs produce big winners, so the key is finding the baskets that typically produce those winners."

Dig into the numbers, and it turns out what dragged down the average was a poor showing by small companies, while the relatively big ones did splendidly. Ritter divides the 8,600 IPOs into two categories of sales that he adjusts for inflation, those above and below $100 million. That figure is based on revenues over the 12 months before the IPO. The "small" group gained just 4% a year, underperforming by more than eight points annually, and trailing those of similar "style" by four points.

Why have smaller companies underperformed? "In every decade, small companies have done worse than large ones," says Ritter. But the types of sub-$100 million enterprises has shifted greatly over time. "Back in the 1980s and 1990s, tiny companies of all types were going public, supported by low-quality underwriters," observes Ritter. "Investors got burned and went on a buyers' strike."

That retreat stopped the flow of microcap industrial and service players hitting the public markets. But biotech startups took their place. "In the past eight years, almost all the ultra-low-sales IPOs have been biotechs. Most of them have zero sales and are posting losses. Almost no other types of companies today go public with no sales," says Ritter.

He adds that the young biotechs have venture capital backing for a couple of rounds as private companies, and once public, typically get no revenue from product sales. "It's like buying a lottery ticket that occasionally pays off," says Ritter. But these ultra-small biotechs don't produce overall returns any better than the tiny laggards of old. "The numbers are the same for the earlier group, and for the biotechs," says Ritter. "The biotech startups have been disappointing investments."

In comparison, the larger-revenue IPOs have done splendidly. Those starting at sales of $100 million or more notched annual returns over their first three years as public companies of 12.5%, beating the market by a point a year, and their "style" peers by two points.

Tech outpaces non-tech

Ritter divides the IPO market into two industry groupings: technology, accounting for one-third of all offerings in the past four decades, and non-tech, encompassing biotech, restaurant chains (Shake Shack), apparel retailers (Poshmark), and sundry smaller sectors.

Tech waxes non-tech by wide margin. (Ritter excludes the IPOs in the Internet bubble from 1999 to 2000.) Even for smaller companies with revenues of under $100 million, tech beats the comparable grouping of mainly small-cap growth players. But the top gains go to the larger sales contingent. IPOs in software, cloud, semiconductor, and the like generated 20% annual gains over the three-year periods, beating the market (9%) and other big-cap growth stocks (11%) by 11 and nine points, respectively. "The tech companies starting with bigger sales have done really well," says Ritter, citing shooting stars Facebook, Apple, LinkedIn, Google, and Amazon.

Unsurprisingly, the "insiders" who bought tech IPOs at the offer price garnered even richer gains that those who purchased in the aftermarket. The first day bump raised their returns to just under 28% a year, eight points higher than for investors who bought at the closing price. Still, it's hard to beat a strategy that's delivered 20% gains by following simple, by-the-book rules: purchasing larger-sales IPOs; leaning toward tech; and holding for the relatively short time periods that, as we'll see, maximize returns by capitalizing on the momentum driving fresh IPOs.

Starting profits don't matter much

Ritter also splits IPOs between those that are profitable and unprofitable over the 12 months preceding the offering. He finds that for all IPOs over $100 million in sales, the starting moneymakers do a lot better. But in the most promising arena, the larger tech IPOs, profitability makes surprisingly little difference. IPOs in the black scored just over 20% gains annually, while those in the negative column advanced 18%. Says Ritter, "The conclusion is that bigger tech stocks are the place to invest, even when they start off booking losses." He points to DocuSign, Pinterest and CrowdStrike as future winners that had losses prior to going public.

You can enter the game through two excellent funds specializing in IPOs

It would obviously take a lot of time and trading to establish your own portfolio of IPOs, guided by data showing that the tech is the big winner. Fortunately, you can benefit from this underrated sector via two funds with outstanding records. **The First Trust U.S. Equity Opportunities ETF** (symbol: FPX) is the world's largest IPO fund ($2.8 billion in assets under management). It holds the 100 biggest IPOs, measured in market cap, each in proportion to its weight in the top 100. It purchases shares on the seventh day following the debut, and has a buy-and-hold period of four years. The funds are managed and marketed by First Trust; it's IPOX of Chicago that oversees the index, determining the weightings and how the weightings shift over time.

IPOX CEO Josef Schuster explains why four years is an ideal time frame. "It's the optimal tradeoff," he says. "It enhances overall performance by keeping the younger companies in their early growth phase. If you have a portfolio of IPOs that are six or eight years old, their performance becomes very much like that of the Nasdaq 100." IPOX also practices "rebalancing." Each quarter, it sells the companies whose valuations fall out of the top 100, and purchases those that newly qualify, having undergone the IPO process within the past four years. "There's lots of action in IPOs. They rise and fall a lot," says Schuster. "Through rebalancing, we're able to get out of losing positions quickly and stay in the winners. We also trade into momentum IPOs that were initially too small but are gaining in market cap."

No one company can account for more than 10% of the total fund, a strategy aimed at ensuring that a couple of overpriced names can't dominate the index. IPOX also incorporates an unusual feature that gives its portfolios extra ballast and diversification. The fund holds non-IPO spinoffs, in which a parent company distributes stock in a subsidiary to its shareholders, transforming the business into a publicly traded company.

That would appear an awkward fit, since units that big enterprises "spin off" are often industrial stalwarts, not tech sprinters. "But spinoffs resemble IPOs," says Schuster. "They have similar growth dynamics. Those units become much more entrepreneurial once they're independent. They're also in some of the fastest expanding sectors of the economy."

Schuster cites such FPX holdings as Dow Inc. , which thrived after breaking from DuPont, and elevator maker Otis and AC manufacturer Carrier which roared after their liberation from United Technologies. He's also frank about the flops, notably the Mondelez spinoff of Kraft Foods. "From the portfolio management perspective, spinoffs provide diversification without dampening growth, and give our holdings more of an old economy tilt," adds Schuster.

Though FPX is primarily an index fund, it still harbors an important element of active management. When an IPO is purchased by another company, FPX has the option of adding the purchaser to the index—if it sees big appreciation ahead. In 2014, the index sold Tesla after the EV maker's shares ran from $5.20 to $40 over the standard, four-year holding period. But when Tesla bought IPO SolarCity in late 2016, Schuster grabbed the opportunity to jump back into a name that's the quintessence of Big Momentum. During the second four-year ride to 2020, Tesla's shares exploded 13-fold to nearly $600.

FPX leans heavily toward larger-revenue companies, given that it chooses only the top 100 IPOs in market cap. Thirty-six percent of its holdings are in technology, followed by health care at 14%, and industrials at 11.7%, a share bolstered by its array of spinoffs, while communications services represent another 10%-plus. Its four largest holdings are Marvell (8.21%), Snap (7.0%), Uber (5.2%), and Tradeweb (3.4%). Since the fund's inception in 2006, it's delivered annual returns of 13.55%, net of fees. The fund returned an incredible 86.5% last year in one of the best IPO markets in history. This year, it's up 7.6% so far, well behind the S&P 500's 16.5% gains. That's due to the weak performance of some of last year's high-fliers, such Zoom, Carvana, Chewy, Airbnb, and 10x Genomics, not to mention such newcomers as Coinbase.

Another top choice is the Renaissance IPO ETF (symbol: IPO), managed by Renaissance Capital of Greenwich, Conn. It keeps shares for a shorter period of two years. "We're able to generate much better than market returns because we emphasize the largest, most liquid companies that have gone public in recent years," says Kathleen Smith, chairman and cofounder of Renaissance. Its top holdings are Snowflake (9.5%), Palantir (7.4%), and Peloton (9.3%). Unlike FPX, IPO doesn't include non-IPO spinoffs or acquiring companies. It tilts more heavily to tech than FPX, with 47% of its holdings in the sector, followed by consumer discretionary (16%) and health care (13%). Its performance is also robust: Its five-year average annual return is 28%, though it's also lagging thus far in 2021 at just 2.8%. Thanks to a great 2020, its gain over the past 12 months is 63.8%.

Sure, it's still the fat cat mutual and hedge funds that get the richest IPO milk, courtesy of Wall Street. But in a sense, the elites looking to play the "free money" game are missing the point. IPOs on their own, once all-comers get a chance to vet them, are proving good investments on the merits. They offer what serious investors are looking for: broad portfolios of the most innovative players that combine great growth potential and the powerful momentum of youth. The big, engineered "pops" get the headlines, but robust gains await once the pops pop and the headlines fade.