Revival of the Fittest

The Trouble with Buy and Hold

In his recent note, Hedonism and the Value of Money, George shared his enthusiasm for the 1961 E-Type Jaguar. Although this "breathtakingly pretty" car survived the test of time, Jaguar Cars as an independent company didn't fare quite as well; a defensive merger with British Motor Corporation and a subsequent ill-fated merger with Leyland Motor Company ended with enforced nationalisation in 1975. Although it regained its independence in 1984, Jaguar lost it again a few years later - this time to Ford - and was finally sold along with Land Rover to the Indian Tata group in 2008. Jaguar's history is colourful but not unusual; survival for more than a short number of years in the corporate world is increasingly rare.

The average graduate starting work the year Jaguar launched the E-Type could have expected the company they were joining to outlive them, or at least survive until their retirement. A young man, for example, graduating in 1961 could have anticipated living for another fifty years, a graduate today can expect to live for another seventy[1]. However, if starting work today, he can only expect the company he is joining to survive for another twelve years. We humans have become much more resilient, on average, but the firms on which we most often depend for our income have become less so.

Companies in general might be dying younger, but the oldest ones are truly ancient. Swedish paper company, Stora Enso, started life as a copper mine around seven hundred years ago, an adolescent relative to some Japanese companies originated in the eighth century. A number of western household names are of pensionable age; Du Pont, Colgate-Palmolive, Johnson & Johnson, Procter & Gamble, Nestle, Louis Vuitton, Michelin, Marks & Spencer and the London Stock Exchange were all founded in the nineteenth century. The gap between the oldest and the average, however, is like nothing we observe in the natural world; very large long-term survivors are rare and they are becoming more scarce. The average tenure of a company in the S&P 500 sixty years ago was more than sixty years, by 2012 it was 18 years and it's falling fast[2]. The corporate corpses are everywhere, 88% of the Fortune 500 as it stood in 1955 is now gone (more than half of this illustrious list has disappeared since 1999[3]), either into bankruptcy or into the

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[1]We are assuming the graduate was 21 years old and life expectancy is based on ONS data for male life expectancy.

[2] Creative Destruction Whips through Corporate America, Richard Foster, Innosight, 2012.

[3] What is the Life Expectancy of your Copany, Mark Goodburn for World Economic Forum, 2015.

hands of an acquirer. Eastman Kodak, Blockbuster, Bethlehem Steel, Woolworths, Enron and Lehman Brothers - some of the worlds' most iconic names, one way or another, have disappeared.

The S&P 500 alone doesn't give a full picture, it is only the cream of corporate America; when industries consolidate or when companies fail, it's generally S&P constituents that buy what's left. The darker side of declining corporate longevity might not therefore be fully reflected in the index as bankruptcies generally happen further down the food chain. When looking at all public companies, not just those in the index, death rates are much higher – only one in three are likely to survive the next five years, one in ten will be gone within the next twelve months[4].

What we might call corporate Darwinism is not all bad however; even if companies are dying younger they are quite often living faster. Corporate adolescence, fuelled by accelerating technology, can now deliver scale previously achieved after decades. Facebook; with nearly one in four of mankind logged on and $22 billion of revenue, has a market value half as big again than AT&T. While it took Hilton and Starwood one hundred years to offer 700,000 hotel rooms, Airbnb did it in six. The "unicorns", technology upstarts valued at more than a billion dollars, numbered more than 200 by the start of this year[5]; Uber, Snapchat, Dropbox and an army of companies developing anything from smart homes and cloud based computing to online financial services are upending incumbents everywhere.

Shifting sands

The rapid rise and early demise of corporations is no longer news, but an arguably more important impact of disruption is on how profits are shared along the way. On this front, the sands are shifting fast beneath the world's largest corporations.

It has become fashionable to highlight how just a few companies take most of the profits – today the 10 largest companies share a quarter of all S&P earnings. In practice, however, earnings concentration is at best stable and at worst cyclical. The Gini Coefficient of S&P net earnings, normally used to measure inequality in society, shows a broadly stable distribution for the last fifteen years except for the period around the dotcom crash and the Global Financial Crisis – more a reflection of how profits outside of the most successful companies are hit during a recession[6].

What's more interesting is how quickly the companies at the top of the profits-chain change through cycles. Only half of the top ten earners in 2002, for example, were still amongst the big earners in 2009 and the top ten earners today include only four companies that were there in 2009. Of this small elite, 20-30% change each year which means no single company can expect

[4] Boston Consulting Group - Die Another Day: What Leaders Can Do About the Shrinking Life Expectancy of Corporations - July 2015 – Martin Reeves, Lisanne Pueschel.

[5] VentureBeat 19th January 2016

[6] Equitile's measure of the Gini Coefficient shows it was between 0.73 and 0.88 for all years since 2000, with the exception of 2001/2 and 2008/9. In those years is was significantly more than 1.0 due to the losses made by many companies during each of those recessions.

to remain among the top ten for more than 3-5 years[7]. In terms of absolute net profit, only one company, Exxon Mobile, has remained among the top ten between 2000 and 2015 – an accolade, most likely, to be lost this year.

Of 637 companies that have been in the S&P 500 since the turn of the millennium, only two have been amongst the fifty most profitable, as measured by return on equity, in every year; Colgate Palmolive and discount clothing retailer T.J. Maxx (T.K. Maxx to those in the U.K.). Their resilience shouldn't be understated. Throughout that period, only 59% of companies in the top fifty in any one of those years, on average, managed to remain there the following year; to stay at the top for all fifteen years therefore is quite some achievement. If those numbers were down to chance, which we don't believe they are, then the odds of staying amongst the top fifty throughout would have been 2,700:1 against.

The sands can shift surprisingly quickly. After being amongst the top ten earners between 2000 and 2008, General Electric hit the buffers in 2009. The company slashed its dividend by two-thirds, lost its prized AAA credit rating and $269 billion of market value[8]. The engineering titan's strategic shift into lease financing, lending and insurance, through GE capital, left the company excessively leveraged just at the wrong time. Conversely, Apple commanded 1.8% of S&P profits in 2010 but by 2015 it captured 6.5% of S&P 500 earnings. The rise and fall of titans is happening quicker than ever.

Investment Implications

So what's happening?

The short answer is nothing new; it's what economist Joseph Schumpeter called creative destruction, the natural process of the new replacing the old, the strong overturning the weak. It's acceleration however, presents investors with an increasingly difficult challenge; predicting who'll be tomorrow's survivors, let alone which companies will thrive, is trickier than ever.

Firms exist because the cost of doing business without them is prohibitively high[9]. Arranging contracts as individuals - to employ each other, to supply to each other and to collaborate on new ideas - is too cumbersome unless done under one roof. If the cost of cooperating without them is falling, however, then we should expect them to disappear more often than they used to.

The traditional way to address this challenge is to find a few long-term survivors and stick with them - by finding companies that have endured for many years already and allowing time to weave its magic, we might sidestep the problem. A so-called buy-and-hold strategy has its benefits; it takes less time, effort and concentration; moreover, trading costs are lower. It does

[7] We did the same analysis on the top thirty which showed only slightly lower turnover of 20% each year on average.
[8] Between 2008 and 2009.
[9] The Nature of the Firm. Ronald Coase 1937.

though expose us to selection bias, the statistical equivalent of a drug company stopping a clinical trial just when it looks like they've found a cure.

If buy-and-hold still has value as part of an investment strategy it can only apply to those few companies healthy enough to adapt quickly - those with balance sheets so strong that they can readily scrap legacy capital, technology and ways of doing things. Opportunities to buy and hold will remain, but they will be few and far between.

The Jaguar graduate of 1961 is now 76, he's outlived expectations and if he invested in equities for his retirement he's financially comfortable - since he started work the S&P has increased nearly forty-fold. He's had to adapt of course - in fact only 36 out of the 500 companies in the S&P of 1961 are still there today - but since retiring he's had time to watch the spread of mobile telephony, the internet and renewable energy, the birth of social networks, the iPhone, the iPad, smartTV, nano-materials, 3D printing, drones, quantum computing and the mapping of the human genome - just for starters. For those starting out today, a much more adaptive approach to investing for their retirement will become imperative. While buy-and-hold might be a comforting mantra, adapt-to-survive is more realistic.

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