HOW TO REPLACE FAANGS WITH CLOUD

Jianing Wu – Senior Analyst, Research
09/27/2019

If you were hoping for yet another contrived acronym to describe a group of stocks, you can stop reading now.

But if you are in the market for fast-growing technology companies that don't face the same degree of uncertainty from trade wars or antitrust scrutiny, we think cloud-based businesses represent an attractive alternative to mega-cap companies in the Technology sector.

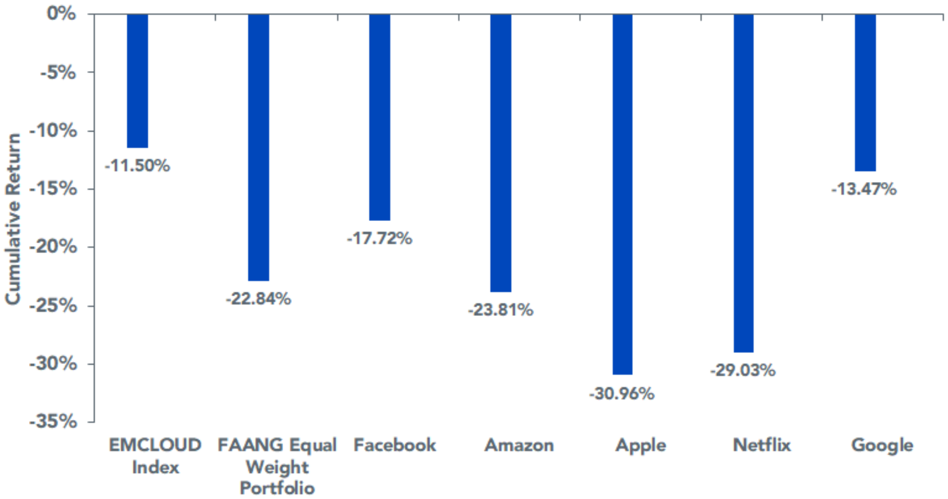
FAANG (Facebook, Amazon, Apple, Netflix, Google)[1] stocks have tripled their market capitalization over the last decade and have been the main drivers of the S&P 500 Index's return. But in the fourth quarter of 2018, they suffered meaningful drawdowns and bouts of volatility. When political tensions ratchet up, some investors could question whether it may be time to seek out a new engine of growth and returns.

In our view, cloud computing could represent one compelling alternative.

Recent Drawdowns

During the fourth-quarter of 2018 market swoon, FAANG stocks declined by 23%, on average. By contrast, cloud computing stocks (as proxied by the BVP Nasdaq Emerging Cloud Index, or EMCLOUD), also experienced volatility but fell by half as much compared with the FAANGs. The parent company of Google, Alphabet, was the most resilient, but it still underperformed EMCLOUD by nearly 200 basis points (bps). This was surprising given that cloud companies tend to have higher volatility on account of their faster growth and smaller market caps, but they have also experienced greater total returns during the rebound as well.

Cloud vs. FAANG Performance (10/2/18 – 12/31/18)

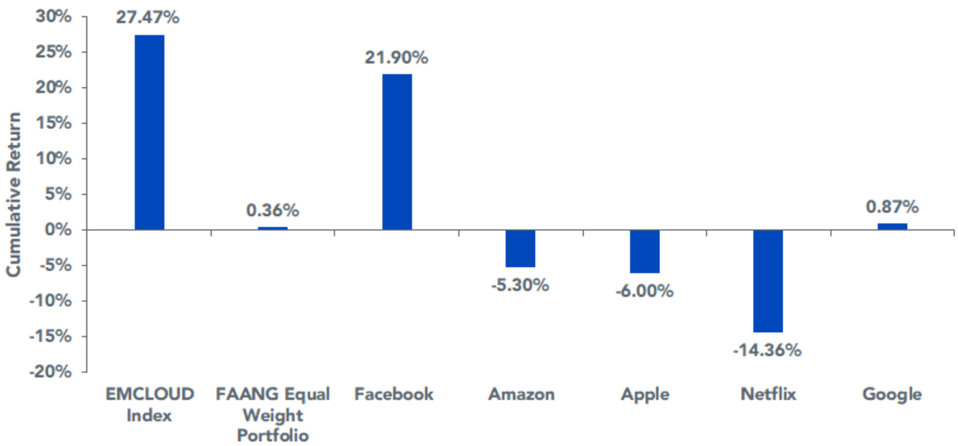


Sources: Bloomberg, Bessemer Venture Partners. Past performance is not indicative of future results. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns. WisdomTree, its affiliates and their independent providers are not liable for any informational errors, incompleteness or delays or for any actions taken in reliance on information contained herein.

For fund performance click here.

Comparing the performance since the inception of EMCLOUD on October 2, 2018, we observe that while most of the FAANGs had negative returns, the BVP Nasdaq Emerging Cloud Index generated a return of 27.47%.

Cloud vs. FAANG Performance (10/2/18 – 7/31/19)



Source: Bloomberg, Bessemer Venture Partners. Past performance is not indicative of future results. You cannot invest directly in an index Double-digit returns are highly unusual and cannot be sustained. Investors should also be aware that these returns were achieved primarily during favorable market conditions.

The recent downdraft in high-growth stocks on September 9, 2019 has some investors questioning their decision to invest in software companies generally and cloud computing stocks specifically. While we note the rapid shift in sentiment, we still believe in the secular trend in adoption for the industry.

The Growth of Cloud-Based Businesses

Digging deeper, cloud computing's unique subscription-based business model is one of the reasons we believe these companies could be less prone to market drawdowns compared with the FAANGs.

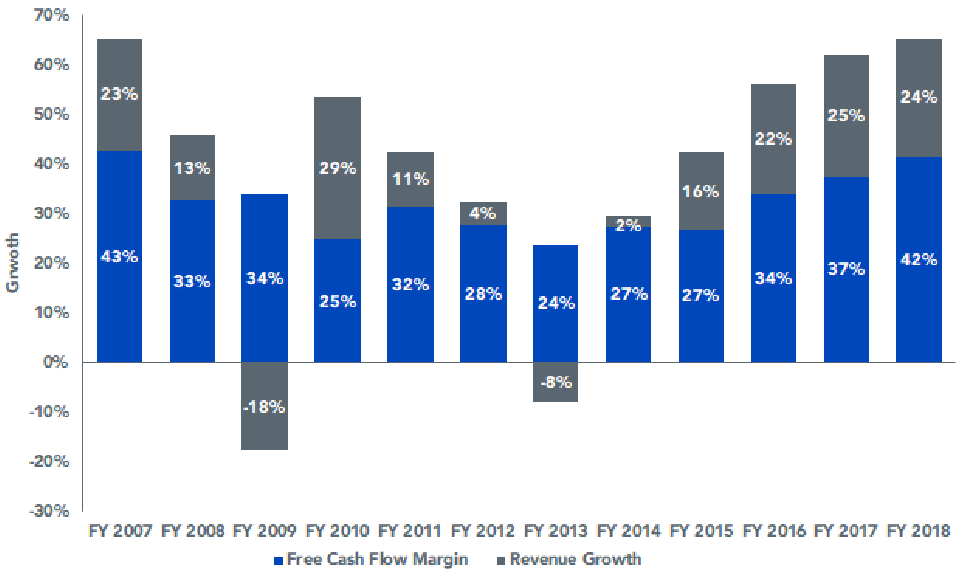
For cloud services, customers typically pay a recurring subscription fee each month/quarter/year rather than the one-time up-front fee they would pay to purchase a software license. This recurring subscription fee can provide a stable, predictable revenue to sustain a company's growth amid market volatility. While certain elements of the FAANGs' businesses may appear similar, we believe these differences can best be shown through a mega-cap tech name that transitioned to the cloud industry.

Company Snapshot

Adobe,[2] a cloud computing company that offers digital marketing tools, exemplifies how a subscription-based business model helped a licensed software company achieve explosive growth.

Before 2008, Adobe sold software in physical and boxed discs for customers to install. During 2008 and 2009, Adobe started considering the possibility of transitioning to the cloud for two reasons. First, the difficulty of pushing updates and delivering improved products to customers made Adobe's tools less attractive to users. Second, the financial crisis in 2008 had a dramatic impact on its cash flow and exposed the limited resiliency of its business.[3]

Adobe then undertook an expensive and arduous transition to the cloud that concluded in 2013. Since then, Adobe's revenue has grown at a rate above 25%. Subscription-based revenue also started to account for more of its total revenue, reaching almost 90% in fiscal year 2018.



Source: Bloomberg, as of 7/31/19.

An important rule of thumb for SaaS (software-as-a-service) companies is known as the "40% rule." This states that if the sum of a company's free cash flow margin and revenue growth both exceed 40%, the business has a solid balance of growth and profit that enables it to expand efficiently going forward.

From the chart above, we see that before 2013, Adobe's growth was slowing and its free cash flow margin diminishing. But after 2013, it had a steady growth in revenue and a gradual increase in free cash flow margin. Now, with its established cloud subscription-based business model, Adobe has regained its status as one of the world's largest technology companies, with a market cap of nearly $140 billion dollars.[4]

Conclusion

WisdomTree believes cloud computing has disrupted the software sector. While mega-cap tech is facing challenges due to increased government scrutiny, cloud computing could be in the middle innings of its growth curve. For investors seeking better returns but the same growth-oriented, technology-focused exposure in their portfolios, the [WisdomTree Cloud Computing Fund (WCLD)] could be a compelling alternative.

[1]WCLD does not hold any FAANG (Facebook, Amazon, Apple, Netflix, Google) stocks

[2]Adobe Inc. (ticker symbol: ADBE) has a 2.01% weight in the WisdomTree Cloud Computing Fund as of 9/24/19.

[3] Sprague, Kara. "Reborn in the Cloud." McKinsey Digital, 2015

[4]Source: Bloomberg, as of 9/6/19.

Important Risks Related to this Article

There are risks associated with investing, including the possible loss of principal. The Fund invests in cloud computing companies, which are heavily dependent on the internet and utilizing a distributed network of servers over the internet. Cloud computing companies may have limited product lines, markets, financial resources or personnel and are subject to the risks of changes in business cycles, world economic growth, technological progress and government regulation. These companies typically face intense competition and potentially rapid product obsolescence. Additionally, many cloud computing companies store sensitive consumer information and could be the target of cybersecurity attacks and other types of theft, which could have a negative impact on these companies and the Fund. Securities of cloud computing companies tend to be more volatile than securities of companies that rely less heavily on technology and, specifically, on the iInternet. Cloud computing companies can typically engage in significant amounts of spending on research and development, and rapid changes to the field could have a material adverse effect on a company's operating results. The composition of the Index is heavily dependent on quantitative and qualitative information and data from one or more third parties and the Index may not perform as intended. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our Economic & Market Outlook

View the online version of this article here.

IMPORTANT INFORMATION

U.S. investors only: Click here to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an “as is” basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the “MSCI Parties”) expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

Mega Cap : Market Capitalization over $100 Billion.

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

Drawdowns : Periods of sustained negative trends of return.

Growth : Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.

BVP Nasdaq Emerging Cloud Index : designed to track the performance of emerging public companies primarily involved in providing cloud software to their customers.

Basis point : 1/100th of 1 percent.

Cash flows : a measure of how much cash a business generates after taking into account all the necessary expenses, including net capital expenditures.

Software-as-a-Service (SaaS) : Software applications provided over a network connectio.