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TAGStone CAPITAL INC

Fourth Quarter **2019**

FOURTH QUARTER MARKET OVERVIEW

Fourth Quarter 2019 saw a huge upswing for stocks, a continuing theme for 2019 that resulted in most major stock indexes posting returns well north of 20% for the year.

In the U.S. markets, large-cap stocks led the way. For the quarter, the broader S&P 500 large-cap index soared 9.07% for the quarter to finish 2019 up a whopping 31.49%.

Small U.S. stocks also enjoyed strong gains, with the Russell 2000 index gaining 9.94% for the quarter and 25.52% for the year.

International stocks joined the party in 2019 as well. The MSCI EAFE index of large stocks in Europe, Australasia, and the Far East gained 8.17% in the fourth quarter to finish up 22.01% for the year.

Alternative asset classes likewise saw big gains for the quarter. The Dow Jones US Select REIT (real estate stock) index dropped slightly to finish the quarter down 1.23%, but the index still enjoyed a 23.10% gain for the year. Finally, the MSCI Emerging Markets index gained 11.84% during the quarter to finish the year up 18.42%.

Bonds also had a strong year, relatively speaking. The Barclays U.S. Aggregate bond index gained 0.18% for the fourth quarter to finish 2019 up 8.72%.

2019 proved yet again the adage, "stocks climb a wall of worry" is more pertinent than ever.

IPOs: Profiles Are High. What About Returns?

Initial public offerings (IPOs) often attract initial public interest—especially when familiar brands become broadly available to investors for the first time.

In recent months, investors have had the opportunity to buy shares of ride-hailing networks Uber and Lyft, workplace productivity services Zoom and Slack, and other high-profile businesses ranging from Pinterest to Beyond Meat.

News outlets contribute to the frenzy, building anticipation, tracking the early hours of trading, and casting judgment on the IPO's success. Investors, perhaps lured by tales of outsized returns, try to get in on the action early.

New research by Dimensional Fund Advisors reveals the fundamental challenges IPO investors face. For example, investors may not be able to trade during the early hours of the IPO, when the biggest price movements frequently occur. Lockup periods also often restrict when shares held by early investors can be resold on secondary markets, which can meaningfully limit the available liquidity in the first six to 12 months after an IPO.

Medium-term IPO performance is often underwhelming. The research team at Dimensional studied the first-year performance of more than 6,000 US IPOs from 1991 to 2018 and found they generally underperformed industry benchmarks. The researchers also found that known drivers of expected returns largely explain that underperformance.

SELECTED 2019 EQUITY INDICES

	Dec. '19	4th Qtr.	YTD
S&P 500 Total Return (Large-Cap Stocks)	3.02%	9.07%	31.49%
Russell 2000 Total Return (Small-Cap Stocks)	2.88%	9.94%	25.52%
MSCI EAFE (Developed International Stocks)	3.25%	8.17%	22.01%
MSCI Emerging Markets (International Emerging Stocks)	7.46%	11.84%	18.42%

SELECTED 2019 FIXED INCOME INDICES

	Dec. '19	4th Qtr.	YTD
Barclays U.S. Aggregate (Broad Domestic Bonds)	-0.07%	0.18%	8.72%
Barclays 1-5 Yr. Credit (Short-Term Domestic Bonds)	0.36%	0.84%	6.58%
Barclays 5-10 Yr. Credit (Intermediate-Term Domestic Bonds)	0.43%	1.18%	13.90%
Barclays U.S. TIPS (Treasury Inflation Protected Securities)	0.38%	0.79%	8.43%
FTSE World Gov't 1-5 Yr. Hedged (Short-Term Global Bonds)	0.11%	0.18%	3.86%

Short-Term IPO Returns:

IPOs are commonly associated with outsized stock returns on the first day shares become available, although these returns may not be attainable by all investors due to the allocation process. Researchers have shown that initial trading prices typically exceed the IPO offering price.[1] However, accessing these first-day returns requires an allocation from the underwriting banks. Studies have documented an adverse selection problem associated with IPO share allocations and find that allocations to IPOs having poor first-day returns have generally been easier to obtain, while allocations to IPOs with good first-day returns have usually been reserved for certain clients of the underwriting banks.[2]

Medium-Term IPO Returns:

Given that many investors may not be able to access these initial returns, Dimensional focused on the performance of IPOs in the secondary market. How do IPOs perform in their first year?

The sample for Dimensional's study consists of 6,362 US IPOs that occurred from January 1991 to December 2018 and for which data is available.[3] **Exhibit 1**, on the adjacent page, shows the annual frequency and market cap distribution of IPOs among firm size groups. The period from 1991 to 2000 is characterized by a relatively high IPO frequency rate of 420 per year and is followed by a less active 18-year period during which the rate falls to 120 IPOs on average per year. Although the number of IPOs has declined, the average IPO offering size is almost three times larger over the most recent period, as compared to the initial 10 years in the sample.

Most IPOs fall into the small cap size group, defined as firms that fall below the largest 1,000 US-domiciled common stocks at the most recent month-end. Large cap and mid cap IPOs represent 24% and 19%, respectively, of total capital raised through IPOs over the sample period.

IPO Performance:

Dimensional evaluated IPO returns by forming a hypothetical market cap-weighted portfolio consisting of IPOs issued over the preceding 12-month period, rebalanced monthly.[4] This methodology excludes the initial first-day returns by design to alleviate the adverse selection problem inherent in the IPO allocation process. **Exhibit 2**, below, compares the returns of the IPOs to the returns of the Russell 2000 and 3000 indices over the full sample period as well as two subperiods covering 1992–2000 and 2001–2018. IPOs underperform the Russell 3000 Index in both the overall period and sub-sample periods. For example, IPOs generate an annualized compound return of 6.93%, 13.63%, and 3.74% over the full, initial nine-year and final 18-year sample periods, respectively, as compared to 9.13%, 15.70%, and 5.98% for the Russell 3000 index over the same time horizons. In comparison to the Russell 2000 Index, the hypothetical portfolio of IPOs underperforms in the overall period (6.93% vs. 9.02%) and the 2001–2018 (3.74% vs. 7.29%) subperiod and outperform (13.63% vs. 12.56%) over the period from 1992 to 2000.

Known drivers of returns largely explain the underperformance of IPOs. IPOs have underperformed the market because, as a group, they have behaved like small growth, low profitability, high investment stocks, which have had lower expected returns than the market.[5]

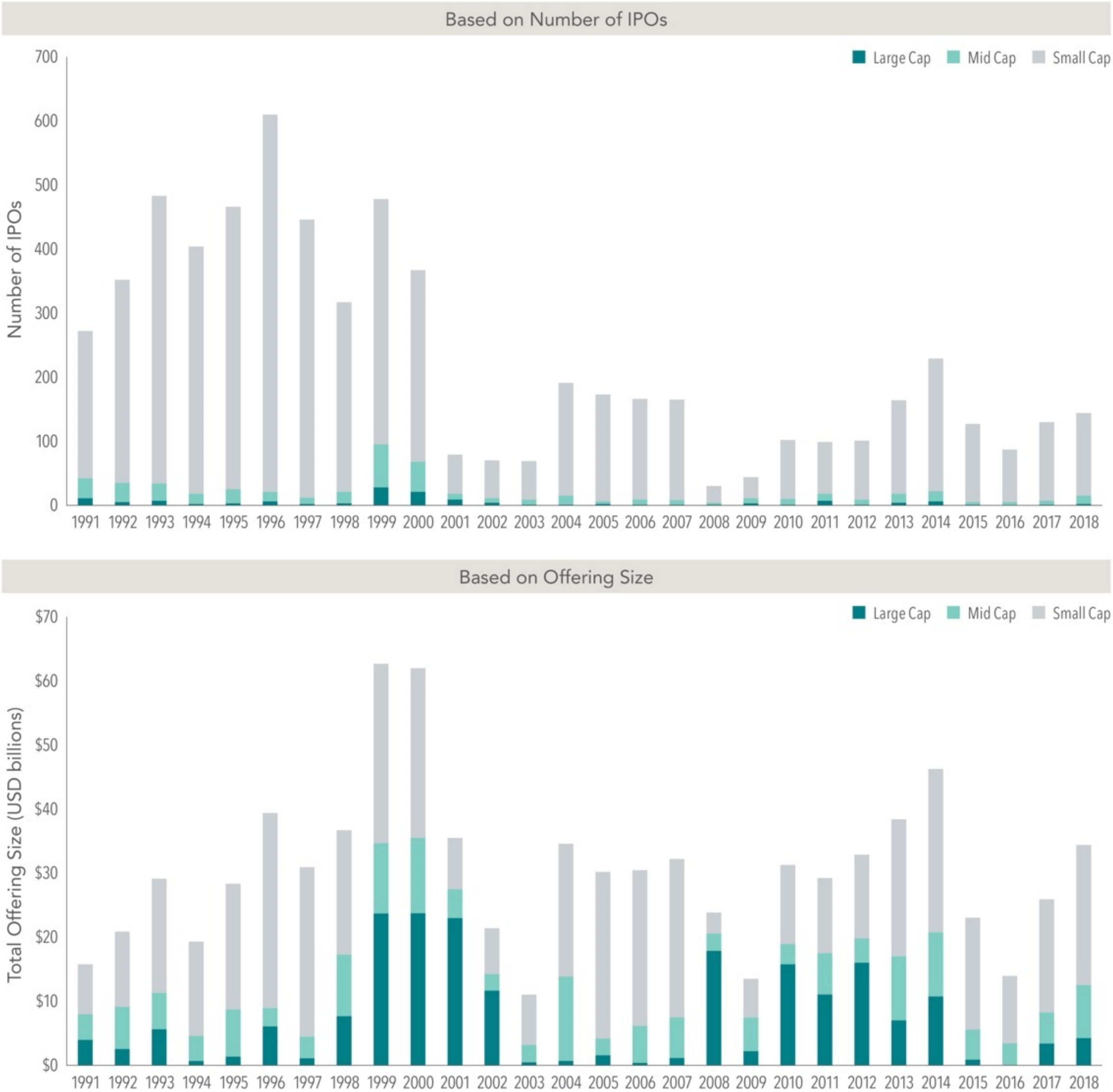
Exhibit 2. IPO Returns Analysis, 1992–2018

Annualized compound returns	1992–2018	1992–2000	2001–2018
Hypothetical Portfolio of IPOs	6.93%	13.63%	3.74%
Russell 3000 Index	9.13%	15.70%	5.98%
Russell 2000 Index	9.02%	12.56%	7.29%

Past performance does not guarantee future results.

Source: Dimensional using Bloomberg data. The sample includes US market IPOs, including US-domiciled companies and foreign-domiciled IPOs in the US, with an offering date between January 1, 1991, to December 31, 2018. Excluded from the sample are IPOs with an offer price below $5, unit IPOs (common stock and warrants), and IPOs involving real estate investment trusts, closed-end funds, American depository receipts, partnerships, and acquisition companies. The hypothetical IPO portfolio is formed December 31, 1991, and is rebalanced monthly to include all firms with an IPO during the prior 12-month period. Weights are based on prior month-end market capitalization. Frank Russell Company is the source and owner of the trademarks, service marks, and copyrights related to the Russell Indices. **Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.**

Exhibit 1. Annual IPO Activity by Market Cap Size Group, 1991–2018



Source: Dimensional using Bloomberg data. The sample includes US market IPOs, including US-domiciled companies and foreign-domiciled IPOs in the US, with an offering date between January 1, 1991, to December 31, 2018. Excluded from the sample are IPOs with an offer price below $5, unit IPOs (common stock and warrants), and IPOs involving real estate investment trusts, closed-end funds, American depository receipts, partnerships, and acquisition companies. IPO categories (small, mid, and large) are based on market cap rank relative to all US-domiciled common stocks as of the most recent month-end. Large, mid, and small cap are defined as firms that rank in the top 500, 501–1,000, and >1,000 by market value, respectively.

Summary:

Investors considering IPOs should be aware of potential adverse selection and post-offering activities, such as the expiration of insider lockup periods. Investors should also understand that IPOs have generally underperformed broader market benchmarks in recent decades and that their fundamental characteristics suggest lower expected returns.

Appendix (continued on next page):

Benjamin Graham's Description of IPOs and Investment Bankers in the 1973 Edition of "The Intelligent Investor"

The term "investment banker" is applied to a firm that engages to an important extent in originating, underwriting, and selling new issues of stocks and bonds [i.e. IPOs]. (To underwrite means to guarantee to the issuing corporation, or other issuer, that the security will be fully sold.) A number of brokerage houses carry on a certain amount of underwriting activity. Generally, this is confined to participating in underwriting groups formed by leading investment bankers. There is an additional tendency for brokerage firms to originate and sponsor a minor amount of new-issue financing, particularly in the form of smaller issues of common stocks when a bull market is in full swing.

Investment banking is perhaps the most respectable department of the Wall Street community, because it is here that finance plays its constructive role of supplying new capital for the expansion of industry. In fact, much of the theoretical justification for maintaining active stock markets, notwithstanding their frequent speculative excesses, lies in the fact that organized security exchanges facilitate the sale of new issues of bonds and stocks. If investors or speculators could not expect to see a ready market for a new security offered them, they might well refuse to buy it.

The relationship between the investment banker and the investor is basically that of the salesman to the prospective buyer. For many years part the great bulk of the new offerings in dollar value has consisted of bond issues that were purchased in the main by financial institutions such as banks and insurance companies. In this business the security salesmen have been dealing with shrewd and experienced buyers. Hence any recommendations made by the investment bankers to these customers have had to pass careful and skeptical scrutiny. Thus, these transactions are almost always effected on a businesslike footing.

But a different situation obtains in a relationship between the *individual* security buyer and the investment banking firms, including the stockbrokers acting as underwriters. Here the purchaser is frequently inexperienced and seldom shrewd. He is easily influenced by what the salesman tells him, especially in the case of common-stock issues, since often his unconfessed desire in buying is chiefly to make a quick profit. The effect of all this is that the public investor's protection lies less in his own critical faculty than in the scruples and ethics of the offering houses.

It is a tribute to the honesty and competence of the underwriting firms that they are able to combine fairly well the discordant roles of adviser and salesman. But it is imprudent for the buyer to trust himself to the judgement of the seller. In 1959 we stated at this point: "The bad results of this unsound attitude show themselves recurrently in the underwriting field and with notable effects in the sale of new common stock issues during periods of active speculation." Shortly thereafter this warning proved urgently needed. As already pointed out, the years 1960-61 and, again 1968-69 were marked by an unprecedented outpouring of issues of lowest quality, sold to the public at absurdly high offering prices and in many cases pushed much higher by heedless speculation and some semimanipulation. A number of the more important Wall Street houses have participated to some degree in these less than creditable activities, which demonstrates that the familiar combination of greed, folly, and irresponsibility have not been exorcised form the financial scene.

The intelligent investor will pay attention to the advice and recommendations received from investment banking houses, especially those known by him to have an excellent reputation; but he will be sure to bring sound and independent judgement to bear upon these suggestions—either his own, if he is competent, or that of some other type of adviser.

1. Ritter, Jay. 1987. "The Costs of Going Public." Journal of Financial Economics 19: 269 -281.
2. Reuter, Jonathan. 2006. "Are IPO Allocations for Sale? Evidence from Mutual Funds." The Journal of Finance 61: 2289 -2324; Jenkinson, Tim, Howard Jones, and Felix Suntheim. 2018. "Quid Pro Quo? What Factors Influence IPO Allocations to Investors?" The Journal of Finance 73: 2303 -2341.
3. Dimensional mirrors the traditional empirical research approach to analyze US IPOs by excluding the following: IPOs with an offer price below $5, unit IPOs (common stock and warrants), and IPOs involving real estate investment trusts, closed-end funds, American depository receipts, partnerships, and acquisition companies.
4. Market cap figures are based on Bloomberg data that exclude shares subject to IPO lockup agreements.
5. Black, Stanley and Kevin Green. 2019. "What to Know About an IPO." *Research Matters*: 3.