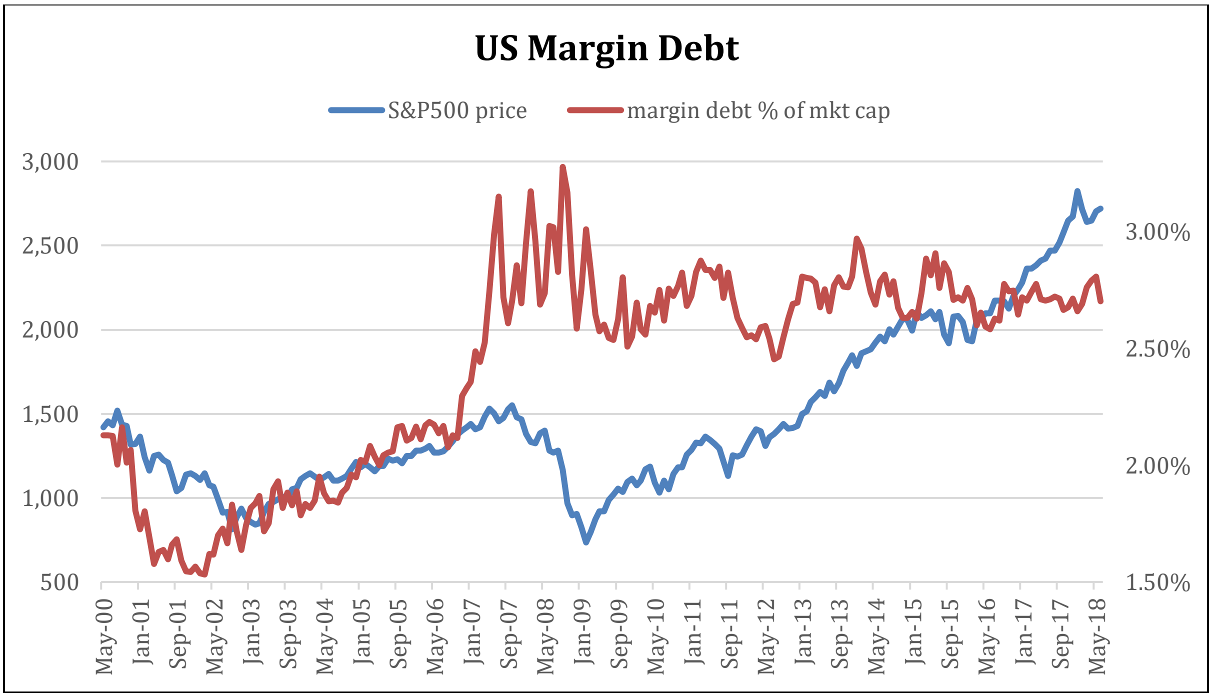
FAANGs 👍 or 👎 ?

Last month I received a marketing letter. Well I receive many marketing letters every month, but one in particular left me agog: it was from the provider of my pension plan. As usual the letter invited me to consider investing with them and to focus on the equity market as a long-term generator of performance: nothing unusual about this spin. What attracted my attention was that they included a list of stocks, probably to tickle my greed as well as to help me in the selection work. The list included the ten most popular overseas shares among their clients over the previous month. They were: **F**acebook, **A**pple, **A**mazon, **N**etflix, **G**oogle, Tesla, Microsoft, Nvidia, Spotify and Alibaba. Can anyone guess what they do have in common?

Before the Great Financial Crisis, it was common to hear coffee chats about unexperienced retail people margin betting on stocks or taking leveraged investments in real estate developments in Mediterranean countries. And those old enough would remember similar almost mythological stories before the 2000s about buying into the crazy one-day double-digit returns on any IPO that had a “dot com” at the end of its name. Probably most of you also remember how the two bull markets ended.

Spotting bubbles is a most difficult exercise, not least because one can see the symptoms of a bubble long before they reach a tipping point and still being left out alone crying wolf and looking silly for a long time in front of family, friends and, worst of all, colleagues. Having said that, one of the agreed-upon signs of bubbles is exactly a shared sentiment of a bull run. We can describe it as the situation when not only the professional investors, but also the retail investors who are farther detached from the markets in their daily life are very optimistic about the potential returns on the basis of the already high returns experienced in the recent previous periods.



Source: Finra, Bloomberg, own calculations.

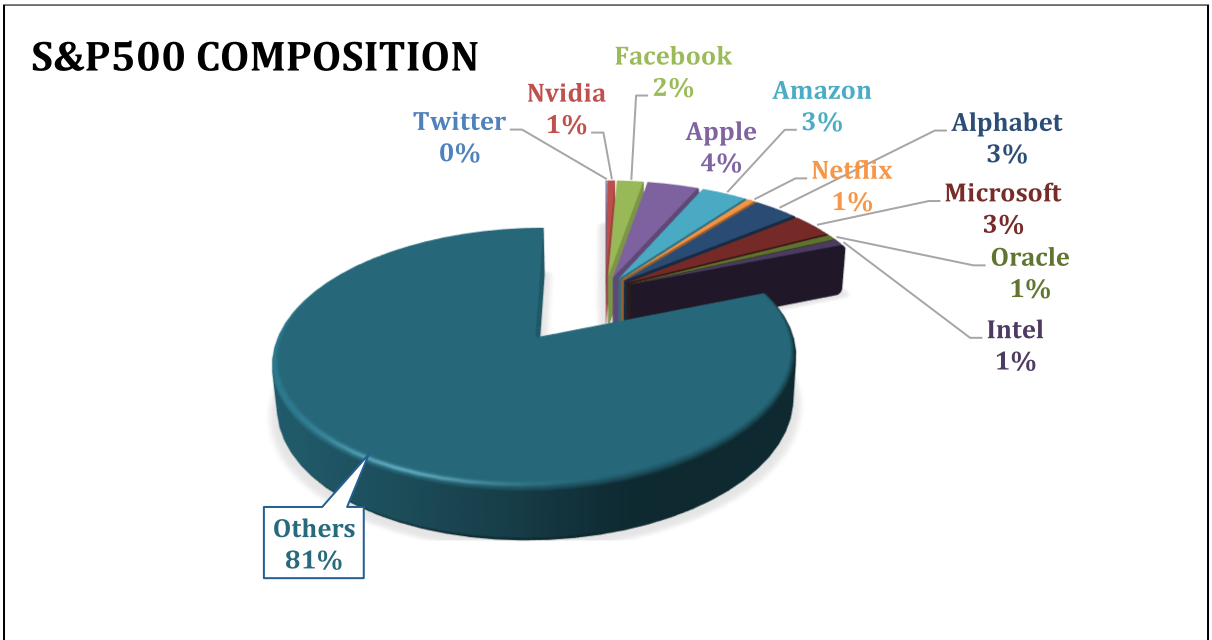
Data and figures updated on 31st July 2018

Growth companies are always an almost necessary ingredient in the build-up of a bubble. This time round, the never-ending growth stories are the FAANGs. But, even if margin debt is not an issue this time (as can be seen in the chart), history teaches us that growth ends sooner or later. A healthy reminder is that we have recently seen some bad news stinging some of the FAANGs. For example, Facebook and Twitter both tumbled around 20% after disappointing sales and user growth respectively. The million (or better in this case billion) dollar question is if this is the start of a bigger sector retrenchment or not.

So, what's their performance?

First of all, it is interesting to note the weights that these tech/digital/social media companies have in, or in comparison with, the S&P500.

The original FAANG group represents around 14% of the S&P500, the FANG+ group, which includes Tesla and a couple of Chinese names (as defined by the NYSE in their homonymous index) would be equivalent to 17% of the S&P500 and a basket including the FAANGs plus some of the biggest "traditional" technology companies in the S&P (like Intel, Oracle and Microsoft) would be close to 20% of the S&P500.



	Market Capitalisations	as % of S&P
FAANGs	3,332,921,000,000	13.32%
S&P FANG+BIG TECH	4,558,531,000,000	18.22%
NYSE FANG+	4,127,860,000,000	16.49%

Source: Bloomberg, own calculations. The chart and table show that just 10 technology names out of 500 stocks make up 1/5 of the S&P500.

Since 2015 in total return terms, the NYSE FANG+ has outperformed both the S&P and the NASDAQ, by far every year. In 2018 alone the NYSE FANG+ has had a total return of 23.53% (43.4% annualised) while the S&P500 is merely up 6.47% (11.28% annualised) and the NASDAQ 11.78% (20.92% annualised). This roughly means that sector-wise the FANG and friends are those who have led and driven the performance of the main indices.

TOTAL RETURNS		period			annual eq.		
start	end	***NYSE FANG+***	***S&P500***	***NASDAQ***	***NYSE FANG+***	***S&P500***	***NASDAQ***
31/12/2014	31/07/2018	193.15%	47.20%	69.25%	35.00%	11.39%	15.82%
31/12/2014	31/12/2015	29.66%	1.37%	7.11%	29.66%	1.37%	7.11%
31/12/2015	30/12/2016	15.52%	11.95%	8.97%	15.52%	11.95%	8.97%
30/12/2016	29/12/2017	58.43%	21.82%	29.73%	58.63%	21.89%	29.82%
29/12/2017	31/07/2018	23.53%	6.47%	11.78%	43.40%	11.28%	20.92%

Source: Bloomberg, own calculations.

The performance of the FANG+ since 2014, as the chart below shows, looks like a power law growth, which is usually associated with asset classes that have later experienced bubble-like bursts. It is also interesting to note that it represents around 90% of the performance of the whole S&P500. In fact, the 10 stocks in the S&P FANG+BIG TECH Basket above have a YTD total return of around 32%, multiplying it by their weight in the S&P500, i.e. 18%, we get a 5.83% total return contribution. <u>That's around 90% of the 6.47% total return of the whole index</u>. I will say it again: <u>these 10 stocks make up almost all the return achieved by an index comprised of 500 members</u>! Yes, they represent a fifth of the index market capitalisation, and that is another amazing thing in itself.

Source: Bloomberg.

This leaves us with something to ponder: what would happen if the tech sector, or the growth factor, suddenly reverse their courses? In my opinion, it is going to be overall bearish, unless one thinks that suddenly the other 490 stocks are going to start a bull run.

Valuation? What valuation?

We need not to forget that even if we associate all these companies in the same group, they have very different operational issues and they execute different business models. Nonetheless the correlations of their returns are strikingly high; testimony to the fact that probably the investors' community is treating all of them as belonging to the same risk factor, i.e. growth.

Another weakness of the group as a whole is that while they have different business models, each of them are often dependent on one big source of revenues: Amazon on cloud computing, Google on search ads, Apple on iPhones, Netflix on producing its own series, etc… Also, in order to expand their business opportunities, they are now often stepping into each other's turf.

All happy FAANGs are alike; each unhappy FAANG is unhappy in its own way.

USD mio

Company	P/E	EV/EBITDA	Mkt Cap	EBITDA	Lev ND/EV	Sales	12m growth
Baidu	**29.99**	25.4x	86,199	3,321	-2.15%	14,448	32.50%
Alibaba	**49.27**	37.5x	485,335	12,636	-2.35%	37,825	60.70%
Tesla	**n/a**	n/a	50,622	-326	21.89%	12,471	45.90%
Twitter	**103.53**	31.8x	24,153	668	-13.65%	2,697	9.80%
Nvidia	**43.39**	34.6x	148,630	4,170	-2.99%	10,984	45.60%
Facebook	**24.17**	16.9x	498,276	27,395	-7.53%	48,497	46.20%
Apple	**18.35**	13.1x	970,700	77,657	4.30%	254,634	13.90%
Amazon	**182.27**	42.4x	867,000	21,095	3.15%	208,125	38.60%
Netflix	**150.72**	108.0x	146,945	1,479	7.97%	13,879	36.20%
Alphabet	**31.55**	20.0x	850,000	38,258	-10.88%	123,898	24.80%
Microsoft	**28.53**	17.8x	814,000	45,319	-0.96%	110,360	14.30%
Oracle	**18.02**	11.8x	189,821	17,104	6.04%	39,830	5.60%
Intel	**13.72**	8.2x	221,789	28,584	5.93%	66,230	7.30%
mean	***57.79***	*30.64*					

S&P BLOOMBERG	**17.54**	
S&P Best	**20.65**	
S&P Shiller CAPE	**32.73**	current
S&P Shiller CAPE	**16.88**	long-term mean

Company	Earnings	12m growth	Net Margin	Goodwill	Employees	EBITDA/emp	Debt	Cash
Baidu	2,894	20%	20%	2,429	39,343	0.084	13,626	15,440
Alibaba	12,931	34.20%	34%	25,787	66,421	0.190	22,301	33,430
Tesla	-2,211	-17.70%	-18%	60	37,543	-0.009	16,425	2,236
Twitter	239	8.90%	9%	1,229	3,372	0.198	2,761	5,661
Nvidia	3,579	32.60%	33%	618	8,191	0.509	2,989	7,300
Facebook	21,333	44%	44%	18,221	25,105	1.091	6,807	41,711
Apple	55,430	21.80%	22%	5,717	123,000	0.631	114,600	70,970
Amazon	4,890	2.30%	2%	13,944	575,700	0.037	55,255	27,050
Netflix	1,028	7.40%	7%	0	5,400	0.274	16,628	3,906
Alphabet	28,232	22.80%	23%	17,895	89,058	0.430	18,870	102,254
Microsoft	28,992	26.30%	26%	35,683	124,000	0.365	126,028	133,768
Oracle	11,219	28.20%	28%	43,755	137,000	0.125	79,453	67,261
Intel	16,816	25.40%	25%	24,351	103,700	0.276	26,196	12,225

Source: Bloomberg, own calculations.

The tables above sum up some of the main metrics and figures of each company. Looking at the actual figures is always a good exercise to cross check our opinions and hunches. What do the numbers tell us then?

Firstly, leverage is not an issue in this sector, even for mature companies. The most levered one is Tesla, which is not generating enough cash to fund its capex. In this respect Netflix is similar to Tesla, albeit on a lower leverage. Both companies need access to capital markets to keep up the speed of investments and growth.
Simply looking at the P/E (the EV/EBITDA ratio is similarly ordered), it strikes that this group of companies as a whole is clearly expensive on this metric at 57x on average; but surprisingly Apple, the trillion-dollar company, seems fairly priced at 18x. The old school tech companies have lower and more reasonable multiples, which could be seen as the long-term multiples to which successful companies would tend to.
The stocks that seem the most vulnerable in comparison to Apple are Amazon, Netflix, Twitter, Tesla and Alibaba. In particular Amazon, which has almost the same market cap and the same level of revenues as Apple, it only generates 1/10 of the earnings with historically more volatile growth. If Amazon's strategy of reinvesting everything it generates from the cloud business into traditional on-line market places (drugs, food, etc…) showed signs of weakness, it could really be the driver of a huge selloff in the tech space.
Similarly to Amazon, Netflix and Twitter have very low Net Margin and low efficiency or productivity per employee. Personally, I see the growth on Twitter's revenues as capped and Netflix's main risk is linked to the possibility of a string of unsuccessful TV series or change of viewers' tastes.
Tesla is a dream always on the verge of becoming a nightmare: the final chapter has not been written yet, but the well-known production issues and cash burning makes it reliant on capital markets for funding (like Netflix). Sooner or later some of the incumbent car makers will show up as powerful competitors in the most lucrative middle market range: more of a tragic, rather than happy, ending.
Remarkably, the scandal-prone and privacy-gentle Facebook seems more fairly valued than the others at 24x PE, on the assumption that the current level of sales, margins and hence earnings can be maintained or improved.

Forecasts: the sky is the limit, isn't it?

It could well be that some of these new growth companies will transition from growth to value, in the process smoothly accruing and releasing value for shareholders at every point in the future. But in practice this kind of rotation is not easily done and not without lower valuation readjustments, i.e. by factoring in less future growth whilst margins are not yet "mature" enough.
The situation is that these stocks have become behemoths and in order to remain such, they need to show the same degree of growth quarter in and quarter out, which is ultimately impossible to do forever. What we have seen time and again is that the room for error when valuations are inflated is very small and even small changes in assumptions about the future can lead to big drawdowns.

The macroeconomic background is positive and has been such for several years now; it is actually so good that central banks around the world are either rising interest rates or thinking about it. Even in Japan, where the BOJ is officially not even thinking about interest rate increases, the yield on the long bonds is going up (albeit from a very low level). Usually equity people see rate increases and inflation as positive for stocks: a justifiable view if one sees stocks as real assets. The problem is that typically the growth assumptions are adjusted and update much longer before the monetary policy becomes hawkish. Therefore, even if you think that the effect of higher discount rates on valuations are negligible (a view that I do not personally subscribe to), the stock prices are still going to be negatively affected by tighter monetary policies because they are already incorporating the good news about growth but not its monetary countereffect.

In other words, the market for FAANGs seems to be priced for perfection. Maintaining perfection for a very long period of time is a zero-probability event: not impossible, but unlikely. The current valuations imply that these companies need to be successful on each and every criterion in order to avoid a sell-off.

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Data and figures updated on 31st July 2018.