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# How Markets Work and the FAANG Mentality

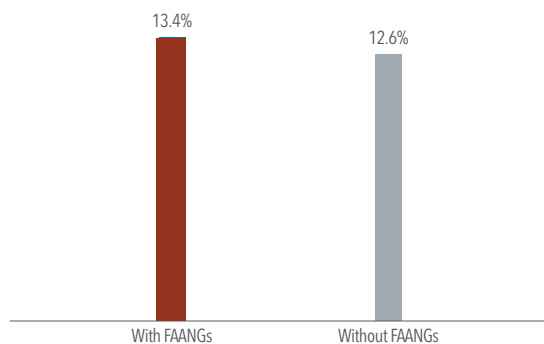
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The stocks commonly referred to by the FAANG moniker—Facebook, Amazon, Apple, Netflix, and Google (now trading as Alphabet)—have posted impressive gains through the years, with all now worth many times their initial-public-offering prices. The notion of FAANG stocks as a powerful group holding sway over the markets has sunk its teeth into some investors. But how much of the market's recent returns are attributable to FAANG stocks? And does their performance point to a change in the markets?

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## Exhibit 1: A Little Help from the FAANGs

Annualized US market compound returns with and without Facebook, Amazon, Apple, Netflix, and Alphabet (Google), 2009–2018



Source: Dimensional using data from the Center for Research in Security Prices (CRSP) covering the 10 calendar years since the financial crisis. With FAANGs portfolio formed each month including common stocks listed on NYSE, NYSE MKT, and NASDAQ. Stocks are weighted by market capitalization. Without FAANGs formed similarly but excluding Facebook, Apple, Amazon, Netflix, and Alphabet (Google). **Past performance is no guarantee of future results.**

Research has shown no reliable way to predict the top-performing stocks, arguing for diversification instead.

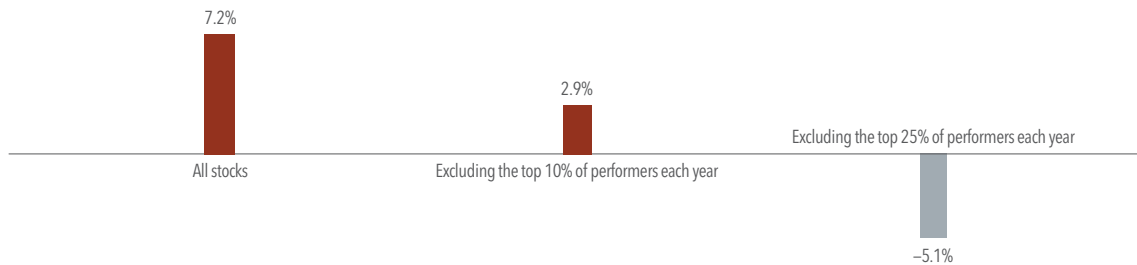
Over the 10 years through December 31, 2018, the US broad market<sup>1</sup> returned an annualized 13.4%, as shown in Exhibit 1. Excluding FAANG stocks, the market returned 12.6%. The 0.8-percentage-point bump resulted from the FAANGs collectively averaging a 30.4% yearly return over the decade.

Investors may be surprised to learn that it is actually common for a subset of stocks to drive a sizable portion of the overall market return. Exhibit 2 shows that excluding the top 10% of performers each year from 1994<sup>2</sup> to 2018<sup>3</sup> would have reduced global market performance from 7.2% to 2.9%. Further excluding the best 25% of performers would have turned a positive return into a relatively large negative return.

This lesson also applies to capturing the premiums associated with a company's size and its price-to-book ratio. Research by Eugene Fama and Kenneth French ("*Migration*," 2006) provides evidence that these premiums are driven in large part by a subset of stocks migrating across the market.

## Exhibit 2: Weighing the Impact

Global stock market performance excluding top performers, 1994–2018



*“All stocks” includes all eligible stocks in all eligible developed and emerging markets at their market cap weights. Eligible stocks are required to meet a minimum market capitalization requirement. REITs and investment companies are excluded. Compound average annual returns are computed as the compound returns of the value-weighted averages of the annual returns of the included securities. “Excluding the top 10%” and “Excluding the top 25%” are constructed similarly but exclude the respective percentages of stocks with the highest annual returns by security count each year. Individual security data are obtained from Bloomberg, London Share Price Database, and Centre for Research in Finance. The eligible countries are: Australia, Austria, Belgium, Brazil, Canada, Chile, China, Colombia, Czech Republic, Denmark, Egypt, Finland, France, Germany, Greece, Hong Kong, Hungary, India, Indonesia, Ireland, Israel, Italy, Japan, Republic of Korea, Malaysia, Mexico, Netherlands, New Zealand, Norway, Peru, Philippines, Poland, Portugal, Russia, Singapore, South Africa, Spain, Sweden, Switzerland, Taiwan, Thailand, Turkey, the UK, and US. **Diversification does not eliminate the risk of market loss. Past performance is no guarantee of future results.***

Research has shown no reliable way to predict the top-performing stocks. Looking at the top 10% of stocks by performance each year since 1994, on average less than a fifth of that group has ranked in the top 10% the following year.

The tendency for strong market performance to be concentrated in a subset of stocks is therefore also a

cautionary tale about the importance of diversification—investors with concentrated portfolios may actually miss out on the very stocks that deliver the best of what the market has to offer. An investment approach built around broad diversification can help achieve a more reliable outcome for investors over the long term—sharp acronym or not.

1. With-FAANGs portfolio formed each month including common stocks listed on NYSE, NYSE MKT, and NASDAQ. Stocks are weighted by market capitalization. Without-FAANGs formed similarly but excluding Facebook, Apple, Amazon, Netflix, and Alphabet (Google). Source: Dimensional using data from CRSP.
2. The onset of broad coverage of all-cap stock data across developed and emerging markets.
3. All eligible common stocks in all eligible developed and emerging markets, ranked by total return. Source: Dimensional, using data from Bloomberg LP.

There is no guarantee investment strategies will be successful. Investing involves risks, including possible loss of principal. Investors should talk to their financial advisor prior to making any investment decision. There is always the risk that an investor may lose money. A long-term investment approach cannot guarantee a profit.

Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio.

Past performance is not a guarantee of future results. Diversification does not eliminate the risk of market loss.

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