



Goldilocks and the Bears— Innovation, Disruption, and the End of the “Virtuous” Cycle

Being on the right side of change is arguably more important than ever.

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The low-growth, low-inflation, and high-disruption world we live in today is constantly on my mind. What does this mean for us as investors in this era? As we’ve written about this before, I would highlight this analysis is like predicting the outcome of a football game at halftime. Much of this has already happened. Ultimately, what is important for me is to own companies with improving economic returns. That’s the way I can generate performance for my clients.

Goldilocks—The Self-Reinforcing Liquidity/Credit Cycle

I learned in school that inflation is “too much money chasing too few goods.” So why don’t we have inflation if we have all this money?

In part it’s because we are in a liquidity and credit “bubble” that is self-reinforcing. Why? Because liquidity is funding technologies across sectors that unlock capacity. More capacity means more deflation or “no-flation.” This, in turn, is reinforcing a chase for yield, low interest rates, and more access to liquidity and credit.

Part of our thesis is that an extremely low cost of capital combined with a fundamental intersection of technological change is funding unprecedented innovation and



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disruption. A flood of liquidity is therefore funding disruption that otherwise would have taken much longer.

This speed of innovation and disruption is incredible in one sense, but also has unequal and unintended consequences. While we are deep into a shift from scarcity to abundance, and this sounds wonderful at a headline level, abundance does not mean dollar-based GDP growth. Abundance does imply “low-flation” or “no-flation,” however.

Electric Cars to Good Living— Disruption Is Everywhere

Tesla is a prime example. Although electric vehicles are certain to win long term, liquidity is allowing an acceleration of innovation and disruption that couldn’t happen with a 5% U.S. 10-year Treasury yield.

Tesla couldn’t exist in its current form with such an interest rate backdrop. But,

We live in a unique
time in history.
Technology is
unlocking capacity
across sectors.

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despite the wishes of the bears, Tesla does exist in a world of easy and cheap capital (full disclosure, I'm on my second Model S and will probably never go back to an internal combustion engine car ever again).

As Tesla invests and innovates, one consequence will be that it forces the rest of the industry to accelerate investment. This means electric vehicles crossing the chasm early and Elon Musk succeeding in his goal—to move the world to electric cars.

Across the global economy we see liquidity funding a virtuous circle for innovators. Huge levels of funding are available for companies capitalizing on e-commerce, social networks, and cloud computing. It's a golden age for private investing (especially for those that invest early) and a golden age for disruption and disruptive investing.

Here are a couple more examples. Take Allbirds (the environmentally and sustainability-oriented shoe retailer making shoes from wool, trees, and sugar cane). I don't see any real differentiation in shoes with a wool upper. But Allbirds success is driven by fundamental disruption in advertising, distribution, and IT and a change in consumer tastes. Shoes made from trees with a direct message and distribution channel to a mass audience via the internet was not possible 15 years ago, but it's very possible now.

As per Tesla, not only does Allbirds funding feed back into the success of the disruptive platforms it uses, but it also forces the established player—Nike, for example—to accelerate investment in the same platforms.

Kraft Heinz is the same. Once a yield play on the monopoly of beans, ketchup, and mustard, it has been disrupted. Unlike Nike, however, it's now much worse off because of a fundamental lack of innovation to stay relevant to

consumers. EA Sports and Activision didn't know what hit them with Fortnite. JUUL, the electronic vaping company, has benefited from vaping and health trends that are disrupting smoking—and, by association, tobacco stocks as well—at a rapid rate.

When you amalgamate all these forces, they exert a large impact on the characteristics of stocks and the “factors” that have been used to describe them in an investment sense. Disruption has bred disruption, and one outcome is that factors aren't behaving in the way many expect them to. As a consequence, it's more important to look forward than back.

Platforms—A New Era

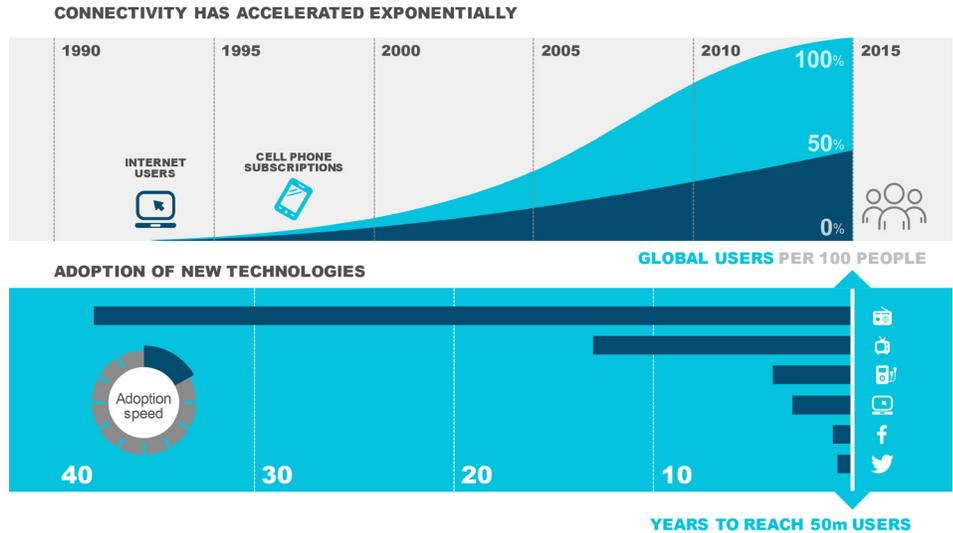
We believe this era of investment has accelerated the maturity and scale of disruptive platforms, which has put real and negative price pressure on many business models. While some argue this is transitory, you could also argue the only way for incumbents to get back to their industry dominance is to turn back time and spend enough to re-monopolize sales, marketing, and distribution of the industry. However, how much would Kraft Heinz or Nike have to spend to snuff out Allbirds or vegan food marketing on Instagram and Facebook? A lot.

Liquidity and this period of easy credit are unlocking capacity and deflating dollar growth rates within many sectors. As liquidity and credit keep pouring in, companies have the capital and, just as importantly, the technological foundation via a world of technology, e-commerce, and social networks to cross the chasm in a way they never had before.

The list of industries being impacted by this phenomenon goes on—disruption is real. It's also hard to model because it often hasn't happened yet. Insights about change and an imagination about what it may mean for an industry and individual stocks are an investor's

(Fig. 1) Adoption and Connectivity Have Accelerated Disruption

As of December 31, 2015



Sources: World Bank and McKinsey.

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defense mechanism. Being on the right side of these changes is more important than ever given the dispersion of outcomes between winners and losers.

The Productivity Problem—We Are Getting More Efficient; We Just Can't Measure It

Headline economic growth rates have also been impacted by the failure of productivity to rise for much of the past decade. This has long perplexed many economists and central bankers, but part of the problem appears to be that we can't measure productivity growth very well in this era of change and disruption.

Take energy. Our energy team believes new technologies are driving higher productivity as measured by barrels of oil produced per dollar of capex. That counts as progress on the productivity dimension surely? However, investment and innovation are not driving up the

ratio of the dollars extracted per unit of capex. Why? Because innovation and the associated unlocking of capacity is putting pressure on the price of oil as we extract more. Fears of peak oil supply have effectively faded to a reality of oil abundance in the space of a decade driven largely by technological change. Amazon Web Services (AWS) is different but the same. AWS is driving incredible improvement in IT efficiency but shrinking and deflating the industry as it does so.

While the world is probably better off because of innovation, access to iPhones, Netflix, autonomous cars, gene science, and cheap energy, we're not necessarily better off in terms of dollars of GDP.

The sum of disruption and abundance across sectors is therefore "no-flation" and a break with presumed wisdom about how this cycle will evolve.

MSGA (Make Stimulus Great Again)

One result of this era is that governments will try to fight low growth with stimulus. Chinese stimulus and U.S. stimulus have been constant features of the past decade even as the cycle has matured and the equity bull market has passed its 10-year anniversary. Such stimulus can spur short bursts of growth driven by debt, and when debt service costs are low this is sustainable. However, imbalances will inevitably build in such a world and risks will be created. This is happening.

As a result, the bear will eventually show up back at the house, and it's important to beware the stimulus fade. While stimulus does not change the midterm path of growth, it does cause mini-growth expansions and fades. These ebbs and flows of growth influence both data and sentiment. In turn, this has been an important driver of short-term asset prices in this cycle, with quant capital exaggerating these moves as the panic or momentum button (or both) is hit with greater magnitude than at any stage in financial markets history. This is an evolution of ownership and economy playing out in tandem.

Concentration of Intellectual Property, Wealth, and the Rise of Populism

If technology makes our world so much better, why are populations unhappy? In part this is because:

1. Change is absorbed and then “assumed” very quickly at the individual level. How often do you take a flight and marvel at the altitude, speed and time to travel while simultaneously complaining about the terrible food?
2. The disruptive platforms concentrate wealth. Silicon Valley, London, and Shanghai are disproportionately “winning” and “wealthy.” Europe arguably made a large mistake letting Google, Facebook, and Amazon

establish themselves in foreign territory. China was smarter when it blocked these companies and fostered/allowed domestic champions.

3. Legacy businesses with legacy labor forces are being disrupted. The pain of low wage growth and reduced pricing power for labor is broad-based. The joy is concentrated.

Time for the Bear to Return Home and Confront Goldilocks?

While many investors have long regarded the return of higher growth and inflation as the point to jump off into the bull case, we think the bear in this cycle is higher inflation and rates. A reversal of liquidity provision and higher debt servicing costs could bring the Goldilocks narrative to a very unhappy and child-unfriendly ending. The big question is whether inflation and interest rates are mean reverting.

Deflationary Progress—What Does It Mean for Investors?

Eight factors to consider:

1. We are in a low-GDP growth, low-inflation, and low-rate world, and we think this will persist given the structural drivers underlying these trends.
2. Higher growth and inflation remain a real risk to the “virtuous” cycle.
3. Industry consolidation is a natural response to the environment we live in and will continue.
4. Populism, regulation, and societal pushback will be features of investing for some time to come.
5. A decade ago banks were the enemy, now governments and society are shifting to new targets; technology companies will need to acknowledge their social importance.



Be very cautious of owning a company with declining returns.

— David Eiswert

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6. Developed market banks are still swimming against a riptide; selectivity is crucial.
7. Mean reversion should be thoughtfully questioned; industry structures being disrupted by new natural monopolies should be treated with caution.
8. Owning companies with pricing power and improving returns will be crucial for alpha.

Final Thought

We believe the world is making progress, but this era of secular change and disruption contains new risks and new opportunities that require an active approach. While we will continue to pick stocks to generate the best of the opportunities we see, the big-picture points above will need thoughtful action as we move into new and equally disruptive times.

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