July 2024 – Chasing the Magnificent Seven

"Those who cannot remember the past are condemned to repeat it."
– George Santayana, writer and philosopher

Rational Exuberance?

When Callahan Advisors was founded in 1999, the market was just about to enter the Dot-com boom, which resulted in very large valuations for companies that had little or no revenue nor cash flow. Federal Reserve Chairman, Alan Greenspan, delivered a speech in December 1996 that coined the term "Irrational Exuberance". He was correct in his warning, but premature. The Dot-com bubble didn't burst until 2000.

Today instead of Dot-com we have artificial intelligence (AI). Many in the financial press report that the Magnificent Seven (Amazon, Apple, Microsoft, Nvidia, Google, Meta and Tesla) are must-have investments. These Magnificent Seven have significantly outperformed other stocks, and the obvious question now is: Will this outsized performance continue? After all, as someone pointed out, in the movie *The Magnificent Seven,* four of the seven died.

History clearly says such performance cannot continue forever. Shortly after starting our firm, we wrote our First Quarter 2000 Client Letter: "Old Versus New Economy Stocks". This letter referred to the Dot-com or Internet stock boom. At that time, we referenced a March 14, 2000, *Wall Street Journal* article by Jeremy Siegel. To quote from our now twenty-four-year-old letter:

> (Siegel's) belief is that the high valuations that the market affords tech stocks are not justified. He reaches this conclusion by focusing on the eighteen largest tech stocks from a market capitalization standpoint and calculating their required P/E ratios five and ten years hence if their earnings grow in line with consensus estimates and if their returns to investors are 15% annually. His conclusion is that the resulting P/E's are not sustainable and that, "Our bifurcated market has been driven to an extreme not justified by any history."

But is it different this time? Some things are definitely different. The Magnificent Seven are truly exceptional companies with real revenue, cash flow, and bright prospects. But none of these stocks are bargains. Except for Tesla, all have a market capitalization of more than a trillion dollars.

If we assume that the companies that have a market capitalization of one trillion dollars or more maintain their current P/E ratios and expected growth rates for the next five years, their market capitalizations will be approximately forty percent higher than the current Gross Domestic Product of the United States! Given the unlikeliness of that happening, does it seem reasonable that allocations to these stocks will give investors reasonable returns? History and Siegel would say clearly not.

The Magnificent Seven are enormous companies and carry a sizeable heft in their sphere of operations. Their market capitalization is bigger than the stock markets of entire countries, regions, and sectors of the economy (the entire U.S energy sector is 3.6% of the S&P 500 vs. 7% for Microsoft alone!).

(713) 572-3366 | (713) 572-8771 Fax
3555 Timmons Lane, Suite 600 | Houston, Texas 77027
www.callahanadvisors.com

But even for the very best companies, we must consider market valuations when initiating, increasing, or holding such positions with a clear understanding of the risks and likely rewards. We are not suggesting we should fully divest positions in the Magnificent Seven, but we do not agree with the market's current weighting of holding almost 33% of one's total stock portfolio in just seven companies. While we plan to continue to hold large positions in many of these stocks for many of our clients, we feel that such a concentration in a small collection of stocks presents unnecessary risks, and most portfolios would benefit by maintaining our typical focus on greater diversification and balance.

While we do believe the Magnificent Seven will continue to grow, assuming their stock prices will continue to increase faster than the market seems to invite disappointment for the long-term. However, when considering reducing any of these positions, we must always consider any related federal and state capital gains taxes, especially for long-term holdings with low-cost basis in these stocks.

Given all that, and the attractiveness of interest rates across the broad spectrum of fixed income maturities, we believe an investment strategy incorporating such fixed income investments and seeking growth among the other four hundred and ninety-three S&P 500 stocks will likely be more rewarding and stabilizing in the long term.

As always, we are grateful to you for allowing us to continue to help you with your investments.

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