

The seeds of a reversal

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Economists use the term crowding out when government borrowing displaces private investment. We think a version of it is at work in markets today: dominant investment themes absorb capital and attention, leaving less fashionable opportunities overlooked. Here, the cause is not government borrowing but market leadership narrowing investors' focus.

Five technology companies now account for 30% of the S&P 500 index. Concentration is not only an American feature. In the MSCI Emerging Markets index, just three companies make up the same share.

The growth of index tracking makes this concentration matter more. In market-capitalisation-weighted indices, the largest companies receive the largest allocations, irrespective of whether their valuations are attractive. A tracker fund in your pension or ISA inherits their concentration rather than making an independent assessment of value. This does not mean indexing automatically increases concentration, but it does mean that owning the market can involve substantial exposure to its established winners.

Yet the businesses attracting that capital face a different force: competition.

High profits act as an invitation. Success encourages investment in competing products, additional capacity and alternative business models. Over time, this can undermine the conditions that supported exceptional profitability.

History offers clear examples. The motor car and the aeroplane transformed daily life in the twentieth century, yet, as Warren Buffett has observed, few of the companies that built them made their shareholders rich. The fibre-optic networks laid around the turn of the millennium carried the internet's growth, but many of the companies that laid them went bust along the way. A technology can become more widely adopted without its providers becoming proportionately more profitable. Demand may continue to grow while higher investment requirements and greater competition reduce returns on capital. The heavy spending now going into artificial intelligence raises the same question.

This is how we think about US equities and emerging markets. Rather than asking how much further valuations might diverge, we ask what could bring about a sustained change in the underlying economics.

Valuation alone is rarely enough. Expensive markets can remain expensive, while cheap markets can remain cheap. For emerging markets, lower prices must be considered alongside the durability of earnings, capital discipline and the treatment of shareholders. A low price is a starting point, not a conclusion.

As value investors, our task is not simply to buy what has lagged. It is to compare the expectations embedded in prices with the returns businesses can reasonably deliver.

In the portfolios we manage, that has two consequences. We do not hold the largest companies simply because they are large; we size that exposure by what we think the businesses are worth, not by their weight in an index. And where we look beyond them, including in emerging markets, we want lower valuations backed by companies that invest sensibly and treat minority shareholders fairly. The aim is that your portfolio does not quietly depend on a handful of companies continuing to earn exceptional returns in the face of rising competition.

The question is not only where the capital is flowing, but who will retain the profits once it arrives.

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