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Embrace the Hegemony of Big Tech

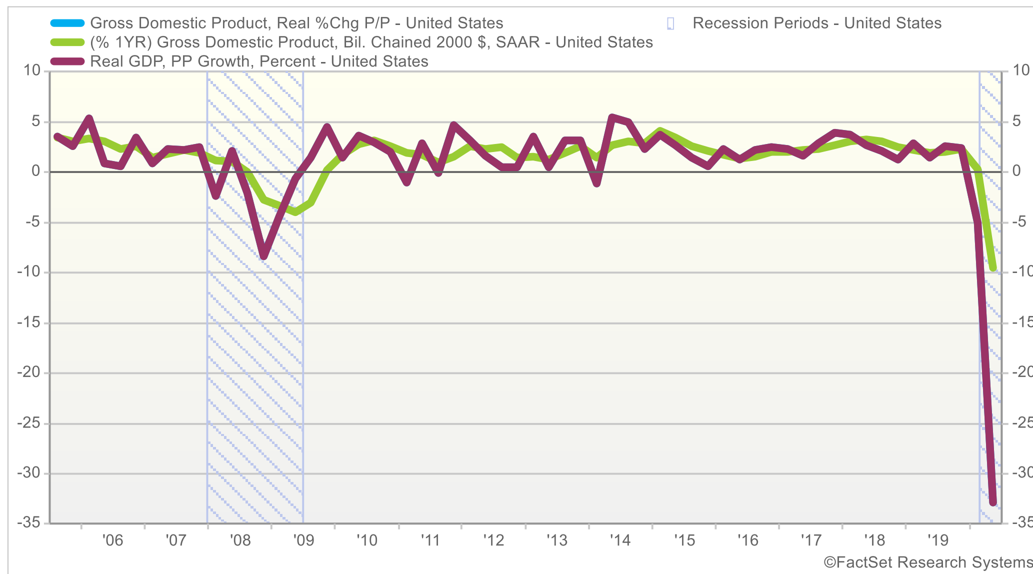
Summary: Distortion from coronavirus has aided, not hurt, large technology firms, and these continue to lead the market higher. The debate around the valuation of Big Tech is not new but has reached a new level of anxiety with the top five names valued at $6.6 *trillion* and comprising more than 20% of the S&P500. We are not particularly concerned. We remain bullish regarding the long-term outlook and prospects for *exceptional companies including Big Tech* to create value.

Does Market Concentration Increase Risk?

To the (technology) victors go the spoils. Last week the CEOs from Facebook (FB), Amazon (AMZN), Apple (AAPL) and Google/ Alphabet (GOOGL) were virtually dragged before congress to respond to questions from lawmakers. We did not study the discussions. However, given the complexity of these companies and the format (video Q&A with questions from non-experts), it did not surprise us to read that little insight was generated by the exercise. Perhaps fittingly, shortly after the hearings, three of the four companies reported record revenues and profits, sending their share prices soaring to all-time highs.

Big Tech has earned congressional ire via each's alleged dominance of its respective market, among other factors. However, it is not abuse of their competitive positioning (in our view) that produced the exceptional and better-than-expected second quarter results. It was coronavirus. More accurately, it was each company's respective business model and the impact of stay-at-home-orders together with stimulus payments, that accelerated already strong growth and secular trends. See figure 1 for the GPD backdrop that accompanied both the coronavirus hit and helped to produce record results from several Big Tech companies.

Figure 1. Disconnect: FB, AMZN, and AAPL, all reported record results during the same quarter that GDP tanked 10% on a seasonally adjudged annual rate (SAAR) and over 30% sequentially.



The shares of the largest five U.S. companies measured by market cap are worth $6.6 trillion in aggregate. Does that matter? Outside of congressional halls, the dominance of Big Tech is creating agita with a different group: investors and finance professionals. Market commentators have focused on this group's ballooning market value, which now accounts for greater than 20% of the total value of the S&P 500. This is a record. The market's total value has never been as concentrated in such a small group of stocks. To provide some context, a previous peak in concentration occurred 20 years ago, during (*the first?*) tech bubble. See figure 2.

Figure 2. Two-horned monster: S&P 500 is more concentrated than ever before thanks to Big Tech.

Source: BofA Global Investment Strategy, Bloomberg

Market concentration seems like a problem and is being highlighted as a risk by some observers. We disagree and there is a point to be made about investing philosophy. We believe there are two factors underlying unease with the value of Big Tech relative to the rest of the market. First, concentration of the index appears frightening because many investors have internalized the idea, sold by index fund promoters and others, that diversification = safety. Since the S&P500 is so concentrated today, it is no longer as safe, according to this line of thinking. On the contrary, diversification by itself does not reduce the chances of losing money. It also does not eliminate systemic risk. Further, the reduced risk provided by diversification diminishes quickly in a portfolio, well before you get to 500 stocks. Consider Figure 3 which we borrowed from a friend. It compares the performance since 2015 of the five largest companies in the S&P 500 to the performance of the remaining 495. The Big Tech names have gained more than 250% while everything else has increased a paltry 25%. S&P 500 indexers have participated in the performance of Big Tech, but this was diluted by their "diversification" with investments in many poorly performing businesses. With hindsight, concentration would have been a better strategy.

Figure 3. Diversification = dilution. While we acknowledge there is some hindsight bias in this statement, it's hard to argue that investors in the S&P 500 have benefited from owning a large number of underperforming companies.

A deep belief in the power of information contained in charts is the second factor contributing to concern about Big Tech's market value. Charts can contain useful information that can form a part of the research process for investors, for sure. However, "information" contained in charts is often just noise. A theme of our newsletters is that investor psychology is wired to find patterns *even when there none* and then to create coherent narratives to explain these "found" patterns. As noted above, the last time the S&P 500 became highly concentrated it coincided with an overvalued market and preceded a terrible bear market and loss of value. Accordingly, it follows that if we are even more concentrated now, then… what? Then nothing, is the way we see it. Investors were really excited about tech in 2000 and they are very excited about Big Tech now. However, the resemblance in this case does not equal predictive power. Last comment on charts: charts are necessarily composed of historical data, but investing is about the future.

Investors "Beat the Market" All the Time

Another of the financial media's favorite themes is that it is not possible to beat the market (so don't try). It is true, from the data we've seen, that *the majority* of professional investors underperform the market indexes. The media loves to point this out as they call out the hubris and pillory hedge fund managers and other professional investors for their ridiculous salaries and outrageous Hamptons mansions. The index fund industry has massively profited as investors have taken heed of this message and transferred trillions of dollars from "active" managers and into "passive" strategies that seek to only mimic major market indices (like the S&P 500). However, even as *the majority* of professional investors underperform the market while simultaneously charging silly fees, *a sizable minority are consistently beating the market*.

How We are Managing Client Money

Our approach: Do the work. Own the best companies. Stay fully invested. Don't trade in and out of names (focus on the long-term). Take Concentrated Positions. Our view is that the value of a stock is determined by the underlying company's future earnings and cash flows, and adjusted for the risk profile of the business (including the balance sheet), its rate of growth, and other factors. There is no shortcut to estimating these future earnings or cash flow potential. You simply have to do the work. This includes, among other things, generating or reviewing financial forecasts, and taking the time to understand the company's strategy, management, operating structure, markets, and competition. In our portfolio, we own

several of the Big Tech names we've discussed here including AAPL, FB, GOOGL and also MSFT. We have highlighted each of these names in previous newsletters and have owned each since inception. We continue to view these names favorably. Our book is rounded-out with other tech names and several best-in-class consumer companies.

Spending summer here in Europe while waiting for the U.S. to open back up. Last month we took advantage of the travel bans on Americans, Brits, cruise ship passengers and other undesirables to visit some of the best Greek islands during high season. Normally, these islands are completely overrun. It gets so bad that in Oia, (produced EE-a) a village on Santorini, the locals have resorted to identifying every piece of private property with a sign in English indicating "don't climb here". This includes the rooftops of churches and entrances to cemeteries. This year, thanks to coronavirus, we had no difficulty finding a seat at a restaurant or taking photos without too many fanny-pack wearing tourists marring the view. For August, we will be working from the French countryside, but also have a trip planned to Malaga, Spain to visit friends. The travel experience to Greece during coronavirus was no worse than a normal travel experience, that is, painful, but manageable. For Spain, we are hearing the rules are a bit more strenuously enforced with fines doled out to unmasked beachgoers. In Greece we were completely left alone. Hopefully, the Spaniards won't get in the way of my plan to eat large quantities of jambon Iberico.

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Mr. Zolidis started his career in finance in 1996 following degree studies in Philosophy at Kenyon College and the University of Oxford. He has followed U.S. consumer companies as a senior analyst since 1999, mostly on the sell-side, writing research for institutional investor clients. He also managed money in a buy-side role at a long-short equity fund over 2013-2014. He was named in the Wall Street Journal's Best on the Street list in 2005. Mr. Zolidis founded Quo Vadis Capital, Inc., a Registered Investment Advisor (RIA) and research consultancy, in 2017 and works from New York and Paris, France.

Not thinking about work. In 1600 BCE a massive volcanic explosion literally annihilated the island of Thera (now Santorini) in the Aegean Sea. The explosion spawned a massive tsunami, possibly responsible for completely wiping out the Minoan civilization on Crete 75 miles away. What remains of Santorini today are the shattered edges of the original island, including the stunning caldera (volcanic cliffs) that are as high as 1,000 feet in some places. The shot in this photo was taken from Imerovigli, which is the highest point on the caldera. Try to visualize the explosion that created the island. Makes the tech bubble seem less frightening, eh?

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