# Investing for 2030: Productivity and 'Winner Takes All'

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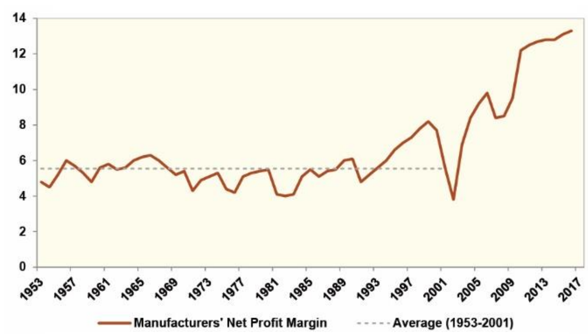
*DURING THIS YEAR, our commentary focuses on the "Investing for 2030" theme and speak in greater detail on the specific trends, industries, and companies we believe will best serve the equity investor.*

Prudential Global Investment Management (PGIM) recently published a research piece on the technology frontier, and within the commentary outlined two specific points most pertinent to our 'Investing for 2030' theme.

***First: the tremendous productivity gains by technology firms and their beneficiaries*** over all other 'slow-to-adopt' industries in the past several years. According to a study by McKinsey and Company, from 1995-2000, 'IT-producing' firms represented nearly 60% of overall productivity growth; from 2000 to 2007, and 'IT-producing' and 'IT-using' firms combined for roughly 90% of productivity gains in that stretch.

As technology itself offers great potential for increases in productivity, technology firms—in other words, 'IT-producers'—are early and fast adopters of these innovations. And, naturally, *firms that are heavy 'IT-users' will also be first* in line for the adoption and implementation of productivity-boosting innovations, for similar reasons. Manufacturing is the finest example: as automation, robotics, and logistics have streamlined processes in numerous industries, the profit margin of manufacturing has seen terrific expansion in the past 20 years (Figure 1).

Figure 1: Manufacturers Profit Margins 1953-2017




*Source: Empirical Research Partners*

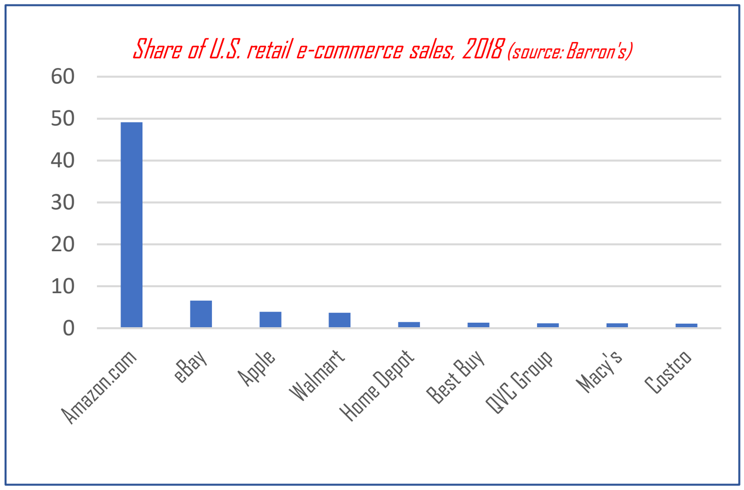
TOP 'FRONTIER FIRMS'

A specific example lies within online commerce. As virtual retail emerged, one of the industry 'gaps' that needed solving was a safe, secure, and expedient payment system. Someone buying an item from a retail business, or from another person (i.e auctioning off grandpa's bowling ball on eBay) needed a way to send a payment, and the seller needed to be able to receive funds and deposit into their bank account.

eBay, being in the middle of millions of these transactions, co-founded (with current Tesla CEO Elon Musk) PayPal, to serve as the payment system. PayPal was so successful that following eBay's spinoff of the firm in 2015, Paypal's revenues exceeded eBay's each year since and is now three times the market capitalization as its' once dominant parent.

This leads us to Prudential's second point: companies like PayPal are "'frontier firms- younger, more profitable, and more patent-intensive, and tending to be first to adopt cutting edge technologies, and fundamentally diverge from the rest of their sector in terms of productivity growth." ***Under these conditions, a single firm emerges with a dominant market share—the Winner Takes All.*** Think of PayPal in e-commerce payment systems, Uber in transportation, and Netflix in streaming content

From Prudential: ***By capturing productivity gains from new technologies in a single, dominant player with network or scale benefits, this trend towards a "winner takes all" economy acts as a near-term dampener on broad productivity gains among the other firms in a sector.*** And unfortunately for new entrants, while patents and large legal teams can be used by leading firms such as Apple or Netflix to defend their IP, it is difficult for smaller firms to prevent their advancements such as algorithms or knowledge-based capital from spreading. As a result, leading firms can sometimes undercut new entrants by copying their approach. (One example is Instagram's launch of the Stories feature, replicating a key feature of Snapchat – and leading to a significant decline in Snapchat usage growth.)




Viewing the landscape of the next ten years for investment purposes, our firm believes the cornerstone of the growth equity portfolio should be concentrated exposure in both the 'clear winner' in a given industry or subsector, and the emerging 'frontier firms' and efficiency vendors that enable higher productivity and greater profit margins.

And of course, the biggest winner of them all: Amazon.com. Their e-commerce sales in 2018 alone were ***more than twice the combined e-commerce sales*** of Walmart, Target, Best Buy, Costco, Nordstrom, Home Depot, Kohl's, and Macy's.

While index funds and broad-market exposure still have a role in a portfolio (especially when the underlying equity market is deeply undervalued), we believe this role may diminish as a core holding and may be more suitable as a tactical or complimentary holding, for one main reason: if the earnings growth of a broad equity market, such as the S&P 500, continues to be concentrated among a small group of companies, the remaining wide swath of underperforming companies act a drag on overall investment performance. *In other words: what you DON'T own is just an important as what you DO own.*

Our summary: a firm's expedient, widespread, and deep embrace of new technologies translates to increased productivity and efficiency, leading to potentially higher sales, profits, and free cash flow. As firms build these productivity advantages over competitors, they may possibly emerge as a clear winner, perpetuating the growth dynamic.

Identifying these companies such as Amazon, PayPal, as well as smaller and emerging firms, particularly those that provide an essential productivity or efficiency gain for the marketplace (rather than a discretionary or luxury product one can do without), is key for investors who wish to capitalize on future investment growth for the foreseeable future.

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All quotations and paraphrasing sourced from "The Technology Frontier: Investment Implications of Disruptive Change", Insights, PGIM Investments, Fall 2018.