The plain truth

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Americans were shocked when they heard the news that Deutsche Börse announced plans to take over the New York Stock Exchange. It is the same feeling as when a Japanese company announced the purchase of the Empire State Building. Another icon of American capitalism bites the dust. The "New York Times" editorial announced it as "Wall Street's Dead End".

For some people, it was no surprise at all. The forces that put Wall Street at risk are shaking bank boardrooms and fund managers around the world. The global capital flow has shifted dramatically with significant results. The fact is that change is now a fact of life and will radically affect the financial industry.

For Wall Street, the signs were there for some time. Over 10 trillion US$ have left the U.S. investment market since 2000. The high of 7,000 companies listed on the stock exchange in 1997 has consistently declined to 4,000 today and the decline continues. Initial Public Offerings (IPOs) have been the essential element for many exit strategies. However, they are now virtually non-existent and the private-equity model is severely damaged. As the editorial stated: "Put another way, as the number of initial public offerings steadily declines, the stock market is becoming little more than a place for speculators and algorithms to compete over who can trade his way to the most money. (…) What the market is not doing so well is its core public function: allocating capital efficiently. (…) Today, however, stock markets, once the bedrock of American capitalism, are slowly becoming a noisy sideshow that churns out increasingly meager returns. The show still gets lots of attention, but the real business of the global economy is inexorably leaving the stock market (…) behind."

In global capital flow 101 the rules are simple. Call them "simple truths" to remember in your daily economic life. Capital flows where it is best used. The person who takes the risk should get the return. The more you deviate from a direct investment in something tangible, or the more complex the structure for an investment, the greater the chance that things can go wrong and you are left with lots of paper, but no cash. Keep things simple. The regulations of the financial world more and more have, in the end, inhibited efficient investment in the business world. What's more, they have prevented the financial world from adjusting to the new environment as rapidly as it should.

The signs are there. Private investment does not need the public market today to efficiently provide capital to worthy investments. The rise of the global investor with access to necessary information directly has correspondingly permanently altered the playing field reserved for funds and many private banks trying to play the investment-advisor game. It is not that the deals were bad. They just are inherently inefficient for the investment of funds for family offices and private investors. Today, you can find better returns elsewhere.

Family offices are rapidly doing business with other family offices. They keep their costs low and put 98% or more of the investment in the deal. Raising money on a stock market, by contrast, could take a huge bite out of the initial investment so that only 75 or 85% of the investment actually makes it to the target of the investment. The rest goes to "distribution costs" (payments to your banker or investment advisor), lawyers, auditors and a host of businesses that have grown to take advantage of the lack of transparency in many investments. I still remember reading a prospectus, claiming transparency, when there were 8 different companies with similar names taking fees based on the gross assets invested once or on an annual basis. Some deal!

The ongoing reporting required annually creates a huge additional cost, and the senior management of the company is tied up acting as PR people for the media, not working on the company issues at hand. It is no wonder why the preference today is for private companies interested in real growth that never go to the public market.

Of course, this has tremendous implications for players in the financial industry. The capital flow is quickly passing them by. Ask any fund manager or private-banking executive. There will always be a place for funds with smaller investors, but the trend line is there. Were you surprised by the acquisition of Wall Street by Börsenstrasse? If you understand global capital flow, it was already a "fait accompli".

If you don't, just remember those simple truths. You will not go far wrong.

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