

Asset TV Interview

“How IPOs Have Transformed the U.S. Equity Market”

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Aaron Rial (Asset TV)

Hello, joining me in the studio today we have Abhishek Gupta, Executive Director, MSCI Research and Development. MSCI recently published a paper titled The Anatomy of US Equities, which focused on how broadly the MSCI USA Index has captured the structural drivers behind the US equity markets, which have led global equities for most of the past 50 years. Abhishek said the paper is called The Anatomy of US Equities. And what first made you want to look at the actual structural side of US leadership rather than just the returns?

Abhishek Gupta (MSCI)

Because people usually focus on the returns.

Aaron Rial (Asset TV)

So what was the precipice for this?

Abhishek Gupta (MSCI)

Yeah, the performance of the US equity market tells you that it has done well. What it doesn't tell you is how or why. There are many drivers here. Of course, there's the longstanding geopolitical risk order. Then there is the US dollar reserve currency status. And there are many different macro drivers that have helped the performance of US equities. And when you look at the US equity market cap as a share of global equities over the past 50 years, you see that it has really sustained dominance over there. But underlying that sustained dominance has been a market in constant motion, where industries have risen and declined, and the top 10 stock leadership has reshuffled over time.

Aaron Rial (Asset TV)

So what's behind this dominance?

Abhishek Gupta (MSCI)

And we really wanted to figure that out. We found that there were two channels that explain this. There are incumbents that have continuously reinvented themselves to adapt to the new environment, to the new technology waves. And then there is another channel through which new companies have gotten listed and they have built new businesses of that era. We found this pattern to be repeating itself across 5 distinct innovation waves that we studied over the past five decades, spanning everything from personal computing to today's AI boom. What sustains both this reinvention and replacement is corporate fundamentals. The US annual spending has reached about \$800 billion on an annualized basis, which is multiples higher than any other region. That spending has translated into a profitability and a

productivity advantage that has really sustained, in our view, this leadership of US over time.

Aaron Rial (Asset TV)

So IPOs, they actually turn out to be a major channel of renewal in your data, and that's roughly 60% of today's market value. It's sitting in companies that, believe it or not, were not even public just as recently as five decades ago. So what was the most surprising finding there?

Abhishek Gupta (MSCI)

Yeah, IPOs form an integral part of the US equity market, and it is really the scale of the number that you mentioned that really struck us. The MSCI USA index, which comprises large and mid-sized companies, it has about 60% of its index weight today, or I should say \$38 trillion of the \$64 trillion in total value that is sitting in companies that went public 50 years ago. That's an astounding number. What's more telling is how evenly that has been spread. Companies that were listed in the 1980s and the 1990s each account for close to one fifth of the index weight today. And the companies from the 2000s and the 2010s each contribute to roughly another tenth. So it's not one single IPO boom that is still showing up in the numbers. It's actually been a continuous process across decades. It's also quite broad across sectors. Now you might think that a lot of these companies are sitting in the information technology sector, and that's true. One quarter of those listings are from IT. But financials, healthcare, and consumer discretionary, they have all contributed quite meaningfully to this IPO pipeline that we have seen.

Aaron Rial (Asset TV)

Abhishek, what does it take for a newly listed company to become fully investable? And what does that timeline mean and matter to investors for?

Abhishek Gupta (MSCI)

When a company goes IPO, it does not necessarily mean that the stock becomes investable right away. They may not have a very high float or they may have poor liquidity. MSCI only adds companies to its indexes once they meet certain investability criteria. So an IPO inclusion can actually be delayed, but only for as long as it takes to establish that the stock is generally tradable at scale. There is no other seasoning requirement or criteria that we put beyond investability. Now, if you look back and go at the IPO pipeline from the past 25 years, the median time that it has taken for a company to go from IPO to direct MSCI USA index inclusion has just been 10 months. This timeline matters. It matters because when a company gets listed, that is the time when it is attracting the most investor attention. And so it is exactly during this period, if a slower moving benchmark were not to include these companies, it would once again be the other thing that would be catching the investor attention.

Aaron Rial (Asset TV)

What happens to a company's investment profile once it actually enters a benchmark? And why should investors care about the evolution rather than just the inclusion event itself?

Abhishek Gupta (MSCI)

Yeah, index inclusion is only one step in a firm's life cycle. In the years that follow, a newly included company's free float typically tends to rise because there are insider investors who are selling their stocks, the initial lockup has expired, and so on and so forth. Simultaneously, what also happens is that the company's investment profile shifts in a consistent direction. Companies at listing typically tend to have higher growth characteristics, they tend to be more volatile, and they tend to raise a lot of capital. But then as they age and mature, we generally see that their growth stabilizes, they become more stable, and at the same time, they also start practicing a lot more capital discipline. Now, that maturity shows up most clearly in buybacks, which have become a dominant mechanism through which these established US companies are returning capital to their investors. And I would say that this shift that we have seen from issuance to buybacks as companies are aging and maturing is really what is keeping the index's fundamentals so strong, even though the index constituents in themselves are changing over time.

Aaron Rial (Asset TV)

So there's a substantial private pipeline for AI-related companies behind this trend as well, and some already are large enough, believe it or not, to rank among the biggest constituents on day one. So how ready is index construction for that next wave?

Abhishek Gupta (MSCI)

Yeah, we have this index called the MSCI All Country Venture-Backed Private Company Index, and we looked at the top 50 constituents of that index. The picture is quite concentrated. Information technology accounts for roughly two-thirds of the index's value, and 43 out of those companies are US domiciled. And they all together have an estimated valuation of roughly \$3.2 trillion. These companies aren't small. The top five companies here each are worth more than \$100 billion. And the largest one actually exceeds a trillion. So these companies are many times larger than a median MSCI USA index constituent. Now, because we do not know at which float these companies are going to list, we modeled different scenarios, like 5%, 25%, and so on and so forth. Now, we know that when companies list, they generally list at lower float, but then eventually their float increases. So I'm going to stick with the 25% scenario. Under that assumption, we found that roughly 9 out of the 10 largest companies already meet the bar for standard index inclusion. And 6 out of those nine companies are large enough to qualify for early inclusion. Now, early inclusion, I should describe, is a mechanism through which companies that are large enough can enter indexes within days of their IPO rather than having to wait for a scheduled review. This has been a feature of the MSCI methodology for a very long time. So I would say that through the early inclusion mechanism, the MSCI indexes are ready for this new cohort of IPOs. The open question, however, is whether investors' benchmarks, whichever they are using, are really responsive enough. Are they going to respond at the same speed? Because some of these companies are pretty large and they could rival some of the largest index constituents on day one.

Aaron Rial (Asset TV)

Abhishek, your research actually puts a number on the cost of either delayed or incomplete benchmark coverage. So what does that cost mean in practice, both for

the institutional allocator who's managing a policy benchmark, and separately for just a wealthy investor who wants to be in US equities?

Abhishek Gupta (MSCI)

Yeah, we have described how the US market has renewed itself and the driver of the next potential wave that is forming in private markets. That's what we've been discussing. But it is important to understand that for that renewal to be accessible to investors, the benchmark should capture the opportunity set comprehensively and without unnecessary delay. What we have done is quantify the cost of incomplete or delayed benchmark coverage using tracking error, which is simply a measure of how far your portfolio's return drifts from the benchmark it is meant to follow. What we found is that a benchmark covering even 95% of the MSCI USA index carried a tracking error of 40 basis points on an analyzed basis. In a separate study, we looked at six past IPOs, popular names like Visa, Facebook, Tesla and SpaceX. What we did was build a parallel index where we would exclude one of these companies following its actual inclusion. Then we would compare that against the standard MSCI USA index. We found that the analyzed tracking error from those single missing names reached as high as 18 basis points over a three-week rolling window. Now just to put things in context, 20 basis points of tracking error really implies that there could be a performance deviation of 60 basis points at three standard deviations. So this cost is pretty systematic, if you think of it.

Aaron Rial (Asset TV)

Now, what are the implications for investors?

Abhishek Gupta (MSCI)

I think there are far too many. For an institutional allocator, that shows up directly against a policy benchmark that a board is actively monitoring. Or for an active manager who is holding these names during this gap period, it may seem like they are taking an active bet when they are simply holding a stock that their benchmark is too slow to respond to. And for a wealth investor, it is more about expectation, right? If they are really putting their money towards an allocation that is labeled as US equities, it should rather mean that it is US equities, and it should represent the full opportunity set, not a narrower or a slower version of it.

Aaron Rial (Asset TV)

After reading this paper, what is one question that you'd want every investor to ask about their own US equity benchmark?

Abhishek Gupta (MSCI)

I think every investor should ask: does their benchmark really capture the market comprehensively? And does it really add large new companies without unnecessary delay? I think these are the two places where we found measurable, quantifiable cost. And I would also say that it matters more now, because there are several large companies sitting in the pipeline, and some of these companies could be the largest index constituents when they list. So a benchmark that is too slow to respond wouldn't really miss one name in isolation. It would actually miss several of them at once, in the same narrow window.

Aaron Rial (Asset TV)

Abhishek, thank you so much for your time and your insight. That was Abhishek Gupta, Executive Director, MSCI Research and Development. I'm Aaron Rial, and this is Asset TV.

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