The Warnings Were There About FAANG Stocks
by Larry Swedroe, 9/12/22

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The spectacular underperformance of the FAANGs this year came as no surprise to investors familiar with the history of growth stock bubbles. As happened in the lead up to the dot com and Nifty 50 bubbles, P/E ratios increased without any material justification.

As we age, our long-term memory skills tend to remain strong, while our short-term memory skills erode. Unfortunately, individuals don’t benefit from that tendency when it comes to investing. It is an all-too-human failing for investors to fall prey to “recency bias” – the tendency to give too much weight to recent experience, believe that “this time it’s different,” and there is a “new normal.” That leads to ignoring long-term historical evidence, which many investors are sadly unaware of. Recency bias and the lack of historical knowledge lead to the mistakes of both overconfidence and treating the unlikely as impossible.

I was reminded of this problem when I read about the recent 2022 reclassification of stocks by Russell in which it reclassified Meta (formerly Facebook, the “F” in FAANG) and Netflix (the “N”) from growth to value. The FAANG stocks (those two comprising 40%) have typically been the poster children for the view that innovative, disruptive, high-tech growth stocks would outperform value stocks because of the “new normal.” That is despite more than 90 years of evidence demonstrating that value stocks have
outperformed growth stocks – from July 1926 through July 2022, the Fama-French U.S. value research index returned 12.8% versus 9.9% for the Fama-French U.S. growth research index.

Of course, there is nothing new about the recent case of the “new normal.” Those who knew their history had “been there and done that” in the late 1990s (the dot-com era), in the 1960s (with the Nifty Fifty, which included such innovative disrupters as IBM, Digital Equipment, Texas Instruments, Xerox, Polaroid and Kodak) and in the 1920s (when RCA, General Electric and General Motors were among the innovative disrupters).

The FAANGs (Apple, Amazon and Google are the other three) returned 28.0% per year from 2012 to 2021, dwarfing the performance of the Russell 3000 Index, which returned 16.3% per year. At the end of 2011, while Apple had the second largest market cap and Google (now Alphabet) had the eighth, Amazon was ranked 33rd, and neither Facebook nor Netflix were ranked in the top 50. By the end of 2021, Apple was the largest, Amazon was the third largest, Alphabet Class A and C shares were the fifth and sixth largest, and Meta Platforms was the ninth largest.

Thanks to the research team at Dimensional, one can see how stocks have historically performed before they became one of the 10 largest by market cap and compare that to how they performed after joining that list. The data covers the period 1927-2021. In the five and 10 years before joining the top 10, stocks that entered that list outperformed the market by 10.0% and 19.3%, respectively. However, in the five and 10 years after joining the list, they went on to underperform by 1.1% and 1.5%, respectively.

That is a warning about recency bias.

The future underperformance of the companies that became the largest stocks is what investors should expect: If growth firms such as the FAANGs are superior, all else equal, the greater certainty about their future success should be associated with lower expected
returns, as their expected future cash flows should be discounted at a lower level (investors require a lower risk premium). Investors should be careful about equating expected company success with expected stock returns.

**The end of the new normal**

Over the period January 2017 through October 2020, the Fama-French U.S. growth research index outperformed the Fama-French U.S. value research index by 20.7% per annum (20.2% versus -0.5%). Before investors jumped to the conclusion that this was the new normal, they should have asked what the source of that outperformance was: Was it superior earnings, perhaps justifying that view? Unfortunately, Robert Arnott, Campbell Harvey, Vitali Kalesnik and Juhani Linnainmaa, authors of the study, “Reports of Value’s Death May Be Greatly Exaggerated,” found that virtually all the outperformance of growth stocks over value stocks as far back as 2007 was due to a widening of the valuation spread (the P/E ratio increased). They also found that there was little difference in overall profitability of growth and value, as the average return on equity difference was almost the same before and after 2007: -11% versus -12%. In other words, the outperformance of growth was a repeat of the 1990s – there was no new normal or one would have seen a widening in profitability.

Signs of the end of the new normal in which growth stocks outperformed by wide margins began to appear in November 2020. From then through July 2022, the Fama-French U.S. value research index outperformed the Fama-French U.S. growth research index by 26.2 percentage points per annum (37.3% versus 11.1%).

The year-to-date returns of the FAANGs through August 31, 2022, were Meta, -51.6%; Apple, -11.1%; Amazon, -24.0%; Netflix, -62.9%; and Alphabet (Google), -24.6%. Equal weighting the five stocks results in a portfolio return of -34.8%, almost three times the loss of the Russell 2000 Value ETF (IWN), which was down 12.2%.
Finally, despite value’s strong outperformance since November 2020, the valuation spread between value and growth remained at about the 98th percentile. That’s good news for value investors, as the research, including the 2007 study, “Does Predicting the Value Premium Earn Abnormal Returns?” the 2018 study, “Value Timing: Risk and Return Across Asset Classes,” and the 2019 study, “Strategies Can Be Expensive Too! The Value Spread and Asset Allocation in Global Equity Markets,” all found that the spread is positively correlated with the future value premium.

![Global Value Spreads](https://www.advisorperspectives.com/articles/2022/09/12/the-warnings-were-there-about-faang-stocks)

**Investor takeaways**

Critics of value investing have more than once declared the death of value. However, financial theory (based on discount rates) and the empirical analysis demonstrating that value's major drawdowns have resulted not from earnings underperformance of value companies but from the relative increase in the valuations of growth stocks suggest otherwise.
The reversal in value’s fortunes that began in November 2020, along with the reversal in fortune for the FAANGs, serves as a reminder that investors should avoid being subject to recency bias, avoid getting caught up in the herd mentality, and be cautious when assuming past returns will continue in the future. Investors should avoid investing based on social media, as the research, including the 2021 paper, “The Rise of Reddit: How Social Media Affects Retail Investors and Short-sellers’ Roles in Price Discovery,” has found that social media activity and retail flows cultivate price bubbles, while the short-sellers correct them.

While FAANG stock performance in recent years reflected those companies achieving financial success that exceeded investor expectations, one cannot buy yesterday’s returns, only tomorrow’s. And there is certainly no guarantee that these companies can sustain their success. As history demonstrates, they too can be disrupted (e.g., the Nifty Fifty stocks such as Xerox, Kodak, Polaroid and Digital Equipment). And even if they do continue to be highly successful, that doesn’t mean the success will translate to spectacular future returns because of already-high expectations. As Dimensional noted: “It is somewhat ironic that 40% of the pillars [Meta and Netflix] supporting an aversion to value investing have now become value stocks themselves.”

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