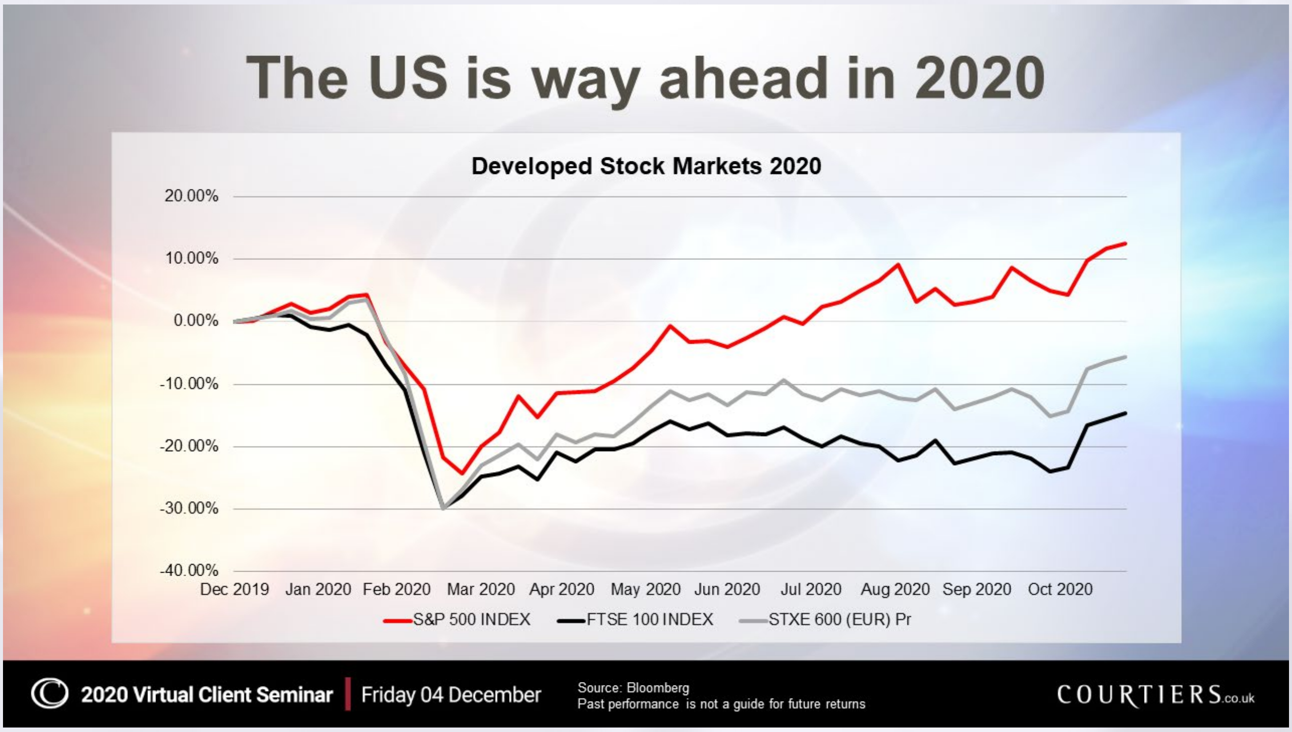
By Jacob Reynolds, Quantitative Analyst & Data Scientist

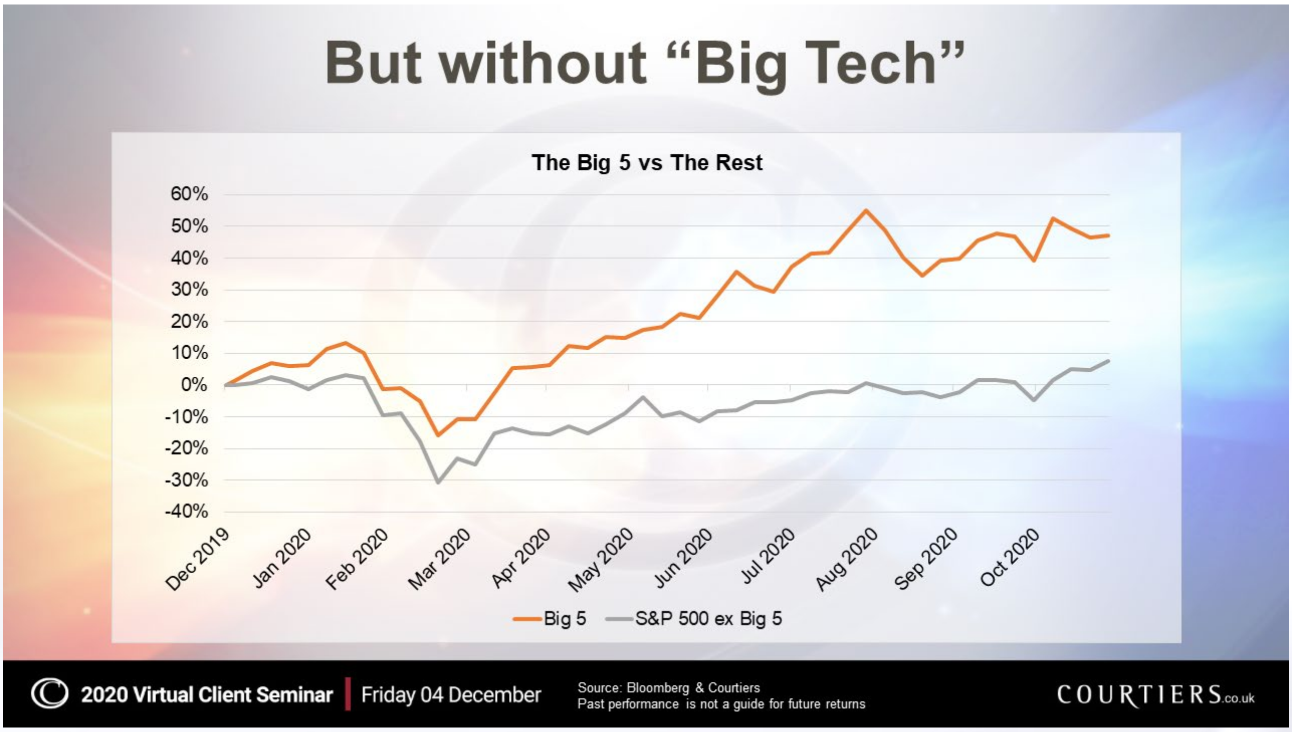
"Many shall be restored that now are fallen and many shall fall that now are in honor."

— Horace

The US has been a standout performer this year. The flagship US indices, the S&P 500, has outperformed the UK (the FTSE 100 in black below) and Europe (the Eurostoxx 600 in grey below). Since 2007, the S&P 500 has beaten the annual return of the FTSE 100 10 to 3.



However, when we scratch the surface of this performance, we can see it's been driven by a small number of large stocks.



The line in orange above shows that the five largest stocks in the indices (known as the 'Big 5') are up nearly 50% this year, pushing the indices to new all-time highs and opening a wide gap between themselves and the other 495 stocks in the S&P 500.

The largest five stocks are Apple, Google, Amazon, Microsoft and Facebook and they are all tech stocks. The rise of 'Big Tech' has drawn comparisons with the tech bubble of the late 90s. However, the big difference is that these companies are the most profitable companies in the US in 2020, and are on track to make a combined $200 billion dollars in profit this year. Considering the underlying strength of the 'Big 5', it is unlikely we will see a dot com style bust, but this doesn't mean we should chase these stocks.

$200 billion dollars and counting

NAME	PRICE TO 2020 EARNINGS	2020 EARNINGS	RANK IN U.S.
APPLE INC	34.06	$58,868,733,000	1
MICROSOFT CORP	33.81	$48,366,920,000	2
AMAZON.COM INC	67.34	$25,354,250,000	5
ALPHABET INC-CL C	31.68	$40,190,917,000	3
FACEBOOK INC-CLASS A	28.53	$28,151,368,000	4
	AVERAGE: 35.61	**TOTAL: $200,932,188,000**	

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Whilst they are very profitable, they also trade on huge multiples of their profit. The long run average price to earnings ratio is 15 on the S&P500, but the ‘Big 5’ trade on an average price to earnings ratio of 35.6. To put this number into perspective, that is 36 years of annual profits needed to cover your initial investment. It was approximately 36 years ago that the five largest stocks made up close to 20% of the Indices. Back then, Schlumberger, Standard Oil of Indiana, Exxon, AT&T and IBM were the world leaders, but they’ve now disappeared completely or do not resemble their former selves. Whilst Big Tech may be built on stronger footing than their counterparts of the late 90s, it doesn’t mean that their foundations will be chipped away in the future.

Buying stocks like the ‘Big 5’ is called *growth investing,* as you expect the companies to grow into their big prices. However, Eugene Fama and Ken French showed that buying value stocks (stocks that trade on low multiples) outperform expensive stocks in the long-run. Showing that the principles that Benjamin Graham laid down in Security Analysis in the 1930s would not only provide a margin of safety but would also outperform the market.

There are many competing theories as to why value investing works better than buying expensive as the market prices the risks correctly, but a widely accepted theory is that it is behavioural i.e. investors tend to forecast out current trends indefinitely and fail to price in a future where a company loses its competitive edge. This could be from rising competition of new entrants to the market, increased regulation or incumbents fighting back. There are many examples of this happening in history.

On 12th November 2007, Forbes released the below magazine with Nokia on the front cover and the accompanying headline ‘*One Billion Customers – Can Anyone Catch the Cellphone King?*’

Unfortunately for Nokia, 2007 coincided with the release of the iPhone. Over the next five years, Nokia would lose 92% of its market value.

Nokia Share Price 2004 - 2012

Nokia joins a long list of fallen tech giants that includes companies such as Kodak, Polaroid, Compaq or Blackberry.

Apple derives 82% of revenue from products and the majority of its revenue comes from iPhone sales.

With so much profit being made by a few firms, incumbents will inevitably look to adopt their techniques. An example of this is Reach Plc, which has been the top performing stock in the UK fund this year. Reach, formally known as Trinity Mirror, owns newspaper brands such as the Mirror and the Daily Express along with many local news outlets. They have pooled together all of their online resources to become the fifth most visited company online in the UK, with 42 million unique visitors to their websites each month. Only the big tech names are ahead of them.

Big Tech Techniques!

RANK	COMPANY	UNIQUE WEBSITE VISITORS PER MONTH*
1	Google	50,448,000
2	Facebook	45,014,000
3	Microsoft	44,872,000
4	Amazon	43,726,000
5	Reach Group	42,081,000

* Number of people accessing the website in a month, excluding returning visitors

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What Reach has realised is with this volume of website traffic, it can use visitors' data to build user profiles and include more specifically targeted advertising across all of its digital platforms. This is how Google makes 83% of its revenue and how Facebook gets 98.5% of its revenue.

We originally bought Reach in September 2019 when it was trading at 3 times earnings. Over the year, our average purchase price for Reach is 79p. It is now trading at £1.40 and still only 4.5 price to earnings with a growing digital advertising business.

As observed by Horace 2,000 years ago, the competitive landscape is constantly changing and as innovation abounds into 2021, our eyes will be open for opportunities.

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