MV CAPITAL MANAGEMENT

Weekly Market Flash

Public Markets, Private Markets and Asset Allocation

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The languid dog days of August are truly upon us. Risk asset markets would seem to be feeling the soul-draining humidity as much as runners and cyclists slogging through day after day of relentlessly damp blankets of heat while training for fall goal races. The S&P 500 hovers just below its January record high, while volatility has resumed last year's deep slumber. The 10-year Treasury yield casts a sleepy glance every now and then at the 3 percent level, yawns and goes supine again somewhere around 2.95 percent.

Random headlines make a splash on these days where nothing much from macroeconomic or corporate earnings data releases manage to perk up investor attention. This week's little diversion came – as seemingly all diversions in 2018 must come – from Twitter and specifically from the account of Elon Musk, founder of Tesla, as he mused about the likelihood of taking his $60 billion enterprise private. Now, once upon a time a major strategic undertaking like taking a public company private would have simmered under the radar in boardrooms and hushed discussions with bankers, lawyers and advisors before proceeding in an orderly fashion into the public domain. But such are the times in which we live.

Mind The (Listing) Gap

While Musk's method of communication may have been unusual (and quite possibly illegal), the decision itself – to take a public company private – is anything but an anomaly. Our interest piqued, we went hunting for some data on the subject and came across a 2017 Credit Suisse paper entitled "The Incredible Shrinking Universe of U.S. Stocks" with some eye-opening facts and figures. The universe of publicly traded equities – i.e. shares of common stock traded on an accredited stock exchange, compliant with SEC disclosure and transparency regulations, and available for purchase by any institutional or retail investor – has radically diminished over the past several decades.

Here's a good illustration of what this means in practical terms. How many stocks do you think make up the Wilshire 5000 Total Market Index? Ah – you were about to say "5,000, of course!" but then realized it must be a trick question if we're asking it. Indeed, this bellwether index launched in 1970 to represent the "total US stock market" does not consist of 5,000 companies. It consists of 3,486 companies as of June 30, 2018. Why? Because that is roughly how many publicly traded companies exist in the United States. In 1976 there were about 4,800 companies with publicly traded stock, and in 1998 that number soared to more than 7,500. The Wilshire 5000 reached its peak holdings with 7,562 names on July 31 of that year.

Where Did They All Go?

Why are there so many fewer listed companies now, and how much does it actually matter from the standpoint of an investor seeking to capture as wide a swath of global wealth as possible through portfolio diversification? The answer to the first question is relatively straightforward. The second – not so much.

The main reason why there are fewer companies on stock exchanges in 2018 than there were in 1998 or 1978 is twofold. First, mergers & acquisitions (M&A) activity has gone gangbusters over this period, and has been the main driver for delisting (a company, when acquired, naturally retires its stock ticker at the signing ceremony). Second, initial public offering (IPO) activity has fallen. If M&A is the main way that a company falls off the stock exchange, then IPOs are the main source for new supply. According to the Credit Suisse report we noted above, the average number of IPOs every year from 1976 to 2000 was 282. From 2000 to the present the average annual number was a mere 114.

Long story short – M&A fever has raged while the IPO market has slumbered. This in itself is unusual. Historically, strong equity markets tended to encourage both M&A and IPOs. That makes sense – companies feeling flush look to bulk up by taking out competitors or to buy their way into new industries, while start-up founders want to cash in with the high valuations available in bull markets. But that positive correlation no longer holds. From 1976 to 2000 the correlation between M&A and IPO activity was 0.87 (1.0 being perfect positive correlation). From 2007 to 2016, the correlation is actually negative: minus 0.08. Those start-up founders apparently have other, more enticing options for cashing in.

The Changing Market For Private Capital

And indeed, those alternatives exist. Probably the most noteworthy, in terms of explaining the diminished attractiveness of IPOs, is the growth of late-stage venture capital / private equity. Venture capital used to be concentrated in the early years of a start-up company's history, with the VCs motivated to get their investments through successive funding rounds and out the door into the public markets via IPO as fast as possible. Now there is a whole distinct asset class of late-stage private investors. This includes most of the major mutual fund families, like Fidelity and BlackRock, that operate dedicated late stage private equity funds. This asset class provides a level of liquidity that previously could be found only in public markets. For example, late stage private deals allow start-up founders and their employees to cash out some of their stock and options – again, reducing the natural pressure to go public.

The Implications for Asset Allocation

So the story about how we wound up with so many fewer public companies is relatively easy to understand. But that second question we posed a few paragraphs ago remains outstanding. Is the long term investor with a diversified portfolio missing out on a major asset class exposure by not being invested in private equity?

This is a question we take seriously: after all, our primary job is to construct portfolios with a prudent level of diversification aligned with each client's specific investment objectives and risk considerations. The data thus far are somewhat inconclusive, with attendant benefits and costs.

For example, while there may be fewer publicly traded companies out there, the total market capitalization of the US stock market is more than 1.35 times the value of US real gross domestic product (GDP). By comparison, total market cap in 1976 was just 0.47 times GDP, and in the late 1990s, when the number of listed firms peaked, it was 1.05 times. The collective profits of all listed firms today is close to 9 percent of GDP versus 7 percent in 1976. And share volume – hence liquidity – is at record levels today.

For investors there are other potential downsides to owning private equity, including reduced transparency and less consistent, available data for performance benchmarking. On the other hand, it is not possible to simply dismiss the reality of a new structure to the US capital market and the existence of distinct new asset classes large enough to demand consideration, if not inclusion, for long term diversified portfolios. We will have more to say about this in the coming weeks and months.

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