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The Magnificent Seven: Risk or Opportunity?

Wayne Richardson & Peter Roberto

In 2023, a major focus for equity markets was a select group of stocks now known as "The Magnificent Seven" (i.e., Apple, Microsoft, Alphabet, Amazon, Nvidia, Tesla, and Meta Platforms). Why dub this group magnificent? A quick look at the numbers tells part of the story.

These seven companies comprised nearly a 30 percent weight of the S&P 500 by year-end and accounted for roughly 60 percent of the index's gains in 2023. On a market cap-weighted basis, the performance of the Magnificent Seven was up nearly 80 percent in 2023, including Meta Platforms (up more than 150 percent) and Nvidia (up more than 200 percent).

While few investors would quibble with such results, it does present an interesting dynamic. Here, we'll explore the impact of the Magnificent Seven on the investing outlook and how investors can tap into opportunities and manage the risks.

Looking Back at 2023

Before we evaluate the road ahead, let's look back at how we got here. Figure 1 highlights how 2023's performance compares to other years when considering the contributions of the index's largest constituents.

A couple of things stand out in this data. There are several years toward the top that preceded a particularly rough stretch for the market (e.g., 2007, 1999, 2021). But there are also some years in the mix that were followed by a continued market rally (e.g., 1998, 1996, 2019).

Figure 1. Positive Years for the S&P 500 Index: Contribution of the Top 10 Weights

Year	Top 10 as Percentage of Total
2023	80.1%
2007	78.7%
2020	58.9%
1999	54.5%
2021	45.0%
1998	36.8%
1996	33.9%
2017	33.3%
2019	32.8%
1991	28.6%
2006	27.6%

Source: Strategas Research Partners (data as of November 30, 2023)

The journey of markets in years past raises some questions about where markets stand heading into 2024, what it may mean going forward, and what investors can potentially do about it.

Surveying the Landscape

One consequence of the Magnificent Seven is a concentrated market. On the growth side, this group represents north of 40 percent of popular growth indices (e.g., large-cap-weighted growth indices like the Russell 1000 Growth). Looking at the broader market, Figure 2 illustrates the level of concentration of the largest companies in the S&P 500 relative to the past 25 years (roughly) compared to the earnings they have generated.

Figure 2. Top 10 Stocks in the S&P 500 Index: Concentration Vs. Earnings Contribution

Weight of the top 10 stocks in the S&P 500: % of market capitalization of the S&P 500

Earnings contribution of the top 10 in the S&P 500 based on last 12 months' earnings

Source: FactSet, Standard & Poor's, JP Morgan Asset Management 4Q Guide to the Markets

As shown above, the concentration of the top 10 names had a clearer and more persistent upward trend than their earnings contribution did. One thing to keep in mind when looking at this data is the economic distortions caused by the 2020 pandemic and subsequent lockdowns. At that time, the spike in their earnings contribution was largely

because many smaller companies in the S&P 500 saw their earnings decimated from the lockdowns. Therefore, the spike did not reflect a large jump in earnings from the group.

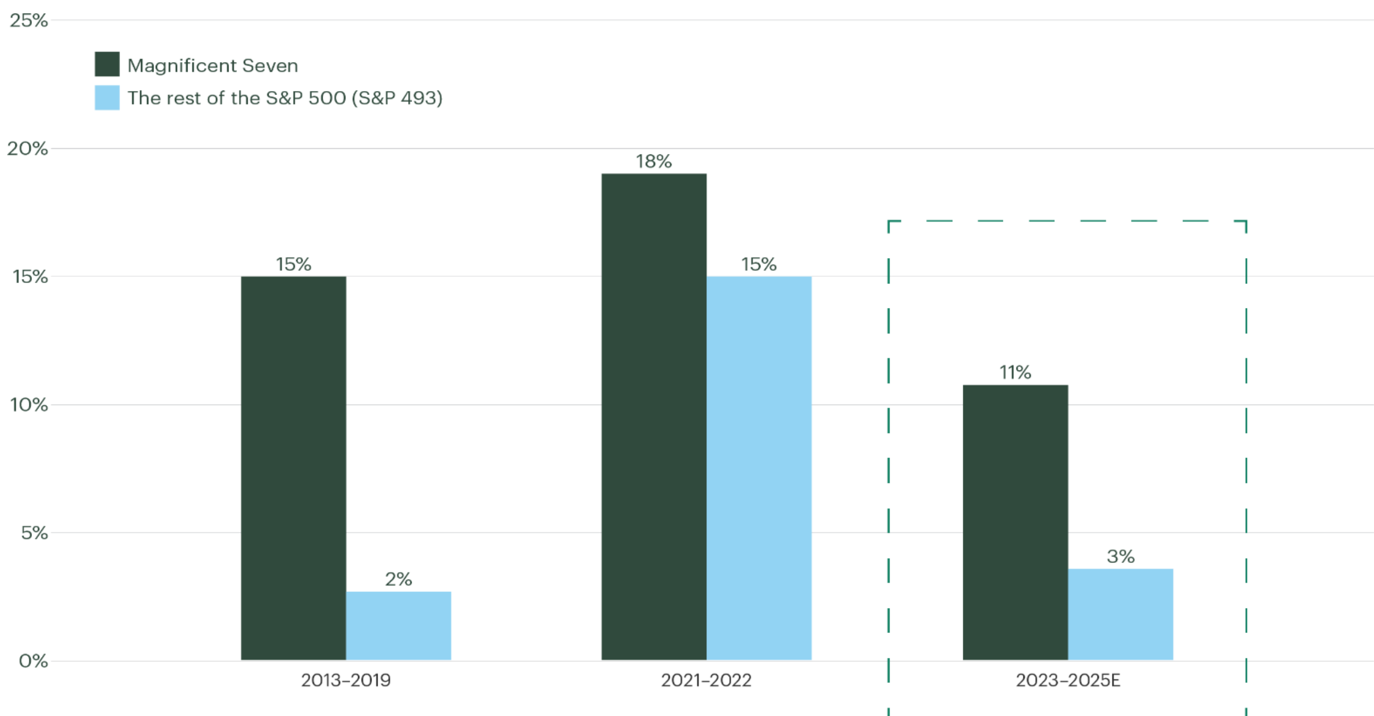
Even with that caveat, the bottom line is this: the concentration of the largest stocks has grown much more than their relative earnings contribution. As of September 20, 2023, the forward P/E of the top 10 in the S&P 500 was 128 percent of its historical average going back to 1996, whereas the S&P 500 as a whole has a forward P/E of 108 percent of its historical average. The top 10 make up a greater weight in the index. They have also become increasingly more expensive compared to the rest of the market based on their earnings. Because of this, the collective group must grow earnings that much faster than the rest of the market to justify their current index weight and valuations.

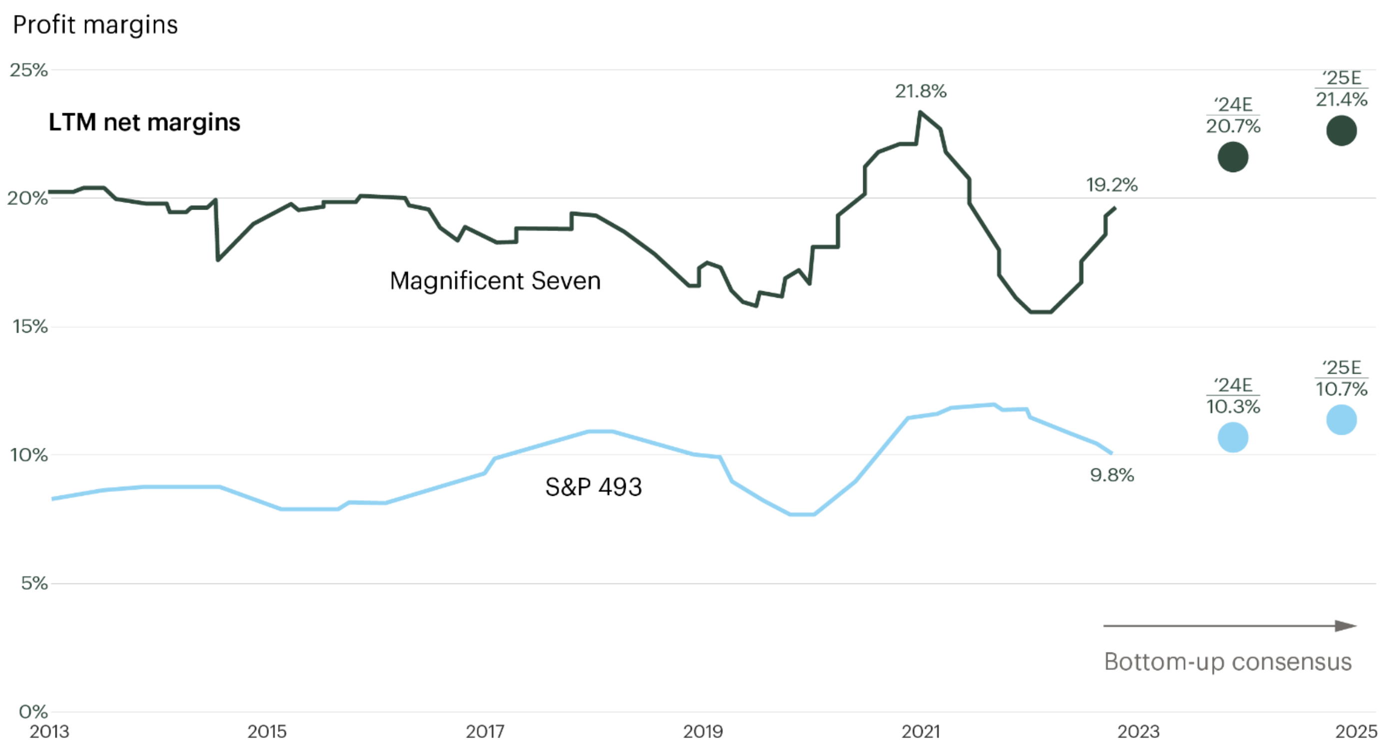
Paving the Way with AI

Of course, one explanation for all this can be summed up in two letters: AI. It's safe to say that nearly everyone has heard the hype around AI, most notably regarding ChatGPT. Nvidia has become something of a poster child for AI companies, known for its powerful GPU (graphics processing unit) chips.

In this environment, companies that show how they can benefit from AI—or at least articulate how they could benefit from it going forward—have been rewarded by the market. And from an investor's perspective? There's data to support the hype.

In Figure 3, the chart on the top illustrates the sales growth of the Magnificent Seven over the last several years, as well as analyst estimates for sales growth from 2023 to 2025. On the bottom, we see the Magnificent Seven's last twelve months' net margins (LTM net margins) compared to the rest of the S&P 500 constituents, as well as analysts' bottom-up consensus estimates for net margins in 2024 and 2025.





Source: FactSet, Goldman Sachs Global Investment Research (data as of November 15, 2023)

With this lead over other companies in profitability (20.7 percent versus 10.3 percent for 2024) and growth (11 percent versus 3 percent for 2023–2025) expectations, who wouldn't want as high a concentration in these names as possible from the index? But herein lies the potential problem.

Seeking to Smooth Out the Ride

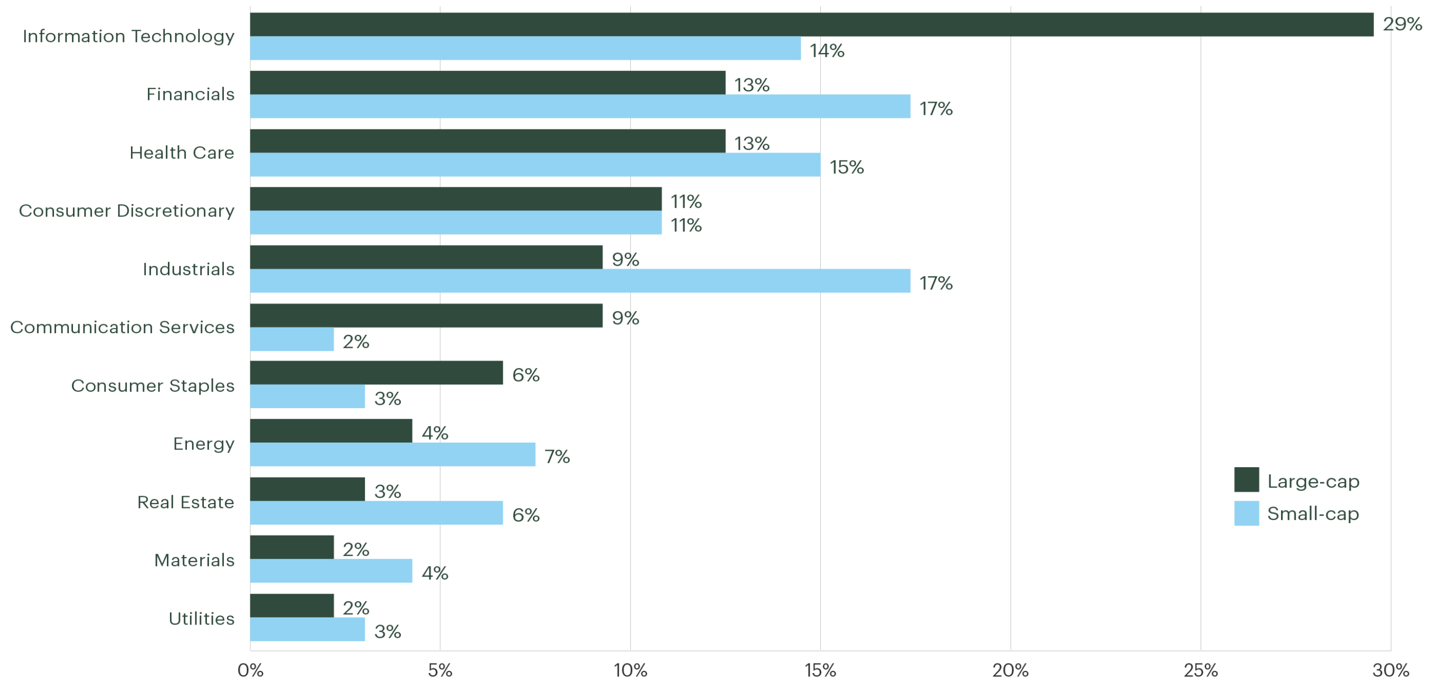
There are a few ways families can mitigate this risk without completely avoiding these names and missing out on the potential upside.

Diversification. The first and perhaps most obvious method is a key tenet in the investing discipline: diversification. It can be useful to implement this strategy at the asset class level (e.g., between stocks and bonds) but also within an asset class. In equities, this can mean diversifying with the international space, having growth and value stocks, and providing exposure to varying market caps.

Figure 4 compares sector exposure in large-cap versus small-cap, highlighting how clients can gain differing exposures to industries within the economy at different market cap sizes.

Figure 4. Sector Exposure: Large-Cap Vs. Small-Cap

Sector composition: % of index market capitalization



Source: Compustat, FactSet, FTSE Russell, NBER, J.P. Morgan Asset Management. The S&P 500 is used for large-cap and the Russell 2000 is used for small-cap. Guide to the Markets - U.S. Data, as of December 31, 2023.

Systematic rebalancing. Another strategy that can help smooth out the ride for investors and mitigate risk is systematic rebalancing. Essentially, the process equates to ongoing maintenance of a portfolio's diversification and keeps with one of investing's oldest adages: buy low, sell high.

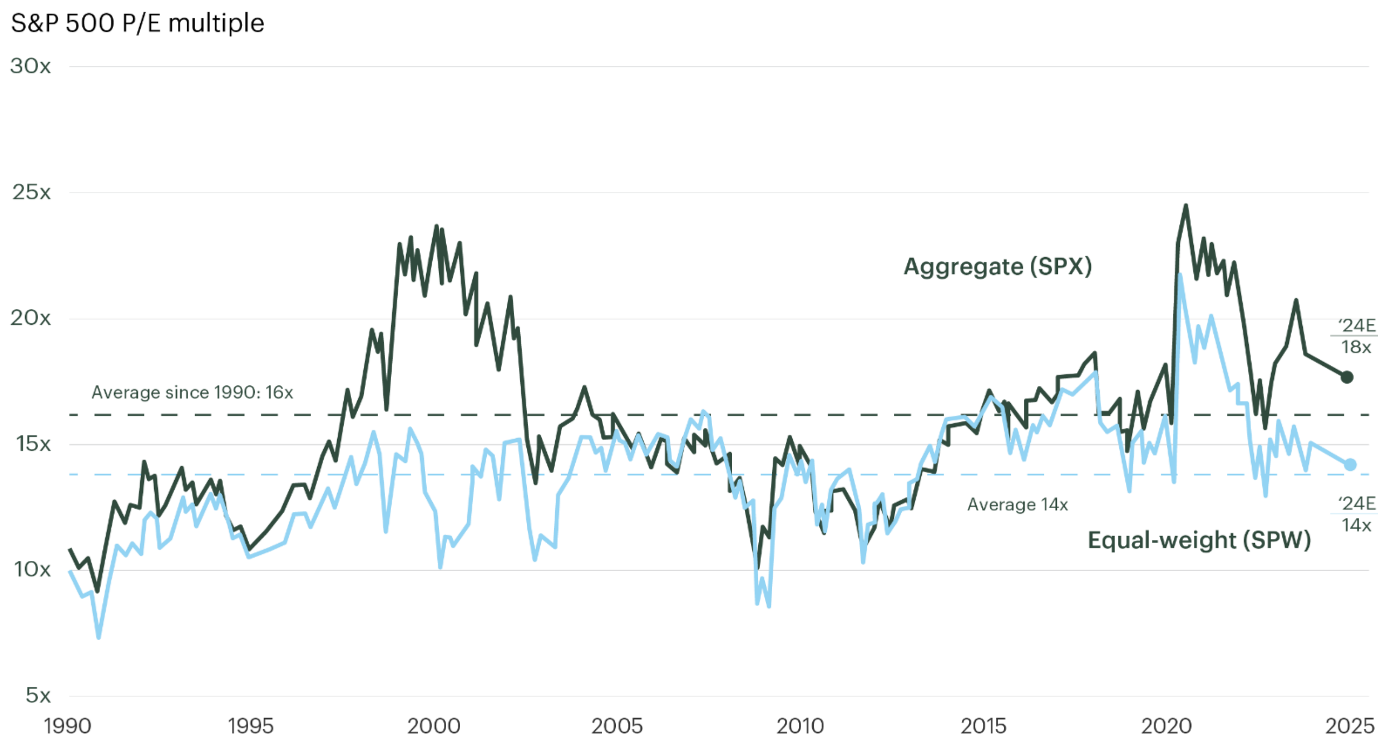
Generally, it makes sense to rebalance on a set time frame (e.g., at least annually or semiannually). This schedule helps ensure that the emotion is removed from the decision-making process while keeping the portfolio allocated appropriately. If left to choose when to rebalance, individuals may be tempted to see if what has performed best can do a little better or shy away from lagging areas in the market and sell low.

Large-cap exposure. Finally, given how concentrated many large-cap equity indices have become, you may also look for ways to spread out your large-cap exposure.

Large-cap is the only area of the market with this concentration problem. Why? There isn't anywhere for the largest constituent companies to "graduate," like they do when they move from small to mid or mid to large. So, to better spread out exposure in the large-cap area, you can supplement other holdings with an equal-weighted option (e.g., an index fund tracking the S&P 500 Equal Weight Index).

Figure 5 highlights the P/E of the standard market cap-weighted S&P 500 compared to the equal-weight version. As you can see, the equal-weight version has been closer to its historical average. For context, the last time there was such a sustained, wide discrepancy in P/E between the two indices was leading up to the dot-com bubble burst.

Figure 5. P/E Ratio: S&P 500 Index Vs. S&P 500 Equal Weight Index



Source: FactSet, Goldman Sachs Global Investment Research (data as of November 15, 2023)

One interesting quirk of the S&P 500 being so top-heavy is that 400 of the constituents have a larger weighting in the equal-weight version of the index. So, adding the equal-weight index to supplement a market cap-weighted index may help mitigate the concentration in the top names and counterbalance the overall growth tilt in the large-cap space.

Trees Don't Grow to the Sky

There is an old German proverb that goes, "trees don't grow to the sky," and it's apropos of the ongoing narrative of the Magnificent Seven. These high-flying names serve as a reminder of the inherent limitations of exponential growth. Similar to how the mightiest oak eventually reaches its physical constraints, the most promising companies also encounter headwinds, competition, and market correction. Again, it all comes back to managing that risk.

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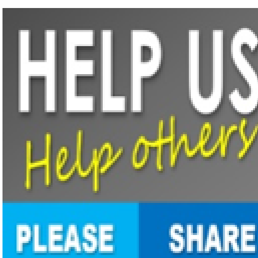

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