



Jim Parker
 Vice President
 DFA Australia Limited,
 a subsidiary of Dimensional Fund Advisors LP

OUTSIDE THE FLAGS

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Catchphrase Investing

The financial media is drawn to catchphrases, acronyms, and buzzwords that can be sold as the new thing. FAANG (Facebook, Apple, Amazon, Netflix, and Google) is the latest of these. But does this constitute an investment strategy?

For journalists, commentators, and marketers, acronyms like FAANG are useful. They fit easily into headlines and they appeal to a feeling among some investors that their portfolios should match the “zeitgeist” or spirit of the age.

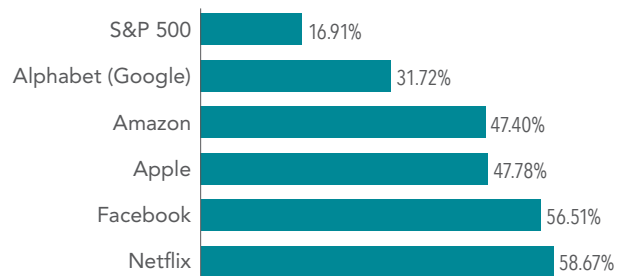
But as we’ll see, investment trends tend to come and go. This is not to downplay the transformative nature of new technologies and the possibilities they present. But as an investor, it is wise to recall that all those hopes and expectations are already built into prices.

The FAANG acronym has become particularly popular in 2017 as returns from the five members of the unofficial club have far outpaced the wider market. **Exhibit 1** shows the total year-to-date returns of the FAANG members compared to the S&P 500.

Such is the public interest in the tech giants that the parent company of the New York Stock Exchange recently launched the NYSE FANG+™ Index that includes the quarterly futures contracts of the FAANG members apart from Apple (hence only one “A”), plus another five actively traded technology growth stocks.

Exhibit 1: Total Returns

Year to date as of October 31, 2017



So, does this mean, as some media gurus suggest, that you should reweight your portfolio around these tech names? After all, these companies have fundamentally reshaped traditional sectors like newspapers, television, advertising, music, and retailing.

For investors, there are a few ways of answering that question, none of which involve denying the significant influence Facebook, Amazon, Apple, Netflix, Google, and other technology names are having on our lives.

Firstly, market leadership is constantly changing based on a myriad of influences, including shifts in the structure of the global economy, commodities, technology, demographics, consumer tastes, and supply factors. Trying to build an investment strategy by anticipating these forces is like trying to catch lightning in a bottle.

In the 1960s, the then often-quoted Nifty Fifty of solid, buy-and-hold blue-chips included such names as Xerox, Eastman Kodak, IBM, and Polaroid, all of which were disrupted in one way or another by newer, more nimble competitors in the following decades.

By the late 1990s, the media was full of stories about the dot-coms, companies that were building new businesses using the transformative power of the internet. A handful of those companies (Amazon, for instance) fulfilled their promise. Many others (retailer Boo.com, prototype social network TheGlobe.com, and pet supplies firm Pets.com were just three examples) crashed and burned.

In the mid-2000s, the focus turned to companies with a large exposure to the so-called BRIC economies, an acronym based on the fast-growing emerging economies of Brazil, Russia, India, and China.

Several financial services companies even set up BRIC products, with mixed degrees of success. One investment bank, having argued that the superior growth for emerging economies justified a bias to stocks exposed to these markets, ending up closing its BRIC fund in late 2015 after years of poor returns.¹

So, while individual sectors each can have their time in the sun, it is not clear that weighting your portfolio toward an industry currently in favor is a sustainable long-term strategy.

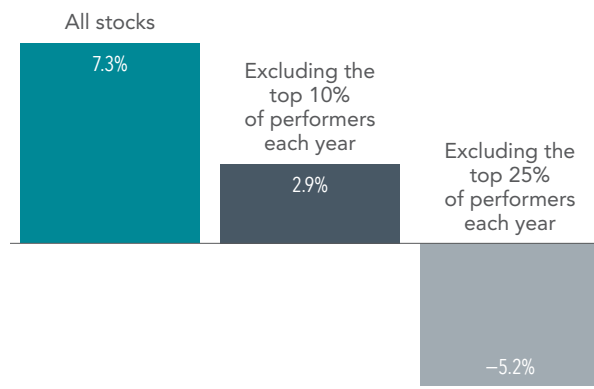
A second way of looking at this issue is that accepting it is difficult to pick winning sectors does not mean you should exclude these zeitgeist stocks in a diversified marketwide portfolio. You can still own them, but you do so by casting a much wider net.

The more concentrated the portfolio, the more you are exposed to idiosyncratic forces related to individual stocks or sectors. Being highly diversified means you can still benefit from the broad trends driving technology or whatever is leading the market at any one time, but you are doing so in a more prudent manner.

Put another way, by diversifying you are not only *reducing* the risk of placing too much of a bet on one sector, you are *improving* the odds of holding the best performers. Look at **Exhibit 2**, which shows what would have happened if you had excluded the top 10% and top 25% of market performers in a global portfolio from 1994–2016.

Exhibit 2: Diversification May Prevent You From Missing Opportunity²

Compound average annual returns: 1994–2016



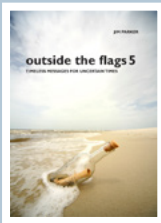
We’ve seen that even professional investors can find it tough to pick which sector will lead the market from year to year.

It’s true that technology companies like Amazon and Facebook have performed well recently. But it is worth recalling that current prices already contain future expectations about those companies. We don’t know what future prices will be because these will reflect information we haven’t received yet.

1. “Goldman Closes BRIC Fund,” The Wall Street Journal, November 9, 2015.

2. The “All stocks” portfolio consists of all eligible stocks in all eligible developed and emerging markets. The portfolio for January to December of year t includes stocks whose free float market capitalization as of December t-1 is greater than \$10MM in developed markets and \$50MM in emerging markets and with non-missing price returns for December of year t-1. Annual portfolio returns are value-weighted averages of the annual returns on the included securities. The portfolios “Excluding the top 10%” and “Excluding the top 25%” are constructed similarly. 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, United Kingdom, and the United States. Diversification does not eliminate the risk of market loss. Past performance is no guarantee of future results.

Because no one has a reliable crystal ball, a better approach is to diversify. That way we increase the odds of being positioned in the next big winning sector without chasing hot trends or latching on to cute-sounding acronyms.



“Outside the Flags” began as a weekly web column on Dimensional Fund Advisors’ website in 2006. The articles are designed to help fee-only advisors communicate with their clients about the principles of good investment—working with markets, understanding risk and return, broadly diversifying, and focusing on elements within the investor’s control—including portfolio structure, fees, taxes, and discipline. Jim’s flags metaphor has been taken up and recognized by Australia’s corporate regulator in its own investor education program.

Past performance is no guarantee of future results. There is no guarantee an investing strategy will be successful. Diversification does not eliminate the risk of market loss.

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