Episode 238: SpaceX, Mega-IPOs, and Indexing: When to Buy, When to Wait

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SpaceX IPO, mega IPOs, index investing, retirement income, financial personality, market cap, Russell 1000, S&P 500, profitability, IPO underperformance, reconstitution, passive investing, market premiums, investment strategy, AI companies.

SPEAKERS
Wade Pfau, Briana Corbin, Alex Murguia

Briana Corbin 00:00
The purpose of Retire with Style is to help you discover the retirement income plan that is right for you. The first step is to discover your retirement income personality. Start by going to retirewithstyle.com/style and sign up to take the industry's first financial personality tool for retirement planning. SpaceX just went public-an evaluation bigger than most national economies. And today, Alex breaks down what that actually means for your portfolio. Spoiler alert: the rocket doesn't come with the returns.

Wade Pfau 00:55
Hey, everyone! Welcome to Retire with Style. I'm Wade, and I'm here with my trusty co-host, Alex. he was waving. If you're watching on YouTube, and we're continuing our Q and A series. We just completed our retirement income challenge, and we had a lot of great questions that came in through that process. We did address the questions that more related to the software, but we kind of ran out of time with all the retirement income planning questions. So we're going to be continuing that Q and A series as well. Now today we do have a Q and A episode, although it's a bit of a different flavor at McLean Asset Management. A lot of questions have been coming in about the investing side of things, especially with the SpaceX IPO, and so this is really an opportunity today for me to ask Alex some questions about index investing IPOs, mega IPOs, and the like, and so it's not quite that normal retirement income planning topic, but it is an investing related topic, and a lot of questions may be on on your minds. So let's let's address that, and so Alex, let's get started. This SpaceX IPO has been in the news. It's everyone's been talking about it. What makes this particular IPO so historically unique?

Alex Murguia 02:11
That is explosive. No. Well, actually, as of today, like when we're recording this, it's actually now below its its IPO price. But everyone is talking about SpaceX and what makes it unique, and the obvious one is is its sheer size. I mean, IPOs of famous private companies always attract attention. Aramco was one. You know, usually the IPO market is for burgeoning companies getting that next phase of growth, you don't necessarily see these 100 billion plus companies getting ready to to go public, if you will. But the reality is, with private equity over the last let's

say 15 years or so, coming off of the OA crisis, even that made everyone have stricter requirements and the like. A lot of companies, frankly, were not even choosing to go public and going and and getting private funding, and so you had this these issues where these huge companies are now deciding to go public, and it seems SpaceX is the first one we have. So what we're talking about is going to apply to SpaceX, applies to SpaceX, but you know you have Anthropic in the on the horizon. You have ChatGPT on the horizon. You have this whole wave of now AI companies that are also getting ready to get their their ducks in a row. And you even have some financial services company like let's say Stripe and things like that that are going to be 100 plus billion valuations getting ready to go. And and that's usually not common. So it's the sheer size of it is just unprecedented. I mean, in its private offering, in its public offering, SpaceX raised 80- billion I mean, that's a staggering amount, and with a opening valuation of, I believe, 1.8 trillion in that range, maybe a little less than that, and so that would make it you know top handful of companies in in the world already, and frankly, OpenAI and Anthropic may get similar valuations. So from that standpoint, it's not just another IPO, but it becomes immediately one of the largest companies in the world. But because it's an IPO, it's bringing to light all of the sort of IPO hype, for lack of a better word, that that that you see in when certain movements happen, and undoubtedly, just like the internet, you know, was back then, this is the next sort of quote unquote revolution, if you will, and so you're going to see a lot of companies coming through, especially with the success of at least the public offering of of SpaceX. So, the the takeaway from here would be this is going to generalize a lot. You know, numbers may change per company, but what we're about to discuss, you know, it's it's very relevant.

Wade Pfau 05:00
Okay, so right there's a lot of hype. How should investors be thinking? Should they be excited simply because a company like SpaceX is going? Well, I

Alex Murguia 05:08
think the danger now there's a little behavior finance, right? Where you know it's easy to think of like Google, Met, you know, which is Alphabet now, right? But when it became public, everyone used Google, every everyone thought it was great and the like, but everyone was thinking, "Well, this is going to change the world, right? And maybe some people didn't invest in didn't invest in it, and are now thinking, "Well, who cared if I overpaid for Google the moment it came out? Who cares? I should have just gotten in and not done anything about it because look where we are now. I knew it was going to be a success, and I would say for every Google, there's five others that were not a success. So there's always that trick, and there's there's this kind of issue that you you have to kind of make amends with, which which is huge companies, even great companies, can still be poor investments if you paid too much of a premium for it, you can live in a great house, right? But if you paid $20 million for a house that was a $2 million house, you know that's that's not the best use of capital. And so, to a large extent, huge companies can still be poor investments. And keep in mind, even Facebook, Meta. Now it's called Meta. I believe that dropped 50% You know, after after its IPO and everything, it dropped 50% You could say to yourself, "Oh, but if I would have held it for you know now, then look at me now. I would venture to say the folks that bought it and dropped, and and then the account dropped by 50% I'm not so sure how many of those stuck with it. I'm sure there was news that came out that made it seem, "Oh my goodness, this Facebook thing's not going to work out, or the chances are 50-50 at best, and people sold, right? If all of a sudden there's an announcement that says, "Hey, data centers in space, for whatever reason, is not physically possible, you know, it defies the laws of physics, it cannot happen. What's going to happen to

the valuation for SpaceX? I'm not saying it's not or it is or anything like that. I'm just I'm just pointing at that news comes out every day that changes things, and when things are priced to beyond perfection, you know, here you are. You can some people argue they're pricing they're they're pricing it now as if we already have a colony in Mars, you know, when in fact that's pretty far from the case. So it's it's good to be excited about it, and it's good to feel happy about what it represents from human progress and things along those lines. But will these companies ultimately become successful businesses on a going forward basis, I don't know, but on average, and on average, you can make the case SpaceX is not an average stock based on what I've just discussed. But again, don't take this as a referendum on SpaceX, but as the IPOs in general, on average, IPO investors generally experience disappointing returns. Right. So now

Wade Pfau 08:01
you're getting into historical like research on historical IPOs. What? So you're well, yeah. I mean, but a little more detail about that.

Alex Murguia 08:10
Yeah, yeah. At the end of the day, look, every company you can make the case. Yeah, but this one is different. I would just refrain judgment, and you know, past returns. I know the indication of whatever, but the reality is, what does history tell us about the IPO world and and you know and what goes on here? And academic research is fairly consistent. You know, since the 1980 s, IPOs have underperformed already listed companies with similar sizes and valuations. So I'm not taking like Google and comparing it to Spam or Motorola or something like that, right? So since the 1980s, IPOs have underperformed already listed companies with similar valuations, and that underperform. You can make the case, oh, but that's just for lockups. After the lockup period expires, that's when the internal people that bought that had the stock, the employees and so forth that have the stock have to hold it for another six months of it after it goes public starts selling you know obviously that causes price deflation it's not just during that time period you'll see this for about five years out this sort of underperformance of an IPO relative to a similar company of size and valuation, so the underperformance lasts well beyond the initial excitement. It's not just a oh, it didn't happen. How much so?

Wade Pfau 09:29
What was that? Oh yeah, how much underperformance? And then also why? Why are why? Sure, sure.

Alex Murguia 09:34
You'll see about 2% a year. You'll see it happens for about 2% a year for the first, not a year, 2% for the first five years. So

Wade Pfau 09:42
returns are annually 2% less than yeah. You see that now. Companies

Alex Murguia 09:47
again, lockup expirations may explain part of it, but they don't. That's not going to explain the long term performance. You know, why would you say that? Why would be some of the reasons? Yeah, for the purposes. Podcast, it's it's not the sort of lecture, but what you can see is again when you control for size and valuations, you got to look at profitability, right? And as we've seen, that's one of the the most recently discovered key factors, if you will, not most

recently discovered, but quantifiable now, and you know, from a three-factor perspective, you know the Fama French piece. It's evolved to include profitability. But if you really think about profitability, why do many companies go public while they're still losing money? Right? They do it to raise capital. SpaceX was fine going private. They sort of exhausted-not exhausted, but the private equity markets were there. But all of a sudden, they're looking at the potential to raise 30-five, $40 billion in the public markets that you know may not have been available before, and this helps fund future growth. We're going through this inflection point right now with AI, where it's all about building the whole thing. It's almost like the interstate highways after World War II. You're almost going through a similar infrastructure thing right now, and so everyone is trying to raise money to build out the future. That you know, all these companies that were asset light are going to be asset heavy. To be asset heavy, it's going to hit the profitability, right? And so, to a large extent, I'm talking about the IPOs that you may see coming out right now, but in essence, that's why companies go public. They they need to raise capital. Why would you need to raise capital? Because you can't fund it from existing operations, right? That means the the profitability isn't there, at least relative to what they want to do going forward with growth expectations and the like. They're willing to take losses now for future growth, but that still doesn't hide the fact that they're not profitable right now, and so not all of these companies make it. In fact, you know a large percentage of IPOs since the 1980s have reported negative trailing 12 trailing 12 month earnings. So a lot of these IPOs, they're being sold to the investment public on the potential for future execution. It's not a good thing or a bad thing. It's just how it is. You know, investors. You know, it's a risk-reward equation that investors have to solve for themselves, right? And so you're paying mature company prices for effectively immature businesses. And so there's just a lot of inherent risk to that, and that that risk manifests itself when you see the underperformance over the five years. Is there a Google? Yeah, absolutely. Is there a Facebook? Yeah, absolutely. It happens. Every company at a certain point had an IPO, right? I mean, Apple. You know, if you invested in the IPO, how would you do now? You know that kind of thing. Nvidia, same thing, but that's not usually the investor experience. You know, through through the whole lifespan. So you do see them underperforming for those reasons.

Wade Pfau 12:54
Okay, and then another big part of the discussion, especially with these very large IPOs, is the role of index funds, and now that index funds have become more and more common, how do index providers change the economics around these? Yeah,

Alex Murguia 13:09
and this is interesting, and this is more a piece of a SpaceX relevant issue. But you may see that with Anthropic, you may see that with OpenAI as it become public, because they're going to become public at these huge, huge valuations. They're not going to be a $5 billion you know, IP, you know, market cap IPO, if you will. Those are still considered in the small cap range. But so there's a little game that indices play with regards to reconstitution and the like, and we'll discuss that. But once an IPO enters a major index, right? Like the interestingly enough, the Russell is going to include is going to fast track and include SpaceX in their indices. S and P will not. They will follow the the norm that they have, which is wait a certain number of of wait a certain time period. You know, once financials have consistently come in, et cetera, et cetera. Before we include them in index, Russell's going to put them in there, and so if something is in an index, it causes forced buying. If you're tracking, if you're buying the Russell 1000, right? If if you're you know you're market indexing, and instead of the S and p5 100, you chose to track

the Russell 1000, well, effectively, that's going to have SpaceX in it. SpaceX just became, you know, just became a public company. All investors know, investors out there know that hey, Russell needs to buy SpaceX. You know what? I'm going to buy it now before Russell reconstitutes and buys SpaceX because all that buying pressure is going to cause the stock to go up after it gets in the index, I'm selling because that was kind of an artificial inflation because they were forced to buy it for no other reason than it's robotically in an index, right? And so whenever forced buyers meet voluntary sellers, prices can become temporarily inflated for. But you know, adding a giant company also forces the funds to sell existing holdings to make room. So you're going to see a lot of-I don't know what the right word is-but let's just say friction-based trading, just because you know something is in an index or out of an index, and this just creates huge implementation costs that are you know you don't see that you know to index investors it's not like Russell they'll just report a return they won't say oh we return 10% and you know what we would have had 11 if we didn't have to have these four sales or the like if it you know if it wasn't for SpaceX so it's going to be to me personally interesting to see how large cap S and P and large cap Russell behaves over the next year or so with regards to tracking, because they're kind of tracking the market, and they usually get you know they're very close in tracking percentages. In fact, many people have them as tax tax loss harvesting substitutes, you know, towards the end of the year, but all of a sudden, because these huge company IPOs such as SpaceX, which is over a trillion dollars, is in the market. You know that's going to have a significant influence on a market cap weighted index like the Russell 1000 and the the S and p5 100. Yeah, well, the S and p5 100, or as an act of omission as opposed to commission.

Wade Pfau 16:21
Well, yeah. Then these are, to be clear, these are market cap indices, like you just mentioned. Yeah, yeah, yeah. Market cap indices

Alex Murguia 16:26
and market weight. You know, now equal weighted indices isn't the answer. I think those are fraught with a lot of errors, frankly. But that's for another discussion.

Briana Corbin 16:37
If you're looking for more personal advice, take a look at this episode's sponsor, McLean Asset Management. You can learn more at mcclaneam.com. That's m c l e a n a m.com. McLean Asset Management is there to help you on your path to the retirement that you deserve. And don't forget to check the show notes to get your free ebook on retirement income planning,

Wade Pfau 17:03
but that's the issue. A big company is automatically then going to constitute a much larger percentage of the index. So when you have the glaring difference of one index has basics, the other doesn't, they're not going to perform in the same way. It's going to be driven by how differently SpaceX performs relative to the the rest of the market.

Alex Murguia 17:24
Yeah, and and if you're a betting man, which Wade we all know you are, think about it. The so the Russell is going to have the SpaceX juice, and the S and P isn't. Knowing what you know about IPOs in general, will the S and P outperform the Russell this year? I don't know.

Wade Pfau 17:44

It follows historical trends. Yeah,

Alex Murguia 17:46
I'm sure you have that arbitrage going right now. Wait, are you showing the Russell and buying the S and P? Yeah,

Wade Pfau 17:53
something like no, I'm not. No, I don't. I know. Yeah, we

Alex Murguia 17:58
know that. And to me, that a broader lesson is just ignore the media hype right now. Look, it makes for great stories, right? Who doesn't want to know that? Wow, there's a company going coming. Let me get this straight: a company is becoming public, part of Tesla and all of this, and it's gonna put colonies in the moon. It's gonna be able to extract resources from the moon. It's going to be able to put space centers, you know, data centers in space and solve our energy grid problem. As a human being, I'm rooting for space. I think it's a great, great, great story, and it may be a great, great investment over the long term. I I just want to disabuse folks from thinking, "Oh my God, let's get in here! It's fantastic, you know that kind of thing immediately. You don't know right now because it's the price relative to value that you're getting for it, and that's just a tough question to to answer. It's not, it's not a a referendum on on SpaceX one way or the other, it's more just to comment on the public markets and you know how the news hits you, you know, because you're going to see in a few months, if not sooner, the same thing with OpenAI, and you're going to see it with Anthropic, you know, as soon as one of them announces they go public, most likely the other one will try to do it as well, simply because why not, you know, that that kind of thing, and yeah, there's keys. It's not just it's not just an IPO too. You have to look at the factors that are behind it, and you know are those premiums that you can that you can take advantage of. And and frankly, from a profitability standpoint, I'm not so sure that's going to be there yet in any time soon. Now, someone could call me short-sighted because it's not about profits right now. So much money needs to be put into this thing that who cares? And I would agree.

Wade Pfau 19:50
Okay, so what are like? Sounds like you're getting into some broader lessons. What are the the broader lessons that folks can take away when thinking about these types of mega IPOs?

Alex Murguia 20:02
Well, I mean, ultimately, it you know to me it's buyer beware. I I wouldn't necessarily if if you wanted to like take a flyer, whatever, go ahead. But you know, with regards to your retirement income strategy in terms of retire with style, I would stick to the true and basics of you know capturing the markets and not worry about the IPO. If an index happens to include an IPO in the market, you know so be it. Just keep in mind you know what's going on with that and what you're getting into with regards to potential differences, with regards to the the S and P and the like. But at a broader scale, in terms of shifting it a little bit, what I think is interesting is how how reconstitution and adding companies into the indices really can change the performance of an index. And I I think to me that's what interests me more from an investment standpoint, from an investment portfolio manager standpoint, with a SpaceX IPO, I'm I'm disabusing myself from the actual company and the prospects and things like that. I'm sure, you know, those are fascinating things to consider. But to me, it's from an urge perspective, I'm interested in how different the S

and P will will look from the Russell, and again a little bit about reconstitution. The Russell is as announced recently that they're actually reconstituting twice a year, not once a year, because again, if you think about it, the Russell, the the Russell 1000 just recently reconstituted, and the Russell 1000 added about 60 companies and it removed about 40 companies, right? Why? Because they no longer met the criteria for being in the Russell 1000, which is more large companies, et cetera, et cetera, right? It doesn't be

Wade Pfau 21:50
exactly 1000 It sounds like you're saying, huh? Sounds like it's not exactly 1000 companies. Well,

Alex Murguia 21:56
that's how much they added. They added 600 They added 60-one. They removed 30-seven, and the rest were the same. The rest just stayed. All right, I think

Wade Pfau 22:05
not 1000 overall. Then

Alex Murguia 22:07
the Russell 1000,

Wade Pfau 22:09
yeah. I mean, if they're adding more than they're subtracting. Oh, oh,

Alex Murguia 22:13
I see what you're saying. Yeah, yeah, yeah, yeah, yeah, yeah, yeah, yeah, yeah. I didn't even, yeah, yeah, yeah. It usually hovers. Even the S and P, it's like it's funny. It's like right around there, but you know who's counting, right? It's just numbers. But even that, it gets it gets wonky because Apple and Microsoft are both in the Russell 1000, you know, but they're they're kind of like in the growth one as well. So what happens there? And then the Russell 2000 that one I think added 240 companies removed 150-ish, 160 or so. So there's always this word constitution. But think about what happens. Everyone knows what companies are going in and out. They announce it and then they don't actually execute it until like a few weeks later. So think about what that does to the index from a part from a price artificial, from from inflating prices artificially, right? All of a sudden, you're announcing to the world what you're buying and what you're selling before you actually do it. It's very easy to take advantage of that. Yeah, it's like a good

Wade Pfau 23:14
idea. Why why do they do that? Why do they not just provide? Because they're just concerned

Alex Murguia 23:19
with well, index funds are concerned with tracking error. That's that's their main concern, tracking error, and so they're not judged by how the index performed, because if I say I'm an index fund and I'm tracking the Russell 1000, and I and the Russell lost 20% this year, and that's what published, and your index fund lost 18% that's actually weird, and that's actually a little disconcerting. Even though it performed better, because it would be like that's not what I paid you for. I paid you to track the index. What's going on? And so, what happens is, you know,

that that leads to tracking or leads to uncertainty. Why is that a bad thing? Why is that a good thing? Or why why do people do like this? It doesn't make any sense. Why don't they just quietly make their trades? Well, you go back to why indices started. An index was just something that was used to measure stock performance. It wasn't meant as an investment vehicle. It wasn't until the the 70s or you know and things like that that they said, why don't we just create a bat? You know, all the research came out about market efficiency, and it was just like, why don't we create a tradable basket? You know, and at that point, you know, the Russell 1000 was there, and they said, "Okay, here you go. Let's track this. Wasn't anything more complicated than that. And so, effectively, what happens is Russell's just-they don't-they kind of divorce themselves a little bit from the actual implementation. They're just thinking, what stocks go in our index? What stocks don't? And they sell that license to mutual fund companies to track them effectively, you know. And and it's up to the mutual fund company to to track that or not. And that's why you have companies like Dimensional Fund Advisors or Avantis, in which they're. Not active stock pickers. They're they're they're non forecasting sort of fun vehicles, but they're not blindly tracking an index for the sake of tracking an index. They're just one. They just want to capture those market premiums, you know, in a non forecasting way. And so you you do see things moving away from this robotic thing. But that's not to say there's not tons of of index funds that are just blindly following an index and they're falling sort of victims to this. I mean, so much so that Russell taking the heat decided to reconstitute now twice a year to lessen that that hit that happens when the reconstitution happens. I mean, there's like when when it reconstitutes that day alone, it's it's like $350 billion worth of trades occur just for the reconstitution, and those aren't trades that are driven by by investment research or anything like that. They're just driven by arbitrary index rules. So whenever there's a you know Bob, you know Bob's famous phrase was money's like soap, right? The more you touch it, the less there is, and this is unnecessary touching.

Wade Pfau 26:08
And that's a reference to Bob French. Yes, for listeners who've been with the podcast a long time. Okay, so that kind of covers the the reconstitution. Then, as an investor, like looking at building your portfolio in retirement, maintaining your portfolio in retirement, why should they care, or should they care about all this trading going on for these types of huge transactions? Yeah, well, there

Alex Murguia 26:34
are two reasons why I thought this was an interesting topic. Listen, a lot of our clients at McLean are asking us about this, and the question is usually, hey man, can I put a flyer on SpaceX? I know it's not part of my normal portfolio. It's not something that we would do personally. But as an aside, can I just have a little SpaceX play money? You know, you're getting a lot of those lately. So I thought, you know, let me just put something out there real quick on SpaceX, but blend it into the theme of IPO performance and the theme of SpaceX as it as it pertains to being in an index or not, you know. So in terms of direct, what should you do about this? This episode is more like buyer beware kind of thing, where sometimes not doing anything is the best thing, you know, as it pertains to yourself as an investor and investments, well, index funds, you know, you know, could the Russell and the S and p5 100 could have noticeably different returns this year, and not because of stock picking, but simply because of the different index methodologies that they use, and so from that vantage point, you know, as an investor, make sure that you're you're picking an index that stays true to its reasoning. I don't have any back knowledge, information, or anything like that. But it's interesting that the S and P chose to stick to their guns

in terms of listen. This is how we traditionally put a company in, and everyone needs to get in line effectively and show that they're investment worthy. Whereas the Russell, for whatever reason, it could be very valid reasons. I don't know, but it's an interesting question to ask. Is you we're going to fast track you, and and you know we just after five trading days, you're in. So they

Wade Pfau 28:19
specifically change the rules too. I

Alex Murguia 28:22
think they can fast track. They, I, I think it's something that they they always have a trump card there, you know what I mean. And so they're pretty much putting them into their index. And so I don't know, something about that is interest. It it's interesting to to do the. Tell me more about that. You know what I mean, if if you're talking to Russell, you know, walk me through your thinking about that again. Why why is this fast track? And hey, it's never about the money. It's always about the money. You know, I'm sure there was you know some reason like that from that perspective. So to me, the broader lesson for investors is two passive funds can produce different outcomes simply because they're following different index rules that have nothing to do with investment thesis and more to do with just like operational methodologies.

Wade Pfau 29:13
And usually companies are small enough that those differences are not all that noticeable overall. But in this case, there could be some big differences. Yeah,

Alex Murguia 29:22
and and I and you're going to see two other ones coming if not if not more so. So you know, yeah, everyone thinks OpenAI and Anthropic, but I think I mentioned at some point Stripe, and Stripe is a significant financial tech company at this point. So we'll see. All right, but look, at the end of the day, I mean, if you had to write a bullet point list of things, you know, don't chase IPOs just simply because they're exciting. Understand that index methodology matters. You know, passive, you know, to us, passive investing is a way to go on a non for better said a non forecasting way of investing. Investing for retirement is the way to go, but not all indexes are identical. And frankly, you know what I think is a better, more effective strategy is not blindly following an index, but doing something along the lines of what companies like Dimensional and Avantis are doing with regards to capturing the market premiums in those areas, but not doing it like you know robotically, doing it like how you would shop, you know when you go out, how you would personally go grocery shopping, you know, hey two for three. Let me let me look into this one a little bit more, you know that kind of thing. Do you know what your index follows? Do

Wade Pfau 30:35
you have insight on what they're doing with regard to SpaceX?

Alex Murguia 30:40
What who's doing

Wade Pfau 30:41
the DFAs and Avantises of the world?

Alex Murguia 30:44
Off the top of my head, I do not. I would imagine it goes through their screeners, and it goes from there. But no, I was the focus of this. I was, I was just interested in the S and P and the Russell sense. I figured that's what most people have.

Wade Pfau 30:57
Uh huh. All right. Well, thank you for that insight into SpaceX, one of the the biggest financial stories of the year for sure. So it's definitely a timely topic, and it's part of our Q and A series next week. Actually, we've recorded a couple episodes that will air after this one, so we're continuing that Q and A series, and we'll continue also with those retirement income challenge questions. So thanks, everyone, and we'll catch you next time on Retirement Style.

Alex Murguia 31:26
Take it easy, everyone.

Briana Corbin 31:28
Wade and Alex are both principals of McLean Asset Management and Retirement Researcher. Both are SEC registered investment advisors located in Tyson's Virginia. The opinions expressed in this program are for general informational and educational purposes only, and are not intended to provide specific advice or recommendations for any individual or on any specific securities. To determine which investments may be appropriate for you, consult your financial advisor. All investing comes with a risk, including risk of loss. Past performance does not guarantee future results.