'The fountain of youth' – Lindy's Law and quality growth investing

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In 1993, Princeton astrophysicist Richard Gott compiled a list of all the then-current Broadway and off-Broadway shows and noted when each had first opened in New York's famous theatre district.[1] He then predicted, "how long each show would run, based solely on how long it had been running already".[2] Ultimately, Gott was proven right – with an accuracy of 95%.[3]

Gott's theory, known as 'Lindy's Law', can be applied to estimating the life expectation of 'non-organic' products and services in various industries. For example, the publishing industry has a golden rule that if a book has been in circulation and selling successfully for a decade, it will continue in the same vein for at least another decade. If a book is successful for another 10 years, this raises its future lifespan to 20 more years.

We can use this law in investing as well as a useful counterpoint to the excitement that investors often feel when they see young companies and the "next big thing". It's easy to become convinced these companies will drive huge returns, but the better long-term investments are actually 'marathon runner' companies that have lasted a long time. Lindy's Law translates into 'the longer a company lasts, the longer it is to last'.

Marathon runners gain strength over time in a sort of anti-aging process. They can leverage their competitive advantage to drive more innovation and strengthen their position. When it comes to investing, big companies benefit from the 'winner takes all' rule.

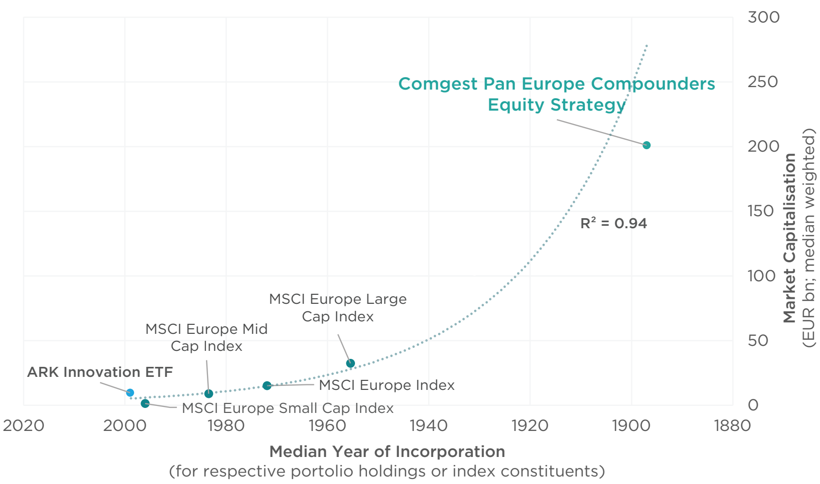
One example of a company that embodies this anti-aging process is L'Oréal. The company began as a one-man operation selling hair dyes to Parisian hair salons in 1909, and has become a global beauty brand powerhouse with remarkably consistent returns. Today L'Oréal is much stronger than it has been at any point in its history.

For the past 40 years, L'Oréal's earnings per share has grown by 11% per annum and its dividends by 14%.[4] This consistent growth has given the company significant amounts of money that have been invested to establish successful US and China-based businesses, as well as e-commerce solutions that position the company to maintain this growth well into the future.

Of course, just because a company has lasted a long time is no guarantee that it will continue to be successful. Occasionally, an outlier – like Microsoft – comes along and knocks a heavyweight from the top – like IBM. IBM was once the biggest IT company in the world, but started to struggle in the late 1980s and 1990s as it failed to adjust to the PC revolution pioneered by its much younger competitor, Microsoft's Windows operating system and office software.

However, what is certain is that stories, like that of IBM, are more common for younger, early-stage

The power of age and compounding



Past performance does not predict future returns. Source: Comgest / FactSet financial data and analytics, unless otherwise stated. Data as of 31-Mar-2023 expressed in EUR. See important information below for more details on the data presented.

companies: in the US, 30% of companies fail within their first two years, showing their survival rate is quite low.

The riskiness of investing in young early-stage companies can be illustrated by the rise and fall of the ARK Innovation Exchange Traded Fund (ETF). The fund rose to fame in 2020 during the Covid-19 pandemic, as its net asset value more than quadrupled between March 2020 and February 2021 thanks to its investments in highly innovative and disruptive new technologies such as adaptive robotics, blockchain and artificial intelligence. However, by February 2022, the ARK Innovation ETF had lost all of its gains – after just one year.[5]

So while it may be tempting to focus on very young companies betting on the next big thing that have the potential to drive large returns in a very short space of time, Lindy's Law tells us such investments are very risky and their survival rate is actually low.

Often the 'next big thing' fails because a market leader, usually marathon runners or compounder stocks, uses its competitive advantages, such as pricing power and greater R&D budgets, to grab the next opportunity: Microsoft's success in the SaaS and Cloud markets or artificial intelligence is a good example.

Therefore, if you want to create a portfolio that compounds your growth in the long-term, you need marathon runners with a long track record of success. Lindy's Law reminds us that the established players may just be your best bet over the long term.

FOOTNOTE

1 Ferris, Timothy. How to Predict Everything, The New Yorker, 12-Jul-99.
2 Parrish, Shane. The Copernican Principle: How To Predict Everything, Farnam Street, May 2019.
3 J. Richard Gott III, A grim reckoning, New Scientist, 15-Nov-1997. Gott applies the Copernican Principle to the fate of humanity.
4 Company results, as of 31-Dec-22.
5 https://ark-funds.com/funds/arkk/

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