

## What are stock exchanges for? And why should we care?

*This is a short summary of our latest report on ‘What are stock exchanges for? And why should we care?’ The paper is part of the [Purpose of Finance initiative](#) on which New Financial is collaborating with Pension Insurance Corporation. You can download the full paper [here](#) and an infographic [here](#)*

### >>> Introduction:

#### **1) The paradox of stock exchanges**

Stock exchanges have played a vital role at the heart of the economy helping companies raise capital for more than 200 years. Healthy stock exchanges are crucial to financing growth and innovation. They provide access for companies to a deep pool of capital, enable price discovery, spread risk, help widen and share wealth creation, and improve transparency, accountability and corporate governance standards. But something is wrong.

In this paper we highlight ‘the paradox of stock exchanges’: on many measures, stock exchanges are bigger, more liquid and more efficient than ever before - but fewer and fewer companies are choosing to be listed on them or to use them to raise capital. The value of stockmarkets in the UK and US has risen more than six-fold in real terms in the past 50 years and the value of trading in listed companies listed in the UK and US has increased by more than 50 times in real terms.

But the number of companies that are listed on stock exchanges in the UK and US has roughly halved over the past 25 years, the number of new listings has dropped by three quarters, and the amount of capital being raised on stock exchanges has dropped by around two thirds in real terms.

The main thesis in the paper is that over the past 25 years the pendulum has swung too far from raising capital to trading as a result of a range of factors, including: the growth in alternative sources of private capital; the rapid growth of cheap and tax-friendly corporate debt; shifts in regulation and the increased burden on listed companies; and structural shifts in the financial industry, particularly the increase in scale and complexity of the markets. We think without urgent action, there is a risk that this vital engine for raising capital, sharing risk, and widening participation in wealth creation, could be seriously undermined.

#### **2) The purpose of stock exchanges**

We define the fundamental purpose of stock exchanges as capital formation and intermediation: they provide a centralised marketplace to enable companies to raise capital from investors who have it, and to enable those investors to trade shares in listed companies. This intermediation involves a delicate balance between overlapping and often competing interests of different groups (issuers, investors and intermediaries). This juggling act can be broadly split into primary markets (raising capital) and secondary markets (trading and price discovery).

The two sides feed each other: a strong flow of new companies raising capital in the primary market requires a healthy secondary market in the shares of those companies, while a strong secondary market requires a healthy flow of listed companies in the primary market. Like any market, the secondary market side of a stock exchange’s business provides the vital function of price discovery (setting a valuation at any given time on the company and its shares). It also provides what is known as the ‘liquidity risk premium’, which means that a listed company with freely-traded shares is worth more than as a privately-held company.

### **3) The history of exchanges**

The initial purpose of stock exchanges was to enable companies to raise more money on a more sustainable basis from a wider range of investors. Indeed, the first stock exchange in the modern sense of the word was actually set up by a company to enable it to raise money: the Amsterdam stock exchange was founded in 1611 by the Dutch East India Company to enable it to raise around €1bn in today's money to fund its trading and exploration voyages. The role of stock exchanges grew rapidly in the early 18<sup>th</sup> century: in the two years running up to the South Sea Bubble in 1720, nearly 200 companies raised an astonishing £48bn in today's money on the London stock market. And in the 19<sup>th</sup> century, stock exchanges played a vital role in funding the growth of railways and utility companies on both sides of the Atlantic: by 1900 the combined value of listed railway and utility companies in London was about £300bn in today's money, and roughly twice that in the US.

### **4) Why should we care about stock exchanges?**

The fate of stock exchanges has a big impact beyond the world of the financial markets in at least three ways. First, stock exchanges play a valuable role in financing growth and investment. Equity is a unique form of financing that is ideally suited to support long-term investment with an uncertain outcome. Equity encourages innovation and improvements in productivity that are required to drive economic growth, and there is growing evidence that listed companies invest more for the long-term in their business than non-listed companies.

Second, public equity markets are a mechanism to reduce inequality and an engine for the wider participation in wealth creation through people's pensions and direct investments. The shift from public to private capital over the past few decades means that high growth and high returns from venture capital and private equity-backed companies are increasingly limited to those investors who are able to invest in private markets – such as wealthy individual investors and the shrinking number of people lucky enough to be part of a defined benefit pension scheme. Millions of individuals coming into contact with the stockmarket for the first time through auto-enrolment pensions are being excluded from this growth opportunity. And third, stock exchanges play an important role setting standards, providing transparency and accountability, and supporting the social licence for businesses across the economy.

## **>>> What has changed over the past 50 years?**

### **5) Shrinking equity markets**

The most obvious trend in stock exchanges in developed markets over the past few decades is that public equity markets have been shrinking: the number of listed companies in the UK and US has virtually halved since the mid-1990s; the number of new listings has slumped by around two thirds; and the amount of capital being raised on stockmarkets has more than halved. In the UK, for example, companies raise around £20bn a year on the stockmarket today, compared with more than £60bn in today's money in the late 1980s. This decline has been particularly acute for smaller companies, where activity in the UK and US has fallen by as much as 80%. Listed companies are becoming bigger, older and (in most cases) less profitable, they're leaving the market at a faster rate than they can be replaced, and share buybacks, acquisitions and delistings are sucking valuable equity out of the market.

### **6) A seismic shift**

At the same time, companies are facing ever greater pressure from investors to deliver short-term results at the expense of longer-term growth. And the huge growth in trading volumes; improvements in technology; the shift in the underlying business model of most exchanges from mutual to for profit companies; and the increased complexity of market infrastructure around stock exchanges, have arguably shifted the main role of exchanges towards the secondary side of the market at the expense of the new issue markets, with a particular impact on smaller companies. The increased scale and complexity of the wider financial services industry, and the rise of passive investment, have changed the economics of the industry and helped to create a bifurcation between a hyper-efficient market for

capital raising and trading for the biggest companies at the top end, and a less efficient and less active market for smaller companies at the other.

### **7) Look on the bright side**

On the other hand, it's important not to over-react to the apparent decline in listed companies. There is little indication in the US or UK that high-potential companies are unable to access the growth capital they need, and the structural shift in the economy over the past 50 years from a reliance on fixed assets to intangibles has reduced the overall of funding required. And new listings are only part of the story: two thirds of the capital raised on stock exchanges is by companies that are already listed. Too much focus on the UK and US can distract attention from the fact that stock exchanges in emerging markets are thriving and many exchanges have launched successful smaller and growth company markets.

### **>>> What have been the main drivers of these changes?**

There is no single factor that explains the decline of listed companies and new issues over the past 25 years, and we have grouped some of the potential causes under three main themes: i) the availability of alternative sources of capital; ii) the cost and burden of being a listed company; and iii) structural changes in the finance industry.

### **8) The growth of private capital**

One of the main reasons why fewer companies are choosing to raise capital on stock exchanges is the rapid growth over the past 25 years in alternative sources of funding. Venture capital has provided much of the growth financing for high potential companies, private equity has provided an attractive and well-funded alternative to being listed, corporate bonds have offered a low cost and tax-friendly source of funding, and selling to bigger companies has become a quicker route to growth than listing.

For example, around the world, there are now nearly 400 'unicorns' (privately-held companies with an estimated valuation of more than \$1bn. In 2013 when the term was first coined by Techcrunch there were 19. Virtually all these unicorns are reliant on venture capital and their rapid growth has been captured by a small number of investors in venture capital firms.

### **9) The cost and burden of being listed**

Listing has many advantages: it enables firms to access the deepest pool of investors to raise permanent capital, gives them a currency to help fund future acquisitions, raises their profile and status, enables shareholders and employees to realise their investment, and it improves standards of governance within a company. However, the cost and burden of being listed has gone up over the past few decades: more disclosure, more corporate governance rules, more public scrutiny, and the high cost of listing in the first place all add up to a perceived increased in overall 'hassle' of being listed.

For example, over the past 25 years in the UK, there have been more reports and codes on corporate governance for listed companies than there have been Prime Ministers (from the Cadbury Report in 1992; the Greenbury Report in 1995; the Hampel Report in 1995; the Combined Code in 2000; the Higgs Review in 2003; the Walker Review in 2009; the Stewardship Code in 2010; and the revised Corporate Governance Code that took effect this year).

### **10) The big shifts in the finance industry**

Financial markets and the finance industry have been transformed over the past few decades. Virtually every corner of the market is bigger and more complex than it used to be. While this growth has brought many advantages in terms of lower costs and greater competition it raises a fundamental question as to whether this increase in scale and complexity has inevitably led to a disconnect and sense of detachment between individual listed companies, the ecosystem that supports them, and their investors. This shift is

particularly acute for smaller companies: virtually every trend in markets over the past few decades - from the shift to electronic trading, tighter regulation of markets, tougher governance standards for listed companies, growth in passive investing and the increase in the scale of investors – has undermined the already fragile economics of the smaller company market.

### >>> What can we do about it?

There is no silver bullet to reverse what appears to be a structural change in the UK and US market. We think there are three main areas that could be improved

#### **11) Rethinking regulation**

High standards of corporate governance and disclosure are a hallmark of high-quality markets and we think it is important to avoid any sense of a regulatory ‘race to the bottom’ to try to kickstart new issues by lowering standards. However, there are a number of areas where regulation can be reviewed and reset, including: reforming the tax treatment of equity finance; resetting regulation to encourage more investment in equity markets by long-term asset owners such as pension funds and insurance companies; improving access to private capital for defined contribution pensions to widen sharing in wealth creation; reducing the disclosure differential between privately-held and public companies by raising standards for large private companies; and developing a less onerous regulatory framework for smaller companies.

#### **12) Collective action**

There are many areas of the market where listed companies, investors, exchanges and intermediaries could collaborate to encourage a different approach to investing, including: different sectors of the industry should work together to support industry-wide initiatives such as the Long-Term Stock Exchange and Focusing Capital on the Long-Term in the US, and the Investor Forum in the UK; reforming the IPO process and dragging it into the 21<sup>st</sup> century (such as shortening the timeframe, wider use of technology, widening access and improving the allocation process); encouraging more direct retail interest in equity; and creating industry-wide initiatives such as pools of capital to invest in smaller companies and supporting the ecosystem around them.

#### **13) Rethinking exchanges**

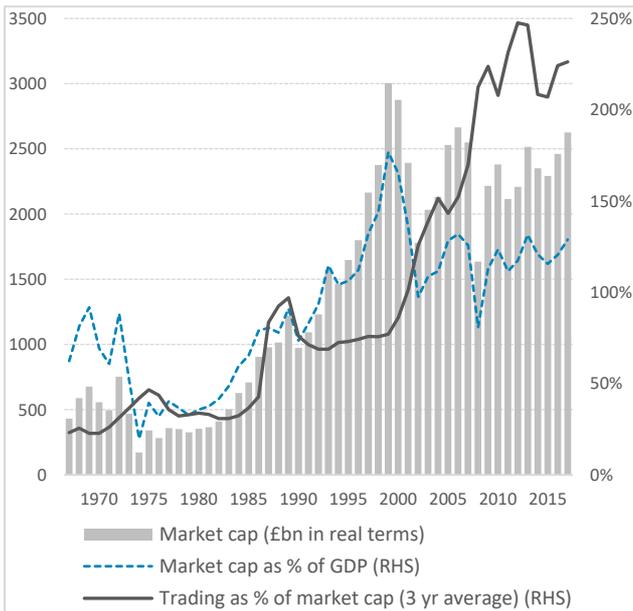
As gatekeepers to the equity markets, stock exchanges play a vital role. There are several ways in which a remodelled stock exchange industry could encourage a renaissance in public equity markets, including: the rationalisation and consolidation of exchanges and market infrastructure; introducing more speed bumps and auctions into trading; investing more in corporate services to support listed companies; developing pre-IPO markets and escalator programmes for companies considering a listing; and focusing on removing the barriers to effective competition between exchanges.

>>> Some key charts from the report:

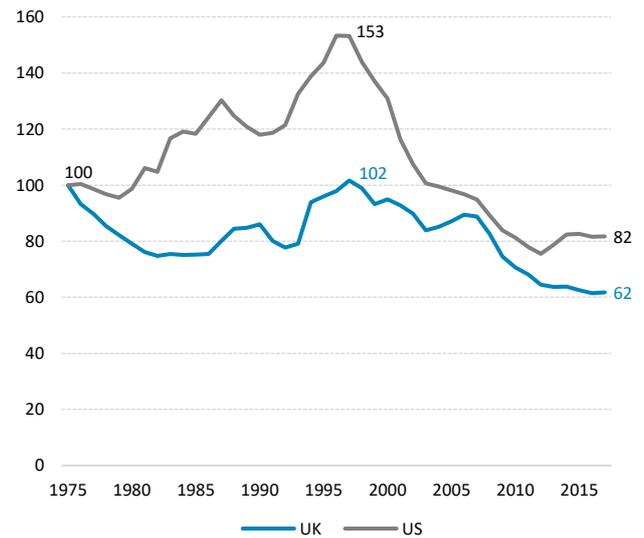
The value of the UK stockmarket and trading volumes has increased significantly in real terms over the past 50 years

The number of listed companies in the UK and US has virtually halved from its peak in the late 1990s...

**Fig.1: The growth in the UK equity market 1967 to 2017:**  
Source: New Financial analysis



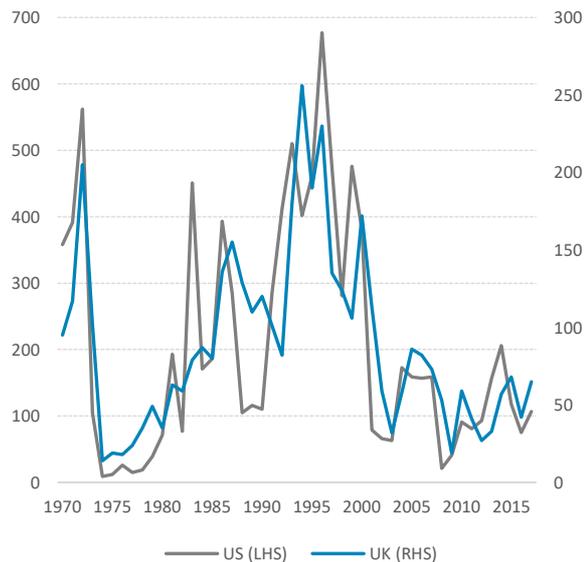
**Fig.2: The number of listed companies in the UK and US 1975 to 2017:** rebased to 1975 = 100  
Source: The listing gap / CRSP, LSEG (includes AIM)



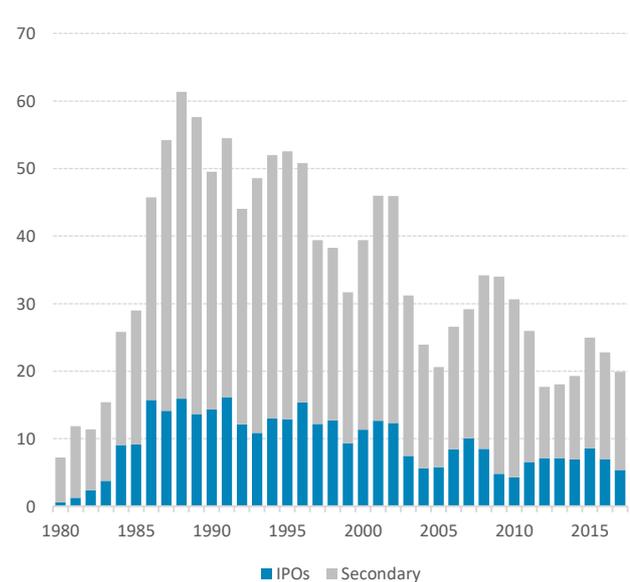
The number of new issues has dropped by more nearly three quarters over the same period...

The value of capital raised on the stockmarket in the UK has fallen by around two thirds in real terms since the 1980s...

**Fig.3: The fall in the number of new listings in the UK & US**  
Number of new issues 1970 to 2017  
Source: The listing gap / CRSP, LSEG



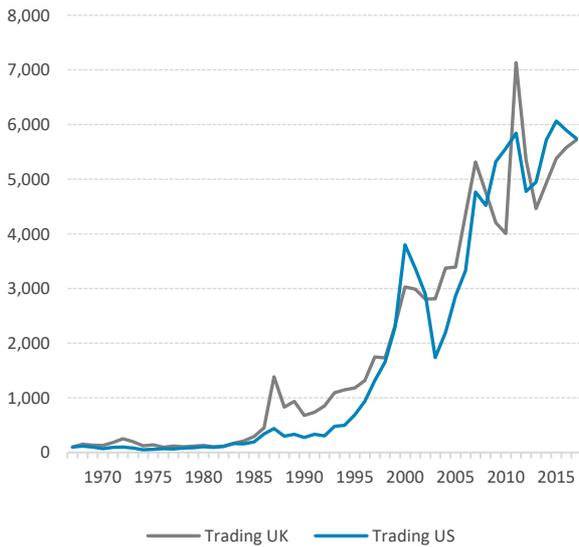
**Fig.4: Total capital raised on the UK stockmarket**  
£bn in real terms, three year rolling average 1980 to 2017  
Source: New Financial, LSEG



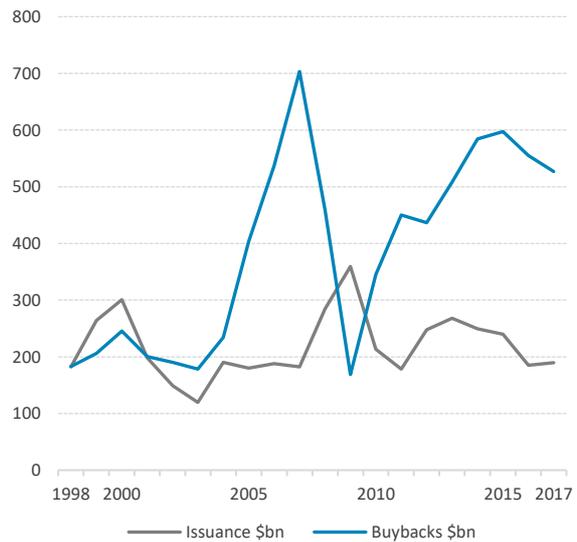
The value of trading on stock exchanges has increased nearly 60 times in real terms over the past 50 years

Over the past 20 years in the US the value of buybacks has been more than double the value of new issues...

**Fig.5: The growth of trading volumes in UK and US equities 1967 to 2017 (in real terms, rebased to 1967 = 100)**  
Source: Stock exchanges, Fidessa, S&P, SEC



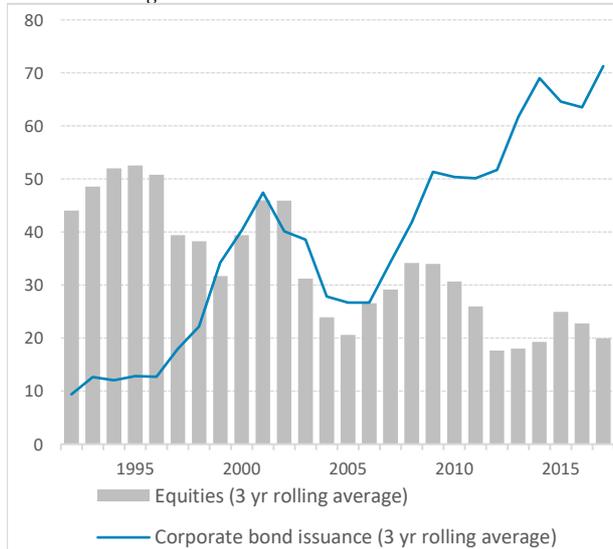
**Fig.6: Buyback and new issuance in the US 1998 to 2017 \$bn in real terms**  
Source: Dealogic, S&P



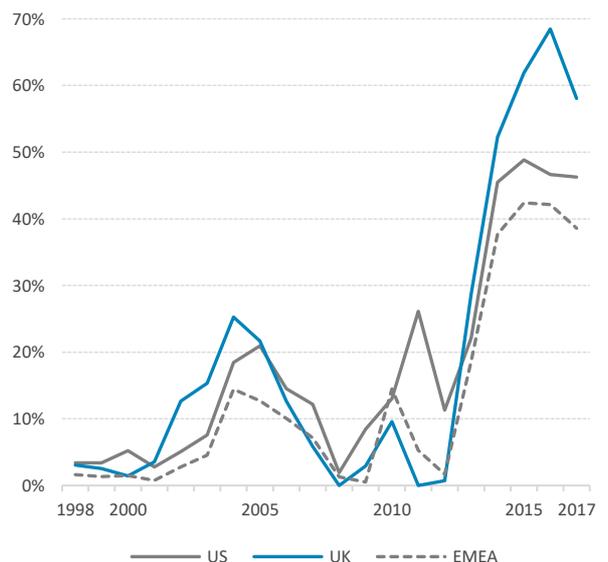
Capital raising in the UK corporate bond market has overtaken equity markets, fuelled by low interest rates ...

Companies owned by venture capital & private equity firms account for a growing proportion of IPOs...

**Fig.7: The rise in corporate bond issuance**  
Corporate bond & equity issuance by UK companies 1990 to 2017, £bn in real terms (rolling three-year average)  
Source: Dealogic



**Fig.8: A tighter grip**  
% of IPOs by value involving in a private equity or VC seller  
Source: Dealogic, New Financial (rolling three-year average)



>>> If I ruled the world...

Here is a selection of responses at a recent dinner we hosted to discuss this paper to the question: ‘If you were an omnipotent but benevolent dictator, what single measure would you take to reinvigorate public equity markets?’:

- **A level playing field:** eliminate the tax differential between equity and debt (equity is effectively taxed four times, while debt attracts tax relief).
- **A statement of purpose:** every firm in the banking and finance industry should publish a clear statement of purpose, how they create wealth, and how they benefit society.
- **Widening ownership:** add ‘widening public ownership of equity’ and ‘capital formation’ to the mandate of regulators.
- **Joined up thinking:** not more regulation but more coherent regulation, with an audit of all new regulation to identify any unintended consequences and analyse how it interacts with existing regulation.
- **Public access to private markets:** democratising access to private capital such as private equity and venture capital.
- **Less is more (1):** accelerated consolidation between European stock exchanges to reduce costs and complexity.
- **Less is more (2):** reduce trading hours on exchanges to limit unnecessary trading (the US market is open for two hours a day less than in the UK)
- **Less is more (3):** Ban quarterly reporting
- **A small contribution (1):** a levy on asset managers to allocate 1% of their assets under management to investing in smaller companies and new issues (that would add up to nearly £80bn in the UK)
- **A small contribution (2):** a small levy on stock exchanges and trading to help fund smaller company research (similar to the Takeover Panel levy of £1 on every trade over £10,000)
- **A new media playbook:** for every negative story that the media write about a company, they should publish a positive story on another company alongside it.
- **A helping hand:** give every baby born in the UK a trust fund of £5,000 fully-invested in equities and top it up with £100 on each birthday (assuming an annual 5% real return, they would have £15,000 by their 18<sup>th</sup> birthday, and it would ‘only’ cost about £4bn a year).
- **Do nothing:** the combination of a return to normal interest rates and the ingenuity of the financial industry will sort it out.
- **Catch them early:** develop a series of children’s cartoons that teach them the basics of financial literacy from an early age (Peppa Pig & Pensions, Iggle Piggle Goes Investing, Duggee Does Derivatives. If you have small children, please send additional suggestions...)