WEEKLY REPORT SEPTEMBER 2021

Private Asset Management Ltd

Brent Sheather is a Financial Advice Provider and a personal finance and investments writer.

IPOs: Risk and Access

Two weeks ago we looked at IPOs and in particular their performance relative to the market. But there are two aspects of investing: return and risk. In respect of portfolio risk IPOs are generally bad news. Because IPO companies are often small so the addition of an IPO stock to a portfolio can introduce higher risk and high tracking error into that portfolio. Most institutional investors manage risk by having regard to the relative size of a stock. Because most stocks being IPO'd are small they don't constitute a big part of a stock market index. Investment theory and best practice says that the least risky portfolio is the portfolio that approximates the weightings of the index. For example Fletcher Building is about 5% of the NZ stockmarket so should be about 5% of a portfolio. If a fund manager likes Fletcher Building he might go to 5% plus 1 and if he doesn't like it he might go to 5% minus 1. This is how fund managers manage risk but often anything goes as far as retail portfolios are concerned. The fund manager strategy is acknowledged as best practice globally and is the rationale behind index funds which we know outperform most active fund managers. However that sort of risk management doesn't sit well with the investment banker who is trying to sell you an IPO because, for example, with that strategy MyFoodBag (MFB) would not have had much relevance to most retail investor portfolios. MFB was capitalised at about $448.5m and with the NZX valued at $189bn a market weight in MFB would be just 0.3% ie virtually zero. Anecdotal evidence however suggests that many advisors in charge of discretionary portfolios don't have particular regard to the relative size of the stock and are more focused on fulfilling their obligations to their investment banking superiors.

This obligation was quite evident in a legal action against a stockbroking firm about 10 years ago where I was an expert witness. The broker concerned managed the portfolio on a discretionary basis where he made the decisions for the client …. not always a great move. Recall Oscar Wilde's comment that "a stockbroker is someone who invests your money until it is all gone". That is almost what happened here. The reality of "discretionary" in this case was that whenever the firm underwrote an IPO which was unpopular the discretionary client ended up taking lots of the surplus stock. In the court case the poor client ended up with huge holdings in lots of IPOs underwritten by the broking firm, all of which performed badly, and many of which went bust. So to be clear buying IPO's in anything but the biggest companies like Genesis, Mighty River and Meridian may not be prudent, unless of course, you can pick the good ones from the bad ones and you can get shares in the good ones.

This brings us to the question of access to IPOs. The truth of the IPO market is that the more wealthy and valuable the client is to the institution in charge of allocating the shares the more chance they have of getting shares in the IPO. This is despite the FMA's overarching objective "to promote and facilitate the development of fair, efficient and transparent financial markets". The float of SOE, Genesis Energy, illustrates the access issue. In the Genesis float many small retail investors who applied for shares were heavily scaled. Back then Herald columnist Mary Holm, responding to a mum and dad investor who applied for 30,000 Genesis and got just 3,000, asked for a response from Treasury. The Treasury official, who may well have been a politician in a former life, said "661 applications were received for 30,000 or more shares and the majority were allocated to institutions". At first glance that seemed to be fine however it may be that the Treasury official was being a little bit economical with the truth.

To get the facts I obtained a printout of all the shareholders in Genesis on the day before it listed. It made for interesting reading and it was quite clear that the stock brokers who acted as gate keepers for the float

While every effort has been made to ensure accuracy, no liability is accepted for errors of fact or of opinion herein.

allocated large numbers of shares, shares that were sold by all New Zealanders, to a small number of wealthy New Zealanders.

So, whilst someone who applied for 30,000 shares ended up getting 3,226 shares and a "sorry about that mate" letter from the Treasury, one of NZ's richest people whose name I won't mention got more than 600,000 shares in the issue at a price of $1.55. That delivered a gain of almost $250,000, a transfer of wealth from all New Zealanders to someone who is apparently worth $500m or more. This story was repeated time after time if you look down the list of shareholders in Genesis. We see the names of ex stockbrokers, brothers, sisters, aunts and uncles of stockbrokers, fund managers, ex fund managers, executives, solicitors and the wealthy all receiving huge allocations of shares simply because they have a relationship with a stockbroking firm. I put these facts to the FMA at the time and they "declined to comment".

It's no surprise that the big clients of stock broking firms in the US and UK also get preferential allocations of hard to get IPOs at the expense of everybody else. In a recent paper from The Journal of Portfolio Management: "Hedge Funds and their Prime Brokers, Favourable IPO allocations" the authors find:

- "Investment banks that act as prime brokers for hedge funds and are lead underwriters for IPOs tend to allocate larger amounts of under-priced IPOs to their hedge fund clients
- Investment banks reward those clients that have stronger relationships with them"

This is because hedge funds are lucrative clients for investment bankers, "Wall St collects $33 million a year in trading commissions from the average hedge fund versus $16 million from the average mutual fund."

Preferential access to new issues is not just limited to the equity markets – it happens in primary markets for debt as well. Back in 2018 Meridian Energy, a company half owned by the NZ Government, issued $200m of long dated 2025 bonds. At the time quality long dated bonds were difficult to buy on the secondary market and, at 4.21%, these bonds were issued at an attractive yield versus comparable issues. Repeating the experience of the SOE sales the average retail investor was unable to get much or any allocation of the issue. Anecdotal evidence suggests that a typical retail client who applied for $20,000 worth of bonds received just $7,000. In contrast various large clients of the organising institutions received holdings of $1m, $800,000 and $500,000 respectively. Why should the gatekeepers to this issue have been able to reward their largest clients with preferential allocations of SOE debt at the expense of small NZ investors? This sort of thing happens in the US too but the difference is that the securities regulator there, the SEC, is alert, awake and onto this bad behaviour. Just last week the SEC charged RBC Capital Markets LLC with failing to give priority to retail and institutional investors in a municipal bond offering. Not only did the SEC charge RBC it individually charged two of the investment bankers with responsibility for the misbehaviour. According to the SEC RBC improperly allocated bonds to parties known in the industry as "flippers" who then resold the bonds at a profit. In addition the SEC found that in three instances where an issuer had instructed RBC to place retail customers orders first RBC violated those instructions by allocating bonds to flippers ahead of orders for retail customers. The SEC said "we will continue to pursue those who crowd out legitimate retail or institutional customers from getting access to newly issued municipal bonds".

So if you combine the fact that IPO's are generally small stocks which make portfolios risky, that you often only get access to the unattractive IPO's and that on average IPO's underperform the broad market after listing it is not difficult to conclude that they aren't the "free lunch" the finance industry likes us to believe they are.

Brent Sheather is a Financial Advice Provider. A disclosure statement is available upon request. Brent Sheather may have an interest in the companies discussed.

While every effort has been made to ensure accuracy, no liability is accepted for errors of fact or of opinion herein.