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What Matters, What Doesn’t

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As of yesterday’s close, the largest public company in the world, Apple Inc, has a market capitalisation which is approximately equal to the total market capitalisation of the FTSE 100 – an aggregate of the largest public companies in the UK. What may come as an even bigger surprise is that the combined market capitalisation of Apple and Microsoft, the two largest listed companies in the USA are worth more than the combined value of every company listed on the UK market.

To some people, this is patently absurd and shows how cheap the UK market is. To others, it is just another sign of a speculative bubble in America. Either of these could be true. But they are *not necessarily* true based on the fact of relative size alone. Just because the market value of two companies is larger than the total market value of an entire country does not mean that those companies are overvalued. If one is truly determined to find meaning behind such large differences in value, such an unequal distribution is actually to be expected.

Choose any domain of human enquiry and you will see evidence of similar uneven distribution of outcomes. This is known as a power law distribution or more commonly as the pareto distribution.

Over 300 years of Romanov rule ended in 10 days during the Russian revolution. A few words in the English language like “the” and “is” occur with disproportionate frequency compared to every other word. A minority of the population owns the majority of the wealth. A minority of all pieces of art ever created generate a majority of the attention. A few languages are used in the majority of communications. A few programming languages are used to build the majority of the applications and software we so depend on. Even in investing, a few stocks account for the majority of the returns. The examples go on ad infinitum.

Why is any of this important? The near universality of power law distributions in so many different subject areas also applies to company valuations. A few companies will capture a majority of the wealth. Simply looking at relative size as a measure of market rationality is wrong. There are obviously some constraints to growth – a company cannot be larger than the global economy.

As uncomfortable as it may sound, it is not absurd to think that a few companies like Apple and Microsoft can be worth more than the total value of all companies in a developed market like the UK. These two companies generated roughly 40% of the profits created by all public UK companies. That is no small feat. They are also less cyclical, enjoy higher growth rates and most importantly, can grow without deploying significant amounts of capital. The same cannot be said for most companies.

At Tacit, we have always had exposure to these types of companies and continue to do so even after they have performed so well. It would be a great folly to sell them simply because they are so large. Relative size is a poor measure of underlying value and at Tacit, we continue to focus on value wherever it may be.