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Echoes of the Dot-com era: The Magnificent Seven's impact and vulnerabilities

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Over the past decade, the Magnificent Seven have dominated market returns, much like the leading tech companies of the dot-com era. The Magnificent Seven stocks refer to a collection of highly influential and top-performing companies in the U.S. stock market, including Apple, Microsoft, Alphabet (Google), Amazon, Meta Platforms (Facebook, WhatsApp, Instagram, Threads), Nvidia, and Tesla. This unique stock group's performance has driven the S&P 500 and Nasdaq-100 to new heights. Since February 2016, the S&P 500 climbed by 194%, while the Nasdaq-100 surged by 259%.

These tech giants hold significant weight in the S&P 500. Apple leads with 7.02%, followed by Microsoft at 6.18% and Nvidia at 6.55%. Other companies like Amazon (3.78%), Meta Platforms (2.44%), and Alphabet (1.95%) also have considerable weight, while Tesla has dropped to 1.88%. Together the Magnificent Seven account for over 29% of the S&P 500's total composition.[1]

This dramatic rise, fuelled by passive investing and the growth of market-cap-weighted indices, has led to a significant concentration of wealth in these technology giants. As capital flowed into index funds, the market values of the Magnificent Seven swelled, with Apple and Microsoft each reaching close to $3-trillion. However, this heavy reliance on a small group of companies presents growing concentration risks, much like the technology stocks of the dot-com bubble, where market overdependence on a few leaders led to sharp declines.

The concentration challenge: S&P 500 versus Equal Weight Index

The Magnificent Seven's increasing dominance of the S&P 500 has led to growing concerns about concentration risk. The S&P 500 Equal Weight Index (EWI), introduced in 2003, offers an alternative by assigning equal weights to all stocks in the index, reducing the outsized influence of mega-cap stocks like the Magnificent Seven. By design, the EWI assigns the same weight (0.2%) to each stock, mitigating concentration risk and providing a more balanced representation of the broader market.

Historically, equal-weighted indices have outperformed their market-cap-weighted counterparts during periods of market volatility or sector rotation, particularly when smaller-cap stocks rally. However, in recent years, the EWI has underperformed, delivering a return of 82.77% over the past five years compared to the S&P 500's 109.83%. This performance gap is largely attributed to the Magnificent Seven's outsized returns, fuelled by AI-driven optimism and growth in key industries like semiconductors and cloud computing.

[1] Source: Slickcharts "S&P 500 Companies by weight".

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Daniel Harris Cooper has highlighted that market-cap-weighted indices like the S&P 500 and the Nasdaq Composite are particularly vulnerable to the effects of noise trading, where stock prices are driven more by investor behaviour than intrinsic value. This structural inefficiency creates a feedback loop: as larger companies attract more capital their valuations grow increasingly disconnected from their fundamentals. Cooper's analysis sheds light on how these dynamics exacerbate market concentration and systemic vulnerabilities, a pattern also reflected in the dominance of the Magnificent Seven.[2]

Yet, as history suggests, sustained outperformance by a small group of companies is not guaranteed. During the dot-com bubble of the early 2000s, the broader market eventually rotated away from tech-heavy stocks, allowing indices like the EWI, with greater exposure to other sectors, to perform better in the aftermath. Similarly, over the long term, the EWI tends to outperform when large-cap growth stocks (like the Magnificent Seven) face pressure due to high valuations or market saturation.

Concentration risk and key learnings from the "Dot-Com Bubble"

The dot-com bubble emerged from speculative investments in internet-based companies, many of which had little or no profitability. From 1995 to March 2000, the Nasdaq Composite soared to 508.12%. In March 2000, the Nasdaq broke 5000 points for the first time but soon began its decline, falling to around 2000 points.

Financial economists, including Robert Shiller, were puzzled by the excessive valuations. Shiller remarked that "unjustified optimism" might be fuelling market decisions. Like today's Magnificent Seven, large-cap tech stocks — Cisco, Intel, Microsoft, and Amazon — drove the market to unprecedented highs. By 2000, it became clear many of these companies were overvalued. [3]

The crash of the dot-com bubble, which wiped out trillions of dollars in market value, was triggered by three primary factors:

1. **Overvaluation:** Tech stocks (much like the Magnificent Seven today) were trading at extremely high price-to-earnings (P/E) ratios.
2. **Unsustainable Growth:** Many internet companies had no sustainable revenue models.
3. **Rising Interest Rates:** The Federal Reserve raised rates to combat inflation, putting pressure on speculative and high-growth companies.

The Nasdaq Composite lost 78% of its value between March 2000 and October 2002, demonstrating the risks of over-reliance on a small group of high-growth stocks.

Parallels to today

The Magnificent Seven craze bears striking similarities to the dominant tech leaders during the dot-com bubble. These companies currently represent over 29% of the S&P 500 and an even larger share of the Nasdaq-100, leading to concerns about overvaluation and market concentration. Although today's Magnificent Seven are more profitable than the dot-com firms, the valuation risks and concentration persist.

While the Magnificent Seven have driven market returns, signs are emerging that this dominance may be nearing an end. By mid-2024, companies like Tesla, Apple, and Alphabet began to underperform. These tech leaders, which once pulled the market up, have shown signs of slowing growth, highlighting the dangers of over-reliance on a few dominant stocks.

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[2] Source: The Standard and Poor's 500 Effect: Evidence of Evidence of Noise Trading and a Failure of Fundamental Value Efficiency in the Financial Markets? By Daniel Harris Cooper, published April 2001.
[3] Source: Shiller, R.J., 2000. Irrational Exuberance. Princeton, NJ: Princeton University Press. Published March 15, 2000.

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By July 2024, cracks began to form in the impenetrable Magnificent Seven, with several companies experiencing notable declines. Tesla, Alphabet, and Microsoft led the drop, with losses of 13.89%, 13.53%, and 10.55%, respectively

This market shift presents opportunities for sector rotation into areas beyond tech, such as energy, healthcare, and financials, which are underrepresented in the market-cap-weighted S&P 500. The S&P 500 Equal Weight Index offers a more balanced portfolio and mitigates some of the risks associated with the Magnificent Seven's dominance with its broader sector exposure.

Where to from here?

The market is watching closely to see if the Magnificent Seven will continue to dominate or if we could be entering a period of shifting market leadership. Recent data shows that these seven stocks have contributed significantly to the S&P 500's gains this year, but their performance appears to be slowing. In contrast, the S&P 500 Equal Weight Index (EWI) has a broader approach, distributing exposure evenly across all constituents, which naturally reduces concentration in any single group of stocks. This diversification can lead to different outcomes, especially in periods of heightened volatility or changing market trends.

While the S&P 500 has benefitted from the performance of a few large-cap tech stocks, the EWI offers broader exposure to the entire market, reducing the risk of over-concentration. As the market evolves, adopting a diversified and balanced investment strategy will be crucial to navigating the complexities of the ever-changing financial landscape.

In conclusion

The dot-com bubble serves as a powerful example of the risks associated with market exuberance and concentration. While today's Magnificent Seven are more established than many of the dot-com-era companies, valuation risks and market concentration concerns persist. Historical trends indicate that heavy reliance on a small group of stocks can amplify market volatility. The S&P 500 Equal Weight Index, with its even distribution across all constituents, reflects a broader and more diversified representation of the market, which has historically responded differently to periods of volatility.

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