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Strategies: History and Predictions on Initial Stock Offers

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Both good and bad news emerges from a historical review of the market cycle as it relates to initial public offerings.

The good news is that the stock market will not forever remain as unreceptive to I.P.O.'s as it is currently — so unreceptive, in fact, that only three companies went public in January and six in February, according to a database maintained by Prof. Jay Ritter of the University of Florida.

The bad news is that it could be a long time before I.P.O. volume returns to the levels set just prior to the Nasdaq composite index's all-time high a year ago. In February 2000, no fewer than 55 companies came to market, and during their first day of trading alone those I.P.O.'s gained an average of more than 116 percent.

Many investors, however, do not even consider the possibility that another easy money era could be years away. This no doubt is because of their limited historical perspective. Even if their experience of the I.P.O. market extends back 10 years, for example, they still have not witnessed anything that would suggest the current closing of the I.P.O. window is anything more than temporary. After all, this market came roaring back almost immediately following late-1994 and the fall of 1998, the two periods during the last decade in which I.P.O. volume fell to levels as low as today's.

But a longer view of history paints a far less sanguine picture. In fact, there have been several extended periods since 1960 in which the I.P.O. window has remained largely closed for several years running.

Consider volume before and after the 1973-1974 bear market. As many as 80 companies were going public each month during the go-go years before that decline. Yet monthly I.P.O. volume dropped to zero halfway through that bear market, and it remained barely more than a trickle for six more years. It was not until late 1979 that monthly volume rose back to double-digits.

There is another pattern inherent in the I.P.O. market cycle that suggests the window may stay closed, if not for six years then at least a lot longer than the market's Pollyannas are expecting.

This other pattern has to do with the kind of companies that tend to go public.

especially during those periods in which the market for I.P.O.'s is most receptive. These newly public companies fall predominantly within the category known as small- cap growth, according to recent research by two finance professors, Michelle Lowry and G. William Schwert, of Pennsylvania State University and the University of Rochester, respectively. One implication of their work is that the I.P.O. market cycle is part of the broad market's style rotation between the extremes of large capitalization versus small capitalization stocks and growth versus value stocks. The I.P.O. window is open widest when the small-cap growth sector is leading the market.

Instead of asking when the new-issue market will reopen, this research suggests that it would be more useful to ask when the small- cap growth sector once again will set the pace. This reframing helps us answer our question. The small-cap growth sector, once it is out of favor for more than a month or two, tends to stay out of favor for several years. Currently, it has been out of favor for about one year.

Though the 1974-1981 period is the most extreme example of this sector's unpopularity, there are others. Small growth stocks also remained out of favor for about five years in the early 1960's, during which I.P.O. volume nearly dried up. These stocks also succumbed to the crash of 1987, and on that occasion as well, low I.P.O. activity persisted for several more years.

The I.P.O. market therefore must overcome formidable historical hurdles if it is to quickly return to its glory days.