The Exchange

How an ageing population is driving the decline in equities

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Corporate share buybacks in the US have reached a post-crisis high. This matters, because the trend of declining stock volumes on the global stock markets could prove destabilising for the capital markets. According to the Wilshire 5000 index, the number of tradeable stocks on US bourses now stands at around 3,691, down from 6,639 in 2000.

The de-equitisation of the capital markets reflects changes in the dynamics of demand and supply, driven not just by tactical — and thus reversible — shifts, but more worryingly by changing demographics. The latter are structural, deeply entrenched and arguably irreversible.

The ageing population is transforming savers and risk-taking investors into rentiers — meaning an increasingly large proportion of the economy relies on a stable, regular and predictable income derived from past investments.

As baby-boomers become pensioners, this class increasingly favours bond-like instruments and moves their portfolios away from stocks. According to Towers Watson, worldwide pension fund assets under management in the 16 major markets total $36tn — equivalent to nearly half of global gross domestic product. In the seven largest markets, pension asset allocation to bonds (30.6 per cent) was close to that of equities (42.3 per cent), and there is a discernible shift away from other investments towards bonds.

This asset move also suggests that investors are rewarding companies that turn their equity instruments into bonds and bond-like structures, which offer stable cash flows and pay dividends. They are looking for companies that harvest cash flow today rather than investing in those that will grow tomorrow.

In the US context, the class of ageing investors who no longer have the long time frame or horizon to invest, hold the lion's share of savings. Although very rational, their decision could have significant deleterious consequences for the appetite for equities and thus constrain the ability of companies to invest and grow.

The tactical shifts also have an impact on the scale of the equity markets, as companies have an incentive to buy back relatively expensive financing (equity) and replace it with cheaper debt. For instance, the notable mispricing between fixed income and stocks presents an arbitrage. Compared with historically low interest rates, the return on equities is markedly higher. Thus, the spread or equity risk premium — that is, the excess return that investing in the stock markets offers over the risk-free rate — makes a compelling argument for companies to borrow to buy back their stock, reducing the notional value of equities that is tradeable in the market.

Having previously peaked in 2007, S&P 500 companies have spent more than $2tn repurchasing shares in the past five years, and Goldman Sachs forecasts that this will rise by 18 per cent in 2015. S&P 500 buyback announcements have jumped 50 per cent since last year, to $521bn.

Dividend payments are increasing, too — and forecast to rise 7 per cent in 2015, suggesting that companies' managements prefer to return capital to investors rather than invest, as they do not see economically viable and attractive projects in the current market.

In essence, rather than reinvest free cash flows in the business in a world characterised by greater uncertainty (low global growth prospects, an ever-changing regulation and tax environment, no discernible goods inflation), or have cash sitting in the bank earning low interest rates, business managers are returning capital to their shareholders. Again, as a consequence, capital earmarked for equity investments is taken out of stocks and the stock market, and increasingly, as the Towers Watson data shows, directed to low-yielding fixed income instruments.

The trend of less money chasing the equity markets, and more money chasing bonds, has at least two effects: it hurts productivity, which is propelled by innovation, by diverting funds from equity risk investments. This is particularly worrying at a time when global productivity is continuing to stall. However, the market shift also presents opportunities and more attractive returns for growth investors who are willing to take a longer investment horizon.

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