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FANG, FAAMG: Too big a bite of the market?

Are FANG valuations bloated or an ongoing opportunity? Investors of a certain age might recall the implosion of the "Nifty Fifty" in the 1970s, which brought the stock market to its knees. This month, we talk FANG and FAAMG stocks to determine whether these thriving businesses have staying power.

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With the S&P 500 up nearly 10% for the year through mid-June, many investors are nervous about what lies ahead. Even more nerve-wracking is that an outsized portion of the total returns have been generated by just a few stocks. A few mega-technology companies have, in fact, been driving returns on and off for the past three years: the FANG stocks (Facebook, Amazon, Netflix and Google) which have recently been modified with a new, mouth-crunching acronym, the FAAMG stocks (Facebook, Amazon, Apple, Microsoft and Google). Depending on which lovely acronym you use, between 33% to 40% of returns are attributable to those stocks alone (and more than 50% of Nasdaq's returns year-to-date), even though they represent barely 10% of total market capitalization.

The question then is whether this is a good thing—a stable basis of market performance, or a bad thing—too much concentration, too much weight, too little diversification, and too many investors piling in just cause. The short answer? Aspects of momentum trading may be propelling these names, and they may be ripe for volatility, but at their core, these names are surging disproportionately because they are disproportionately benefiting from the continued disruptions in our economy. These stocks are soaring because their businesses are thriving.

Too much, too fast? Or just right?

There's no doubt that the strength of these names has attracted scrutiny. On June 9, the group was slammed, with Apple down more than 5%, after several Wall Street investment banks issued client notes warning of overvaluation and overconcentration in the sector. Goldman Sachs issued a note asking, "Is FANG Mispriced?" Others flagged the fact that the FAAMG names had added more than $600 billion in market capitalization in 2017 alone, and that many of the shares appear to be owned by individual investors, which can be taken as a sign of momentum buying without due consideration of fundamentals.

The selling continued into the following week before the names bounced a bit. That sell-off seemed to prove the point: that these names have been surging on momentum and mindless buying, which makes them vulnerable to exactly the pullback that they then demonstrated.

Yet even those reports, warning as they did of potential pitfalls, were not negative about the underlying fundamentals. And how could they be? These mega-cap companies have impressive earnings growth and continue to generate more revenue each year. Even Apple, which is in many ways a mature company that should be long past its "growth" stage, has shown modest revenue growth on nearly $300 billion in sales. In 2016, Apple had a slight decline in total sales, and its shares lagged (which is one reason why is it was not included as part of that initial FANG group), but this year it has returned to modest single-digit revenue and earnings growth. And it is the laggard among that mega-tech group.

Amazon recently announced its bid to purchase Whole Foods Market for $13 billion, thereby continuing CEO and founder Jeff Bezos' quest to make Amazon "the everything store." He has ignored Wall Street's demands for years, and rather than act like an established company focused on earnings has instead plowed almost all revenue back into growth and expanding into new areas, such as web and hosting services, drones, and now groceries. After years of skepticism, financial markets have fallen in love with Bezos and his ambitions, as have tens of millions of consumers.

And then there is Google, now Alphabet, which dominates search and on-line ads along with Facebook, and is spending billions on skunk-work projects ranging from literal moonshots to self-driving cars. Alphabet has yet to discover a cash-stream to offset the market risk of deriving so much of its income from search, but it remains absurdly profitable. The same can be said of Facebook. Facebook and Google together account for nearly all of the growth in the multi-billion dollars on-line advertising industry, making them a duopoly. Their dominance is growing, not waning.

Figure 1:
2015 was an exceptional year for FANG stocks…
2015 performance: FANG vs. indices

	% Return
Facebook (FB)	34.15%
Amazon (AMZN)	117.78%
Netflix (NFLX)	134.38%
Google (GOOGL)	46.60%
S&P 500	-0.73%
Dow Jones	-2.23%
Nasdaq	5.73%

Source: Morningstar

Figure 2:
… but FANG lost some steam in 2016.
2016 performance: FANG vs. indices

	% Return
Facebook (FB)	9.93%
Amazon (AMZN)	10.95%
Netflix (NFLX)	8.24%
Google (GOOGL)	1.86%
S&P 500	9.54%
Dow Jones	13.42%
Nasdaq	7.50%

Source: Morningstar

Figure 3:
Will FAAMG grab most of returns in 2017?
2017 YTD performance: FAAMG vs. indices

	% Return
Facebook (FB)	30.93%
Apple (AAPL)	22.84%
Amazon (AMZN)	31.72%
Microsoft (MSFT)	12.65%
Google (GOOGL)	20.97%
S&P 500	8.68%
Dow Jones	8.21%
Nasdaq	14.28%

Source: Morningstar. 2017 YTD performance as of June 16, 2017.

Microsoft, meanwhile, written off as a moribund dinosaur only a few years ago, is benefiting from an energetic new CEO, Satya Nadella, and a push into integrated software and hardware that is starting to yield results. And it still has the default platform for office software and home computers. Netflix, which is the baby in the group, is turning itself into a 21st century movie studio that controls not only its own content but also its distribution, which recalls the monopolistic Hollywood ecosystem of the early part of the 20th century, with all the attendant profits.

That all of these companies are going gangbusters is, of course, no indication of sustained success. Nor does it mean that their current stock price and valuation accurately gauge either the future health of their franchises or future investor sentiment about what these businesses are worth.

The concentration of gains also raises legitimate concerns about the lessons of the late 1960s and 1970s, a peak time for the so-called Nifty Fifty, the "it" stocks of their day. The Nifty Fifty were seen as solid investments in the companies leading America's economy, names such as Kodak, IBM, and McDonald's. They soared in the 1960s, and by 1972, they commanded a valuation of more than twice the S&P 500. Then they crashed and brought the market down with them. Many of the same arguments made about those stocks then are made about these dominant tech companies today.

Past patterns are useful and important, but as they say, past performance is no guarantee of future results. The collapse of the Nifty Fifty in the 1970s was part of a larger economic malaise of double-digit inflation and low growth, along with political turmoil and a crisis of national confidence.

Some of those elements may be in play today, of course, but the ongoing digital revolution appears to be still in its middle rather than late stages. In addition, unlike the 1970s Nifty Fifty, today's tech giants can thrive even as significant parts of the overall economy suffer. They are not proxies for "the economy;" they are the change agents disrupting the old economy and reaping disproportionate rewards from the new.

In addition, these new names have not gone straight up. 2016 was a lagging year for them, Apple in particular, while Google also barely budged. They represented a high proportion of gains in 2015 and now in 2017, but they were back and forth in 2016, as investors paused to evaluate. Valuations may be excessive, or not, but investors are hardly mindlessly pouring into these names.

Figure 4:
Will FANG or FAAMG follow the fate of the "Nifty Fifty"?
Blue chip stock performance, 1973-74

	% Return
Du Pont	-58.4%
Eastman Kodak	-62.1%
Exxon	-46.9%
Ford Motor	-64.8%
General Electric	-60.5%
General Motors	-71.2%
Goodyear	-63.0%
IBM	-58.8%
McDonalds	-72.4%
Mobil	-59.8%
Motorola	54.3%
PepsiCo	-67.0%
Philip Morris	-50.3%
Polaroid	-90.2%
Sears	-66.2%
Sony	-80.9%
Westinghouse	-83.1%

Source: Hussman Econometrics, December 1999

Some bite left...

In general, therefore, there seem to be solid fundamental reasons why these names are leading the market on and off over the past few years. Valuation, of course, is always tricky to gauge. On rare occasions, names trade at extreme lows or extreme highs. One could make the case that both Amazon and Netflix have had very high multiples, and that expectations for future returns are unrealistic. But both have proven able to remake themselves and create entirely new markets, and both are plowing ahead in that direction.

If you are invested in an index fund that tracks the S&P 500 or the Nasdaq, you are, of course, invested in these names along with others. Single-stock investing is usually riskier than asset allocation, and many retail investors may indeed be over-doing it if they are putting large percentages of retirement savings into FANG or FAAMG or any limited numbers of names. The larger point is that many are quick to call market tops, announce that we are in a bubble or that one is forming, and warn that current gains are unsustainable. Then when pullbacks do occur, and such pullbacks are close to inevitable, they pounce and say, “I told you so.” And often, those pullbacks were the time to invest. Amazon has gone up almost a hundred-fold since 2002, for instance, but it has crashed and sold-off numerous times through the years. Yes, it is far easier in retrospect to say those were the times investors should have bought more, but that bears remembering. While a diversified market where gains are widely dispersed is certainly preferable to a concentrated one, in this case, at least the concentration is in names that are creating new economies. They may be volatile, and investors should be cautious as always, but the fact that they have done so well has solid justification. ■

June Takeaway:

The rise and dominance of today’s FANG stocks is often compared with the trajectory of the Nifty Fifty in the 1970s. They soared and then plummeted. But past isn’t always prologue. Back then, record inflation, slow growth, and political crises constituted a general economic malaise. Now, economic disruptions and the digital revolution are transforming consumers’ way of life and the businesses that support it. Each of the FANG (or FAAMG) stocks is a leader, and valuations are propelled by hefty revenue and earnings growth. Although the group may be vulnerable to a short-term pullback (as witnessed recently), they show no signs of slowing.

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