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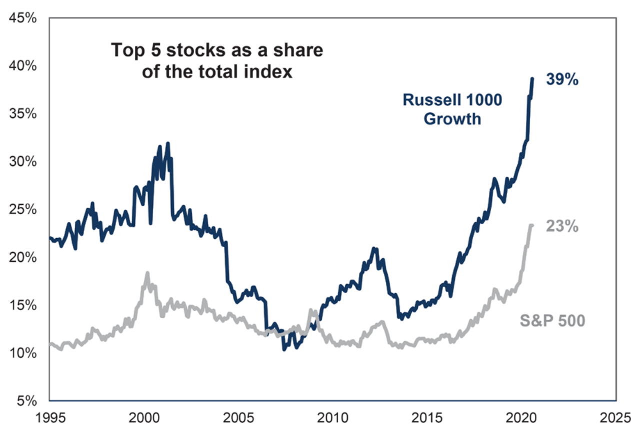
The Problem with Hindsight

Every year, the financial columnist John Authers (formerly of the Financial Times and now at Bloomberg) publishes an amusing annual report for an imaginary investment firm called Hindsight Capital, which as Mr. Authers describes: "is the most successful hedge fund of all time, and uses the one strategy guaranteed to beat all others, all of the time: hindsight. It places its trades in full knowledge of how they will end up."[1] Unsurprisingly, Hindsight Capital delivers consistently stellar returns. Unfortunately, we can't replicate the strategy and go back in time to invest all our capital in stocks like Apple, Amazon and Microsoft at fractions of their current valuations. Hindsight is a useful thinking exercise insofar as we can learn from the past. Without the aid of time travel, however, fixating on hindsight can lead one towards a risky approach for evaluating investments and deciding on portfolio construction.

The inherent risk with hindsight is that it lends itself to extrapolation. Trends that in rearview appear so obvious seem sure to persist into the future – no? It is certainly a seductive way of reasoning and, most of the time, it is likely to be correct, at least in the short-term. A major problem with evaluating investment decisions in hindsight, though, is that doing so overlooks the many contingencies that led to the present and discounts the many potential outcomes that may unfold in the future. An analytical framework using hindsight gives too much weight to things staying the way they are and too little weight to the inevitability of change.

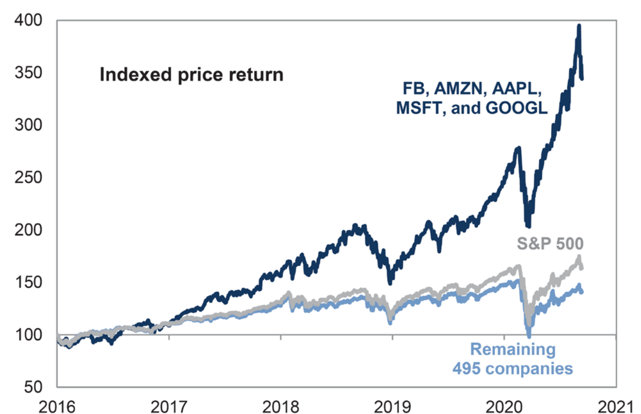
For investors, extrapolating from hindsight is simple and easy: recent winners are likely to continue winning. There is more than a kernel of truth to this when it comes to markets, as hundreds of billions of dollars in momentum-based trading strategies are essentially based on that simple principle. Consequently, investing with hindsight can be a comforting – and often profitable – decision. Going with the crowd is usually a defensible choice, both from an investment standpoint (markets tend to be efficient in assimilating data) and from an evolutionary standpoint (there is safety in the herd). The point of this letter is not to dismiss the wisdom of the crowd or to argue for being a contrarian just for the sake of being different. Rather we want to urge some caution in taking the simple and easy route with investing right now, as doing so has led investors into an extremely narrow set of companies concentrated in the large-cap technology space. As seen in the charts below, the top-5 stocks in the S&P 500 (Apple, Microsoft, Amazon, Alphabet and Facebook) now account for 23% of the Index and have been instrumental in contributing to the market's performance over the last five years.[2]

Exhibit 2: The "current five" account for a record share of market cap
as of August 31, 2020



Source: Compustat, Goldman Sachs Global Investment Research

Exhibit 3: FAAMG outperformance has accelerated in 2020
as of September 11, 2020



Source: FactSet, Goldman Sachs Global Investment Research

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These firms unquestionably have been the best performing investments following the Covid selloff in March (and going back far longer than that). Most large-cap tech firms have pristine balance sheets (with cash exceeding debt), excellent management teams, seemingly insurmountable competitive advantages and – key to their recent outperformance – they provide the essential products and services that consumers and businesses have relied on during the pandemic. Their stable growth outlook amidst such an unstable economic backdrop, combined with the low interest rate environment and ample monetary/fiscal support, has resulted in rapidly expanding valuations.

To be clear, we like owning large cap tech firms in our portfolios and have for years. However, just because purchasing them seems like such an obvious choice to have made in hindsight, it does not mean that the decision is as obvious going forward. Will investors be willing to pay in excess of 30 times forward earnings to own mature tech firms (and far higher multiples of earnings and sales to own newer firms) when we are no longer stuck inside, working from home, spending all day on our phones and ordering everything online? Right now, these stocks are benefitting from their perceived scarcity value. There are few companies with the ability to survive – let alone grow – in the current environment. However, in the probable scenario that one of the many Covid vaccines in clinical trials is approved and ready for distribution by next year, our collective behavior might return to normal faster than most expect. Moreover, investors will likely adjust their portfolios and shift some exposure from technology stocks to value and cyclical stocks that would disproportionately benefit from improving economic growth.

Despite recent volatility, we do not expect large-cap tech stocks to crash, nor do we suggest selling them unless you need cash or are heavily overweight a single position. We just doubt that the pace of share price and valuation gains is sustainable, especially if economic expectations improve and companies with stable growth outlooks become a less scarce commodity. In this case we would expect that stocks more sensitive to the broader economy will outperform relative to their technology and growth brethren. These firms (which primarily include value and cyclical stocks) have underperformed growth stocks significantly over the last six months – and frankly over the last decade as most developed countries have failed to grow GDP by more than 2% annually since the 2008 Financial Crisis. The prospect of substantial fiscal spending to re-accelerate growth or just simply a reversion to mean economic activity trends would benefit value and cyclical stocks far more than technology and growth firms.

Source: Bloomberg

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What's this all have to do with hindsight? If your analysis is anchored to what has worked well in the recent past, you may have a blind spot for identifying important changes that may be taking shape around the corner. Today's large cap tech firms seem like clear positions to be overweight now, but few of us likely felt comfortable adding to them during the March selloff or initiating positions 5-10 years ago when their business models were still proving out. Recall some of the prevailing concerns over the last decade:

- Apple can't innovate without Steve Jobs; Samsung will overtake their business with lower cost phones.
- Facebook won't figure out mobile.
- Microsoft has no business prospects beyond a stale Windows; Satya Nadella can't reignite growth.
- Amazon will never make money; other retailers will catch up to them online.
- Google is too focused on areas outside search; the online ad market will soon be saturated.

Further, a decade ago there was still widespread investor apprehension toward technology stocks in the aftermath of the Nasdaq cratering in 2000. Investing in these firms may seem like a "no-brainer" when looking back from today, but it doubtfully felt like such a sure decision at the time. Today, a similar aversion exists to value and cyclical companies given their underperformance for the last decade.

The most important takeaways from the past for investors is that change is constant. The leading companies of today will likely be around for decades to come, but they may not turn out to be the most lucrative investment opportunities – particularly if the starting point is from an elevated valuation. If you are one of the many investors who looks to the past with some regret for not owning more of today's leading tech firms, consider how to position your portfolio for the future to capitalize on potential trends that are yet to be fully appreciated.

As discussed above, one near to medium-term trend could be a market leadership rotation from growth stocks to value and cyclical firms. Looking out longer-term, there are several disruptive technologies we are following all with the potential to create substantial value for shareholders and society at large. Examples include new generation communication technologies like 5G, artificial intelligence, advanced semiconductor design and manufacturing, quantum computing, gaming, renewable energy, digital health management, synthetic biology and precision/genetic medicine. All of these categories today seem risky and stocks that provide exposure can be highly volatile without the benefit of time-tested business models. But the same could be said of today's leading technology firms at one point as well.

To reiterate, we are not making an argument to sell out of large cap tech stocks. We just aren't advocating adding to them at the moment. For those wondering how to allocate new capital going forward, we think basing investments off what has worked well in the past may lead to future disappointment. If you are looking for stable holdings without demanding valuations, we recommend considering value and cyclical stocks in sectors including financials, utilities, materials, healthcare and industrials. If you are seeking a chance to replicate the substantial returns enjoyed by tech companies over the last decade, we suggest allocating a small portion of your portfolio to companies providing exposure to potential breakthrough technologies and business models. Some of these companies will perform poorly, but some will likely turn out to be the ones that, in hindsight, investors 10 years from now wish they owned more of.

As always please feel free to reach out with any questions or concerns. We hope you and your families are doing well and staying healthy.

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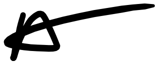
Sincerely,



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Citations and Disclosures

[1] John Authers, Bloomberg, *A Decade of Market Wins for Hindsight Capital LLC* (Dec. 30, 2019; available at: https://www.bloomberg.com/opinion/articles/2019-12-30/a-decade-of-market-wins-for-mythical-hedge-fund-hindsight-capital)
[2] Goldman Sachs, *Secular growth stocks: "Rule of Ten" and the Future Five* (Sept 16, 2020).

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