FACTORS IN FOCUS

Which FAMA(A)?

by Eric D. Nelson, CFA

If you had peeked under the hood of the S&P 500 Index in 1999, you would have found plenty of technology companies. Microsoft, Cisco, Intel, Lucent, IBM and AOL were all in the top ten. In the late 1990s, these stocks were all the rage. They helped propel the growth-oriented S&P 500 to a gain of +55.6% (+24.8% annually) between 1998 and 1999.

For some investors, even this wasn't enough. They wanted a concentrated dose of tech and found it in the form of the NASDAQ Index, large-growth oriented mutual funds and, in extreme cases, technology sector funds. Over this same two-year period, the NASDAQ Index was +160.1% (+61.3% per year). I don't need to point out that these returns were many multiples of the long-term average return on stocks (about 10% per year) and wholly unsustainable. Back then, however, it seemed entirely rational to many investors.

Not every stock asset class shared the spoils. US large and small value companies, which had historically produced returns of 2% to 4% per year more than the S&P 500, languished. The DFA US Large Value Fund returned 17.3% (+8.3% per year) over this period, while the DFA US Small Value Fund returned just +4.8% cumulatively.

Alas, long-term asset class risk/return behavior exerted a force over the market much like gravity, pulling everything back to its sustainable levels. The 2000-2002 bear market saw catastrophic losses on tech stocks, inflicting severe punishment on the NASDAQ (-66.2%) and resulting in the worst decline for the S&P 500 (-37.6%) since the 1970s. The much maligned value stocks returned to relative form — the DFA US Large Value Fund shed only -2.6%, the DFA US Small Value Fund *gained* +21.3%!

Some were quick to conclude that value stocks must be safer than the market, explaining away their exemplary bear market performance. But this result was more about market prices returning to long-term fundamentals; a shift that continued through the 2003 to 2006 bull market. While the NASDAQ and S&P 500 recovered (+16.9% and +14.7% annualized, respectively), it was large and small value stocks that excelled. The DFA US Large Value Fund gained +20.5% per year, the DFA US Small Value Fund returned +27.2%.

When viewed over this entire stretch, asset class returns were about what we would expect. The NASDAQ, chock full of the highest-priced, glamorous growth

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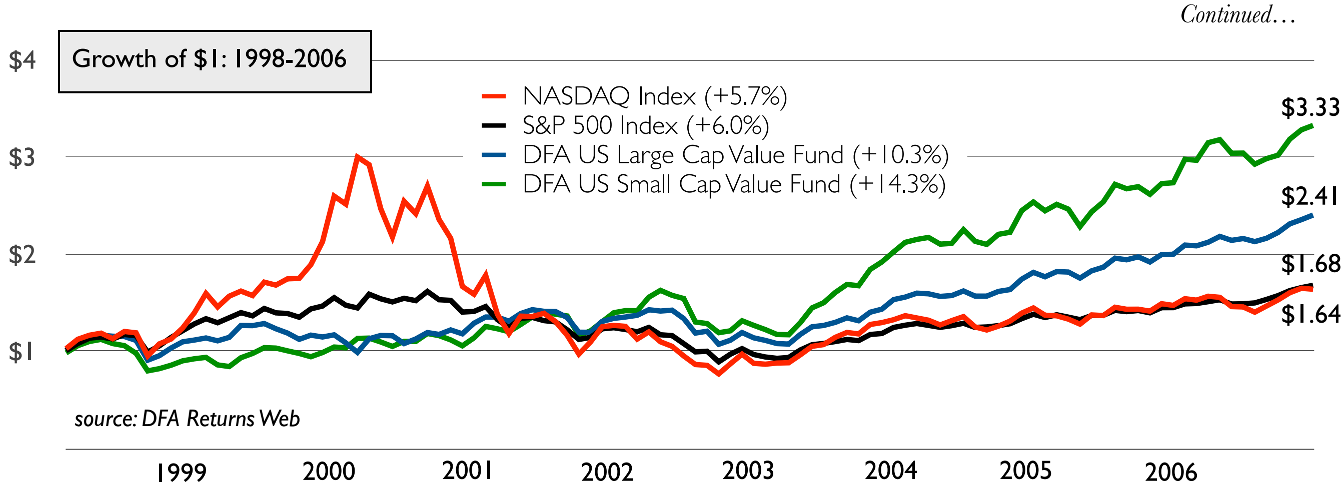

stocks, had the lowest returns — +5.7% a year. The S&P 500 Index, a growth-oriented portfolio with better overall balance (see the table below), looked similar with a +6.0% result. The DFA US Large and Small Value Funds returned +10.3% and +14.3% per year, very close to the long-term index results on these asset classes over the previous 70 years. In the short run, returns were extreme and rarely matched expectations based on historical performance. But eventually, the stars aligned.

The FAMAA Stocks

Why the trip down memory lane, you might ask? We haven't experienced anything close to a 25% annual gain on the S&P 500 in recent years. We have, however, seen the emergence of a new group of tech stocks that are driving a disproportionate amount of market gains. A look at the top ten S&P 500 holdings today reveals familiar names: Facebook, Apple, Microsoft, Amazon and Alphabet (Google), or collectively, the "FAMAA" stocks.

From 2014 to 2015, the NASDAQ (42% in the FAMAA stocks) gained +22.7% and the S&P 500 (13% in the FAMAA stocks) returned +15.3%. Value stocks languished—the DFA US Large and Small Value Funds (0% FAMAA stocks) were +6.2% and -4.6%, respectively. After a brief reprieve in 2016, a similar pattern has emerged again in 2017. Through May, the NASDAQ is +15.7%, the S&P 500 +8.7%, with the DFA US Large and Small Value Funds +4.1% and -4.4%.

FAMAA or Fama?

This trend has lasted long enough so that recent returns on diversified asset class portfolios have noticeably trailed broad market indexes and especially the tech-heavy NASDAQ Index. Returning to the example first mentioned in this article, investors have a choice today, much like the difficult one they faced in the 1990s. Should they ride the momentum, embrace the "new era" economy and shift to a cutting-edge stock portfolio (the FAMAA stocks)? Or should they stay diversified, emphasizing the out-of-favor large and small value asset classes (globally) that Eugene Fama and Ken French identified over 25 years ago as having higher long-term returns?

Of course, history and financial theory tell us that sooner or later, the beaten down, distressed companies that comprise value stock portfolios will retool or reinvent themselves (Apple was once a value stock). This will be reflected in value stock returns that are much greater than their glamorous, growth-stock counterparts. While we cannot say with certainty when this will happen, several years into a growth-stock surge is usually closer to the end than the beginning.

In the meantime, take solace in the fact that your portfolio is not so heavily concentrated in these FAMAA high fliers, and is far less likely to crash when the euphoria eventually fades on today's popular stocks.

Top 10 Holdings Across Portfolios

Ranking	NASDAQ Index	S&P 500 Index	Asset Class Mix*
#1	Apple (11.5%)	Apple (3.6%)	JP Morgan Chase (1.2%)
#2	Microsoft (8.2%)	Microsoft (2.6%)	AT&T (1.1%)
#3	Amazon (7.2%)	Amazon (1.9%)	Exxon Mobil (0.9%)
#4	Facebook (5.5%)	Johnson & Johnson (1.8%)	Intel (0.9%)
#5	Alphabet C (5.0%)	Facebook (1.8%)	Comcast (0.9%)
#6	Alphabet A (4.4%)	Exxon Mobil (1.7%)	Cisco (0.8%)
#7	Comcast (2.8%)	Berkshire Hathaway (1.5%)	Pfizer (0.7%)
#8	Cisco Systems (2.4%)	JP Morgan Chase (1.5%)	Bank of America (0.6%)
#9	Intel (2.4%)	Alphabet A (1.4%)	Apple (0.6%)
#10	Amgen (1.9%)	Alphabet C (1.4%)	Citigroup (0.6%)
Top 10 % of Portfolio	**51.2%**	**19.1%**	**8.4%**

**21% DFA US Large Cap Equity Fund, 21% DFA US Large Value Fund, 28% DFA US Small Value Fund, 18% DFA Int'l Value Fund, 12% DFA Int'l Small Value Fund. Source of data: Dimensional Fund Advisors and Morningstar.*

Contact Eric Nelson, CFA at eric@servowealth.com with any questions, comments, thoughts, or to discuss your own personal financial situation.