FINANCIAL TIMES
MONDAY 29 OCTOBER 2018

OPINION

Markets Insight

The paradox at the heart of the US stocks rally

Buybacks and passive investing combination should worry even equity bulls

SUPRIYA MENON

Whichever way you cut it, the scale of the post-crisis US stocks rally has been impressive.

Investors brave enough to have bought and held since March 9 2009 have enjoyed a 310 per cent cumulative return from the S&P 500, or 16 per cent a year. The index has gone 3,510 days without a fall of more than 20 per cent — its longest winning streak on record, backed by a pretty remarkable performance in the benchmark's constituents. Corporate earnings have risen 8 per cent a year — in line with the long-term average — while gross profit margins have expanded to a historic high of 11.3 per cent.

And yet for all this, there's a paradox at the heart of the rally. It appears to be the most unloved bull market in living memory.

Intuitively, a record-breaking run should have been accompanied by equally unprecedented levels of investor backing. Yet the data tell a different story. Investors have been rather unenthusiastic participants.

Comparing the amount of money invested in equity funds to that flowing into fixed income funds over the nine-year period, it turns out that investors have allocated about twice as much of the total capital they've invested to bonds than to stocks. That's the first time this has happened in any of the equity bull markets of the past three decades.

To unravel this conundrum, there are other, more structural, factors to consider.

The first of these is share buybacks. Spurred on by a sharp fall in the cost of debt finance relative to equity, companies in the S&P 500 index have bought back just close to $4.5tn of their own shares since 2009, equivalent to about a quarter of their total market capitalisation. That is an even higher figure than the $3.5tn of US government bonds the US Federal Reserve amassed under quantitative easing.

On average, large-cap US groups have repurchased $380bn more shares than they have issued each year. That's a dramatic reduction in the supply of stocks that we estimate accounts for about a third of the S&P 500's gains since 2009.

And investors should know that the buyback trend is unlikely to reverse any time soon. Thanks to the Trump administration's tax cut on corporate cash repatriated from overseas, share repurchases could become an even bigger feature of the investment landscape over the next 18 months to two years.

So far, US companies have brought home about a third of the cash they had accumulated abroad. This means there is still up to $2tn of it sitting idly in overseas accounts. Further boosting the pot available for buybacks are multi-nationals' foreign profits — US firms are generating an additional $100bn of international earnings every quarter. It's for these reasons that analysts such as those at Goldman Sachs believe share repurchases could exceed $1tn this year.

But there is more to the equity market shrinkage than share buybacks. There is also a shortage of tradable stocks. For this, it is not US companies that are to blame but their shareholders — or rather, the growing number of investors who prefer to own their piece of corporate America via index-trackers.

Since 2009, the proportion of US equity fund assets held in passive rather than actively managed vehicles has grown from 25 per cent to more than 45 per cent. Most of that money has flowed into S&P 500 index-trackers run by one of the world's three largest money managers. These three investment houses between them now control about 20 per cent of the largest 100 stocks in the benchmark.

This has serious implications for the functioning of the equity market. The mechanics of indextracking dictate that the shares of companies with large weightings in the main indices attract the lion's share of investment flows irrespective of their underlying fundamentals. And when a large enough percentage of stocks is owned by shareholders who can't vote with their feet, the process of price discovery starts to break down.

In other words, the growth of passive investment appears to be creating a captive market: capital can flow in easily, but struggles to come back out, reducing the total amount of shares that can be traded.

So if the S&P 500's record-breaking does indeed reflect changes in the supply of tradable securities and in the motivations of equity investors, then it could be argued that future market corrections will be shallower than those of the past. The sell-off we saw in January proved to be shortlived. It could be that the one that began in October fizzles out too.

More worrying, though, is that the combination of buybacks and passive investing could lead to a significant misallocation of capital in the world's biggest economy. That's something that even the equity market bulls should be concerned about.

Supriya Menon, senior multi-asset strategist at Pictet Asset Management