FAANG Investors Running a High Risk of Being Bitten.

The U.S. equity boom is getting long in the tooth and has lately been driven by the so-called 'FAANG' portfolio of Facebook, Amazon, Apple, Netflix and Google Alphabet. This has gained over 120% since the beginning of 2017—up almost 30%in the past 3 months. We expect to see a correction that will wipe out at least the past two years of gains in that investment.

Back to the Dot Com days?

With the continuing rally in tech stocks the imbalance between tech and the rest of the US large cap companies has surpassed the dot-com levels at a time that investments in the FAANG portfolio has been listed by Bank of America as the world's most crowded trade for the fourth month in a row[1].

The apparent complacency of FAANG investors has recently led to warnings that this overcrowding will be costly. Last week Howard Marks pointed out that "Things that are most hyped…produce the most pain." and pointed out that the rise of ETFs has compounded the problem by the use of a common momentum factor[2]. As always, 'passive' investment during market booms is very attractive until the inevitable correction arrives.

Unstable Expansions Always Signal Overheating

Omega Analysis' risk measurement technology reveals predictable Risk Cycles that are leading indicators of asset price booms and busts. Unstable Expansions–unsustainable asset price increases–signal overheating and predict the correction level which will result.

In the case of an equal weight portfolio of FAANG stocks this signal has been flashing red since 2016. The magnitude of the correction which it predicts has been growing since then. It will be enough to wipe out at least the past two years of gains.

Drawdown risk is high and growing

After stumbling badly in February and March of this year, the S&P 500 Index has not yet managed to regain its all time high. This is in spite of the tremendous surge in the FAANG stocks without which the Index return would have been negative[3].

Omega Metrics® Value at Risk (VaR) and Expected Shortfall (ES) estimates have proved accurate in measuring drawdown risk across asset classes and in particular for the FAANG portfolio. When its value dropped by almost 13% in March, most of that in a single week,the loss was merely a 99% VaR breach—something investors should be ready for.

The risk of large 5-day drawdowns is high and growing as the tails of the returns distribution fatten. A 5-day loss of more than 10% in the FAANG portfolio hasn't happened since February 2016. Our tail analysis now shows that it should be expected once every 9 months.

The average loss should such an event occur is more than 15% which would be a repeat of the worst week for FAANGs in August 2015. The same tail analysis puts the frequency of a repeat of that event at once in 2.4 years— so a large shock may be imminent.

If that happens the rush for the exits will be painful indeed.

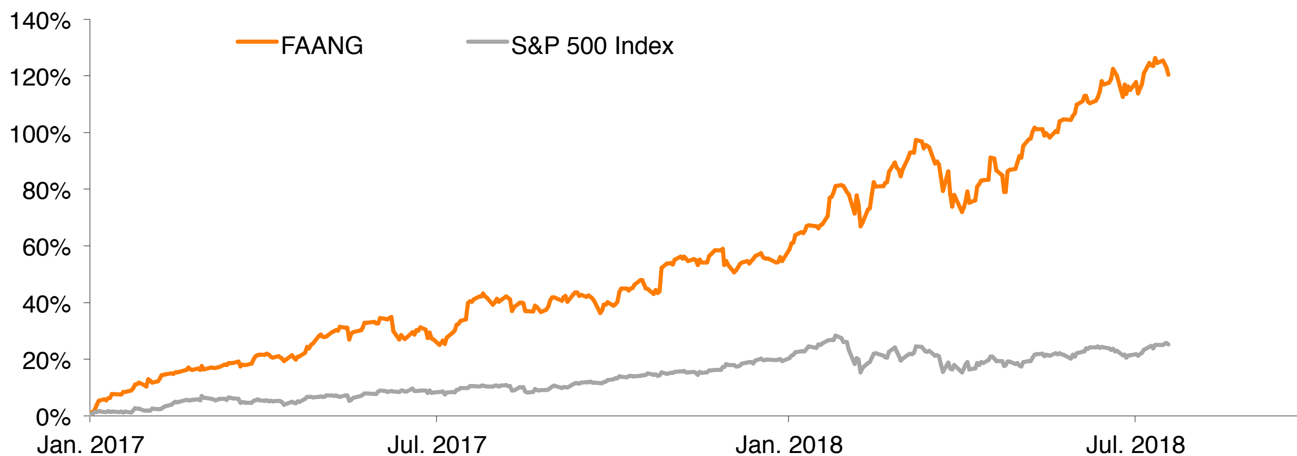

Figure 1. FAANG NAV against S&P 500 Index in % from January 2017.

[1] https://www.bloomberg.com/news/articles/2018-06-08/hedges-get-a-test-as-300-billion-faang-surge-lives-another-week
[2] https://www.cnbc.com/2018/07/17/billionaire-howard-marks.html
[3] https://www.zerohedge.com/news/2018-07-20/why-one-analyst-thinks-its-time-sell-faangs

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