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Big Isn't Always Beautiful

by Mark Wright, Fund Manager

If one didn't work in the financial industry, they would be forgiven for thinking the Magnificent 7 was the latest overhyped Marvel movie. If I "google" Magnificent 7 on my home Wi-Fi, the main characters from the 1960 Western, The Magnificent Seven, appear. It scores 7.7 on IMDB and so I've added it to my ever expanding 'Must Watch' list.

In the office, the same search unsurprisingly yields the mega-cap stocks: Apple, Alphabet, Amazon, Meta Platforms, Microsoft, Nvidia and Tesla. A good example of internet cookies doing their job. Collectively, the Magnificent 7 more than doubled in value last year which is why they are talked about so much.

There are now even published indices tracking the Magnificent 7 and an ETF was launched in April last year that provides investors with passive exposure to them. That got me thinking: does it actually make sense to always invest in the biggest of the biggest companies? Often the most simple investment strategies are the best investment strategies, but surely investing shouldn't be that easy?

Apple became the first stock in the world to surpass a valuation of over three trillion dollars last year. That's a three followed by twelve zeros or $3,000,000,000,000. It's a big number and is equivalent to the value of everything produced, both goods and services, in the United Kingdom each year.

Whilst an impressive feat and a staggeringly large number, it is not actually strictly true to say Apple was the first listed company to exceed a $3 trillion valuation. Not in real terms anyway i.e. adjusted for inflation. Three companies beat Apple to it: Dutch East India Company in 1637, Mississippi Company in 1720 and South Sea Company in the same year[1]. All three were shipping companies poised to benefit from rapidly growing world trade in early colonial times.

The Dutch East India Company was effectively the world's first initial public offering (IPO). Its value ultimately topped out at the equivalent of $8.3 trillion in today's money, dwarfing that of Apple's now. All three companies were bust by 1800[2]. It would probably be foolish to draw any conclusions from the demise of what were the biggest companies several centuries ago; so how have some of the biggest companies more recently fared?

Researchers at Dimensional Fund Advisors studied the subsequent performance of companies once they had become one of the ten biggest companies in the United States between the years of 1927 and 2019. Interestingly, the data revealed that those companies on average underperformed the wider market by 1.1% p.a. over the subsequent five years and by 1.5% p.a. over the subsequent ten years[3].

We only have to look back twenty years to 2004 to see that only one of the ten biggest companies back then still remains one of them today. That company is Microsoft. The biggest company back in 2004 was General Electric[4]. The shares have returned a woeful 15% in total since then[5].

Other former darlings from the 2004 honours list include AIG, Cisco Systems, Citigroup, IBM, Intel and Pfizer, all of which have significantly underperformed the S&P 500 since then[6]. Not unsurprisingly, the share prices of AIG and Citigroup are down materially over the last twenty years. It may seem strange to draw a comparison between two former financial behemoths and the tech companies that comprise the Magnificent 7 but there was equally a lot of hype around the likes of AIG and Citigroup back then. The new financial "Whizz Kids" of Wall Street had allegedly unlocked the secret to ever increasing financial returns from very little capital. The truth is, the sectors represented by the biggest companies has varied greatly over time, from transport to energy and communications.

The countries in which some of the biggest companies are listed also changes over time. At Berkshire Hathaway's 2022 Annual Shareholder Meeting, Warren Buffett looked at which companies were the twenty largest by stock market value back in 1989. The majority were Japanese, with the top four all banks[7].

Mr Buffett was exclaiming that markets have always been susceptible to periods of euphoria and overvaluation and that many of the biggest companies turnout to be bad investments in time. This is not necessarily because they were expensive at the time of investing, but also because competitive forces and regulation often serves to prevent companies earning exceptionally high returns on invested capital over prolonged periods of time.

Another astonishing example of competitive forces that he gave was the fact that over the last 125 years or so, there have been more than two thousand automobile manufacturers in the United States. Today, there exists just three (traditional ones) – Ford, General Motors and Stellantis.

Whether or not the Magnificent 7 are currently overvalued and how susceptible they are to competitive forces and regulation is debatable. They trade on an earnings multiple of almost twice that of the biggest companies from 2004 that I mentioned earlier (AIG, Cisco Systems etc). However, they also earn twice the return on invested capital that those companies did back then… at least for now. One thing that time has definitively demonstrated is that big isn't always beautiful.

Sources
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