The Bad Side of a Good Idea

Why fewer companies are going public, why it's a problem, and what we can do about it.

By Morgan Housel, The Collaborative Fund.

Reed Hastings built Netflix into one of the most admirable companies of the last generation.

More than half of American households now use Netflix. It's created some of the best original content in recent memory. Its stock is up 10,000% in the last 15 years.

For all of this, Hastings spends a lot of time apologizing to shareholders.

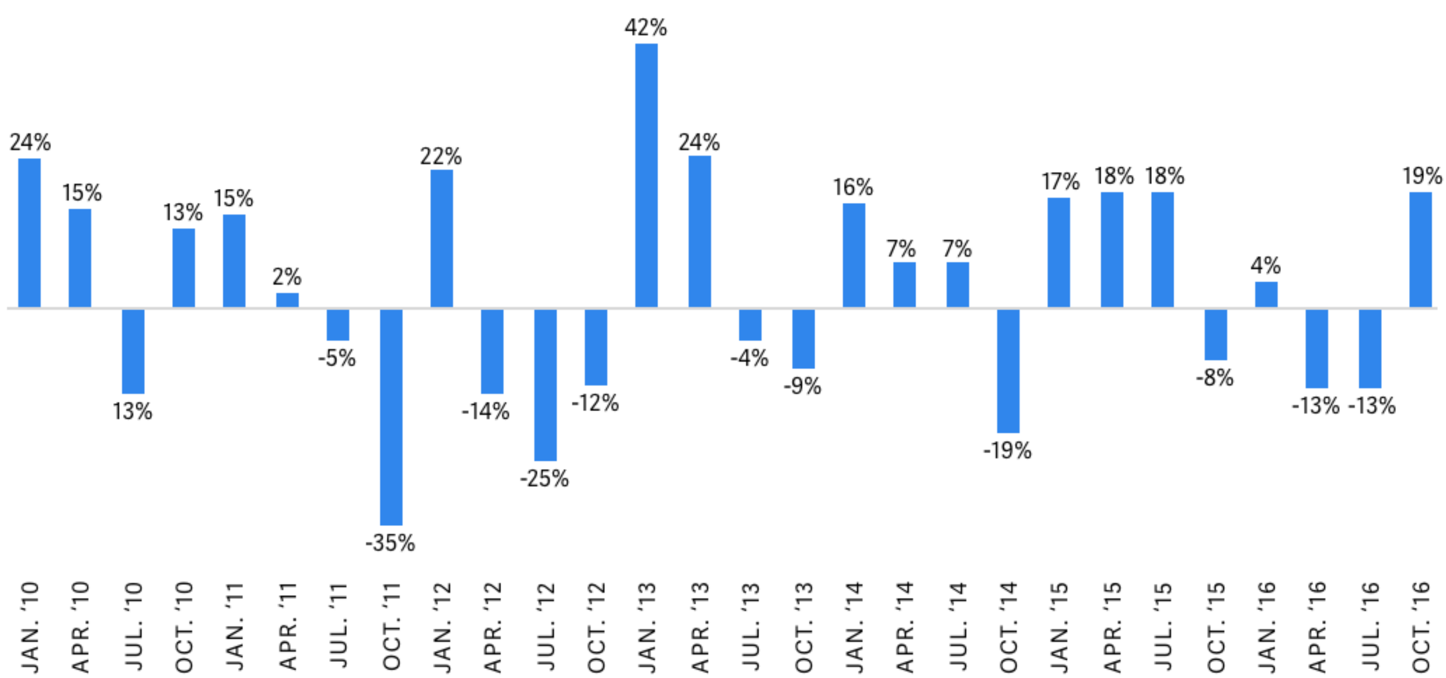
"We apologize for the volatility. I know it's not easy on everyone," he said on a July earnings call.

"It's time for me to apologize for the volatility again," he said on another earnings call in October.

He's apologizing because he's been given so much grief about fluctuating quarterly results.

Over the last seven years Netflix's quarterly earnings announcements have moved its stock by an average of more than 16% in either direction:

Netflix Stock Move Day After Earnings Announcement



Source: S&P Capital IQ

I can't imagine what it's like to run a public company in this world. The pressure it puts on employees. The signal it sends your customers. The way it incentivizes you, as a manager.

People like Hastings are the true wizards of long-term thinking, anticipating trends decades before anyone else and having the gumption to exploit them. But the landlords who own his company hold him to performing in 90-day intervals, reacting to how many subscriptions he sold over the last 2,000 hours and might sell over the next 2,000 hours.

It's a big disconnect. The guy who changed the world and created fifty billion dollars of value over the last 15 years is apologizing for not satisfying shareholders over the last 90 days.

Who would want to run a company in this world?

The answer is: Fewer and fewer CEOs.

The number of publicly traded U.S. companies peaked in 1996 at 7,322. Today there are just over 3,700, according to data from Wilshire Associates. The U.S. population has risen nearly 50% since 1975, and real GDP has tripled. But the number of public companies has declined 21%.

Companies that do go public are waiting longer to do so. According to research from Wellington Management, "Companies are waiting longer to IPO, stretching on average from 4.6 years after founding to go public from 1990–2001 to 6.5 years from 2002–2015."

This report argues three points:

- Fewer companies are going (and remaining) public, and those that do are waiting longer, in part because there are now better alternatives than the short-term madness of being a public company.

- Those alternatives have downsides, as individual investors now have access to fewer of the economy's most dynamic and promising companies just at the moment they're required to invest their own money for retirement.

- There is a better way forward, incentivizing patient long-term capital in a more democratized way.

Part 1: The History

The whole idea of a modern stock market is no more than 160 years old.

To understand how we got here, let's go back a few hundred years.

Seventeenth-Century Holland was like the Silicon Valley of finance. It invented stuff no one had thought of before, and modernized stuff people had. Maritime insurance. Pensions. Annuities. Futures.

But nothing was more important than its invention of investment banking, or the industry of splitting up capital into small pieces to sell to investors. Bill Bernstein, in his book *The Birth of Plenty,* writes:

> *For the first time in history the risk of loans could be parceled out among thousands of investors, who could reduce their own investment risk by diversifying their holdings among the many different bonds sold by the investment bankers. Reduced investment risk led to an increased willingness to invest.*

For centuries there were two groups: Those who had capital and would always have lots of it, and those who held none of it and stood no chance of ever getting it.

Investment banking changed that. Ownership could be sliced up, diversified, and democratized.

Taking this idea global was a slow process. In London, the Bubble Act of 1720 stipulated that businesses could have no more than seven shareholders without express permission from Parliament. Even as the shackles of limited share ownership came undone, owning any amount of stock was staggeringly risky. Before 1855, shareholders in most British companies were personally liable for business debts "to his last shilling and acre," according to the Bubble Act. Limited liability—the idea that each shareholder risked no more than the amount they invested in the company—was not a widespread feature in London until 1855. Before then, any investment in the primitive stock market risked every penny to your name. Businesses do not flourish in these conditions.

It wasn't until the mid-1800s that modern investment banking met limited liability in a large way that the modern stock market as we know it today took shape.

And most of the period since then did not generate anywhere near the social importance of a modern stock market. Equities were still owned by a small number of institutions and individuals.

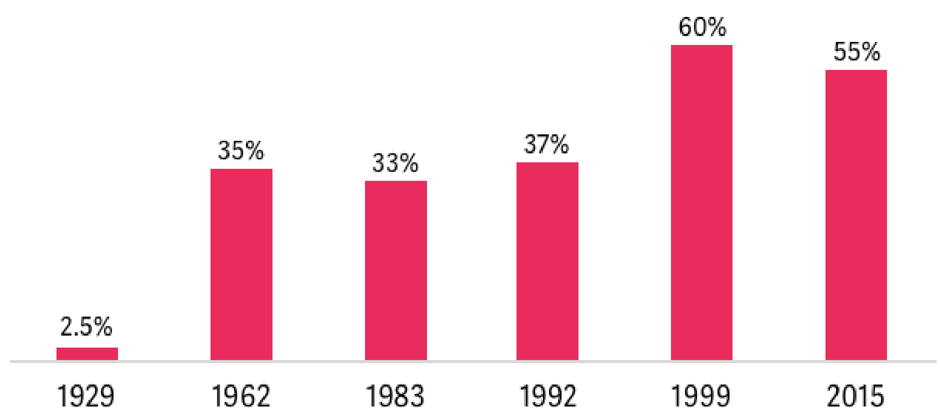
In 1929—the peak of the 1920s stock bubble—stock ownership was something a tiny fraction of Americans experienced. The book *The Great Depression: A Diary*, tells the tale:

> *While the gut-wrenching drama that played out in the stock market those October [1929] days made an indelible mark on many Americans,* ***only about 2.5 percent of Americans actually owned stocks in 1929.***

Household ownership of stocks surged over the following four decades, as memories of the 1929 crash faded, and a newfound expectation of retirement sparked investment demand. But owning stocks still remained a minority activity for most of the 20th Century.

It took the advent of the IRA and 401(k) in the late 1970s to change that. 401(k)s, which weren't in widespread use until the early 1990s, boosted household ownership of stocks to levels that covered a majority of Americans, even after the 2008 financial crisis:

Percent of U.S. Households Owning Publicly Traded Equities or Mutual Funds



Source: Gallup, James Poterba, MIT

Which is to say: Investing as we know it is a pretty new idea. It's hard to overemphasize this point. In her book *Bull!*, Maggie Mahar writes:

> *In 2002, fully 56 percent of those who owned stocks or stock funds had purchased their first shares sometime after 1990, while 30 percent of all equity investors had gotten their feet wet only after 1995.*

The democratization of stock ownership over the last 30 years is one of the most important developments in financial-market history.

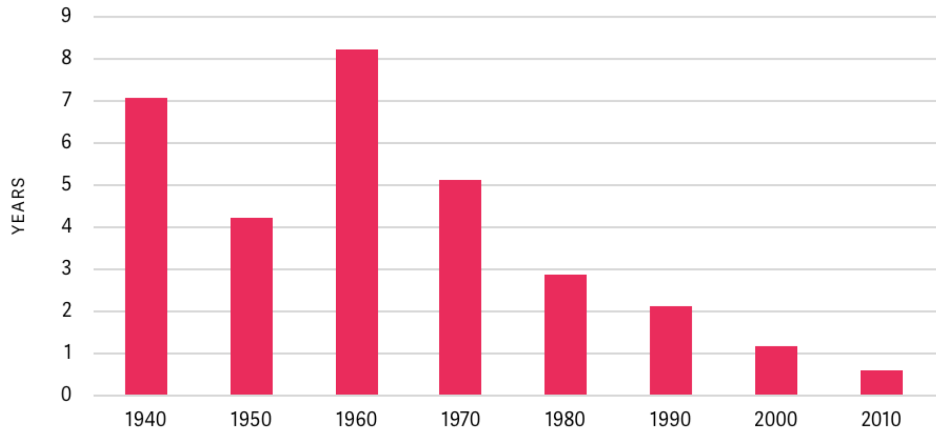
And it happened at the same time as another powerful trend.

Just as more people began relying on stocks, the way markets operate and the way we think about stock markets fundamentally changed.

In short: Our attention spans shrank.

The amount of time the average stock is held for has fallen off a cliff, from more than seven years to less than one:

Average Holding Period for Stocks by Decade



Source: LPL Financial, NYSE

This is part of the reason people like Hastings are given such a hard time by investors. For most of the short history of the stock market, investing was a long-ish endeavor where profits accrued slowly over time. Today, the attention is on the here and now, over the next 90 days.

It is, I think, the most powerful market development in the last half-century. And it impacts whether our most innovative companies choose to be public companies at all.

Three important things occurred over the last half-century that caused investors to think in shorter and shorter periods.

1. *A surge in asset managers increased competition for returns*

In 1990 there were 610 hedge funds managing $39 billion of assets, according to Hedge Fund Research. Today there are nearly 10,000 hedge funds controlling more than $3 trillion of assets. There are another 9,000 mutual funds in the United States, bringing the number of actively managed fund companies to roughly 19,000. For perspective, there are about 13,100 Starbucks locations in the United States.

Asset management is one of the most competitive industries in the world. And most of that competition came onto the scene in just the last 25 years.

With so many funds to choose from, institutional investors that invest in hedge funds have a hard time distinguishing luck from skill. Unwilling to wait five or ten years to see if a new manager has what it takes, results are demanded in increasingly shorter periods of time. *Prove yourself today, or else I'll move onto the next manager.*

The average lifespan of a hedge fund is 3.5 years, according to David Lee of Ferrell Asset Management. Put another way: From the time a hedge fund incorporates to the time their investors pull the plug and they're out of business is about half the length of the average peak-to-trough market cycle.

It's nearly impossible to be a long-term investor in this world.

So most investors are not long-term investors.

As Henry Blodget once explained, most investment managers are graded based on how they are doing right now, today, this second. "If you talk to a lot of investment managers, the practical reality is they're thinking about the next week, possibly the next month or quarter," he said. "There isn't a time horizon; it's how are you doing now, relative to your competitors. You really only have 90 days to be right, and if you're wrong within 90 days, your clients begin to fire you."

I remember watching CNBC in March 2009—the month the market bottomed during the Great Recession. Reporter David Faber remarked that most managers he talked to said they were confident the market was nearing a bottom, and a big rally was due. "So how are you positioned?" he asked them. "Cash," was the most common response, he said. Faber explained that even though managers wanted to own stocks, they couldn't afford to have another down month. Their investors would start to fire them. So cash was the preferred option, even if they knew it was subpar.

Professional investing has turned into something akin to the restaurant business. There are so many options to choose from that customers demand perfection right here, right now, which causes the failure rate to be off the charts. One bad experience in a restaurant and a customer has dozens of other options to choose from. Same for professional investing. The question investors need answered is not "What can you do for me in the long run?" It's "What are you doing for me right now?" Investors hold people like Reed Hastings to short periods of time because they, themselves, are held to such short periods of time.

2. *The ease and cheapness of trading sparked by the deregulation of brokerage commissions*

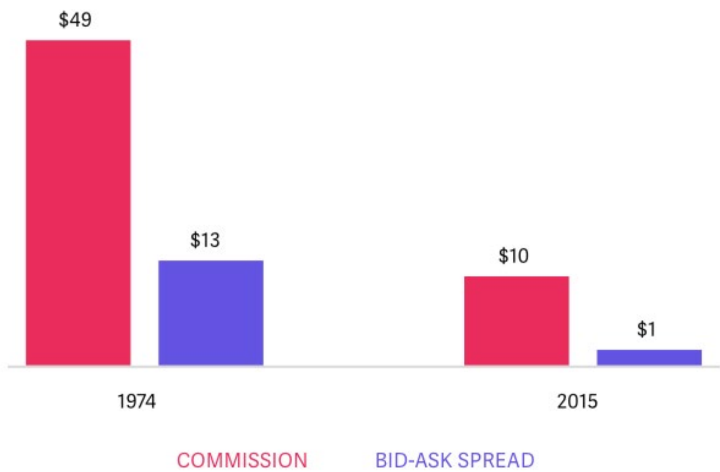
When the New York Stock Exchange formed in 1792, it set a firm rule: Trading commissions charged by brokers were to be fixed, and equal among anyone with a seat on the trading floor.

It stayed that way for the next 183 years.

Jason Zweig of the *Wall Street Journal* writes: "With some minor exceptions, for 183 years it had cost the same amount per share to trade 100 shares as it did to trade 1,000 or 100,000—and brokers regularly shaved 2% or more for themselves off the typical trade."

That changed in 1975, when commissions were deregulated and a new free market was set loose. Brokerage commissions plunged overnight, and new discount brokerages like Charles Schwab came to life. Zweig shows how big an impact this had:

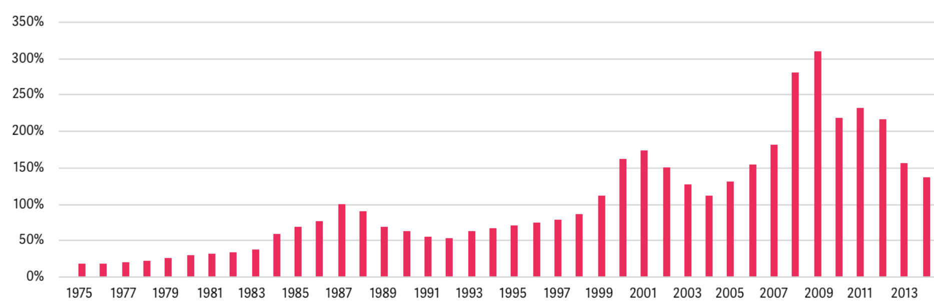
The Cost of Trading Before and After Commission Regulation



The result of deregulating commissions and the ensuring plunge in trading costs was predictable: Trading volume went up.

As a percentage of market capitalization, total annual market trading doubled between 1975 and 1983, and then quintupled by 2008:

Stock Value Traded as a Percentage of Market Capitalization



Source: Federal Reserve

With cheaper trading creating more liquidity, the ability to exploit short-term market inefficiencies and anomalies also went up.

It was too costly in the 1960s to, say, buy Coke stock before earnings with the intention of squeezing a few basis points out of the market's reaction.

With a 2% trading commission, the only trades that made sense were those that could earn a big return. And where do most big returns come from? Long holding periods. High fees by their nature encouraged long-term thinking.

But with trading commissions that now round to zero, investors can efficiently and economically exploit the smallest of market movements that occur in increasingly shorter periods of time.

So that's where our attention span has gone.

In his book *Flash Boys*, Michael Lewis writes:

> *One day, investors woke up to discover that they'd bought shares in some company for $ 30.0001. Why? How was it possible to pay ten-thousandths of a penny for anything? Easy: High-frequency traders had asked for an order type that enabled them to tack digits on the right side of the decimal, so that they might jump the queue in front of people trying to pay $ 30.00.*

This is the kind of stuff you can get away with in a world where commissions round to zero. *And it's new.* It didn't exist 40 years ago. Or even 10 years ago.

3. *Technology as a trading platform*

A fundamental characteristic of stock exchanges before about 30 years ago is that almost nothing moved faster than the speed of a human.

Art Cashin, a familiar face on the New York Stock Exchange for almost half a century, once told me a story about what the NYSE was like in his early days:

> *"In the summertime it was popular to wear straw hats of the kind with the hard brim. There was actually a rule that you couldn't wear a hat with a hard brim on the floor for fear that if I were rushing and you were rushing, we'd wind up poking each other in the eye with the hard hats."*

This is what happens in a world where, according to Cashin, there could be more than 4,000 people at a time trading on the floor of the NYSE.

Here's the NYSE today. It's a dozen or so people, many of whom are media-related:

In Cashin's early days, high-speed trading was done with pneumatic tubes sent through the basement of the NYSE, like at an old bank. Today, almost everything is done by computer, and some of the fastest computers in the world. High-frequency traders have begun measuring trades in picoseconds, or one-trillionth of a second.

Ronan Ryan, an executive at startup exchange IEX, once told me a fascinating story about how competitive high-frequency trading has become.

HFTs want to have their servers in the same building as the exchanges, because less distance between you and the exchange means your data reaches the exchange servers a millionth of a second faster than if you were a few miles down the road. Here's Ryan:

> *What happened is when NYSE first allowed [traders] to collocate in the [same building], people started to get into pissing matches over the length of their cables. Just to give you an idea, a foot of cable equates to one nanosecond, which is a billionth of a second. People were getting into pissing matches over a billionth of a second.*

To quell the arguments, exchanges mandated that traders use the same length cable. Here's Ryan again:

> *NYSE measured the distance to the furthest cabinet, which is where people put their servers. It was 185 yards. So they gave every [high-frequency trader] a cable of 185 yards. Then, traders who were previously closer to the [exchange server] asked to move to the farthest end of the building. Why? Because when a cable is coiled up, there's a light dispersion that is slightly greater than when the cable is straight.*

Technology has driven the speed of trading down to levels we couldn't fathom even 10 years ago. So much money is traded at such unbelievable speeds that what's happening here and now—this millionth of a second—is the priority. The next quarter, year, or decade isn't an afterthought. The business itself isn't even an afterthought.

Even if investors want to look at the long run, the havoc high-speed trading can do in the short run harms confidence and gives the impression that the market is anything but a long-term game.

"You have people looking at the stock market and calling it a crapshoot or a casino," Seth Merrin, CEO of brokerage Liquidnet, said a few years ago, responding to the May 2010 flash crash. Nearly half of 18-to- 30-year-olds agree with the statement, "I will never feel comfortable investing in the stock market," according to MFS Investment Management.

Can you blame them? The same bank that says it takes five business days to settle your paycheck measures stock trades in picoseconds. This is not a system conducive to trust.

Part 2: The Problem

Ford Motor did not go public until 1956—a half-century after its founding. This was not the industry norm. GM had been a publicly traded since 1916.

Ford stayed private for as long as possible because Henry Ford did not like people telling him what to do. When Edsel Ford attempted to prod his father to take the company public, Henry Ford replied, according to biographers: "I'll take every factory down brick by brick before I let any of those speculators get stock in the company."

It's not a bad philosophy.

Richard Branson, who changed the world by taking enormous, long-term risks, put it this way: "Fortunately we're not a public company—we're a private group of companies, and I can do what I want."

Going public usually means giving up control of your company. Giving up control today can also mean giving up destiny.

Two years after his taking computer company private, Michael Dell reflected that "the last two years have been fantastic for me." By "not [being on] the 90-day shot clock" of constantly worrying about earnings, Dell said, he could focus on the long run. He even recommended it: "I'm even more convinced that going private is the right thing for you and your company."

This is not anecdotal. There is evidence that private companies make better capital decisions than their public peers. Accounting professor Kristian Allee once crunched a database of public and private companies and concluded:

> *We find robust evidence that public firms are associated with significantly lower operating profitability three and five years into the future when compared with private firms and that the differential future profitability is driven primarily by future profit margins. We also find that the association between the lower future profitability of public firms is more pronounced for firms in short-term focused and highly competitive industries.*

Why does this happen? Here's one example.

In 2006, Deutsche Bank did a study on how the average public corporation responds to a cash crunch.

What's first thing to be cut when a public firm runs low on cash? Basically, anything but the dividend:

> *After cutting deferrable investment, North American firms would borrow*

money to pay the dividend, as long as they do not lose their credit rating. Next, they would sell assets at fair value and cut strategic investment. Only if all these actions are insufficient, would they resort to a dividend cut.

Why would you cut investment before a dividend? Here's the report:

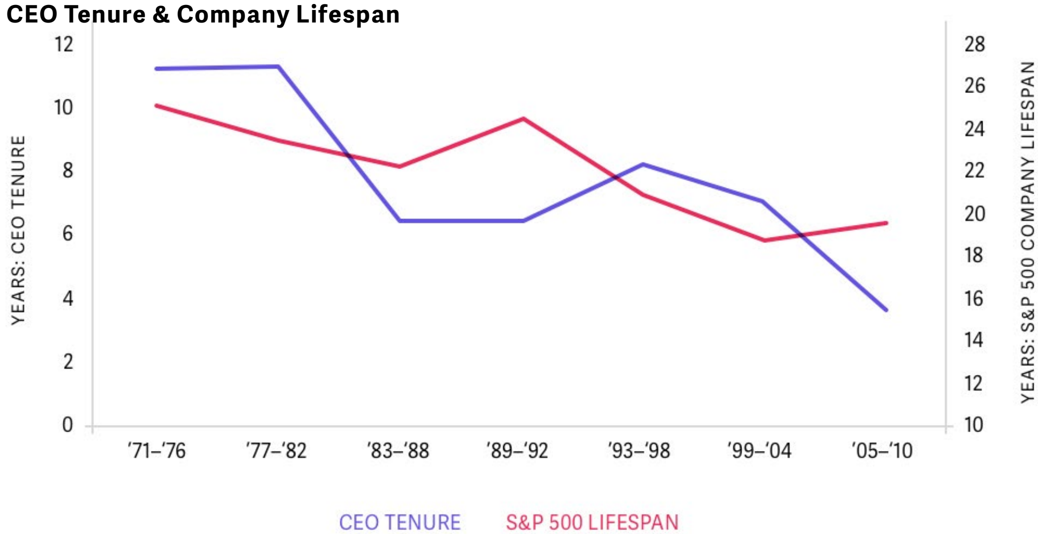
Even if an investment can be deferred, deferral is not free. North American firms are willing to pay this cost, presumably because they feel that the negative signal associated with the dividend cut outweighs the cost of deferral.

The message is clear: Dividends, which benefit shareholders this quarter and next, take precedence over investment, which bene it shareholders years down the road— in potentially larger ways. Small returns today are prioritized over larger returns tomorrow.

A public-company CEO acting this way—and increasingly acting this way—makes rational sense when you put yourself in their shoes.

The average CEO tenure at S&P 500 companies has been cut by more than half over the last 40 years. The lifespan of public companies themselves has also declined:

CEO Tenure & Company Lifespan



Source: Conference Board, Foster.

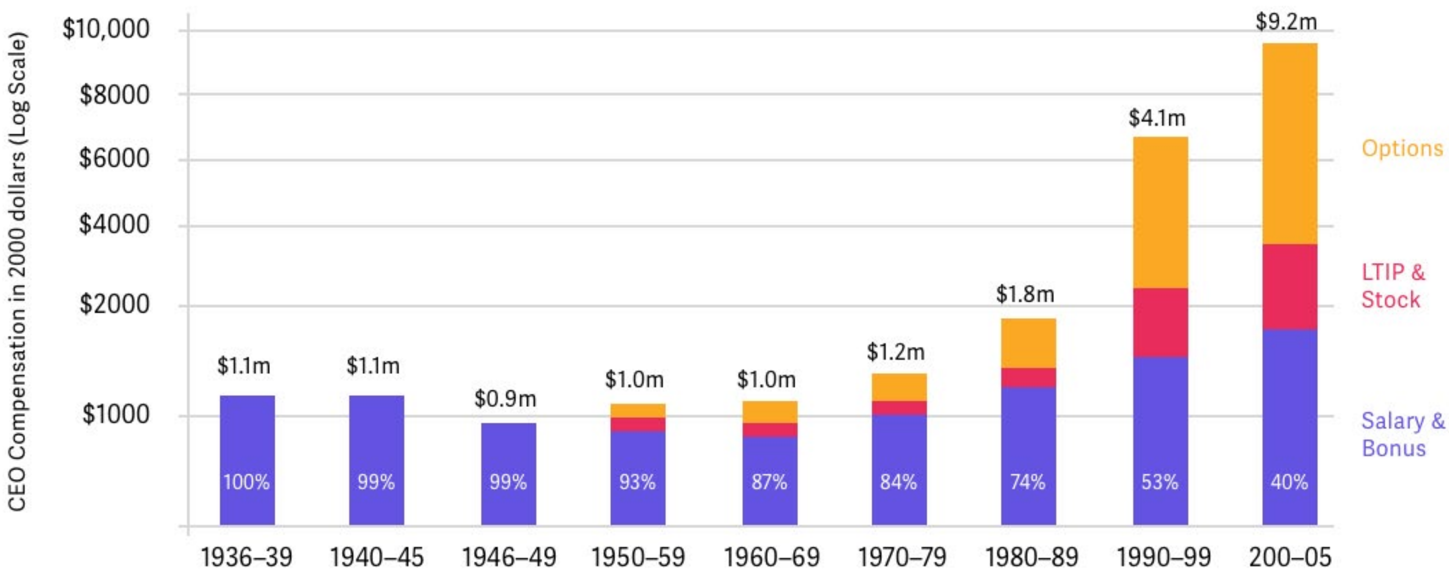
Most CEOs can't think about the next 10-20 years, because there may not be be another 10-20 years. They'll be long gone before any long-term investment bears fruit.

And two things have happened to CEO compensation over the last 30 years.

Real compensation has gone way up, and the structure of compensation has shifted from nearly all cash to heavily tilted toward equity and options.

Which is to say: Today's CEO has a huge incentive to perform, and that incentive is often a stock option that may extend a year or two into the future. So that's where their attention and managerial skill resides.

Composition of CEO Compensation



Source: CEO Compensation, MIT

All of which is to say: I understand why both investors and CEOs act the way they do. It's what the competitiveness and incentives of our public markets have given us.

But even if this short-term behavior makes sense, no one should accept it. It has downsides.

When public markets don't provide an efficient home for long-term focused companies, the good ones will find a home somewhere else.

Which is exactly what's happened.

Private equity assets have swelled almost sevenfold in the last 15 years, from $600 billion in 2000 to more than $4 trillion today.

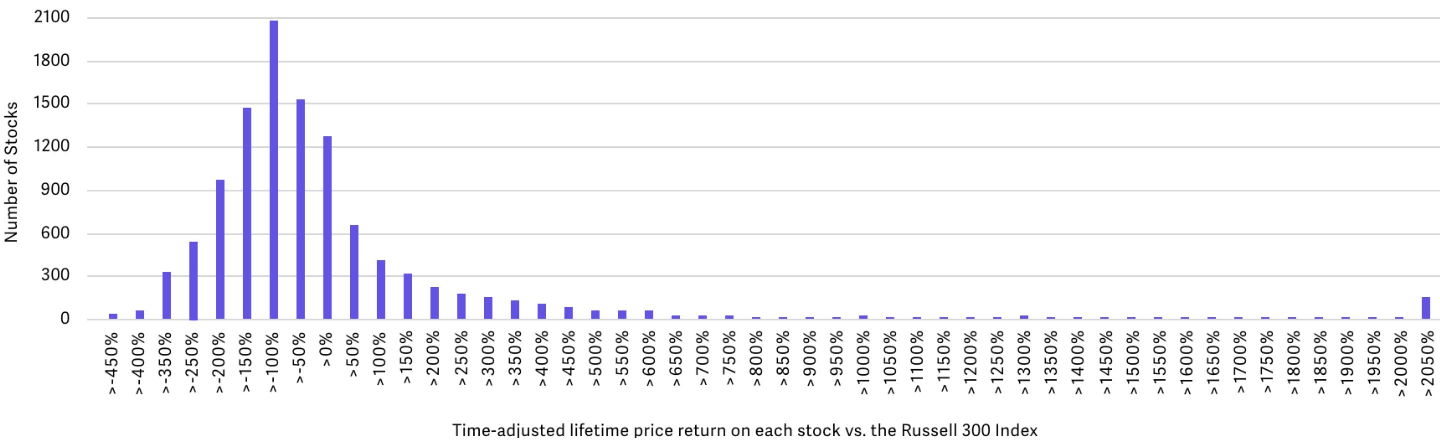
As a percentage of public-equity market cap, that's a rise from about 4% to more than 16%. So private equity, all else equal, has captured about twelve percentage points of equity market share over the last 15 years. Trillions of dollars of companies that may have be public 15 years ago are now private.

That’s a big deal for individual investors who rely on public-market returns to drive their retirement accounts.

The math of stock market returns blows people’s minds. According to research from J.P. Morgan Asset Management, the median stock in the Russell 3000 Index underperformed the overall index by almost 100 percentage points from 1980 to 2014. Fully two-thirds of stocks in the index underperformed the market average over this period.

The huge majority—effectively all—of overall index returns came from fewer than 7% of index constituents, on the far right of this chart:

Distribution of Excess Lifetime Returns on Individual Stocks vs. Russell 3000, 1980–2014



Source: FactSet, J.P. Morgan Asset Management

This is not a fluke. In most diversified portfolios, overall returns are driven by a small number of holdings. This is partly why diversified index investing has historically outperformed active managers: It’s hard to keep up with the market if you don’t own the small handful of stocks that drive most of the market’s returns. One of the top factors determining mutual fund performance over the last decade has been: Do you own Apple, Google, and Facebook? Few other things mattered.

You can see how this becomes a problem when fewer companies go public.

What happens to public-market returns when the next Facebook, Google, Apple, or Microsoft chooses to stay private?

The answer is: They could be considerably lower.

Consider that in 2015, more than 100% of the S&P 500’s gain came from Facebook, Apple, Netflix, and Google. This was true in the late 1990s as well. The market rose 27% in 1998, more than half of which came from Dell, Lucent, Microsoft, Pfizer, and Wal-Mart alone, according to Merrill Lynch.

Flip this around and ask: What would market returns have been if Facebook had gone public as a $500 million company, rather than waiting until it was a $104 billion company? What if Apple were taken private 15 years ago? What would market returns have been over the last few years if Snapchat, Uber, Airbnb, and Palantir had all been public—as they likely would have been in a different era?

Even given the cap-weighted nature of public market indices, it makes a difference. The top five U.S. private unicorns would already be in the top decile of S&P 500 components by weighting. Despite having a liquidity discount, Uber is larger than American Express. Airbnb is larger than Waste Management. WeWork is 50% larger than Whole Foods. And virtually none of their returns are accruing to public investors.

No one wins in this situation.

Companies that could have broader and deeper access to capital in public markets stay private because public markets have been so unforgiving, and public investors are stuck with a less-dynamic set of companies to invest in at the very moment they need public-market returns to fund their retirements.

What can we do about it?

Part 3: Solutions

Changing this system is massively complicated. But three things could help—two fairly simple, one quite ambitious.

1. *A capital-gains tax structure that truly incentivizes patient capital*

Most investors have two capital gains tax rates: Short term (less than one year) and long term (more than one year).

The problem is that one year is not long term in a world where most investors have goals multiple years or decades into the future. Selling a stock you held for for 365 days does not deserve a reward. And anything less than, say, six months is not short-term investing; it's speculation.

One proposal floated for years but never gaining traction is a higher-tiered capital gains tax with a punitive rate at short holding periods, and an extremely low rate at true long-term periods.

Proposing the ideal rates are beyond the scope of this report. But what if, say, any gains on public stock held for less than 90 days were subject to a 50% tax, less than one year were taxed at 40%, less than five years, 30%, more than 10 years, 10%, and more than 15 years, 5%?

Behavior would shift toward long-term investing.

We already see this within retirement accounts, were penalties incentivize people to think about their investments for long periods of time. What's a fundamental characteristic of retirement accounts versus traditional accounts? Few transactions and low turnover. Professors Brad Barber and Terrance Odean showed this in their seminal paper *Trading Is Hazardous to Your Wealth*. After scouring more than 66,000 brokerage accounts, they concluded:

> *Turnover in tax-deferred accounts is high: 67.6 percent annually (monthly turnover of 5.63 percent times 12), though not as high as in taxable accounts: 89.4 percent annually (monthly turnover of 7.45 percent times 12).*

If markets teach us anything, it's that people respond to incentives. If investors become more incentivized to think and hold for the long term, that's where they'll push their fund managers, and fund managers will in turn push corporate managers.

2. *A more inclusive and open IPO process*

The current IPO process is a joke for investors and a hassle for corporations.

For most of history, when information was scarce and didn't travel far, investment banks had to allocate initial public offerings to a small set of institutional investors. To entice them, bankers engineered an IPO price that may generate an initial "pop," providing quick and easy returns for those allocated pre-IPO stock. There wasn't an efficient way to let small investors in on the process, given technological and information demands. It would be too inefficient and too expensive.

That is no longer the case. In the 21st Century, we need an IPO process that is open, transparent, and as equitable as it should be in a country where more than half of households participate in the stock market.

Google, Morningstar, and Sam Adams have shown that, with a little courage and planning, you can take a company public in a fair and orderly way. Google and Morningstar used variations on an auction process that collects market bids and sets an IPO price based on those bids.

Albert Wenger of Union Square Ventures describes how something similar should become the norm:

> *In the year 2016 here is how a company should go public. The company, with the help of banks, brokers and the exchange should build a complete*

> *buy and sell order book. The IPO price and the opening trade should be one and the same. To help facilitate this, the float should be meaningful, requiring both a primary and secondary component to the IPO.*

Part of the process has to include a renewed sense of transparency. Here's Wenger again:

> *We should also get rid of the private road show. The company should hold multiple public streaming sessions and take questions (known as an earnings call once a company is public). Again, in the age of the Internet there is exactly zero reason to have private discussions prior to an IPO, which is supposed to be an "initial *public* offering—otherwise we should call it what it currently is: "BCD"—best club deal.*

The idea is that going public should be an honorable step companies strive for, not a spectacle of rewarding a few institutional investors with a 30% one-day return.

3. *A whole new system*

Inertia is hard to stop. Too many lawyers, bankers, and consultants make a good living from the current public market to have any appetite for change that might rock the boat.

Often what's needed in a system as broken as our public markets have become is a fresh start, reimagined from the beginning.

The Long-Term Stock Exchange is attempting just that.

Upset by what he saw as a broken public market and waning IPO supply, Eric Ries set out to build a better system that gives public companies the freedom to think and act in a long-term way.

LTSE is building a new stock exchange with sticks and carrots to bring investors and public companies on the same page. It's based on a simple idea: Things work better when everyone is incentivized toward a long-term view.

Companies that list on LTSE must design executive compensation guidelines that focus on the alignment of compensation with long-term value - including provisions like vesting after an executive has left the company, to ensure he or she truly makes long-term decisions while they're at the helm. On the other side, shareholders with longer tenure will get greater voting power than those who have owned shares for a short period of time. Both sides will enjoy better access to information: Investors will have a broader view of things like R&D and how a company invests for the future. Companies will get a clearer view of who their investors are and when long-term investors, as a class, are buying and selling.

It’s based on aligning goals of everyone in the system. Being a public company today is an exhausting endeavor, where management must spend an inordinate amount of time focusing on short-term actions to please the market. With LTSE, Ries told Quartz, “they spend more of their energy focusing on serving customers, less on the kind of distractions that cause a lot of value to be destroyed in today’s markets. And therefore everybody makes more money.”

We are not passive in this mission. The Collaborative Fund recently invested in LTSE. We see its mission as critical to the success of a broad-based capitalistic system built for the 21st Century.

The concept of being a public company is a great idea. But today’s market highlights the bad side of that good idea. Irving Azoff, an entertainment executive, recently said “You can’t be an entrepreneur and work in a public company anymore.” He’s (mostly) right. And no one should be happy about it.

By understanding how we got here, what the problem is, and what we can do about it, we can push the system toward a better way—a happy home for businesses that generates the greatest returns for long-term investors.