EQUITY STRATEGY INSIGHTS

Magnificent Seven Growth and Profitability Metrics Justify Large Valuation Premiums

A Publication of LPL Research

February 6, 2024

Jeffrey Buchbinder, CFA
Chief Equity Strategist

Adam Turnquist, CMT
Chief Technical Strategist

EXECUTIVE SUMMARY

- Performance of the Magnificent Seven mega-cap technology stocks has been excellent over the past year. But after a terrible year in 2022, the two-year performance is not ahead of the S&P 500 by as much as one might think.

- Based on the stellar earnings growth of these companies (six of them, at least) and significantly better profitability metrics, we would argue that a large price-to-earnings (P/E) premium to the S&P 500 is warranted. How much of a premium is debatable.

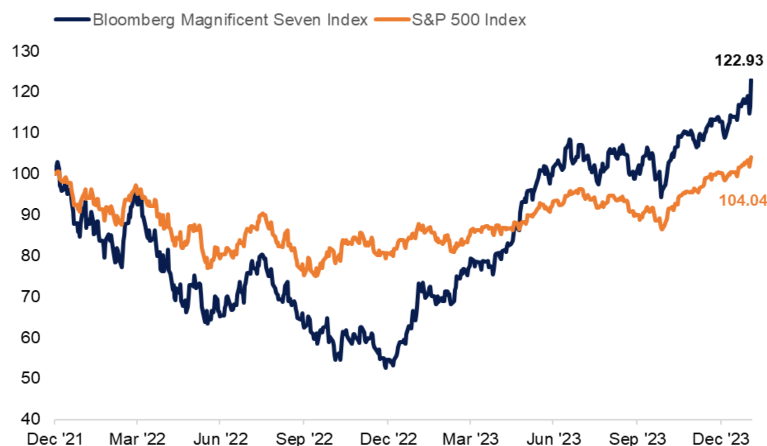
- This mega-cap tech group has rallied to record highs and momentum indicators suggest the rally has more room to run. Relative strength for the group is also bullish.

The Magnificent Seven (Mag 7) mega-cap technology companies have been the center of attention among investors for several years now. The seven stocks include Alphabet (GOOG/L), Amazon (AMZN), Apple (AAPL), Meta (META), Microsoft (MSFT), NVIDIA (NVDA), and Tesla (TSLA). Some prefer to use the “Super Six” moniker, omitting Tesla because its shares have struggled recently and earnings are declining, but for this analysis, we include all seven.

Performance Recap

Let’s start with performance before we get into whether this group’s recent rally is justified and where these stocks might go from here. **Figure 1** compares the performance of the S&P 500 to the Mag 7 since the start of 2022, around the time of the last record high before it was eclipsed last month. These mega-cap technology stocks had a terrible year as a group in 2022, falling 45%, before storming back last year with a remarkable 107% rally. The Mag 7 has outperformed the S&P 500 since the start of 2022, up 22.9% compared with 4.0%, but not by

1 Magnificent Seven Doesn’t Look So Stretched on a 2-Year Lookback



Source: LPL Research, Bloomberg data as of 02/05/24
Indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results.

__LPL Research__ is your financial professional’s trusted partner. Our mission is simple: Provide independent and sound investment research to support you and your financial professional as you work toward your investment goals.

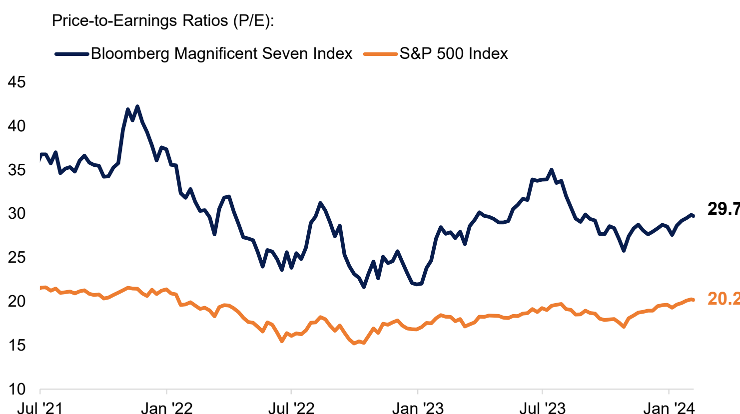
as much as one might think after such a strong 2023. Year to date, this group is up 8.2% despite Tesla's 29.2% decline — in large part due to Meta's 30.5% surge — while the S&P 500 is up 3.2%.

Is the Magnificent Seven Too Expensive?

Removing the Magnificent Seven from the S&P 500 only takes its P/E down to 18.2 from 20, so its valuation impact is not as significant as one might think.

Few would argue that these are not good companies well positioned for future growth, but after such strong performance over the past few years, valuations are elevated. The group trades at a price-to-earnings ratio (P/E) of about 30 according to Bloomberg data, well above the S&P 500 at just over 20.2 on a forward earnings basis (**Figure 2**). If that sounds high, it is (though removing these seven stocks only takes the S&P 500 P/E down to 18.2 from 20). But the premium of this group to the market's P/E has remained relatively stable in recent years, averaging 60% in 2021, 51% in 2022, 57% in 2023, and 55% year to date. Also, consider tech sector valuation premiums were well over 100% around the peak of the dotcom bubble.

2 Magnificent Seven Relative Valuations Remain Within a Reasonable Range



Source: LPL Research, Bloomberg, as of 02/05/24
Indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results.

Does the Earnings Outlook Justify the Price?

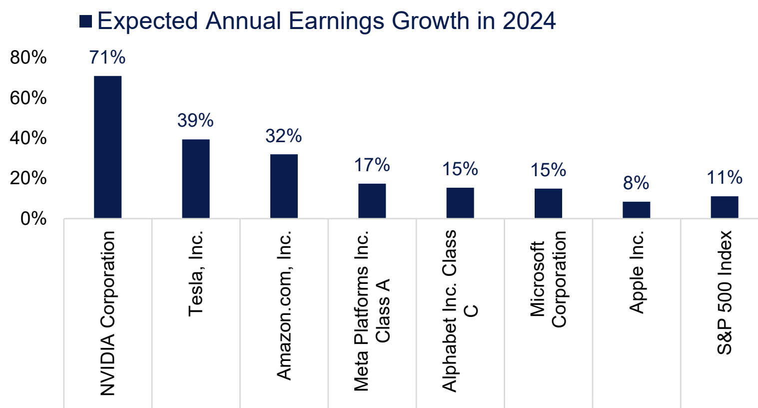
Remarkably, these seven companies are expected to contribute nine percentage points of S&P 500 earnings growth when all results are in.

Taking a look at earnings, the five companies from this group that grew earnings in the fourth quarter (all but TSLA) will deliver these gaudy earnings growth rates: GOOG/L: 50%, AMZN: 3,277%, AAPL: 13%, META: 198%, and MSFT: 26%. NVDA is expected to grow earnings by a whopping 410% when the AI chip leader reports fourth quarter results on February 21, 2024, while TSLA saw a roughly 40% year-over-year earnings decline. Remarkably, these seven companies — even including TSLA — are expected to contribute nine percentage points of S&P 500 earnings growth when all the results are in.

Ironically, that earnings contribution may be wiped out by three sectors experiencing large earnings declines (energy, financials, and healthcare). Given the S&P 500 is tracking to a 1–2% increase in earnings for the quarter so far, with about half of index constituents having reported, the other 493 are a 7–8 point drag on S&P 500 earnings. The importance of these companies in driving S&P 500 earnings simply cannot be overstated, which clearly warrants a sizable valuation premium.

We can also look at 2024 earnings growth expectations, which can fit on a chart. With estimates implying an average earnings growth rate of 28%, spanning from 71% for NVIDIA down to 8% for Apple (**Figure 3**), a significant 50% or greater valuation premium seems quite fair. Valuations are more art than science, but for some of the most profitable businesses anywhere, we would argue that these stocks deserve large premium valuations, especially if the economy slows as we expect and it's more difficult for many companies to deliver much growth.

3 Mega-Cap Technology Company Earnings Likely to Outgrow the Market in 2024



Source: LPL Research, FactSet, as of 02/05/24
Estimates may not materialize as predicted and are subject to change. Past performance is no guarantee of future results.

Impressive Profitability Metrics

According to Goldman Sachs, the Mag 7 saw nearly 750 basis points (bps) of net margin expansion over the past year to 23%. The remaining 493 saw margins contract by 110 bps to just

The pace of earnings growth is probably enough to justify premium valuations for these stocks, but when looking at how profitable these companies are it becomes even more compelling. First, take profit margins. According to Goldman Sachs analysis, the Mag 7 saw nearly 750 basis points (7.5%) of net margin expansion over the past year to 23%, while the remaining 493 saw margins contract by 110 basis points (1.1%) to just 9%.

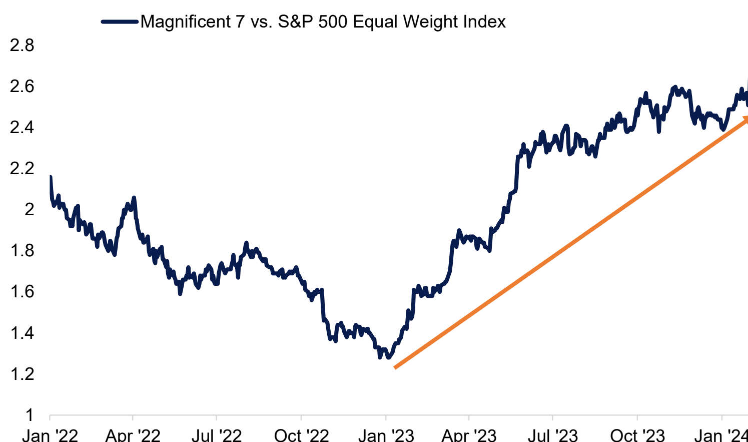
Differences are also quite evident when comparing return on assets (15.9% to 3.8%), return on equity (33.8% to 17.9%), and return on capital (22.7% to 7.9%) for the Mag 7 vs. the S&P 500. This massive profitability advantage, along with strong balance sheets flush with cash, justify much higher valuations than the broad market for these highly scalable business models.

Technical Analysis Suggests This Group Has Room to Run

From a technical perspective, the Bloomberg Magnificent Seven Index (equally weighted) has rallied to record highs after breaking out from a consolidation range late last year. Momentum indicators suggest the rally has more room to run.

Relative strength for the group is also bullish. The Magnificent Seven Index vs. the Equal Weight S&P 500 ratio chart remains in an uptrend and recently climbed into record-high territory (**Figure 4**).

4 Magnificent Seven vs. Equal Weight S&P 500 Ratio Chart in Solid Uptrend



Source: LPL Research, Bloomberg, as of 02/05/24
Indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results.

We use the equal weight index as the basis for comparison because it reduces the influence of the stocks with the biggest weights to highlight how the mega-cap tech stocks are doing relative to the average stock. The breakout to new highs adds to the evidence of continued leadership ahead for the group.

The Mag 7, or "Generals", continue to move the battle line for the broader market, although contributions among these mega-caps have not be equal.

Finally, the Mag 7, or "Generals" as some technicians refer to them, as current leadership, continue to move the battle line for the broader market, although contributions among these mega-caps have not been equal. For example, shares of GOOG/L, AAPL, and TSLA have detracted 59 bps to the S&P 500's year-to-date total return thus far, compared to the 280 bps of positive contributions from AMZN, META, MSFT, and NVDA.

Conclusion

The Mag 7 has performed so well over the past year that investors are questioning whether valuations are justified. Based on the stellar earnings growth of these companies (at least six of them) and significantly better margins and other profitability metrics, we would argue that a sizable P/E premium to the S&P 500 — perhaps in the 50% range — is fair. When considering the strong momentum these stocks enjoy, the fundamental tailwind of artificial intelligence, and an economy that will likely moderate in 2024 and make earnings growth more scarce, we expect further gains ahead for this group and potentially further outperformance in 2024. This positive outlook for these stocks is reflected in the Strategic and Tactical Asset Allocation Committee's preference for growth over value and large caps over small caps, expressed in *Outlook 2024: A Turning Point*.

Key risks include heavy-handed regulation, market concentration, and sub-par monetization of artificial intelligence.

IMPORTANT DISCLOSURES

This material is for general information only and is not intended to provide specific advice or recommendations for any individual. There is no assurance that the views or strategies discussed are suitable for all investors or will yield positive outcomes. Investing involves risks including possible loss of principal. Any economic forecasts set forth may not develop as predicted and are subject to change.

References to markets, asset classes, and sectors are generally regarding the corresponding market index. Indexes are unmanaged statistical composites and cannot be invested into directly. Index performance is not indicative of the performance of any investment and do not reflect fees, expenses, or sales charges. All performance referenced is historical and is no guarantee of future results.

Any company names noted herein are for educational purposes only and not an indication of trading intent or a solicitation of their products or services. LPL Financial doesn't provide research on individual equities.

All information is believed to be from reliable sources; however, LPL Financial makes no representation as to its completeness or accuracy.

Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

The Standard & Poor's 500 Index (S&P500) is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

All index data from FactSet.

This research material has been prepared by LPL Financial LLC.

Securities and advisory services offered through LPL Financial (LPL), a registered investment advisor and broker-dealer (member FINRA/SIPC). Insurance products are offered through LPL or its licensed affiliates. To the extent you are receiving investment advice from a separately registered independent investment advisor that is not an LPL affiliate, please note LPL makes no representation with respect to such entity.

Not Insured by FDIC/NCUA or Any Other Government Agency | Not Bank/Credit Union Guaranteed | Not Bank/Credit Union Deposits or Obligations | May Lose Value

For Public Use | Tracking # 537779 (Exp. 02/25)