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Rethinking IPOs

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In the wake of the Facebook IPO last spring, and the ensuing public relations debacle, many investors have become more wary of newly minted stocks. Even before this event, the public perception regarding IPOs was heavily influenced by the IPOs of the late 1990s that helped fuel the dot-com bubble. For many, the primary motivation for investing in IPOs has been the potential to receive a short-term surge in price, irrespective of a stock's longer term potential for success or failure.

However, there is a compelling case to be made for investing in recent IPOs and spin-offs beyond their first week of trading. In this newsletter, we will consider the investment case for this group of stocks, we'll take a closer look at a disciplined strategy for investing in recent IPOs and spin-offs, and we'll consider how this strategy might fit within a diversified investment portfolio.

Why invest in recent IPOs and spin-offs?

Foundational to the case for investing in recent IPOs and spin-offs is the recognition that there are unique dynamics that impact these stocks, which are not shared by more seasoned stocks, and which tend to fade away over time. For example, in the early stages after a stock's initial public offering, "lock up" and short-selling constraints may bias returns. Additionally, there may be a substantial amount of information asymmetry among market participants; initially, investors are heavily reliant upon data provided in the stock's prospectus, while many analysts are subject to a "quiet" period before issuing research reports or forecasts.

Following the expiration of the quiet period, as analysts begin to initiate coverage, there is a relatively wide dispersion of subsequent returns. Notably, following the initial week of trading, the majority of new IPOs and spin-offs in the US have tended to produce negative returns during the subsequent 12, 24, 36, and 48 month periods (see "% negative" in Table 1 below). However, the best performing stocks from this group have more than compensated for the losers, producing attractive average returns for the group as a whole during these same time periods (see "average returns" in Table 1 below). So, while the odds may be stacked against investors attempting to select a few winners from this universe, broader exposure to recent IPOs may be more desirable.

Table1

Aftermarket performance of IPOs/spin-offs (%) from 1996-2011 (excluding initial returns)[1]

	Month 1	Month 3	Month 12	Month 24	Month 36	Month 48
(worst)	-75.35	-99.20	-99.93	-99.99	-100.00	-100.00
(25th percentile)	-7.64	-15.29	-44.00	-66.36	-73.38	-76.50
(Median)	**-1.47**	**2.00**	**-6.08**	**-26.01**	**-31.93**	**-33.69**
(75th percentile)	13.92	23.30	39.11	36.37	40.86	44.98
(best)	7757.14	6864.29	7625.00	13858.51	12378.50	3840.51
Average	**9.91**	**13.53**	**15.09**	**12.53**	**18.63**	**20.71**
(% negative)	44.20	45.95	54.07	62.33	62.69	62.85

[1]Source: IPOX Schuster. Includes equally-weighted results from all US IPOs from 1996-2011, excluding returns from the first day of trading after IPO or spin-off. Past performance is no guarantee of future results. This table is for illustrative purposes only and not indicative of any actual investment. The illustration excludes the effects of taxes, brokerage commissions, and other expenses incurred when investing.

One factor that has supported the above average performance of IPOs and spin-offs has been the tendency for successful companies to be targeted by larger companies in M&A deals. According to IPOX Schuster, since the launch of the IPOX®-100 U.S. Index in 2004, 12.2% of index constituents have been targeted in M&A deals, often at significant premiums.

Another important consideration underpinning the rationale for including recent IPOs and spin-offs in an investment portfolio is the fact that, while these stocks constitute a significant portion of the capital markets (in the US, IPOs and spin-offs have added an average of $150 billion per year to the market capitalization of the US stock market over the past decade[2]), there is a substantial time lag before they are added to most broad equity indexes. As a result, recent IPOs and spin-offs are generally underrepresented in index-based exchange-traded funds (ETFs) and mutual funds and may benefit from broader ownership when they are subsequently added to the index.

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Past performance is not a guarantee of future results and there is no assurance that the above mentioned events or improvements will continue.

A strategy for investing in IPOs

We believe one efficient way for investors to gain diversified exposure to a portfolio of recent IPOs and spin-offs is via the First Trust US IPO Index Fund (FPX), which tracks the IPOX®-100 U.S. Index. This index selects 100 of the largest recent IPOs and spin-offs that are domiciled in the US from the IPOX Global Composite Index. A stock may be added to this base index after 5 trading days, subject to size, float, and initial performance requirements, and considered for inclusion in the IPOX®-100 U.S. Index on a quarterly basis, when the index is rebalanced. According to IPOX Schuster, the unique characteristics of IPOs and spin-offs tend to fade away over the course of about four years, so constituent stocks are removed from the index after no more than 1000 trading days (approximately four years).

Where does this strategy fit?

From the standpoint of traditional size and style attributes, the First Trust US IPO Index Fund (FPX) is classified as a large cap growth ETF by Morningstar, although the fund is not restricted from including stocks from any size or style classification. The "growth" label is generally appropriate for this strategy, though, as many companies use newly raised capital from IPOs to invest in plant & equipment, as well as to increase hiring, in order to seek above average revenue growth. Moreover, the strategy is not limited to investing in any specific sectors or industries, and this exposure tends to evolve over time. As of 12/31/12, consumer discretionary, energy, and information technology represented the largest sector allocations.

Since the fund is not constrained by any specific style/size or sector requirements, one appropriate way in which it may be utilized is as a satellite position within a "core and explore" strategy, with the goal of seeking alpha for an investment portfolio.

However, this fund may also be useful for filling in some of the gaps among the core holdings of strategic asset allocation models, since most index mutual funds and ETFs are generally underweight newly listed stocks. As of 12/31/12, FPX holdings represented just 1.35% of the S&P 1500 Composite Index, despite the fact that these stocks had a collective market capitalization of approximately $543 billion.

For some investors, IPOs are simply tools for short-term speculation, but this perspective may obscure some of the unique characteristics and longer-term benefits of these stocks. While IPOs have often evoked emotional responses and investment decisions, we believe the First Trust US IPO Index Fund (FPX) provides an unemotional, rigorous, and disciplined approach to investing in recent IPOs and spin-offs.

Past performance is not a guarantee of future results and there is no assurance that the mentioned events or improvements will continue.

[2]According to IPOX Schuster, as of 12/31/12.

ETF Characteristics

The First Trust US IPO Index Fund lists and principally trades its shares on the NYSE Arca, Inc.

The fund's return may not match the return of the IPOX®-100 U.S. Index. The fund may not be fully invested at times. Securities held by the fund will generally not be bought or sold in response to market fluctuations.

Investors buying or selling fund shares on the secondary market may incur customary brokerage commissions. Market prices may differ to some degree from the net asset value of the shares. Investors who sell fund shares may receive less than the share's net asset value. Shares may be sold throughout the day on the exchange through any brokerage account. However, unlike mutual funds, shares may only be redeemed directly from the fund by authorized participants, in very large creation/redemption units.

RISKS

The fund's shares will change in value, and you could lose money by investing in the fund. One of the principal risks of investing in the fund is market risk. Market risk is the risk that a particular stock owned by the fund, fund shares or stocks in general may fall in value.

The fund may invest in securities issued by companies concentrated in a particular industry. The fund may invest in small capitalization and mid capitalization companies. Such companies may experience greater price volatility than larger, more established companies.

The fund is classified as "non-diversified." A non-diversified fund generally may invest a larger percentage of its assets in the securities of a smaller number of issuers. As a result, the fund may be more susceptible to the risks associated with these particular companies, or to a single economic, political or regulatory occurrence affecting these companies.

You should consider the fund's investment objectives, risks, and charges and expenses carefully before investing. Contact First Trust Portfolios L.P. at 1-800-621-1675 or visit www.ftportfolios.com to obtain a prospectus or summary prospectus which contains this and other information about the fund. The prospectus or summary prospectus should be read carefully before investing.

A patent with respect to the IPOX® index methodology has been issued (U.S. Pat. No. 7,698,197). IPOX® is a registered international trademark of IPOX® Schuster LLC (www.ipoxschuster.com).

First Trust Advisors L.P. is the adviser to the fund. First Trust Advisors L.P. is an affiliate of First Trust Portfolios L.P., the fund's distributor.

Not FDIC Insured • Not Bank Guaranteed • May Lose Value