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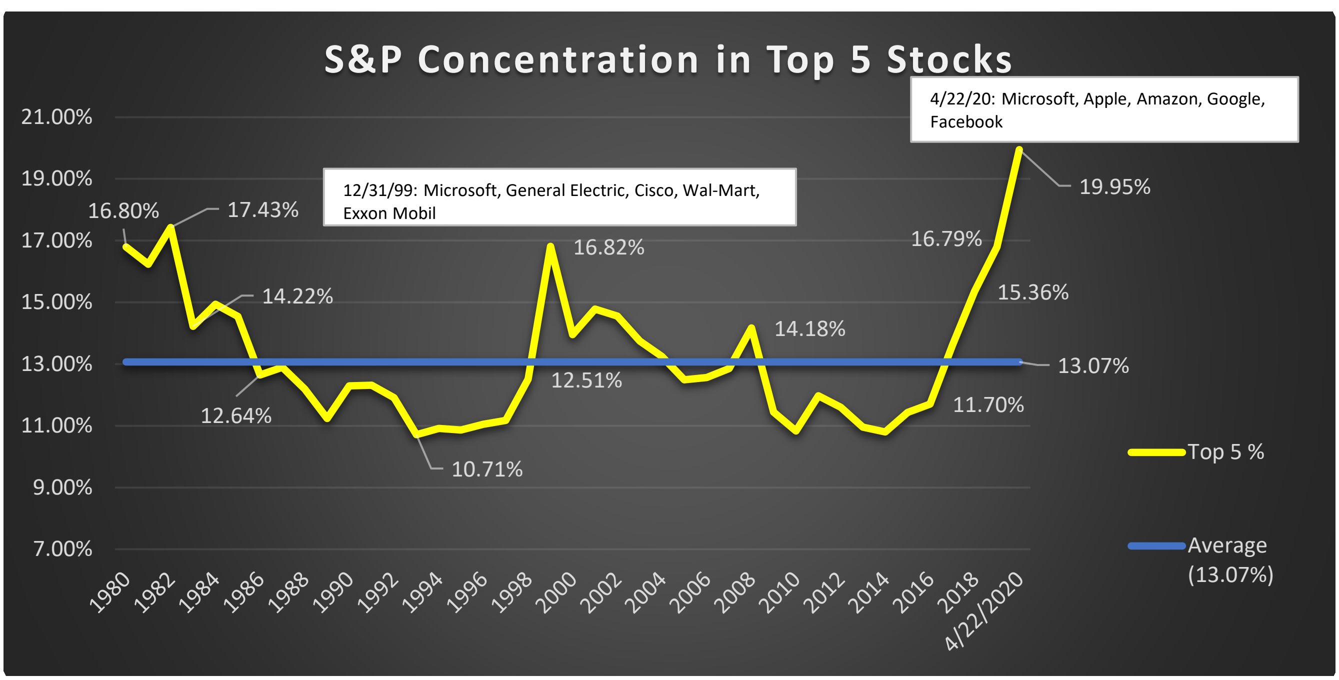
Great Businesses – Bad Stocks?

Every once in a while, a business or group of businesses fall into the Great Business – Bad Stock category. It happens when a business becomes increasingly dominant and profitable and investors' future expectations, expressed by valuation, become so ebullient the performance of the business and the performance of the stock are likely to diverge materially. The best example of this was a group of stocks in the 1970s called the "Nifty Fifty." The Nifty Fifty were a group of incredible growth businesses widely regarded as "one decision stocks" – buy and hold at any price. Included in the group were dominant franchises of the time like McDonald's, Merck, Avon, Polaroid, Coca-Cola, Johnson & Johnson, Sears, Xerox, IBM and others. Investors bought without regard to valuations and the share performance of the group outpaced the broader market. Subsequently, the group underperformed for the next two decades.

Valuations are driven by supply and demand – as more investors decide to buy a particular stock, the valuation goes higher. When everyone desires to own the same stock the price goes up, up, up! So long as the price is going up (also called momentum) it works out well for everyone involved. Analysts upgrade the stock, employees generate wealth from stock options/issuances, shareholders fall in love, and the question becomes, how can you not own this business? The chart below shows the combined market capitalization of the top five stocks in the S&P 500 going back to 1980 through 4/22/2020.



Although a few stocks have historically accounted for a large percentage of the index, today the 20% weight of the top five is higher than any time in the last 40 years. The top-five is a rotating list, but going back to 1980, only 26 businesses have occupied the 200 available slots (40 years x 5 slots = 200). The current top-five is listed below and we'll refer to them as the "Fab 5." The Fab 5 weighted average annual revenue growth and net income growth from 2009-2019 (Facebook from 2012) is significantly higher than the S&P 500.

Business	Revenue Growth	Net Income Growth
Microsoft	8.6%	9.2%
Apple	19.1%	19.9%
Google	21.2%	17.8%
Amazon	27.6%	40.5%
Facebook	19.5%	18.4%
Fab 5	**19.5%**	**18.4%**
S&P 500	**3.7%**	**9.6%**

Surely, these businesses are exceptional by any measure, but investors should be concerned with future growth, not past growth. Past growth only matters to the extent it's replicated in the future. Here stems the problem. As you can see below, the Fab 5 represent 20% of the S&P 500 market cap, but only 7% of revenue, 13% of earnings and 6% of dividends. So, investors are willing to accept less earnings and dividends (proportional to the index) from the Fab 5 in exchange for superior long-term growth.

Business	Market Cap % of S&P 500 - 4/22/2020	% of S&P 500 Revenue - 2019	% of S&P 500 Earnings - 2019	% of S&P 500 Dividends - 2019
Alphabet	3.24%	1.27%	2.74%	0.00%
Amazon	4.24%	2.17%	0.95%	0.00%
Apple	4.97%	2.13%	4.65%	2.75%
Facebook	1.89%	0.54%	1.52%	0.00%
Microsoft	5.70%	1.06%	3.46%	2.81%
	20.04%	**7.17%**	**13.32%**	**5.56%**

Many expect the Fab 5's revenue and net income grow to continue the pace of the last decade (~20%). The table below shows the Fab 5's proportion of S&P 500 sales and net income if they grew at 15%, 20%, and 25% for ten years – assuming the S&P 500 grew both measures at 4% over the period.

Fab 5 Annual Growth (2020-2029)	Fab 5 Sales as % of S&P 500	Fab 5 Net Income as % of S&P 500
15%	20%	36%
20%	**30%**	**56%**
25%	45%	84%

In the 20% growth scenario, the Fab 5 would make up 30% of sales and 56% of the profits for nearly all US publicly-traded businesses. The likelihood of this happening is almost zero, for a few reasons:

1. Regulatory pressures would likely impede such a large concentration of profits in the hands of a few businesses. A few of the popular names on the top-five historic list include Standard Oil and American Telephone & Telegraph. Both of the businesses were forced to split up.
2. Capitalism or economic competition is a vicious force, similar to gravity. No business is immune to this force, the only hope is to delay it.
3. Change in consumer tastes is a certainty. People/businesses change and so do the goods and services they demand. Today, it's hard to imagine a group of five businesses more important to the world than the list above (OK, maybe except for Facebook!), but that was said about every other top-five list too.
4. If that's not enough, the forces within a successful business work against it. Warren Buffett has called it the "ABCs of Business Decay."
    a. Arrogance
    b. Bureaucracy
    c. Complacency

Many of our investors are sports fans, so I'll end with a sports example. Assume you're the owner of the Los Angeles Lakers. You're competitive and have a deep desire to win but need to maintain profitability and earn an adequate return on your investment. You compare the cost (price) of adding a new player to the value he brings. Your job is not to select the five best players – anyone could do that. But you and your staff have to balance the price vs. value equation, what you pay vs. what you get. From a fan's perspective, a starting five of Lebron James, Anthony Davis, Kevin Durant, Steph Curry and Kawhi Leonard makes sense. From an ownership perspective, it likely doesn't.

Investing is similar. Anyone can select the top-five business in the world – that's easy (and I would agree the Fab 5 fit the bill). Comparing what you pay to what you get is harder. Today, people own the Fab 5 because they're great businesses, not because they're great investments. At 41x average trailing earnings per share and a .5% dividend yield, I can think of better investments.

Stock	Price (4/22/20)	Market Cap (4/22/20)	% of Market Cap	P/E - trailing	Price to Free Cash Flow - trailing	Dividend Yield
Alphabet	$1,162	$866.64 bn	3.24%	26x	31x	0.00%
Amazon	$1,949	$1,178.56 bn	4.24%	103x	94x*	0.00%
Apple	$254	$1,208.07 bn	4.97%	22x	19x	1.22%
Facebook	$166	$519.64 bn	1.89%	22x	25x	0.00%
Microsoft	$157	$1,319.80 bn	5.70%	31x	33x	1.22%
			Average	**41x**	**40x**	**0.5%**

**lease-adjusted*

This time might be different. In the past, the four forces listed above acted as a gravitational pull against businesses' profits and valuations growing to the sky. Time will tell if the Fab 5 can avoid the fate of the past, but I believe the list will rotate and investors extrapolating the past into the future without regard to history (or valuations) could receive an expensive tuition.

Sincerely yours,

John

April 30, 2020