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GABELLI FUNDS

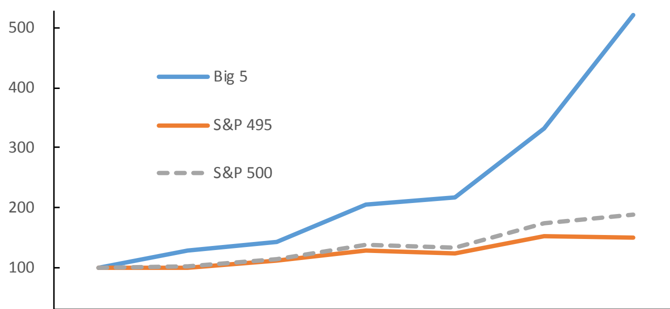
# THE NATION STATE COMPANIES

## INTRODUCTION

We are often asked for our views of the FANG[1] stocks, especially in the context of growth/momentum investing outperforming Graham & Dodd value investing for most of the last decade. This note summarizes our view of what has driven the market over the last several years and how the current regime might change.

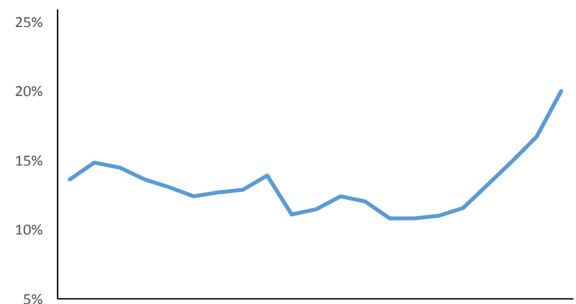
First, some nomenclature. We'll dispense with the acronyms and simply refer to the top tier of US companies – Apple, Microsoft, Amazon, Google and Facebook – as the "Big 5." The Big 5 are practically countries unto themselves.[2] With an aggregate capitalization of $7.6 trillion (currently 24% of the S&P 500), the Big 5 have accounted for 11.1 points of the S&P 500's 9.8% YTD 2020 total return (i.e. the "S&P 495" remain collectively down 1.3%) and nearly one-third of the index's annualized returns over the last five years. The Big 5 don't just dominate the market, they *are* the market.

**Exhibit 1: Current Big 5 vs the Other 495**




| | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|---|
| S&P 500 return | 1.4% | 11.9% | 21.8% | -4.4% | 31.5% | 9.8% |
| Big 5 Annual: | | | | | | |
| Return | 28.1 | 10.1 | 45.6 | 5.4 | 52.7 | 60.5 |
| Avg.Weight | 9.8 | 11.0 | 12.6 | 14.8 | 15.7 | 20.5 |
| Contribution (pts) | 2.2 | 1.0 | 5.2 | 0.5 | 7.2 | 11.1 |

**Exhibit 2: S&P 500 Top 5 As % of Index**




| | 2000 | 2005 | 2010 | 2015 | 2020 (avg) |
|---|---|---|---|---|---|
| #1 | GE | GE | Exxon | AAPL | AAPL |
| 2 | Exxon | Exxon | AAPL | MSFT | MSFT |
| 3 | Pfizer | Citibank | GE | Exxon | AMZN |
| 4 | Cisco | MSFT | MSFT | JNJ | GOOG/L |
| 5 | Citibank | P&G | IBM | GE | FB |
| Weight | 13.7% | 12.4% | 11.5% | 11.0% | 20.0% |

Often seeking cheap diversification, buyers of passive S&P 500 vehicles today are placing nearly one-quarter of their portfolio in five very similarly situated securities.[3] This has been a winning strategy for the last decade; it might not always be the case.

We are not calling a top, but these erstwhile safe havens might harbor underappreciated perils and valuations *will* still matter (ask Cisco owners circa 2000, 5% of the S&P at its peak). Calamities need not befall the Big 5. From here their stocks could simply be outrun by more cyclical stocks. This translates into inordinate risk buying "the market." Instead, one of the greatest valuation disparities on record, combined with increasing confidence in a post-COVID economic recovery, could make this an opportune time to invest in unloved small to merely large stocks still trading at less princely valuations.

[1] **F**acebook, **A**mazon, **N**etflix and **G**oogle: credited to CNBC personality Jim Cramer in 2013, usually expanded to include Apple and Microsoft with varying acronyms. We exclude NFLX (rank #21) and its more focused video subscription model.
[2] Many commenters make the flawed comparison of market caps to GDP (i.e. stocks vs flows) because it makes for good headlines (i.e. the Big 5's market cap is bigger than the Japan's GDP, AAPL would be the eighth largest country, etc.)
[3] Although classified as Communication Services (GOOG, FB) Information Technology (AAPL, MSFT) and Consumer Discretionary (AMZN), we would argue the Big 5 are all platform tech companies far more correlated than past leaders.

## THE RECENT PAST

Some of the dynamics underpinning the ascendency of the Big 5 include:

- The "M" word. Successive innovations requiring scale, such as railroad transportation, oil exploration and production and automobile manufacturing created the behemoths of the Industrial Revolution. The Big 5 of the Information Revolution have gathered a different kind of scale - network effects centered around two-sided marketplaces and data aggregation (and, some would assert, good old-fashioned predatory pricing). During this time, it has been argued that trustbusters have been asleep, hypnotized by the siren song of laissez faire economists and lulled by arguments supporting the greater consumer good. A growing chorus of opponents may finally cause this to change.

- Financial repression. Historically low interest rates have abetted disruptive companies in at least two ways. First, the present value of cash flows is worth more in a low interest rate environment; this tends to flatter growth companies whose cash flows may be more weighted into the future. Second, a lower cost of capital can more easily finance the losses necessary to take share through aggressive pricing and investment. Higher stock multiples/lower costs of capital further tip the scales in favor of growth companies.

- Passive explosion. The share of indexed US equity mutual funds and ETFs now exceeds 50%, having more than doubled over the past five years.[4] S&P estimates that $4.6 trillion alone tracks its eponymous index (for context, the capitalization of the entire US market is $40 trillion). It should be no surprise that the rise of the Big 5 has coincided with the rise of indexation. The business success of the Big 5 has been amplified by funds flows into the indices they dominate, while the success of investors in those indices has prompted more inflows, all in a self-reinforcing manner. By virtue of their construction, indexes force passive investors to own what *has done well* and not necessarily what *should do well* in the future. Unfortunately, fly wheels can also operate in reverse. Indexers may be unprepared to face the business challenges that almost inevitably will one day face the recipients of their investments.

- Safe havens. With $480 billion in net cash and wide competitive moats, the Big 5 have partially insulated themselves from a world of geopolitical turmoil and ballooning government deficits. COVID, a recent and hopefully temporary phenomenon, has accentuated these virtues. Few businesses have benefitted more from work/play from home than the tech platforms as evidenced by their outstanding Q2 2020 earnings and the $3 trillion in market cap these companies have gained since the end of 2019.

## THE NEAR FUTURE

The Big 5 are unquestionably great companies with many of the characteristics fundamental investors covet. Until recently, they haven't even traded at extreme valuations. But they won't be dominant forever. We are not recommending selling the Big 5 at this point (we own them across several strategies), but some broad challenges they may face, in addition to the idiosyncratic questions of each (e.g. Apple and China), include:

- Regulatory overhang. As demonstrated in the July Congressional hearings, there is a bipartisan desire to exercise greater oversight of the Big 5.[5] If federal and state agencies take action, outcomes could include structured remedies (e.g. forced divestitures, "utility" search, app store limitations, etc.), tougher privacy requirements and financial penalties. Actions by the European Union directed at American tech companies appear to have had little impact thus far, with EU privacy rules further entrenching incumbents. Nonetheless, a looming heavy hand could depress cash flow as companies take prophylactic action and/or multiples as investors are faced with increased uncertainty.

[4] Morningstar 2019. This estimate excludes assets held in other vehicles but is a good approximation of the entire market.
[5] Having sat before Congress in 1998 preceding a decade long anti-trust war, MSFT was notably absent from these hearings.

- The law of large numbers. The Big 5 began by addressing large markets such as advertising, retail, entertainment and computing. The runway is long in some of those markets, but GOOG and FB's success in advertising demonstrates its limits. Their $250 billion in ad revenue now accounts for nearly 75% and 50% of global digital and total advertising[6]; since advertising expenditures are unlikely to outpace GDP growth, how high might their share extend? The deceleration in GOOG's ad growth in Q2 was not well-received but underscores that secular tailwinds won't always overcome cyclical headwinds.

  Remarkably, the Big 5 do keep finding new markets (e.g. AI, transportation, space) to attack both in service to existing businesses and as stand-along opportunities. Arguably that optionality is priced-in today. Execution risks increase as these companies diversify. A simple discounted cash flow of the Big 5 in aggregate suggests the market is currently embedding an expectation of 4% perpetual growth – at roughly twice global growth expectations, this may not be outrageous but it is a tall order for such large companies, including some with limited exposure to the fastest growing large market (China).

- Execution. The Big 5 have been blessed with talented leadership and strong cultures. However, management will be taxed by growth and, in some cases, generational succession. Notwithstanding the earlier anti-trust arguments, competition remains from upstarts (e.g. TikTok, Zoom, Slack), incumbents (e.g. Wal-Mart, Disney) and especially between the Big 5 (e.g. Amazon in ads, Microsoft and Google in compute). Internecine warfare seems more likely as size increases. Disagreements over Apple's app store policies are but one example. Microsoft offers both a cautionary and hopeful tale: the dominant tech company of the 1990s missed mobility and search under succession and regulatory distractions but has obviously been reinvigorated. Some of the Big 5 will beat the odds, but we doubt all of them will.

### *Blowing Bubbles?*

Today's rich valuations, robust IPO market and strong retail interest invites comparisons to historic market manias. 2020 rhymes with the early months of 2000, but differs in some ways. Both periods were preceded by tax cuts, declining interest rates and, most importantly, public fascination with new technologies and the business models they've enabled. While the '99 Big 5 made up a smaller 16% proportion of the S&P (and included two truly non-tech companies), it traded at a much higher 61x forward P/E (interestingly, the premium to the multiple on each set of "Other 495" is closer at 145% vs 141%). Although the '99 Big 5 underperformed the S&P 500 in 2000, the real carnage came amongst the next tier of e-commerce and telecom ventures. Time will tell if the analogue to those darlings are the EV/AV vehicle and everything SAAS companies of today.

### Exhibit 3: Big 5 – Class of 1999 vs Class of 2020

| 1999 Big 5 | | | | | |
|---|---|---|---|---|---|
| | 12/31/1999 | | Annualized Returns (a) | | |
| | Weight | '00 P/E | 3 Yr '96-'99 | 3 Yr '00-'03 | 20+ Yr '99-Date |
| Microsoft | 4.8% | 60x | 78% | (24%) | 14% |
| General Electric | 4.0 | 48 | 48 | (21) | (1) |
| Cisco | 3.0 | 107 | 97 | (37) | 4 |
| Intel | 2.2 | 36 | 36 | (27) | 8 |
| Walmart | 2.4 | 55 | 84 | (9) | 6 |
| Total/Wtd. Avg. | 16.4% | 61x | 69% | (24%) | 7% |
| S&P 500 | | 24x | 28% | (15%) | 6% |

| Current Big 5 | | | |
|---|---|---|---|
| | 8/31/2020 | | Ann. 3 Yr Return |
| | Weight | '21 P/E | '17-'20 YTD |
| Apple | 7.3% | 32x | 52% |
| Microsoft | 5.9 | 35 | 43 |
| Amazon | 5.0 | 74 | 20 |
| Alphabet | 3.3 | 29 | 21 |
| Facebook | 2.4 | 28 | 27 |
| Total/Wtd. Avg. | 24.0% | 41x | 36% |
| S&P 500 | | 22x | 15% |

(a) Assumes each security held in proportion to its 12/31/99 weighting

*Source:* Factset, Bloomberg

One notable coda to the 2000 tech bubble is that investors holding the '99 Big 5 through the present would have ultimately edged out the market, a testament to the resilience of MSFT and an endorsement of a buy-and-hold strategy. In our view, it is also an invitation for active managers to best market averages.

[6] Group M, company reports, Gabelli Funds estimates. Note AMZN is quickly following with 4% of global ad dollars.

## OUR ROADMAP

We are not predicting the direction of the market or the future of value versus growth. We *are* suggesting investors look beyond just the Big 5. They may not face the fundamental issues outlined above any time soon, but even the most extraordinary businesses will deliver ordinary returns if purchased at the wrong prices. The odds are long that the next five years can approximate the last five for these stocks. And when you hold such sway over the market average, it's difficult to be above average.

Long evolving changes in market structure, exacerbated by the economic shifts brought on by COVID, have created a wealth of opportunities among smaller companies, especially among those characterized as "value." At this writing, the Russell 2000 Value (small capitalization) and Russell 3000 Value (all capitalization) indices remain down 18% and 10%, respectively, with roughly one-third of the stocks in each index down by more than 25%. At least three elements could trigger a more durable rotation in investor preferences:

- Sustained COVID re-opening and economic recovery. This appears to us to be more a matter of when than if and should favor cyclical firms and those most directly impacted by COVID (including live entertainment, travel and leisure companies).

- Renewed M&A activity as the economic and electoral landscape becomes clearer. Scale remains as important as ever, funding costs are still low and a number of entities stressed by the COVID crisis will be looking for alternatives. Small and mid-cap companies dominate this menu.

- A shift from the Goldilocks macroeconomic backdrop of low interest rates, low inflation and steady but modest economic growth of most of the last ten years. With rates pinned to nearly zero and demographic, political and productivity trends pointing to decelerating long-term growth, government stimulus-fed inflation would seem to be the variable most likely to change. A steeper yield curve should benefit financials while above-expectation inflation would favor those with pricing power (which admittedly includes the Big 5).

Our Private Market Value with a Catalyst™ methodology, supported by deep fundamental research on a wide range of companies, should be particularly well-suited to this environment. We remain disciplined yet adaptable in our approach and long-term with ever-present intensity in our outlook.

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