

## **The Big and Strong Get Bigger and Stronger**

We don't know about you, but we have been ordering a lot from Amazon recently. We have always been somewhat addicted to Amazon, but it seems that recently the addiction has gone to another level. From the normal level of orders, like books and supplies, we have now added grocery delivery from Amazon Fresh and Whole Foods (which is owned by Amazon). And our subscription items now include countless items, from batteries and diapers, to vitamins and Clif bars. And let's not forget watching Amazon Prime Video, day and night, during quarantine.

We are not the only ones. Amazon recently reported a stellar quarter, with net sales increasing 26% to \$75.5 billion in the first quarter. Operating cash flow increased 16% to \$39.7 billion for the trailing twelve months. And this was during a period where retail sales were being crushed by the current global pandemic.

Indeed, the current COVID-19 crisis has been a boon not just for Amazon, but for the other large technology corporations in America that we have come to depend on. We certainly do not want to downplay the human toll of this pandemic. As of this writing, more than 100,000 Americans have died — equivalent to 22 Iraq wars, 33 Sept. 11 attacks, 41 Afghanistan wars, 42 Pearl Harbors, or 25,000 Benthazis — and all this in just three months. In this article, though, we want to focus on the business ramifications of the crisis and highlight how it has made the strong companies even stronger.

### **Bigger and Stronger**

The last few years have seen the largest companies in America—especially those in the technology sector—get bigger, stronger, and much more valuable. Amazon, Microsoft, Apple, Facebook, and Google's parent Alphabet have expanded their dominance with their global reach, near-monopoly status, and mountains of cash.

While economic downturns tend to favor giant corporations, it seems that the current crisis has peculiar characteristics that only benefit the specific giants of today. With so many people staying at home, we are turning more and more to online shopping (Amazon), cloud computing (Amazon, Google, Microsoft), mobile computing (Google, Apple), and social media (Facebook). And it is these five companies that are at the vanguard of these technologies. Technologies that will most likely only become more prevalent.

So how has this market dominance translated to stock market returns? Today, three of these companies have a market cap greater than \$1 trillion (Amazon, Apple, and Microsoft) and one other is not far behind (Alphabet). The five companies have a combined market cap of more than \$5.5 trillion. While the S&P 500 and the Dow Jones Industrial Average are down between 10% and 15% from their highs, these market darlings are trading at all-time time highs, or very close to them.



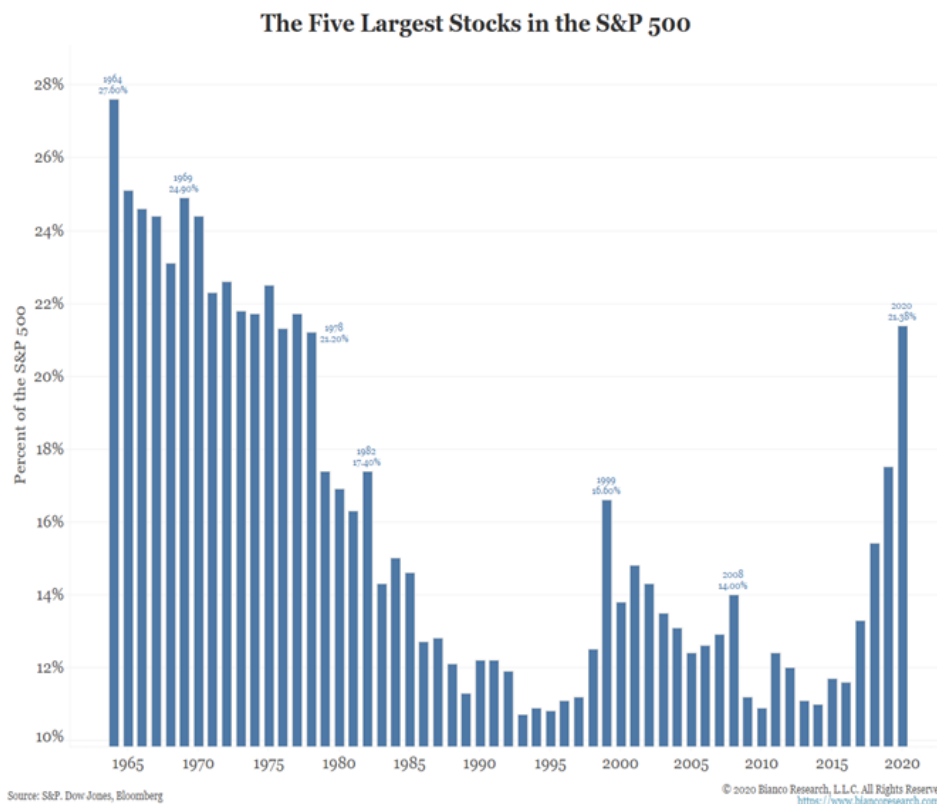
And as these companies grow and their stock prices keep rising, they become a bigger and bigger part of the entire market. As seen on the chart below, Amazon, Microsoft, Apple, Facebook, and Alphabet now make up more than 21% of the S&P 500 Index. Think about that: only 5 companies make up more than 21% of an index that has 500 components. If every company had the same weight in the index, these five companies would each have a weight of 0.2%, or a combined weight of 1%.

So what does this all mean and what are the ramifications going forward? Well, we don't know, but if history is any guide, the news does not look too good for future performance. As can be seen in the chart below, this current level of concentration is higher than the concentration level reached during the dot-com bubble of the late 1990s when tech was also all the rage. We have to go back to 1978 to match this high level of concentration.

Can you guess what were the five biggest companies back in 1978?

They were IBM, General Electric, General Motors, AT&T, and Exxon (now ExxonMobil). Interestingly, unlike today, these five companies were in five different industries: technology, industrials, automobiles, telecommunications, and oil.

And how did these companies, which were once so promising, perform going forward? In one word: poorly. Of these, General Motors went bankrupt and the rest have badly underperformed the S&P 500. ExxonMobil is the best performer among the bunch, and it is up less than half the S&P 500 Index.



## Going Forward

The Russell 2000 is a stock index that tracks the 2,000 smallest public companies of the Russell 3000 index, which in turn tracks the 3,000 largest public companies comprising roughly 98% of the total U.S. stock market. To know the state of the smaller companies in America, one needs only to look at the Russell 2000 Index. As you can imagine, the dominance discussed above of the biggest and strongest companies has come at the expense of these smaller companies, and that can be seen by looking at how the Russell 2000 has performed recently.

To appreciate this discrepancy in the starkest terms, let's look at the performance of the Nasdaq 100—an index of the largest technology companies (which also happen to be the largest companies, period)—with the Russell 2000. As of this writing, the Nasdaq 100 is *up* 8% year-to-date, while the Russell 2000 is down 14%. That enormous 22% gap is wide enough to drive a dump truck through. What is driving that difference? The answer to that question could be its own research project, but we'll name just two of the more prominent factors here: smaller companies tend to have more debt and are more dependent on the domestic economy.

Will this huge discrepancy continue? It might for a while, but it won't continue forever. We can see a day—although we don't know how far into the future—when the virus is a distant memory and things are back to normal. We would not be surprised if, at that point, the best performers in the market are those that have been hit the hardest. The big question is whether you have the stomach to wait for that.



Felipe Garcia, CFA  
Chief Investment Officer  
INKWELL CAPITAL LLC



Aaron Byrd, CFA  
President  
INKWELL CAPITAL LLC

