ISS EVA

G. Kevin Spellman ("Coach"), PhD, CFA
Senior Advisor, ISS EVA
Professor of Practice & David O. Nicholas Director of Investment Management, University of Wisconsin-Milwaukee
Adjunct Professor, IE Business School
kevin.spellman@issgovernance.com
608-334-2110

Macro Strategy

DEMAND & SUPPLY (OF STOCKS)

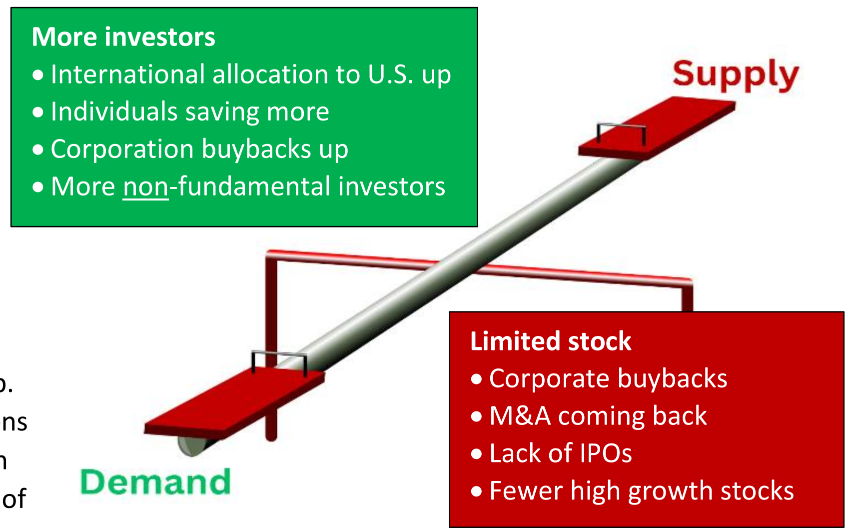
Stocks are driven long term by fundamentals → factors that drive earnings (or EVA), risk, and valuation. However, in the short term, stocks can diverge significantly from value because of psychology → those who make decisions have biases (my doctorate is in behavioral finance). I've written substantially on fundamentals and psychology, but not on a third driver of market prices – demand and supply of stocks. Demand is way up, while supply is constrained (see right).

Demand by international investors for U.S. stocks is up. As individuals age, they must save more, and allocations to stocks are lofty. Corporate buybacks have been high for some time, which raises demand for stocks. Much of trading is short-term, but ownership by index funds is rising. The combination of short-term trading and ignoring the investment merits of individual stocks by indexing means that less buying (and selling) is perhaps driven by the merits (fundamentals) of securities.

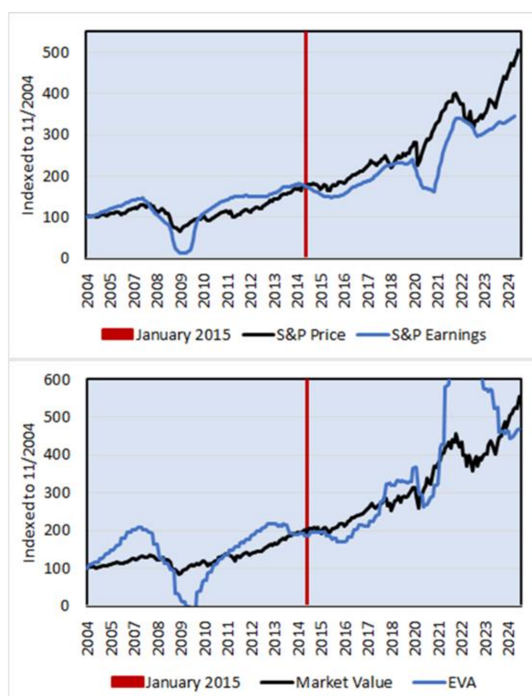
On the supply side, corporate buybacks also limit the supply of shares. M&A is making a comeback in 2024, and it reduces the supply of stocks (and increases demand for it). IPOs are up this year but still lowish overall. There are also fewer high-growth stocks, but the United States has more of them.

Demand and supply seem to be impacting prices. However, one may argue that AI is the reason for the market's rise or point to Trump's policies. These arguments have some merit, but I doubt they explain all the movement up (unless fueled by psychological "animal spirits" which drives excesses). My goal, as always, is to add value by making you think, and this time by making important points that show that demand and supply may be overwhelming fundamentals. Stocks are are up more than EVA and earnings, and more than perhaps is justified by future growth from AI and the reasons for the "Trump bump." Before discussing demand and supply, let's take one page to explain that prices cannot be justified by only fundamentals.

Imbalance! Demand for Stocks > Supply!



Stocks Are Up Way More Than Earnings & EVA

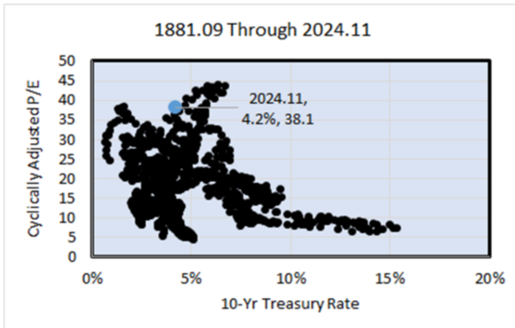


ISS EVA, Shiller data; the index value was the same for price and earnings in January 2015

Market Up More Than Fundamentals

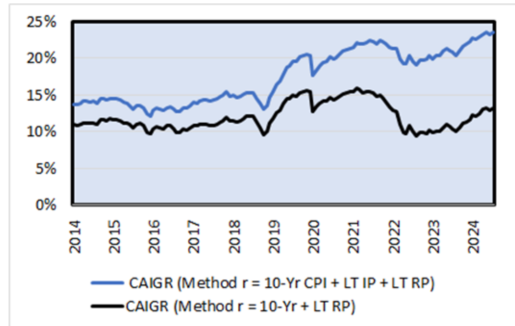
Since 2015, stocks have been up way more than earnings and EVA. At the beginning of the rally, one could have claimed that low interest rates made the present value of earnings (or rather FCF and EVA) higher. The drop in rates also lowered the cost of capital, which provided additional opportunities for positive NPV investments and growth. However, fast forward to today, and you can see that the P/E is at the highest it's ever been (since 1881), with interest rates at current levels.

Stocks Are Expensive vs Interest Rates



ISS EVA, Shiller data

Growth Expectations Have Risen



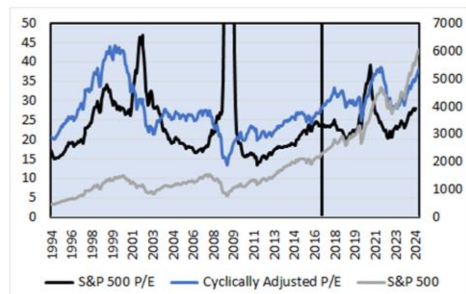
ISS EVA, Shiller data

Markets are expensive. In [Talking About Growth](#) (1/24), I introduced the CAIGR. The CAIGR backs out implied 10-year growth from prices after normalizing for interest rates (or the inflation premium and inflation), earnings and payout, and the risk premium. Economists estimate that AI could boost the next 10 years of growth by 1.1% (see [Q2 '24 RECAP](#) for the range which is 0.1% to 1.9%), but the CAIGR is up 2.6%-2.7%. A 1.1% increase implies a market should be between 4,930 and 5,130.

Rallying Like 2016, But Conditions Different

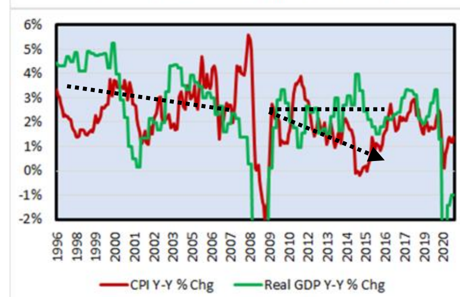
12/16:
CAPE: 27.8
TTM: 23.8

Today:
CAPE: 38.1
TTM: 28.0



2016:
Inflation low & slowing, growth languishes after GFC

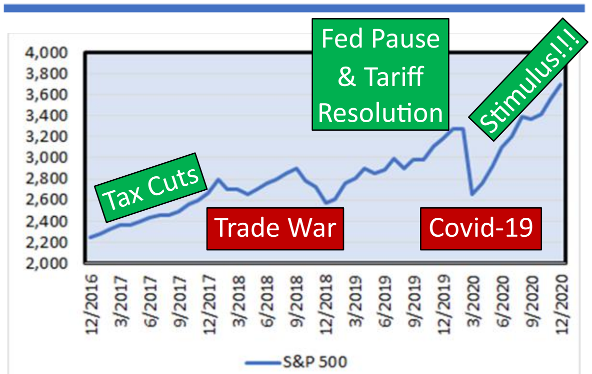
2020:
Inflation high & downtrend stalled while growth solid



ISS EVA, FactSet, BEA, Shiller data

Can the "Trump bump" explain prices? Today is different from 2016. Valuations are much higher now. in the several years before and including 2016, inflation was low and slowing, and GDP growth was slow as people and banks de-levered after the GFC, but inflation and growth are higher now. Markets sold off with the first trade war, but today investors don't appear worried. I argued in 2017-18 that the Trade War was overblown, and people may have finally come around to that view; however, tariffs were lower and tariff-induced inflation may have been welcomed back then. While Trump has other policies besides new tariffs, uncertainty is high and some policies make investors worried, yet the market rises (see [The Election, Psychology, and The Consumer](#) for short-term and long-term impacts of the policies).

Trump Presidency Revisited



ISS EVA, Shiller data

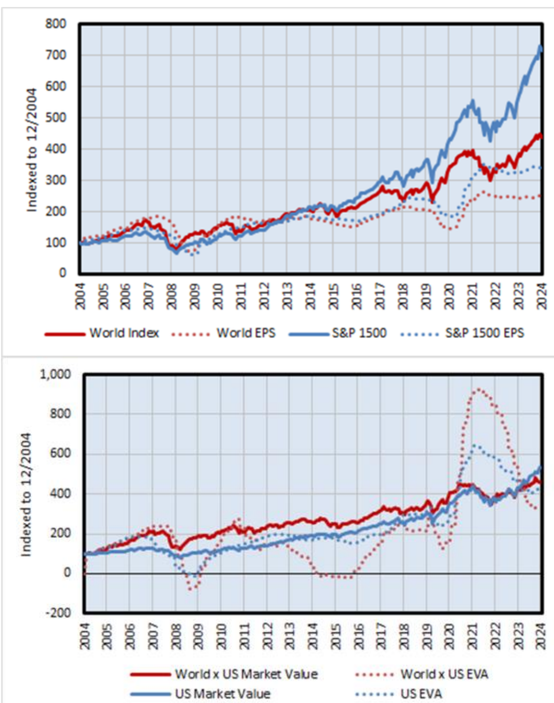
Extending the tax cuts of 2017 is not the same as initiating them. Immigration policies could reduce growth and boost inflation. DOGE could solve the debt issues, but even Musk said "[temporary hardship](#)" could be ahead. Maybe reducing financial regulations boosts growth, [but fewer regulations may have also contributed to the Silicon Valley mess a couple years ago](#).

Non-U.S. Investors' Demand for U.S. Stocks Way Up

International ownership of U.S. stocks rises unabated. Rest of world (**ROW**) ownership was 17.5% in Q3 2024, up from 15.4% in Q3 2014, and from 9.7% in Q3 2004. The rise accelerated during the 2000s and 2010s; in Q3 1999, international investors owned 7.4% of stocks, which was only 3.4 percentage points higher than in Q3 1979.

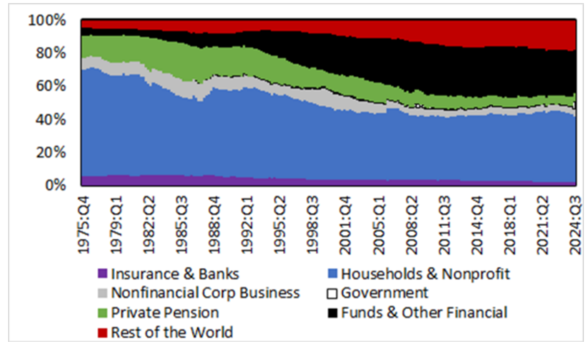
The rotation to U.S. stocks over the last 20 years may be because the United States, in general, has outperformed the world in earnings growth over the last 20 years, and especially the last decade. Assets are attracted by growth, so investment flows traveled to the United States.

U.S. EPS Up More Than World



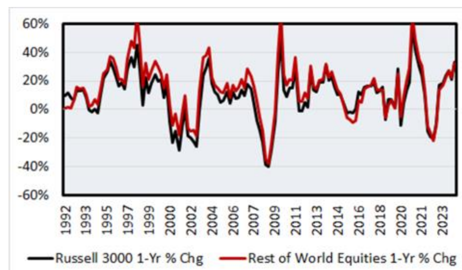
ISS EVA, FactSet
Note: The EVA charts are impacted by the addition of (primarily non-U.S.) securities to the dataset, so World x U.S. index is upward biased. Still, U.S. stocks are up more than World x U.S. over last decade; however, they may have started undervalued 10 years ago as stocks for the World x U.S. were up more than U.S., while EVA dropped below zero in 2015.

ROW Ownership of U.S. Stocks 17.5%, Up From 9.7% in Q3 2004



ISS EVA, Federal Reserve

U.S. Stock Allocation Up More than Returns



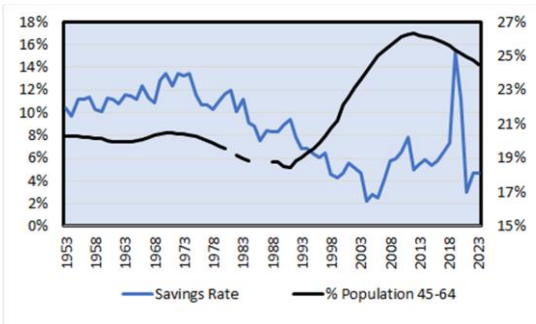
Period	Cumulative Rest of World Equities Rise in Value since Q4 '19	Cumulative Russell 3000 Rise in Value Since Q4 '19	Difference
2020:Q4	29%	19%	10%
2021:Q1	38%	26%	12%
2021:Q2	49%	36%	13%
2021:Q3	49%	35%	14%
2021:Q4	68%	47%	21%
2022:Q1	57%	39%	18%
2022:Q2	32%	15%	16%
2022:Q3	25%	10%	15%
2022:Q4	31%	17%	14%
2023:Q1	40%	25%	15%
2023:Q2	50%	35%	15%
2023:Q3	46%	30%	16%
2023:Q4	61%	45%	16%
2024:Q1	77%	59%	18%
2024:Q2	83%	64%	20%
2023:Q4	93%	73%	20%

ISS EVA, FactSet, Federal Reserve, Russell

Is it overall demand and supply that sets prices or marginal demand and supply? Likely, it's the latter. Remember, prices are determined by the interaction of those buying (right now) vs those selling (right now). Of course, if prices change significantly, holders or potential stockholders may come off the sidelines, but for most practical purposes, only those engaged in trading set today's prices. Since 2019, foreign investors made up at least part – and maybe a significant part – of the marginal buyer. They've added 20% extra to U.S. markets beyond stock market capital gains. Instead of rebalancing and taking gains, they added to their U.S. allocation.

Individuals' Demand for Stocks Up

45-64 Year Olds Should Save More



ISS EVA, FactSet, DOL, U.S. Census Bureau

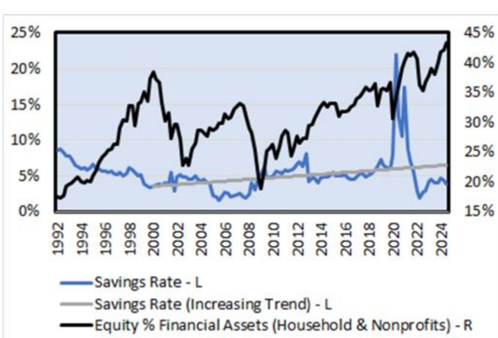
But Older People Don't Have to Save More If the Market Just Goes Up

ISS EVA, FactSet, BEA, S&P, 1/01 – 12/24

As one grows older, one has more discretionary income (kids finish college, income is higher, housing costs decline as mortgages become a smaller portion of income) and needs to save more (for retirement). However, since the turn of the century, people have perhaps under-saved. That could be because the market has risen and saved for them.

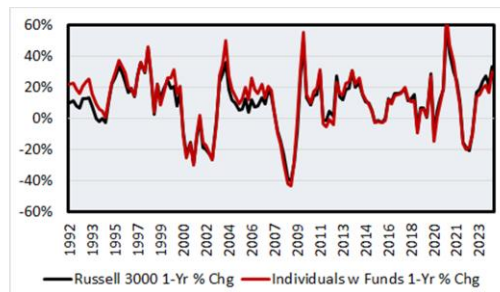
There are negative relationships between both the savings rate and returns and the savings rate and allocation to equities. The current allocation to equities is at a high and the savings rate is below trend. Since Q4 2019, the gain in the stock market is greater than the gain in the value equities for individuals, which means individuals have, on average, rebalanced to sell equities (unlike non-U.S. investors (prior page)). On the other hand, the gain in the value of equities is 77% more than the rise in the stock market since Q4 1999.

Equity Allocation Has Been Rising



ISS EVA, FactSet, BEA, Federal Reserve; financial assets consist of equity (43% on 6/24), debt (9%), non-corporate business (12%), and other (35%) consisting of deposits, defined benefit entitlements, and other; see Federal Reserve website for additional charts

Stock Allocation Up More Than Returns Since Q4 1999



Period	Cumul. Individuals' Rise in Value since Q4 1999	Cumul. Russell 3000 Rise in Value Since Q4 1999	Dif-ference	Period	Cumul. Individuals' Rise in Value since Q4 2019	Cumul. Russell 3000 Rise in Value Since Q4 2019	Dif-ference
2000:Q4	-11%	-9%	-2%				
2001:Q4	-20%	-20%	0%				
2002:Q4	-37%	-38%	1%				
2003:Q4	-16%	-21%	5%				
2004:Q4	-3%	-13%	9%				
2005:Q4	9%	-9%	18%				
2006:Q4	33%	4%	29%				
2007:Q4	38%	7%	31%				
2008:Q4	-20%	-34%	15%				
2009:Q4	5%	-18%	23%	2020:Q4	19%	19%	1%
2010:Q4	23%	-6%	29%	2021:Q1	28%	26%	2%
2011:Q4	17%	-6%	23%	2021:Q2	38%	36%	3%
2012:Q4	35%	7%	28%	2021:Q3	39%	35%	4%
2013:Q4	77%	40%	37%	2021:Q4	45%	47%	-2%
2014:Q4	98%	54%	44%	2022:Q1	39%	39%	0%
2015:Q4	95%	52%	43%	2022:Q2	16%	15%	1%
2016:Q4	113%	68%	45%	2022:Q3	11%	10%	1%
2017:Q4	155%	99%	56%	2022:Q4	18%	17%	1%
2018:Q4	132%	86%	46%	2023:Q1	25%	25%	0%
2019:Q4	195%	138%	56%	2023:Q2	33%	35%	-2%
2020:Q4	252%	183%	68%	2023:Q3	28%	30%	-2%
2021:Q4	327%	251%	76%	2023:Q4	40%	45%	-5%
2022:Q4	247%	179%	68%	2024:Q1	52%	59%	-7%
2023:Q4	314%	246%	67%	2024:Q2	55%	64%	-9%
2024:Q3	390%	314%	77%	2024:Q3	66%	73%	-7%

ISS EVA, FactSet, Federal Reserve, Russell

Share Buybacks – High Demand, Which Lowers Supply

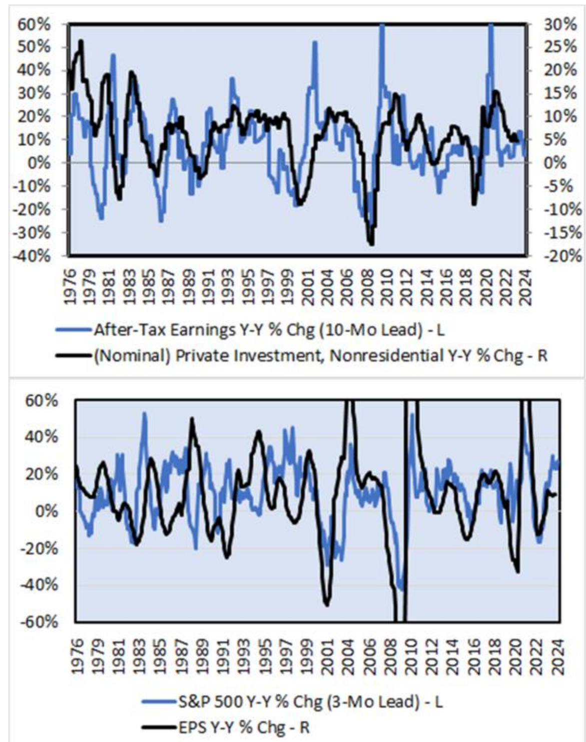
A wise investor should not look to corporate investing activities as an indicator – unless it is a contrary indicator – of what to do. Sadly, corporations love to buy high and buy less low.

Corporate investing activity (e.g., cap ex) lags earnings by about 10 months. Investors are not that much better, as the S&P 500 only leads earnings growth by about three months.

Share buybacks are another way of investing in the firm or perhaps expressing that a company has substantial profits but not enough good projects (maybe firms realize earnings are peaking). Buybacks are highest following periods of high returns, which as noted above lead earnings by only a few months. Overall, this means that corporations tend to buy back stock at or near highs.

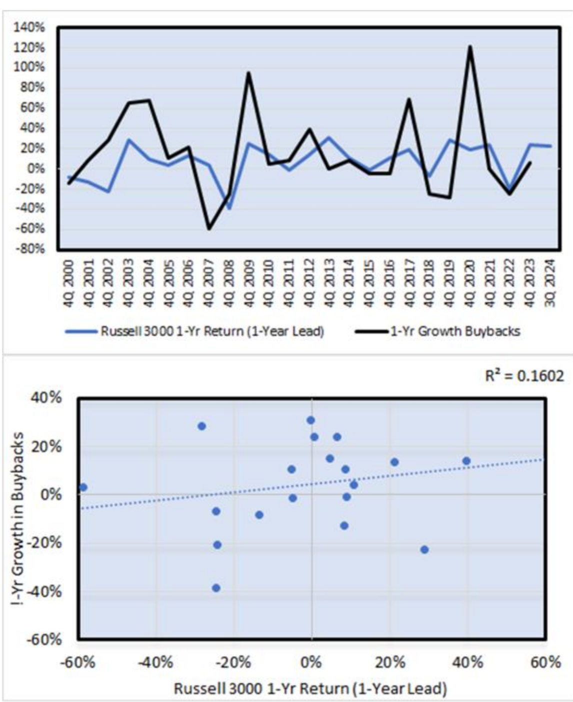
The table below shows that firms have repurchased about 58% of their stock since 1999. Take this figure with a grain of salt given data limitations (see note below table), but we can assume that there is a good 2% extra demand (and a reduction in supply) caused by share buybacks each year, and **buybacks rebounded in 2024.** However, this does not imply that shares fell 2% per year. Shares are issued for M&A, IPOs, management compensation, etc., but they are not open market transactions between a buyer and seller, so they may not have the same impact on prices as share buybacks.

Corporations Buy High (and Buy Less Low)



ISS EVA, FactSet, BEA, Shiller

Corporations Buy High (and Buy Less Low)



Period	(Billions) T4Q Buybacks	Buybacks % of Market Value	Cumulative % of Market Value	1-Yr Growth Buybacks	Russell 3000	Russell 3000 1-Yr Return
4Q 1999	$160	1.3%			1,458	
4Q 2000	$145	1.0%	2.3%	-9.4%	1,333	-8.5%
4Q 2001	$126	0.9%	3.2%	-13.6%	1,165	-12.6%
4Q 2002	$136	1.1%	4.3%	8.5%	899	-22.8%
4Q 2003	$176	1.5%	5.8%	29.1%	1,158	28.7%
4Q 2004	$291	2.1%	8.0%	65.3%	1,274	10.1%
4Q 2005	$487	3.2%	11.1%	67.2%	1,329	4.3%
4Q 2006	$539	3.2%	14.3%	10.8%	1,510	13.7%
4Q 2007	$654	3.6%	17.9%	21.3%	1,560	3.3%
4Q 2008	$269	1.8%	19.8%	-58.8%	956	-38.7%
4Q 2009	$203	1.6%	21.4%	-24.5%	1,200	25.5%
4Q 2010	$396	2.7%	24.1%	94.5%	1,377	14.8%
4Q 2011	$414	2.6%	26.7%	4.7%	1,364	-0.9%
4Q 2012	$452	2.7%	29.4%	9.0%	1,555	14.0%
4Q 2013	$631	3.1%	32.4%	39.8%	2,036	30.9%
4Q 2014	$630	2.6%	35.0%	-0.2%	2,249	10.5%
4Q 2015	$684	2.7%	37.8%	8.5%	2,216	-1.5%
4Q 2016	$650	2.5%	40.3%	-5.0%	2,446	10.4%
4Q 2017	$617	2.1%	42.5%	-5.2%	2,908	18.9%
4Q 2018	$1,041	3.5%	45.9%	68.8%	2,704	-7.0%
4Q 2019	$784	2.4%	48.3%	-24.7%	3,476	28.5%
4Q 2020	$561	1.4%	49.7%	-28.4%	4,130	18.8%
4Q 2021	$1,244	2.5%	52.2%	121.8%	5,122	24.0%
4Q 2022	$1,253	2.5%	54.7%	0.6%	4,073	-20.5%
4Q 2023	$947	2.0%	56.7%	-24.4%	5,049	24.0%
3Q 2024	$1,009	1.8%	58.4%	6.5%	6,167	22.1%

ISS EVA, FactSet; buyback numbers for 3Q 2024 are annualized; to compile the data, FactSet screens were run for both share buybacks and market value, and only firms with data were used for the buybacks as a percentage of market value ratio; less data was available for earlier years

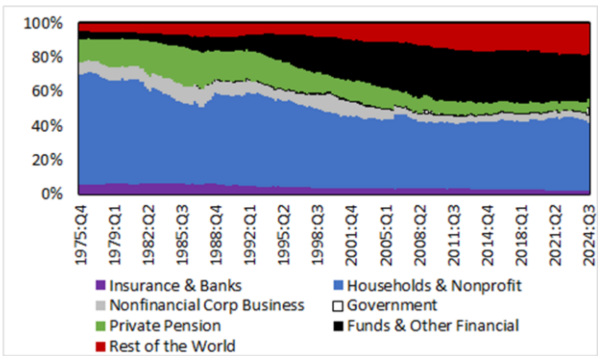
More Demand from Non-Fundamental Investors

The portion of the market that is trying to determine value from fundamentals keeps getting smaller.

Households (and non-profits) make up 40.5% of stock ownership. Some of these investors are professionals, but if you asked others what a "P/E" is, it is quite possible they will give you a blank stare or direct you to the restroom.

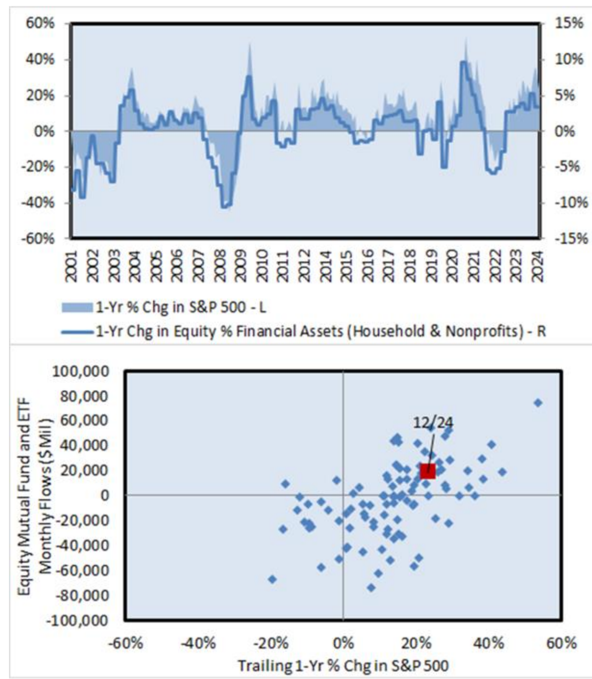
Is Market Driven *Less* by Fundamentals?	
✓	Households' equity allocation correlated with returns
✓	Passive investing up and indexes momentum in disguise
✓	Many with a momentum overlay
✓	Holding period only 5.5 months
✓	High frequency trading majority of transactions

Households 40.5% of Stock Ownership



ISS EVA, Federal Reserve

Households Increase Equity Allocation at Highs



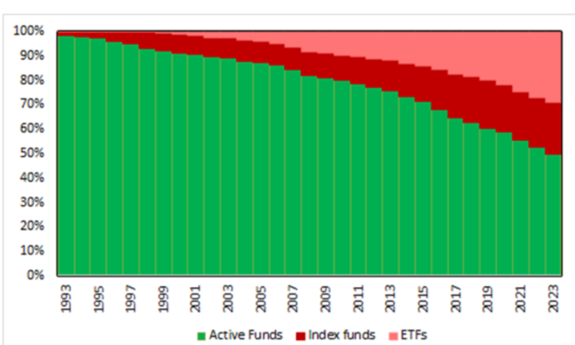
ISS EVA, FactSet, Federal Reserve, S&P

Individuals are well-known to buy what is in style. They tend to be bullish at market tops, and bearish at bottoms.

The next largest category for ownership of stocks is funds. That's the domain of professional money management. Are there enough of these investors to keep the market efficient – i.e., prices quickly and accurately adjusting to new information? Maybe not...

[88% of mutual funds are owned by households] which, as noted earlier, are driven by recent returns. Even active portfolio managers who prefer long horizons to capitalize on market mispricing cannot have them if their clients will not patiently wait for those returns.

Active Funds Only 49.6% of Funds



ISS EVA, ICI

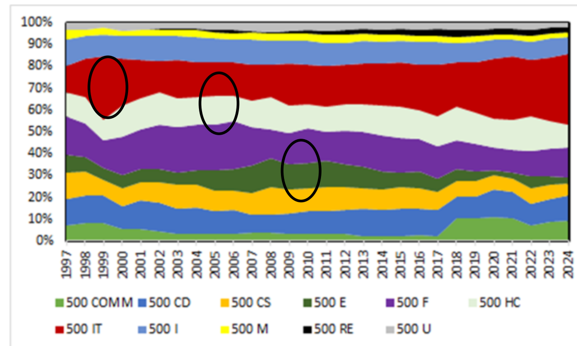
Plus, active funds have dropped to less than 50% of the total fund AUM. I spent a good deal of time trying to dig up the percentage of active funds using a momentum approach, but surprisingly, there's a dearth of information on this. ChatGPT suggests 30%-50% have momentum at least as part of the investment philosophy and process, perhaps catering to clients and capitalizing on the market's tendency to trend over the short-term. I've long said that "Fundamentals (e.g., EVA, value, etc.) tell you "what" to buy, and technical analysis (e.g., price trends, momentum, etc.) tells you "when" to buy, or at least when others are buying." As a business manager, being aware of

More Demand from Non-Fundamental Investors Continued…

momentum is quite important because, as Keynes purportedly said, "Markets can stay irrational longer than you can stay solvent."

Index funds and ETFs (most track an index) make up just over 50% of the funds. Those who manage these funds don't search for the best stocks (i.e., they don't care about fundamentals). Instead, they buy proportionately to the weights of stocks in indices, but these indices are momentum in disguise. The S&P 500, Russell 2000, MSCI ACWI, and other market-capitalization-weighted indices increase weights in the winners and reduce weights in the losers. These indices are *guaranteed* to have the most weight in the most overvalued stocks at peaks of bubbles. Most active managers are judged against these indices, which means they must heed their attention. If you are underweighting a stock that goes up, you must buy to keep the underweight unchanged, which makes it go up more. Plus, while index funds and ETFs are passive vehicles, ETFs still made up 30% of the trading volume in 2023!

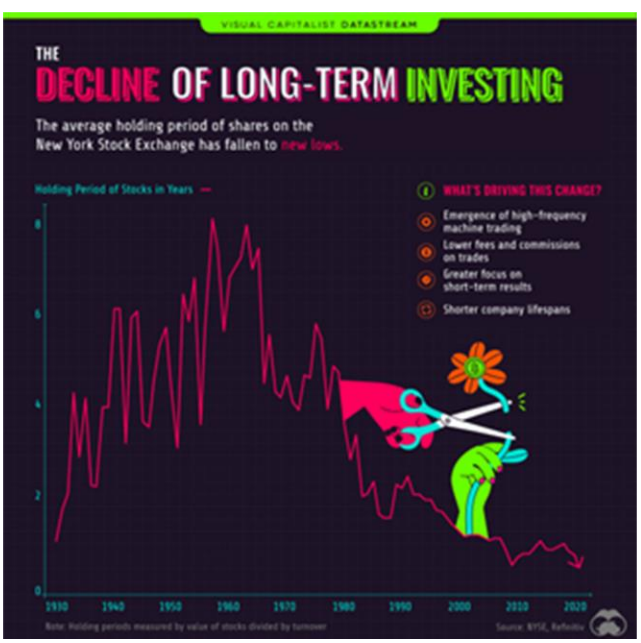
S&P 500 is a Momentum Index in Disguise



ISS EVA, S&P; circles indicate bubbles in technology, financials, and energy; COMM = communications, CD = consumer discretionary, CS = consumer staples, E= energy, F = financials, HC= health care, IT = information technology, I = industrials, M = materials, RE = real estate, and U = utilities

Now that over 1/3 of assets in the S&P 500 are in the seven Magnificent 7 stocks, one could argue that the index isn't well-diversified, yet the S&P 500 is the most popular benchmark as it represents the vast majority of the value of U.S. stocks. The MAG 7 are a favorite with individual investors, who made up 30% of their ownership in Q2 2023, according to McKinsey ("index" made up 27% and "closet index" was another 16%). *The Wall Street Journal* recently published an article titled, "More Men Are Addicted to the 'Crack Cocaine' of the Stock Market." Earlier, I noted that individuals tend to sell at bottoms of markets, but the Covid-19 sell-off was different. As the market started to rebound and people sat at home with nothing to do, a huge number of brokerage accounts were opened. The market became a casino (that people couldn't visit during Covid-19). In 2021, the *Journal of Behavioral Addictions* published "The Stock Market as a Casino: Associations Between Stock Market Trading Frequency and Problem Gambling." Conclusion: frequent trading is like gambling.

Average Holding Period on NYSE is 5.5 Months



Visual Capitalist, "The Decline of Long-term Investing," December 8, 2021

> Short-termism, indexing, etc. is good for fundamental investors if it results in more mispricing, but it's bad if mispricing does not correct before the long-term investor is out of a job. It's also good for those who model human emotions in investing.

This brings up another interesting development. The ownership time horizon has dropped to 5.5 months (June 2020). This is attributed to the rise of technology on exchanges, more information flow, online trading, a drop in commission rates, and high-frequency trading (HFT) (over 50% of daily volume). Does HFT make markets more efficient by providing liquidity and through arbitrage strategies? Or does HFT make it less efficient if it makes markets more volatile, fake orders are made, and trading is not based on fundamental analysis and is rather based on modeling human irrational interactions? For a review of HFT, see "High-Frequency Trading: Definition, Implications, and Controversies," in the *Journal of Economic Surveys*, and "Implications of High-Frequency Trading for Securities Markets," in the *Annual Review of Economics*.

M&A Taking Away While IPO Activity Adding Little to Supply

Free cash flow (FCF) can be used to buy back shares, pay a dividend, increase the cash balance, and/or reduce debt. On page 5, I showed that corporations increase buybacks about nine months after earnings rise. It takes some time for boards to approve buybacks and for them to be implemented, for corporations to adjust expectations to higher earnings, for management to cave into short-term investors who encourage them to “do something” with the extra free cash flow, or just as bad, for firms to herd to buy shares as everyone else is doing so. The same story applies to cap ex.

Over the long-run, value rises as firms grow FCF (and EVA). While cap ex reduces FCF in the year of spending, the hope is it increases FCF in the future. Unfortunately, cap ex is poorly timed as cap ex follows earnings growth by about 10 months (shown on page 5). If firms invest earlier, they may generate more profits when conditions rise. Plus, by investing before earnings growth, capital growth and buybacks may be cheaper when stock prices are low, and firms wouldn’t be building out capacity as earnings start to roll over (i.e., low growth follows high earnings growth). As shown in “Manage Risk by Managing Expectations,” a cautiously optimistic strategy – capital growth without adding too much debt – tends to work well in all four phases of The Expectations Clock. It’s unfortunate that much of management compensation is tied to earnings. If a firm focuses on EVA instead of earnings, this builds in caution when it comes to investing in capital, since EVA is NOPAT minus a charge for capital. More capital → higher charge → and less EVA unless NOPAT rises sufficiently to offset the additional capital.

M&A Activity = Dumb Money

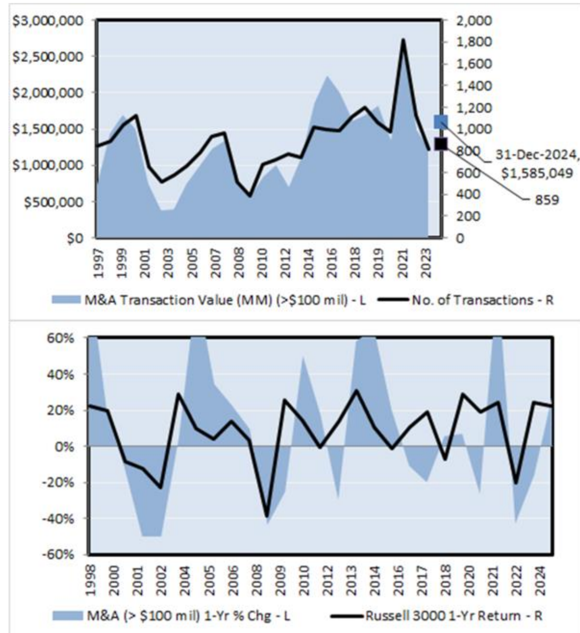
DUMB MONEY: One of the most egregious blunders and quickest ways to substantially increase capital is by making a large acquisition. While it may increase earnings, it could result in a disaster if it is based on overconfidence, purchased at market tops, and capital rises more than earnings (thereby lowering EVA). Unfortunately, corporations make more acquisitions at market peaks. As seen on the right, M&A activity was highest (1) running up to the internet bubble, (2) during the financial bubble, and (3) in 2021 in the post Covid-19 bubble. ***M&A activity was coming back in 2024.***

M&A reduces the supply of stock as companies are folded into another; although, the reduction is offset somewhat by new shares issued to make the acquisition. Furthermore, buying another company ***drives up demand for stocks***.

IPO Activity = Smart Money

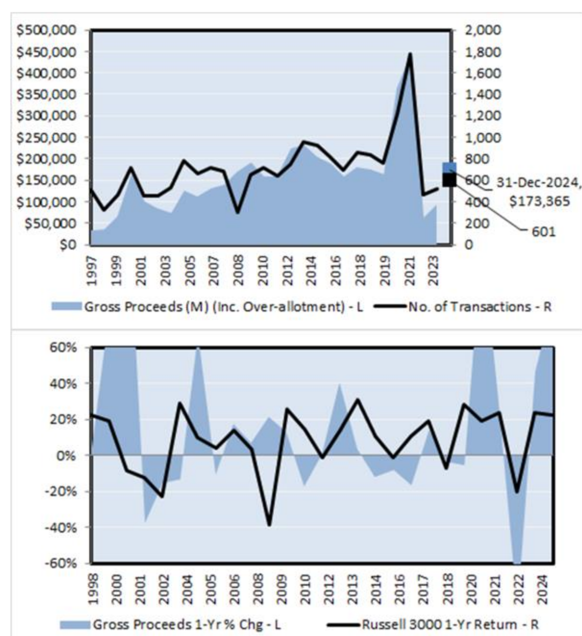
SMART MONEY: While M&A activity can be used as a contrary indicator, IPO activity is the smart money indicator. Private business owners know when to sell! The two biggest peaks in IPO activity were during the internet bubble and the 2021 bubble. **IPO activity, while low, is well off its bottom during 2024.**

M&A Coming Back – Dumb Money Indicator



ISS EVA, FactSet, Russell

IPO Activity Still Subdued – Smart Money Indicator



ISS EVA, FactSet

Supply of High Growth Stocks Declining, and More in U.S.

On page 3, I discussed how non-U.S. investors have increased their allocation to U.S. stocks above and beyond what is simply justified by capital appreciation. There are at least three reasons for this.

First, the percentage of high growth stocks has declined since 2014. The graph on the right shows a declining percentage of stocks (available in FactSet) that have sustained a 10-year sales growth rate of more than 15% per year.

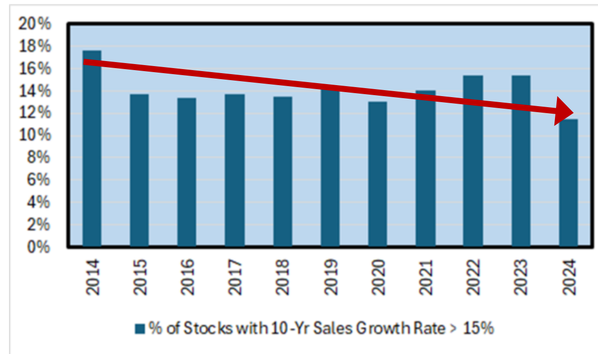
Holding demand constant, as something becomes scarcer, its price should rise. If demand also rises, the price goes even higher. Demand is likely up for growth stocks given investors' shortened time horizon, the rise in momentum investing, and increased trading by individual investors who may not fully understand how to value a stock.

Second, the growth rate for U.S. stocks has increased over the last several years. I show the average 10-year sales growth, but the same upward trend exists for the median 10-year sales growth rate and 5-year sales growth figures. The United States also has a sales growth rate advantage over non-U.S. stocks, which has further driven investors to the United States (see discussion on page 3).

Third, these medians and averages are not outliers. The U.S. has a higher percentage of stocks with greater than 15% 10-year sales growth. It also has a higher percentage of large stocks (> $5 billion in market capitalization) with growth rates greater than 15%.

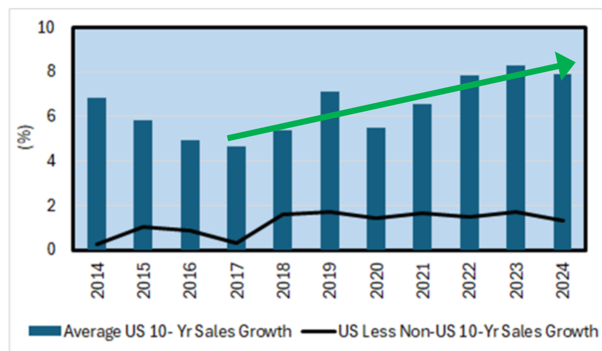
While these may be reasons for the shift to and run up in returns and valuation of U.S. stocks, please realize that high growth rates have a tendency to reverse (see [Drivers of Growth]) and selecting stocks based on past high growth rates generally does not produce the highest alpha (moderate growth is best) (see [Finding The Investment Gems]).

Fewer Stocks with > 15% 10-Yr Sales Growth



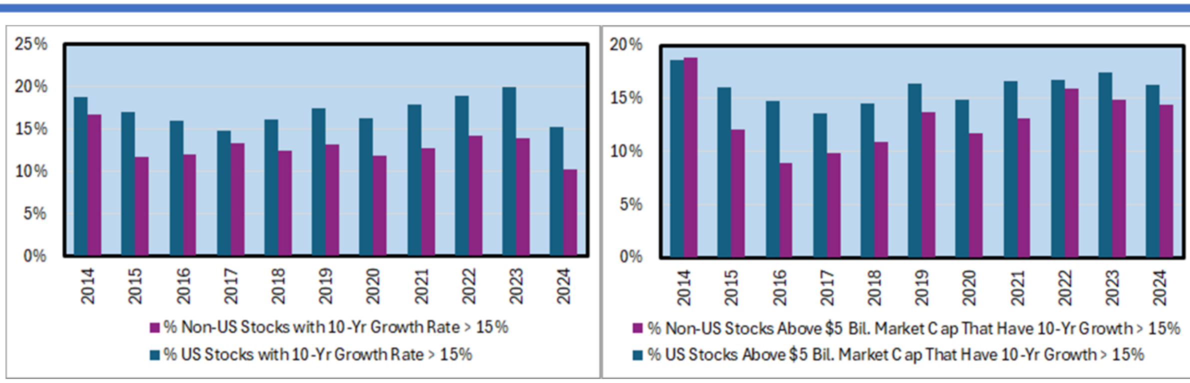
ISS EVA, FactSet; year-end data except 2024 which is 9/30/24.

U.S. Growth Improving and U.S. Higher than Non-U.S. Growth



ISS EVA, FactSet; data is for all stocks where a growth rate can be calculated; year-end data except 2024, which is 9/30/24

U.S. Has a Higher Percentage of Stocks with > 15% Sales Growth



ISS EVA, FactSet; data is for all stocks where market cap and sales growth for 10 years were available (11,098 stocks on 9/30/2024 and 6,365 stocks on 12/31/2024); year-end data except 2024, which is 9/30/24

Investment Takeaways

It appears that current market valuations cannot be fully justified by fundamentals – by interest rates, extra growth from AI, or the Trump bump. Does psychology explain the valuation of U.S. markets – are people flooding to the United States as they herd and chase past growth and returns? Or is the outperformance of the United States explained simply by supply and demand dynamics for stocks? Or are returns explained by the interaction of fundamentals, psychology, and demand and supply? Imagine that the United States produces higher growth (fundamentals), which results in higher demand for stocks and pushes up prices (supply and demand), which leads to increased interest from and buying by short-term investors who believe the past returns will be replicated (psychology), which leads to additional investment in AI that makes companies more efficient and raises earnings and EVA (fundamentals), which causes demand for U.S. stocks to rise (demand and supply), and so on. This feedback loop works – until it doesn't – but it can create bubbles – that eventually pop – along the way.

There's long-term and short-term drivers for the demand and supply of stocks.

- Long-term
  - Demographics probably matter. While the peak in the percentage of 45-64-year-olds in the United States occurred about 10 years ago and the current savings rate seems to be below trend, equity allocations are high.
  - Non-U.S. investors have flooded to the U.S. stock market. This could have been driven by the United States' higher growth, but will it last? The investment in the U. S. isn't limited to stocks. The United States Department of Commerce notes "With its workforce, legal protections and encouragement of innovation, the United States continues to be an attractive destination for business investment." The U.S. has been the country with the largest inward foreign direct investment (20% of GDP in 2023), but the trend has been slowing.
  - There's been a declining percentage of high growth stocks, and many are in the United States. However, consider this: if AI is successful, will it be Google, Amazon, Apple, Meta, and Nvidia which benefit most long-term, or will it be the firms which adopt the products that these companies make? Perhaps growth broadens over time, and if this is the case, then maybe many current underperforming industries and smaller companies that are relatively cheap (but maybe not absolutely cheap) and have lagged headline market returns (e.g., S&P 500) deserve a closer look?
- Short-term
  - A long-term trend that impacts short-term demand is the increased investments from non-fundamental investors (e.g., index funds and ETFs, individual investors, momentum strategies, HFT, etc.). This may make the market less efficient. Should we just let AI invest for us? If AI models market behaviors to trade it may end up modeling irrational human short-term behaviors and make the market even less efficient. (Please refer to pages 6-7.) What percentage of trading is from investors who analyze fundamentals (e.g., business drivers, earnings/EVA, and valuation) and invest long-term? Could this be as little as 10%? Less? Is that enough to keep markets efficient?
  - Share buybacks drive up demand and reduce supply of stocks at the same time. Changes in buybacks seem to be positively driven in the short term by earnings, which means corporations tend to buy the most stock at the highest prices and the least at lower prices. Shouldn't one buy low and sell high?
  - M&A trends tend to be highest when returns are highest, so corporations again tend to buy high. M&A increases demand for stocks at the same time as it reduces supply. On the other hand, IPO activity – or increase in supply – is also highest when returns are highest. However, the size of M&A dwarfs IPOs, so in general corporations buy the most stock at high prices and the least at low prices.

Investment Takeaways Continued…

This week, Bloomberg ran an article titled, "Here's (Almost) Everything Wall Street Expects in 2025." As I read the summaries of the strategists, I found that I agree with the author that there is an unusual degree of consensus, and it is positive. "The US economy and assets are once again expected to power ahead, enjoying new momentum from Trump and benefitting from the comparative lack of appeal of other major markets, many of which could be hit by his tariffs."

I also read "On Bubble Watch" by Howard Marks, one of my favorite investors. He notes that "In the third stage (of a bull market), after a period in which the economic news has been great, companies have reported soaring earnings, and stocks have appreciated wildly, everyone concludes that things can only get better forever." He also said, "When a whole market or a group of securities is blasting off and a specious idea is making its adherents rich, few people will risk calling it out."

I'm happy to be the person (along with perhaps Howard) to "call it out." However, I apologize for calling out in this piece the frequent short-sightedness of individual investors, institutional investors, and corporations. In professional investors and corporate managers' defense, if they sit out a trend and are wrong then they may lose their jobs or have no assets to manage when the tide turns. Also, short-sightedness is due to natural human behavioral biases to overweight current and recent past conditions in expectations of the future.

However, when prices tell me a story that seems stretched, I default to what Howard said that "It's not what you buy, it's what you pay that counts." Every asset is a buy at the right price. Using my CAIGR, I've noted that the market should be about 5,000 if economists' optimistic expectations of 1.1% higher growth from AI over the next 10 years come true. 1.1% extra growth is a big number, given that real GDP grows only 2-3% per year. This 5000 estimate of value also assumes no recession, and no negative outcomes (and probably positive outcomes) from Trump's policies. This assessment could be right, but the current valuation does not seem to provide, to quote Benjamin Graham, a "margin of safety." This does not mean that market prices cannot move even higher. Demand and supply dynamics and psychology do not rely on underlying fundamental logic, even if the trend begins for logical reasons.

Don't you just love investing? There's something new to learn every day, and hopefully now I've given you something else to consider about supply and demand.

Have a good day!

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