Pensions&Investments

INDUSTRY VOICES

Commentary: Concentrated market risk makes the case to question your 'FAANG' exposures

BY YVES CHOUEIFATY · AUGUST 13, 2018 12:00 PM

Market indexes weighted according to capitalization can take on heavy structural biases that evolve over time, because they accord greater representation to stocks as they have appreciated and less as they have declined. This bias carries danger for investors at the best of times, and almost never more so than now.

Looking at the sector allocation of the MSCI USA index, 26% is allocated to information technology and 14% to financials. Two of the 11 sectors account for more than 40% of the index, as measured by weight. By construction, market-cap-weighted indexes bet on past successes, and the strong performance over the past few years of IT and financials has driven up their weights in the MSCI USA.

Most interestingly, looking at the main performance contributors of the MSCI USA over the six months through June, (Figure 1) shows the concentration of performers and the role of the so-called FAANG stocks — Facebook, Amazon, Apple, Netflix, Google (i.e., Alphabet) — in

the U.S. equity market. Nine out of 10 are IT stocks, while the remaining stock, Amazon, officially being consumer discretionary, has a market behavior similar to an IT stock.

Figure 1 Top 10 performance contributors, December 2017 to June 2018

Company	Total return	Market cap weight	Percentage of MSCI U.S. return	Sector
Amazon.com	45%	2.5%	45%	Consumer discretionary
Microsoft	16%	2.8%	18%	Information technology
Apple	10%	3.7%	15%	Information technology
Netflix	104%	0.5%	22%	Information technology
Facebook - A	10%	1.8%	7%	Information technology
Alphabet - Class C	7%	1.4%	4%	Information technology
Alphabet - Class A	7%	1.3%	4%	Information technology
Mastercard - A	30%	0.7%	8%	Information technology
Visa - Class A shares	17%	0.9%	6%	Information technology
Adobe Systems	39%	0.4%	7%	Information technology
NVIDIA	23%	0.6%	5%	Information technology
Top 10 contributors	**21%**	**16.8%**		
MSCI USA	**3%**	**100.0%**		

This trend isn't just a recent observation. Looking at a longer period, in the two years through May 31 the weighting of IT in the index surged 32%. Anyone buying into the index, in effect, is betting that this outperformance is set to continue and that these megacap stocks will continue to dominate the top rankings.

'Passive' is not the same as 'neutral'

History, however, teaches that such concentrations eventually are corrected, as happened memorably at the start of this century, when it seemed that high-tech stocks riding the dot-com boom would appreciate indefinitely. On the day before they began their dizzying fall, these stocks represented nearly 35% of the capitalization of the S&P 500 index.

By the end of 2002, the figure shrank to 15%.

Many investors seem to believe that being "passive" is the same thing as being "neutral." It really isn't. A neutral approach to investment would involve a level of diversification that indexes, as per their construction methodology, do not offer today.

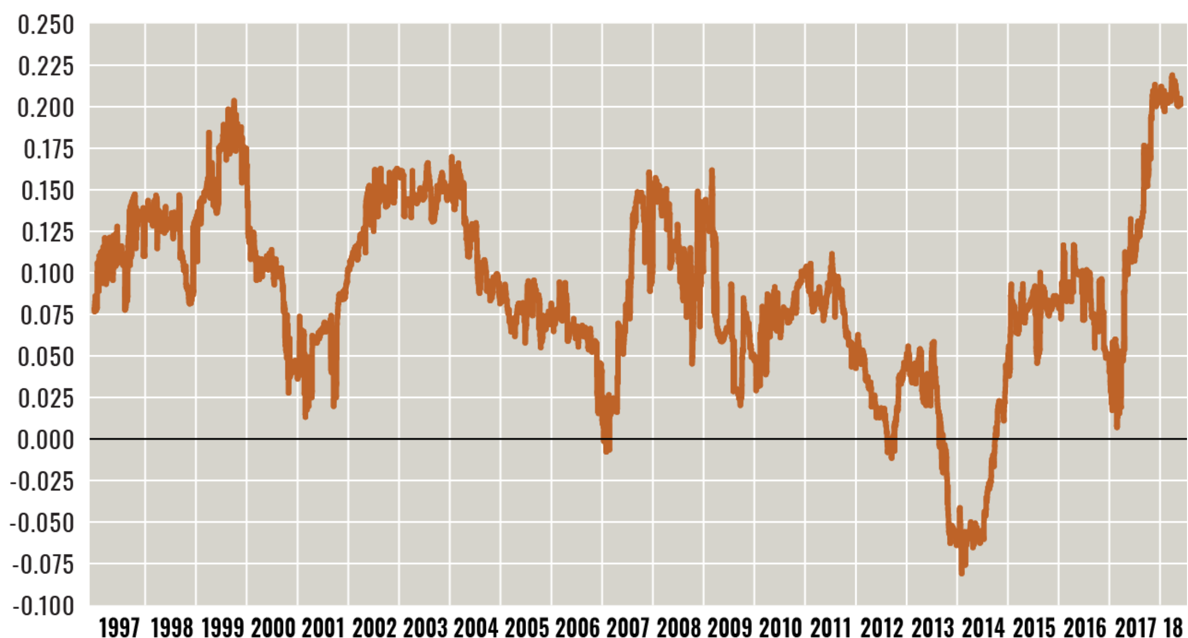
Indexes capture the past, not the future

Pairwise correlation compares stocks in every possible pairing to measure the extent to which they are related or correlated on average. Figure 2 plots the pairwise correlation of the top 10 stocks of the MSCI USA relative to all other stocks. It illustrates that these particular stocks are closer to each other than they have ever been in the past 20 years, according to this measure. Note that a similar level was reached during the 2000 internet bubble.

As such, the MSCI USA is today concentrated into few assets, which furthermore exhibit an increased correlation relative to other stocks.

Figure 2 Difference in behavior between the Top 10 stocks in the MSCI USA & the entire MSCI USA index

Measured by the difference between "Top10" and "All Universe" pair-wise correlation



Source: TOBAM and MSCI. Data from May 1997 to May 2018.

The pair-wise correlation is a measure of the 1-year rolling correlation between any two stocks of the universe.

The figure above plots for each date the difference in the average of all the pair-wise correlations for each respective universe (top 10 minus MSCI USA).

The structural bias of indexes toward larger companies poses clear challenges for passive investing. But active investment management is no guarantee that concentration risk can be avoided. Active management pursued in a "benchmark aware" manner can replicate, sometimes involuntarily, the biases seen in passive investment.

Capturing the past, however, is not the only option. Investors have an opportunity to take a proactive approach to plan for the future by avoiding the concentration trap of the market-cap-weighted methodology. Investors might look at the current environment, question the "FAANGization" of their core portfolios, and decide if they agree with such a strong bias or if they are looking for a more risk-neutral approach to investing in U.S. equities.

Decision time for U.S. equity investors

The current U.S. equity market environment calls for investors to dissect their allocations, risk exposures and potential duplicated exposures. Risk concentrations are a source of concern, as history has demonstrated that excessive concentrations are eventually corrected. Risk concentrations challenge the most fundamental rule of portfolio management: diversification. Some investors, without any strong view on the market, looking for a core exposure to equities, tend to invest in market-cap-weighted indexes (i.e., passive management) with the incorrect perception that this will deliver a neutral allocation. But because market cap weighted benchmarks, by construction, can take on heavy structural biases, that is not the case — particularly in the current market environment.

If investors are strong FAANG believers and assume that largely allocated sectors such as IT will continue to outperform the index with these market bets compounding and continuing to outperform all other sectors, then a passive market capitalization strategy will suffice.

However, for investors concerned about overexposure to certain stocks or sectors associated with passive investing that have no views on the future or forecasting capabilities, a diversified approach is the best option.

This could be achieved through maximizing diversification, aiming to gain exposure to each available independent source of risk within the index, to collect the full risk premium of the equity market.

Yves Choueifaty is president and chief investment officer of TOBAM, Paris. This content represents the views of the author. It was submitted and edited under P&I guidelines but is not a product of P&I's editorial team.