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Market Insights from Mitch Zacks

Zacks INVESTMENT MANAGEMENT

Are FAANG Stocks a Bubble Waiting to Burst?

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Recently, technology stocks have experienced greater downside volatility than the market (S&P 500). In the last three months, ending 11/16/18, the S&P declined -4.44% while the NASDAQ fell nearly twice that (7.19%).[1]

These relative declines have investors worried that tech stocks are overvalued and could add a layer of vulnerability to the broader market. But, I'm not convinced just yet that technology stocks, in aggregate, are overvalued or in bubble territory. Often, I think, investors conflate valuations of companies like Facebook, Amazon, Netflix (FAANG stocks) with the broader technology sector. But, doing so doesn't paint a full picture.

If one's portfolio is concentrated in a few companies like those mentioned, I'd agree that one might reconsider positioning now. But, if broadly invested in technology, I wouldn't be so worried. Here are 4 reasons why.

Tech Valuations are Average Relative to History

As of Q3, the Tech sector was trading at roughly 29x earnings, which is pretty close to in-line with the long-term average of 28x.[2] During the Tech Bubble (late 90s into 2000), valuations approached 70x with several companies trading well above 100x earnings. Those types of companies currently exist, but they're well-respected businesses and are not as common.[3]

Tech Valuations are Reasonable Relative to the S&P 500

During the late 90's, in the run-up to the tech bubble bursting, the Tech sector traded at between a 1.5–2x premium to the S&P 500. Currently, it's closer to 1–1.25x.[4]

Tech Still Profitable and Balance Sheets Provide Flexibility

Tech companies achieved nearly a 90% earnings beat rate in the second quarter, and it seems likely to eclipse 90% in Q3.[5] Balance sheets are largely in good shape across the board as well, with large cash balances and relatively low debt. This gives tech companies cushion and flexibility as macroeconomic conditions change. They could choose to increase capital expenditures, become more aggressive in pursuing mergers and acquisitions or even increase dividend payments and share buybacks.[6]

Ongoing Innovation

It's difficult to fathom that Facebook was founded less than 15 years ago and is now valued at ~$400 billion.[7] A similar story applies to Google, Facebook, Netflix, and others. We're continually seeing innovation in the technology sector, and I'm not sure it would be wise to bet this stops any time soon. Technology is likely to bring new efficiencies, new products, and new companies. But, this stream of innovation also means investors must be vigilant when choosing companies—and always aware of the competition.

Bottom Line for Your Clients

Tech stocks have been disproportionately affected during recent downside volatility, but it's important to put these steeper drops in perspective. Through Friday, November 16, the NASDAQ was still better off for the year than the S&P 500, having risen 2.74%, versus the S&P 500's 0.63% gain.[8]

I would also add that, often, the areas of the market that are hurt the most during downdrafts also tend to bounce back the strongest when the market recovers – an outcome I would expect this time around as well.

Mitch

1 Google Finance, November 16, 2018.

2 CSI Market, November 16, 2018. https://csimarket.com/Industry/Industry_Valuation.php?s=1000

3 BlackRock, June 13, 2018, https://www.blackrockblog.com/2018/06/13/tech-bubble-fears/

4 BlackRock, June 13, 2018, https://www.blackrockblog.com/2018/06/13/tech-bubble-fears/

5 FactSet, November 16, 2018, https://www.factset.com/hubfs/Resources%20Section/Research%20Desk/Earnings%20Insight/EarningsInsight_111618.pdf

6 Charles Schwab, November 16, 2018. https://www.schwab.com/resource-center/insights/content/information-technology-sector

7 Google Finance, November 16, 2018.

8 Google Finance, November 16, 2018.