The Market in Review

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This week's articles and insights

1. *Concentrate to Get Rich*
2. *Face to Face with Office Space*

"Concentration comes out of a combination of confidence and hunger."

- ***Arnold Palmer***

Your Index Report

	Current	Last Week	Year-to-Date
Dow Jones Ind. Avg.	25,746	- 1.28%	- 9.79%
S&P 500	3,084	- 1.01%	- 4.55%
TSX	15,446	- 0.22%	- 9.48%

Concentrate to Get Rich

World War II saw the largest engagement of US troops in tropical climates. This meant a lot of men on ships eating canned food. By then, scurvy was a well-known issue, but so was its Vitamin C cure. The U.S. Army provided vitamin-C lemon crystals, but the soldiers disliked them. The army and its agricultural scientists back home worked hard on a solution.

They succeeded with something called *concentrated orange juice*, which was a water-reduced form of the real thing. However, it arrived late - three years after the war ended. It was still a hit though. Concentrated orange juice proved to be so popular that over 10 million gallons of the new juice were being sold by 1949.

Like all things, concentrated orange juice has its pros and cons. It is easy to ship, stores well, and is quick to prepare. However, it loses flavour and needs supplements like citric acid and sugar to get that "natural" taste back. New processes were developed, as well as an aversion to additives, such that most orange juice sold today is no longer concentrated. In fact, it is labeled as "*not from concentrate*."

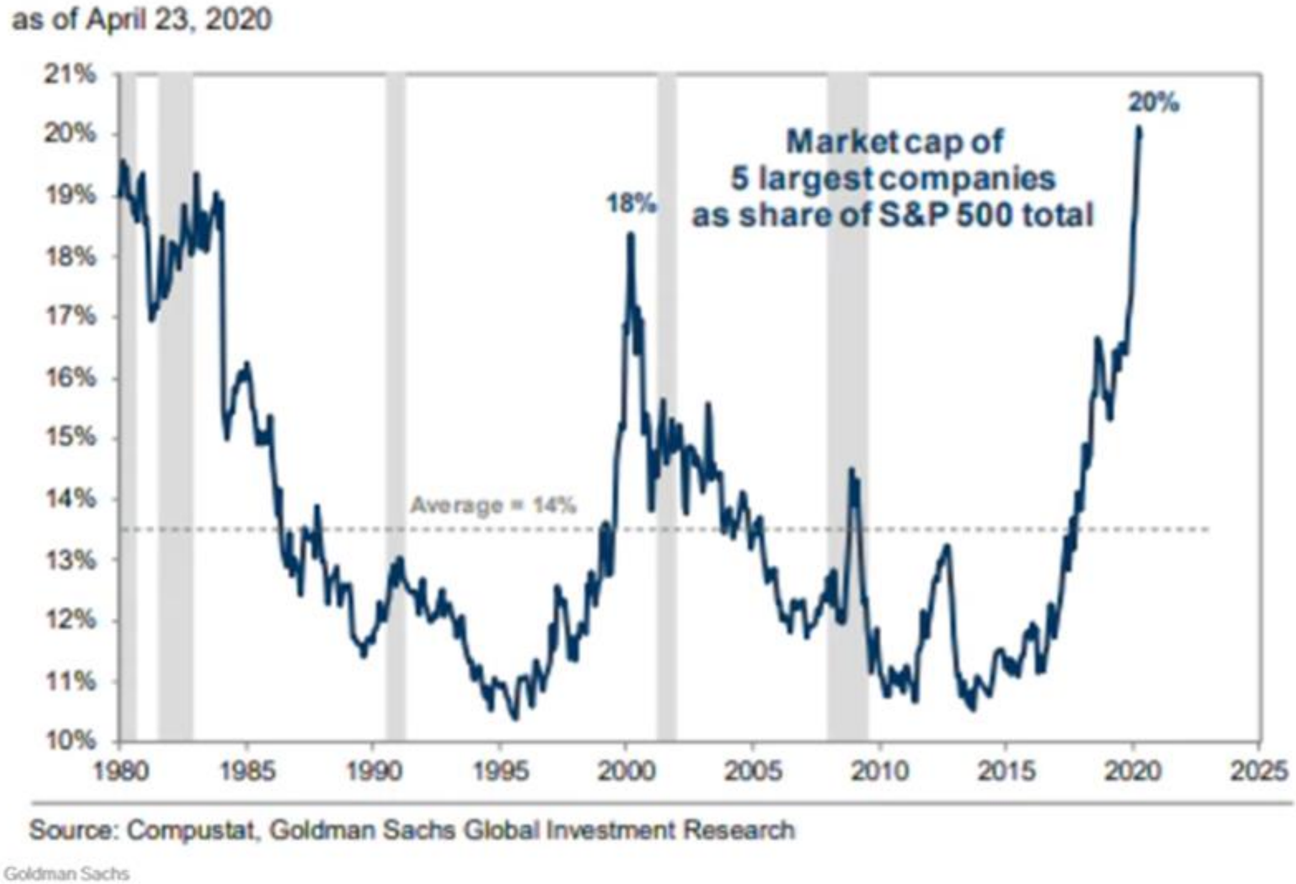
In the financial world, concentration is also a word that is both welcomed and feared. We like it when one industry separates itself from the pack and becomes a leader. We don't like it when that group falls from favour.

Most fortunes are built when new industries rise to the fore. There is an old saying in our business that says “Concentrate to get rich; diversify to stay rich.”

Bill Gates is a good example. He became a billionaire by owning only Microsoft (**NASDAQ MSFT**) shares as they soared in value. But once he was rich, he was determined to stay that way. By 2010, he was selling 20 million shares every quarter to diversify – that would be $4 billion worth every three months if he was still doing this today.

The proceeds were then invested in a broad portfolio of stocks, bonds, land, and even digital rights to paintings (he was once the largest owner of such rights in the world). Being a smart billionaire, as well as a close friend of Warren Buffett, Bill understood how hard it is to get rich, and how rare it is for someone who has lost it all to get a second chance. Lightning doesn’t strike twice very often.

Like politics today, the financial world is very polarized and concentrated. Just five stocks make up 21% of the value of the S&P 500 index. Apple (**NASDAQ AAPL**), Alphabet (**NASDAQ GOOG**), Facebook (**NASDAQ FB**), Amazon (**NASDAQ AMZN**), and Microsoft account for the largest portion of the index by the fewest members since 2000. Today even beats the 1980 peak before that.



Is this unusual? Well, not really. It seems to happen every 10-20 years. However, the amount of concentration is, with just 5 stocks accounting for the big imbalance.

The reality is that there is always profit inequality: a few industries make almost all the money in certain eras. There will always be a handful of giants that dominate, just as there will always be rich and poor people, despite our best efforts.

Of course, these giants age and pass away over time. When the Dow Jones Industrial Average was created in 1880, the largest companies were those in the cattle, coal, rubber and rail businesses. Andrew Carnegie of Carnegie Steel became the richest man in the world when Carnegie Steel joined the Dow Jones in 1901 – he was the Bill Gates of his era.

Today? Steel is a marginal industry in North America and has been relegated to the lowest cost producers in China, South Korea, and cheap-labour emerging markets.

IBM (**NYSE IBM**) was the #1 stock in the world from 1980 to 1990 and stayed in the Top 10 until 1999. GE (**NYSE GE**) was in the Top 10 for 28 straight years, which may be a record. Although being at the top doesn't mean you are making investors money – GE had the same market capitalization in 2008 that it held in 1996.

Today's giants are the internet companies. They have the best growth, the loudest voices and attract the most coverage. Amazon has risen 2300% in the last 20 years – who doesn't look at that company with some element of envy?

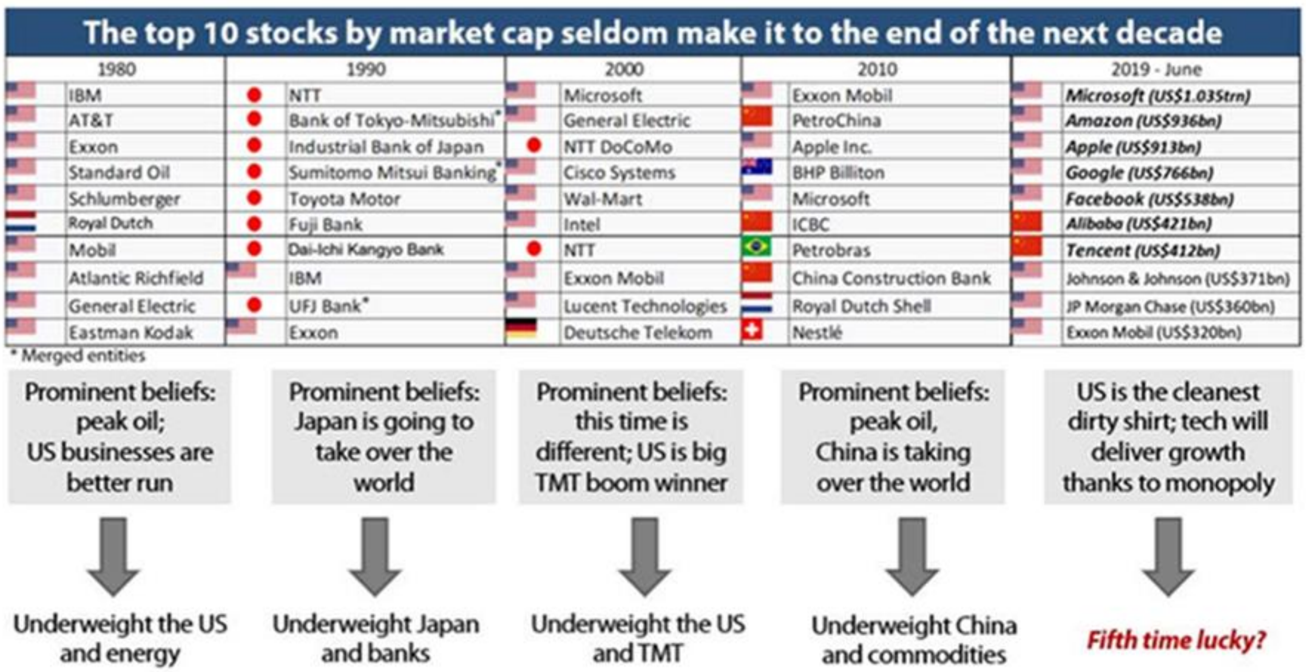
As we have seen over the decades, however, nothing stays at the top forever. And being #1 means you *have* grown, not necessarily that you will continue to grow. Former leaders like AT&T and Standard Oil were broken up by antitrust laws, while IBM was brought down by smaller rivals. Today, there are moves afoot to force Alphabet/Google to pay for news content and to ban Facebook from taking ads from foreign powers. Netflix (**NASDAQ NFLX**) has to spend more and more to produce its shows, as there are now at least six large streaming services doing exactly what they do. Those companies at the top at the end of each decade are rarely those at the top ten years later. Valuations matter in the long-term. Those at the top tend to be the most expensive in terms of multiples, and can perform poorly as a result over the years.

As we have seen with Amazon, it pays to watch those companies on the rise. When they break into the Top 10, for example, they are more often on their way up rather than on their way down. While most analyses of top companies focus on the beginning of the decade (i.e. which companies were the biggest in 1980, 1990, 2000), the biggest shifts in the leaders tend to occur a few years later. Note that every year ending in zero coincided with a recession, or was very close to one (2008-2009). The biggest shifts in the Top 10 happened after the bear market ended. This is when debts get exposed, economic conditions shift, or governments bring in big policy changes.

The first big era of concentration in memory was in 1972 when the Nifty Fifty came to prominence. Companies like Coca-Cola (**NYSE KO**), McDonald's (**NYSE MCD**), and Johnson & Johnson (**NYSE JNJ**) sported p/e ratios of 50 and higher when the average at the time was around 12x. They were so loved that every investor piled into them at the same time.

Did they go out of business? No, but they did not make investors any money in the decade ahead because they were just too expensive. None were among the Top 10 by 1980.

Here is a chart that shows the leaders at the end of each decade and the common beliefs held by investors in each of these eras:



The top 10 stocks by market cap seldom make it to the end of the next decade

1980	1990	2000	2010	2019 - June
IBM	NTT	Microsoft	Exxon Mobil	*Microsoft (US$1.035trn)*
AT&T	Bank of Tokyo-Mitsubishi*	General Electric	PetroChina	*Amazon (US$936bn)*
Exxon	Industrial Bank of Japan	NTT DoCoMo	Apple Inc.	*Apple (US$913bn)*
Standard Oil	Sumitomo Mitsui Banking*	Cisco Systems	BHP Billiton	*Google (US$766bn)*
Schlumberger	Toyota Motor	Wal-Mart	Microsoft	*Facebook (US$538bn)*
Royal Dutch	Fuji Bank	Intel	ICBC	*Alibaba (US$421bn)*
Mobil	Dai-Ichi Kangyo Bank	NTT	Petrobras	*Tencent (US$412bn)*
Atlantic Richfield	IBM	Exxon Mobil	China Construction Bank	Johnson & Johnson (US$371bn)
General Electric	UFJ Bank*	Lucent Technologies	Royal Dutch Shell	JP Morgan Chase (US$360bn)
Eastman Kodak	Exxon	Deutsche Telekom	Nestlé	Exxon Mobil (US$320bn)

* Merged entities

Source: MSCI data set

1980: 7 of the top 10 companies were oil companies. They represented over 62% of the dollar value of the Top10.

1990: Only 2 oil companies were left in the Top 10 and represented just 9.6% of this elite group. Exxon (**NYSE XOM**) still managed to double in value from 1980 to 1990 but a newcomer called GE rose 3 ½ times from its debut in 1980 to 1990.

Merck (**NYSE MRK**) and Philip Morris (**NYSE PM**) arrived in the Top 10 in 1986. Coca-Cola (**NYSE KO**) in 1990. They never looked back, with Coke rising over 500% by 1998. *Once again, it paid to watch the newcomers*.

2000: In January 2000, 6 of the top 10 were tech stocks. By the end of 2002, just 2 were left. This era was marked by the end of the telecom stocks and China's emergence with its insatiable desire for commodities.

The real changes didn't happen until 2005 and they were outside the S&P 500. Petro China (**NYSE PTR**) and Gazprom became two of the largest companies in the world – the first time we had seen leaders from China and Russia. These grew alongside Exxon as it exploded into the #1 spot in the S&P 500 by increasing in value by $100 billion in just a single year.

2010: Remember all those undersea cables laid by the telecom giants in the late 1990's? The ones that were mostly empty? By January of 2008, a new boom was beginning that would fill them with data – the smartphone revolution. AT&T (**NYSE T**) and China Mobil (**NYSE CHL**) had risen into the top 10 worldwide.

Apple and Google both broke into the Top 10 in late 2009. Again, watch the new entrants. Amazon debuted in June 2015. We know how well it did after that.

2020: It is early in this recession. We have seen in the past that the biggest shifts don't occur until the recession ends, so the leaders from 2017-2020 remain the leaders today. We can only guess that the 5 biggest companies in 2020 are unlikely to remain there by 2030, so we are watching closely.

One big shift in the pandemic of 2020 has been the rise in on-line shopping and the rapid decline of physical cash. No digital currency has risen to replace the dollar or the yen or the renminbi yet, but every one of us is using credit and debit cards more than ever.

Is it a surprise, then, that the newest entrant to the Top 10 of the S&P 500 is Visa (**NYSE V**)? Visa is now in the #9 spot, with MasterCard (**NYSE MC**) not far behind. While they are both giant companies already, history hints that they may just be getting started.

Visa is held in our Dividend Value portfolios.

Face to Face with Office Space

There has been a great deal of discussion about offices lately. When should we return? What are we returning to? Should we return at all?

No one is more interested in this topic than the commercial landlords who own the towers downtown, as well as the thousands of small businesses – from cleaning companies to sandwich shops – that service them.

The demise of the office has been a topic since the 1960s. Longer and more clogged commutes. Expensive parking. Smaller and smaller cubicles. All of these have led workers to dream of a time when they could work anywhere. From home, ideally.

And then along came the pandemic, when working from home turned from a dream to a necessity. The neck tie and the handshake were the first to go. Now, even shaving and pants are optional for the new basement-bound workforce.

However, research that began in the 1970s suggests we should not be so quick to shutter every office tower. A recent article in Project Syndicate by Carlo Ratti discusses the many ties we lose when we stay home.

“As the sociologist Mark Granovetter argued in 1973, functioning societies are underpinned not only by “strong ties” (close relationships), but also by “weak ties” (casual acquaintances). Whereas strong ties tend to form dense, overlapping networks – our close friends are often close friends with one another – weak ties connect us to a larger and more diverse group of people.”

A group at MIT did a recent study of these strong and weak relationships by examining campus interactions before and during the pandemic. It found that we are good at maintaining our strong networks – families and close friends – but our weak connections – office colleagues, the building superintendent, the owner of the restaurant down the street – have all faltered. We are speaking more and more with those who <u>like</u> us and <u>are</u> like us, and less and less with those of different backgrounds. The research shows that these weak connections are exactly the ones that lead to compromise and increase our tolerance for fresh ideas. If we had political and racial polarization before social distancing, it has only gotten worse because of it.

As anyone who has participated in a Zoom video call knows, it is a wonderful new way to communicate. However, it can also be even more distant than a phone call. Don’t want to be identified? Turn off your video camera. Don’t like someone’s opinion? Mute them. None of these options are available when meeting face to face by the photocopier or in a coffee shop.

The new reality suggests that working from home part of the time is here to stay. This means offices could be shared, leading to less demand. However, some have argued that offices will need to be larger than they are today to accommodate more physical distancing. So will we need less real estate, or more?

Other studies have shown that people working in an office are more productive than those working at home, something we have certainly observed since returning to the office last week. A strict routine is a powerful motivator.

Either way, office space utilization will be a very fluid number for the next several years. Companies and governments will be looking at how much they saved in hard costs with people working from home during the pandemic. They will have to balance this against lower productivity from these workers.

But, as this study shows, society must also look at the soft costs of everyone working in isolation inside social-bubbles. We need interaction and mixing, despite the perceived danger such actions bring.

The article can be read here:

https://www.project-syndicate.org/commentary/covid19-remote-work-office-benefits-by-carlo-ratti-2020-06

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http://www.dividendvaluepartners.com

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*Prices shown as of **June 25th, 2020***

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