

## Bonus Chapter 2

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# Taking It Further: Technical Analysis and Initial Public Offerings

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### *In This Chapter*

- ▶ Coming to terms with the risks and costs of being an active trader
  - ▶ Doing technical analysis, reading stock quotes, and studying stock charts
  - ▶ Locating Web sites to help you read and understand technical analysis
  - ▶ Understanding how to get information about initial public offerings
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**I**f you can't help but stare at flashing stock quotes on your computer screen, this chapter is for you. This chapter is dedicated to traders who think asset allocation and diversification are for wimps and are confident that they can beat the stock market by studying the movements of stock prices.

In this chapter, you find out about *technical analysis*, which is the method of selecting stocks by looking for patterns in stock charts. You also get a crash course in reading stock quotes and understanding what different technical indicators can tell you about a stock. I then show you different Web sites that can provide you with advanced charting information. Finally, I go over initial public offerings (IPOs), show you how to invest in them, and explain the risks. I cover IPOs in this chapter because they're risky and only for investors who know what they're doing.

## *What Is Technical Analysis?*

You can usually spot technical analysts by just looking at their desks. Rather than having annual reports and industry profiles strewn all over them, a technical analyst's desk is covered with printouts of stock charts. If you ask technical analysts what the companies they've invested in actually do,

they likely won't know or care. To them, such fundamental details are meaningless because, generally, technical analysts believe

- ✔ **Everything you need to know about a stock is reflected in the stock's price.** In the minds of technical analysts, the buying and selling of stocks yanks the prices up and down in patterns that give clues about the future. There's no sense wasting time reading financial statements, these investors figure. Other investors with more experience have already read the reports and made the proper adjustments to the stock price.
- ✔ **Stocks follow predictable patterns.** Like astronomers who find patterns of stars in the sky and name them, technical analysts look for patterns in stock price movements. The analysts look at "double-tops," "head and shoulders," and other patterns. These chart patterns, if identified early enough, can tip investors off about future price movements. Technical analysts believe this gives them an edge when buying and selling stocks at the right times.
- ✔ **Trends in stock prices continue long enough to profit from.** Many technical analysts invest based on momentum. Momentum investors believe short-term price movements tend to continue, and you can make money by piling on. For instance, momentum investors like to find stocks that are soaring and pile in hoping the momentum will keep going. Similarly, momentum investors will avoid or short stocks that are falling, betting they'll only decline more.



When you're at a dinner party and don't want to stoke controversy, you probably know to avoid certain topics like religion and politics. Believe it or not, technical analysis is a similar lightning rod among investors.

The topic of technical analysis can turn usually cool-headed investment managers red in the face. As I mention earlier, fans of technical analysis say everything you need to know about a stock is reflected in its stock chart. Technicians also believe human nature causes investors to follow patterns, which when spotted early, can make them money.

Fundamental analysts, who study financial reports to determine whether a stock is under or overvalued, vehemently disagree. Fundamental analysts believe stock prices aren't a good measure of a company's true or *intrinsic value*. Fundamental analysts think investors can be successful only by studying financial statements and determining how much a company and its stock is worth.

Passive investors, who believe markets correctly price stocks over time, think both technical and fundamental analyses are a waste of time. Passive investors figure it's practically impossible for investors to consistently beat the market over the long term. These investors buy passive index mutual funds, described in Chapter 10 in the book, hold them, and let other investors lose money

buying and selling stocks, usually at the wrong times. Studies have shown passive investors not only save time and effort but also tend to beat most other approaches.



If you're new to investing or are a long-term investor, passive investing is likely your best bet. Technical analysis often requires subscribing to expensive Web sites or installing complicated software on your computer. That's a lot of work for questionable returns. Most investors will be better off buying index mutual funds or exchange-traded funds, as described in Chapters 10 and 11 in the book, and profiting that way.

## Getting Started with Technical Analysis

Just as a palm reader claims to glean insights by studying the lines in your hand, technical analysts can look at a stock quote and tell you *something* about a stock. In the following sections, I dissect a stock quote, available from nearly all online investing Web sites, and show you the things that might stick out for a technical investor.

### Dissecting the online stock quote

When you enter a stock symbol in just about any online quote service, including the ones discussed throughout the book (particularly in Chapter 2), you get more than just a stock price or *quote*. Table BC2-1 shows you the information you'll typically get from these quote services.

<i>Data Point</i>	<i>What It Means</i>
Ticker symbol	The abbreviation or code used to designate the stock.
Last sale	The price at which the last shares of the stock traded hands.
Time	The time of the day the quote information is based on.
Previous close	The price the stock closed at in the last trading session.
Net Change	Tells you how much the stock price has changed from the previous close. The change is usually given as a dollar amount and percentage.
Bid	The price a buyer is willing to pay for a share of the stock.
Ask	The price a seller is willing to accept for a share of the stock.

*continued*

**Table BC2-1 (continued)**

<i>Data Point</i>	<i>What It Means</i>
Market	Tells you where the stock trades. Might be the New York Stock Exchange, NASDAQ, American Stock Exchange, or markets like the Pink Sheets.
Volume	The number of shares that have traded hands during the day.
Average daily volume	The number of shares that trade hands between investors, on average, over a period of time (such as a quarter).
Today's high	The highest level the stock traded at during the day.
Today's low	The lowest level the stock traded at during the day.
52-week high	The highest the stock's price has been over the past year.
52-week low	The lowest the stock's price has been over the past year.
Shares outstanding	The number of shares available for shareholders to buy and sell.
Market capitalization	The total value of the company based on the current stock price.
P-E ratio	The price-to-earnings ratio. A way to determine whether a stock is cheap or expensive. The P-E is discussed at length in Chapter 12 in the book.



When you're looking at online stock quotes, pay close attention to the time of the quote. Most free online stock Web sites provide *delayed quotes*, which are usually 15 minutes old. If you need a real-time current quote, most online brokers provide them for free from their sites. You can also get free real-time quotes from MSN Money (<http://moneycentral.msn.com>) — just click on the Real-Time Quotes link on the left side of the page under the Investing heading. FreeRealTime ([www.freerealtime.com](http://www.freerealtime.com)) also provides real-time quotes at no charge once (after registering).

## *The many levels of stock quotes*

The quotes you get from most online investing Web sites and in newspapers are called *Level I* quotes. Level I quotes show you the prices at which stocks actually traded hands. For investors who want to dig deeper, there are *Level II* quotes. These quotes let you view the *order book* for NASDAQ stocks. Essentially, you can see the orders that have been entered by large investors for blocks of stock. If a stock is trading for \$50, Level II quotes let you see

how many buy orders are entered at \$50 and below and sell orders entered at \$50 and higher. Level II quotes can give you an idea of what the true demand for stocks are. You can get Level II quotes and other advanced chart tools from the following sources:

- ✔ **Online brokers:** Many online brokers provide access to Level II quotes to investors who trade frequently. TD Ameritrade ([www.tdameritrade.com](http://www.tdameritrade.com)), for instance, offers Level II quotes in special trading software that it offers customers. The software is called Streamer Suite and QuoteScope. Brokers almost always charge subscription fees — fees that are typically higher than trading commissions — for access to these premium systems.
- ✔ **eSignal:** ([www.esignal.com](http://www.esignal.com)) This site sells advanced stock trading data and information and makes them accessible on your computer. It also lets you access quotes and charts from portable devices, such as cell phones and personal digital assistants. The software provides access to real-time stock quotes and lets you closely track stock price movements using scores of indicators that technical analysts pay attention to. The software and service cost \$125 a month.
- ✔ **SmartMoney Select:** ([www.smartmoney.com](http://www.smartmoney.com)) This feature of the SmartMoney site is a paid service that offers real-time quotes including Level II data. The service costs \$109 a year. (You can get more information about signing up at [https://ecommerce.smartmoney.com/ecommerce/login?cmd=displayLanding&promo\\_page=general](https://ecommerce.smartmoney.com/ecommerce/login?cmd=displayLanding&promo_page=general).)
- ✔ **Equis International:** ([www.equis.com](http://www.equis.com)) A Reuters company, Equis International offers three versions of its MetaStock software: MetaStock Pro, MetaStock Pro FX, and MetaStock End-of-Day. Pro is targeted toward active traders who need real-time quotes, Pro FX offers real-time data for investors who trade foreign currencies, and End-of-Day lets users study stocks based on daily closing prices. The software ranges in price from \$500 to \$1,400, plus you might have to pay additional charges for quote data services.
- ✔ **NASDAQ LiveQuotes:** ([www.esignal.com/livequotes](http://www.esignal.com/livequotes)) This NASDAQ service provides an *a la carte*-style system. The base system, which costs \$15 a month, offers real-time streaming stock quotes and news. You can add on more services, such as Level II quotes, for extra charges. You can give the service a test drive with a one-month free trial.



Unless you're a serious day trader trying to profit from small or split-second moves in stock prices, paying to get access to Level II quotes probably isn't necessary.

## *How technical analysts interpret quote data and charts*

The first thing technical analysts do when they're analyzing a stock is bring up a *stock chart*. A stock chart is a graph that plots a stock's price on different days. Most financial Web sites provide charts, but some sites are more geared for technical investors, including BigCharts (<http://bigcharts.marketwatch.com>). Using BigCharts as a guide, I show you a few of the hundreds of indicators that technicians look for and how to interpret them. A stock chart allows analysts to quickly spot indicators that matter most to them. The following sections detail the most important indicators.

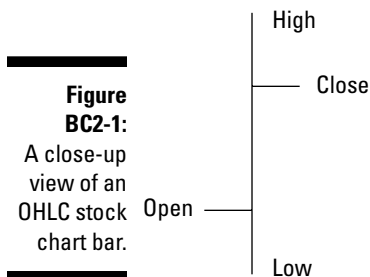
### *Price trends*

Technical analysts pay close attention to stocks that are rapidly rising or falling because they think trends like these can continue. Moving averages are the tools commonly used to find stocks on the move. A moving average is calculated by adding up the stock's daily prices over a series of days and dividing by the total number of days.



The moving averages measure a stock's average price over a specific period of time. Generally, investors pay most attention to a stock's average price over a month (30-day moving average), three months (90-day moving average), or 200-day moving average.

To get a stock's moving average, go to the BigCharts home page at <http://bigcharts.marketwatch.com>. Enter the ticker symbol for the stock you're interested in into the search field at the very top of the screen and then click the red Interactive Chart button. A stock chart, called the Interactive Chart, appears. In the middle of the screen, you see a stock chart with lots of lines. If you look (very) closely, you'll see that each day has a vertical bar with two small horizontal lines attached to either side of it. These are called open-high-low-close, or OHLC, charts. OHLC charts are designed to show you a stock's range, which is where the stock started trading (the open price), how high it got, how low it got, and where it closed. Figure BC2-1 is a magnified view of the vertical bar to help you understand how to read an OHLC chart.



No, I haven't forgotten about the moving averages. That's next. If you scroll down a little, you can see to the left of the OHLC stock chart a section labeled Upper Indicators. Choose SMA — short for simple moving average — from the section's first drop-down list. Just to the left of where it now says SMA, enter the number of days you're interested in and click the red button with the two arrows bent into a circle. The OHLC Stock chart gets redrawn, this time with an overlay of the stock's moving average.

Technical analysts generally evaluate moving averages one of two ways:

- ✓ **Stock price is above the moving average: Good, or bullish, news.**  
Technical analysts think when a stock price is higher than its moving average, the stock has momentum in its favor.
- ✓ **Stock price is below the moving average: Bad, or bearish, news.** The stock is beginning to break down, and technical analysts would avoid the stock.



If you're looking for short-term trends in a stock, consider using the 30-day moving average. Longer-term traders pay close attention to the 200-day moving average. Even if you're not a trader, the 200-day moving average is worth watching because sometimes it explains why a stock might act strangely at or around a certain price.

### *Volume*

Volume is the number of shares trading hands in a day. Technical analysts pay close attention to volume as an indication of how much conviction there is behind stock price movements. It makes sense, right? Imagine you advertise your old golf clubs online for \$200. If no one calls, you know the price was too high. Conviction for the clubs at that price is low. But when you drop the price to \$100, your phone rings off the hook. Conviction is now high.

Trading volume kind of works the same way. You can see how many investors are trading a stock when it rises or falls to find out how anxious investors are eager to sell or buy.

Using the same BigCharts example from the previous section, check out the second chart — the one beneath the OHLC stock chart. You’ll notice that it sports a bunch of vertical lines and is labeled Volume. Those lines shows you how much trading volume occurred on each day. The taller the line, the more volume there was. Click the volume box to activate control. Then you can put your cursor in the box to find out exactly how many shares traded hands.



Technical analysts generally compare a stock’s volume to its average daily volume. Average daily volume is available on the main quote pages of most financial Web sites.

Table BC2-2 gives you some general rules technical analysts use to interpret a stock’s trading volume.

<b>Table BC2-2      How Chart Readers Interpret Trading Volume</b>		
<b><i>Stock Moves</i></b>	<b><i>... And Volume Is Lower Than Average</i></b>	<b><i>... And Volume Is Higher Than Average</i></b>
Up	Move can’t be trusted. There aren’t many buyers supporting the rise.	The rally is for real. Indicates investors are eager to buy the stock.
Down	Selloff might be temporary. Most investors are holding on as a few investors bail out.	A bad sign. Indicates investors are breaking the door down to get out of the stock.

### ***Patterns***

Technical analysts look for all sorts of patterns in stock charts. One pattern you might hear about is a *channel*, a low and high price a stock tends to stick between. Think of an inner tube floating down a river. If it floats too far one way, it hits the riverbank, and if it goes too far the other, it bumps the other bank. Similarly, technical analysts believe stocks tend to float between a high and low point.

Technical analysts find stocks’ channels by literally drawing a line that connects several high points and another line that connects several low points in the stock price. If the stock price breaks higher than the upper channel, that’s considered bullish because it has busted through resistance to the upside. If the stock price breaks lower than the lower channel, that’s considered bearish because the stock has fallen below support to the downside.



You can use BigCharts to draw channel lines on the screen. When you have an OHLC chart on your screen, look to the left and you’ll see an empty white box next to where it says Draw Trendlines. Click the box, and you can draw lines on the chart to help you find channels.

## *Finding out more about technical analysis online*

Technical investors pay attention to hundreds of patterns, most of which have funny sounding names. There are so many indicators, in fact, that covering them all could be the topic of a book itself. Fortunately, the following online resources describe the other indicators in detail if you're interested:

- ✓ **Investopedia:** ([www.investopedia.com/university/technical/techanalysis8.asp](http://www.investopedia.com/university/technical/techanalysis8.asp)) This Investopedia page provides its own Technical Analysis Chart School, complete with sample diagrams of different patterns.
- ✓ **Yahoo! Finance:** (<http://biz.yahoo.com/charts/index.html>) This corner of Yahoo! Financer offers video tutorials that cover both basic and advanced chart-reading techniques. Yahoo! Finance's charts are easy to use and let you examine large term stock charts and easily compare stocks with competitors and indexes.
- ✓ **StockCharts.com's ChartSchool:** ([http://stockcharts.com/school/doku.php?id=chart\\_school](http://stockcharts.com/school/doku.php?id=chart_school)) This site covers the basic technical analysis philosophy and uses examples to help you understand how to read charts.
- ✓ **InvestorGuide.com:** ([www.investorguide.com/igu-article-446-investing-strategies-technical-analysis.html](http://www.investorguide.com/igu-article-446-investing-strategies-technical-analysis.html)) This article on the InvestorGuide site outlines the main techniques used by technical analysts.

## *Letting Web Sites Read Charts for You*

There's no shortage of Web sites that promise to help you read the message of the markets buried inside stock charts. If you'd rather have the computer help you find stock price patterns, consider using these sites:

- ✓ **StockCharts.com:** ([www.stockcharts.com](http://www.stockcharts.com)) Here you can find a stock chart for just about anything you can imagine. In addition to long-term stock charts of stocks and indexes, you can customize charts to your taste, including creating simple line or bar charts. StockCharts.com lets you display charts that plot stock prices in such a way that it makes significant stock moves easier to spot. There's also a feature that lets you compare different securities to one another. And StockCharts.com offers other types of charts that show you how stocks inside specific indexes are doing. StockCharts.com charges for some portions of the site, but you can find free at <http://stockcharts.com/charts>. The

Predefined Scans (<http://stockcharts.com/def/servlet/SC.scan>) feature finds all the stocks and mutual funds that meet certain criteria watched by technical analysts.

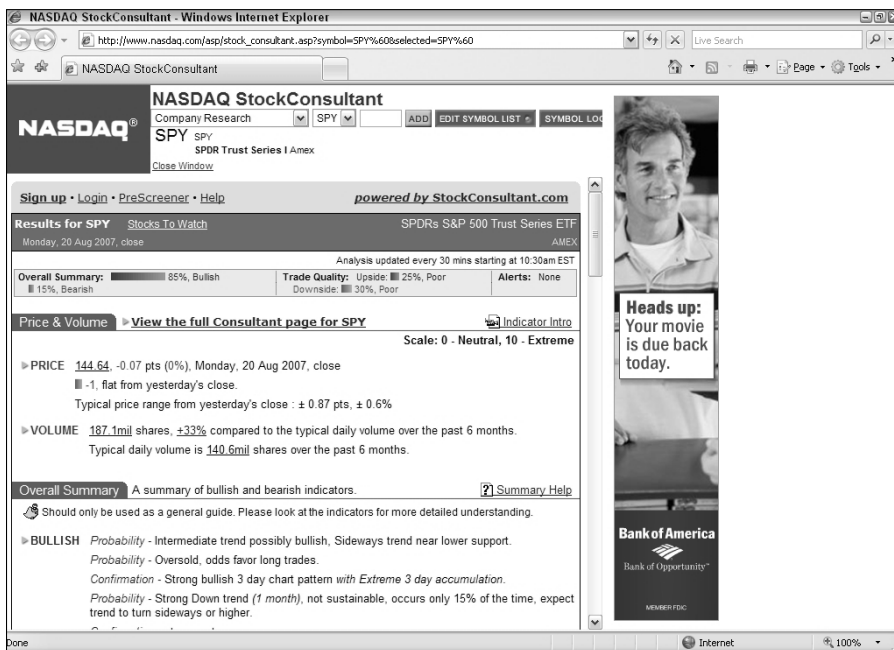
- ✓ **NASDAQ.com's StockConsultant:** ([www.nasdaq.com](http://www.nasdaq.com)) This NASDAQ feature does much of the chart-reading work for you and boils down its findings into easy-to-understand conclusions. Just enter the symbol of the stock you're analyzing into one of the white blanks at the top of the screen and click the Info Quotes button. On the new page that appears, click the StockConsultant link located in the middle of the screen. You can scroll through the report that pops up to get all the nitty-gritty technical details.



If all this chart reading stuff is too confusing, StockConsultant can help. At the top of the StockConsultant report, you can see the site's bottom-line rating, from bearish to bullish. The site, shown in Figure BC2-2, also measures your potential upside and downside.

- ✓ **Wall Street Analyzer:** ([www.lathuy.com](http://www.lathuy.com)) This site is worth a look, if only because it's free — unusual for a site offering technical analysis software. The software plots stock charts and lets you look for patterns.
- ✓ **AnalyzerXL:** ([www.analyzerxl.com/index.htm](http://www.analyzerxl.com/index.htm)) This site allows you to download stock trading information into Microsoft's Excel spreadsheet software. AnalyzerXL's basic software (used for downloading historical data) costs \$50, and the more advanced software (the one you can use to test your trading strategies and spot trends) costs \$250.

**Figure BC2-2:** NASDAQ StockConsultant helps investors study stocks for some of the things that are important to technical analysts.



- ✓ **Prophet.Net:** ([www.prophet.net](http://www.prophet.net)) Prophet.Net uses technical analysis tools to help investors prospect for stock ideas. The site scans for industries and stocks showing momentum. Prophet.Net also offers software for investors to get Level II quotes and software to download stock data into Excel. Basic features of the site are available for free if you register, but the subscription services range from \$20 to \$50 a month.
- ✓ **QuoteLinks.com:** ([www.quotelinks.com](http://www.quotelinks.com)) The folks at QuoteLinks sell a variety of software programs designed to help you spot trends in stock charts. Some software programs do everything from plotting stock charts to letting you view various technical indicators. Most of the software ranges in price from \$40 to \$300.
- ✓ **StockFetcher:** ([www.stockfetcher.com](http://www.stockfetcher.com)) This site uses advanced computer graphics techniques to help you quickly find stocks with desirable trading patterns. Visitors can see limited lists of stocks that meet certain trading criteria, such as those hitting a new 52-week high, crossing above or below moving averages, or gaining or falling for several straight days. Most of the site's features, though, require a subscription that costs \$9 a month.

## Getting in Early: Investing in IPOs

Indiana Jones sought the Temple of Doom, and Dorothy was looking for the Wizard of Oz. Most investors are always looking for their pot of gold, and that's typically the elusive "next Microsoft." Investors aim to get in on the ground floor of a new company that's destined to grow exponentially and become one of the most valuable in the world.

That's why many individual investors are very interested in *initial public offerings*, or IPOs. In an IPO, companies sell pieces of themselves to public investors. Shares are first snapped up by large institutions and high net-worth individuals at the offering price, which is the price a company's investment bank guesses the shares will sell at. This initial sale of stock is the only time the company itself makes money from the IPO. Companies raised \$43 billion selling shares through 198 IPOs in 2006, says Renaissance Capital.

Those initial investors that bought shares at the offering price, though, are free to do whatever they choose with their shares, including selling them to you. Large investors can sell their shares on the stock market, which is when most regular investors can buy them. When you buy IPO shares after they begin trading, it's called buying shares in the *aftermarket*.



IPOs are infamously risky, and studies have shown that regular investors who try to buy them are usually disappointed.

It's still possible, though, to make money from IPOs. Even if you bought all 198 of 2006's IPOs at the price they closed on their first day of trading, your return would have been 13%. Table BC2-3 shows you how many IPOs there have been over the past five years, what the average returns for the lucky investors who bought at the offering price have been, and also the average returns posted by regular investors who bought shares in the aftermarket.

<b>Table BC2-3</b>		<b>IPOs Can Be Profitable, or Not</b>				
	<i>2002</i>	<i>2003</i>	<i>2004</i>	<i>2005</i>	<i>2006</i>	
Number of IPOs	70	68	216	194	198	
Return for investors who bought at offering price	3%	28%	34%	18%	26%	
Return for regular investors who bought at first-day close price	-5%	14%	21%	6%	13%	
Return of broad stock market (Standard & Poor's 500)	-22.1%	28.7%	10.9%	4.9%	15.8%	

*Sources: IPO data from Renaissance Capital; S&P 500 data (including dividends) from Global Financial Data*

## *Beware of the risks of IPOs*

The idea of IPOs is alluring and irresistible to many investors. Companies that go public are often in industries of great interest to investors at the time. IPO companies also tend to sell products that have become household names to investors in a short period of time. These companies turn to IPOs as a way to raise cash to sustain their rapid growth. But despite their allure, IPOs are highly speculative because they

- ✔ **Lack a stock-trading history:** It's impossible to see how the stock has behaved over the years because an IPO isn't trading yet.
- ✔ **Are usually young companies:** Smaller and fast-growing companies are often the ones that go public. These companies tend to have limited operating histories, immature management teams, and only a few products or customers.

## How IPO hype can cost you

VA Linux is one of the greatest examples of the risks investors face with IPOs. A technology company that develops software based on the Linux operating system, VA Linux was widely anticipated by investors when it went public on Dec. 9, 1999. Investors were so eager to get their hands on VA Linux stock that shares soared 698% from the offering price of \$30 to

close on their first day of trading at \$239.25. That gave VA Linux the best first-day pop of any IPO. Investors that piled into VA Linux, though, were about to learn a rough lesson. Shares of the company, later known as SourceForge, had cratered to \$5 by the end of 2006, and it might be a long time before it ever retakes its price on its first day of trading.

- ✔ **Sell their shares first to large institutional investors:** IPOs are usually first sold to large investors such as pension plans and endowments at the offering price. When the stock begins trading, investors are free to bid those shares above or below that offering price. Much-anticipated IPOs often attract so much interest from the general public that the shares get driven to unreasonably high levels. Investors that buy in at the height of the mania are often disappointed with their returns.

## Online sources for information about IPOs

Given just how risky investing in IPOs can be, it's that much more important that you know exactly what you're doing. If you're going to dabble with IPOs — which you should do only if you're willing to take on large risk — you should check out a number of online resources, including the following:

- ✔ **Regulatory filing sites:** These sites, described fully in Chapter 2 in the book, are excellent places to get the *prospectus* for an IPO. (As a first stop, I'd recommend the Securities and Exchange Commission's site at [www.sec.gov](http://www.sec.gov).) The prospectus is a document that must be filed by a company going public that outlines its business, the risks it faces, as well as details about its management and other information. The prospectus is the best and only source of information you'll get from the company.

Sometimes regulatory filing sites will list an IPO prospectus by its formal name, the S-1.

IPO prospectuses can be hundreds of pages long and filled with legalese. If you have only a few moments to read an IPO prospectus, skip straight to the section labeled Risk. This section is where the company must tell investors everything that could go wrong. If any of the risks make you too uncomfortable, don't buy the stock.





- ✓ **IPOHome:** ([www.ipohome.com](http://www.ipohome.com)) All IPO, all the time, the IPOHome site is a complete source of news, commentary, and data on the IPO market by Renaissance Capital. You can click the IPO Calendar link in the center of the page to call up a Calendar page listing what companies are expected to go public in coming weeks. Click the Calendars tab on the same page ([www.ipohome.com/marketwatch/ondeck.asp](http://www.ipohome.com/marketwatch/ondeck.asp)) to access other calendars, including one showing the number of IPOs that are expected to make their debut in coming months.

IPO activity tends to be a *lagging indicator*. When the stock market begins to struggle and fall, the number of IPOs due to be released (said to be “in the pipeline”) tends to dry up. And when the stock market is soaring, the number of IPOs in the pipeline tends to increase.



- ✓ **Jay Ritter’s IPO page:** (<http://bear.cba.ufl.edu/ritter>) This site is maintained by University of Florida finance professor Jay Ritter, widely regarded as one of the leading experts on IPOs. The site has links to historical data about IPOs as well as working and published papers on IPOs.

Ritter’s research has found that most IPO investors tend to get poor returns. Investors are especially disappointed with their returns on IPOs of immature companies with very little revenue.

- ✓ **Gaskins IPOdesktop:** ([www.gaskinsco.com](http://www.gaskinsco.com)) This site is a source of all sorts of commentary about upcoming and past IPOs. You can even hear IPO analyst Francis Gaskins discuss IPOs in an online radio show and describe, in detail, upcoming IPOs. The show’s frequency increases during busy months for IPOs, but you can usually count on at least one new show a month.

## *Picking the good IPOs from the not so good*

The Web sites listed in the preceding section provide data and commentary about IPOs to help you find the ones with the best prospects. Even so, IPO investing is tricky. Pros look at many things when evaluating an IPO’s potential, but a few things you should ask yourself include

- ✓ **How stable is the company?** The company’s prospectus shows you how much revenue and earnings the company has generated over the last couple of years. You should look to see whether the company is profitable and growing. Chapter 12 in the book provides tips on how to analyze companies’ financial statements and compare companies with their industry peers.

- ✔ **How expensive is the stock?** A company will constantly revise its prospectus as the IPO nears. One thing a company will disclose is the *expected price range* for the stock, which is how much it expects to sell the shares for. IPOHome.com also provides an IPO's expected price range when it becomes known. Take the time to evaluate the price and determine the company's valuation, using the techniques I describe in Chapter 13 in the book.
- ✔ **Does the management have a stake?** It's a good idea to scan through the prospectus and see how the company's management is paid. Some professional IPO investors prefer companies where the management team holds a large position of stock. That can be a sign the top management still believes in the company's future.
- ✔ **What is the company planning to do with IPO cash?** The prospectus must state what the company is going to do with the money it raises from the IPO. It's best if the money is being used to expand the business, rather than to pay off large investors who want to cash in their stakes.

### *How to invest in IPOs*

If you've read the warnings and disclaimers in this bonus chapter and still think you're ready to dabble in the speculative world of IPOs, it's time to figure out how you're going to do it. You have four main ways to invest in IPOs:

- ✔ **Through mutual funds:** Investing in IPOs through an actively managed mutual fund provides several advantages. Most importantly, you'll be invested in a variety of IPOs, reducing your exposure to losses if any one newly public company runs into trouble. These funds also have analysts who are trained at studying IPOs, which hopefully means they'll be able to sidestep the bad or especially risky IPOs. Renaissance Capital's IPO Plus Fund ([www.ipohome.com/ipoplus/ipoplus.asp](http://www.ipohome.com/ipoplus/ipoplus.asp)) is a well-known mutual fund that invests in IPOs. The mutual fund's symbol is IPOSX.
- ✔ **Through index mutual funds:** If you want to own a basket of IPOs but don't want a manager picking which ones, you can consider the First Trust IPOX-100 exchange-traded fund. The ETF tracks the IPOX-100 index, which tracks the 100 largest U.S. IPOs for their first 1,000 days. First Trust provides additional information about the IPOX-100 index and the ETF (which trades by the symbol FPX) at [www.ftportfolios.com/retail/etf/ETFsummary.aspx?Ticker=FPX](http://www.ftportfolios.com/retail/etf/ETFsummary.aspx?Ticker=FPX). IPOX Schuster also provides information about the index at <http://ipoxschuster.com>.
- ✔ **Through a brokerage:** If you're not a Rockefeller or Hilton, don't expect to buy an IPO at the offering price. Most IPOs are handled by the investment banking arms of full-service brokerage firms. These firms are then given the right to offer shares of IPOs to their biggest brokerage clients or clients they make the most money from.



From time to time, online brokers might get their hands on IPOs and offer them to you. But these are rarely the IPOs you want to buy, because if they were that attractive, the full-service brokers would keep them for themselves and their clients. The SEC explains why it's nearly impossible for individual investors to buy IPOs at the offering price at [www.sec.gov/answers/ipodiff.htm](http://www.sec.gov/answers/ipodiff.htm).



The tight grip full-service brokers keep on IPOs means that if you want to invest in an IPO through an online broker, you need to buy it when it begins to trade. And, as mentioned earlier, you run the risk of paying an inflated price and losing money as a result.

- ✓ **Directly from the company:** Periodically, a company will try to break Wall Street's stranglehold on its IPO by allowing individual investors to buy shares at the IPO price. One way to do this, used by Google when it went public, is a dutch auction. In a dutch auction, any investor is permitted to enter a bid for the shares before they begin trading. The bids are then analyzed, a price is set, and investors who place adequate bids can buy the shares. If you're interested in these IPOs — known in the industry as *Open IPOs* — WR Hambrecht ([www.wrhambrecht.com](http://www.wrhambrecht.com)) is a leader here and provides IPOs using this method.

Another way you can sometimes get access to IPOs is when companies offer shares to their customers. These deals are often called *direct public offerings*, or DPOs. Boston Beer, brewer of Sam Adams, allowed customers to buy 25% of its 1995 IPO at the offering price. And Internet phone company Vonage offered customers 13.5% of its IPO shares. Drew Field/Direct Public Offerings ([www.dfdpo.com/index.htm](http://www.dfdpo.com/index.htm)) offers more details on these types of offerings.



Don't assume that just because you're a customer of a company that's going public, the company is doing you a favor offering you shares of its IPO. You can still lose money. Investors in Boston Beer, for instance, watched as the stock fell from the \$20 initial price in 1995 to \$6.50 on Oct. 8, 1998. And Vonage customers who paid \$17 for the stock suffered as its value cratered 59% in 2006 and became the worst IPO of the year.