



*“Speculative bubbles do not end like a short story, novel, or play. There is no final denouement that brings all the strands of a narrative into an impressive final conclusion. In the real world, we never know when the story is over.”*

- Prof. Robert Shiller

For much of the last decade, ETFs, and for that matter passive or index based products, have been the darling of the investment world. The reasons for this trend are pretty evident. First, passive investment options have grown exponentially over the last decade and can provide investors with cheap and diversified exposure to entire asset classes. Additionally, the average active mutual fund manager has underperformed their respective benchmark for much of the last 10 years, leading investors to question the rationality of paying higher fees for lackluster results.

This brings up the question then....why would we as investors want to do anything other than simply own the market portfolio at a cheap price? On the surface this sounds like a perfectly logical investment approach. Unfortunately, many investors either neglect to acknowledge or are just completely unaware of some of the hidden risks involved in such a strategy.

In today's market environment, one of the most overlooked risks is related to the so-called FAANG stocks (Facebook, Apple, Amazon, Netflix, and Google) and the potential for many investors' portfolios to hold unintentionally large allocations to this subset of the market. For instance, most investors are likely unaware that by just owning the iShares Russell 1000 Growth ETF (Ticker: IWF) they are investing nearly 20% of their portfolio in just these five names. But what could be wrong with that? This group of stocks has gained approximately 50% over just the last year and more than 150% over the prior 3 years. The only drawback is expensive valuations, but with lofty analyst expectations for future earnings growth, Amazon and Netflix look reasonably priced to many, trading at "just" 300x and 200x times earnings, respectively. Sound eerily familiar? Rewind the clock about 18 years and replace Amazon and Netflix with Cisco and Oracle and you are right near the peak of the tech bubble.

In this quarter's Market Insights letter, we are going to address the lofty valuations of a small number of highly influential stocks, the FAANGS, and examine the parallels that exist with some of the tech sector's largest companies during the late 1990s. Additionally, we will discuss how blindly investing in traditional indexes may lead investors to hold surprisingly large positions in these overly expensive names, and propose a few possible solutions to this problem.

### **Indexing 101 - Market Cap vs. Equal Weighting**

Before diving into our analysis, it is worth quickly discussing a few basics around index investing. While indexing at its core is a simple concept, there are a number of nuances that exist, the most important being an index's weighting scheme. The most traditional form of index construction is market cap weighting. In market cap weighting, you first define the constituents in your index and then simply weight each constituent based upon its size or overall market capitalization. For example, let's assume that we have a hypothetical index of 10 stocks and this index has a total market capitalization of \$10 billion. One of its constituents, which we will call ABC Corp., has a market cap of \$2 billion. What weight does ABC Corp. receive in the index? The answer is 20% or \$2 billion/\$10 billion. Simple, right? Well this is the exact methodology

used by most major indexes (S&P 500, Russell 2000, MSCI EAFE, etc.) and, as a result, most of the industry's largest ETFs.

There are a number of alternate methods to the standard market cap weighting methodology. While the list of these alternate or fundamental-based methods continues to grow on what seems like a daily basis, we will limit our discussion to the equal weighting methodology. There are no tricks here, this methodology is exactly as it sounds. This is simply an alternate weighting scheme to traditional market cap weighted indexing that equally weights all index constituents. Going back to our prior example, under the equal weighting methodology ABC Corp. would receive a 10% weight in the index (i.e.  $1/10 = 10\%$ ), as would each of the other 9 constituents.

### The FAANGs Have Us Feeling Like it's 1999

With Indexing 101 out of the way, let's turn our discussion to the so-called FAANG stocks, as they are dubbed by the media. As we've already mentioned, these five stocks account for more than 20% of the Russell 1000 Growth index, meaning that their returns will have a significant impact on the performance of the index. To quantify, during 2017, if we were to exclude these names from the index, the Russell 1000 Growth would have returned 27.23% vs. 30.21% if the names were included. That is, by removing just 5 companies from the 550 company index, performance of the entire index would have declined by nearly 3%.

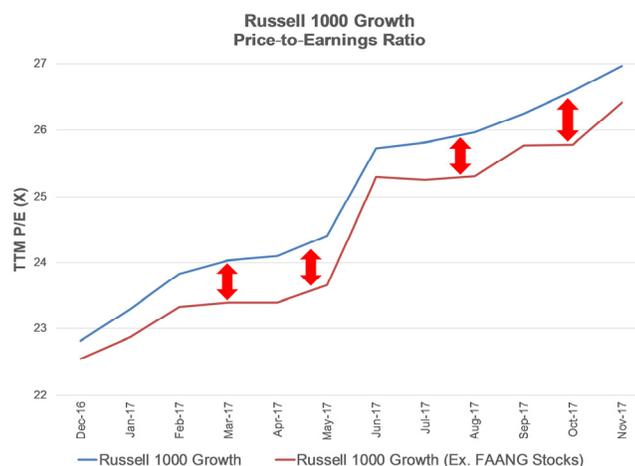
While this disproportionate influence is obviously a concern, the greatest risk to investors' portfolios pertains to valuations, specifically, the risk of inadvertently owning overvalued stocks.

As we already discussed, the weight assigned to index constituents for a market cap weighted index is driven by the size of a company (i.e. a stock's market capitalization). As companies grow, they have a larger impact on the index. This can be additive to index performance, as company share prices grow, and along with it their market caps. This is exactly what we saw with our FAANG stock example. However, it can also pose a significant risk to investors' portfolios if market caps are rising for the wrong reason -- if they are rising due to increases in valuations and not earnings. This is what occurs as speculative bubbles inflate, setting index investors up for potentially large and unexpected losses, as they own large amounts of potentially overvalued stocks simply because of the weighting methodology

We can see this scenario play out in its entirety if we look back to the tech bubble of the late 1990s. Focusing our attention on the Russell 1000 Growth index,

## Large Growth Valuations Including & Excluding FAANG

Chart 1



Data Source: Russell Investments, Bloomberg

While the impact on valuations from removing the FAANG stocks looks minimal, keep in mind that this impact is the result of excluding just 5 of the index's 550 total holdings.

investors saw the bubble peak around August 31<sup>st</sup>, 2000. At the time, the index carried a trailing twelve month P/E ratio of roughly 67x, more than double where it sits today. The meteoric rise of the index's valuation level speaks directly to the problem we just discussed. Stock valuations, or multiples, were increasing at a much faster pace than earnings, and this was particularly true for the index's largest constituents. For instance, if we look at just 4 names in the index -- Cisco, Intel, EMC, and Oracle -- these names accounted for nearly 20% of the index and carried an average P/E ratio of 124x earnings. Needless to say, from its peak in August of 2000, the index declined by nearly 60% over the subsequent two and a half year period, leaving many investors shocked and with portfolios well below their peak values.

Although today's situation is not as extreme as the late 1990s, some striking similarities do exist. Starting with the broad Russell 1000 Growth index, it currently exhibits a P/E of 27x earnings – relatively reasonable compared to the summer of 2000. However, if we look at the FAANG stocks, these five names carry an average P/E of a staggering 114x earnings, more than 4 times the index level P/E. For investors following a simple “own the market” index-based approach, this exposes their portfolio to what we consider one of the greatest risks possible -- the risk of owning expensive assets.

### Equal-Weighting as a Possible Solution

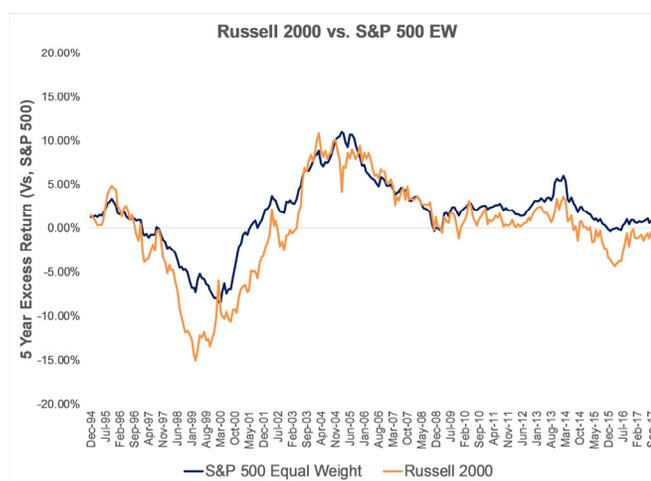
To potentially solve this problem, we can first look to a relatively straightforward and simple solution – invest using an equally weighted strategy. This alleviates any concern of the FAANGS, or any other large and expensive names that account for a disproportionate amount of risk within a given index. Simple, right? Just assign each member of your index an equal weight and now each name has an equivalent impact on risk and return. Not so fast!

While in theory this methodology does a reasonable job of solving the problem, it comes with its own set of biases. Most notably, equally weighted indexing introduces a small cap bias into an investor's portfolio versus the more traditional cap weighting methodology. That is, an investor will be tilting their portfolio toward lower market cap names. Let's examine the evidence.

First, just from a portfolio construction standpoint, the reason this bias occurs is pretty evident. Companies are no longer assigned weightings based on their size, but rather all simply receive an equal share just due to the fact that they are an index constituent. What this means is that a company like Apple, which has a market cap of over \$800 billion and a weight in the S&P 500 of just shy of 4%, would have

## 5 Year Excess Returns Small Caps vs. S&P 500 EW

[Chart 2](#)



Data Source: S&P, Russell Investment, MPI Stylus

The excess returns of small cap stocks and the equally-weighted S&P 500 exhibit a notably strong positive relationship. From a statistical standpoint this relationship is highly significant, exhibiting an R<sup>2</sup> of nearly 90%.

the same impact on the performance of the S&P 500 Equal Weight index as Foot Locker, a \$5 billion company with a 0.02% weight in the cap weighted S&P 500. This leaves the equal weighted index with a significantly lower average market cap than its capitalization weighted counterpart. In the case of the S&P 500, we find a difference of nearly \$150 billion in average market capitalization (S&P 500 - \$193B vs. S&P 500 EW - \$48B).

As one can imagine, this small cap bias can have a meaningful impact on the risk and return characteristics of an index. This has led some to tout the superiority of equal versus market cap weighting, as long-term returns have been superior for equally weighted indexes for some time. However, these same individuals neglect to recognize the additional level of risk that comes with utilizing such a strategy. As we all know, there is no free lunch and higher returns seldom come with less risk. This is precisely the case here. Capturing these higher returns involves embedding a small cap risk premium into one's portfolio, a bet that has the potential to lead to unexpected results for investors.

We can substantiate this statement quantitatively by continuing to examine the S&P 500 index. To do so, we compare the excess returns (vs. the S&P 500) of the S&P 500 Equal weight and the Russell 2000 index, the industry benchmark for small cap stocks. We find that a strikingly strong relationship exists between the excess returns of these two indexes versus the traditional S&P 500 (See Chart 2). In statistical terms, this relationship exhibits an  $R^2$  of 88%, which would be considered highly significant. Said differently, small caps and the equally weighted S&P 500 tend to out and underperform over the same time periods, directly supporting our point about the small capitalization bias of equally weighted indexes acting as a key driver to returns.

### **Valuations to the Rescue**

Equally weighting our portfolio clearly alleviates our significant exposure to the pricey FAANG stocks, but it leaves us in another just as troubling situation. While, we surely don't want to be left holding the bag when the next bubble bursts, nor do we want to inadvertently increase the risk of our portfolio by adding exposure to higher risk small cap stocks. What then is a prudent investor to do? The answer, as it typically does, leads us back to valuations.

Taking a disciplined relative valuations-based approach, such as the one utilized at iCM, an investor may be better equipped to gauge the relationships across a global set of assets. In other words, this type of approach helps an investor to understand when one asset class appears expensive or cheap in relation to another. Using this data to tactically underweight expensive assets, while overweighting those that appear more attractively valued, can minimize the risk of falling prey to asset class bubbles.

We can apply this concept to our conversation about the expensive nature of the FAANG stocks, and large growth stocks in general. As we pointed out earlier, large cap growth stocks currently look expensive, in part due to the elevated valuations of just a handful of names. Using our valuations-based approach, we are able to identify this risk and allocate away from large cap growth stocks in favor of more attractively valued large cap value names. The same logic carries over to relationships outside of the U.S., where we have chosen to overweight attractively valued international developed and emerging markets equities, at the expense of a broadly overvalued U.S. equity market. Taking this positioning into account (i.e. underweight growth and underweight U.S. equities), we have effectively limited our portfolios' exposure to the so-called FAANG stocks to less than 2% versus a more than 10% weight in the S&P 500.

### **Conclusion**

As we do every quarter, we began Q1 2018's Market Insights letter with a quote. This quarter we chose to use one from Professor Robert Shiller, in which he eludes to the uncertainty of asset bubbles and the difficulty of knowing when one has reached its "final denouement". Throughout this quarter's letter, we speak to one such potential bubble that exists in today's market – the FAANG stocks. True to Professor Shiller's words, it is impossible to tell how far this

bubble can continue to inflate before inevitably bursting. At iCM, we believe that limiting exposure to such bubbles plays a key role in successfully achieving one's investment goals. We thrive to accomplish this by utilizing proper diversification and following a disciplined and time-tested investment strategy -- in particular, one that takes into account the fact that valuations matter. As always, we thank you for your trust and confidence.

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