THE AFFLICTION OF SHORT-TERMISM AND PRIVATE EQUITY AS A SOLUTION

A growing number of prominent business leaders have been campaigning regulators to address what they believe to be one of the most significant detriments to U.S. economic growth – "short-termism", or the heightened importance that public companies and their shareholders place on near term profits. Warren Buffet and Jamie Dimon co-authored an op-ed piece last June in The Wall Street Journal, arguing that far too many public companies are holding back on investing for the future because they feel pressure to increase the bottom line to meet the next quarter's forecasts.

At the same time, a movement has gained ground to make it easier for individual investors to access the private equity market, where many businesses take a longer-term approach to creating value and where more growth is occurring in our economy. Last month, SEC Chairman Jay Clayton announced that the SEC will weigh the possibility of a major regulatory overhaul that would broaden the definition of "accredited" investor. This would allow more individual investors to take part in private placements, giving them greater opportunity to tap into a rapidly growing segment of the economy. The fact that these two developing stories are unfolding at the same time is no mere coincidence.

THE INCREASING PREVALENCE OF SHORT-TERMISM

McKinsey & Company has spent years analyzing and quantifying the extent to which public companies have shifted their focus away from long-term strategic planning and towards maximizing short-term profits.[1] Using a dataset of 615 domestic large and mid-cap companies that were publicly listed from 2001-2015, McKinsey developed the Corporate Horizon Index (CHI), which measures the aggregate amount of "short-termism" in the market. Their findings show that the median CHI score has become increasingly short-term over the last 20 years. McKinsey also conducted a series of surveys which showed that 87% of public company executives reported feeling the most pressure to generate strong financial results in under two years.

IMPLICATIONS FOR ADVISORS AND THEIR CLIENTS

The rise in short-termism could have a meaningful impact on individuals who hold a significant percentage of their wealth in public companies via 401(k) plans and IRAs. While these structures are intended to help individual investors with long-term wealth creation, there is a growing misalignment between the objectives of these vehicles and the goals of the public companies in which they're invested.

There are two primary reasons that stock market returns are expected to decline. First is the logical assumption that public businesses focused on short-term profits are less likely to deliver sustainable growth over the long-term. To this point, McKinsey's research shows that from 2007 to 2014, companies classified as having a long-term focus invested more in R&D and showed revenue and earnings growth that was 47% and 36% higher, respectively, than that experienced by short-term oriented businesses. Additionally, the long-term focused firms were 50% more likely to rank in the top decile for total shareholder returns within their given industry and they created significantly more jobs, providing a boost to total economic growth in the country.[2]

In contrast, experienced private equity (PE) managers are almost obsessively focused on creating value in their portfolio companies over a three- to six-year period, which is the typical length of PE ownership.

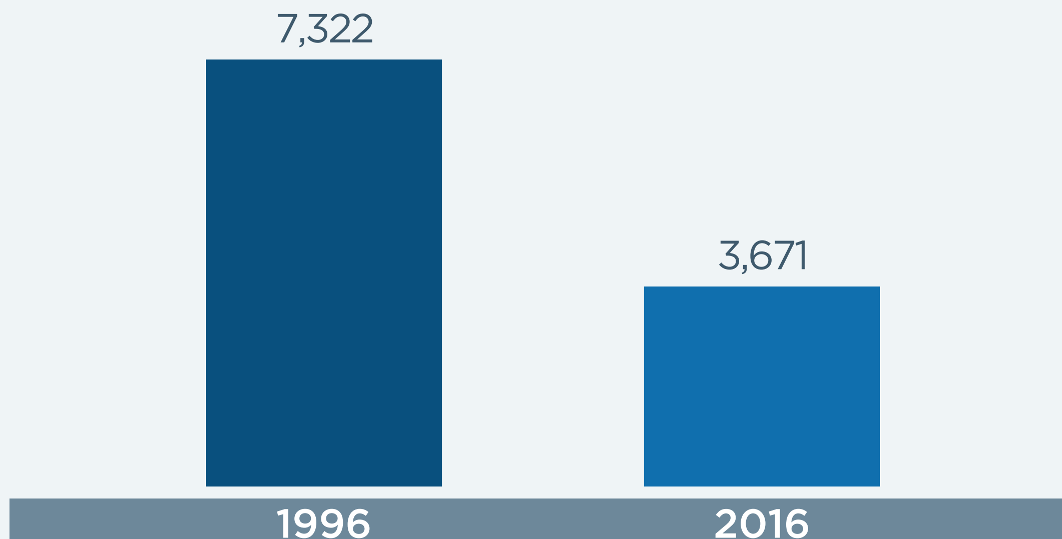
These managers spend a tremendous amount of time with the senior executives running their portfolio companies, focusing on long-term value creation plans such as expanding into new markets, making add-on acquisitions, selectively consolidating a fragmented sector by acquiring smaller companies at lower entry multiples, and/or improving operations by streamlining costs and selling non-core assets.

THE SHRINKING UNIVERSE OF PUBLIC COMPANIES

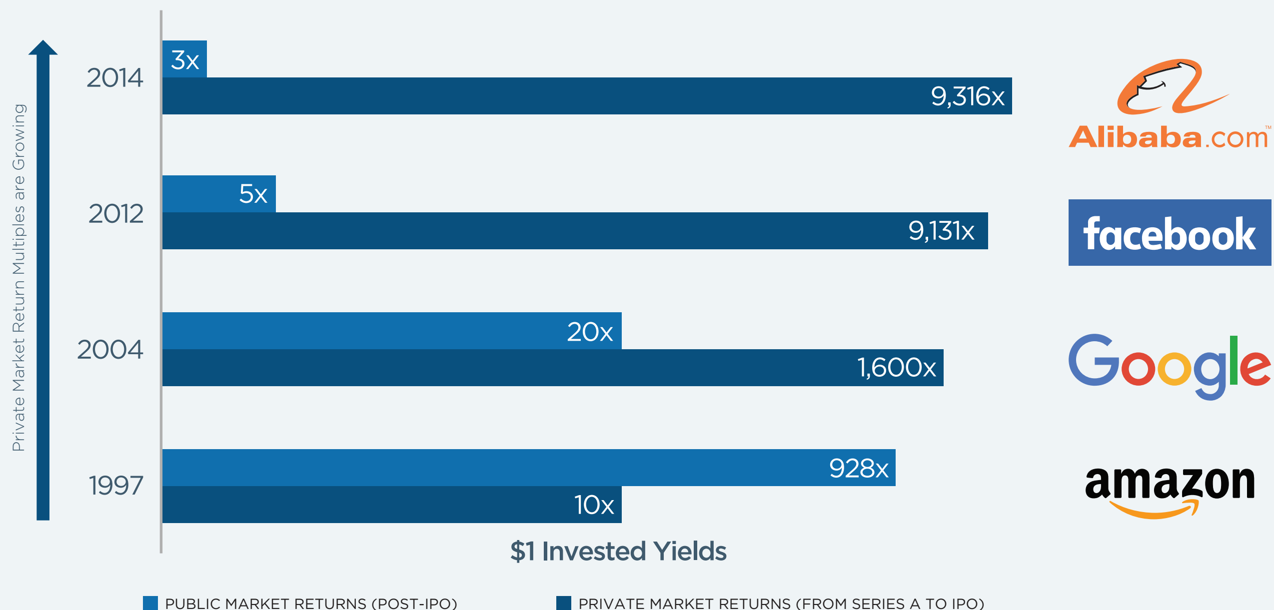
The second potential cause of declining equity returns is the shrinking universe of publicly-traded companies, which has accompanied the rise in short termism. All too aware of the constant pressure applied by public market investors and analysts to meet quarterly earnings, many leading private companies are avoiding listings altogether. With the number of IPOs running at half the levels of the 1990s and 1980s, the number of U.S. public companies has nearly halved over the past 20 years to under 4,000, as seen in figure 1, leaving a pool of generally more mature, lower growth companies. The average age of publicly listed companies has increased by 50% from 12 years at the peak of public listings in the mid-1990s to over 20 years in 2016.[3] On a per capita basis, the number of publicly listed companies for every 1 million people in the U.S. has declined from 22 in 1975 to 11 in 2016.[4]

FIGURE 1

LISTED COMPANIES IN THE U.S. STOCK MARKET



For illustrative purposes only. Source: Credit Suisse, "The Incredible Shrinking Universe of Stocks: The Causes and Consequences of Fewer U.S. Equities' by Michael Mauboussin, Dan Callahan, CFA, and Darius Majd (March 22, 2017)



For illustrative purposes only. Note: Private multiple is from Series A to opening price upon IPO; Public Multiple is from IPO open to April 2018. Sources: Equiam, S-1 and other regulatory filings, Yahoo Finance.

There is also mounting research which suggests that much of the equity value in some of the world's most successful and often disruptive businesses is being created prior to an IPO, leaving retail investors unable to participate in most of the upside. This trend can be seen in figure 2 – if your retail clients had purchased stock in Amazon's IPO in 1997 and held it until today, they would have achieved a return of over 900x. By comparison, if your clients had bought into the IPOs of Alibaba, Facebook and Google (all of which stayed private much longer than Amazon did) they would have experienced much smaller returns, as private investors had already reaped the hyper growth which occurred during the private phase.[5]

Some public companies are even delisting from exchanges to focus on long-term goals. One high profile example is Dell, the technology giant that was taken private in 2013 after spending 25 years as a publicly-traded company. Dell believed that it was unable to execute upon its long-term plans while operating under the microscope of public markets, with the company's founder, Michael Dell, highlighting that as a private company they were "able to be bold, make investments and focus 100 percent on customers." After spending five years turning the business around and investing in several growth initiatives and some major acquisitions, including buying EMC in 2016, Dell is now worth an estimated $70 billion - nearly triple its valuation at the time of its buyout, which involved a major private equity firm.

PRIVATE EQUITY AS A SOLUTION FOR YOUR CLIENTS

With continued "short-termism" posing a threat to the long-term return profile of public markets, it is increasingly important for your clients to find ways to gain exposure to private businesses that buck this trend. This is where the SEC announcement about potentially loosening of the definition of "accredited" investor comes into play and is an area to watch closely.

Perhaps the biggest issue for investors looking to allocate to private equity is liquidity, as these funds typically require long lock-up periods. However,

for investors truly intending to maintain long-term exposure to equities, reallocating 5%-10% of a total portfolio to PE should have a negligible impact on overall liquidity while enhancing diversification. In addition, one of the inherent benefits of the illiquid nature of PE is that the investor is placing the decision of when to sell in the hands of experienced fund managers, thereby preventing individuals from selling investments at the wrong time under adverse market conditions. In other words, the private equity model forces individual investors to adopt a "buy and hold" discipline.

Fortunately, technological advancements have made private equity more accessible to qualified investors than ever before while also streamlining the reporting and administration for their wealth advisors. Your clients who take advantage of this asset class stand to benefit in the form of greater long-term value creation, which may be difficult to find in today's public markets.

An earlier version of this article was published in ThinkAdvisor

END NOTES

[1] McKinsey Global Institute. Measuring the Economic Impact of Short-Termism. February 2017.
[2] Ibid.
[3] René M. Stulz. The Shrinking Universe of Public Firms: Facts, Causes, and Consequences.
[4] Kathleen M. Kahle and René M. Stulz. Is the U.S. Public Corporation in Trouble? May 2017.
[5] Note: Private multiple is from Series A to opening price upon IPO; Public Multiple is from IPO open to April 2018.
Sources: Equiam, S-1 and other regulatory filings, Yahoo Finance.

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