Mitch on the Markets

How FAANG Stocks Put the Diversified Portfolio in Danger

By Mitch Zacks
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Most readers know the return metrics surrounding the “FAANG” stocks, namely that these five companies (Facebook, Apple, Amazon, Netflix, Google) have widely outperformed the S&P 500 and pretty much every other category or index during this bull market. There have been a few periods where the S&P 500 may have been negative had it not been for the FAANG stocks carrying so much weight.[1]

For many investors, a natural response to this information is the desire to get in on the action. My guess is that investors routinely ask advisors how many shares of the FAANG stocks they own, and whether it might make sense to own more. **That’s what worries me.**

We see this type of behavior often when it comes to investing, but we tend to see it more around market tops or when there is an exaggerated amount of hype for a category or specific security. In the late 1990’s, just about everyone was pining for the dotcoms. Just last year, it was bitcoin driving investors mad. Neither turned out to be a sound investment, as far as we can tell.

In this week’s column, we’re picking on the FAANGs not because we necessarily think they are in a bubble, but because these stocks seem to be having an effect on investors where the allure of high double-digit returns is outweighing the desire for long-term, risk-adjusted returns. It becomes a constant battle of, “why settle for boring, diversified portfolio returns when I can just load into these FAANG stocks instead?”

And, in my view, therein lies the danger to diversification. Whether it’s FAANG stocks, cryptocurrencies, junk bonds, gold, or whatever other ‘hot’ security is all the hype, investors are often tempted to abandon a long-term plan in favor of the possibility of big short-term gains.

With FAANG and technology stocks being such big leaders of late in this bull market, it may *feel* like broad diversification is coming at a cost. It’s almost as though prudent investors are being advised to watch the party from the sidelines.

It follows that investors start to get return envy, and then they begin to analyze their portfolios for weak holdings, wondering why they're invested in laggard stocks instead of the FAANGs. For some investors, this performance weakness becomes an issue that needs to be addressed or fixed, instead of being seen as an issue of *correlation,* where assets are held with the intent of being distinctive and differentiated. This element of diversification that is designed to 'smooth' out returns over time, instead becomes a feature that can hold back an investor back.

In my view, what happens next is the ultimate danger to diversification: rather than believing that prudent diversification is crucially important to achieving risk-adjusted returns in line with their long-term goals, they see diversification as inhibitive to their ability to keep pace with the rapid ascent of the hottest security on the market, whether it be tech stocks or FAANGs or gold or whatever else. When an investor reaches this point, the risk of making an error is about as high as it gets, in my view.

Bottom Line for Investors

The idea of diversification is to create a portfolio designed to address an investor's long-term return needs through a range of potential outcomes. Diversification is also rooted in the historical wisdom of owning non-correlated assets so that return streams vary and are often the opposite of other assets in the portfolio. This approach has been a time-tested method for 'smoothing out' returns over time.

The temptation to shift a portfolio into concentrated positions (like FAANGs) is both common and difficult to resist. But, just remember that portfolio holdings moving in 'unison' all of the time – even if it's with big returns – might actually be a sign of weakness, not success.

About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

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[1] Zacks Investment Research, May 8, 2018, https://www.zacks.com/stock/news/302708/heres-why-faang-stocks-are-still-undisputed-market-leaders

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