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summaries

SIGMA INVESTMENT COUNSELORS

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UNINTENDED CONSEQUENCES

Over the past two decades or so the number of publicly traded companies in the United States has shrunken dramatically. According to Bloomberg.com, the tally of companies listed on US stock exchanges in 2017 (roughly 3,600) was less than half of that compared to 1997 ("Where Have All the Public Companies Gone", April 9, 2018, Bloomberg.com).

It is easy to ignore this as meaningless chatter coming out of Wall Street, but one of the reasons the US has retained its century long leading position as a global powerhouse is because it has uniquely captured the essential economic ingredients of prosperity and poverty alleviation – intelligent innovators, adequate capital and the rule of law. Hence, the shrinkage in the number of public companies should be a source of concern. It results from the negative impact of the laws of unintended consequences. The causes? There are several.

MARKET FORCES

Consider the following headline:

Number of merger and acquisition deals worldwide 1985-2021

Over one million merger and acquisition (M&A) deals have been completed globally over the past 35 years. 2020 was the worst year in terms of the number of deals completed since 2014, and 10,000 deals were closed in the first four months of 2021. (Statistta.com; Jennifer Rudden, Oct 19, 2021). Not all companies acquired or merged out of existence were publicly held, but a significant number were. The "urge to merge" has accelerated in the last two decades.

In addition to the impact of mergers and acquisitions reducing the volume of publicly traded companies, curtailed bank lending has also been a factor. Banks are routinely prompted by regulators to avoid lending to certain, disfavored industries (and debt capital is as important as equity capital for economic development). Therefore, a reluctance to lend, stifles progress.

Several years ago, payday lenders were considered to be a disfavored industry and many went bankrupt due to regulations and lender avoidance. While not weighing in on the merit of payday lenders, the reality is that government regulations designed to starve certain companies of funding means that a critical form of capital for business formation is denied. Interestingly, last year, the state of New Mexico considered payday lenders "essential businesses."

More recently, US banks have been pressured by policy makers to restrict lending to fossil fuel energy companies while imploring non-US fossil fuel companies to increase oil production!

Finally, scores of investments pools are forming, or have been formed, to enable predominantly well-heeled investors and institutions to acquire private companies that wish to remain private. Cutting off smaller investors like this could prove harmful to them - missing out on returns.

NEW LAWS/REGULATIONS

In 2002, the law known as Sarbanes-Oxley was passed in response to the dot.com bust and related financial scandals of the late 1990's. The purpose of this law was to discourage corporate executives from taking advantage of public shareholders. In particular, companies seeking to go public were required to enhance their disclosures to shareholders and prospective investors. In addition, executives became personally liable for significant errors and omissions.

In 2010, and in response to the Great Recession of 2008, the Dodd-Frank Wall Street Reform and Consumer Protection Act was passed which further restrained companies as it related to responsibilities towards customers and shareholders.

While the intent of these laws is noble, they raise the capital cost of companies going public and discourage many successful entrepreneurs from accessing public capital markets where smaller investors – like their larger brethren - gain opportunities for productive investments.

IMPLEMENTED AND PROPOSED TAX CHANGES

The recent proposal (since rescinded) to tax billionaires' wealth received extensive media coverage and the ensuing congressional deliberations revealed that billionaires whose wealth was held in the form of publicly traded stock would be at a disadvantage to those billionaires whose wealth resided in private companies. "Many of the richest people in America own private businesses that are quite hard to value and seem likely to be excluded," said Eric Zwick, a finance professor at the University of Chicago Booth School of Business. "The tax could end up exempting a lot of wealth held at the top, which is what we've seen with these taxes in Europe." (Democrats Target 'Buy, Borrow, Die' With Their Billionaire Tax Plan; Bloomberg.Com, 10/27/21).

The clear recommendation advisors would provide to billionaires to mitigate the effect of this proposal, whether enacted now or in the future, would be to ensure they retain private company status, or if their wealth is largely from the shares they own in their publicly traded company, to take the company private.

CONCLUSION

In concert, and for the reasons cited above, it is reasonable to expect that fewer and fewer companies will turn to the public capital markets for financing. As a result, ordinary investors could miss out on the opportunities provided by new companies. The unintended consequences of those foregone investment returns to ordinary investors could very well impair the means for a successful retirement.

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