WHAT HAPPENED TO THE FANG STOCKS DURING WISDOMTREE'S EARNINGS REBALANCE?

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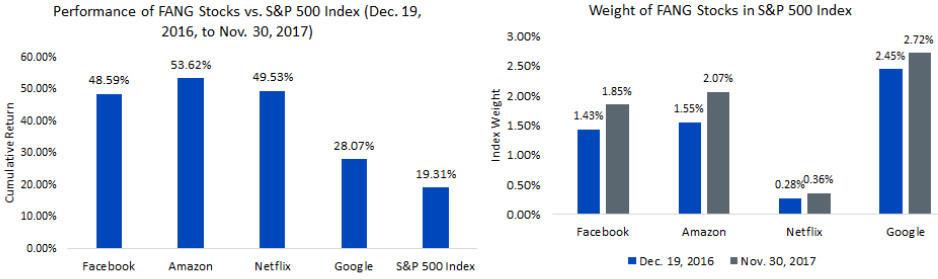
Almost every day, our society is barraged by information about at least one of the FANG (Facebook, Amazon, Netflix and Google) firms. Each one has the ability to influence the daily lives of millions–and possibly billions–of people. Not to mention, their equity performance was strong in a year when the S&P 500 Index reached record highs.

Potential Flaw of Market Capitalization-Weighted Indexes

It's no secret that trillions of dollars are benchmarked to the S&P 500 Index–the most widely followed equity index in the world. In that Index, share price x number of shares outstanding = index weight. One of the reasons we're hearing about the FANG stocks is their superior share price performance, and we can quantify how this has connected to increases in index weight.

Strong Performance => Increased S&P 500 Index Weight



Sources: WisdomTree, Bloomberg, with date range of 12/19/16 to 11/30/17 chosen to reflect the WisdomTree U.S. Earnings 500 Index reconstitution (12/19/16) and the 2017 index screening date (11/30/17). You cannot invest directly in an index.

Now, so long as these stocks continue their trends of outperformance, we can't say this is a "bad" outcome. In fact, as momentum continued to drive the S&P 500 Index higher in 2017, holding greater and greater weights in these stocks has been positive. But many investors don't believe the S&P 500 Index will simply continue up and up and up–they want to be ready for the correction they think is coming.

How WisdomTree's Earnings Approach Differs from Market Capitalization Weighting

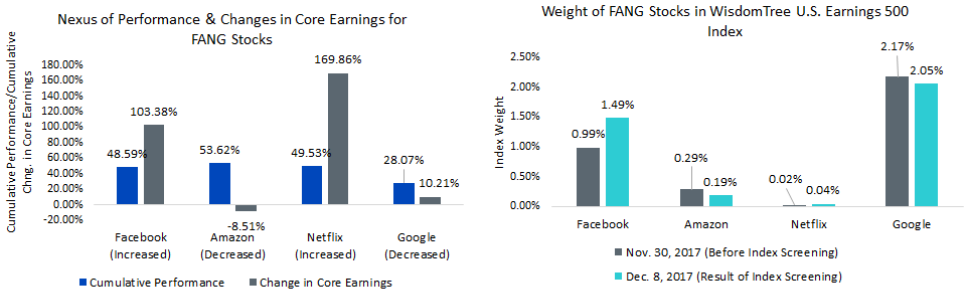
The FANG stocks–with their wide recognition–give us an opportunity to contrast what has happened using a market capitalization-weighted approach with what happens during an earnings-weighted rebalance. These stocks have been constituents in the WisdomTree U.S. Earnings 500 Index, which is where we now turn our focus.

Broadly speaking, the WisdomTree U.S. Earnings 500 Index methodology seeks to delink the level of the share price (and subsequently the size of the firm's market capitalization) from the outcome of the index weighting decision. It does this by weighting each stock based on its core earnings. Over the course of a given year:

- Firms whose share prices appreciate and outperform the overall WisdomTree U.S. Earnings 500 Index will tend to grow in weight through that year until the annual rebalance, the data for which is screened each year on the last trading day of November. If the share prices of these firms have outperformed the growth of their core earnings, they will see their weights ***DECREASED***.
- Firms whose share prices drop or underperform the overall WisdomTree U.S. Earnings 500 Index will tend to decline in weight through that year until the annual rebalance. If the share prices of these firms have underperformed the growth of their core earnings, they will see their weights ***INCREASED***.

One could look at this as an inherent discipline that is driving the Index to "buy low and sell high." From a factor perspective, there could be an inherent "anti-momentum" sensitivity being intuitively introduced, cutting the weight of top-performing companies unless they've grown their core earnings even more than their share prices have appreciated.

What Happened to the FANG Stocks in the WisdomTree U.S. Earnings 500 Index at the 2017 Rebalance?



Sources: WisdomTree, Standard & Poor's, with data on cumulative performance and change in core earnings measured from 2016 index screening and rebalance to 2017 index screening and rebalance. Data on weight of constituents from 11/30/17 for the before screening data and then as of the 12/8/17 posting of constituent weights.

- **Tech Companies:** Looking at the weights, we see that Facebook's weight increased by approximately 50%, and it is becoming a very influential firm in the WisdomTree U.S. Earnings 500 Index with an exposure nearing 1.50%. Even though Google's weight dropped, at 2.05% it remains the most influential company of the four because of its massive relative weight. While it might seem as though Information Technology should have seen its weight drop as part of this methodology, given that it was the top-performing sector, we find it interesting to point out that the weighted average growth in core earnings for the sector saw almost exactly the same performance as the WisdomTree U.S. Earnings 500 Index (about 35%). While Facebook's weight grew and Google's shrank, the aggregate sector weight of Tech firms stayed about the same.

- **Discretionary Companies:** Netflix saw its weight double, but it was only from 0.02% to 0.04%, so from a core earnings perspective it is relatively insignificant against these others. Amazon, the company that may at some point have a trillion-dollar market capitalization, saw its relative weight drop significantly on a core earnings basis, as its massive investment programs and spending are not helpful in increasing current core earnings. The Consumer Discretionary sector, unlike the Tech sector, saw a decline in weight of nearly 1.0%.

What's the "Right" Exposure to the FANG Stocks?

While we aren't aware of an index methodology that can tell us the "right" exposure to any stock today, we can say that the WisdomTree U.S. Earnings 500 Index has around half the exposure to these firms, at approximately 3.8%, as the S&P 500 Index, at approximately 7.0%. We'd simply caution people at this stage that, although these firms may continue to grind higher, owning more of what's performed strongly is a strategy that hasn't worked at all times in history, and it has never ceased to surprise people with the way in which it stops working.

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DEFINITIONS

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.

Market capitalization-weighting : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

Momentum : Characterized by assets with recent price increase trends over time. This term is also associated with the Momentum Factor which associates these stock characteristics with excess return vs the market over time.

Correction : A drop of 10% or greater in an Index or stock from a recent high.

Core Earnings : Income generated by the company's daily operations rather than one-time events or market fluctuations.