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No: 63, July 2018

It's been FAANGtastic; but it might be time to cut down on the sweets

There are five technology companies in the USA that together are now worth more than the entire FTSE 100 Index; worth more than all the firms comprising Hong Kong's Hang Seng Index; and worth more than Germany's Dax and France's Cac 40 indices combined.

Not long ago, the mammoth tech companies that make up the FAANG stocks (Facebook, Apple, Amazon, Netflix, Google) were held up as bastions of corporate and social progress; producers of content that users wanted, providers of hugely popular (and now integral to society) 'free' services, innovators, disruptors. In 2017 there was even a feeling that Mark Zuckerberg, the tech pin up of the time, would run for president in 2020, and might win.

How things have changed

2018 has seen Mark Zuckerberg hauled in front of US Congress to explain Cambridge Analytica's access to the data of 50 million Facebook users. Google, now under the Alphabet umbrella, stands accused by the European Commission of stifling competition by ensuring its apps are preinstalled on Android devices and has been fined €4.3 billion.

Now tech behemoths that rely on monetising users' data for profit are at risk from those users becoming better informed about how their data is used, and governments feeling pressure to clamp down on these firms before they are too big to control, if they are not already.

But still the market loves them

Their valuations suggest that investors are expecting them to double or triple in size over the next ten years from their already huge base. Netflix, the current darling of the S&P 500 Index, has a valuation entirely based on the notion of prima facie profits; it has never earned a dollar, and yet was valued at more than Disney a few weeks ago!

While there is undoubtedly huge potential in the technology sector as a whole, investors seem to be ignoring some inherent risks, namely that the goodwill of governments and regulators is fast running out and, as the companies themselves are keen to point out so that they are not seen as too dominant, the disruptor that makes them redundant is just around the corner.

Have we been here before?

One would be forgiven for thinking that all large companies in the US enjoyed a decent first half of this year. However, when FAANG, which were up a combined 21% for the first six months of the year, are stripped out from the S&P 500, the index was actually down 0.3%. 'Regret Aversion' is a behavioural bias often associated with bubble formation, and in 1999 investors who feared that they were missing out largely drove the late surge in the market. In 2017 we saw the same herding behaviour contribute to Bitcoin's meteoric rise and subsequent fall. There is certainly an element of Regret Aversion driving current valuations of the FAANGs. Also, for those investors looking at fundamentals, for years the FAANGs have provided the growth that was lacking in the economy as a whole, and while growth was hard to come by investors were happy to pay a heavy premium for it.

However, whether one is predicting a pick-up in economic activity or a slowdown may be irrelevant to the fate of tech stocks in the near term; a pick-up in growth would lower the premium applied to future growth prospects of the FAANGs (when growth is less scarce people will pay less for it), while a slowdown would likely hit tech hardest with its stratospheric valuations and discretionary nature.

Is this the beginning of the end for the tech titans?

Almost certainly not; there are still opportunities in sectors yet to be conquered by tech, financial services and healthcare being the obvious ones. There is also no guarantee that attempts at regulation would be particularly successful considering how cross border the reliance on these companies is. An example of this is the US regulator asking for $14 billion from Deutsche Bank to settle claims of packaging and selling of risky mortgages, allegedly in retaliation for Apple's €13 billion backdated tax bill imposed by the EU in 2016.

By far and away the FAANG's biggest protection is society's addiction to them; addicts do not have to like or approve of their poison. However, there will likely be further teething issues (and better entry points) as regulators battle to ensure that these titans do not become bigger than those that seek to regulate them. We may not be as far away from the inflection point as some think.

What does this mean for investors?

The FAANG stocks currently account for 12% of the S&P 500 Index, so any passive investor is automatically weighting their US exposure heavily towards them. While this has been highly beneficial over the past few years, active managers' ability to seek opportunities elsewhere may well come into its own as the inevitable power struggle unfolds.

It has been an epic ride, but investors will have to see the dentist at some point.