Right across the sector spectrum, companies are increasingly deploying innovative technology to give them a robust competitive advantage over their peers – but it hasn’t always been that way. In the past, gaining a competitive advantage in technology was typically a fleeting affair, partly because technology was not a sector in its own right until it was separated out from aerospace and defence.

Instead, technology was primarily a hardware-driven investment with few significant barriers to entry. As such, those companies generally enjoyed three to five years of competitive advantage, followed by a normalisation to very average returns. These days, the tech sector is a very different beast, and the companies we are analysing come with far more durable competitive advantages.

Take the big five US tech players – Amazon, Google, Microsoft, Apple and Facebook – then throw in the two Chinese giants – Tencent and Alibaba – and you’ve got a seven-strong cohort of companies that account for a huge 8.67% of the MSCI All-world market cap.¹ In fact, if combined they would be the second-largest equity market in the world. This year alone, these companies are set to build their revenues by more than $200 billion, profiting by an incremental $40 billion.² And each of them is currently spending around $100 billion a year on research and development and capex, which is both driving competitive advantage and underpinning the clout of these businesses in the future.

¹ 31 August 2018.
² Bloomberg consensus estimates, 31 August 2018.
CREATIVE DESTRUCTION: THE OTHER SIDE OF THE COIN

But there’s a flipside to this competitive advantage: the erosive force of creative destruction, where capitalism eventually destroys itself because it invents new ways of doing things. This well-established phenomenon appears to be unfolding at a faster pace than ever, reinventing the value chain in the process, as demonstrated by Google which is gearing up to break into the autonomous vehicles market with the launch of its ride-hailing service Waymo. Google has 80,000 vehicles on order – a significant number when stacked up against the 13,500 yellow taxi cabs in New York.

This creates a real business optionality, in that the huge free cash flows being amassed, which are flowing into innovative ideas and the application of technology in new areas, are creating yet further competitive advantage.

As yet, there is no detail on how Google will commercialise the operating system for autonomous vehicles. But if it were to charge $3,000, compared to the $27,000 value of the average car in the US, it would have neatly removed the whole value chain of the automotive industry – all without ever having produced a single car. This provides a striking example of the extent to which the traditional profit margins that we’ve typically observed in industries are set to evolve in the near future.

New York taxis are another case in point. As recently as seven years ago, a New York yellow cab licence – or medallion – was worth around $1.2 million. In fact, taxi medallions were actually more compelling than the S&P for decades because they enabled investors to tap into the income growth of one of the most dynamic cities in the world. Now, however, they can go for as little as $160,000 through the bankruptcy courts. Why? Because their value has been destroyed due to the erosive impact of technology. Faced with creative destruction on this scale, we can expect to see more changes in value chains in the future than we’ve witnessed for a very long time.

TARGETING A QUALITY GROWTH APPROACH

So how do we incorporate these themes within our Global Equity strategy? Our quality growth approach means we look for businesses with barriers to entry, plus a sustainable competitive advantage that enables them to consistently deliver above-average returns on invested capital in the business. We also look for companies with good management that can reinvest the free cash flow they generate into the business to compound superior growth, revenues and profits that far outstrip the market average.

Mastercard and Visa are a prime example of this. Taking the world ex-China, this effective duopoly enjoys a market share of 85% on payments. While both companies are subject to regulation, the metrics of Mastercard show that the company generates 40%+ returns on invested capital, while taking on none of the associated credit risk itself. And with each of us spending 11%-14% more each on plastic rather than cash, Mastercard is successfully compounding out high teens profit growth based on revenue growth of around 12%. The barriers to entry that facilitate this translate into business metrics that are more predictable on a three- to five-year view.

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3 Columbia Threadneedle Investments, 31 August 2018.
4 Columbia Threadneedle Investments, 31 August 2018.
5 Based on Gross dollar volume (GDV) growth announced by Mastercard and Visa in recent results, Columbia Threadneedle Investments, 31 August 2018.
6 Bloomberg, company reports - based on average of last 10 calendar years (2008-17) of revenue growth, Columbia Threadneedle Investments, 31 August 2018.
HOW GROWTH STACKS UP AGAINST VALUE

Since 1995, growth as an investment style has outperformed value by 48%; the bulk of this outperformance having occurred since the global financial crisis (GFC). There are some very good reasons for this. First, the cost of capital almost collapsed to zero during the GFC. Second, growth businesses should have a high duration of earnings, with high-duration assets outperforming as the cost of capital declines. Third, the earnings pattern of the MSCI All-country Index since the GFC shows that, despite an initial bounce-back in earnings after the shock itself, earnings for the average business have not in fact grown at all. And fourth, there has also been material growth in the tech earnings base, with outperformance currently being driven by fundamentals rather than valuations – partly because of the defining cost of capital in long-duration assets.

Our philosophy has always been focused on identifying quality growth relative to the market. Indeed, we’ve been materially overweight in technology for some years due to the huge amount of competitive advantage that comes from innovation. Looking again at Mastercard, six years ago the stock was trading at around a 30% premium to the market; it is still trading at that premium today, indicating that compound growth has been successfully delivered in between. In essence, we want to know whether a business has a sustainable competitive advantage over time, what sort of compound earnings growth it could achieve as a result, and whether this has been priced into the stock over a three- to five-year timeframe. As a manager, if you’re not on the right side of this trend, you won’t outperform.

MEAN-REVERSION MATTERS

Against this backdrop of increased creative destruction, within and outside the tech sector, we are likely to see more losers at a stock level than in the past. This has an interesting impact on the value/growth conundrum. If a value manager holds 10 stocks, seven to eight of them may continue to underperform the benchmark, while two to three will mean-revert – and it’s that mean-reversion power that makes value work, and which can often translate into very significant returns.

However, the escalation of creative destruction means that losses for the value names that fail to mean-revert could be bigger than in the past. And as we saw during the GFC, value strategies fail when mean-reversion doesn’t occur. This scenario shows the critical importance of an active management approach when it comes to differentiating the winners from the losers – a topic that we analysed in detail in an earlier white paper.²

² 2017: Brave New World: Why active managers are well placed to take advantage of social, economic and political regime change, Columbia Threadneedle Investments, Feb 2017.
It’s fair to say that the economic impact of the GFC has been a material driver behind the outperformance of quality growth versus value stocks over the past 10 years or so. But more significant still is the rise of Artificial Intelligence. As it extends its influence into other industries, and the resulting competitive advantages become more enduring, we expect to see a marked shift in value chains and the increased erosion of more traditional profit margins. And if this shift takes place, it could create a sustained period during which mean-reversion simply fails to occur on a sufficiently large enough scale.

Make no mistake, those industries and companies that fail to embrace innovative technologies will be at a distinct competitive disadvantage to those that do. The ability to pick the winners and avoid the losers just became that much more critical to generating sustained outperformance.