



Philequity Corner (July 29, 2019)

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Natural Selection

I just came back from a tour of the Galapagos Islands. In my stay there, I discovered the unique geography of the Galapagos and the different species which inhabited the islands. I learned more about Charles Darwin's theory of evolution by natural selection. As a fund manager and an avid student of investments, I tend to relate my experiences to the stock market. Apart from the study of life, I believe that Darwin's insights may be applied in investing and the stock market.

Darwin's Theory of Evolution

Darwin developed his theory by observing different species of birds, seals, tortoises, penguins, iguanas, and other animals. In particular, he noticed that the finches in Galapagos had different beaks because they coped with distinct living conditions in the islands. According to Darwin, these variations were caused by natural selection. This refers to the preservation of functional advantages over successive generations that enable a species to better compete in their respective environments. By looking at present-day animals or plants, one can see that they have survived harsh environments by evolving from earlier ancestors through natural selection.

Survival of the fittest in the stock market

Darwin's theory of evolution by natural selection can also be applied in the stock market. In the US, the biggest stocks in terms of market capitalization are industry leaders which have pioneered innovations and are attuned to changing consumer behavior. Microsoft, Amazon, Apple, Alphabet (Google), and Facebook are the top five constituents of the S&P 500. These companies have a combined market capitalization of \$4.4t or P225.5t. These stocks have become household names for most investors and many Filipino consumers. On the other hand, companies that fail to evolve fizzle out and become less relevant. This can be seen in the fates of Nokia and Blackberry, and in the bankruptcy of Sears and other retail stores.

Big caps drive US market to new highs

The strong performance of the five biggest American companies has driven the S&P 500 and Nasdaq to new all-time highs last week. This shows that the biggest stocks in the world can continue to grow their earnings and maintain strong fundamentals, notwithstanding the scale that they have already attained. Moreover, this underscores the importance of big caps to the direction of the stock market.

Size begets size

Following the move of the US market, the PSEi has posted a year-to-date return of 9.6%. This was driven by the performance of Ayala Land, Inc (ALI), SM Investments Corp (SM), Universal Robina Corp (URC), Intl Container Terminal Services, Inc (ICT), JG Summit Holdings, Inc (JGS), and BDO Unibank (BDO). These stocks are among the biggest constituents of the PSEi and are run by some of the most innovative and intelligent minds in the country. These companies have solid business models and attractive long-term growth prospects. Because of their track record, size, and ample trading liquidity, large institutional and foreign investors focus on these stocks when looking at the Philippines.

Adapt or perish

We have seen many Philippine companies undergo massive transformations in order to survive major technological shifts, expand their businesses, or enter new ventures. We describe some of these notable evolutions below.

1. **Globe Telecom (GLO).** GLO was formerly Globe-Mackay, a leader in telegrams in the 1980s. The company eventually transformed into a wireless cellular network and is now a provider of digital wireless communications services. GLO would have been extinct if it failed to adapt and keep pace with technological developments.
2. **PLDT (TEL).** TEL was a monopoly in telephone services and was the only provider of landline telephones. Like GLO, TEL embraced technology and was able to morph into a telecom giant which provides fixed-line, cellular, and digital wireless services.
3. **San Miguel Corp (SMC).** SMC started out as a brewery. It eventually acquired Pure Foods Corp, and became the dominant food and beverage player in the country. SMC has funneled earnings from its legacy businesses into major investments in power and infrastructure. This completes SMC's metamorphosis into one of the country's biggest conglomerates.
4. **Universal Robina Corp (URC).** URC was a cornstarch manufacturing plant which expanded into coffee and chocolate candies. URC has since become a diversified food business which includes branded consumer foods, agro-industrial products, and commodity foods.
5. **SM Prime Holdings (SMPH).** From a shoe store in Carriedo, SMPH grew by building retail shopping outlets. SMPH started constructing massive shopping malls and transformed into the largest mall operator in the country. The company has since expanded into the residential and office businesses, making it the biggest property stock in the country today.

Applying natural selection to stock investing

A friend of mine, who is one of the best minds in investments and a former partner in Goldman Sachs, once told me that he applies Darwin's theory of natural selection in managing his stock portfolio. On the one hand, he increases his exposure to stocks that do well. On the other hand, he pares down or eliminates investments which do not perform. Guided by the theory of natural selection, his portfolio management style is very similar to my investment philosophy of keeping winners and selling losers. Following this strategy has been profitable for me and has prevented losses from widening. Just as Darwin observed among different species, companies that adapt to change are the ones which end up as winners in the stock market and survivors in their respective fields. These are the stocks that one should keep in his portfolio as they stand the best chance of generating sustainable long-term gains.

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