Market insights

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Don't fear the FAANGs

Key highlights:

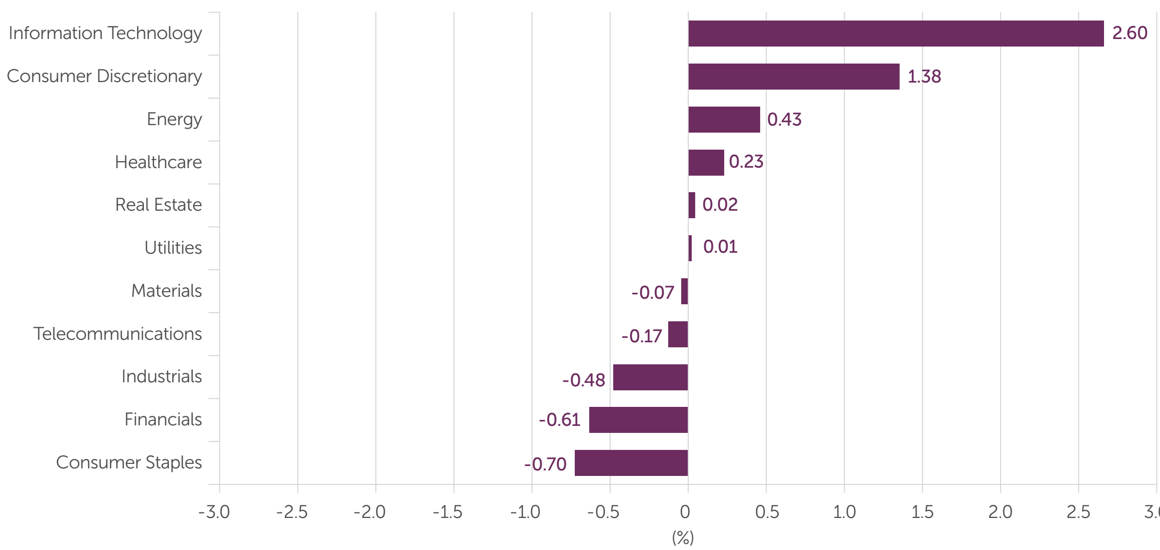
- Narrow market leadership, meaning that only a few stocks are contributing to returns in the broader equity market, has been a popular recent headline.
- To our way of thinking, narrow leadership is not necessarily an indicator of an overvalued market.

You may have noticed that recent headlines have been dominated by a few stocks that have been propelling financial markets higher. This dynamic is commonly referred to as "narrow leadership", meaning that only a handful of companies are contributing to returns in the broader market. Sometimes the outperformance of the few stocks is small, but other times it can be fairly significant. At its most extreme, when the outperformance is substantial and driven in large part by only a few names or even a single sector, the conventional market wisdom is that a stock market bubble may be forming or that a shift of some kind is about to occur (see *Exhibit 1*). While we don't think this is necessarily the case currently, we do think that narrow breadth may be indicative of a weaker market as we move forward in 2018.

IT dominating 2018 equity performance

Year-to-date as of 6/30/18, the S&P 500 Index had a total return of 2.65%.[1] The Information Technology sector, as shown in *Exhibit 1*, contributed 98% of the Index's performance for the first half of the year. As the chart illustrates, there has been a heavy tilt toward not only the Information Technology sector, but the Consumer Discretionary sector as well. These two areas have largely powered equity markets this year and when examined on an individual issuer level it becomes abundantly clear why.

Exhibit 1: Contribution by sector to S&P 500 total return



Source: Bloomberg, 6/30/18.

What's in a name?

Upon closer examination, the top contributors to S&P 500 Index performance for 2018 consists of five stocks, four of which form the majority of the so-called "FAANGs" and includes Facebook, Amazon, Apple and Netflix (see *Exhibit 2*).[2] Of the S&P 500 Index's total return through the second quarter, these companies, which fall into the Information Technology and Consumer Discretionary sectors, provided 2.36% of the 2.64%, or 89.4% of the Index's YTD performance.[3] At first glance, an investor may think that such domination

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may be a cause for alarm; however, large companies often form a significant portion of the Index weighting. In fact, since 1972, the average weight of the top five stocks has been 14.3%, while today it totals 12.0%, which may surprise some market observers.[4] This suggests to us that the current "dominance" of a small group of companies in driving index performance is not necessarily a cause for immediate concern.

Exhibit 2: FAANGs putting the bark into the market (S&P 500 Index Top 10 constituents as of 6/30/18)

	Avg Wgt (%)	Total YTD return	Contribution YTD
Amazon.com Inc	**2.6**	**45.35**	**0.91**
Microsoft Corp	3.13	16.31	0.47
Apple Inc	**3.88**	**10.25**	**0.42**
Netflix Inc	**0.57**	**103.91**	**0.37**
Facebook Inc	**1.86**	**10.12**	**0.19**
Mastercard Inc	0.72	30.23	0.18
Visa Inc	0.97	16.55	0.15
Adobe Systems Inc	0.47	39.13	0.15
Cisco Systems Inc	0.9	14.09	0.15
Nvidia Corp	0.62	22.58	0.12

Source: Bloomberg, 6/30/18.

What does this mean for investors?

Although, clearly, market leadership in the stock market is quite narrow, we don't think equities are necessarily at a tipping point but rather are suffering from a fairly common symptom. There is a certain amount of inevitability to a limited number of companies leading the thundering herd, as momentum can be a powerful impetus for such trends. Beyond single issuers like the FAANGs, single sectors can also drive the equities and may lead to outperformance from other companies. In fact, sector leadership may be rotating in the market at this time, which would allow the bull market to continue. When talking heads start to focus on a particular market theme, we think it's best to dive into the data and determine if there really is something different about a market.

[1] Source: Bloomberg, 6/30/18.
[2] Microsoft is not a member of the FAANGs; however, Google is and has rebranded itself as Alphabet.
[3] Source: Bloomberg, 6/30/18.
[4] Source: Ned Davis Research, 7/24/18.

Disclosure

The **S&P 500 Index** in an unmanaged capitalization-weighted index of 500 stocks designed to measure the performance of the broad domestic economy through changes in the aggregate market value of such stocks, which represent all major industries. Return data is available daily. It is not possible to invest directly in an index.