The Impact of Technology Stocks on Retirement Portfolios

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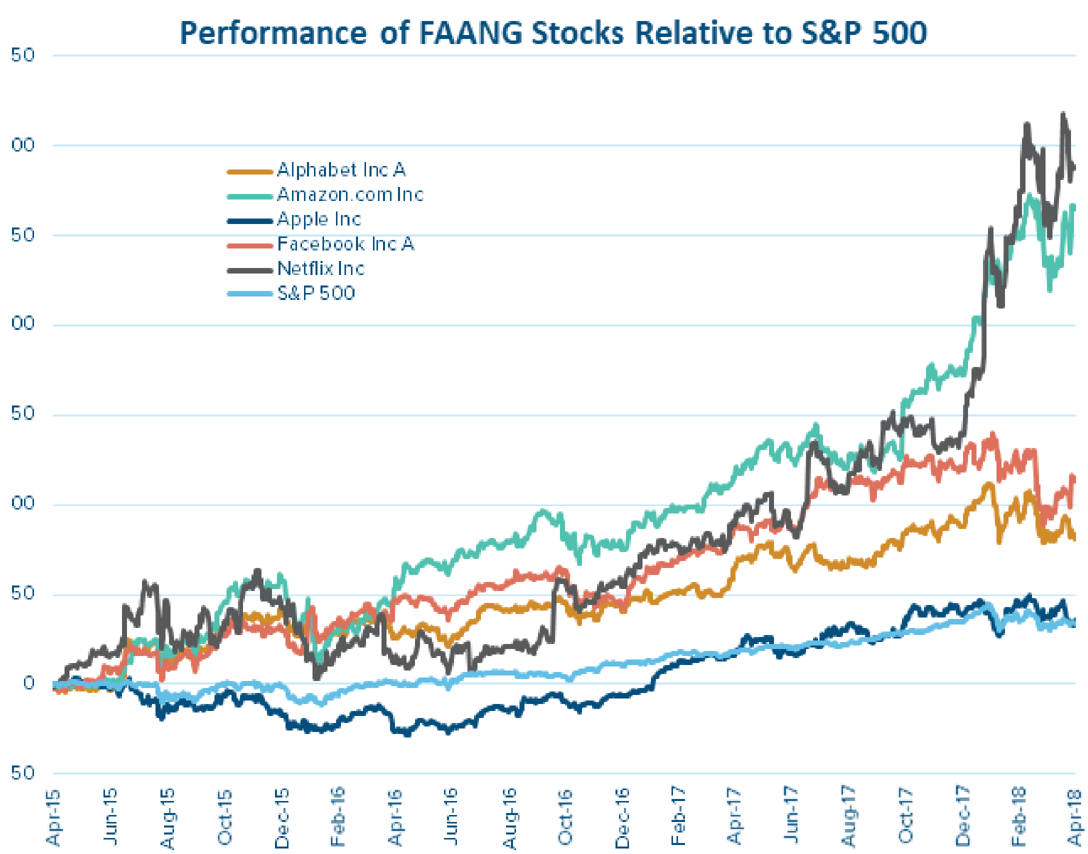
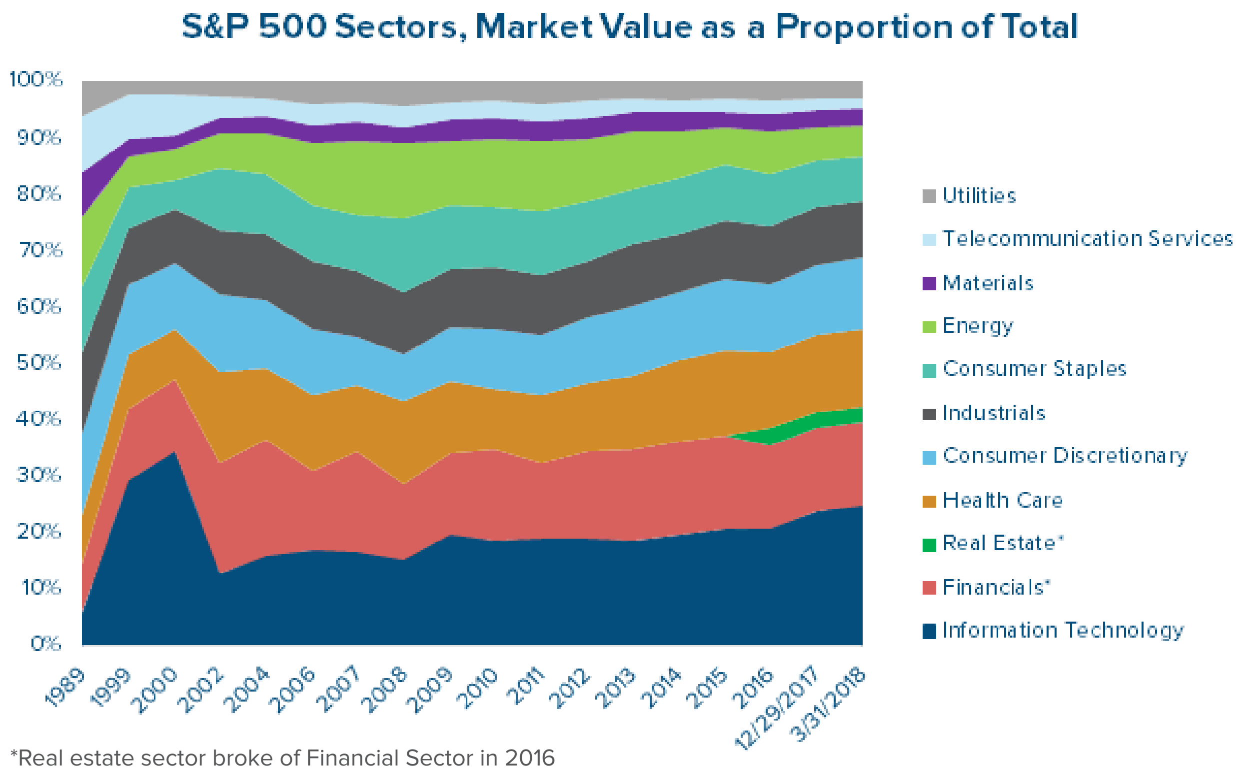
The recent selloff of technology company shares has magnified not only the influence of these companies, but also the effect they have on global indexes. The increasing concentration in major U.S. indices and mutual funds has raised questions as to whether investors are over-exposed to these technology giants and potentially at risk for bigger market downturns.

FAANG is a Wall Street acronym for the five most popular and best-performing technology stocks in the market: Facebook, Apple, Amazon, Netflix, and Google (Alphabet). In the past three years, the share prices of these technology giants have risen faster than the major indices, with Netflix and Amazon leading with an astonishing cumulative gain of 283% and 273%, respectively. This compares to a 35% gain in the S&P 500 over the same period. However, after leading global equity markets to record highs, many technology giants are facing intense regulatory scrutiny, rising trade tensions with China, and renewed concerns over valuations. With recent volatility among technology stocks, investors are considering whether this is the end of the road for these high-flying stocks, and potentially, the bull market.



Source: Morningstar Advisor as of 04.30.2018

Technology stocks have been the most crowed trades in recent years; therefore, their recent market value losses have hurt the performance of U.S. equity indices, as well as the performance of many active managers, especially in large-growth style. The technology sector accounts for nearly 25% of the S&P 500's market capitalization, the largest sector weighting of the index. The weight of the five FAANG stocks alone is 15%; more than the entire financial, healthcare, or industrial sectors.



*Real estate sector broke of Financial Sector in 2016
Source: Standard & Poors

The outperformance of the technology and technology-related consumer discretionary sector has contributed to the dominance of growth-style stocks over value-style stocks. The current cycle favoring growth is approaching its 10-year mark, the longest period of extended growth outperformance on record. A key factor in the growth outperformance has been the rising valuations and market capitalizations of the FAANG stocks. The rapid rise in passive investing in recent years has also contributed to the momentum of these stocks. As the market cap of the technology giants increases, cap-weighted indices are forced to invest an increasing portion of the new inflows into the same stocks, leading to even greater prices and cap values.

	Technology	Consumer Discretionary
Russell 1000 Growth weight	38.70%	18.60%
S&P 500 weight	24.90%	12.70%
Russell 1000 Value weight	9.30%	6.80%

Source: JPMorgan Asset Management Guide to the Markets as of 03.31.2018

According to eVestment research, technology companies like Google (Alphabet), Facebook, and Microsoft Corp. were among the most widely-held last year by asset managers. Apple, Inc. and Amazon, technically consumer stocks, also cracked the top-10 in ownership breadth. As previously mentioned, the combined market capitalization of the FAANG stocks accounts for nearly 15% of the S&P 500 index, up from nearly 6% in 2013. However, the declines in the FAANG stocks earlier this year wiped out nearly half of the year-to-date gains of some of the best-performing actively managed funds. Such a high concentration in a handful of stocks contributing to the bulk of the fund managers' performance has unnerved some investors, sparking comparisons to the dot-com stocks in the early 2000s. When the historic tech bubble popped, over-concentration in unsuitable and risky technology and internet stocks hurt portfolio returns.

	Technology	Consumer Discretionary	S&P 500	Russell 1000 Growth	Russell 1000 Value
Cumulative return since the market low (March 2009)	548.60%	639.30%	372.40%	418.30%	341.70%
12 Month Forward P/E	17.9x	19.7x	16.4x	19.5x	14.2

Source: JPMorgan Asset Management Guide to the Markets as of 03.31.2018

There is no doubt that valuations of these companies have looked frothy relative to the rest of market, however, these companies offer better growth prospects and are therefore able to support higher valuations. Unlike to the dot-com bubble, technology companies' profits are in sync with their stock prices. In the early 2000's, the technology sector saw its share of S&P 500 market capitalization soar to over 30%, while its earnings contribution was about half of that. Today, however, this relationship is in far better balance – the technology sector's weight in the index is almost exactly in line with its earnings contribution.

The recent market sell-off has made these companies even more attractively valued. The overall impact of the recent decline has been to bring the technology sector's forward P/E ratio in line with its 15-year average, leaving the sector attractively priced relative to itself, the broader market, and fixed income. While the cheaper valuations reflect an increase in political and regulatory uncertainty and a re-pricing of the firms' cost structure, given the solid fundamentals - they may also represent an opportunity. As the first quarter earnings season kicked in, those stocks already made up some of the declines. Current earnings-per-share estimates are predicting year-over-year earnings growth of 24% for S&P 500 companies with strength in technology, financials, energy and telecom. A solid earnings season is likely what this jumpy market needs to calm it down.

Dominance of these technology and consumer discretionary stocks have caused the growth style to significantly outperform value stocks. At such historic performance levels, many analysts believe that this is the turning point and value stocks will start outperforming growth-oriented stocks. While there is clearly an increased risk for these stocks, the consensus is that the level of risk is manageable. On the regulatory side, new restrictions could slow innovation and impact the financial performance of these companies; however, the powerful trends driving this industry are likely to remain unchanged over the long term.

Despite the positive outlook for technology companies, those investing for retirement should keep their portfolios diversified across asset classes as well as equity styles. Investing in the technology sector can be volatile, therefore complimenting these investments with other equity wings, such as a value manager, may potentially lessen the unpredictability of a retirement portfolio.

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