PICKING THE WINNERS from ‘creative destruction’

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“ is the only way to reliably outperform.”

As an investment manager, our approach is to deliberately narrow our investment universe. There are large swathes of the market we never approve for investment. Sometimes this means we can miss out on returns as the bandwagon trumpets the latest must-have stock. But we’re fine with that.

WHY?

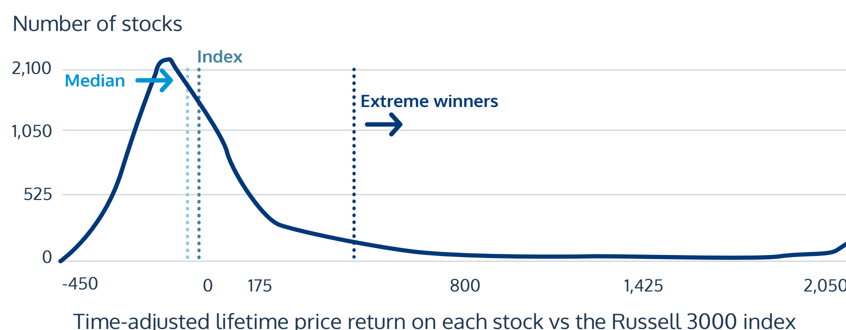
Many of you might have heard this one before – the phenomenon commonly referred to as creative destruction, a term first coined by Austrian-born economist Joseph Schumpeter in 1942. As he wrote in his book, *Capitalism, Socialism & Democracy*, the “gale” of creative destruction is presented as “the essential fact about capitalism” that incessantly “revolutionises the economic structure from within, incessantly destroying the old one, incessantly creating a new one”.

In simple terms, this means innovation makes the old ways of doing things obsolete. At the start of the 20th century, the best example of this was the Ford motor car of 1908 rendering the best horse-and-buggy companies obsolete. Some accounts suggest there were more than 250 car makers in the US by the 1920s and the uptake of cars spurred new industries and success stories in retailing, tourism, oil, and industry. The Ford Model T was also eventually superseded by the technology developed by General Motors. In more recent times, we have seen steam turbines replaced with natural gas and oil and now solar, wind or renewable fuel farms. Closer to home, the television replaced radio and is now being dethroned by on-demand, individualised cloud-hosted entertainment.

Much like fashion or technology, where built-in obsolescence is key to maintaining interest, so too the music from that bandwagon, currently spruiking stock picks via internet memes, will also eventually fade.

The idea here is that economic growth is fuelled by creative destruction because as the latest innovations replace the old, significant upswings in productivity are achieved. It is also important to note that despite the excitement of new technologies such as electric vehicles, for example, the rewards of this progress do not necessarily reside with shareholders, but often with society, employees, and customers. This may ultimately hurt hopeful investors where singular success has been built into share prices as seen for a ‘market darling’ such as Tesla.

Distribution of excess lifetime returns on individual stocks vs Russell 3000, 1980–2014



This matters because share markets aren't driven by the median stock or the average of all stocks, as many an index proprietor would have you believe. Winners generate all the market's performance when measured over appropriate long-term time frames. In fact, using the S&P 500 Index as a yardstick, 40% of stocks report negative returns over their lifetimes. About 66% of stocks underperform the index in which they are placed over their lifetimes. That is to say, winners drive markets.

While it is unsurprising that some businesses experience negative lifetime returns post inclusion in an index, it is the magnitude that is astonishing. While the facts presented above show that creative destruction has played out over many decades, there is evidence that this phenomenon is becoming more, rather than less, prevalent.

"Companies that fail are often the former titans, the household names"

A recent study by McKinsey[1] found that the average lifespan of companies listed on the S&P 500 has reduced to 18 years from 61 years in 1958. Furthermore, McKinsey forecasts that by 2027, 75% of the companies quoted today on the S&P 500 will have departed and that the average longevity of companies will reduce further to 12 years. Time will tell whether this dire prediction proves true.

When considering this issue of the high proportion of losers within any stock index, it is interesting to examine at a micro level what happens to companies and to understand why so many fail. US investment legend Charlie Munger famously referred to these natural changes in market composition as like human biology; much like creative destruction, new replaces old again and again.

"In biology, what happens is the individuals all die, and eventually, so do all the species. Capitalism is almost as brutal as that," he said. "The one thing I will say is that a lot of the moats that looked impassable, people found a way to displace. Think of all the monopoly newspapers that used to be, in effect, part of the government of the United States. And they're all dying ... A lot of the old moats are going away, and, of course, people are creating new moats all the time. That's the nature of capitalism.

"You have the finest buggy whip factory and all of a sudden in comes this little horseless carriage. And before too many years go by, your buggy whip business is dead. You either get into a different business or you're dead…It happens again and again and again."

Companies that fail are often the former titans, the household names. While many of these operated in competitive industries, some were businesses with such reach and dominance that their competitive advantages, or 'moats', seemed unsurmountable, and indeed the industries have often bustled on while these incumbents failed within them, failing to keep up with new competition.

General Motors, for instance, had the dominant dealer network across the US and had mass-production economies of scale but failed to compete with cheaper foreign cars and changing consumer preferences. US department-store chain Sears dominated mass-market retail and at its peak was larger than its next four competitors combined, conferring significant bargaining power against suppliers. This share was eaten away by the emergence of speciality retailers and Kmart and Walmart. Sears' blinkered view of Walmart was something founder Sam Walton was famously disdainful of.

IBM had a significant incumbency advantage in installed machines across its customers, but its success bred complexity and bureaucracy and a reliance on its mainframe business gravy train. The company invented the microprocessor in the 1970s but this innovation competed with its mainframes. It used Microsoft and Intel as suppliers rather than seeing them as rivals at a time when software was becoming the source of value. Indeed, IBM's support gave these companies legitimacy and early success. Likewise, Xerox didn't take seriously the competition from Japanese rivals who undercut it with simpler and cheaper copiers.

What Munger references and the famous examples above show are classic disruptive threats to strong incumbents. These threats can be multi-faceted, but include:

1. Innovation changing how things are done, such as streaming supplanting DVDs. Simply being a technology company or

1 Six building blocks for creating a high-performing digital enterprise article. https://www.mckinsey.com/business functions/organization/our-insights/six-building-blocks-for-creating-a-high-performing-digital-enterprise#.

an innovative company, however, doesn't confer protection. Disruptive technologies are often replaced by new disruptions.

2. Changing consumer preferences such as the move away from sugar consumption or petrol-guzzling vehicles.
3. Competition: Many companies without competitive advantages can survive and thrive for some time, giving the market a false sense of underlying risk while 'times are good'. Strong results will naturally attract competition and erode these favourable economics. Even if there is a giant market to be won, does the value accrue to shareholders or customers? The amount of competition will determine this.
4. Changes in power balances from industry consolidation that can dramatically alter company fortunes.

Often the issue lies within companies. Management fails to be agile and innovative, wanting to protect their legacy businesses while encumbered by complacency and size (versus the default assumption of being advantaged by it). Alternatively, ignoring disruptive change or old-fashioned excess leverage over expansion or poor M&A decisions based on poor short-term incentive structures may be at fault – classic 'agency risk'. But sometimes the changes are beyond management control. We typically assess these as business risks and these are often innate to the operations of the company. Outside threats can include:

1. Commodity prices: Shocks in oil prices, for example, have created boom-and-bust scenarios for the extractive industries and the tenuously capitalised companies within. Commodity-exploration companies are notoriously volatile long-term investments.
2. Regulatory changes: The loosening of credit standards for US government-sponsored home-lending enterprises Freddie Mac and Fannie Mae in the 1990s led to a dramatic upswing in subprime lending to more than 40% of their acquired loans by the 2000s from less than 10% in the prior decade. Though not the singular cause, this change precipitated the subprime crisis and then in 2008, the financial crisis with which we are all familiar.
3. Patents: Healthcare companies need to be disruptive to maintain their revenue bases as legacy drugs come off patent and are replaced by generics. Much more money needs to be spent on research and development these days because breakthroughs have become harder and costlier to achieve. To illustrate, only five to eight new formulas out of every 10,000 to 15,000 compounds reach clinical testing and of those typically only one will reach full commercialisation.
4. Geopolitical issues and trade policies: The Chinese Communist Party's subsidies to China's auto, steel and other industries increased competition and reduced prices for western competitors.
5. Fraud: Enron, Tyco and others are notable for this too-frequent cause of business failure.

"Often the issue lies within companies. Management fails to be agile and innovative, wanting to protect their legacy businesses while encumbered by complacency and size "

Companies that are low quality or contain excessive business or agency risks will not qualify for our approved lists.

You could argue that companies that have grown to the point of being listed and making it into a major index are already winners. And you'd be right. However, while making it to the top certainly increases a company's chance of success, it doesn't mean it'll stay there.

Companies willing to disrupt themselves are more likely to have longevity, and on average the traditional 'defensives' of consumer staples and utilities also tend to last longer than the exciting ones. Recessions typically 'clean out' companies that were weaker than they might have appeared prior to the shock.

In recent times, low rates and a flood of available capital have no doubt aided entrepreneurship but have also enabled company longevity as it has allowed otherwise failing businesses to continue to operate with increased debt. It is estimated that 'zombie' companies, those generating cash flows less than their debt-servicing obligations, comprise 25% of the S&P 500 at present. These low-quality companies are relying on an ability to increase debt (no increase in risk aversion) and at continued low rates (which a rise in underlying inflation may preclude).

While excessive leverage has always been a source of business failure, this recent escalation does pose a more noticeable risk to markets in coming years.

Looking ahead, we can observe that many of our largest incumbents have not left 'disruption gaps'. Alphabet and Microsoft are investing their substantial annual cash flows into new technologies. Cloud enables low-and high-spec customers to be addressed by the same scalable platform that then precludes the cheap substitute risk. Facebook provides its service at no charge, supported by revenue from a long list of small-business advertisers.

"Quality businesses must also be purchased at appropriate valuations."

Further, not all companies are at risk of disruption from competitive threats. Indeed, Procter & Gamble, one of the oldest companies in the S&P 500 and incorporated in 1890, shows resilience to disruptive threats today and is one of only 10 US companies that has paid a dividend for more than 120 consecutive years. Similarly, Louis Vuitton is a remarkable brand with longevity, in business since 1854.

Many large consumer brand companies continue to enjoy significant economies of scale and capital advantages and after slow starts have adapted rapidly to a digital world. Changes in consumer preferences in health and wellness, including plant-based foods, reduced sugar consumption and allergy management have seen these companies make substantial investments to ensure their offerings stay up to date.

That is to say, the companies that qualify for our investment universe are in our view addressing and, in many cases, benefiting from disruptive change. In future, it will be harder for upstarts like the Dollar Shave Club to displace Gillette as large incumbents harness their size to innovate and engage with customers via digital platforms.

However, the shift to e-commerce, the utilisation of the cloud and decarbonisation, among other shifts, highlight the threat of creative destruction for dominant businesses. As such, we must reassess the merits and quality of each business as the world changes and as our views around regulatory and geopolitical risks evolve. This cements our focus on taking a forward-looking view and intimately understanding industries and disruption as a threat to competitive advantage.

Of course, a quality business alone does not a quality investment make. These quality businesses must also be purchased at appropriate valuations, but as an important starting point, we don't take our approved list of stocks for granted. Monitoring and understanding business risks and how industries and indeed our own lives will change in the years ahead is required to understand the ongoing eligibility of stocks and to avoid being exposed when the 'tide goes out' in markets.

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