MEKETA

The Magnificent Seven: Should we be worried about market concentration?

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Key takeaways

→ **Market dominance:** The Magnificent Seven are a group of seven tech-related mega-cap stocks that have grown to dominate the US stock market in recent years.

→ **Similarities with the Dot-Com Bubble:** The last time the market concentration and the influence of the largest stocks were this high was during the Dot-Com Bubble, another period of technological innovation and exuberance.

→ **Financial metrics:** The current largest stocks have some similarities and some differences with their counterparts during the Dot-Com Bubble, but they appear to be more stable and less vulnerable to short-term cash flow issues.

→ **Future prospects:** The Magnificent Seven may not be able to sustain their growth and dominance, as history shows that market leadership tends to change over time, and only a few companies can adapt to new technologies and consumer demand.

Can you have too much of a good thing? The US stock market's dependance on the Magnificent Seven may be cause for concern.

The Magnificent Seven are a basket of seven mega-cap stocks that currently dominate the equity market. They include Alphabet (i.e., Google), Amazon, Apple, Meta (i.e., Facebook), Microsoft, Nvidia, and Tesla. Five of the seven companies (Alphabet, Apple, Meta, Microsoft, and Nvidia) are considered leaders in the technology industry. The other two (Amazon and Tesla) are heavily intertwined with technology and are also generally considered industry leaders.

A brief history

While the term "the Magnificent Seven" has only been around for about a year, there is a longer history of acronyms used to describe tech-related mega-cap stocks in the market. The term "FANG stocks" was coined about a decade ago to describe some of the highest-growth tech stocks of the period. It included Facebook (now Meta), Amazon, Netflix, and Google (now Alphabet). Not long after, the term was expanded to FAANG to include Apple. A changing market environment and re-branding of several companies prompted a shift in acronyms in 2021. Netflix was dropped from the group and Microsoft was added, changing the acronym to MAMAA.[1] Finally, in 2023, this group of MAMAA stocks was expanded to include Nvidia and Tesla, which together became the Magnificent Seven.[2]

[1] Source: Forbes, "What Happened to FAANG Stocks? They Became MAMAA Stocks," November 2023.

FIGURE 1
Timeline of Tech Stock Acronyms

Source: Meketa Investment Group, 2024.

2013

→ The term FANG is coined.
- **F**acebook (now Meta)
- **A**mazon
- **N**etflix
- **G**oogle (now Alphabet)

2017

→ Apple is added to FANG, expanding it to FAANG.

2021

→ FAANG drops Netflix, adds Microsoft, and rebrands to MAMAA.
- **M**eta
- **A**mazon
- **M**icrosoft
- **A**lphabet
- **A**pple

2023

→ The Magnificent Seven term emerges. (also known as MAMA ANT)
- **A**lphabet
- **A**mazon
- **A**pple
- **M**eta
- **M**icrosoft
- **N**vidia
- **T**esla

The Magnificent Seven's recent dominance

The Magnificent Seven's relative weight in the equity market has grown in recent years. As of December 31, 2023, these seven stocks cumulatively represented 22% of the Russell 3000 index (see Figure 2).

[2] The term magnificent Seven was coined by an analyst at Bank of America in 2023. Source: NASDAQ, "What to Expect from the Magnificent Seven Stocks in 2024," December 5, 2023. The term most likely is based on the popular 1960 western film "The Magnificent Seven," which itself was a remake of the 1954 film "Seven Samurai."

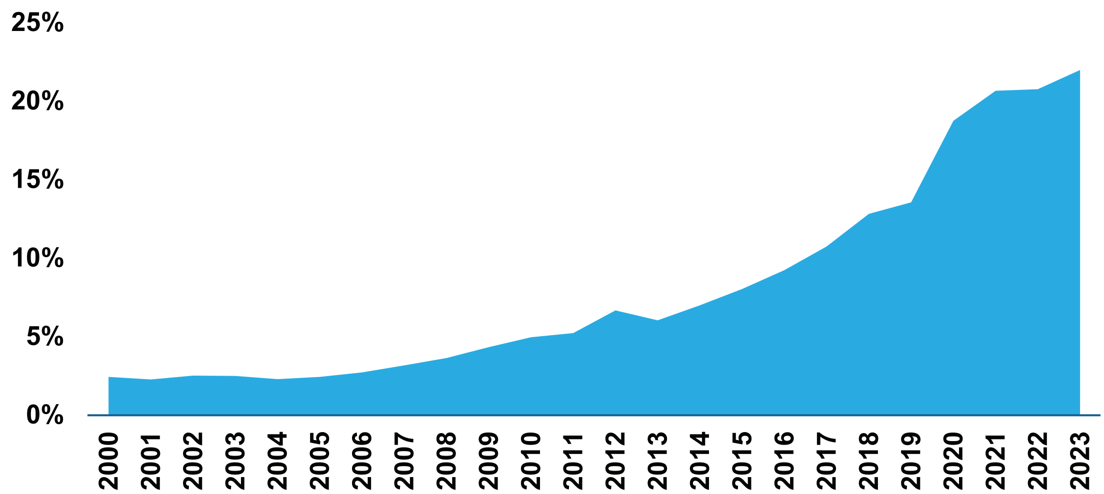

FIGURE 2
The Magnificent Seven's Index Weight in the Russell 3000

Source: FactSet, as of December 31, 2023. Note that Alphabet Class A and C were combined into one category for this analysis. Includes all seven stocks at their weight in the index at that time; note that not all seven companies were publicly listed for the full period shown.

While it is not unusual for the largest stocks in a capitalization-weighted index to have a meaningful impact on the market's performance, the degree to which the Magnificent Seven drove returns for the major indices in 2023, particularly in the first ten months, was extraordinary. As shown in Figure 3, from January to October 2023, the Magnificent Seven represented nearly all of the Russell 3000's gains. This caught investors' collective attention and has led to concerns about market concentration. However, in the rally at the end of 2023 (November through December), their influence on returns was much lower.

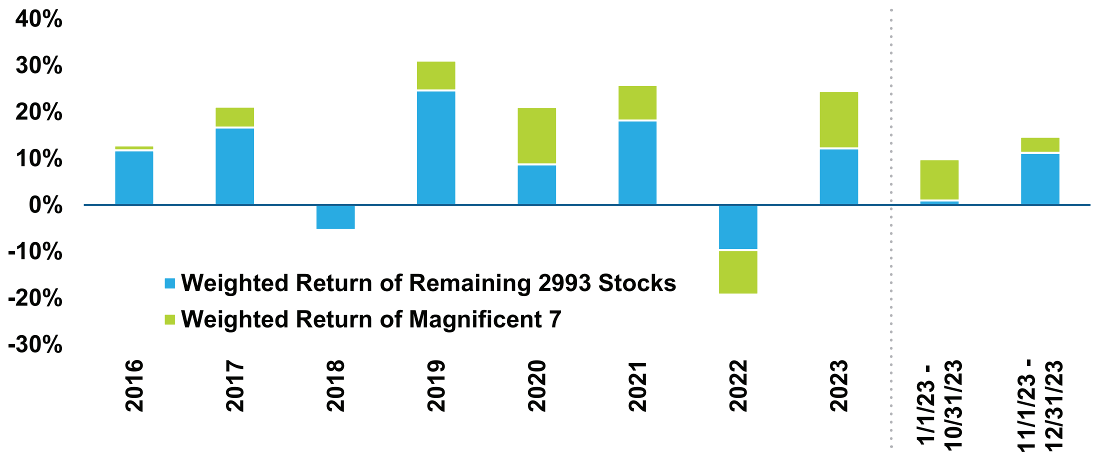

FIGURE 3

The Magnificent Seven's Contribution to Russell 3000's Return

Source: FactSet, as of December 31, 2023. Alphabet Class A and C were combined into one category for this analysis. In 2018, the Russell 3000 returned -5.21% while the Magnificent Seven returned 0.16%.

Has this happened before?

The Magnificent Seven have not always been such a dominant force. Prior to the past several years, they represented a much smaller portion of the market (shown above in Figure 2). Moreover, most were not founded until the 1990s or 2000s. This limited history makes it difficult to conduct a thorough analysis over a longer time period. To gain a longer-term historical context, we look at the market's ten largest stocks (by relative weight) in each year. This would, by default, include the Magnificent Seven stocks in recent years.

The weight of the ten largest constituents in the Russell 3000 index has been cyclical, with periods of both peaks and troughs. Since 1986, the average combined weight of the ten largest constituents in the index has been roughly 17%. There have only been two periods above this average: 1999 to 2004 (i.e., the Dot-Com Bubble) and 2018 to 2023.[3]

[3] Arguably, the rise of passive index products has resulted in an increased direction of cash flow to the largest companies and contributed to the phenomena of greater market concentration.

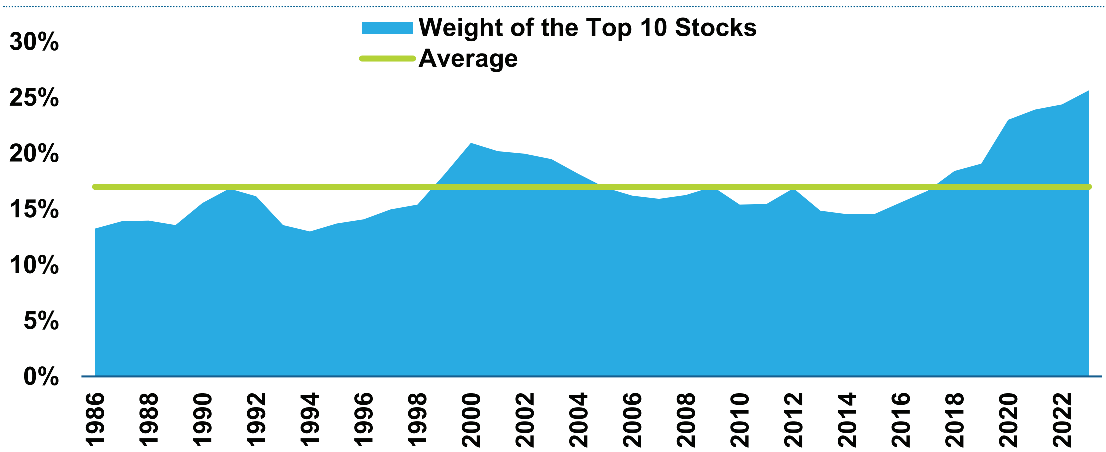

FIGURE 4

Historical Total Weight of the Russell 3000's Top 10 Constituents

Source: FactSet, as of December 31, 2023. Note that Alphabet Class A and C were combined into one category for this analysis.

Historical Contribution of the Top 10 Largest Stocks

Historically, the ten largest stocks have often represented an outsized portion of the index's returns. However, 2023 stands out for the top ten contributing such a large share of returns, and it is part of a larger recent trend. Since 2018, the top ten constituents' influence on the Russell 3000's returns has grown, coinciding with the rise of the Magnificent Seven.

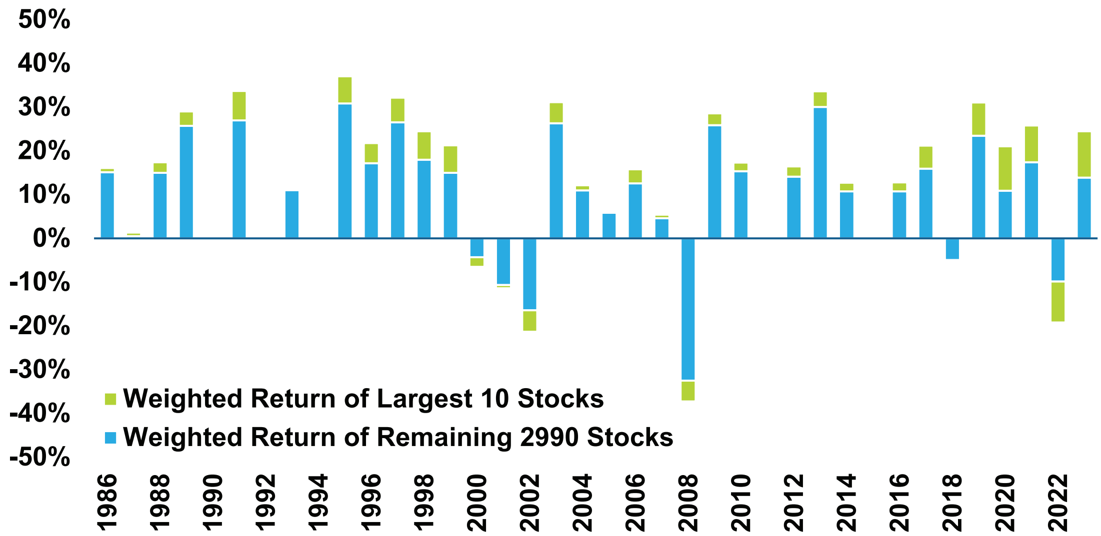

FIGURE 5
Contribution to Annual Return of the Russell 3000

Source: FactSet, as of December 31, 2023. Note that Alphabet Class A and C were combined into one category for this analysis.

In years 1990, 1992, 1994, 2011, and 2015, the top 10 and the rest moved in opposite directions, making the stacked column not meaningful; hence they were excluded from the chart.

As shown below in Figure 6, the Dot-Com Bubble was the last time the top tens' relative influence on returns was this high for a sustained period. When ranking each year since 1986 by cumulative absolute return contribution, the past five years have reflected similar patterns of the Dot Com years.

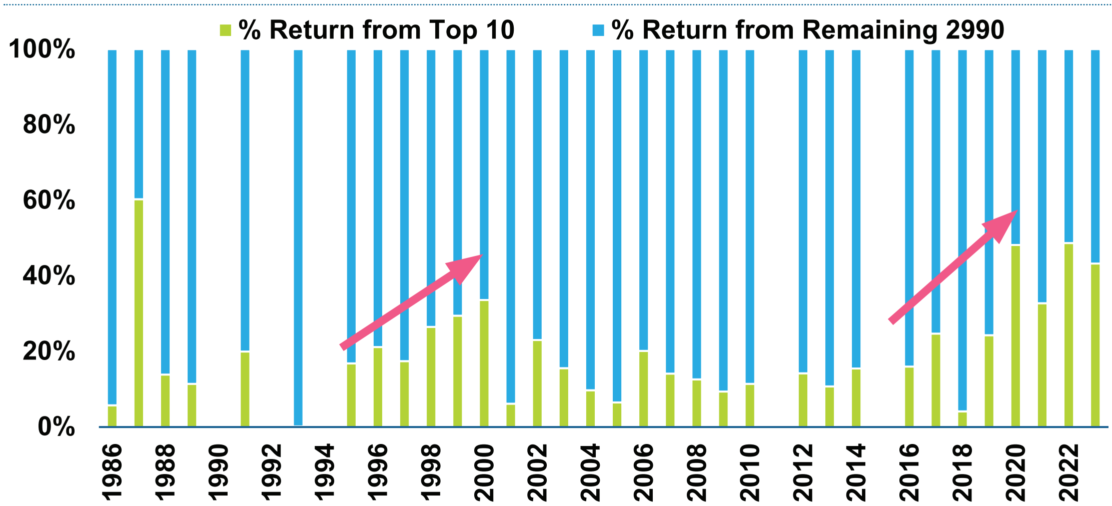

FIGURE 6
Percentage Contribution to Annual Return of the Russell 3000

Source: FactSet, as of December 31, 2023. Note that Alphabet Class A and C were combined into one category for this analysis.

In years 1990, 1992, 1994, 2011, and 2015, the top 10 and the rest moved in opposite directions, making the stacked column not meaningful; hence they were excluded from the chart.

Why these stocks? Why now?

The common theme of the Magnificent Seven is technology. These companies are focused on figuring out how best to incorporate emerging technologies into their business models to more efficiently meet consumer demand and drive product innovation. Two events in particular aided in the Magnificent Seven's recent meteoric rise.

The first was the COVID-19 pandemic, which further boosted the demand for these stocks as many of these companies offered solutions for remote work, e-commerce, entertainment, and communication in a socially distanced world. The second was the broad release of ChatGPT in late 2022, which made generative AI an overnight sensation and ignited the race for companies to develop and bring their own, unique generative AI products to market.

The theme of the market rewarding the stocks it perceives to be best positioned to benefit from new technologies is not new. The sharpest increases in market concentration over the last 30 years have coincided with an affinity for stocks in the technology industry (see Figure 7). The first of these periods, the late 1990s' through early 2000s, was the peak of the Dot-Com era. After the Dot-Com Bubble burst, the weight of the tech industry in the index dropped. In recent years, the technology industry's relative weight has surpassed that of the Dot-Com era.[4] Again, this relative weight increase coincides with the rise of the technology-centered Magnificent Seven.

[4] This does not include Tesla and Amazon, which are both classified as being in the consumer discretionary sector.

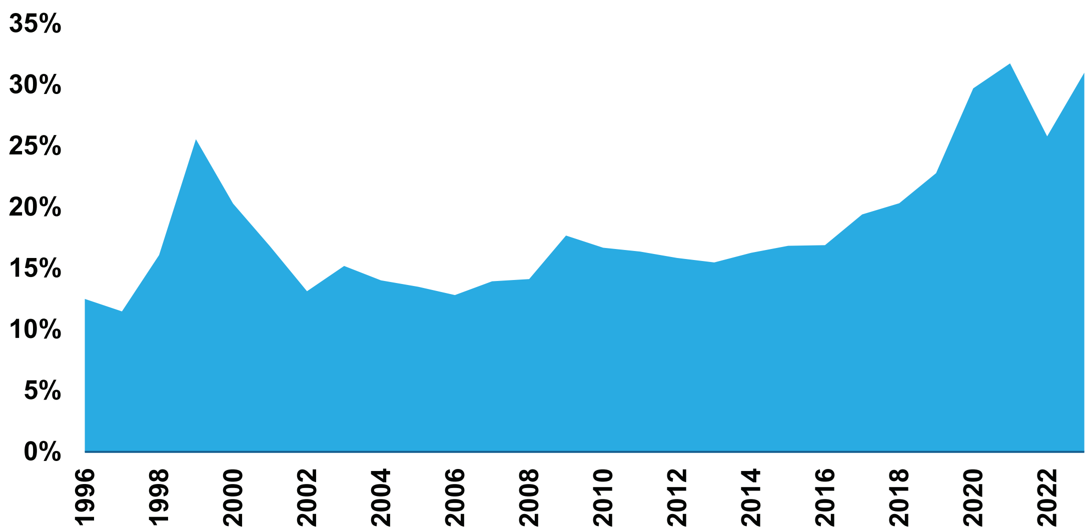

FIGURE 7
Tech Industry Weight in the Russell 3000

Source: FactSet, as of December 31, 2023. See the Appendix for more details on the sectors and sub-sectors included in Technology. Note that Alphabet Class A and C were combined into one category for this analysis.

Might history be repeating itself?

This recent period bears some resemblance to that of the Dot-Com Bubble, with emergent technologies (such as the internet then and generative AI today) potentially changing the way the world operates.

Dot-Com Bubble	Today
→ The unprecedented growth in widespread internet adoption led to exponential demand for online services and products.	→ Generative AI is a potentially transformative technology, like the internet.
→ This benefited firms who provided these internet services.	→ This benefits firms who make generative AI tools, such as Microsoft, Meta, and Alphabet.
→ It also benefited those companies who were building the "infrastructure" needed for the internet, such as Cisco, Intel, IBM, and Microsoft.	→ It also benefits companies who make the components necessary for AI, like Nvidia, the largest US designer of the high-end chips needed to power AI.
→ The bubble burst when many smaller internet-based companies failed to generate profits or revenues, and investors lost confidence in their future.	

FIGURE 8
Similarities between the Dot Com Bubble and Today

Source: Meketa Investment Group, 2024.

These similarities beg the question of whether the current period might follow the path of the Dot-Com era, where many of the most-hyped companies ultimately failed to deliver on claims regarding emerging technologies, and investors suffered as a consequence. Or might the Magnificent Seven companies maintain their growth trajectory by continuing to evolve and use new technologies?

How do the financials match up?

Comparing key financial ratios such as price-to-earnings, price-to-cash flow, operating margin, and debt-to-assets of the ten largest stocks during the Dot-Com Bubble to those of the ten largest stocks in recent years may help to shed some light on the similarities, or lack thereof. Figure 9 below shows that, generally, the ratios in these two periods are in line with each other, with the exception of a few deviations that may imply important differences.

One takeaway is that while both periods have similar total debt-to-assets ratios, the recent period displays a much higher ratio of long-term debt to capital. This means that while the total amount of debt is relatively the same, in recent years, there has been a shift in the type of debt used such that a much greater portion is long-term debt. This is likely due to the easier funding environment of the past decade, as low interest rates allowed companies to term out their debt. Hence the top ten companies today have less funding stress and are better positioned to weather short-term cash challenges than their counterparts during the Dot-Com era.

Another key takeaway is that the top ten in recent years display a substantially lower debt to income ratio. Further, the cost of servicing this debt is lower than it was during the Dot-com era, when interest rates were higher. This may imply that today's debt is more easily serviceable and, thus, the top ten may be more financially stable now than during the Dot-Com era.

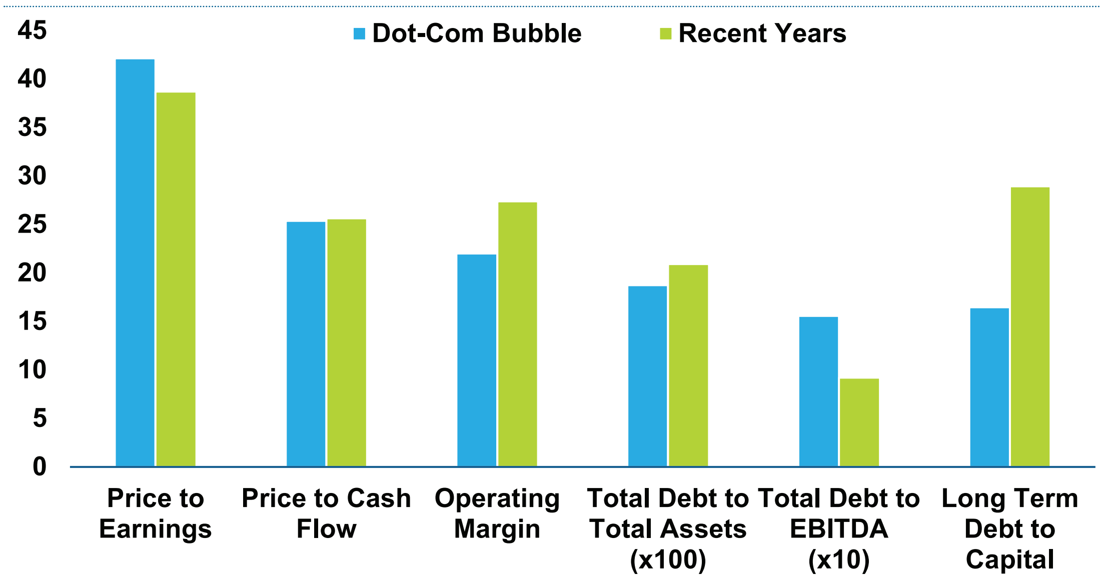

FIGURE 9

Average Financial Metrics of the Top 10 Stocks in the Russell 3000

Source: FactSet. Period for the Dot-Com Bubble is 1998 to 2002. Period for Recent Years is 2018 to 2023. Price to earnings, price to cash flow, and operating margin are as of September 30, 2023, all other ratios are as of December 31, 2023. Total debt to total assets and total debt to EBITDA, are multiplied by 100 and 10, respectively, for the purposes of viewing this chart. Note that Alphabet Class A and C were combined into one category for this analysis.

What will happen next?

If history is any guide, only a few of the Magnificent Seven will continue to outperform. The inherent "creative destruction" of capitalism[5] has a history of dethroning the largest companies.[6] Some of the Magnificent Seven will likely be among the "winners" who learn how to adapt to and benefit from emerging technological trends. For example, Microsoft was a "winner" who survived the popping of the Dot-Com Bubble by successfully adapting to the changing technological environment and is now worth more than 6x its peak Dot-Com era value. However, other companies may fail to evolve or execute and will likely fall behind. One such example from the Dot-Com Bubble is Cisco Systems, which has yet to regain its peak value from 2000.

[5] The "creative destruction" of capitalism refers to the theory that innovation and technological advances inherently destroy and reconfigure economic structures in the market.

[6] According to MSCI, only one-quarter of stocks have historically kept pace with the market after reaching the top ten. Source: MSCI, "AI's Moment and Insights from Themes Past," August 9, 2023.

Figure 10 below shows the weight of the ten largest stocks in the index (shaded in blue) and the weight of those same ten stocks a decade later (green line). From 1986 to 2012, the ten largest stocks declined in market weight over the subsequent decade. Particularly, the period of the Dot-Com Bubble is notable for its steepness, falling from 20% in 2001 to 10.6% in 2011. However, the market weight of the ten largest stocks in the index increased from 2013 to 2023 - the only time this has happened since 1986. This may tell us that there is less turnover in the index over the last decade than there has been historically.

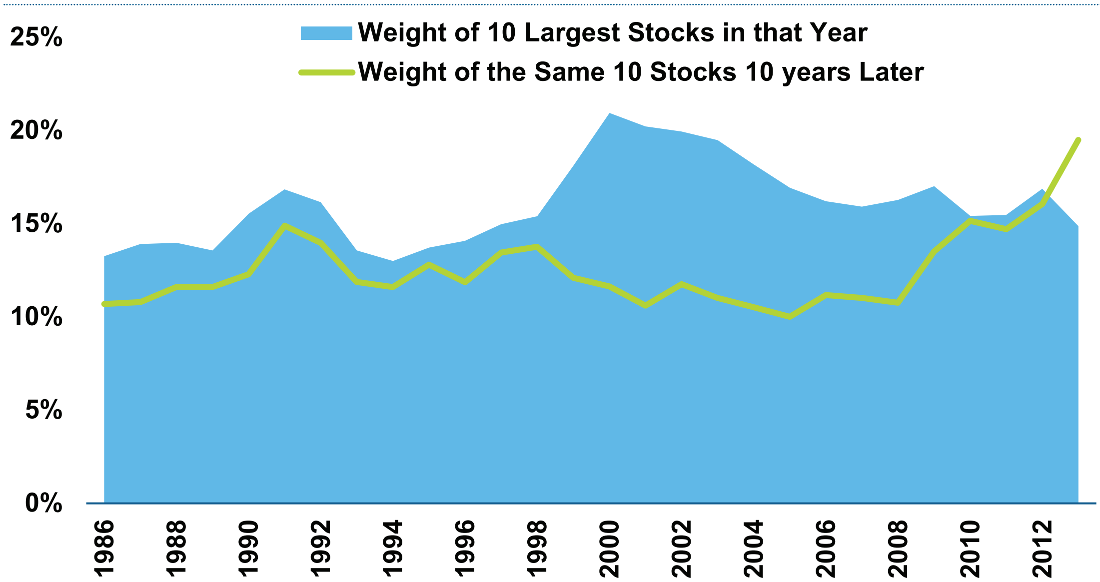

FIGURE 10
Weight of the Top 10 Largest Stocks in the Russell 3000 and Weight of Same 10 Stocks a Decade Later

Source: FactSet, as of December 31, 2023. Note that Alphabet Class A and C were combined into one category for this analysis.

With so much of the market concentrated in such a small number of stocks, the decline of even a few of the largest ten would be painful for all investors in the stock market. Yet investors have survived many past cycles of concentration and changes in market leadership.

Summary

The Magnificent Seven are a group of seven mega-cap stocks that are positioned in, or adjacent to, the technology sector. Their cumulative weight in the US stock market has been growing in recent years, as has their contribution to the market's performance. Notably, the Magnificent Seven accounted for nearly all of the Russell 3000's return from January through October 2023. More broadly, the top ten largest stocks (which include the Magnificent Seven) have recently been driving market returns to a greater extent than they have in two decades. This outsized influence of the largest stocks on market returns has become the new norm in recent years, while at the same time raising concerns about market concentration.

This is not the first time that concentration in the market has spiked. The last major peak coincided with the Dot-Com Bubble, another technology-focused era. A comparison of financial metrics shows some similarities along with a few key differences between the two periods. Importantly, several debt ratios imply that the ten largest stocks today are relatively more stable and better positioned to weather any short-term cash flow issues than their counterparts were during the Dot-Com Bubble. Nevertheless, the parallels between today and the exuberance of the Dot-Com era beg the question of whether the Magnificent Seven and other highly weighted stocks will be the ones that benefit most from emerging technologies such as AI.

Appendix

Appendix 1. Breakdown of the Russell 3000 Tech Industry and Sectors

The tech industries and sectors of the Russell 3000 are listed below:

→ Technology (pre-2020)[8]
- Diversified Technology
- Electronics
- Information Technology
- Telecommunication

→ Technology (2020 to current)
- Software and Computer Services
- Technology Hardware and Equipment

→ Telecommunications (2020 to current)
- Telecommunications Equipment
- Telecommunications Service Providers

[8] Note, in 2020, the Russell 3000 changed their classification system so that Telecommunications became its own industry (separate from Technology) and the remaining tech sectors were re-named and re-classified.

Appendix 2. List of the Top 10 Stocks in the Russell 3000 During the Dot-Com Bubble and Now

Dot-Com Bubble	Now
General Electric	Apple
Coca-Cola	Microsoft
Exxon Mobil	Alphabet
Intel	Amazon
Merck	Meta Platforms
Altria Group	Berkshire Hathaway
Microsoft	JPMorgan Chase
Procter & Gamble	Johnson & Johnson
IBM	Exxon Mobil
Johnson & Johnson	Bank of America
Pfizer	Visa
Cisco Systems	Procter & Gamble
Lucent Technologies	Tesla
AT&T	NVIDIA
Citigroup	UnitedHealth Group
AIG	
Time Warner	
Walmart	

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