Special Report Watch Out for FANG

This is a Special Report to alert investors of one of the dangers of this market: FANG (Facebook, Apple, Netflix, Google, sometimes Microsoft is included in the FANG group). The FANG trade is very crowded, expensive. The problems could include increased risk, liquidity if investors get out at the same time, reduced performance going forward.

I’ve written about how the market is dominated by 401k investors and financial planners. Both participants tend to buy and hold, (financial planners will make allocation adjustments from time to time) and they don’t put much weight on valuations. Diversification, a good strategy to use to reduce risk by not putting all your eggs in one basket, is the main objective of 401ks and financial planners.

These two participants tend to invest in index ETFs and mutual funds. 401k investors add to these funds every paycheck. When a financial planner gets a new client, there is a good chance that the client's assets will be invested in these indexes, funds. There are trillions of dollars in these indexes. Below are the top ETFs, mutual funds by assets under management:

Symbol	Name	AUM					
SPY	SPDR S&P 500 ETF Trust	$375,404,000,000			VINIX	Vanguard Institutional Index	$287,000,000,000
IVV	iShares Core S&P 500 ETF	$290,658,000,000			VGTSX	Vanguard Total Intl Stock Mkt Idx Investor	$404,700,000,000
VTI	Vanguard Total Stock Market ETF	$1,261,000,000,000			FCNTX	Fidelity Contrafund	$142,430,000,000
VOO	Vanguard S&P 500 ETF	$753,000,000,000			AGTHX	American Funds Grth Fund of Amer A	$278,460,000,000
QQQ	Invesco QQQ Trust	$177,487,000,000			AIVSX	American Funds Invmt Co of Amer A	$ 117,130,000,000
TOTAL		$2,857,549,000,000					$1,229,720,000,000
TOTAL ASSETS IN TOP ETFS MUTUL FUNDS							$4,087,269,000,000.00

Source: Dan Hassey database

There are about $4 trillion in these top ETFs and mutual funds. Below is a list of the top holdings of the Vanguard Total Stock Market ETF, symbol VTI:

Top 10 Holdings (22.33% of Total Assets)

Get Quotes for Top Holdings

Name	Symbol	% Assets
Apple Inc	AAPL	4.90%
Microsoft Corp	MSFT	4.60%
Amazon.com Inc	AMZN	3.33%
Facebook Inc Class A	FB	1.88%
Alphabet Inc Class A	GOOGL	1.66%
Alphabet Inc Class C	GOOG	1.56%
Tesla Inc	TSLA	1.18%
Berkshire Hathaway Inc Class B	BRK.B	1.09%
NVIDIA Corp	NVDA	1.07%
JPMorgan Chase & Co	JPM	1.06%

Source: Yahoo Finance

The top holdings are FANG STOCKS. The holdings of the other large ETFs, mutual funds listed on the first page are very similar to the Vanguard Total Stock Market ETF.

Below are the holdings of the mutual fund, Fidelity Contrafund:

Current Portfolio Date	Equity Holdings	Bond Holding:
May 31, 2021	325	0

Holdings	% Portfolio Weight	First Bought
Facebook Inc A	9.99	Apr 30, 2012
Amazon.com Inc	8.29	Jun 30, 2007
Berkshire Hathaway Inc Class A	6.03	Dec 31, 2002
Microsoft Corp	5.25	Oct 31, 2013
UnitedHealth Group Inc	3.24	Jun 30, 2010
Apple Inc	3.01	Jun 30, 2003
Alphabet Inc A	2.88	Sep 30, 2004
Salesforce.com Inc	2.79	Jun 30, 2005
Alphabet Inc Class C	2.73	Oct 31, 2015
Netflix Inc	2.15	Apr 30, 2013

Source: Yahoo Finance

The Contrafund illustrates the problem investors, and money managers face if they own FANG stocks or own ETFs/mutual funds that own FANG. Notice that most of the stocks were bought many years ago. Apple was first bought in 2003. The stock is up significantly since then. On an adjusted basis, Apple was 33 cents in 2003, now it's around $145 with a market cap of $2.43 trillion. If the stock just doubles, the market cap would be around $5 trillion, more than the GDP of most countries in the world. Japan has the third-largest GDP in the world with about a $5 trillion GDP.

Many investors such as myself try to determine what value would another investor/company/private equity/merger partner pay for my company. It's a great feeling when one of your investments is acquired at a significantly more value than the price we invested at. Apple is not a bargain with a $2.43 trillion market cap, it is too expensive. No company would have the sense to acquire Apple for $2.43 trillion. No entity has $2 trillion to acquire a company like Apple. Apple should trade at a discount because of its expensive valuation and it would not be a good acquisition.

I help some of my clients invest their 401k money and found that many 401k funds offered have too much FANG. The problem with managing a fund like the Contrafund is it is sitting on huge profits. If the Contrafund sells one of the FANG stocks Contrafund investors will have profits and have to pay taxes on those profits. Also, the portfolio looked a lot like most index ETFs last year, the current portfolio has changed with Berkshire Hathaway and UnitedHealth Group are now among the top 5 holdings. I'm sure the Contrafund is worried and working to change its top holdings away from FANG.

ETFs are static and will probably not change much, so these investors own an investment that is expensive and risky.

Let's look at how expensive these FANG stocks are:

COMPANY	MKT CAP T(RILLION)	SALES B(ILLION)	P/S	FREE CASH FLOW B(ILLION)	YEARS TO BREAK EVEN	P/E	5 YR PAST GROWTH	2022 FORECASTED GROWTH	2023 FORECASTED GROWTH
F ACEBOOK	1.016	94.48	11.43	32.17	31.58	30.7	42.12%	16.10%	17.60%
A PPLE	2.43	347.16	7.11	94.768	25.6415	28.41	8.40%	3.10%	5.10%
A MAZON	1.81	419.13	4.43	21.786	36	68.49	100.3	29.4	34.1
N ETFLIX	0.227	27.59	8.57	1.39	163	53.28	76.94	23	29.2
G OOGLE	1.812	220.27	13.66	58.536	31.24	28.81	14.93	9.2	17.1
				DIVIDEND	OPTIONS				
AT & T	200.273	176	1.14	7.43%	2.50%	7 YRS MONEY DOUBLES		FREE MONEY AFTER 7 YEARS	

Let's review the valuation metrics for these FANG stocks:

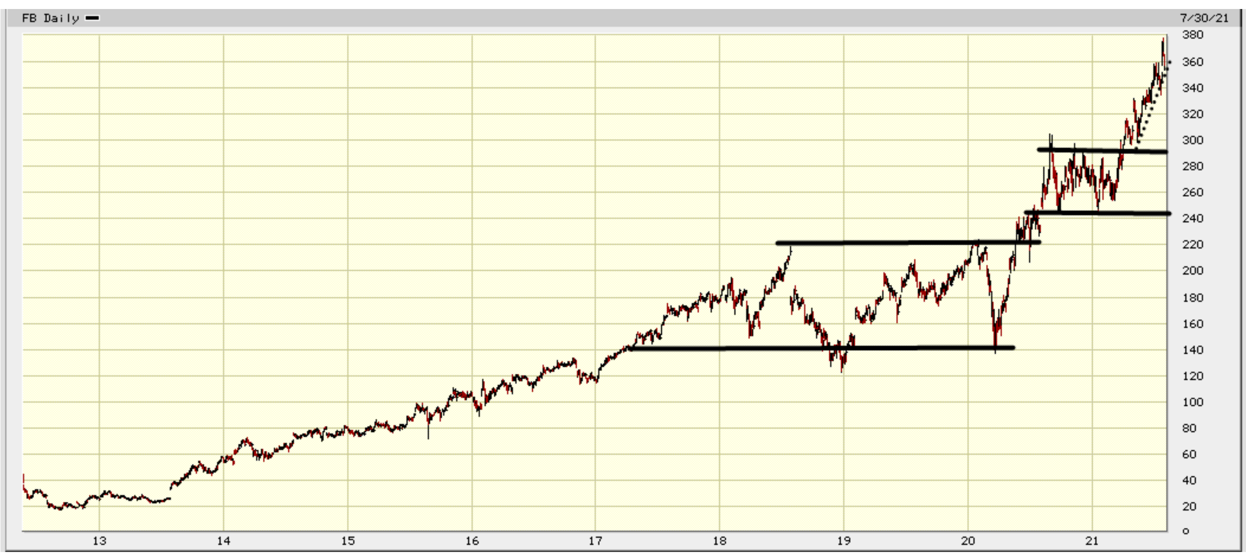
The light green columns focus on sales and answers the question, how much are investors paying for a dollar of sales. The most expensive is Google, investors are paying over $13 ($1.81 trillion market capitalization divided by $220 billion sales) for a dollar of sales. Would you pay $1.81 trillion for $220 billion in sales? I wouldn't.

A better way to view this investment is to determine when you would break even, the blue columns. It's better to look at free cash flow (net income add back non-cash expenses minus money needed to keep the business going including working capital and capital spending). Free cash flow is basically what is left for investors. For Facebook, free cash flow is about $32 billion. The market cap is about $1 trillion for the company, so it would take about 31 years to get your money back, to break even. Most business people, investors should reject this offer, investment.

One of the main objectives of investors is to protect the purchasing power of their investment dollar. One of the best ways to do this is to invest in companies that are growing faster than inflation, the gray columns. FANG stocks are considered fast growers. Normally, you don't want to pay more than 2 to 3 times a company's consistent growth rate. It would seem that Facebook would have a reasonable P/E of 30. Its growth rate for the next two years will be about 17, so a p/e of 34 would be reasonable. But, its growth rate for the last 5 years was about 42%, but its growth rate is dropping more than 50% and projecting growth two years out is very difficult. Also, Facebook faces significant regulatory risks in the U.S. and overseas. Its cost will probably go up to fix its misinformation problems. It's probably true that the FANG stock will grow their free cash flow, but these companies are very large and all have probably seen their peak earnings and revenue growth. Paying these high multiples for sales and earnings is not prudent.

Most of my clients are either retired or close to retirement, so income is more important than growth. For my clients and myself, I would rather invest in a company like AT & T. It pays a dividend of over $2 and if we write options against it for another $1, we would have our original investment back in about 8 years. After about 8 years, the investment is paid down, and T is generating free money, cash.

Let's look at a chart of one of the FANGs:



Let's review the chart:

- Facebook went public in 2012. The stock lost about 50% of its value because investors complained they did not have a good way to monetize its mobile subscribers. That has been fixed.

- The stock was up 10 times by 2018. It then went sideways until 2020. The stock tested the $140 support several times during its consolidation period. Last year FB tested the $140 area.

- Since its low last year of $140, the stock is up about 85% but earnings are expected to grow about 30% this year and about half that the next two years. The stock has gotten ahead of itself.

- The stock did consolidate, trade sideways again last year and early this year.

- The stock has accelerated as shown by the dashed upward trendline. Accelerations from a long-term trend line are normally a sign of speculation and not investing.

Again, would another company pay $1 trillion for a $94 billion company, and where the break-even is about 32 years? Would you invest in this company with these valuation metrics?

Summary and Conclusion

- There are trillions of dollars in FANG stocks thanks to 401ks and financial planners.

- 401ks are automatic buyers of FANG with every paychecks. Financial planners are big investors in index funds and any new clients' money will probably go into index funds, FANG stocks.

- FANG stocks are overcrowded, overvalued, risky, and could have liquidity problems if participants decide to get out all at once. Break-even points are decades away for FANG stocks.

- Investors should check their positions and make sure they don't have too much money in FANG stocks.

- Could FANG stocks double from here? Maybe, they would become even more expensive and risky. I would rather own a good dividend-paying stock where I know when I break even and after breaking even, my cash flow would be free money.

- The positive aspect of 401k investors and financial planners is that they don't tend to sell (they do rebalancing), so that is keeping the markets comparatively stable. Last year is a good example. The short-traders, algorithms sell in the short-run and 401k investors and financial planners and other long-term investors keep the markets stable. The short-term selling creates opportunities for long-term investors by "buying the dip".

We are seeing that when these stocks disappoint because their growth doesn't meet expectations, the stocks see selling. The stocks could see long periods of consolidation, going sideways until valuations catch up with their prices. These stocks have probably seen their peak in sales and earnings growth and paying top dollar with trillion dollar price tags is not prudent.

I would be glad to review your holdings to determine how much risk you're taking with FANG. I can be contacted at danhassey@yahoo.com