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## Dot-Com Déjà Vu?



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How the mighty have fallen. For years, the so-called FAANG stocks – big tech companies like Meta Platforms (aka Facebook), Apple, Amazon, Netflix, and Alphabet (aka Google) – have helped drive the major market indexes ever higher. Many investors, both retail and institutional, blindly bought the names without considering these companies' fundamental valuations. And if they didn't buy them directly, those stocks were a big part of most mutual funds and passive ETFs, meaning that almost every investor owned some.

What's going on now with tech stocks is somewhat reminiscent of the dot-com bubble in the early 2000s. At that time, any company that tacked dot-com onto the end of its name would see its stock price skyrocket. It was exciting while it lasted, but eventually, the tech bubble burst, and everything came crashing back down to earth. Not surprisingly, many of those early internet companies went completely out of business in the aftermath of the dot-com bust.

Since then, markets have matured a great deal. Many of those early dot-com companies were complete startups experimenting with new ways of doing business. But many tech firms that survived that period, and others that followed in their footsteps, are comparatively more mature with more viable business models today. They've seen their share prices rocket up in the face of new work from home requirements with the Covid pandemic. Another factor that seems to have pushed their market values upward was all the stimulus and new money printed by the U.S. Treasury. A lot of that cash had no place to go but into the stock market (or cryptocurrency, but that's a story for another day).

Today, if you examine the major shareholders of these giant tech companies, and pretty much every other large company, a greater and greater percentage of them are owned by firms like Vanguard, BlackRock, Fidelity, State Street, and other ETF purveyors. Investors large and small have just been following the trend and putting their money to work in the stock market with ETFs of all different stripes. However, many of these ETF's hold the same companies under it all, including Apple, Amazon, Google, Facebook, and Netflix. It doesn't seem to matter if it's called a growth ETF or has another described strategy in its name, because many have similar exposures. But, as the most recent earnings reports become public, the market seems to be realizing that it's impossible to maintain astronomical valuations for the FAANGs and several of their ambitious peers.

Another factor to consider is that the record returns we've seen in the stock market have resulted in some companies benefitting just by being large and therefore being part of an index tracked by an ETF. Thus, those companies are attracting big passive shareholders. But some of them have gotten so big that their future revenue growth is now uncertain, and the market is struggling with that. In contrast, some big companies are doing just fine. Amazon beat its earnings estimates, but Facebook and Netflix fared much worse. Both companies showed significant growth slowdowns, catching investors by surprise.

Facebook, which was trading at close to \$400/share in September, closed at \$232 on February 9 – which represented the largest drop in market capitalization for any company in market history. If Facebook were the only tech stock suffering from a dramatically reduced market cap, you might say the drop was caused by consumer outrage over privacy concerns and Facebook's business model of using and manipulating personal data. But it wasn't alone in the fall from the stratosphere Netflix's stock traded at just under \$700/share in November but has recently fallen to below \$400. PayPal has seen its price cut by nearly two-thirds since its peak last summer.

Yet if you look closely at Facebook, even in the face of its reporting a declining user base for the first time, recognizing increased competition from TikTok and other social platforms, and perhaps most importantly Apple iOS changes that render its platform to be materially less valuable to advertisers, there still seems to be a good business that generates a massive amount of cash. As with other large tech companies, several of their largest shareholders are passive ETF investors and therefore don't bother to read through their public disclosures. Like many other tech giants of today, Facebook figured out how to either do something new or do something better than anybody else (establishing a massive digital social platform and medium to sell advertising). For example, Google wasn't the first search engine, but when was the last time you used AltaVista, Yahoo, or Dogpile to research something on the web?

Facebook figured out how to let people share pictures and information and, more importantly, how to closely track those people and target them for advertisers. They've done this to the tune of more than 3 billion users. So, while people may be frustrated that their data is being used, possibly without their consent, or that they are somehow being manipulated for profit, Facebook is not going away any time soon. Its global impact will be long-lasting, at least for the foreseeable future.

If nothing else, what's happened with these tech names over the last few months has made it obvious how much volatility there really is in these stocks. As the economy moves into a tightening cycle, it looks like investors are finally starting to question whether it still makes sense to bet on the future growth of these firms or if we should have a major reset of the tech world.

That said, it's always tough to analyze tech companies, especially given the current volatility in the markets. Many of them have long dated future cash flows, and potential investors need to really think carefully about how their prospects might change over time. When it comes to technology, consumer appetites and preferences can change rapidly. That's another reason for the tech selloff—as interest rates climb, the discount factor for these very long dated future cash flows climbs as well which drives a reduction in fundamental value.

As noted before in this space, it's a strange time in the markets. Now that we're in an environment where interest rates are rising, and inflation is becoming a serious issue, it's proving to be a good time to be a value-oriented fundamental investor. For the rest of this year, there will be numerous

opportunities for value investors and those who work to figure out what companies are fundamentally worth. There are a lot of public companies that are overvalued, partly due to all the cash that's sloshing around and the need for investors to park it somewhere. With some of these stocks that went to the moon, there's now an opportunity to see if their valuation withstands scrutiny after a careful analysis of their cash flow and their real prospects in a competitive marketplace.