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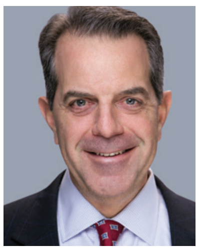


Vincent Costa, CFA
Head of Value and Global Quantitative Equities

Passive-Aggressive Equity:
Live by the FAANG, Die by the FAANG

Executive Summary

- Beyond the euphoria of the most recent bull market, **passive equity investors** may be exposed to more risks than they realize
- Others are doubling down and chasing returns by allocating to the riskiest active approaches — **aggressive managers** with heavy FAANG concentrations
- Style-drift and bloated valuations aside, the more direct threats come from drawdowns exacerbated by unintended concentrations
- As we noted recently*, we encourage investors at this stage in the cycle to navigate these risks by focusing on what has proven to outperform over the long term: systematically selecting stocks that have strong fundamentals and attractive relative value.

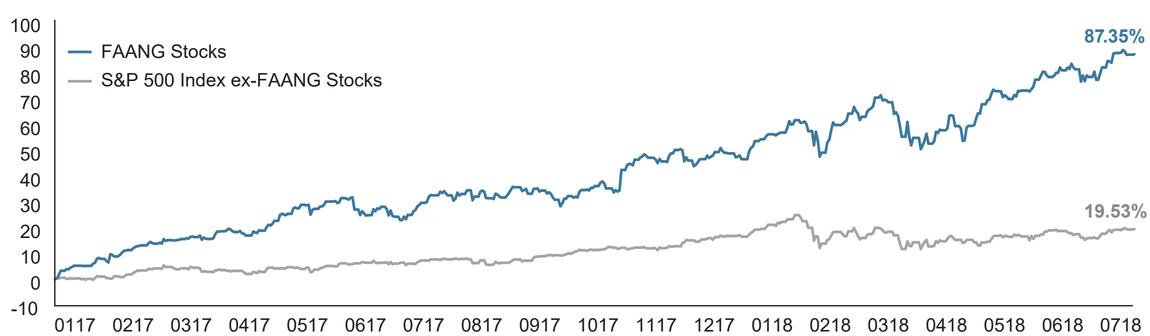
Today's Passive is Overly Concentrated and Dependent on the FAANGs

With history's longest-running, record-high setting equity bull market only now showing signs of losing steam, it is easy to see why passive equity investors appear to have become complacent and ignored the host of risks inherent with index funds. After all, such funds are designed to minimize active risk — that is, the possibility of underperforming the benchmark — which, according to certain managers, is the most important risk factor to consider. However, index portfolios still contain a multitude of other potential pitfalls, such as style factor risk, valuation risk, drawdown risk, and concentration risk — all of which can pose a far greater danger, particularly at this late, momentum-driven stage of the long-term bull market.

Perhaps the clearest dynamic in today's market representing all of these potential risks to passive investors would be the darlings of the past several years: the FAANG (Facebook, Amazon, Apple, Netflix and Google) stocks. Unlike many actively managed portfolios, several of the largest weighted companies in the index — such as the FAANGs — are not owned due to their fundamental value, but rather because their stock prices have up until recently rallied the most over the years (Figure 1), leaving passive investors far more exposed to this narrow corner of the market than they might prefer, or even realize.

Figure 1. Up until the recent pull-back, ex-FAANG momentum has more than led the latest stage of the current bull market

FAANG Stock vs. S&P Index ex-FAANG Stocks



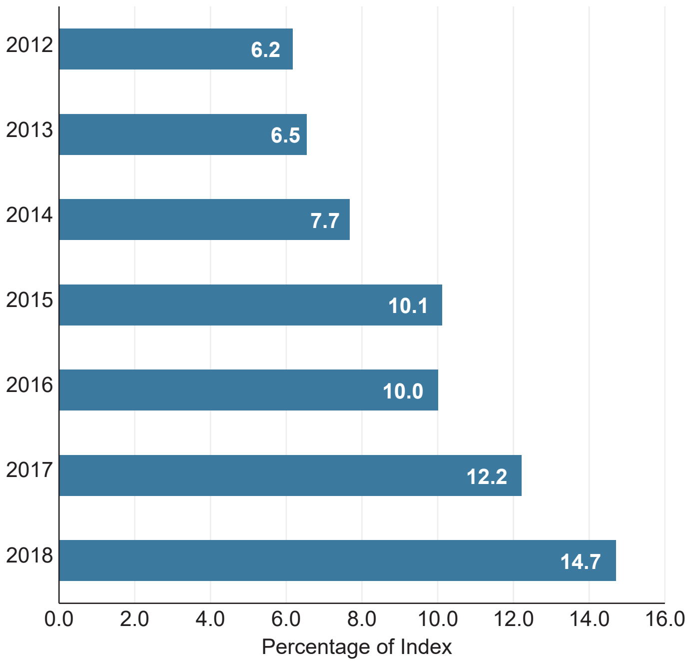
Source: FactSet

**The Momentum Effect: Is the End in Sight?* by Michael Pytosh and Vincent Costa.
https://advisors.voya.com/insights/market-insights/momentum-effect-end-sight

Valuation and Quality Matter

As noted previously, it is the high-beta, large cap growth stocks with plenty of momentum — like the FAANGs — that have led the latest stage of this bull market and allowed them to dominate index funds (Figure 2).

Figure 2. S&P 500 index funds have steadily become FAANG-dominated
Annual FAANG Exposure as a Percentage of the S&P 500 Index



Source: FactSet

Traditionally, valuation and quality have been far more sustainable style factors, but those were virtually ignored during the 18 months leading up to the recent pull-back. Indeed, from the beginning of 2017 through the end of July 2018, growth stocks outperformed value stocks by at least 13%, and the composition of broad large cap indexes reflect that.

Meanwhile, the underlying stocks that make up the indexes themselves have become very expensive, as long-term Shiller P/E on the S&P 500 has essentially more than doubled from 13.3 times in March 2009 to over 33 times in 2018. Even more dramatic, the long-term P/E for large-cap growth stocks is around 40-times versus value stocks at 15 times. The prime example for this is Netflix, up more than 422% over the past five years and trading at 98.7 times earnings. As interest rates tick higher and valuations start to matter again, as they have throughout history, index funds concentrated in large cap momentum stocks will likely begin to underperform more fundamentally-driven active investments.

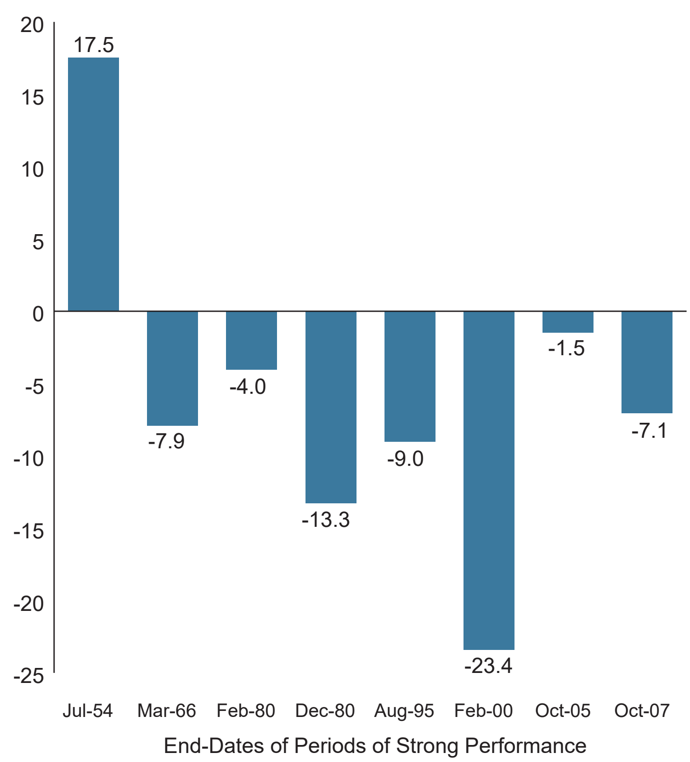
Drawdowns and Unintended Concentrations

Beyond the style-drift and bloated valuation risks of passive are the more direct threats from drawdowns exacerbated by unintended concentrations. While mimicking a benchmark allows investors to fully participate in the upside, it also exposes them to 100% of the down side. For example, in 2008 that meant capturing a loss of over 37% in an S&P index fund. While we are not forecasting a pull-back on par with 2008 any time soon, it's worth remembering that the S&P 500 is only now pulling back slightly from all-time highs. After a nearly 10-year bull market, where the market has gained over 15% per-annum thanks to historically easy monetary policy, it is difficult to see how this double-digit growth continues.

Furthermore, owning index funds inherently exposes investors to a level of concentration risk beyond what they may realize. As noted above, large-cap index funds tend to load up on fewer, higher-priced stocks by design. For instance, the FAANGs make up approximately 13% of the S&P 500, yet combined they have contributed over 25% of its performance since the beginning of 2017.

While FAANGs may be the key driver of today's momentum rally, this dynamic of having market leadership so heavily concentrated during a bull market is neither new nor very encouraging. Since the early 1950's there have been seven periods in which momentum rally leaders — from the dot-coms to multi-industrial conglomerates, and so on — had subsequently underperformed in the 12 months after each peak (Figure 3).

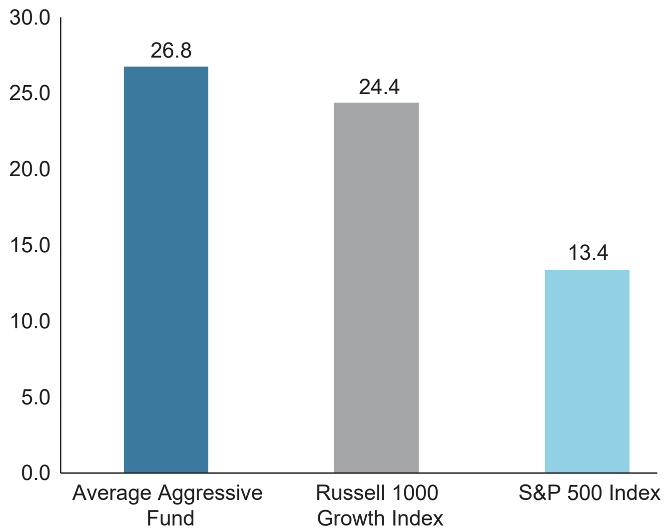
Figure 3. Sector-concentrated momentum rallies and the downswings that followed are not new
Large-Cap Stocks Relative Returns to the Top Quintile of Revenue Growth*
One Year After Periods of Strong Performance 1952 Through June 2018



Source: Empirical Partners Analysis.

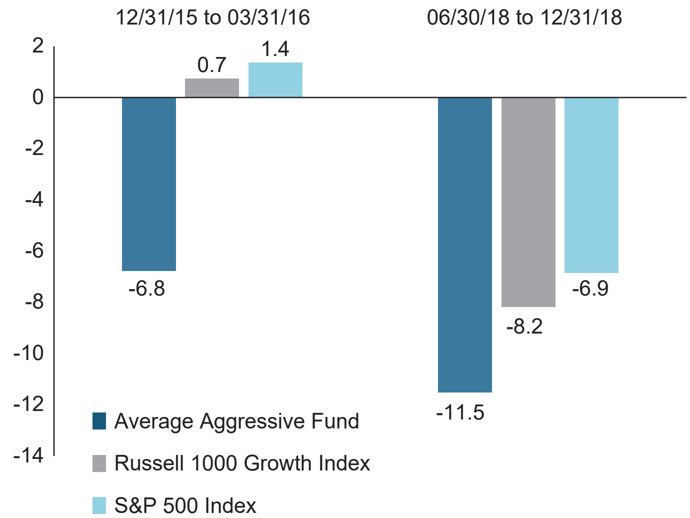
*Capitalization-weighted data measured with one-year holding periods.

Figure 4. Aggressive Growth funds' FAANG-plus allocations were not only greater than the Russell 1000 Growth's, but also double the S&P 500's
Holdings as of June 30, 2018



Source: Morningstar and FactSet
Aggressive Funds represent those deemed above average or high risk by Morningstar with the largest holdings of FAANG-plus stocks.

Figure 5. How fragile can a FAANG-concentrated strategy be?
FAANG-laden Aggressive Strategies During Recent Periods of Volatility



Source: Morningstar and FactSet
Aggressive Funds represent those deemed above average or high risk by Morningstar with the largest holdings of FAANG-plus stocks

The Risks of Being Aggressive in a Crowded Trade

As we noted recently (The Momentum Effect: Is the End in Sight?), history has shown that momentum rallies tend to be short-lived and often brutal on the downside. We see no reason why today's market would be any different. The largest stocks in the index are concentrated in ownership by not only index-fund and ETF titans, who will in turn be forced-sellers should investors begin to sour on equities and outflows pick up — but also by many of the actively managed aggressive funds.

In our view, these investors are simply doubling down and over-exposing themselves to an already crowded, momentum-driven trade. Indeed, up until the recent pull-back, average FAANG-plus holdings among the largest aggressive strategies were not only greater than the concentrated growth index, but also double that of the S&P 500 (Figure 4).

While aggressive strategies in general can certainly add value to a well-balanced portfolio, we believe that concentrating into an already saturated trade — i.e., the FAANGs — over-exposes investors to unnecessary risks. As recent periods of pull-back among FAANGs have shown, it doesn't take a pull-back among all of them to pull aggressive funds in to negative territory (Figure 5).

Indeed, while even a single, mildly disappointing quarterly report from just one of the FAANGs can have a broader knock-on effect, a wider FAANG-led sell-off can have a longer and more far-reaching impact. Per Figure 5, during the recent pull-back when concerns over global growth caused investors to re-evaluate their fundamental expectations against the backdrop of overly rich valuations, the cohort of aggressive managers underperformed. Going back further during the first quarter of 2016 when investors rotated out of momentum stocks, aggressive strategies greatly underperformed versus the broader market.

As FAANGs recede, prudent and diversified stock selection will matter

At this stage of the cycle, we encourage investors to navigate this potential market risk by focusing on what has proven to outperform over the long term: systematically selecting stocks that have strong fundamentals and attractive relative value.

Given the inherent momentum-driven concentration risks in broad market indices, passive equity investors have significant exposure to this downside risk potential. Meanwhile, risky, more aggressive active strategies can also leave investors with even more exposure to this dynamic than they realize. As such, we continue to encourage investors to think long term and diversify either or both of their passive index and aggressive active exposures by using a well diversified active equity approach that focuses on valuation, quality and growth, not one that doubles down on a risk dynamic that they should be diversifying away from at this stage of the market cycle.

Investment Risks

All investments in bonds are subject to market risks. Bonds have fixed principal and return if held to maturity, but may fluctuate in the interim. Generally, when interest rates rise, bond prices fall. Bonds with longer maturities tend to be more sensitive to changes in interest rates.

All investing involves risks of fluctuating prices and the uncertainties of rates of return and yield inherent in investing. High Yield Securities, or "junk bonds", are rated lower than investment-grade bonds because there is a greater possibility that the issuer may be unable to make interest and principal payments on those securities. As Interest Rates rise, bond prices may fall, reducing the value of the share price. Debt Securities with longer durations tend to be more sensitive to interest rate changes. High-yield bonds may be subject to more Liquidity Risk than, for example, investment-grade bonds. This may mean that investors seeking to sell their bonds will not receive a price that reflects the true value of the bonds (based on the bond's interest rate and creditworthiness of the company).

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