From the desk of Amit Lodha

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A time for imagining

Market leaders have changed dramatically over the last ten years. We've seen the rise of companies that have either disrupted an existing industry or challenged incumbents. So what have we learnt from the past decade that we can apply for the future?

Noted sociologist Elise Boulding once said, 'If one is mentally out of breath all the time from dealing with the present, there is no energy left for imagining the future.' Indeed, the 2020s are just around the corner. So, let's take the long lens view to imagine what could be the make-up of the largest companies of the next decade.

The decade that was

We assume that the rise of technology companies into the top ten positions in the S&P 500 index has been a recent phenomenon.[1] However, if you look at the top constituents' composition ten years ago, Microsoft, IBM and Google (now Alphabet) were all on the list, with Microsoft even then appearing in the top five and Apple knocking at the door at number 23. In fact, IBM was the number one stock by market capitalisation as far back as 1980 and maintained its position through to 1990, after which it lost it to new innovators Microsoft and Cisco.[1,2] The change in composition of the top ten has really been a function of continued strong growth and execution by one set of companies, and the failure of management to make the right strategic calls in the other set.

The shining light of strong execution has been Apple, which had delivered a 25% ten-year annualised return on the back of the iPhone, which led it to become the first trillion-dollar company in August 2018.[2] On the other hand, General Electric (which exited from the DOW in June 2018) has been the poster child of poor execution.

Other former members of the top ten have also made some strategic errors, leading to their exit from this esteemed list:

- Walmart did not react appropriately to the threat of e-commerce and Amazon, and neither did Proctor & Gamble.
- IBM seems to have been bypassed by the entire cloud services revolution, leaving Amazon and Microsoft to steal the show.
- Mobile companies like AT&T were reduced to 'dumb pipes' by the rise of ubiquitous data and new technologies (3G/4G), as well as the technical excellence of the iPhone. AT&T now has the dubious honour of being the communication services company with the largest debt in the world (US$177 billion).[3]
- Oil dropped from a heady US$100+ level of the early 2000s to lows of US$40+ levels, driven by the rise of shale – a revolution that both ExxonMobil and Chevron have been late to capitalise on.

It is also quite evident that the past ten years has seen the rise of companies that have:

- disrupted an existing industry and challenged incumbents, such as the brick-and-mortar retail model by Amazon, linear TV to internet TV by Netflix, and taxis by Uber;
- gobbled up the existing pool of advertising dollars, like Facebook/Alphabet; or
- spearheaded the global penetration of new productivity tools, such as Apple.

As always, the common success factors have been few and simple:

- Moats/near-monopolistic industry positions and pricing power – Alphabet in search, Microsoft with its office productivity tools, Amazon with e-commerce, Facebook on social media, etc.
- Strong management teams with clear strategy and strong execution capabilities – JPMorgan, Bank of America.
- Good investment management – Berkshire Hathaway.
- An ability to adapt to change and innovate to turn threat into opportunity – Netflix, Amazon.

The decade that will be

As a bottom-up stock picker (who has also polled the research team on this topic very recently!), I think that a management team with clear, strong execution, operating in a good and growing industry, with differentiated products and services, remains the key mantra for success. And, with the pace of disruption and change only rising, an ability to adapt and change to the ever-evolving market environment through consistent innovation remains the key bulwark to shaping what will be the driving factors of the top ten in the decade ahead.

Having said that, today's valuations mean it is extremely unlikely that the pace of strong returns that investors have enjoyed over the last decade is repeatable in the next decade. We all tend to extrapolate the immediate past but, if Amazon were to maintain that same 35% – 40% CAGR over the next ten years as it has done over the past ten years, its market capitalisation would be US$15 trillion, or approximately 60% of the total current capitalisation of the US market.[2]

Warren Buffett once said: 'Forecasts may tell you a great deal about the forecaster; they tell you nothing about the future.' In that spirit, let's try to imagine the composition of the S&P 500 in 2029.

First, some basic math:

- Microsoft has been the most consistent compounder (ten-year returns CAGR of 15%) in the top ten, and with businesses like Cloud (through Azure), Windows/Office productivity tools, and gaming, it looks set to continue to match its historical compounding. Assuming it compounds at about two-thirds the rate (10% over the next ten years) that it has done in the past ten years, Microsoft's market capitalisation would be in the region of US$2 trillion.

This basic maths above leads to some interesting conclusions:

- Despite the pace of accelerating disruption, incumbency has a huge advantage.
- Apple has had one of the best ten-year CAGRs of 25% – yet to get into the vicinity of Microsoft's 2029 projected market capitalisation, the company we are investing in today needs to have a starting market capitalisation of greater than US$200 billion. That narrows down the potential list of candidates, substantially.
- Size constraints are also management constraints – the complexity of managing a business increases with its size. There is a high degree of probability that over the next ten years we'll see the technology goliaths breaking up into smaller, more manageable entities, either due to government intervention or on the back of managements trying to create both shareholder value and reduce the complexity of these organisations to more bite-sized portions.

Keeping these points in mind – what does the future hold?

Hypothesising a future S&P 500 top ten List

A good portfolio, in my opinion, has a backbone of steady compounders (growth at reasonable value) with some disruptive high growers (moon shots) and, at the same time, needs to avoid the poor managers who will destroy value.

With that in mind, let's take a closer look at possible future leaders:

Technology – The past rhymes with the future – I expect Amazon/Alphabet and maybe Microsoft to split their businesses within the next three to five years, either driven by increased regulatory scrutiny or by management attempting to reduce complexity. Key interesting candidates from a ten-year perspective would be:

- Alphabet – Separate listing of search, YouTube and self-driving (Waymo) project would be on the cards. All these have the potential to be independent candidates for the top ten, with Waymo having the most potential to create value.
- Amazon – Separate listing of Amazon Web Services (AWS), Amazon's cloud business would definitely be on the cards, and maybe divisions of Amazon's core business into business-to-business and business-to-consumer.
- Microsoft – The company has stayed relevant by always being responsive to end-consumer needs, and going forward analysts could push the case for Microsoft (Azure) to do the same. Microsoft also has some interesting plays in the quantum computing area. (CEO Satya Nadella has talked about this at some length in his book 'Hit Refresh').
- Facebook – will need to evolve, as social media loyalty appears to be fickle and regulatory challenges could potentially force them to separate their online properties like WhatsApp.

The new entrant in this space would be a start-up which changes the paradigm on artificial intelligence/robotics/quantum computing – to meet a completely unmet need. Within this, it's my hope that with all the R&D investments and excess cash piles with top US corporates, these start-ups will be absorbed within the likes of Facebook and Alphabet. For Apple, this is especially imperative as its dependence on the iPhone is currently too great. It needs to be early on the next wave of innovation, and inorganic growth could be the only way ahead.

Healthcare has been a consistent presence in the top ten (Pfizer, Merck, Johnson & Johnson) and it is likely that one of these pharmaceuticals majors, especially one which has adopted personalised medicine, will be the leader of the next decade. With the rapidly growing old-age population, healthcare representation in the top ten is sure-fire for any company that addresses any of the various unmet needs of cures for Alzheimer's, cancer, or diabetes, or develops new-paradigm care through gene therapy. Illumina is a company focused on DNA sequencing, which shows great potential, but in my view is likely to be acquired by a pharmaceutical major over time (Roche did try in the past!).

Energy/green energy – Oil companies have been a consistent presence in the S&P 500 top ten list and I expect them to continue their representation. Saudi Aramco (if it lists in the US) and ExxonMobil are likely candidates here. The left-field disruptors will be any company able to harness renewable technology without undue requirement of scarce materials. For now, battery technology requires the use of scarce raw materials (like cobalt or lithium) and, so far, it seems difficult to see these technologies scale at the right price to replace oil as a source of transportation fuel in the next ten years. For the sake of all of us, this is one prediction I would gladly hope to be wrong on.

Moon shots – Start-ups working on artificial intelligence, big data, healthcare, energy technology, food innovation, space travel, or autonomous vehicles are all potential candidates and maybe there is one new entrant which we don't know about today. A company which successfully commercialized space exploration (I confess, I am a Star Trek fan!) would be my nomination for this position.

The exits – Lastly, of the current crop of top ten companies, Apple needs to dramatically innovate if it is to make the cut to the 2029 top ten. Social media as a phenomenon, in my view, now causes more harm than good, and companies like Facebook need to significantly reinvent themselves if they are to stay relevant. Good capital allocation is the single most important driver of future performance and this is what makes Warren Buffett, and by extension Berkshire Hathaway, unique. My second forecast of this note (the exit of Berkshire Hathaway from this list by 2029) is one which I would gladly celebrate being wrong – perhaps by attending Berkshire's 2029 annual meeting in Omaha!

What this means for investors in the Fidelity Global Equities Fund

With the accelerating pace of disruption across industries, it is important to consistently evaluate what makes a company a winner of tomorrow. Assessing the ingredients of long-term winners – including strong management teams and good industry structure in a growing market gives us the insights we need to build a successful portfolio for our investors. The Fund currently has exposure to Visa, Microsoft, Alphabet, Illumina, Merck, and Roche, amongst others.

1. ETF Database, Visual History of the S&P 500.
2. Fidelity International, Bloomberg, 31 December 2008.
3. Fidelity International, Bloomberg, Latest Company Filings, 31 December 2018.