With as many as three-quarters of S&P 500 companies expected to be displaced over the next 10 years, Newton’s Chris Smith examines how investors can identify the survivors.

HOW TO AVOID THE NEXT GENERATION’S KODAK AND BLOCKBUSTER

For companies, investors and governments, the digital economy creates both opportunities for positive change and risks that “old” industries are demolished in the process. Added to this, it is becoming increasingly difficult for firms to adapt and sustain a dominant competitive advantage for longer.

Incumbents ignore disruptive trends at their peril; the struggles of Kodak, Blockbuster and Nokia stand as examples of the consequences of failing to innovate.

Indeed, Cisco estimates that an average of four of today’s top ten incumbents in terms of market share in every industry will be displaced by digital disruption over the next five years. In 1958, the average S&P 500 company lasted in the index for 61 years. By 1990, the average lifespan had shrunk to 20 years. Today, it stands at just 18 years.

This serves as a warning to chief executives: at the current and forecast turnover rate, 75% of the S&P 500 will be replaced by 2027.
SHORTER LIFESPANS BUT THE RACE TO THE TOP IS GETTING QUICKER

Not only is the lifespan of companies shortening, owing to the rise of disruptive digital start-ups with exponential growth capabilities, the race to US$1bn market capitalization is getting faster.

Historically, it took on average 20 years for an S&P 500 company to reach this size. It took Google eight years, Facebook six years, Uber three years, Twitter 2.3 years and Instagram 1.5 years. In 2014, a workplace productivity company called Slack reached US$1bn in just eight months.

WhatsApp is a poster child for this change. Forbes noted that WhatsApp gained more followers in its first six years of existence (700 million) than Christianity did in its first 19 centuries.1

The digital economy has enabled firms to build scale rapidly with minimal cost, fundamentally altering the way we live, work and relate to one another. While technology-based disruptions are not new, in its velocity, scope, and impact, the digital economy is unlike anything humankind has experienced before, disrupting almost every industry in every country.

As Eric Schmidt, Google’s then CEO, said in 2010, “The internet is the first thing that humanity has ever built that humanity does not understand...the largest experiment in anarchy that we have ever had.”

A look at some of the world’s largest and best-known companies reveals the pace and scale of change...

- Taxi company owns no taxis (Uber)
- Accommodation provider owns no real estate (Airbnb)
- Movie house owns no cinemas (Netflix)
- Phone company owns no telecommunications infrastructure (Skype)
- Retailer owns no inventory (Alibaba)
- Media owner creates no content (Facebook)
- Fast-growing lender has no actual money (SocietyOne)

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IT’S ALL ABOUT EFFICIENCY

Digital technologies enable existing infrastructure to be used more efficiently. Uber drivers, usually recruited from minicab firms, are paid less than they were previously paid per journey, but spend less time waiting for jobs so their overall earnings are higher. Airbnb uses spare rooms that were previously unlet, so the housing stock is used more intensively. Google Maps enables us to find faster routes and avoid motorway jams, thereby using the road system more efficiently.

While digital innovations often provide products more conveniently and cheaply, they usually do so via substitution or the redistribution of sales rather than the creation of new incremental sales. A market can move from zero-sum to negative-sum for the disrupter and the disrupted — there is no net wealth creation for society. Take the music industry for example: 46% of its market shifted to digital between 2004 and 2014, driven by iTunes, while total industry revenues fell 35%.²

AN INVESTOR’S PERSPECTIVE

The challenge for investors is identifying which incumbents are capable of adapting, which products are in danger of becoming obsolete, who the successful digital disruptors are likely to be and what impact this might have upon global wealth distribution.

Disruption is everywhere and the future is uncertain. Today’s plans might be obsolete tomorrow. At Newton we continue to be curious about this changing world, and we believe our framework of global themes provides us with good guidance as we aim to identify and explore long-term forces of change.

²International Federation of the Phonographic Industry (IFPI) 2015 Digital Music Report