

Winning at the IPO Game.

11 July, 2019 | Dean Fergie, Cyan Investment Management Pty Ltd

Dean Fergie from Cyan Investment Management shares five lessons from examining 50 new company listings from the last 18 months.

In the past 18 months, there have been over 125 IPO's* land on the ASX boards; their average return to date is around +10%. Despite the modest overall return, more than 2/3 of these new listings are underwater; the mathematical average being held up by the 10 companies now trading between 100% and 500% above their listing prices. Take a bow Althea (AGH) and Unity Wireless (UWL), both up more than 400%.

At Cyan, over this period, we have considered approximately 50 of these listings (we don't invest in resources or biotechnology which make up many of the new market entrants) and have put money into just 11. Despite both our cynical nature and selective investment approach, our hit rate is still less than 50% (only 5 of 11 are above water); however, our average return is over 50%.

So what IPO specific lessons have we learned?

It's a Truly Inefficient Market

In our minds, the huge attraction of IPO investing is the unique opportunity to invest in true market inefficiency. At the time of an IPO, the market has:

1. limited company information;
2. no pricing history; scarce research;
3. no active buyers and sellers operating in an open marketplace; and,
4. most importantly, set pricing (or at the very least a small range).

This gives those investors prepared to back their own research and analysis a rare opportunity to deploy capital in a closed pricing environment.

There's an Asymmetrical Payoff

This is true of all 'long-only' investing but it is particularly acute with IPO's because of the market inefficiency. Most simplistically the "Asymmetrical Payoff" relates to the mathematically advantageous

outcome that the most an investor can lose from a single investment is 'just' 100%; and the most one can profit is, theoretically, unlimited. As stated above, this is why the average IPO return is well above zero even though a majority of IPOs result in losses.

Of course, where this beautiful numerical outcome can fail is when stubborn or arrogant investors feel the need to double down if their IPO investment begins falling. It's the horrible case of thinking, "The market has got this wrong". Never argue with the market!

Conversely, investors should be willing to let a profitable investment run. The stockmarket is a great place to make a quick buck but, really, serious wealth is generated over long periods of time. Notwithstanding the material capital gains tax advantage of holding an investment for longer than 12 months, it's rare that companies that have captivated the market's attention will enjoy a strong rise followed immediately by a steep fall.

Beware the Capital Raising Paradox

This, unfortunately, is the drawback of set pricing and is an outcome of the microeconomic supply/demand curve (that being, for a set price and set demand, supply may fluctuate wildly). In simplest terms, investors are likely to get a lot of what they really don't want; and get not much of what they do. It's certainly no coincidence that the two IPO's we've backed and have been 'looked after' in allocations have not performed nearly as well and those in which we've been seriously scaled back.

Cut Losses and let Winners run

This should be a mandate across all investment securities but it is particularly apt with respect to early trading in IPOs. Investment banks do aim to price their IPO's for early success.

If a security begins trading below its issue price, it's a good sign to get out. And don't wait. Be one of the first out the door, as there's often a long line of investors wanting to exit when a disappointing float doesn't magically rise above its IPO price after a few days trading under water. More often than not, "the first loss is the best loss".

Conversely, if you've been smart (or lucky) enough to be on a winner, stick with it. If the company has been mispriced, it takes time for the market to adjust. Success breeds success.

Develop Relationships

The best way to get access to the hottest IPO's is to deal with a number of different brokers, pay fair brokerage rates and be upfront about your investment objectives. All new IPOs need a spread of 300 shareholders at \$2,000 so there's every chance of receiving the minimum allocation, but if you do want a better allocation, give a genuine indication of your level of interest and desire to be a long-term shareholder.

As always, keep a lookout in the press, the ASX and other media for indications of new IPO opportunities. For those willing to back their own judgement, it can be a lucrative place to invest.

*source: ipowatch.com.au

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