HIGH CONVICTION: THE LATEST IN GLOBAL ACTIVE EQUITY WITH OLIVIA ENGEL

FANGS AND BATS GRAB INVESTORS' ATTENTION, BUT ARE THEY WORTH IT?

Still expensive and risky vs. better-value auto, tech hardware and semiconductor stocks

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The superstar FANG stocks — Facebook, Amazon, Netflix and Alphabet's Google — are still grabbing a lot of headlines, but investors might be better served ignoring them and focusing on more boring sectors of the market, such as autos, tech hardware and semiconductors.

Shortly after the last of the FANGs reported strong first-quarter earnings, *Pensions & Investments* sat down with Olivia Engel, senior managing director and CIO of active quantitative equity at State Street Global Advisors, to find out if she thought the big numbers, combined with a deep pullback in the stocks, suggested that investors ought to take a closer look.

Her answer? Not yet. In fact, according to Engel, FANG stocks are still expensive and risky compared with many other sectors and stocks. Her view is based on State Street Global Advisors' proprietary multi-factor model that takes into account a set of attributes that are important indicators of performance: value, quality, sentiment and volatility.

In many cases, including with the FANGs, stocks get bid up and overvalued amid investor excitement as investors dream about the disruption and technological change that are the hallmarks of these front-page names. But often such sentiment creates opportunity in segments of the market that are not exciting, because investors are not paying as much attention to them.

When expanding her universe of superstar tech stocks to include Microsoft, Apple, Nvidia, Twitter and Tesla — along with their emerging-market equivalents the BATs: Baidu, Alibaba and Tencent — Engel said the group on average continues to be expensive, high risk and of lower quality compared with the rest of the equity universe.

Engel's multi-dimensional view of valuation — which includes cash flow-based measures, balance-sheet measures and some enterprise value measures, as well as an assessment of intangibles — is expressed in terms of relative attractiveness vs. absolute valuation. By that measure, the FANGs and BATs remain expensive.

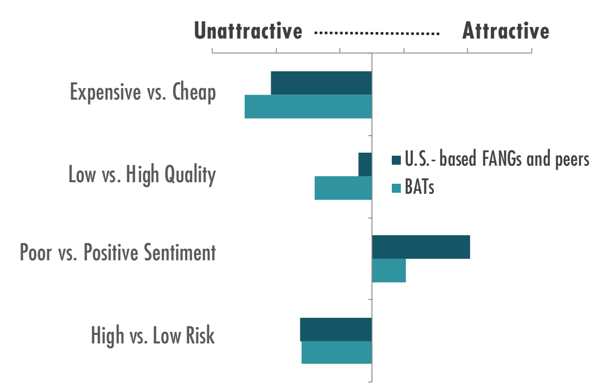
Likewise with volatility — or risk.

To capture a view on risk, there are a number of factors. "You can think about risk in terms of estimated volatility, in terms of beta, in terms of idiosyncratic volatility," she said. "All those help build a multidimensional view of risk, and the bottom line is that view has led us to see these stocks as more risky than they were six months ago."

EMERGING MARKETS VS. THE U.S. WRINKLE

The interesting quirk in the FANG and BAT sector that Engel's analysis identified was that the emerging markets components look worse than their developed market counterparts, which is in direct contradiction to trends in the broad market.

Comparatively Speaking



State Street's directional view of the stocks of U.S.-based FANGs and their peers versus BAT stocks, across multiple proprietary attributes, relative to the broader market universe as of April 30, 2018.

"The difference between emerging markets and developed markets that we observe in this subset is the opposite to what we observe in the broader opportunity set in emerging markets vs. developed," she said.

"Emerging markets have held up pretty well from a risk perspective during this renewed stage of market volatility," Engel said. "In aggregate, emerging markets look more attractive than the U.S. market on a return basis."

She pointed out that while the FANGs and BATs fell roughly the same amount in the March sell-off — around 14 percentage points — the BATs cumulatively lost about 16% during the February drawdown, compared with about a 6% decline for the FANGs. As of early May, average cumulative returns for FANGs and their U.S.-based peers stood at 15.6% compared with the BATs, which are basically flat year-to-date, with average cumulative return of only 1.7%.

"Looking at the attractiveness on [the] different dimensions that we think are important — value, quality, sentiment and risk — the BATs are even less attractive than their developed market counterparts," Engel said. "They have about the same amount of risk, but sentiment hasn't been nearly as positive, and the earnings momentum that we've seen in those names is not nearly as strong."

FINDING VALUE IN THE HO-HUM

So if the FANGs and BATs are not looking attractive, what is?

The auto sector — an industrial, blue-chip group of companies as ever there was — is not particularly exciting compared with the likes of Amazon, Netflix, Alibaba or any of the superstar tech companies, but that's where Engel says value can be found.

"Boredom can create a good valuation opportunity," she said. "These companies typically don't tend to get bid up like other parts of the market."

Hardware is the same, she said, pointing to companies that manufacture mobile phone components.

"There are some solid earnings and sales profiles of technology-component companies that are benefiting from a broad array of brands buying their components," she said.

In emerging markets, a number of Taiwanese and Korean semiconductor manufacturers appear much less expensive and have better operational profitability, according to Engel.

So rather than focusing on today's story stocks – the FANGs and BATs that are attracting all the attention – consider the boring ones. As mathematician and physicist Freeman Dyson once said, "Nothing is boring if you look at it carefully." ■

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