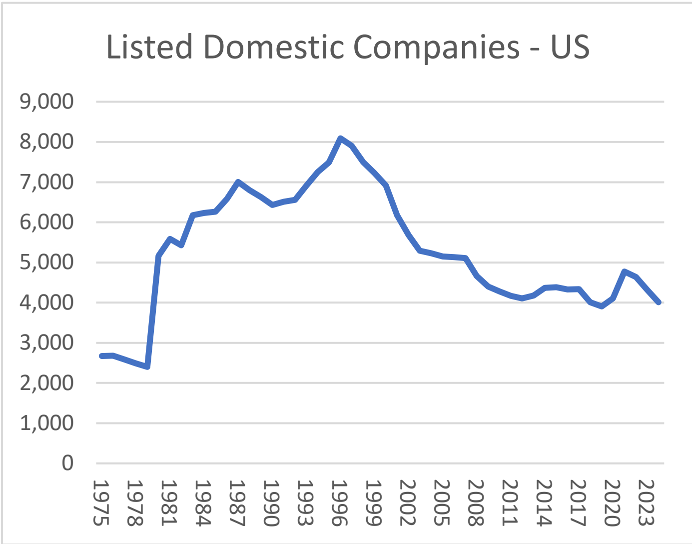
Changing Public Markets and the Impact for Average Investors

By Jordan Waldrep, Chief Investment Officer

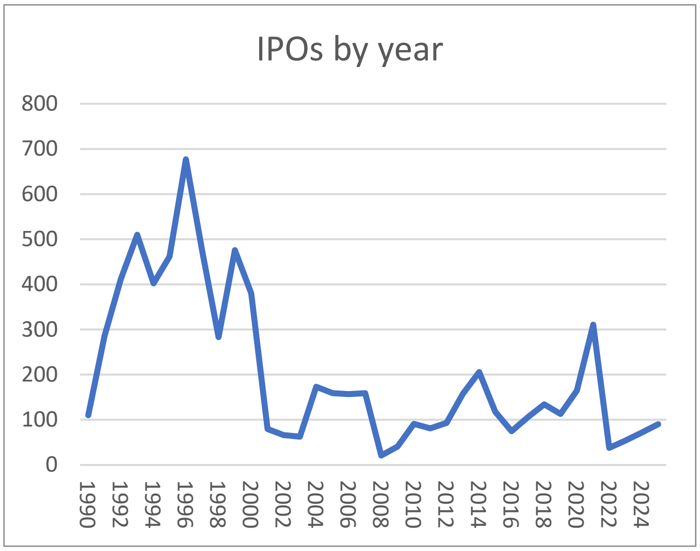
The landscape of public markets in the US has undergone a profound change over the past 30 years with a significant reduction in the number of publicly traded equities. This has been driven by many factors including the rise of globalization, the changing costs and burdens of initiating/maintaining public listings, more sophisticated capital markets, and even low cost of trading for investors among other factors. However, one of the most important changes that has fundamentally shifted the way companies view the appeal of listing publicly has been the rise of private equity and the commensurate shift of companies out of the public market. Taken as a whole, the companies listed on public exchanges today have very different investment characteristics than they did in the past. That change has a real impact on long-term investor portfolio performance. All investors need to understand this and adjust expected returns in the public market while acknowledging that perhaps the only way to achieve the levels of long term returns historically associated with public equities is to incorporate private equity into their portfolios.

A Shrinking Market

The total number of listed companies in the US can be seen in the chart to the right. From the late 70's onward, there was a decades-long upward trend in the number of listed operating companies in the United States. That number peaked in 1996 with a little over 8,000. This period of growth reflected the funding choices of businesses during the time as companies in relatively early stages of growth used the public equity markets to fund expansion. Private equity did of course exist during this period—the 80's were famous (or perhaps notorious) for leverage buyouts, corporate raiders, and the like—but for companies seeking capital, private equity ownership was less attractive than listing in the public markets. Increasing M&A activity in the late 90's concentrated ownership in fewer companies at the top of the market even as the dot-com bubble greatly expanded the listings in the Technology space. However, private equity was already impacting the public market as venture capital firms funded companies through earlier stages of development before exiting via IPO, extending their incubation period in the private markets.



After the dot-com bubble and market crash to kick off the new millennium, something dramatic changed the attractiveness of public v. private market funding. In 2002, Sarbanes-Oxley was passed in response to some of the worst actors during the market bubble. It is a wide-ranging bill that puts a variety of burdens on leadership and boards of public companies. After the passage of this bill, private equity ownership by companies became more appealing. In fact, since that bill was introduced, the number of publicly listed companies has dropped by 35%. This is highlighted by the change in the IPO market that occurred around that time. The chart on the left shows the number of IPOs by year. Coming out of the 1990-92 recession, the IPO market was at its peak through the rest of the 90's. Since the dot-com bubble burst, there has never been a recovery in IPO market volumes. The regulatory burden of the public markets was increased again by Dodd-Frank, passed in response to the Great Financial Crisis of 2008. While much of that bill focused on finanical and banking reform, it did build upon the regulatory enviornment created by Sarbanes-Oxley. Between these two bills, there were a variety of impacts but key among them were the following.



- Increased legal and audit expenses
- Governance structures became more complex and expensive
- Disclosure requirements were expanded
- Increased reporting

These were expensive changes to the real costs of being listed publicly. Even so, large companies could fairly easily absorb these costs with little real impact to bottom line performance or operations, but for small cap companies these requirements changed the math on listing publicly. In the face of this changed dynamic, the Private Equity markets were well positioned to step in with an appealing set of benefits.

- Readily available capital (equity and debt) in the private market
- Fewer disclosure requirements
- Reduced or eliminated quarterly earnings pressure
- Strategic flexiblity to grow a business
- Less public scrutiny and activist pressure

Dodd-Frank finished what Sarbanes-Oxley started and tilted the preference for smaller growing companies seeking capital firmly to the side of private markets.

When we look back in aggregate at the public market changes over the past three decades, we can conclude that there are a few key drivers feeding off each other leading to the reduction of the overall number of publicly traded companies.

1. *Mergers and Acquisitions* – M&A activity including strategic acquisitions absorbed many public companies into larger entities, reducing the number of public companies. This was most apparent in developed parts of the economy, and it was necessary for many companies to compete in larger global markets. This concentrated operating business in fewer listing.
2. *Slowing IPOs* – The significant drop in the number of IPOs from almost 400/year from 1990-2000 to only 116/year from 2003-2025 reduces the influx of new companies to offset M&A activity.
3. *Regulatory & Compliance Costs* – Sarbanes-Oxley and Dodd-Frank changed the math for companies considering going public making private markets more appealing for companies seeking growth capital. This also led to longer incubation periods to further avoid these costs, slowing the IPO market even more.
4. *Growth of Private Capital* – What was already a successful but relatively small part of the market was primed to grow. Private Equity changed from the corporate raider of the 80's into a ready partner for funding growth. Success bred success as companies continued to seek private equity funding, while the number and size of private equity providers exploded. In 2000, there was about $600 billion in private equity assets in about 1,900 companies. Today, there is over $8 trillion in private equity globally with over 11,000 domestic companies owned by Private Equity.

This circle of reinforcing pressures changed the public markets. M&A activity concentrated businesses in the public space into larger companies seeking to gain efficiencies and compete on a global scale. Meanwhile, fewer IPOs, increased regulations, and growth of private equity markets stripped out much of the smaller companies seeking growth capital from the public markets. As a result, the rapidly growing companies seeking capital to expand their businesses are no longer generally in the public market. The remaining companies in the public market are a mix of businesses with varying degrees of quality, but the dynamic fast-growing businesses that drove economic expansion in the past are today mostly found in the private market.

Longer Incubations
The development of robust private markets with less appealing public markets has extended the private lifespan of many companies as well. Historically, companies aimed to go public as quickly as possible to gain access to scaling capital and liquidity. Intel's IPO in 1971 valued the company at $60 million. Cisco's IPO in 1990 valued the company at $1.2 billion. Google's IPO in 2004 valued the company at $23 billion. Facebook's IPO market capitalization was $104 billion in 2012. The incubation period for companies from founding to IPO has trended upwards from 8 years in 1995 to 14 in 2023. Companies (and their private equity sponsors) choose to realize this fast growth phase themselves and wait for greater valuations.

A funny bit of jargon that lives with us to this day: companies that are private and worth $1 billion are often called "unicorns" referring to their magical nature and rarity. Billion-dollar private companies are hardly mystical creatures anymore. Today, it is estimated that there are around 850 private unicorns in the US roughly 45% of the number of public companies with market caps over $1 billion. These are companies that should be filling out the ranks of the Small and Midcap public markets, but they are held in the private market.

Why should all investors care?
It is not surprising that research shows that up to 90% of the decline in listings since the mid 90's has come from the small and micro-cap markets. Investors must be aware of this change because it has real implications for public market investors.

- *Changing Indices* – The indices investors look at to understand what parts of the market are growing and shrinking have become less representative of what is happening in both the broader economy as well as the size of company those indices represent. That is of great concern when the average investor is advised to just buy public market index funds and call it a day. Those index funds no longer reflect their economic spaces as well as they did in the past.
- *Liquidity* – With fewer public companies, there has been a reduction in liquidity and market depth for these spaces. Average investors are chasing fewer options with less liquidity which is not good for execution or performance.
- *Risk/return Profile* – The risk/return profile of smaller capitalizations has changed as growth companies have shifted out of the public space. This means that the dynamic growth portion of the public small cap market is often private now and the average investor cannot take advantage of growth drivers that are not fully represented in the public space.

When one considers these changes, it calls into question the assumption that small companies will outperform big companies over time, particularly amongst those already listed. This long-lived assumption, rooted in factor #2 in the famous Fama/French 3-factor model of the early 90's, and is why many advisors still tilt their allocations towards small and medium cap companies, but the change in overall market structure means that the small outperformance assumption may no longer be valid. The types of companies that drove small v. big outperformance historically are now largely absent from the small and mid-cap market. Further, the expansion of federal and state regulatory regimes has effectively imposed as sort of regressive tax on small business dynamism, as regulatory burdens lie disproportionately heavy on companies that haven't yet achieved massive scale. This is less burdensome for giants, but they are generally much less dynamic to begin with.

If we look at the chart on the next page, it shows relative 3-year performance of the Russell 1000 Index (representing the largest companies in the US) v. the Russell 2000 index representing small caps. Each

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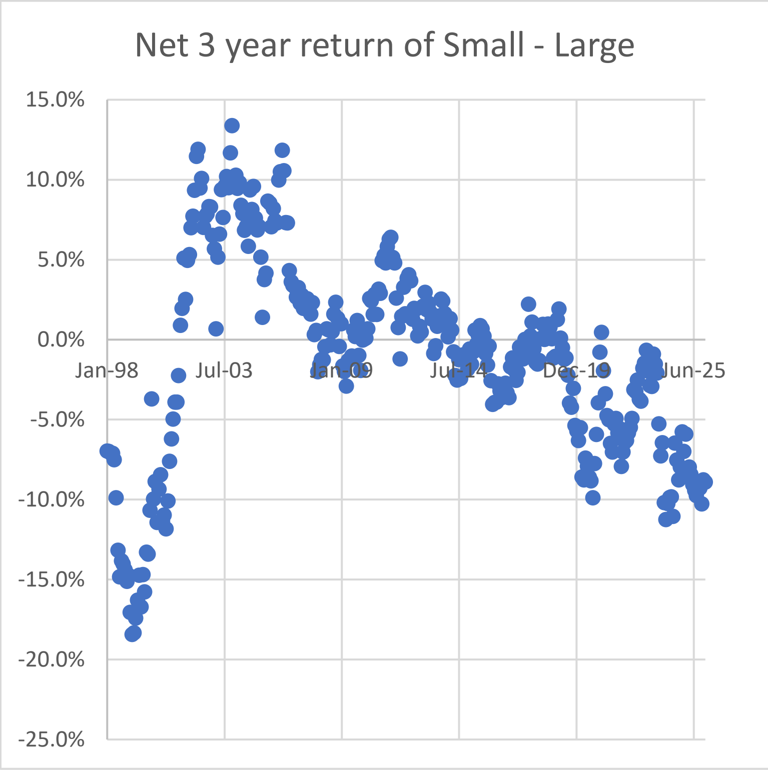
Trust & Wealth



dot represents the conclusion of a 3-year period, so Jan 98 shows that small caps underperformed large caps from Jan 1995 – Jan 1998 by -7%. Coming out of the 2000 crash, small caps led the way as the bubble multiples of the dot com era contracted. What is interesting is that since then, the relative performance of small caps has generally degraded over the next 20 years. This is not a year-to-year issue, it is a 20-year degrading of relative performance by small cap stocks.

Performance, performance, performance

There are a lot of claims made by proponents and sales managers for Private Equity such as low correlation with public markets, high risk adjusted returns, etc. Counter arguments abound surrounding liquidity premiums and volatility washing. There are compelling cases to be made both for and against private equity return claims but the scholarly debate of efficiency or alpha in these market returns is beside the point. At its core, there is no way to avoid two observable facts.

1. Private equity has become an appealing path for companies to get growth capital and thus limit the availability of expanding companies in the public market.
2. Companies are staying private longer during some of the most rapid growth they will experience in their life cycles.

The performance drivers that were central to the Fama/French Big/Small analysis are no longer in place and so that performance is not available to the average investor in the public market (i.e. it is missing from conventional portfolios). The only way to gain this exposure is to invest in the private market. It is not that returns in the private market are better or worse, but that the shift into the private space has REDUCED what an investor should expect to return from the Small and Middle markets. Private Equity investing is not the exclusive province endowments, pensions, and the ultra-wealthy. ALL investors should actively pursue this market in order to gain the exposure and expected returns that history tells us the equity markets will deliver.

A Need For All Investors

Now we come to the key question: how much exposure should the average investor have to private equity? Arguments for including more private equity (and private credit, which has also outperformed relative to bonds funds in recent years) in investor portfolios center around distinct diversification and return benefits. The historical data on such alternative investments supports robust long-term returns given the risk profile. For investors, non-correlated returns can significantly improve risk-adjusted returns for their overall portfolio.

The counterargument against robust allocation to alternative investments centers on the high fees of these investments, limited access, and illiquidity as well as limited oversight and regulation. These concerns are certainly valid and should not be dismissed out of hand. However, the counterarguments ring hollow when one looks at the distribution of companies in the public and private markets. While there is unavoidably more risk adding private equity to an investor's portfolio, there is also no other way to gain access to the full spectrum of economic growth as great businesses remain private through their greatest expansion phase.

Despite the risks, if the public v. private market keeps its current dynamic, there needs to be a path for broader access to private investments. This is a complex problem and delivering such exposure to investors of various profiles has no easy solution. For their part, funds have been working to "democratize" this space with flexible structures to accommodate investors who are not "Qualified Purchasers" or even "Accredited Investors" (solely to expand the investor base). There are managers trying to provide alts exposure, though many of their "solutions" are quite fee-heavy, or otherwise so narrow in their offering that they are more of a box-checking sop to exposure-seeking investors than a genuine portfolio enhancement. Expect growing pains as this evolution plays out with illiquid assets in inappropriate wrappers, misaligned incentives, insufficient client education, and stacking fees.

There is no simple way to add "private equity beta" to a portfolio the way one can add public market equity beta via the S&P 500 or the Russell 1000. Until then, managers should seek thoughtful, diversified exposure to the private equity market where possible. Behemoth institutional investors and ultra-high net worth individuals have dominated this space for years, but it is no longer a special class of investments. For our part, we have enjoyed trying to solve this quandary for our clients, but the work is far from done. Private Equity has become necessary for all investors to holistically participate in the growth of our economy.