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## Characteristics of British Technology Companies

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Britain has a long history of innovation. The Lunar society in Birmingham had members such as Joseph Priestly, Erasmus Darwin and James Watt, who were some of the catalysts behind the industrial revolution in the 18<sup>th</sup> century. In the 20<sup>th</sup> century, Frank Whittle, the co-inventor of the turbo jet engine, ushered in the age of high-speed air travel. Shortly after, Alan Turning created what was, in essence, the first digital computer by storing programs in memory.

Today, a cursory look at some of the largest companies in the FTSE 100 reveals companies not at the frontier of innovation, but relics of the past – miners, oil & gas exploration companies, tobacco companies. This is not a knock on these companies. At the right price, some of these can well be great short to medium term investments. But over the longer term, their high capital expenditure requirements, limited growth prospects (already well-established market shares), poor free cash flow conversions, and low return on equity naturally equate to lower returns.

The dinosaur-like nature of the FTSE 100 is not caused by lack of domestic innovation – the UK is home to many top research universities. Neither is it caused by lack of funding – UK markets are very liquid, with a strong rule of law that attracts many foreign investors. The UK has the third highest number of unicorns – privately held companies valued at \$1 billion or more. This is just behind the US and China in a comfortable third. One reason why the index remains dominated by the fossils of the past is that the unicorns are rarely allowed to grow in domestic autonomy. They are usually sold too early to foreign bidders.

The most vivid example of this is Deepmind, a British artificial intelligence (AI) company. It was acquired for \$500 million (£300 million based on exchange rates at the time) by Google in 2014. Not quite unicorn status when it was acquired, but likely on its way. Deepmind developed the computer program that beat the world champion Go player, a first for a game that is in some ways more complicated than chess (with respect to the number of possible board positions at least). Deepmind also powers Google assistant, the Siri of android phones. More recently, Deepmind used its AI to predict the shapes of nearly every protein in the human body. This could allow biologists to better understand diseases and develop new drugs.

Google got all this through the purchase of Deepmind for about £300 million. For comparison, the UK challenger bank, Revolut, is valued at £24 billion. Now, maybe it is overvalued, and we are in the throes of a historical financial asset bubble. However, even if we apply a 90% haircut on this valuation, it is still worth significantly more than what Google paid for Deepmind. And the reach of Revolut is unlikely to be comparable to the impact and wealth that a company like Deepmind can create.

Why is all this relevant? A cyclical-heavy index like the FTSE 100 means that passive funds and the army of “active” fund managers that are really just hugging the index are unlikely to perform well over the long term. If the few unicorns the UK produces are siphoned off by foreign bidders, the UK’s main equity index will continue to be heavily exposed to the large cyclical stocks and will continue to perform poorly over the long term.

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