Acronyms are not a safe space

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Investing concepts expressed in terms of an acronym have a poor track record. Over the past 40 years, quite a few have come and gone. None of them met with any long-term success. The emerging markets crisis of 1996 savaged the Asian Tigers, the NASDAQ collapse in 2001 pricked the TMT bubble and the global financial crisis in 2008 ended in a BRIC's bust. Today, investors have found a new concept - the FAANGs (Facebook, Amazon, Apple, Netflix and Google). In preview, at Counterpoint the view is that stocks represented by an acronym are not a safe space today.

First - a mea culpa. With perfect foresight, both Amazon and Apple were priced like classic value stocks a few times during the past 20 years. And many value investors did indeed have sufficient foresight to take advantage. Microsoft was once a sizeable position in our funds - criticised at the time - but that was it. Nothing else.

Not owning Big Tech has been a huge sin of omission.

But investing is all about managing your exposure to uncertain events in the future, not perpetually kicking yourself for sins committed in the past. The past is prologue, but not a predictor.

So why should one avoid Big Tech today?

Unsurprisingly, valuation is the primary reason. The market appreciates the stable, growing cash flows these high quality businesses generate, especially in turbulent times like the present. Moreover, during the course of the pandemic, these businesses have gained market share and become even stronger.

Interest rates are the price of money. Today, interest rates have become politicised, administered by governments - not set by demand and supply at a market-clearing level.

Market-determined interest rates make sure investors get the right signals to help them allocate capital efficiently. Administered prices do the opposite. Everyone knows the stories about shortages and surpluses in the old Soviet Union, where bureaucrats set prices at levels which had nothing to do with supply and demand.

Interest rates at zero mean a dollar earned in ten years has the same value of a dollar earned today. It's as if governments have created a wormhole in the fabric of time. Each dollar earned, no matter when, is of equal value. It's no wonder high quality businesses, that dependably compound their earnings over time, attract high valuations. All their future earnings are simply summed to derive today's value. It's a lollapalooza effect[1].

However, is the value of a business correctly calculated using an administered price? What happens if the bureaucrats change their minds? What happens if/when governments lose control of their interest rate manipulating levers?

Markets have become political utilities, their main function being to keep the masses happy. But, under lockdown, they've also become gambling and entertainment utilities, evidenced by the popularity of trading apps such as Robinhood. This is a commission-free trading website, mainly used by novice investors, which has become a veritable thermostat of speculative activity. The Big Tech stocks are invariably amongst the top 50 most popular stocks on the site. By way of contrast, there is not one gold stock in the top 100.

Even if one assumes that the bureaucrats know best, and their indicated interest rate is the correct, market-clearing price for money, and that speculators are keeping the market efficient, there is another problem: The earnings of Big Tech overstates their actual earnings power. Due to the widespread use of stock option schemes, they do not convert all their accounting earnings into actual cash flow that accrues to shareholders.

Work done by Sean Peche at Ranmore funds (ranmorefunds.com) shows that the free cash flow yields of the big 5 (Facebook, Apple, Amazon, Alphabet and Microsoft) are a miniscule 3.1%. If one is happy to accept this as an acceptable return for the risk of investing in these companies then all is good. But Sean goes on to show that if one accounts properly for the cost of stock-based compensation, the yield drops by a fifth to 2.5%.

A 2.5% free cash flow yield does not leave much margin for safety if things go wrong. And there are a few things that can go wrong:

1. **The risk of the law of large numbers catching up with the giants**
   The top 5 companies in the S&P 500 make up over 25% of the index. Historically, large index components have struggled to maintain their position over long periods. They end up running out of growth opportunities. Large companies enjoy economies of scale, but at a certain point, diseconomies start to develop. Additionally, as these gargantuan companies grow, they increasingly start to compete with each other. It is difficult to achieve high rates of growth, over a long period, starting at an already very high level. The base rate of success is vanishingly small.

2. **Market concentration risk**
   As indices become more concentrated, they increasingly do not represent a diversified basket of stocks. As more funds flow towards indices, they end up owning an increasing percentage of the companies. And indices, by definition, are holders, not traders. Combined with large insider ownership, there is not much stock left for active managers to buy. So even a small portfolio reallocation by active managers can move prices dramatically. In both directions. Stenotic markets tend not to price assets efficiently.

3. **Existential risk**
   Technology is becoming the battlefield in a new cold war that seems to be intensifying between the USA and China. From ZTE and Huawei through to TikTok and WeChat, the USA is increasingly excluding Chinese tech from operating in

[1] Coined by Charlie Munger, a "lollapalooza effect" is a when several smaller scale factors of human biases, tendencies and/or actions, when acting together, lead towards a certain (and often very significant) outcome.

their country. And Europe is generally following in their footsteps. But before one jumps to the conclusion that there will be positive spin-offs for the big listed US-centric tech companies, think about this: What if President Xi Jinpeng says that IPhone sales in China are to be banned, due to the IPhone representing a security risk to China? China represents 17% of IPhone sales, and a huge proportion of Apples' supply chain.

Additionally, governments are not only becoming more interventionist externally, they are also increasingly guiding Adam Smith's invisible hand firmly in the desired direction of the administration in power. Potential antitrust actions in the USA and Europe could have a detrimental effect on the growth rates of the tech behemoths.

In summary - the tech giants are widely held assets with an elevated level of expectation around future performance. And they are quite possibly being valued incorrectly. Combining this with some major emerging risk factors, the prudent investor would expect disappointing outcomes. At the same time, the historical performance of this group of stocks has been so good, and the naysayers have been proven wrong so conclusively, that very few are willing to publicly evaluate the objective prospects of the group.

It is better to step over the easy hurdle of low expectations, than trying to pole-vault over the high hurdle of market fascination. Today, low expectations are not present in the world of Big Tech. The good news is widely known. The bad news is ignored. This is not a good set up, and one which has hurt the performance of most previous acronyms. Will FAANG prove to be the exception to the rule?

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