

Equity returns are driven by the few not the average – back the winners!

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Introduction

Over the past decade and a half, we have moved to a globalised, internet and smart phone-enabled, world. The power law distributions that have historically described regional industry structures and competitive landscapes have now become global. The market has become a globalised “winner takes all market”. Power law probability distributions describe the situation where only a small percentage of a certain population produce most of the value. This type of probability distribution is also known as a Pareto Distribution. A common example is the “80-20” rule where 80% of the value is produced by 20% of the population.

Even before the emergence of the internet, returns for global equity markets had been dominated by a small group of highly successful businesses. Most listed stocks produce unattractive long-term buy and hold returns. In a study of the returns produced by U.S. equities from 1926 to 2016, Hendrik Bessembinder (2018) finds an extremely narrow group of stocks drove all of the equity market returns.¹ The top-performing 1,092 listed U.S. companies (or 4.31% of the total number of listed stocks during this time period) accounted for all of the wealth creation from investing in equities (i.e. excess equity returns relative to treasury bills). Bessembinder (2019) replicated this study across 42 countries over the 1990 to 2018 period and found the returns globally were even narrower where the best performing 811 firms (or 1.33%) accounted for all the net global wealth creation².

Power law distributions drive long-term equity returns

Power law distributions, rather than normal distributions, explain the composition of stock market returns over long time periods. Stock market returns over the long term are not driven by most stocks but rather by a small number of structural growth businesses. The extraordinary returns from this small number of structural growth businesses result in the market’s return distribution having a positive skew rather than a normal bell curve shape. It is the compounding impact of high return structural growth businesses (“the winners”) that drive most stock market returns over the long term. Unless a long-term “buy and hold” investor can successfully select future structural growth companies, that is, the structural winners, and give them sufficient weight in their portfolio they will not produce excess returns. Alternatively, market participants including fund managers can attempt to outperform over short time periods using active trading strategies. However, successfully predicting the direction of short-term share price movements is very difficult. Portfolio managers running short-term trading strategies operate in an extremely competitive space where share prices are random and unpredictable. **Short-term trading and speculation become even more challenging as economic tailwinds and rising intrinsic values are replaced by economic headwinds and falling intrinsic values for most listed stocks.**

Historically, most listed companies have produced long-term returns either in line or below the returns achieved from treasury bills. The average period that a typical U.S. equity remained listed between

¹ Bessembinder, H. 2018. Do Stocks Outperform Treasury Bills?. *Journal of Financial Economics*, 129(3): 440-457.

² Bessembinder, H., Chen, T., Choi, G., & Wei, K. 2019. Do Global Stocks Outperform US Treasury Bills?. *SSRN Electronic Journal*.

the years 1926 to 2016 was only 90 months, despite most of this period experiencing strong growth in the U.S. economy³.

Value investing relies on short-term trading strategies in strong economic periods

Even during the incredibly strong economic growth period that existed from the middle of the 20th Century to the GFC, most listed businesses were unable to produce attractive long-term returns. Thus, if an investor failed to allocate sufficient capital to the small number of high quality, structural growth companies that produced most of the long-term returns, then it was difficult to outperform the risk-free rate. During the economic boom period from 1950 to 2007, the most popular and successful investment style was traditional value investing. This style of investing was made famous by academics, including Fama and French, during the 1970s. Value style investing focused on short-term mean reversion of P/E Ratios and EPS recoveries to outperform broad equity indices and the risk-free rate. Value investing worked well during this exceptional economic growth period because most businesses shared in the strong growth of the economy and the associated growth in overall corporate profits. Even when the economy and aggregate corporate profit growth experienced periods of low or negative growth, there was a general belief in society that governments and central banks had the power to ensure a return to strong growth in future periods.

Traditional value style investors tend to invest in average and below average quality businesses because:

- 1) these businesses represent most listed companies; and
- 2) the investment processes and related investment screens commonly used by value investors steer them towards stocks that are selling on below average P/E Ratios relative to other stocks or compared with their historical averages. These types of stocks tend to have above average fundamental business risk.

In an environment where nominal GDP and aggregate corporate profits are expanding rapidly, and this situation is viewed as sustainable, then traditional value investing works well. In this strong overall economic environment, the additional fundamental risk associated with buying average and below average quality businesses is masked or hidden because “a rising economic tide lifts all boats”. In other words, in a high profit growth environment the performance differences in terms of perceived economic fundamentals and future growth potential separating very high-quality businesses and below average quality businesses narrows.

Value investors are not generally long-term buy and hold investors because increases in short-term P/E Ratios are an important driver of alpha. This compares to structural growth investors like Hyperion Asset Management (“Hyperion”) where changes in P/E Ratios are not a material component of our long-term returns. The key driver of our long-term returns and alpha is superior EPS growth on the stocks in our portfolios, not the change in the average P/E Ratio of the portfolios.

Given that most listed stocks produced buy and hold long-term returns in line or below the risk-free rate, value investors need to be able to trade the stocks in their portfolios to boost their overall returns. The strong economic growth environment in the period from 1950 to the GFC increased the opportunities for value investors to profitably trade average and below average quality stocks. This strong economic tailwind is a key reason why value investors performed well during the 6-decade period leading up to the GFC.

³ Bessembinder, H. 2018. Do Stocks Outperform Treasury Bills?. *Journal of Financial Economics*, 129(3): 440-457.

This is an important difference between traditional value investors and Hyperion. Traditional value investors are forced to try and take advantage of changes in short-term P/E Ratios. They do this by selling stocks to realise gains related to a P/E Ratio re-rating during the relevant holding period. **P/E Ratio expansions have a non-compounding or one-off impact on returns. The longer the holding period the lower the return impact per annum of the increase in the P/E Ratio.** Thus, to maximise the return and alpha impact of an increase in the P/E Ratio, value investors need to realise the gain and sell the stock. The importance of P/E Ratio expansion as a driver of returns results in an underlying short-termism mindset that heavily influences most value style investors. **The one-off, non-compounding return impact from changes in the P/E Ratio contrasts with the compounding impact on long-term returns from EPS growth.**

As a rule, the closer an investor moves towards investing in average or below average quality businesses the more important short-term trading metrics like a relatively low P/E Ratio become.

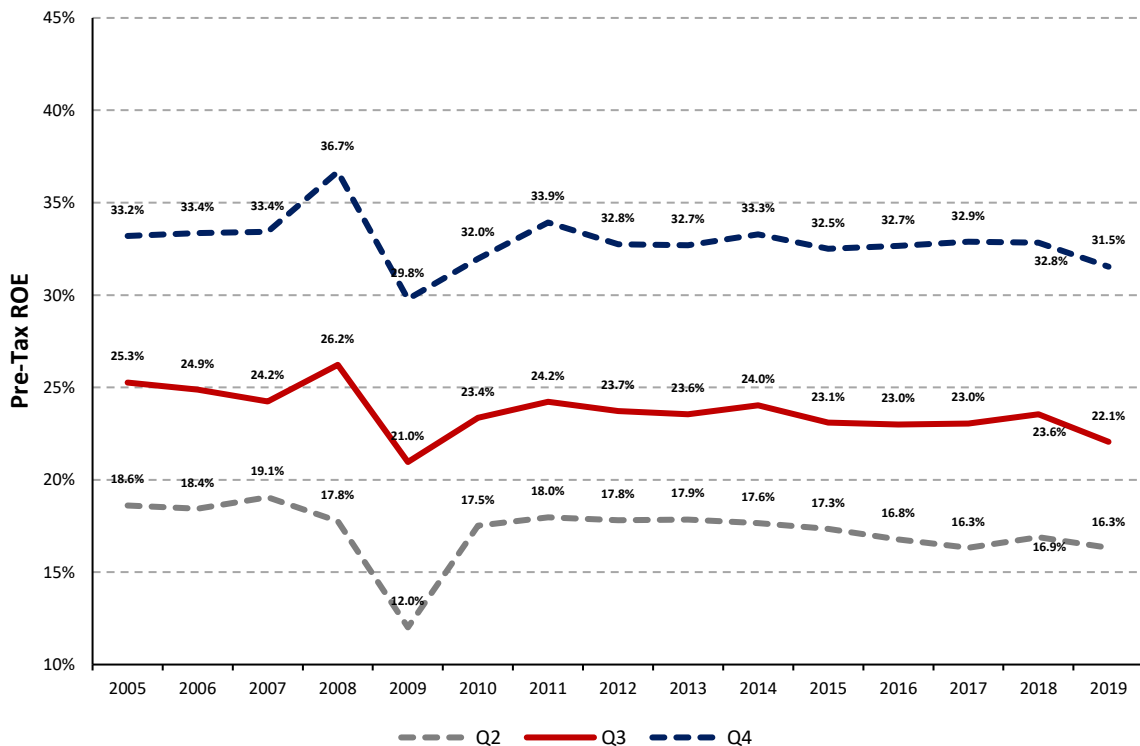
The fact that most stocks do not provide attractive long-term buy and hold returns forces value investors to trade stocks on a relatively short-term basis. They try and string together a series of short-term alpha trades from a combination of P/E Ratio expansion, dividend return and EPS growth during the relevant holding period. Therefore, these investors focus on stocks selling at relatively low short-term earnings multiples and try to take advantage of near-term earnings recoveries.

Many value investors performed well in the high growth world prior to the GFC because they traded stocks rather than buying and holding for long time periods. In a high growth economic environment, it was relatively easy for value investors to buy low P/E Ratio stocks and produce alpha because average quality businesses shared in the growth of the overall economic pie. In addition, this high growth economic period was one of low levels of disruption and globalised competition. This meant there were less value traps to reduce value investors returns during this period.

Intrinsic values are declining for most listed companies

Value investing with its short-term, trading-based characteristics becomes very difficult in a structurally low growth, low inflation, and disrupted economic environment. This is because average quality businesses are more likely to suffer future declines in economic fundamentals rather than recover through cyclical mean reversion of earnings and P/E Ratios. In addition, cyclical recoveries are less frequent, shorter and less robust in a low growth disrupted world. It will progressively be harder to apply short-term mean reversion techniques (short-term cyclical EPS growth and P/E Ratio arbitrage) in this more difficult economic environment. Stock selection and actively avoiding average and below average quality businesses will become more important in a low growth world. **Most businesses will fail and die. Only a few will win and grow.** This is seen in the declining intrinsic values of average companies as approximated by their pre-tax return on equity ("ROE").

Figure 1: Declining intrinsic values of average quality businesses



Source: UBS, Hyperion

Historical U.S. equity returns are driven by a narrow group of winners

We believe that most listed companies will not produce long-term “buy and hold” returns above treasury bills. This is unconventional thinking. The basis of conventional finance theory states that equity investments have higher risk relative to other asset classes such as fixed interest or cash because stocks exhibit higher levels of volatility.

Finance theory also states this higher risk that is associated with some form of short-term market price volatility, should result in higher returns - “higher volatility related risk, higher expected returns”. Sharpe (1964)⁴ concludes this short-term share price volatility relates to a stock’s sensitivity to economic conditions. The more sensitive a stock’s revenues and profits are to economic conditions the higher the general short-term share price volatility associated with that stock.

Traditional finance theory states that provided you diversify sufficiently you can eliminate non-systematic risk or individual company fundamental risk. This theory believes that investing in a broad equity index provides sufficient diversification and removes non-systematic equity related risk.

Sharpe’s 1964 journal, Capital Asset Prices: A Theory of Market Equilibrium under conditions of Risk⁵ stated, “since all other types [of risk] can be avoided by diversification, only the responsiveness of an asset’s rate of return to the level of economic activity is relevant in assessing its risk.” It is assumed that investing in a sufficiently diversified portfolio of equities should result in higher returns above the risk-free rate.

⁴ Sharpe, W. 1964. Capital Asset Prices: A Theory of Market Equilibrium under Conditions of Risk. *The Journal of Finance*, 19(3): 425-442.

⁵ Ibid.

Sharpe-Lintner-Black developed the Capital Asset Pricing Model (“CAPM”) that has since governed the way academics and market participants approach the subject of risk and returns and asset pricing of stocks and other assets. CAPM builds on the mean-variance efficient framework of Markowitz (1959). CAPM states that the expected returns on securities have a positive linear function to their market Betas - where Beta is the slope in the regression of a security's return compared with the market's return. CAPM provides cross-sectional predictions for expected stock returns.

We believe there are two fundamental flaws with traditional theoretical asset pricing models such as the Sharpe-Lintner-Black model around risk and return:

- 1) share price volatility (relative or absolute) does not accurately define risk; and
- 2) averages are misleading and can be the outcome of extreme tail events.

Firstly, we believe that true risk is permanent loss of capital, not short-term share price volatility (relative or absolute). This permanent loss of capital results when an asset's expected future free cash flows disappear or decline permanently. Permanent loss of capital occurs when the business ceases to exist because of bankruptcy, takeover or when the owner of the asset sells. Short-term share price volatility was chosen to represent risk because it was convenient for academics to measure and it enabled them to use substantial amounts of data in their empirical research. You can simply eliminate this kind of volatility related “risk” by investing in illiquid assets such as unlisted real estate and infrastructure. It is obvious that the underlying fundamental risk of a business or other asset is not properly captured by short-term market-based volatility. It should be noted that sensitivity of a stock to changes in economic conditions or short-term market returns is also not a complete measure of fundamental risk.

Secondly, why should a diversified collection of average quality businesses necessarily outperform the risk-free rate? Adding lots of average quality businesses does not necessarily result in a portfolio that outperforms the risk-free rate over the long-term, particularly in a low growth, disrupted world. We believe, equity investing is about long-term growth, which is driven by compounding returns of the survivors (or winners). This produces positive skews not a normal distribution of returns. Essentially the extreme fundamental economic success of a few listed equities masks the failure of most individual stocks. Thus, successful long-term equity investors cannot afford to omit the few structural winners from their portfolios.

Furthermore, Fama and French (1992)⁶ find that over time the linear relationship between risk (Beta) and return has diminished. They concede that earlier studies conducted from 1926 to 1968 using the Centre for Research in Securities Prices (“CRSP”) NYSE dataset do find a positive correlation in support of the traditional finance model. However, when replicating the study, using the same dataset from 1963 to 1990, this simple relationship disappears. They conclude that risks are multidimensional and as such, *the SLB [Sharpe-Lintner-Black] model does not accurately describe average stock returns.*

“Positive mean excess returns for the broad stock market is driven by very large returns to relatively few stocks, not by positive excess returns to typical stocks. The positive skewness of long horizon stock returns is primarily attributable to the effects of compounding.”

Bessembinder (2018)

⁶ Fama, E., & French, K. 1992. The Cross-Section of Expected Stock Returns. *The Journal of Finance*, 47(2): 427-465.

The returns produced by U.S. equities from 1926 to 2016 were driven by an extremely narrow group of stocks. Excess returns relative to treasury bills was derived from a small number of stocks that generated abnormally large returns, not from the performance of a typical common stock (or the “average”). The net gain for the entire U.S. stock market since 1926, measured using CRSP monthly stock returns, is explained by the best-performing 4% of listed companies (Bessembinder, 2018)⁷.

Averages can be misleading as they are driven by the tail

Average businesses produce long-term returns at or below U.S. treasury returns. This means that the long-term returns from most listed businesses fail to justify the additional fundamental risk associated with investing in equities compared with U.S. treasuries. The symmetrical bell curve or normal distribution of returns taught at university does not reflect the reality of complex systems. Averages or mean values do not accurately describe many real-world systems and complex relationships. **Positive skews and compounding create averages from large values in the tail.** Power law distributions rather than normal distributions are more reflective of real systems, particularly when humans are involved. This is often called the “80-20 rule” where a few dominate. We would argue in a competitive, disruptive, and complex world its closer to a “90-10” or even “95-5” rule.

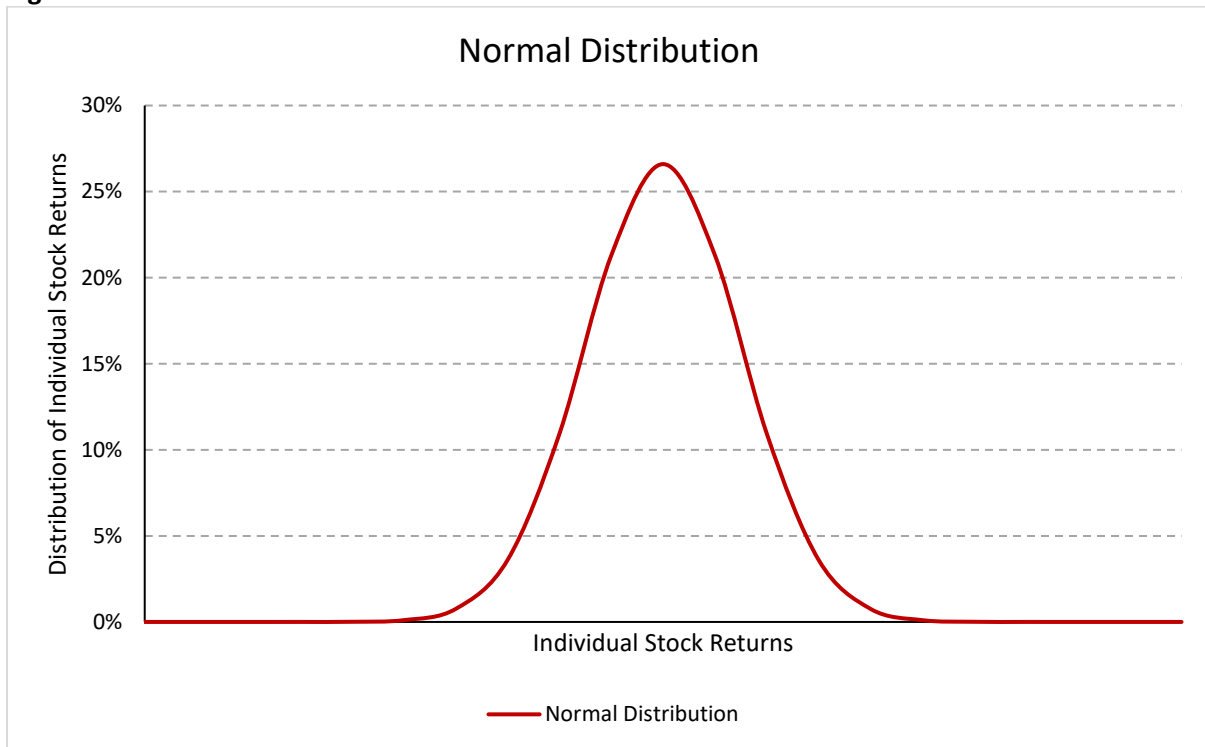
Most businesses fail to grow at high rates sustainably over the long-term. In addition, these types of businesses end up failing because they do not produce sufficiently attractive products and services. The lack of a value proposition that is strong enough to attract and grow customers and sales over the long-term results in eventual business failure.

Over the long-term, very few companies create significant sustained value. The companies that do produce significant value are those that produce exceptional products and services and they tend to accrue all or most of the economic benefits associated with that value creation.

Humans tend to seek comfort from the validation of others, including situations involving the selection of a product or service. This becomes even more important when there is some uncertainty regarding the future performance of that product or service. Examples include the selection of an active fund manager where future performance is uncertain or the selection of a software provider where the functionality required in the future is also uncertain. Hence, a first mover advantage is extremely important in many industries. Human’s seeking confirmation of the best product or service by observing what their peers select creates a self-reinforcing winner’s loop.

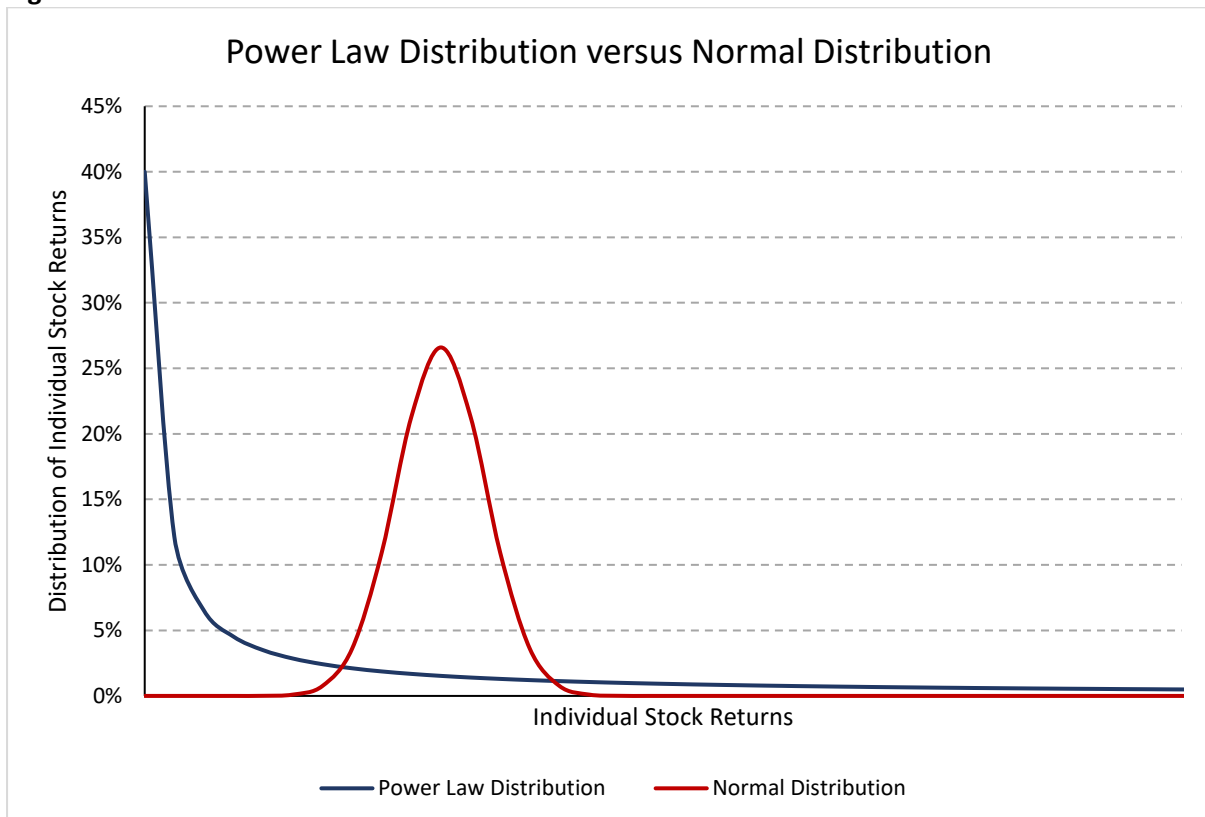
⁷ CRSP month stock returns contain all common stocks listed on the NYSE, Amex and NASDAQ exchanges.

Figure 2: Theoretical distribution of returns – Normal distribution



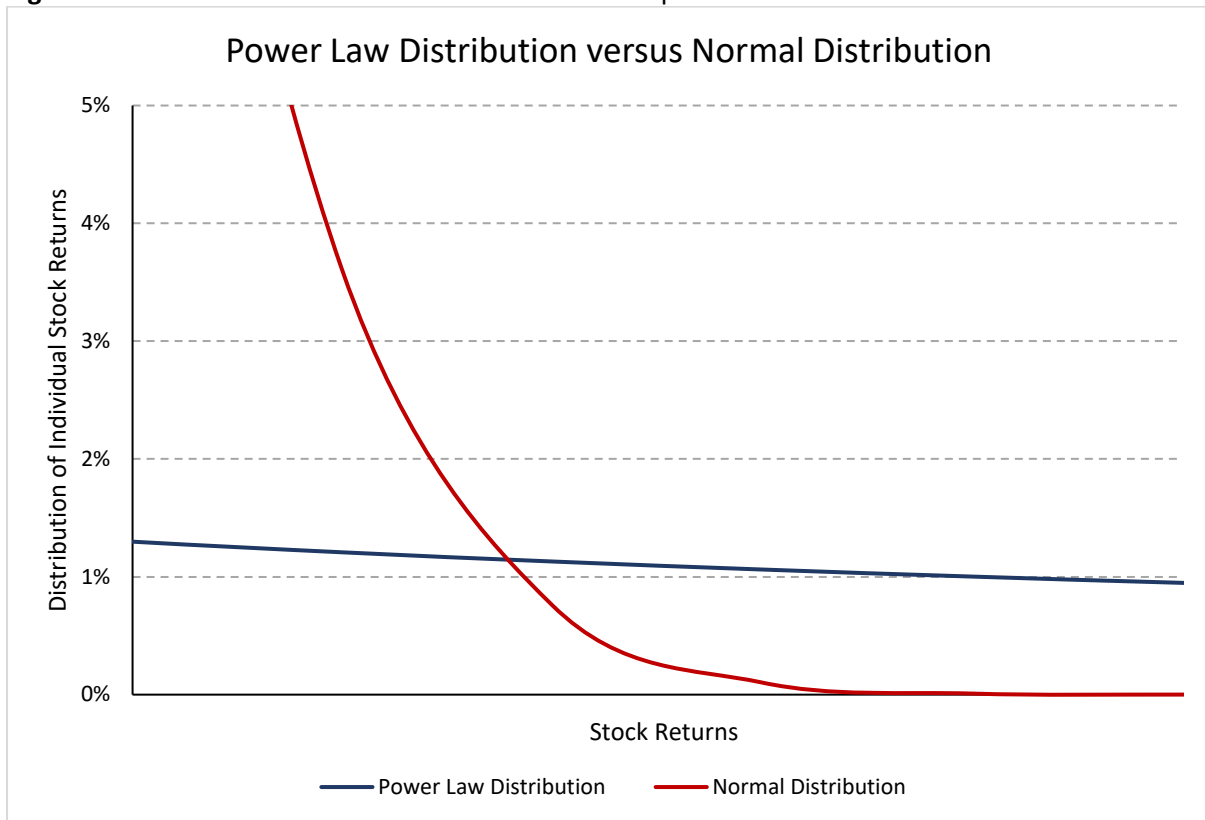
Source: Hyperion

Figure 3: Power law distribution of returns versus a normal distribution



Source: Hyperion

Figure 4: Practical distribution of returns – the tail of a power law distribution

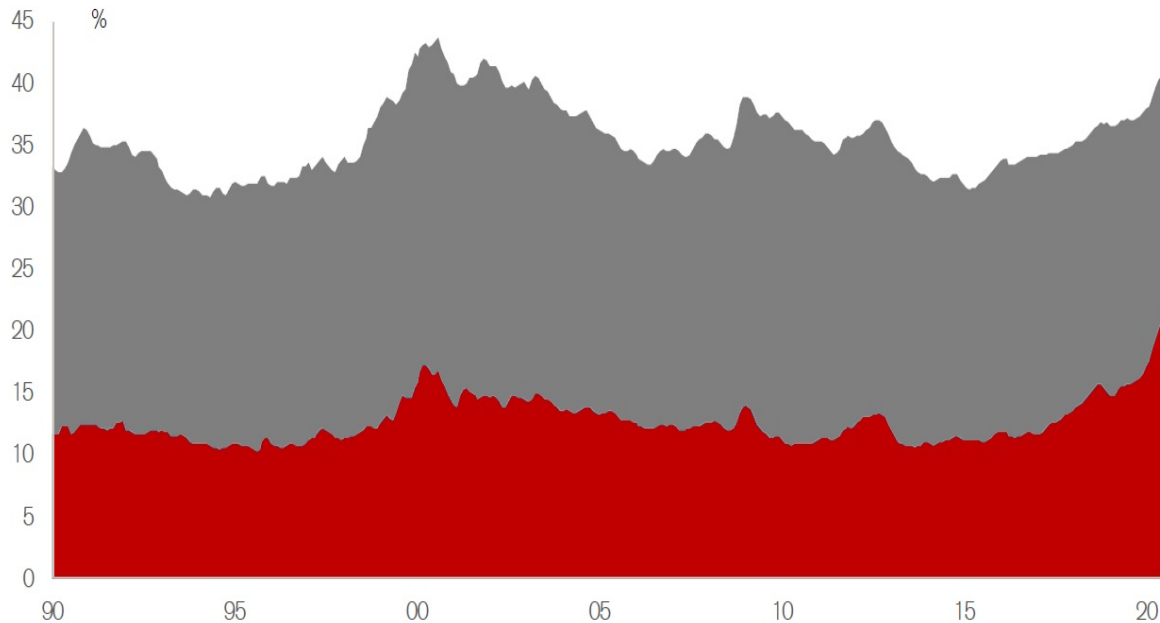


Source: Hyperion

The long-term returns of broad-based stock market indices are driven by a narrow group of elite businesses, effectively the top 99th percentile.

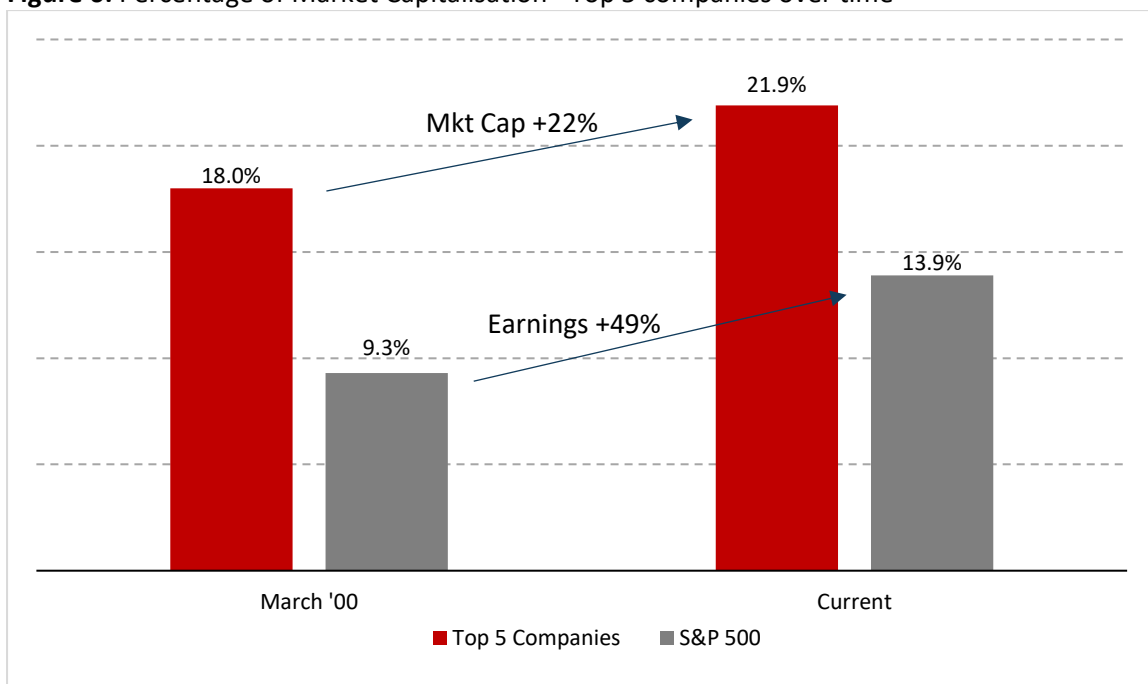
We have observed previously that the listed companies with the highest return on equity (top 10%) in developed markets has been expanding over time. In contrast, the average return on equity of most listed companies has been in decline. These trends commenced in the 1990s with the advent of the internet and became more pronounced post the GFC. In a low growth, low interest rate world the level of competitive intensity has risen as companies fight for market share in stagnant industry revenue pools. We expect positive skews to become even larger over time and thus averages to become even more skewed in a structurally low growth, disrupted world.

Figure 5: % of Market Cap – Top 5 vs. top 25 companies over time



Source: Credit Suisse 2020, Golub, J., Palfrey, P., Manish, B., Coates, M., & Erica, C. 2020. *Market Concentration Not a Problem*, Hyperion

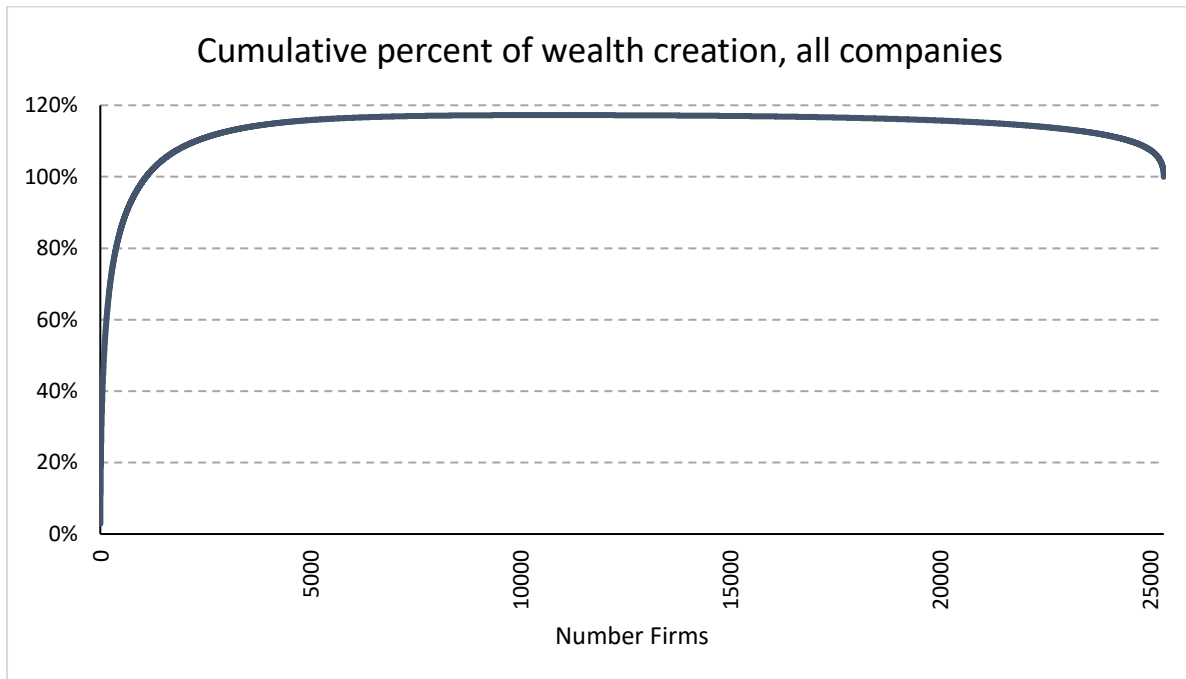
Figure 6: Percentage of Market Capitalisation - Top 5 companies over time



Source: Credit Suisse 2020, Golub, J., Palfrey, P., Manish, B., Coates, M., & Erica, C. 2020. *Market Concentration Not a Problem*, Hyperion

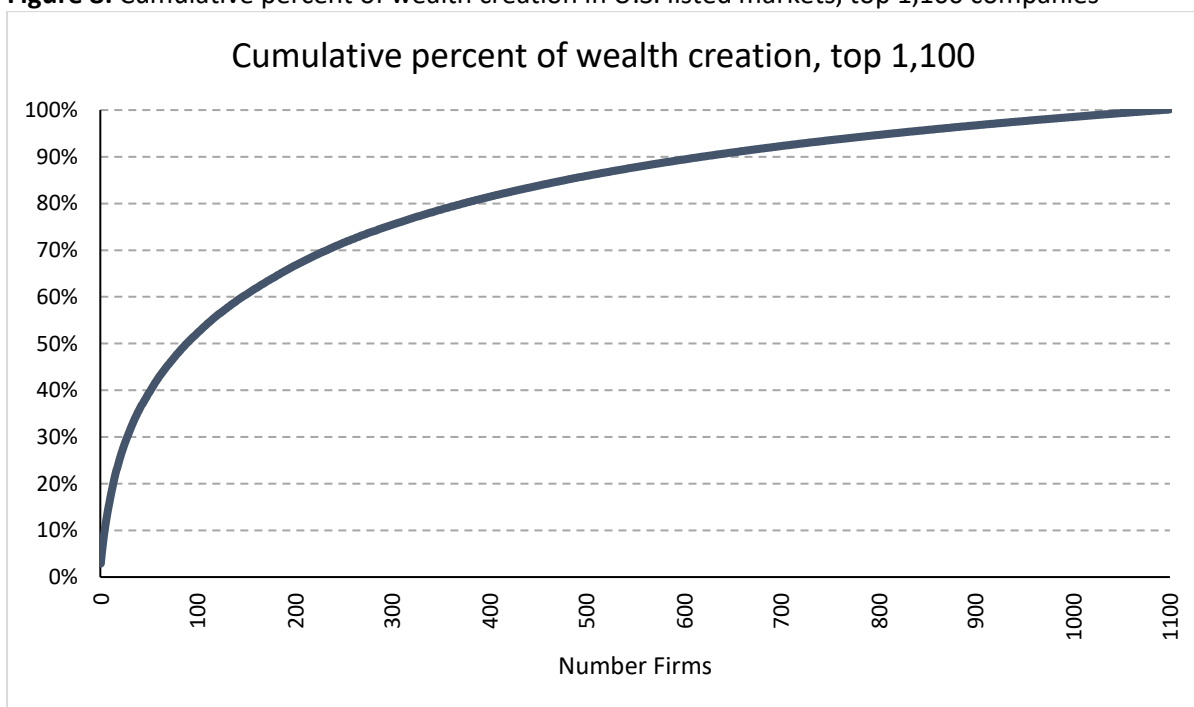
Bessembinder (2018) provides evidence that long-term market returns are driven by a narrow number of long-term winners. The following charts clearly show how narrow the number of companies are that contribute to equity returns from 1926 to 2016 in the U.S. market. The super-abnormal returns of a select few businesses compensate for many losing or average performers.

Figure 7: Cumulative percent of wealth creation in U.S. listed markets, all companies



Source: Bessembinder (2018), Hyperion

Figure 8: Cumulative percent of wealth creation in U.S. listed markets, top 1,100 companies



Source: Bessembinder (2018), Hyperion

The creative destruction of capitalism means there are few winners

The world continues to migrate to a winner-takes-all model where average and below average companies continue to suffer from low industry demand growth and a structural decline in the relative strength of their value proposition to customers. **We believe the return and performance profile of a select group of quality growth companies will persist.** With the largest 5 companies in the MSCI

World between 1.0% to 4.5% of the index each, some of these will become much larger components over the next decade. Market capitalisations of many trillions of dollars will become reality for the largest listed companies in the world over the next decade and beyond.

Table 1: MSCI World Index as at 31 July 2019

Ranking	% weight	Security
1	4.25%	Apple Inc. (APPL-US)
2	3.38%	Microsoft Corporation (MSFT-US)
3	3.06%	Amazon.com, Inc. (AMZN-US)
4	1.39%	Facebook Inc. (FB-US)
5	1.04%	Alphabet Inc. (GOOG-US)

Source: MSCI, Hyperion

Capitalism is driven by the economics of creative destruction and for most long-term business investments, including equities, this results in business failure and loss of capital. This destruction can occur very quickly with most common stocks having short lifespans. According to Bessembinder, more than half of CRSP common stocks deliver negative lifetime returns with the most common outcome a loss of 100%. Individual common stocks tend to have short lives. The median time that a stock was listed on the CRSP database between 1926 and 2016 was 90 months (or 7.5 years).

Value creation within capitalism is rarely linear. To maximise compound returns, we believe investors need to hold a small number of structural growth stocks for very long time periods, generally many years to decades. The typical duration for a Hyperion holding is 10 years. There are companies such as Cochlear (COH-AU), Macquarie Group (MQG-AU), REA Group (REA-AU) and Technology One (TNE-AU) that Hyperion has held for decades in its Australian portfolios.

With the intrinsic value of most listed companies declining and life spans of listed companies shortening, investors need to “protect” before they can “grow.” **We believe that true risk relates to permanent loss of capital or destruction of capital. Share price volatility is not risk. A sustainable business model is essential for earnings to compound over time.** Hyperion focuses on qualitative elements such as value proposition, competitive advantage, strength of business model, recurring level of revenue and strength of balance sheet to ensure we have selected businesses that can survive permanently.

In a structurally lower growth world post 2008, companies have been driven to innovate and invest at a faster rate. The most disruptive companies have accrued significant economic value in this environment. In contrast, there are many traditional average and below average quality businesses that have been sustained by low interest rates, quantitative easing, tax reductions, restructuring and mergers.

Most stocks generate negative lifetime excess returns (relative to treasury bills). Only 42.6% of CRSP common stocks have lifetime buy-and-hold returns that exceed the buy-and-hold return on one-month treasury bills over the same period (Bessembinder, 2018). This shows the importance of **not omitting key stocks from investment portfolios**. Again, the concept of a winner takes all outcome appears in listed equity markets. We expect this to become even more common in the coming decades as the competitive intensity rises in a low growth world.

25,967 individual common stocks since July 1926, collectively created \$34.82 trillion in wealth as at Dec 2016 on U.S. exchanges. However, this cumulative wealth was driven by a surprisingly narrow number of listed securities. Large positive returns to a few stocks offset the modest or negative returns

to more typical stocks. The stock that made the single largest contribution to aggregate wealth over this time period was ExxonMobil at \$1.0 trillion (or 2.88% of total accrued wealth). The second largest contributor was Apple at \$745.7 billion (or 2.14% of total accrued wealth). In fact, the top 5 firms (ExxonMobil, Apple, Microsoft, General Electric and IBM) accounted for 10% of accrued wealth. Further, the 90 top performing companies (representing only 0.36% of the total number of companies) collectively account for over 50% of wealth creation and the top-performing 1,092 companies (representing 4.31% of the total number of companies) account for all the net wealth creation (Bessembinder, 2018).

Table 2: Wealth creation in U.S. listed markets, 1926 to 2016

Number of Companies	% of Listed Securities	% of Accrued Wealth
Top 5	0.02%	10.07%
Top 50	0.20%	39.29%
Top 90	0.36%	50%
Top 295	1.16%	75%
Top 1,092	4.31%	100%

Source: Bessembinder (2018), Hyperion

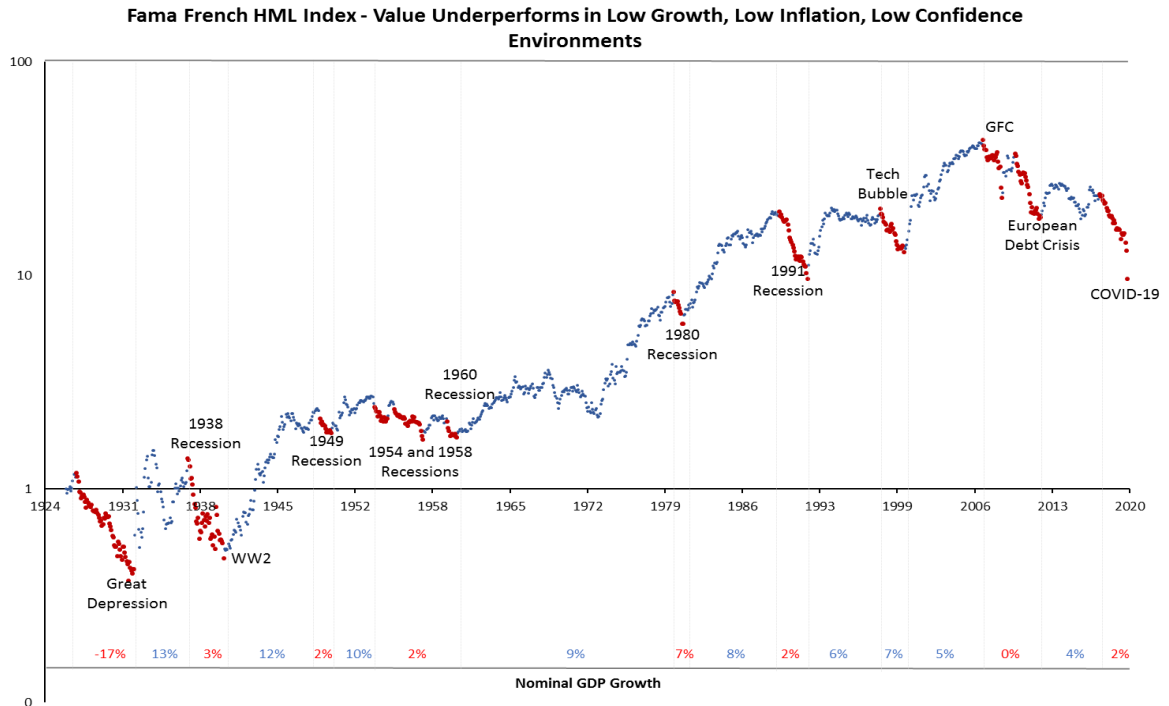
The fact that long-term cumulative equity returns are driven by a small number of exceptional equities does not mean the odds of success are necessarily low. Most experienced investors have some ability to recognise a few good investment ideas over the long term. By investing in a relatively concentrated number of high-quality growth businesses, being patient and holding these businesses over the long term, investors can focus on their best investment ideas and benefit from the compounding growth in their value. This is an extremely powerful and effective approach to wealth creation.

However, long-term investing is still difficult to execute in practice, as organic **growth and returns are rarely linear**. It is difficult not to overweight or extrapolate recent events (“recency bias”). There will be inevitable periods of under-performance, that sometimes stretch on for several years. Factors that influence share prices in the near term can continue to drive directional movements over multiple years in certain circumstances. However, over the long-term share prices follow organic sales growth per share and earnings per share growth.

Traditional value investing is structurally flawed in a low growth world

Value style investing is predicated on successfully forecasting short-term share price movements. This is difficult to do successfully without strong underlying economic tailwinds and regular and pronounced economic cycles. In fact, we have previously observed value style investing has consistently under-performed in periods where nominal GDP growth and aggregate profit growth have been low.

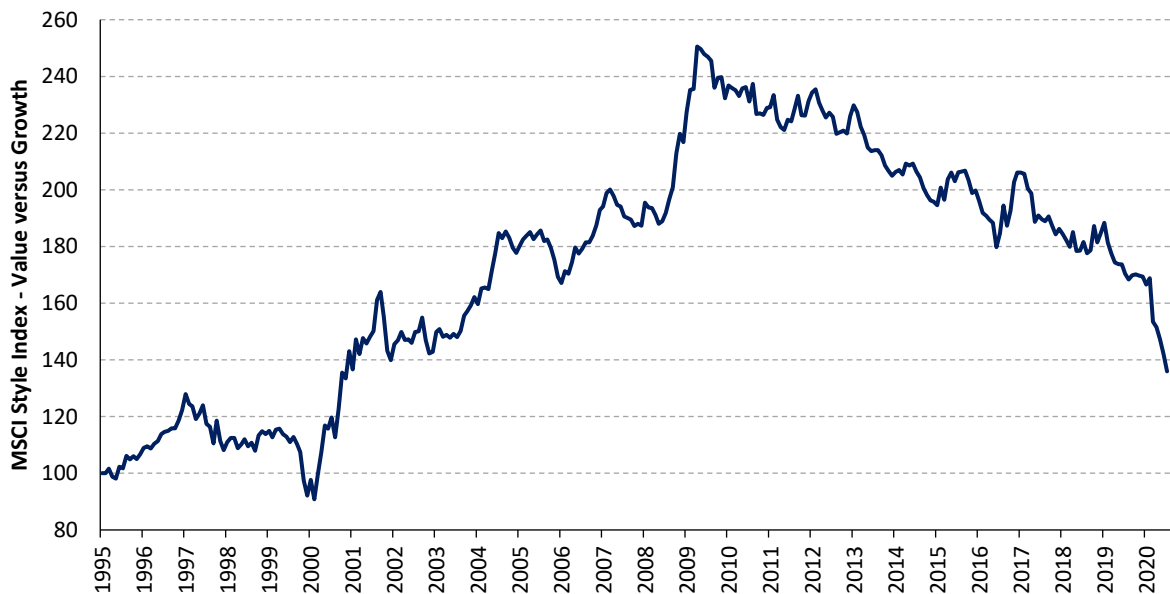
Figure 9: Value underperforms in periods of low nominal GDP growth



Source: Kenneth R. French, Hyperion

Strong aggregate profit growth in Japan prior to the GFC enabled value style investing to perform well, despite the low level of nominal GDP growth during this period. However, post the GFC aggregate profit growth in Japan has been weak and this has resulted in significant underperformance of value style investing.

Figure 10: Value has under-performed Growth in Japan post GFC



Source: MSCI, Bloomberg, Data compiled by Goldman Sachs Global Investment Research, Hyperion

We invest as long-term business owners

Hyperion's approach focuses purely on maximising long-term returns, long-term capital preservation and long-term alpha. We believe Hyperion is different from most market participants in that we do not attempt to generate short-term alpha through trading strategies such as:

- 1) momentum;
- 2) near term news flow;
- 3) feedback loops;
- 4) P/E Ratio mean reversion;
- 5) cyclical EPS recoveries;
- 6) shorting; or
- 7) short-term macro trends.

Our focus is on long-term business fundamentals and long-term valuation.

To select a portfolio of long-term winners, the qualitative factors of an investment become much more important. Insights around the strength of a company's business model, value proposition, competitive advantage and addressable market become essential. In contrast, factors such as short-term financial heuristics or recent news flow becomes less important.

By deliberately tilting our time more in favour of developing long-term knowledge and understanding and less towards short-term noise, we can create a long-term knowledge advantage. Hyperion develops a Business Quality Score ("BQS") for each potential investment to provide a framework to consistently assess the quality of each company. The BQS is derived from a number of components, with both quantitative and qualitative factors contributing to the final score.

Even though our **investment process incorporates short-term share price volatility, we do not attempt to predict the direction** and/or quantum of future short-term share price movements to generate alpha. That is, our investment process is not predicated on accurately forecasting short-term share price movements. The investment process can add long-term alpha regardless of the direction and quantum of relevant short-term share price movements. This is in stark contrast to how most market participants try to generate alpha by implementing investment processes that are reliant on correctly predicting the direction and duration of short-term share price movements.

At Hyperion, we see ourselves as long-term business owners and thus, sustained growth of the business is key to our investment philosophy. **We have never based our portfolio construction on index stock weights.** Our investment decisions are based on long-term business fundamentals. We look for modern businesses, with strong value propositions, that can grow revenues and profits organically at double-digit rates for at least the next decade. To us it makes long-term economic sense to be selective and manage a concentrated portfolio of stocks and not be exposed to a wide number of average to below average quality businesses that comprise most indices and benchmarks. Diversifying into structurally challenged old-world stocks with declining intrinsic values, even if they represent large weights in key indices, is likely to be value destructive in the long term. **This will become more important over the next decade as technology moves from the edge to the core of society and business.**

Global equity returns replicate U.S. findings

The same positive skewed returns found in U.S. listed equities applies globally (see Appendix). Bessembinder (2019) analysed return data for approximately 62,000 global listed common stocks across 42 countries over the 1990 to 2018 period. The findings revealed the best performing 811 firms (1.33% of total) accounted for all the net global wealth creation, and 67.20% of gross global wealth

creation. Furthermore, less than 1% of non-U.S. firms accounted for all the net wealth accrued outside the U.S. in the studied period.

Bessembinder found that the concentration of gross wealth creation is similar across U.S. and non-U.S. firms. For example, the top-performing 1% of non-U.S. firms accounted for 59.9% of gross wealth creation in the non-U.S. group, while the top performing 1% of U.S. firms accounted for 60.1 % of gross wealth creation in the U.S. group (Bessembinder, 2019).

The top 10 contributors to wealth creation in Australia, New Zealand, United Kingdom and United States is included in the Appendix. The positive skews are larger and the long-term winners narrower outside the U.S. (i.e. Australia, NZ and UK).

Conclusion

Equity investing is about long-term compounding. Long-term returns of equity markets are driven by the compounding returns of a limited number of out-performers. The long-term excess return of your typical stock does not generate wealth. Traditional value investing relies on under-paying for average businesses, with returns driven by mean reversion over a relatively short period of time. However, most companies produce poor risk adjusted returns and have short life spans. Value investors tend to buy businesses that are suffering from declining intrinsic values, with many of these stocks likely to have zero long-term value. Successful value investors are extremely skilful and require an exceptional ability to accurately predict stock price movements over relatively short time periods.

Given that it is only a narrow group of stocks that produce most of the sustained wealth creation from equity markets, we believe successful investors need to identify and invest in the highest quality businesses – the structural winners.

Mark Arnold (Chief Investment Officer)

Jason Orthman (Deputy Chief Investment Officer)

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Appendix – Wealth Creation by Country, Top 10 Firms, 1990 - 2018

Table 3: Wealth creation in Australia

Firm	Wealth created (\$ millions)	% of Global Wealth Creation	% of National Wealth Creation	Annualized Dollar Weighted Return
Commonwealth Bank Australia	125,736	0.19%	8.48%	16.05%
BHP Group	123,766	0.19%	8.35%	11.63%
Westpac Banking	84,518	0.13%	5.70%	12.35%
National Australia Bank	72,538	0.11%	4.89%	13.70%
CSL	68,908	0.10%	4.65%	26.04%
ANZ	68,184	0.10%	4.60%	11.72%
Rio Tinto Group	48,473	0.07%	3.27%	12.60%
Woolworths Group	37,063	0.06%	2.50%	15.48%
Wesfarmers	36,254	0.05%	2.44%	13.35%
Macquarie Group	29,885	0.04%	2.02%	16.12%

The top 10 firms in Australia generated 46.9% of gross national wealth competition. This is expanded to 57.92% for the top 20 listed firms.

Table 4: Wealth creation in New Zealand

Firm	Wealth created (\$ millions)	% of Global Wealth Creation	% of National Wealth Creation	Annualized Dollar Weighted Return
Auckland Intl Airport	7,826	0.01%	8.95%	25.17%
Fisher & Paykel Healthcare	5,830	0.01%	6.67%	14.62%
A2 Milk Company	5,328	0.01%	6.09%	59.32%
Meridian Energy	4,117	0.01%	4.71%	25.08%
Ryman Healthcare	4,049	0.01%	4.63%	29.24%
Contact Energy	3,611	0.01%	4.13%	11.07%
Port of Tauranga	3,158	0.00%	3.61%	22.38%
Air New Zealand	2,406	0.00%	2.75%	6.95%
Mainfreight	2,385	0.00%	2.73%	21.27%
Fletcher Building	2,145	0.00%	2.45%	7.12%

The top 10 firms in New Zealand generated 46.7% of gross national wealth competition. This is expanded to 64.7% for the top 20 listed firms.

Table 5: Wealth creation in United Kingdom

Firm	Wealth created (\$ millions)	% of Global Wealth Creation	% of National Wealth Creation	Annualized Dollar Weighted Return
HSBC Holdings	166,739	0.25%	4.48%	9.33%
BP	148,444	0.22%	3.99%	7.20%
Royal Dutch Shell	127,586	0.19%	3.43%	5.61%
Astrazeneca	122,018	0.18%	3.28%	10.52%
British American Tobacco	120,144	0.18%	3.23%	13.44%
Diageo	104,718	0.16%	2.81%	9.97%
Shell Transport and Trading	94,248	0.14%	2.53%	12.59%
Glaxosmithkline	93,286	0.14%	2.51%	6.10%
Rio Tinto	88,784	0.13%	2.39%	11.43%
Sabmiller	88,377	0.13%	2.38%	14.68%

The top 10 firms in United Kingdom generated 31.0% of gross national wealth competition. This is expanded to 46.3% for the top 20 listed firms.

Table 6: Wealth creation in United States

Firm	Wealth created (\$ millions)	% of Global Wealth Creation	% of National Wealth Creation	Annualized Dollar Weighted Return
Apple	1,006,035	1.51%	2.96%	21.00%
Microsoft Corp	954,787	1.43%	2.81%	17.77%
Amazon Com	696,738	1.05%	2.05%	29.35%
Alphabet	528,536	0.79%	1.55%	17.62%
Exxon Mobil Corp	515,827	0.77%	1.52%	11.26%
Berkshire Hathaway	438,959	0.66%	1.29%	12.12%
Johnson & Johnson	437,430	0.66%	1.29%	13.87%
Walmart	407,376	0.61%	1.20%	13.13%
Altria	360,711	0.54%	1.06%	17.12%
Procter & Gamble	315,778	0.47%	0.93%	12.59%

The top 10 firms in United States generated 16.7% of gross national wealth competition. This is expanded to 24.6% for the top 20 listed firms.

Source: Bessembinder (2019), Hyperion Asset Management

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