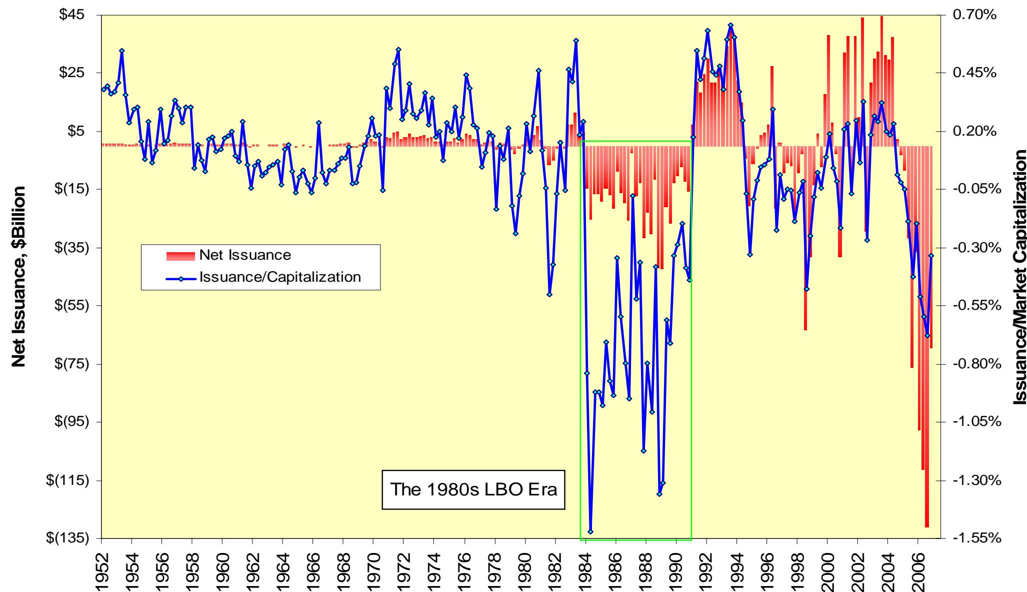
Equity Shrink's Hidden Importance

Walk over to a window, open it and step outside. Assuming this behavior elicits a visit to the scene from the coroner's office, will they attribute your demise to you falling to the earth or the earth rising up to meet you? Incredibly, there is an element of truth to the latter explanation: Gravity describes a mutual attraction.

Those of you who did not take the first challenge are invited to look at a chart of the U.S. stock market since the end of June 2004. Did it rise because of increased demand, decreased supply or some combination of both? Some would look at the chart below and argue the net shrinkage of U.S. equities due to mergers, privatizations and other corporate actions propelled the U.S. market higher via a reduction in supply.

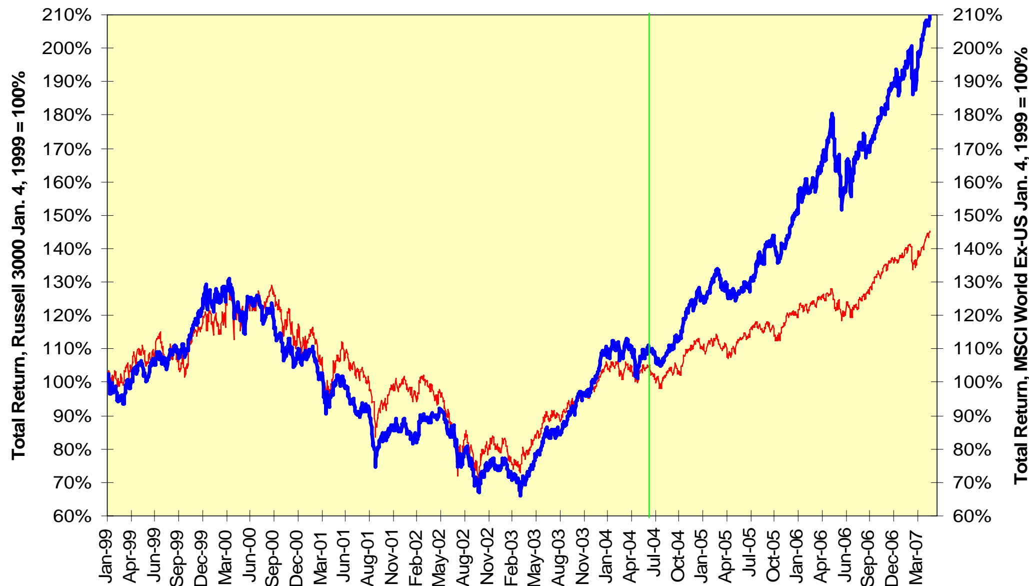


The law of supply and demand, much like the law of gravity, operates in both directions, so we cannot dismiss the importance of the shrinkage in the U.S. equity supply. And, as noted on the chart, a similar spate of equity shrinkage during the 1980s leveraged buyout era did coincide with some solid stock market gains. But this leaves us with a problem: Can we explain the 40% total return in the U.S. market as measured by the broad Russell 3000 index with an average quarterly reduction of just under 0.3% of U.S. market capitalization as calculated by the Federal Reserve?

U.S. And Non-U.S. Returns

More critically, how can we explain an even stronger bull market outside of the U.S., as measured by the Morgan Stanley Capital International World Ex-U.S. index? This index' total return in dollar terms over the same period has been an eye-popping 91.1%.

The answer here is twofold: "No," and "No at an accelerating rate." If we index both the Russell 3000 and the MSCI index to the January 4, 1999 introduction of the euro and compare their total returns, we find the U.S. market has lagged the rest of the world rather badly since the equity shrink began in mid-2004.

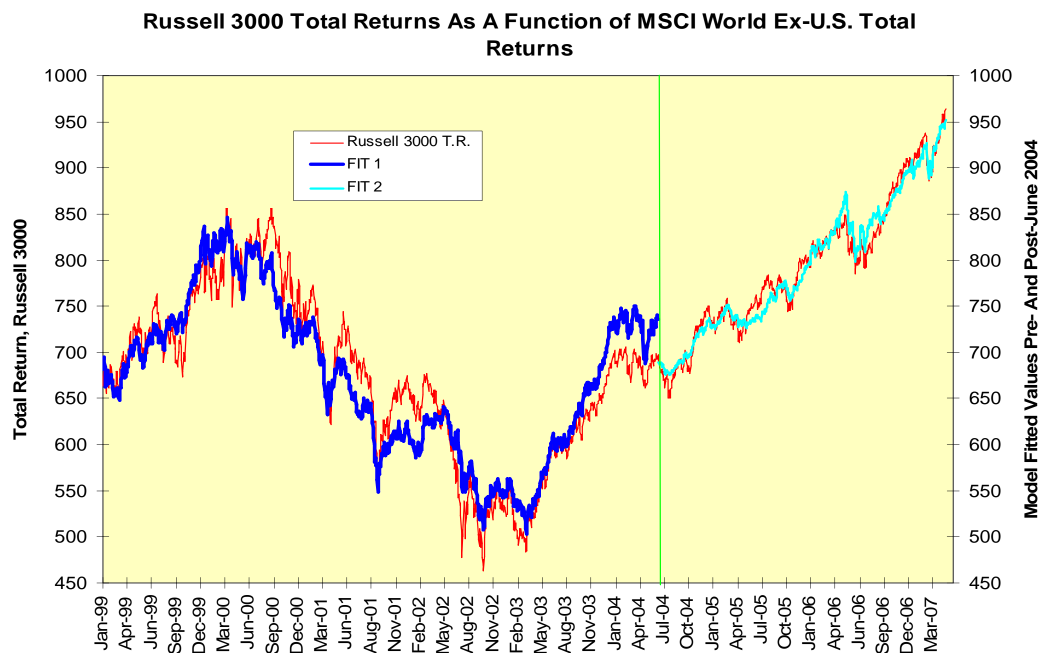


Prior to mid-2004, the argument could be made as to why bother with international diversification as you get the same returns. This stands out on the chart. If we run a Student's T-test on the two return streams, we find a 93.9% probability their means are identical. If we run the same test from July 2004 onwards, that probability drops to 20.6%. International diversification not only mattered for diversification purposes (pretend you care about diversification; like eating your vegetables, it is supposed to be good for you), it provided some very solid rewards in the form of dollar returns.

Moreover, it is more than just a currency trade. While the dollar weakened in late 2004 and again from late 2006 onwards, it posted a solid rally in 2005. The pace of outperformance by non-U.S. markets increased over that period.

Risk, Not Return

Now let's analyze the effect of equity shrinkage in another fashion. We can compare the relative variance of the U.S. and non-U.S. markets by regressing the Russell 3000 against the MSCI World Ex-U.S. index both before and after June 30, 2004 and comparing the results.



The regression's quality of fit improved immensely. Not only did the r-squared or percentage of variance explained increase from .889 to .970, the standard error of the residuals, or unexplained portion, decreased from 29.82 to 12.91. An F-test of the two regressions confirmed they were different at near-100% probability.

The conclusion from these statistical measures is the U.S. equity shrink did nothing – and increasingly less than nothing – to bring U.S. equity returns up to the rest of the world. However, the shrinkage in supply did lead to conformance of U.S. equity variance, or risk characteristics, with those of the rest of the world.

The Somewhat Bad News

This is all well and good, but economically what does it mean? Stocks can get priced in one of two ways. First, the one familiar to most of us, is stocks getting priced simply as a passive investment. You buy it, and either hold it for dividends and capital appreciation or you sell it sometime later at either a gain or a loss. Second, you can buy stock for corporate control. As we see in all manner of takeovers and privatizations, people are willing to pay a premium for achieving control.

Now if the returns on U.S. equities have trailed those elsewhere, as they demonstrably have done since 2004, they will be priced less as a passive investment and increasingly for control. This accounts for the convergence of risk post-June 2004: In order for U.S. equities to compete with the rest of the world on a risk-adjusted basis, they increasingly must provide investors with an opportunity for control in addition to total return. The visible manifestation of this process is the shrinkage of equity.

There is, of course, a limit to this game. You cannot take the entire U.S. market private save for those private equity firms and hedge funds who now find themselves selling shares to public investors. Moreover, those now taking equity private will want to take those very same firms public at some point in the future. If the equity shrink is bullish in the present, it is bearish in the long-term.

Finally, the equity shrink is unhealthy for capital markets. No, this is not one more screed about Sarbanes-Oxley and regulatory overkill. Public ownership allows for entrepreneurs to raise capital and distribute the risks of ownership. Privatization distributes capital and concentrates the risk of ownership. As distribution of risk is a social good – think insurance in this regard – concentration of risk and return must be a negative to society. Such concentrations of ownership are common in feudal societies, and no modern society so organized can compare to capitalist societies for wealth creation and political stability.

The next time the market pops on the latest takeover news, feel good about your rising portfolio. Do not, however, attribute the bull market to equity shrinkage, and above all, recognize there is a hidden future cost to what is happening today.