Are You Suffering From FOMO?

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The S&P 500 has climbed 7.4% since the start of the year, despite a number of pullbacks and an unusual level of political noise. Although economic data and company earnings reports have justified the rise in valuations, many have noted that a large portion of the market's rise has been driven by the appreciation of a small handful of FANG stocks (Facebook, Amazon, Netflix, and Google's Alphabet). This is largely due to the construction of the S&P 500, which gives greater weight to larger companies and may also be driven by a phenomenon known in behavioral finance circles as the "Fear of Missing Out" or FOMO. Some investors are feeling that FOMO and are buying shares of Facebook, Amazon, or even Bitcoin "before it's too late." But an implication of FOMO is that investors ought, perhaps, to be moving in exactly the opposite direction – towards value.

FOMO was originally studied in venture capital (VC) investing, and one of the more notable examples of the dot-com boom and bust was that of Pets.com, which received more than $130 million in funding despite VCs doing almost no due diligence into its business potential. The firm was shut down less than a year after it went public. More recently, Theranos saw its valuation surpass $9 billion before investors realized its promise of pinprick-based blood testing hadn't been verified. The firm announced its liquidation last week, and investors have lost nearly $1 billion.

Research by an economist at the Booth School of Business at the University of Chicago* revealed that FOMO can lead to overinvestment among VCs in a select set of companies. Fear of Missing Out on the returns of possible superstars caused the VCs to invest too little into due diligence in order to move more quickly and grab those investment opportunities before other VCs shut them out. As a result, VC-funded companies would include under-researched, high-valuation companies – and an inefficiently high number of those. But this also means some companies which ought to be seeing higher demand from VC investors would not, because the VC crowd is rushing investments into more high-profile companies because of their fear of missing out. While this outcome is the result of a careful weighing of the time cost of doing research and the possible missed opportunity of investing in some future Amazon or Facebook, it also indicates that there are gems left behind—gems that are cheap compared to their potential.

While the research into the FOMO effect concentrates on patterns of investing and over-valuation in venture capital prospects, we may be seeing the same phenomena in publicly traded stocks. This should be a warning to investors in especially high-valuation stocks, but also points to the likelihood that some low-valuation stocks are trading below their intrinsic value—and that creates an opportunity for investors.

Indeed, value stocks have underperformed over the last several years, while growth stocks have continued to lead the broader market. Given that the growth stocks—and broader market—have been dominated by a handful of high-flyers, we are likely seeing the dynamics of FOMO at work. We also think it likely that the momentum trade is reinforcing this pattern. At some point, these drivers break down—when enough investors start to think a stock's price won't keep moving higher or when enough investors find that Fear of Loss dominates Fear of Missing out.

And then it may be value investing's turn. For long-term investors, the mantra behind investment choices lies in spending extensive time on due diligence by digging through financials and doing deep background research on a company and its markets. As growth slows, we may very well see the forces of FOMO and momentum reverse, and that suggests that the time may be ripe for value stocks to outperform. The cracks are beginning to show: Netflix is down 17% from its 52-week high, Facebook is down 26%, and Bitcoin has dropped 68%.

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