Zacks INVESTMENT MANAGEMENT

Mitch on the Markets

Look for Risks that No One is Talking About

By Mitch Zacks
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When the U.S. and global equity markets took a steep dive in the week of October 8, the headlines were a chorus of replayed fears: *Interest rates are moving higher too fast! The Fed is in danger of making a major policy error! Technology valuations are too high! Global trade is in trouble!*

We've heard them all before – which is actually one of the main reasons I was convinced early-on that this was routine market volatility, not the start of a bear market. Regular readers of my column know that I've been bullish on the U.S. economy and the stock market throughout 2018, based on Zacks Investment Management's fundamental analysis of growth trends, earnings, manufacturing and service activity, interest rates, and inflation. The sharp and sudden selling pressure in the stock market doesn't change our view – it actually reinforces it.

But this is not to say we're in a market with little or no risks. I just think the recycled risks (interest rates, trade, technology stocks) are too widely known and discussed, and are already priced-in to the markets. If we're going to run a real risk analysis of the market, I think we need to look further under the hood – in places where few people are looking. I'm thinking about new regulation in the technology industry, a political standoff with China, or as I detail below, too much investor enthusiasm resulting in overpayment for risk assets.

Enter Initial Public Offerings, or IPOs. The market for initial public offerings (IPOs) is hot, and it may be a symptom of investor confidence running too high.

A study released a few weeks ago by University of Florida finance professor, Jay Ritter, showed that a very high percentage of companies filing for IPOs are money-losers. Of all the companies that filed for a U.S. IPO in the first three quarters of 2018, Mr. Ritter found that an astounding 83% of them did not make any money in the 12 months leading up to their listing. That's the highest percentage on record, going back to 1980.

Even the dot-com era of the late 1990's/2000 did not produce as high a proportion of unprofitable listings. There were far more companies that filed for IPOs in those years, but the highest percentage of money-losers ever reached was 81%. It seems we're in a new era of investors unloading cash on companies whose business models have yet to produce profits, and that can be a worrisome trend, in my view.

To make matters more troubling, the stocks of these money-losing corporations have delivered well above-average performance. Looking at prices at the time of IPO versus their prices from last week, shares of these money-losing corporations have soared +36%. Compare that to the stocks of IPOs that have actually made money (+32%) and the S&P 500 (+9%), and you can see how pricing mechanisms are out of whack.[1]

If you ask me, investors are paying way too high a premium for risk, and the data may suggest there's too much unsupported optimism seeping into the markets.

Why This Matters

Remembering the dot-com bubble should help us recognize the risks of an IPO frenzy. The cycle goes something like this, in my view: investors feel a fresh wave of optimism (tax cut), stocks and the economy go up, investors get an appetite for more risk, IPO issuance goes up, investors flood in, valuations soar. It's a recipe for a bubble, and we're seeing signs of it today.

In the first three quarters of 2018, over 180 companies have raised more than $50 billion, which makes this the top year for issuance since 2014. Investors should just keep in mind that the last time IPOs reached peaked levels in the 10th year of a cycle (2000), it marked the end of the cycle.[2]

Bottom Line for Investors

There's a silver lining to this narrative, however, and it's that the current IPO wave does not have the mainstream appeal or attention that the dot-com wave did. Most retail investors are not aware of the many IPOs being issued today, and you probably don't have your neighbor coming over for dinner to tell you about the hottest new biotech or social media play. If anything, we've seen that frenzy already take place in the cryptocurrency markets, and that bubble has arguably already burst.

Even still, I believe this trend in the IPO market is worth eyeing, particularly to see if that appetite for risk starts to filter into the broader equity markets. In the meantime, it's worth remembering what we believe to be a few key lessons from our past experience with a too-hot IPO market:

1) **Don't Chase Heat –** the temptation to invest in an asset class or strategy with high returns is ever-present, particularly in strong

markets. Human beings by our very nature have a weak spot for wanting to be a part of 'the next big thing,' with the promise of big returns. History has proven to us, however, that more often than not those types of investments and promises should be avoided.

2) **IPOs are Inherently Overpriced –** in my view, IPOS are inherently overpriced. By the time the retail investor gets access to a new IPO, it's already been shopped and (usually) bid-up by institutional investors. If an IPO has been bid up well above its asking price *and* it's a company with no earnings, it's overpriced in my view.

3) **Remember What Works –** the idea of big returns and winning short-term trades has a nice ring to it, but it's not what investors have historically leaned on to achieve their long-term goals. For that, diversified portfolios focused on quality and earnings growth have delivered better and more consistent results, and I don't think that will change over time.

With that said in my view, it is smarter to stay the course and keep focus on the long-term.

About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

1 The Wall Street Journal, October 1, 2018. https://www.wsj.com/articles/red-ink-floods-ipo-market-1538388000

2 The Wall Street Journal, October 1, 2018. https://www.wsj.com/articles/red-ink-floods-ipo-market-1538388000