Trivia time: how many stocks make up the Wilshire 5000 Total Market Index (a widely used benchmark for the U.S. equity market)?

While the logical guess might be 5,000, as of December 31, 2016, the index actually contained around 3,600 names. In fact, the last time this index contained 5,000 or more companies was at the end of 2005. This mirrors the overall trend in the U.S. stock market. In the past two decades there has been a decline in the number of U.S.-listed, publicly traded companies. Should investors in public markets be worried about this change? Does this mean there is a material risk of being unable to achieve an adequate level of diversification for stock investors? We believe the answer to both is no. When viewed through a global lens, a different story begins to emerge—one with important implications for how to structure a well-diversified investment portfolio.

U.S. Against the World

When looked at globally, the number of publicly listed companies has not declined. In fact, the number of firms listed on U.S., non-U.S. developed, and emerging markets exchanges has increased from about 23,000 in 1995 to 33,000 at the end of 2016.

It should be noted, however, that this number is substantially larger than what many investors consider to be an investable universe of stocks. For example, one well-known global benchmark, the MSCI All Country World Index Investable Market Index (MSCI ACWI IMI) contains between 8,000 and 9,000 stocks. This index applies restrictions for inclusion such as minimum market capitalization, volume, and price. For comparison, the Dimensional investable universe, at around 13,000 stocks, is broader than the MSCI ACWI IMI.

While it is true that in the U.S. there are fewer publicly listed firms today than there were in the mid-1990s (a decrease of about 2,500), it is clear that the increase in listings both in developed markets outside the U.S. and in emerging markets has more than offset the decline in U.S. listings. Although there is no consensus about why U.S. listings have decreased over this period of time, a number of academic studies have explored possible reasons for this change. One line of investigation considered if changes in the regulatory environment for listed companies in the U.S. relative to other countries may explain why there are fewer listed firms. Another considered if, since the 2000s, private companies have had a greater propensity to sell themselves to larger companies rather than list themselves. In either case, the implication for investors based on the numbers alone is clear—the number of publicly listed companies around the world has increased, not decreased.

A Global Approach

In the U.S., with thousands of stocks available for investment today, it is unlikely that this change will meaningfully impact an investor's ability to efficiently pursue equity market returns in broadly diversified portfolios. It is also important to note that a significant fraction of the publicly available global market cap remains listed on U.S. exchanges. The weight of the U.S. in the global market is approximately 50–55%. For comparison, it was approximately 40% in 1995.

For investors looking to build diversified portfolios, the implications of the trend in listings are also clear. The global equity market is large and represents a world of investment opportunities, nearly half of which are outside of the U.S. While diversifying globally implies an investor's portfolio is unlikely to be the best performing relative to any one domestic stock market, it also means it is unlikely to be the worst performing. Diversification provides the means to achieve a more consistent outcome and can help reduce the risks associated with over-concentration in any one country. By having a truly global investment approach, investors have the opportunity to capture returns wherever they occur.

Conclusion

While there has been a decline in the number of U.S.-listed, publicly traded companies, this decline has been more than offset by an increase in listings in non-U.S. markets. While the reasons behind this trend are not clear, the implications for investors today are clearer—to build a well-diversified portfolio, an investor has to look beyond any single country’s stock market and take a global approach.

1 Source: Wilshire Associates.
Ever ridden in a car with worn-out shock absorbers? Every bump is jarring, every corner stomach-churning, and every red light an excuse to assume the brace position. Owning an under diversified portfolio can trigger similar reactions.

In a motor vehicle, the suspension system keeps the tires in contact with the road and provides a smooth ride for passengers by offsetting the forces of gravity, propulsion, and inertia.

You can drive a car with a broken suspension system, but it will be an extremely uncomfortable ride and the vehicle will be much harder to control, particularly in difficult conditions. Throw in the risk of a breakdown or running off the road altogether and there’s a real chance you may not reach your destination.

In the world of investment, a similarly bumpy and unpredictable ride can await those with concentrated and under diversified portfolios or those who constantly tinker with their allocation based on a short-term rough patch in the markets.

Of course, everyone feels in control when the surface is straight and smooth, but it’s harder to stay on the road during sudden turns and ups and downs in the market. And keep in mind the fix for your portfolio breaking down is unlikely to be as simple as calling a tow truck.

For that reason, the smart thing to do is to diversify by identifying the right mix of investments (e.g., stocks, bonds) that aligns with your risk tolerance, which helps keep you on track toward your goals.

Using this approach, your returns from year to year may not match the top performing portfolio, but neither are they likely to match the worst. More importantly, this is a ride you are likelier to stick with.

Just as drivers of suspension-less cars change their route to avoid potholes, people with concentrated portfolios may resort to market timing and constant trading as they try to anticipate the top-performing countries, asset classes, and securities.

Here’s an example to show how tough this is. Among developed markets, Denmark was number one in U.S. dollar terms in 2015 with a return of more than 23%. But the year before that, they were the second worst-performing developed market in the world.1

Predicting which part of a market will do best over a given period is also tough. For example, while there is ample evidence to support why we should expect positive premiums from small cap, low relative price, and high profitability stocks, these premiums are not laid out evenly or predictably across the map. U.S. small cap value stocks were among the top performers in 2016 with a return of more than 28%. A year before, their results looked relatively disappointing with a loss of more than 7%. International small cap stocks had their turn in the sun in 2015, topping the performance tables with a return of just below 6%. But the year before that, they were the second worst with a loss of 5%.2

If you’ve ever taken a long road trip, you know that conditions along the way can change quickly and unpredictably, which is why you need a vehicle that’s built for the worst roads as well as the best. While diversification can never completely eliminate the impact of bumps along your particular investment road, it does help reduce the potential outsized impact that any individual investment can have on your journey.

With sufficient diversification, the jarring effects of performance extremes level out. That, in turn, helps you stay in your chosen lane and on the road to your investment destination.

Happy motoring and happy investing.

1 In U.S. dollars. MSCI developed markets country indices (net dividends). MSCI data © MSCI 2017, all rights reserved.

2 In U.S. dollars. U.S. Small Cap is the Russell 2000 Index. Frank Russell Company is the source and owner of the trademarks, service marks, and copyrights related to the Russell Indexes. International Small Cap is the MSCI World ex USA Small Cap Index (gross dividends). MSCI data copyright MSCI 2017, all rights reserved.