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BALANCING ACT | A Series Discussing Active Management in Late-Cycle Equity Markets

PART TWO: PULLING THE FANGs APART

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About the
BALANCING ACT
Series

The bull market in U.S. stocks is now almost nine years old. We are now in the second-longest period on record without a 20% decline in the S&P 500® Index. Returns have been strong and remarkably consistent during this period. From its low point on March 9, 2009, the S&P 500 Index has advanced more than 250%, and in seven out of nine calendar years between 2009 and 2016, the Index earned double-digit returns.

Many investors are worried about the age of the bull market, how much longer it can last and what might happen to their investments in a downturn. We can understand these concerns about a market reversal. As of Sept. 30, the S&P 500 Index was trading at 17.5x forward earnings, well above its historical average, and the current geopolitical environment offers plenty of potential scenarios that could shock the market.

But we can't emphasize strongly enough that it is largely impossible to predict the near-term path of the stock market. Skewing one's portfolio heavily toward a strong bullish or strong bearish belief is speculation, pure and simple. ***We believe that investing in equities should be a balancing act, not an exercise in placing heavy bets on one side of the market.*** *At any given time, we need to weigh the risk and opportunity in the economy, the stock market and individual companies, so we can position ourselves to balance our exposure to both risk and opportunity.*

In this series, various members of our research teams will share their perspectives on this philosophy. The common thread in each of these pieces: For us, solving the "aging bull market" conundrum has nothing to do with trying to time the market and everything to do with embracing the value we hope to create through active, selective equity investment.

Part Two:
Pulling the FANGs Apart

The "FANG" companies—Facebook, Amazon, Netflix and Google—have been a dominant investment story in recent years. They have attracted attention as a group—as a success story and, more recently, as a target of skeptics—but these companies have far less in common than the "FANG" acronym and associated media coverage suggest.

When you look at the way investors process fear about the stock market, you can see some patterns over time. One example is their tendency to direct their general market fears toward a specific group of prominent companies that have performed well and that they think are due for a reckoning. In the 1960s, it was the "Nifty Fifty"; in the 1980s, it was oil stocks. Today, we see this happening with the so-called "FANG" stocks—Facebook, Amazon, Netflix and Google (now Alphabet—for consistency we will refer to the company as Google throughout this piece).

We believe that investors may be led astray by looking at the FANG stocks as a monolith that will rise or fall as one. As we discuss in this article, we believe these are highly differentiated businesses with distinct opportunity sets and distinct risks. As we think about whether to own them, we believe the best place to start is bottom-up, fundamental research that helps us understand each one as an individual entity.

FALSE CONNECTIONS

The acronym "FANG" was coined by CNBC's Jim Cramer to reference a group of highly successful companies that each leveraged technology to leapfrog ahead in its market or create an entirely new market. All of these companies have generated attractive returns in recent years, and in 2017 in particular. Through Nov. 30, Netflix, Amazon and Facebook were each up more than 50%. Google was the laggard of the group with a "paltry" 31% return during this period.

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Equity Research Analyst

On the heels of such strong performance, many investors have concerns about a correction. Their fear is bolstered by historical precedent: In the 1960s and 1970s, the "Nifty Fifty" ran up to extremely high valuations, and many performed quite poorly during the 1970s bear market. In the 1980s, a number of highly valued energy companies dominated the S&P 500 Index's top 10 companies, and these were punished severely in the oil price collapse of 1986.

Investors also tend to naturally focus their valuation fears on big, rapidly growing stocks. When stocks have particularly strong runs due to earnings growth, it is not uncommon to see their multiples expand to what some would consider unreasonable levels. When these stocks begin to look more expensive, investors start to assume they must *be* expensive, and therefore poised for a fall.

Here's the problem: This sort of thinking targets stocks indiscriminately. To be effective as a stock picker, however, **you have to discriminate scrupulously between individual stocks**. A stock's valuation can stem from all sorts of factors; sometimes the valuation is proven to be justified, other times not. But to fear a stock's valuation is overblown simply because the company is big or has grown quickly (or even worse, just because it happens to be in the top 10 of the S&P 500 Index) is to walk away from the concept of fundamental research entirely.

In our view, the FANG acronym creates a false connection among a set of companies with very different business models and business drivers. We don't think about these companies as an amalgam; we seek to understand each business on its own merits and to determine our own view of what each is worth based on our estimate of its future cash flows. Currently, our views on the individual companies in this group vary widely.

FOLLOW THE CASH

We own Google and Facebook across a number of our strategies. Google's dominance of internet search appears unassailable, and it has succeeded in leveraging that dominance into adjacent areas (for example, in video through its YouTube business). Similarly, Facebook has secured its position as *the* social relationship platform for most internet users in the world. From these perches, the two companies control a duopoly in digital advertising that has led to compelling growth and cash flow generation, and we believe they are in excellent position to sustain that duopoly for the foreseeable future.

Despite Google and Facebook exhibiting meaningfully different absolute growth rates, spending requirements and valuations (as shown in the table on the next page), we believe that both stocks are attractively valued relative to the cash flow they should generate in coming years.

Conversely, we do not own Netflix in any of our strategies (although we have owned it in the past). This choice has been painful of late; we've watched its recent upswing from the sidelines. However, if we objectively weigh Netflix's future upside potential against its downside risk, investing in it simply doesn't seem justified to us right now. It has grown its subscriber base tremendously, to its credit, but it has done so through ever-increasing spending on original content. As a result, it is burning cash at a potentially harmful rate, and this has led to a downside scenario (in our view) that outweighs its upside. We certainly respect the power of Netflix's business model—with great content, it can drive subscriber growth, which can fund more great content. But its path to a stable financial profile may be rocky. Today's market backdrop of increasing multiples has only added fuel to Netflix's fire. With all this in mind, we agree that *this* FANG stock may be overvalued. At the right price, it would be more attractive to us, but we don't believe its current valuation fairly discounts the risks associated with its business model.

We acknowledge some viewpoints shared by a number of "FANG skeptics." For example, regulatory issues are a growing focus for multiple FANG companies. Facebook is grappling with a variety of privacy and transparency matters; Google faces antitrust challenges related to its ability to promote its own businesses within its search results and on the Android mobile platform; Amazon faces antitrust concerns as it gains market share in various consumer categories. These are meaningful concerns, and we are devoting considerable time and effort to understanding their potential long-term impacts, but we want to reiterate that these are not FANG regulatory risks—they are individual situations, faced by individual companies, that demand individual and separate analysis. For example, the fallout

SINKING OUR TEETH INTO THE FANG BUSINESSES

Pundits like to talk about the FANG stocks as a monolithic entity, but we see these companies as four highly differentiated businesses. In our view, some of them merit investment currently, while others do not.

As the table shows, Facebook and Google offer robust growth, profitability and free cash flow. Amazon has positive cash flow but is far less profitable. Finally, Netflix is supporting its rapid growth with a heavy cash burn. Our varying stances on these stocks reflect these differences.

	Facebook	Amazon	Netflix	Google
2018 Est. Revenue Growth	33%	29%	28%	18%
Gross Margin	86%	35%	32%	61%
Operating Margin	45%	3%	5%	33%
2018 Est. Free Cash Flow	$15,031	$16,923	($2,241)	$32,453
Market Capitalization	$519,960	$575,184	$83,742	$712,055
Free Cash Flow/ Market Cap	2.9%	2.9%	-2.7%	4.6%

Source: Factset. Information as of 11/30/2017.

from Facebook's challenges regarding the integrity of its advertising could spread far beyond the cost of complying with new disclosure requirements. It could lead to an existential threat for the company if large portions of its user base lose confidence in the social platform. We should note, however, that companies with strong free cash flow are often in the best position to address a challenge like this. Simply put, Facebook has the resources to do something about it, and has already put a very large stake in the ground in its most recent earnings announcement when Mark Zuckerberg announced significant spending on these integrity issues. The company cited plans to hire 10,000 new employees in 2018 to monitor content and advertisements.

This is a meaningful risk for Facebook, and we are evaluating its potential impact alongside our view of the company's response. But the situation is completely unique to Facebook. Companies like Google and Amazon face entirely different primary regulatory risks, and need to be considered separately.

In short, we think any argument for or against "the FANGs" is a dangerous way to think about these companies. Instead, we look at each company's business model and valuation separately. At the risk of oversimplifying, if the business model and price are compelling, we will own the stock; if not, we won't. Over time, our stance on each of the FANG companies will undoubtedly evolve, but it won't be driven by a generalized fear; it will be driven by new information about a *specific* company, unearthed through research, which leads us to a new conclusion about each company's upside potential or downside risk.

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