Active is:
Sharing insights

Active management in times of disruption

Disruptive trends are also changing the dynamics of portfolio construction. In 1960, the average company lifespan was 60 years; by 1990 that was down to 20 years. Technological disruption is therefore placing an increased emphasis on active management.

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Disruption as an argument against indexing.
However, disruptive trends are also changing the dynamics of portfolio construction. In 1960, the average company lifespan was 60 years and had fallen to 20 years by 1990. The current trend is toward 12 years. As most companies are disrupted at an accelerating pace, all the long-term returns come from just 20% of the stocks. Yes, in this real-life example of the Pareto Principle[1], since 1989 20% of stocks have accounted for all market gains in the S&P 500 index with a collective 80% generating no returns. 8% outperformed by at least 500%, 7% underperformed by at least 500% and 24% underperformed by 200% or more.[2] The upshot of this is that:

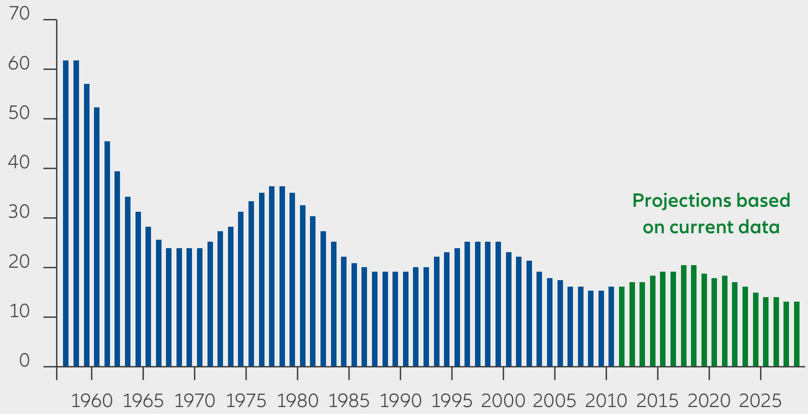
1. Avoiding torpedoes is as important as picking winners, and
2. Somewhat ironically, disruption is placing an increased emphasis on active management.

Avoiding disruption value traps.
A great deal of disruption is rooted in technological innovation but the effects of business disruption are far reaching. Some random examples include:

- The business model of Yellow Pages directory companies have been virtually destroyed over the past five-to-ten years by Google's search engine.
- Mobile telecom operators in Europe have lost a large chunk of their original voice and SMS business to content and equipment companies such as Apple and app developers such as WhatsApp (667,000,000 WhatsApp messages were sent per day in 2015 in Germany alone).
- 3D printing call into question the business model of manufacturers and distributors of basic goods including spare parts and fashion accessories.
- New apps, such as Uber and Airbnb, create a risk to business models of transport and hotel chains.

[1] The Pareto Principle, a.k.a. the 80/20 rule, states that "for many events, roughly 80% of the effects come from 20% of the causes." Interestingly, it was named after a late 19th Century Italian economist who "developed the principle by observing that about 20% of the peapods in his garden contained 80% of the peas." Source: https://en.wikipedia.org/wiki/Pareto_principle
[2] Source: http://www.longboardfunds.com/articles/defense-wins-championships

Chart 1: Average company lifespan on S&P Index (in years)
Each data point represents a rolling 7-year average of average lifespan



Data: INNOSIGHT/Richard N. Foster/Standard & Poor's
Source: http://www.longboardfunds.com/articles/defense-wins-championships

- Average company lifespan on S&P 500 was, on average, 60 years in 1960.
- By 1990 that was down to 20 years.
- Current trend is toward 12 years!
- As most companies are disrupted at an accelerating pace, all the long-term returns come from just 20 % of the stocks

- Can the traditional car manufacturers successfully transform their business models in order to adapt to the new world of electric vehicles?
- Which business models are impacted by the rising penetration of "IoT" (Internet of things): Doctors, utilities, navigation suppliers …?
- What does IBM's iRobot technology mean for professional publishers in the next 5 – 10 years?
- Will the Google/SpaceX trial to roll out internet coverage to rural and emerging market regions via satellites and balloons pose a threat to traditional telecom and satellite operators?

A specific example of where a concerted focus on disruption would have likely helped is Nokia:

- At its peak in 2007, Nokia controlled 41 % of the global handset market.
- Nokia would probably have been viewed as having below-average disruption risk prior to the iPhone.
- Nevertheless, the stock went from €25 in 2007 to €1.50 by 2012.

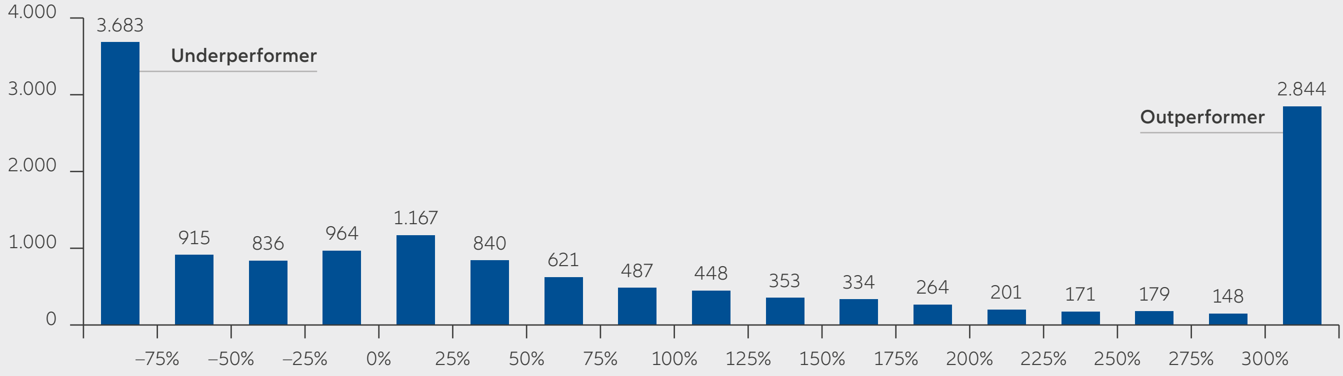
So, how are we responding as AllianzGI?
1. We need to directly respond to disruption within our own industry.
2. Acknowledging that indexing will likely not deliver outperformance over the coming decades (average S&P 500 company trending toward 12 years in the index; all long-term returns come from just 20 % of stocks).
3. Integrating disruption risk analysis into portfolio managers' active strategies via Disruption Risk Ratings.

Similar to what we've done with "ESG" (Economical, Social, Governmental), we're making Disruption Risk Ratings part of the broader Intrinsic Ratings project. Additionally, this is likely to help us identify both specific company ideas as well as investment themes.

- Disruption Risk Ratings (and associated discussion within Chatter) are intended to provide every investment professional at AllianzGI with a clear and current view of the potential for business model disruption (and potential value traps) over a 3 – 5 year horizon.
- The discussion about any particular industry would be expected to evolve over time, because our insight and confidence level about change will be evolving over time as well.
- Disruption Risk Ratings are part of our broader Intrinsic Ratings project in which we're bundling our various non-financial/valuation thoughts on companies into one easy-to-find place in Chatter.
- Identification and analysis of disruptive risks will likely be useful in creating new ideas for Grassroots Research.
- Further benefits of the process are the (early) identification of specific company investment ideas and, potentially, the creation of new investment themes forportfolios.

Thematic investments should gain traction in times of disruption:
- Thematic investing essentially means ignoring the traditional sector and regional classifications that companies are usually categorized in. Instead, companies are solely viewed as either beneficiaries or losers of certain trends which, if large enough in size and impact, aggregate to larger investment themes.

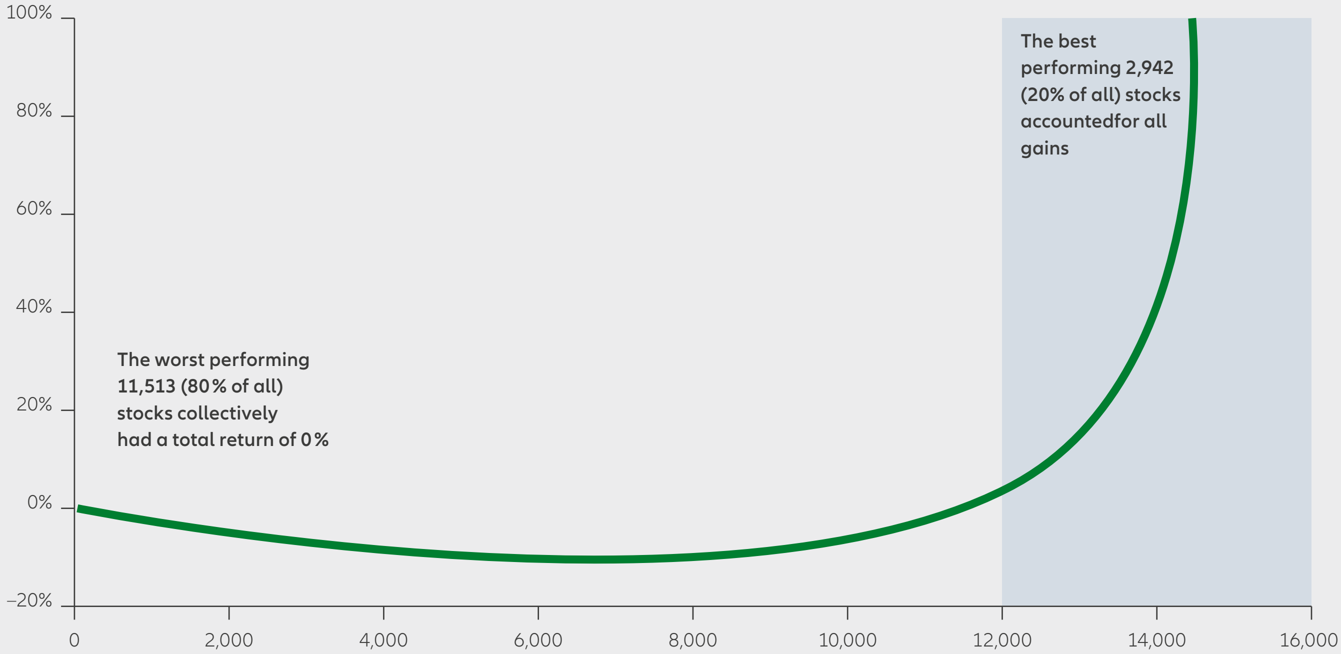
Chart 2: Total life-time returns of individual US stocks (1989–2015)



Source: http://www.longboardfunds.com/articles/defense-wins-championships

- Companies which already stand to benefit today from trends that will slowly but surely materialise in the distant future will be given clear preference over those whose business models increasingly appear at risk of disruption. Print advertisers and traditional power utilities will likely struggle to find investors willing to pay for cash flows these companies are planning to generate beyond the next decade, whilst electric car pioneers or beneficiaries of digitalization are likely to be rewarded for having better prospects of playing a part in shaping our future. As such, there are some similarities to ESG (environmental, social and governance) investing, which also strives to assess a company's readiness to react to long term trends.
- An investible theme will typically have its origin in structural shifts induced by technology, regulation or socioeconomic factors. While the shift might be slow and start out small, it is typically powerful in nature and will grow regardless of short-term cycles. It is important to distinguish long-term "themes" from short-term "trends",

Chart 3: Attribution of collective return (1989–2015)



Source: http://www.longboardfunds.com/articles/defense-wins-championships the latter of which tend to be priced into stocks quickly but typically don't last much longer than a news cycle. Likewise, less-than-specific "visions" for the distant future are usually too vague to actually trigger any investment decisions today.

– A theme will only be relevant to investors if it actually allows for participation. This means that equity investors prefer a sufficiently large number of listed and liquid stocks in order to diversify away stock-specific factors and find stocks which stand to benefit from (or be existentially challenged by) a theme. This is a time-consuming exercise requiring considerable fundamental research skills, ideally spanning all regions and sectors across the globe. Most traditional investors lack this research depth or only look for companies within traditional sector classifications. In addition, as few companies will be pure-play beneficiaries from certain themes, and most will typically have unwanted adjacent activities, a wide range of expertise and fundamental research is needed to determine which stocks will actually move in relation to the theme.
– An investment manager needs to have the skills to focus on outstanding themes. Fewer themes have the advantage of more highly-focused exposure, suitable for investors who are strongly convinced of a particular theme, but also carry the risk of less diversification and missing the point of exit.
– Timing the entry and exit points of an investment in a theme is just as tricky as with a single-stock investment and requires both bottom-up analysis as well as the tracking of top-town developments. A bird's eye view makes it possible to detect when enthusiasm among the investment community towards a theme is cooling or accelerating, while bottom-up valuation discipline prevents staying invested for too long. Screening for sentiment shifts via early indicators or systematic analysis of the beneficiaries' fundamentals can provide an insight into how close a theme might be to a turning point.

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