FINANCIAL ADVISOR
FA
fa-mag.com

Active, Passive Ways To Avoid Being Bitten By The FANGs

By Christopher Robbins

THE LARGEST STOCKS BY MARKET CAPITALIZATION might be too big for their britches, and index funds could suffer as a result.

After several years of active managers warning about indexes like the S&P 500 containing rising concentrations in mega-cap stocks, the FANGs, an acronym for Facebook, Amazon, Netflix and Google, took a tumble in late July, dragging indices with them.

As the bull market ages, advisors and investors may want to consider alternative equity strategies that avoid or blunt the impact of volatility within the FANG stocks, money managers said.

"In market-cap weighting the S&P 500, the top 10 holdings are 22 percent of the weight, and the top 50 holdings have the same weighting as the bottom 450," said Phil Bak, CEO of Ann Arbor, Mich.-based Exponential ETFs. "There's a lot of concentration. It hasn't really harmed investors seriously to date, but there may be a time where it does because there are people out there with indexes who have three, four or five percent of their assets in a single name."

FANG stocks have become emblematic of the rise of behemoth technology stocks and their market leadership—so much so that new acronyms like FANMAG (which adds Apple and Microsoft to the FANGs) and indices like NYSE's FANG+ (which adds Apple, Alibaba, Baidu, NVIDIA, Tesla and Twitter to an investible FANG index) have proliferated in recent months to encapsulate a unique, fast-growing and influential subsector of companies.

These FANG-like stocks led market gains through much of the current bull market, rising in value through mid-July. Thanks to FANG stock leadership, technology indexes have also run well ahead of the broader markets this year. Technology stocks were responsible for approximately two-thirds of the S&P 500's return through the end of July, according to S&P Global.

"As of mid-year, Netflix had added about $80 billion of market cap, but the company's revenue was only projected to grow by $4.5 billion," said Todd Ahlsten, chief investment officer and portfolio manager at San Francisco-based Parnassus Investments. "That means you're paying almost $20 for every dollar of revenue growth that a company like Netflix will generate this year. That's a high price for growth."

Investors have gradually become concerned about the influence the FANG stocks have on the rest of the market. In late June and early July, Oaktree Capital's Howard Marks began raising the alarm on FANG stocks, arguing that investors had unrealistic expectations of the companies' growth and revenue-producing abilities and that valuations had come too far, too fast. The charts of some valuation metrics, like the ratio of enterprise value to revenues, began to look parabolic.

After Facebook reported declining active users and missed revenue estimates in July, the stock dropped 20 percent—equivalent to $120 billion in market value—in one day. Poor second-quarter results from Netflix helped to compound the losses, leading to a broader technology sell-off, impacting mega-cap stocks like Apple, Facebook and Google. On July 30, the FANG+ index was in correction territory, down more than 10 percent from its June high-water mark.

"One of the biggest fears I would say regarding the FANGs, especially in the case of Facebook, would be long-term regulation," said Ahlsten. "Facebook at one point was the disruptor. They were the first big mover in social media and during that time they had a very wide moat, grew cash flows and became a robust company. At some point that robustness has become more of a fragility. They still have a moat, but there are cracks and risks that the company can't really manage."

The story for the FANGs hasn't been all negative: Amazon doubled its profit margins and more than doubled earnings estimates in its second quarter and anticipated third-quarter profits well above analysts' prior estimates. Apple also beat earnings estimates, rising to more than $1 trillion in total market capitalization.

The valuation concerns and recent volatility may have some investors looking for alternatives, both active and passive, that avoid or alleviate concentration in high-growth areas of the market.

"There's no doubt that the FANGs are good companies, but they're so highly valued we're concerned they'll struggle to provide good long-term returns," said Ahlsten. "We prefer to target stocks that will grow cash flow and earnings with less volatility. Outperformance comes from avoiding the permanent loss of capital."

On the active side, a seasoned stock picker should be able to help investors navigate away from the FANG trade. Such a solution might be found in the Parnassus Core Equity Fund (PRBLX), a $15.6 billion active mutual fund managed by Ahlsten.

"Hire us because you want active share," said Ahlsten. "In effective active share, managers are selecting businesses with more narrow range of outcomes, and over the long term it helps to avoid significant downside. You're avoiding paying too high a price for companies and you're avoiding companies prone to disruption."

PRBLX's 37 holdings averaged $120 billion in market cap as of June 30, compared to the $217 billion average market cap of the S&P 500. The fund is slightly less volatile than its benchmark index.

Ahlsten picks large-cap stocks that have a wide moat against competition and are available at relatively low prices. Among his favorite stocks are Gilead Sciences, which is a pioneer in drugs treating HIV, cancer and liver disease, and media stalwart Disney, which trades at 14 times its forward earnings.

"We also like 3M, a fantastic company producing films and adhesives used in products throughout our economy," said Ahlsten. "3M stock is down 25 percent form its peak, you can buy it at 18 times its forward earnings, and they've increased dividends for years on end."

Another forward-looking stalwart targeted by Ahlsten is Clorox, which he likens to a "Silicon Valley version of Procter & Gamble" because it is focusing resources on researching cleaner, more efficient and more valuable products.

At the same time, Ahlsten is divesting from companies where risks are increasing, like McKesson, which was dropped due to risks surrounding opioid drugs, and Wells Fargo, which Parnassus divested from after a long period of shareholder engagement over sales practices and consumer privacy issues.

"ESG is a good way to identify hidden risks in companies. We're particularly looking for sustainability in governance," said Ahlsten. "We want to avoid companies that aren't ethically competing in the marketplace."

According to Morningstar, PRBLX had gained 8.16 percent year to date as of Aug. 3, compared to 7.4 percent for the S&P 500. In the decade ending Aug. 3, PRBLX posted 10.79 percent average annualized returns, compared to 10.82 percent for the S&P 500.

PRBLX has an expense ratio of 87 basis points.

On the other side of the spectrum are passive solutions to avoiding the FANG trade. While a number of ETFs offer alternative indexes by using smart beta factors or by limiting the fund's selection set to a niche, other funds simply reweight the market index. Guggenheim was the first to do this by equal-weighting the market with RSP, now the Invesco S&P 500 Equal Weight ETF. Now, Exponential ETFs has taken the idea a step further with its Reverse Cap Weighted U.S. Large Cap ETF (RVRS).

"I was a manager on the equal-weight ETF," said Bak. "It was one of my favorite strategies because it was so simple, and I like to pull things back to simplicity and the basics of what they really are. The reason equal weight outperformed is that it gives investors a lower-than-average market capitalization, so they get the small-cap premium, and on portfolio rebalance it's profit-taking."

Bak argues that market-cap weighting grew because it is essentially liquidity weighted and costs very little to rebalance. However, in recent years trading costs have declined to the point where market-cap weighting no longer confers as much benefit as it once did.

RVRS takes the S&P 500 and stands it on its head—literally. The largest components of the S&P 500, including the FANGs, receive the lowest allocation, while the smallest constituents receive the highest.

The result, said Bak, is an ETF that should tend to outperform the normal S&P 500 over time, but with slightly more volatility.

"Historically, there's approximately 2 percent alpha per year generated by using equal weighting versus market-cap weighting," said Bak. "By the same logic, there's about a two-percent alpha for reverse cap weighting over equal weighting. Equal weighting large-cap equities is just a half measure. You can take the idea farther."

Launched late last year, RVRS has posted a 4.5 percent total return through Aug. 3, compared to a 7.4 percent return for the cap-weighted S&P 500.

RVRS has an expense ratio of 29 basis points.

"By combining RVRS with a market-cap weighted product, you can reduce your risks dramatically," said Bak. In fact, a 50-50 combination between RVRS and a S&P 500 index fund can significantly decrease concentration while maintaining some weighting to high-market cap names. "You end up with more of an allocation to the smaller-cap tail of the S&P 500, where there's more room to grow and alpha can be generated." FA