Adaptive Corporates

Lode Devlaminck, Managing Director, Equities

Our term "Adaptive Corporates" was inspired by Andrew W. Lo's book "Adaptive Markets,"[1] in which Lo combines the efficient market hypothesis with behavioral finance to explain why success in the markets is an evolutionary process. He argues that investors find new ways to beat the market as financial conditions change, causing the rules of winning to change over time. Adaptation is critical to survival.

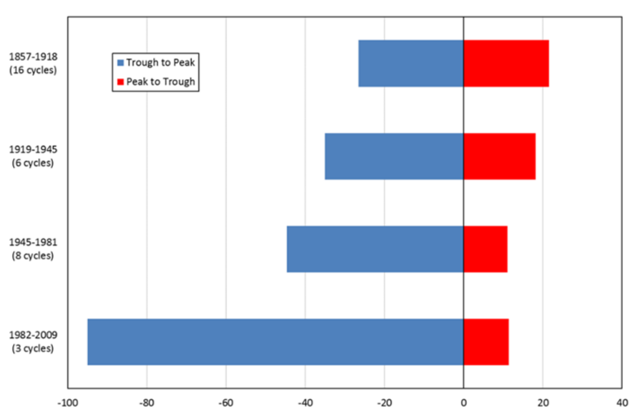
In a similar vein, we argue that corporate strategy and behaviors gradually evolve to adapt to structural changes in their environment. In this piece, we highlight macroeconomic and business trends, how these trends are impacting corporate strategies and behavior, and the resulting implications for equity markets.

Trend #1: A Rising Tide Lifts All Boats?

From a macroeconomic perspective, the changing business cycle has had a noticeable impact on financial markets. Figure 1 shows the average length of the U.S. business cycle (measured in months) over the last 160 years, with expansions shaded in blue and downturns in red. Business cycles have become progressively longer with slower annual growth, while the downturns have become shorter.

This structural shift became more evident during the mid-eighties, when Central Banks started managing the business and economic cycle more actively. The current expansion, not included in the chart, is on track to be the longest expansion in recorded history.

Figure 1: Average Duration of the Business Cycle (months)



Source: NBER, DuPont Capital

We believe the longer, slower growth of the business cycle, coupled with technology's expanding role in economic growth, has brought new risks for low- or no-growth sectors. As economic tides are going out faster, but coming in more slowly, the tide is not always strong enough to lift all boats, increasing the likelihood of value traps.

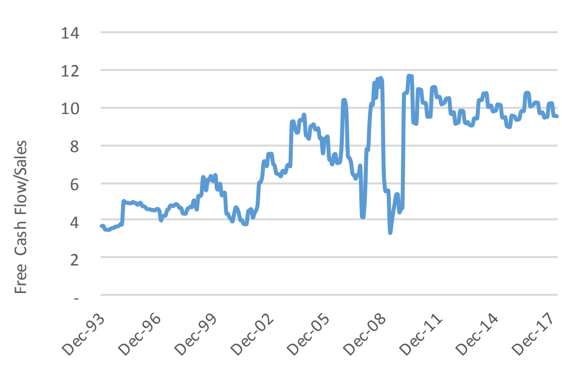
Less economic volatility has also led to a higher sensitivity to growth and quality metrics, and we have seen deep cyclical indicators lose effectiveness. Combining valuation factors with quality and growth metrics seems to be the preferred exposure in the current environment (see our thought piece on factor effectiveness).

Trend #2: If You Can't Beat Them, Join Them

With a market focus on quality, and limited top line growth opportunities in a slowly expanding economy, corporations have shifted their attention away from growth towards bolstering free cash flow generation [Figure 2] and return on invested capital. In the more traditional sectors, we have seen companies turn to M&A, corporate restructuring, and portfolio optimization to improve the quality, sustainability, and bottom line of their operations.

The most visible impact of M&A activity has been industry consolidation. As the old adage goes, "if you can't beat them, join them." The few players that are left now operate under very similar business strategies with less focus on price competition.

Figure 2: Free Cash Flows as a Percentage of Sales for the S&P 500



Source: S&P, FactSet, DuPont Capital

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Product innovation and marketing have become the new differentiators. As industries continue to consolidate and business strategies converge, investing has become less about picking the right company, and more about picking the right industry.

Trend #3: Sharing Shareholders

While corporate strategy has certainly played a leading role in the "normalization" of industries, a change in investor behavior has had a supporting part. The dramatic rise in passive investing, particularly indexing, has led to what is called "horizontal ownership," or a situation where institutional investors own shares of the majority of competitors in a concentrated market. A recent study by the Bank for International Settlements showed that passive ownership of U.S. equities has almost tripled from an estimated 16% in 2007 to a little below 45% in 2017[2]. Because of this growth, an increasing number of companies now share the same shareholders as their competitors, clients, and suppliers.

A direct implication of horizontal ownership is that majority shareholders have a vested interest in the success of the entire industry, leading to greater interest in maximizing the value of the total group, rather than individual companies. Industry trends and dynamics have become more important than company-specific attributes. The key question is not whether you want to buy Delta or United Airlines, but whether you want to be in the airline industry. We expect that continued consolidation in industries, such as tobacco, packaging, and railroads, will further increase correlations among these stocks.

Trend #4: Capitalism Without Capital

Interestingly, the rising importance of intangible assets, such as branding, R&D, and software, has also impacted industry diversity. In the developed world, corporations are now investing more in intangibles than in physical assets. For a broad range of industries, these investments are poised to become a significant source of future growth.

In "Capitalism Without Capital,"[3] authors Jonathan Haskel and Stian Westlake make the case that intangibles have underappreciated consequences for productivity and economic inequality, impacting corporate efficiency, cash flow, and company return profiles. Going forward, we believe the value of these investments will move beyond just efficiency improvements, and will become an increasingly important differentiator between companies.

Platform companies like Google, Amazon, and Visa are extreme examples of companies using intangibles to drive future growth. These platform and network driven models are further diminishing industry diversity as they have come to dominate their respective industries in a winner takes most world.

All Roads Lead to Rome

All roads lead to Rome in the current economic and business environment. Whether driven by the influence of passive investors, slower long-term economic growth, M&A activity, or the impact of technology, a growing segment of the equity market has become in less fragmented and more return focused. Business strategies are less differentiated and business performance is less volatile (adjusted for cyclicality). For equity investors, this means allocation decisions have become even more important, be it on a style, industry, or thematic basis.

[1] Andrew W Lo: Adaptive Markets, Princeton University Press, 2017

[2] Vladyslav Sushko and Grant Turner, The Implications of Passive Investing for Securities Markets, BIS Quarterly Review, March 2018

[3] Jonathan Haskel and Stian Westlake: Capitalism without Capital, Princeton University Press, 2017

Lode J. Devlaminck, Managing Director, Equities, is the lead portfolio manager for the firm's EAFE and Global Equity strategies and a portfolio manager on the Emerging Markets Equity strategy. Mr. Devlaminck is a member of the DuPont Pension Trust Investment Committee and the DuPont Savings Plan Investment Oversight Committee. Prior to joining DuPont Capital in 2014, Mr. Devlaminck was a Senior Portfolio Manager and Sector Specialist of Global Equities at Hermes Fund Managers in Boston, Massachusetts. Mr. Devlaminck joined the investment industry in 1989. Mr. Devlaminck holds a Master's degree in Applied Economics from the University of Antwerp, in Antwerp, Belgium.