

Equities in a Society of Control

Part II

By Didier Darcet

didier.darcet@

gavekal-intelligence-software.com

The readers who missed PART I can access the publication by clicking here:
[*Equities in a Society of Control – PART I*](#)

As highlighted in Part I, we are witnessing the transition of our world from a ‘Disciplinary Society’ to a ‘Society of Control’. In Part II, we study the structural opportunity to buy the winners, i.e. the FAANMG (Facebook, Amazon, Apple, Netflix, Microsoft, Alphabet) and the likes. Without the FAANMG, the US equity market would have performed broadly in line with the rest of the world in the last five years. The FAANMG are clearly a new species.

In Part I, we noted that these companies all focus on the intangible part of value, i.e. information. But there is more.

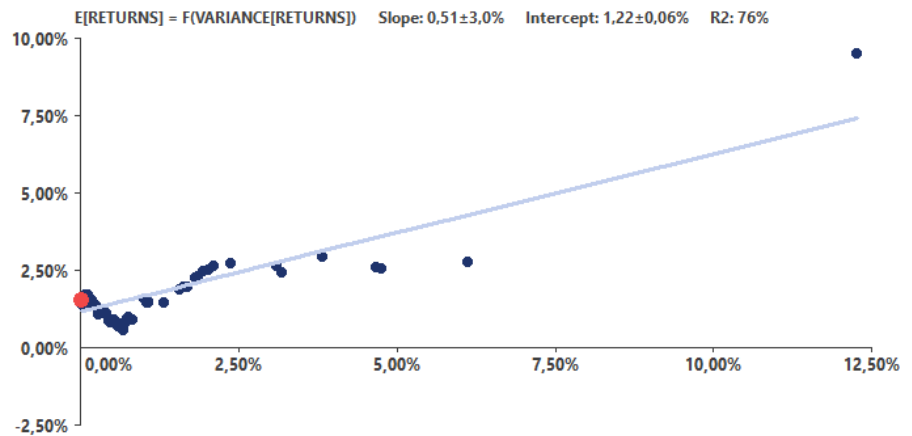
A Hidden Property: Antifragility

The meaning of antifragility

Antifragility is a new metric to group companies. It is potentially as powerful as metrics such as value and growth, small cap or large cap. An antifragile company is the one you can buy on dips. In stressed periods, antifragile assets recover more than they lost in the first place. Figure 1 below illustrates the sensitivity of, say, Alphabet, to its own variance.

When the stock variance increases, its price fluctuates more and more, on the down and the upside, but its expected return increases.

Alphabet – Expected excess return as a function of its variance



Source: Gavekal-IS, Bloomberg data 31/08/2004 to 30/04/2020

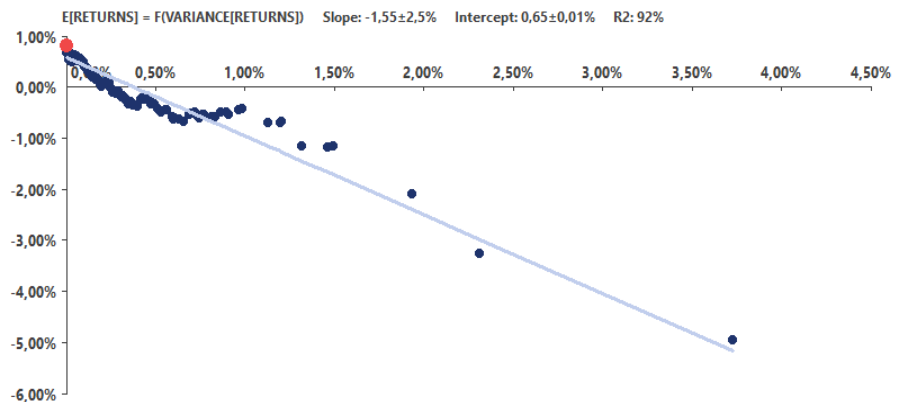
Such an extraordinary antifragile property is shared by Facebook, Amazon, Microsoft. Not by Apple, and not or not yet by Netflix. Among the new international competitors, only a few of them, today, are in the process of gaining such property: Snapchat, Twitter, Alibaba, Vipshop, Spotify...

What one expects from market arbitration

Market Arbitration Across Fragile and Antifragile Assets

Unlike antifragile assets, fragile stocks suffer from stress. They can provide excellent returns in a stable environment, but their expected return decreases with their variance. No free lunch. As volatility grows, variance (which is simply the volatility squared) increases also, until the expected return crosses the x-axis, which represents cash return. Fragile assets thus return less than cash, statistically, in high volatility periods. Figure 2 below shows, for instance, that the S&P500 enters dangerous territory when its volatility crosses 22% on the upside.

S&P500 – Expected excess return as a function of its variance



Source: TrackRisk, Bloomberg data 31/01/1960 to 30/04/2020

© Gavekal Intelligence Software. Redistribution prohibited without prior consent. This report has been prepared by Gavekal Intelligence Software mainly for distribution to market professionals and institutional investors. It should not be considered as investment advice or a recommendation to purchase any particular security, strategy or investment product. References to specific securities and issuers are not intended to be, and should not be interpreted as, recommendations to purchase or sell such securities. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed.

In a well-arbitrated market, a fragile risk asset will return more than cash in calm periods and less in stressed periods. Concurrently, an antifragile asset will return less than cash in low volatility regimes and more than cash in high volatility regimes. This is the case for gold, an emblematic and longstanding antifragile asset at the heart of the monetary system, as described in [Antifragile Assets: Select Bonds or Gold?](#) for instance.

In a transition phase, however, market arbitration can fail, simply because the financial system is self-reorganizing, and far out of equilibrium. The same phenomenon applies in physics. When one pours hot water in a cold bath, a diffusion process starts, creating turbulences and heterogeneity. Fifteen minutes later, the whole bath has turned warm, back to thermodynamic equilibrium.

The FAANGM Escape from Market Arbitration

Arbitration can fail

In the last ten years, the antifragile companies of the FAANGM group, i.e. Microsoft, Facebook, Amazon, and Alphabet escaped from market arbitration. In extremely low volatility periods, they did not return less than cash. Quite to the contrary, they posted between 1% and 2.3% per month excess return, with growing expected returns as their variance increased. There were thus statistical free lunches.

While free lunches do not last forever, they can last during phases of transition. 2020 is a good example: despite massive economic lockdowns and cascade effects on the advertising industry, the FAANGM thrived. They returned 31.8% above USD Libor in the first six months of the year, vs. -13.6% for the S&P 500 ex FAANGM. It is even likely that the Covid-19 pandemic accelerated the transition phase. The antifragile companies of the 'New World' have not ended their ride.