

Will unfriended Facebook “De-FAANG” the stock market?

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Facebook is one of the five “FAANG” stocks (along with Apple, Amazon, Netflix and Google’s parent company, Alphabet) whose market capitalizations (i.e. number of shares outstanding multiplied by stock price) and valuations soared to stratospheric levels on the promise of certain growth, regardless of the state of the economy, interest rates, tariffs or other factors impacting “mere mortals” of corporate America.

On July 25, Facebook shares (NYSE-FB) touched a record high of \$218.62, as investors eagerly anticipated yet another stellar earnings announcement from the company after the market close. Owners were blindsided and “unfriended” the stock in droves after Facebook posted disappointing results for second-quarter revenue, growth in “daily active users” and profits.

Additionally, management reduced expectations for near-term revenue growth (i.e. slowing growth in users and users less willing to share personal information, which negatively impacts FB’s ability to sell targeted ads) and warned a surge in spending for beefed-up security (i.e. Russian election interference), privacy protection (i.e. Cambridge Analytica personal data scandal) and new product launches would negatively impact profitability for the next several years.

The reaction was swift and severe. Facebook dropped 19% the following day, erasing \$119 **billion** of market capitalization, the biggest-ever one-day drop for a U.S. public company. To put this loss in perspective, \$119 billion is:

- Larger than the market capitalization of 457 of the stocks comprising the S&P 500
- Just under the **combined** market capitalization of the **entire** U.S. commercial airline industry (Delta (\$37B) + Southwest (\$34B) + United Continental (\$22B) + American (\$18B) + Alaska (\$7B) + JetBlue (\$5B)).
- About 60% of the total amount of inflation-adjusted market capitalization **lost by the entire U.S. stock market** on “Black Tuesday” (October 29, 1929--\$200B).

The reason this is important is the FAANGs have become “one-decision stocks,” stocks you should buy, no matter how expensive, and hold forever. Indeed, according to Bespoke Investment Group, in 2017 the FAANGs all soared 30% or more and added \$851 billion in market capitalization. This stellar performance continued in the first half of 2018, as the five FAANGs boosted their market capitalization by \$523 billion, while the other 995 stocks in the Russell 1000 large-cap index added just \$183 billion.

According to Goldman Sachs, just 10 stocks accounted for more than 100% of the S&P 500’s 3% return for the first half of 2018, with the five FAANGs contributing 81% of the total. Amazon rose 45% and alone accounted for 36% of the S&P 500’s return. Apple gained 10% and contributed 15%, Netflix jumped 106% and contributed 15%, Facebook rose 11% and contributed 8% and Alphabet increased 7% and contributed 7%.

As shown in the table below from Hartford Funds, as result of their jumbo-sized performance, the valuation of the FAANGs (as measured by their price/earnings ratios) are also much richer than the S&P 500’s.

	2012	2013	2014	2015	2016	2017	2018
% FAANG Weighting in S&P 500	6.2	6.5	6.9	8.9	8.8	10.8	12.6
FAANG P/E Ratio	82.8	65.1	89.2	100.0	48.0	53.9	49.4
Average S&P 500 P/E Ratio	12.3	13.7	15.2	16.2	16.4	17.6	16.1

The FAANGs have been priced for perfection, as if their business models and execution will be infallible. Just like during the technology bubble of the late 1990s, the valuation of the FAANGs don't make sense to us. Also like then, I can attest not owning them has made for a long, lonely walk through the performance desert.

The "Nifty-Fifty" large-cap growth stocks were also "one-decision" market darlings in the late 1960s and early 1970s, but eventually crashed. The second, third and fourth largest one-day drops were Intel (\$90.7B) and Microsoft (\$80.0B and \$64.1B), all coincidentally during the bursting of the technology bubble in 2000.

Nobody can say if Facebook's stumble will prove to be a temporary blip or the proverbial "canary in the coal mine" for the FAANGs. Price and valuation always eventually matter. As Mark Twain said, "history doesn't repeat itself, but it does rhyme."

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