Investors: Here’s Why You Shouldn’t Buy Tech Stock IPOs

Description

Tech IPOs are among the perennial favourites of growth investors. With the well-known success stories of **Microsoft** and **Apple** embedded deep into the markets’ collective unconsciousness, many investors have a desire to profit off the next big thing. It’s true that the best tech IPOs have made many investors wealthy.

However, the majority of the time, they fail to deliver. Although tech stocks can deliver strong returns over time, there’s evidence that they under-perform in their first year, which makes buying tech stocks at their IPO prices a losing prospect in the short term.

Tech IPOs typically under-perform the market by 10% their first year

According to data from the Janus Henderson Group, the average tech IPO under-performs the benchmark by an average of 10% in its first year. With the **S&P 500** only averaging about 10% per year since the 1970s, that makes IPOs a far cry from the high alpha investments investors have come to expect.

And under-performance isn’t the worst IPO investors can expect either. In many cases, buying IPOs is an actual losing proposition. Ask anybody who bought **Uber** or **Lyft** this year how they’ve fared, and they’ll tell you they’d have been better off holding cash.

Why IPOs do so poorly

There are several proposed theories to explain the phenomenon of IPOs under-performing in their first year of trading. The first is that IPO offering prices tend to overvalue the securities, leading to immediate downward pressure.

The second is the lock-up period, a six-month post-IPO window during which insiders can’t sell their shares.

Once this expires, the theory goes, the market is flooded with sell orders for the new IPO in question. A final possible explanation is simple disappointment. If a tech stock goes public and quarterly reports show the company failing to deliver the heady growth that investors wanted, it can trigger a selloff.

When is the right time to buy tech stocks?

There is no right or wrong time to buy tech stocks. Although tech IPOs tend to under-perform in their first year, many go on to become successful over the long term.

Consider **Shopify Inc** (TSX:SHOP)(NYSE:SHOP), for example. Shopify's IPO valued it at $17, and it closed at $35 on its first day of trading. From its first-day success, Shopify went on to have a great first year, another great year after that, and another after that.

Clearly, tech IPOs can be good buys sometimes, and if you're interested in buying a stock, the fact that it's a recent IPO shouldn't discourage you from doing so.

However, whether you buy tech stocks around the time of their IPO or later, it's probably best to buy on good earnings news. When Shopify went public, it was seeing extraordinarily fast revenue growth, which likely contributed to its IPO success.

Uber's IPO, by contrast, was marred by news of multi-billion dollar losses. Because most tech stocks go public long before they become profitable, it's possible that negative earnings news around IPO time is ultimately the biggest factor behind their poor results.

If that's the case, then whether you buy on strong earnings may be more important than whether you buy on or near the IPO date.

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