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The Carlyle Compass

By **Jeff Currie**
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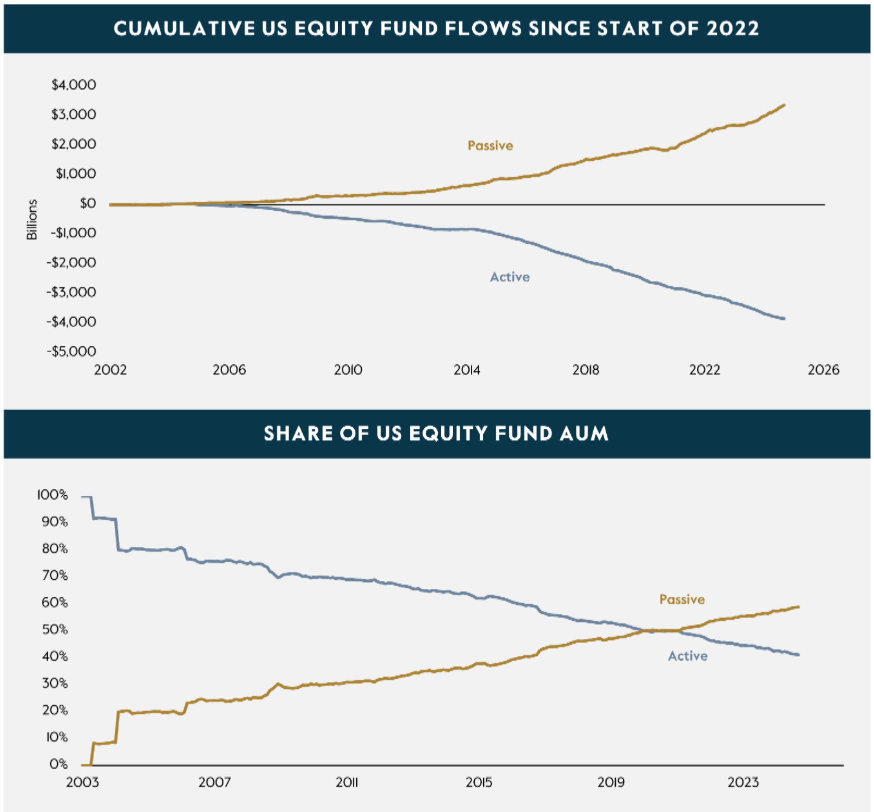
*Welcome back to **The Carlyle Compass**, your weekly newsletter that brings together the latest research and market insights from our global team. This week's edition features guest author Jeff Currie, Chief Strategy Officer of Energy Pathways at Carlyle.*

What happened to the dividend (and active investors)?

When the Dutch East India company first issued equity in 1611, the stated goal was to publicly offer a new investment that would raise capital, diversify risks, and pay a dividend. Do modern day equity markets do any of this? Very little. Twenty-nine percent of the S&P 500 market cap is concentrated in just five names which provide a dividend yield of only 30bps. Market-wide, the dividend yield has fallen to 127bps, the lowest in history, bar the peak of the dotcom bubble, while IPOs remain scarce. Nowhere did the Dutch mention multiple expansion as a goal of equity markets, but that has become the focal point of modern-day equity markets which are driven more by momentum and size than anything else. What happened to the original focus on the dividends which create a positive carry, make investments self-liquidating, and reduce the correlation with the rest of the market?

Driving this shift away from the original market goals has been the rise of passive investors and ETF products, a trend started decades ago, as Jason Thomas pointed out in 2019. After COVID, which accelerated this trend, the passive investor became the majority shareholder of the US equity market and is now roughly 60% of equity AUM after two decades of steadily crowding out active investors (Figures 1 and 2). This makes for an expanding space for private market investors.

Figures 1 & 2: What Happened to the Dividend (& Active Investors)?



Source: Carlyle Analysis; Goldman Sachs Global Investment Research, October 2024. There is no guarantee any trends will continue.

Passive investment tends to focus on larger names, creating a positive feedback loop. The bigger companies get a lower cost of capital as passive skews towards size, which allows them to invest more and earn more, making them bigger and thus even more attractive to passive capital. The largest companies today also benefit from the increasing scale economics of networks, and ETFs benefit from a passive network corollary as the business models in which they invest. Thus, they are a financial expression of the passive natural 'moligopolies' in Big Tech.

Due to this feedback effect, active investors have been crowded out by passive and momentum investors that generate higher returns at lower fees, which in turn forces the remaining active investors to chase momentum in order to remain competitive. Notably, the only time passive investors tend to underperform active investors is during sell-offs, where the active investor can minimize losses while the passive investor is exposed to the entire downside.

As a result, this dynamic will be hard to break in the near term and is likely to remain a structural trend. Moreover, the large cap skew in the public space may keep private equity exits largely limited to larger companies—it is worth noting that ETFs don't do IPOs. Since a peak in 1998 of 7,378, public listings of investable US companies (as measured by the FT Wilshire 5000 index) have fallen by nearly 50% to 3,407 while the size of the market has nearly quintupled. By contrast, the number of private companies backed by private equity firms has risen six-fold to around 11,000. This trend will likely continue. Therefore, private markets will need to get back to basics, focusing on what the first Dutch equity investors initially paid for—a dividend—and less on what passive investors in public markets focus on—capital appreciation.

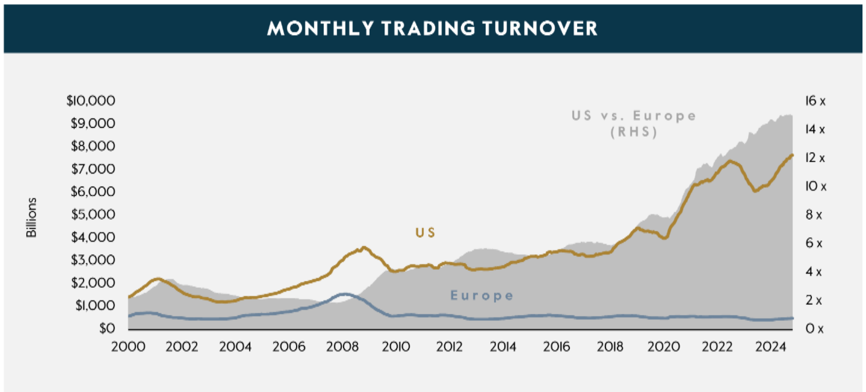
Passive ETFs have also impacted bond and commodity markets as well. In particular, they have crowded out most active investors in macro markets like energy. One reason the oil market currently has been unable to rally in the light of heightened geopolitical risk is because the active investors who would pre-position for geopolitical risks have disappeared. In contrast, passive investors don't buy geopolitical risks until after they actually occur through upward trending prices.

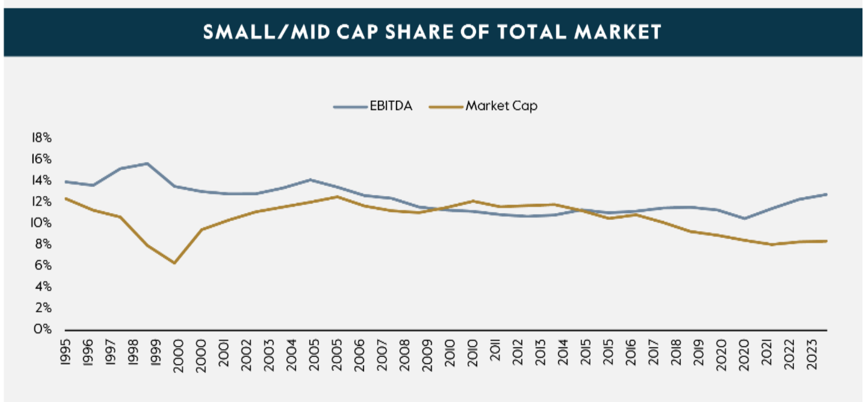
This doesn't mean that investors don't see the geopolitical risks stemming from unrest in the Middle East impacting energy markets, just that it doesn't get priced in by a market dominated by passives. Options markets have priced in a high probability of price spikes, but those are 'insurance contracts' against a price spike, not investor positions.

Public markets like big, bigger, and American

ExxonMobil is up a substantial 19% this year, vastly outperforming its peers, but is that due to its oil exposure and underlying fundamentals, or to it being big and American? We believe it's most likely the latter. This passive flow dynamic has created a liquidity gap between big American companies and everyone else, whether it is small- and mid-cap companies and/or foreign companies of all sizes (Figure 3). If current trends were to continue, the US would likely become ever more so the equity market to the world and be dominated by a few, very large cap global companies. In this process, liquidity would continue to be choked off to small- and mid-cap companies that are not large enough to participate in the passive flows even as their share of EBITDA has been rising (Figure 4).

Figures 3 & 4: Public Markets Like Big, Bigger & American





Source: Carlyle Analysis; Goldman Sachs Global Investment Research, Bloomberg, October 2024. There is no guarantee any trends will continue.

Energy is no exception

While most investors think this 'big-getting-bigger' dynamic is isolated to modern Big Tech companies, there are two names in the world's top 15 companies that were also there over a century ago—the House of Morgan and Standard Oil (ExxonMobil). A closer look at ExxonMobil illustrates how transformational a company's size could be to the energy space should the FTC take a more accommodative view to M&A activity.

First, how big is ExxonMobil at a $538B market cap? Exxon's market cap is almost as large as the next three Western International Oil Companies combined, and it is now bigger than the global financial oil market at $429B which is made up mostly of corporate hedgers. Saudi Aramco is larger in terms of market cap, but that value is trapped on an illiquid Saudi Arabian Exchange. Like J.P. Morgan, ExxonMobil has no peers, and now has a valuable currency given its recent multiple expansion.

The transformation has been rapid. Just a few years ago, ExxonMobil had a multiple of 5x and the view was that oil companies would never have forward value because of the energy transition. Today with a multiple of 15x, nearly any acquisition ExxonMobil makes in the space is accretive, brown or green. For example, it could acquire BP—which has diversified into renewables—and it would only expand its market cap by 15%. ExxonMobil's criteria for acquisitions may well be low-cost, long-lived, low-political risk assets. Interestingly, with green assets coming back into focus after a difficult two years, they may fit these criteria well.

So far, ExxonMobil has avoided investing in electrons, unlike its European competitor Total, which has successfully adopted the joules approach of combining molecules with electrons in a low carbon fuels business model. Should electrons become the focus of such a dominant company, the entire energy transition and landscape could look very different given its new access to low-cost capital and dominant market position. Because ExxonMobil avoided the costly initial stage of investing in green assets, they can now buy those assets much more cheaply—and with more clarity about what is working and what isn't.

Mind the liquidity gap

The ongoing passively driven concentration of capital in large companies will continue to reshape public markets. For investors, we believe this means looking toward private markets and revisiting fundamentals like dividends while putting far less emphasis on capital appreciation. We believe this approach particularly lends itself to sectors like energy, where smaller firms may struggle to compete with their larger counterparts and the assets lend themselves to high cash flow. The benefits of such an approach may solve many of the problems facing private markets today, paramount of which is liquidity.

We see such an approach of emphasizing a dividend over capital appreciation as providing investors with a positive carry for holding the asset, a self-liquidating investment that doesn't keep investors bound to the mark to markets, and a lower correlation with the broader market. We don't know exactly what the founding Dutch had in mind with dividend paying equities, but we could surmise that carry and self-liquidating were at the top of that list. The key for private markets will likely be to get back to basics and focus on what the Dutch did in 1611—the dividend, and not the multiple, which has become the realm of the passive investor.

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