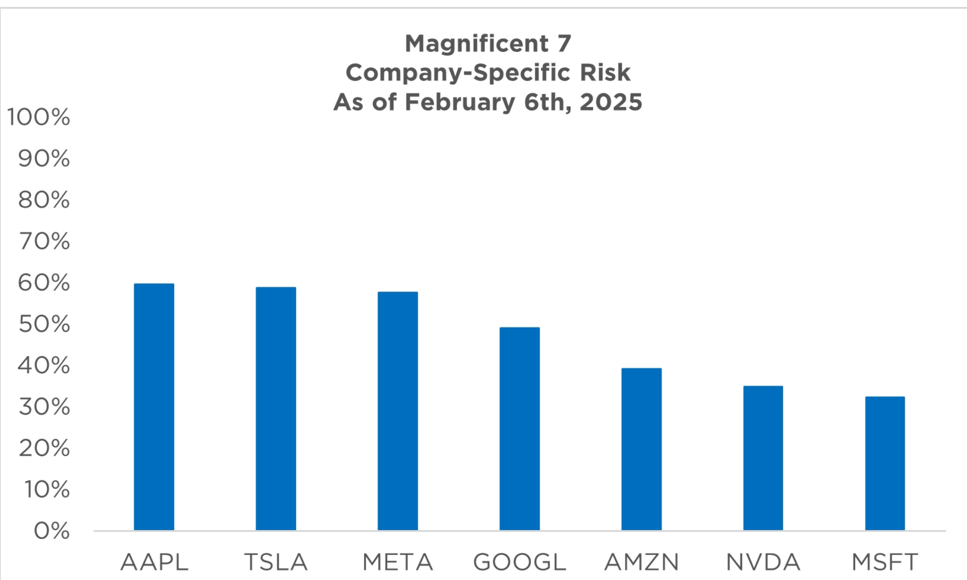
Level Set: Sell Some Mag 7

The Case for Market-Weight the Mag 7

Over the last several years we have maintained the view, that it was prudent for long-only US equity managers to be at least market-weight the Mag 7. **Today, our views have evolved to the point where we are changing our mind and believe lowering exposure is prudent.**

Our logic for owning a market-weight position had been threefold. Firstly, the Mag 7 stocks generally have low company-specific risk. What does that mean? We track how much of every stock's returns we can explain each day from seven macro factors. Those factors are equity market beta, two size factors (mega-/ large- vs. mid-cap., and mid- vs. small-cap.), substance (high-quality vs. junk), style (growth vs. value), liquidity, and momentum. The amount of the returns that is unexplained by these seven factors, we refer to as "residual" or company-specific risk. In other words, for example, if the stock market goes up, growth stocks beat value stocks, and large cap. stocks beat small cap. stocks on any given day, we can explain most of a stock like Microsoft's (Ticker: MSFT) returns. Below we show that the company-specific risk is fairly low for the Mag 7 stocks. In fact, all 7 are "more macro" than the average stock in the S&P500.

Company-Specific Risk Is Relatively Low



Source: Trivariate Research, LP

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Yet They Can't Be Replicated

Secondly, even though the stocks have low company-specific risk, they are still difficult to replicate. By this we mean that we can't find 25 stocks that trade enough like any one of the Mag 7 stocks such that we can reliably replicate the performance of that stock using a basket of other stocks. So the Mag 7 all are "macro" stocks, but can't be replicated by other "macro" stocks. In fact, there are ZERO stocks with a daily correlation above 0.7 to any of the Mag 7 stocks over the last year other than GE Vernova (Ticker: GEV) to Nvidia (Ticker: NVDA). Lastly, these stocks are extremely widely covered. For example, Amazon (Ticker: AMZN), has 84 sell-side analysts currently writing research on the company. Of these analysts, 79 rate it a "buy," 5 a "hold," and not a single analyst rates it a "sell." Moreover, the buyside has hundreds of analysts and portfolio managers who hyper-focus on the earnings results of these companies. We think it is challenging for anyone - OBVIOUSLY INCLUDING US — to know anything about the stock that isn't already in the price. It is certainly hard to romanticize you are a contrarian bull. In fact, only 4.8% of the 504 total sell-side analyst recommendations on the Mag 7 stocks are a "Sell."

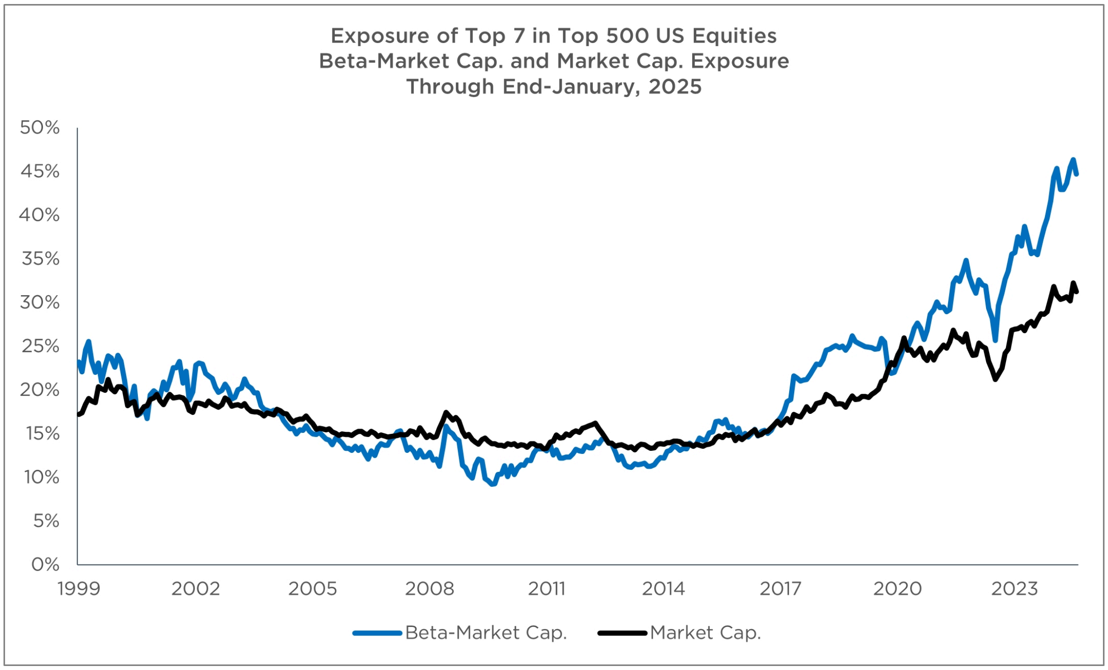
4% of the 504 Analyst Recommendations on the Mag 7 Are a Sell

Magnificent 7 Sell-Side Analyst Recommendations
As of February 6th, 2025

Ticker	Buy	Hold	Sell	Total	Sell Percentage
AMZN	79	5	0	84	0.0%
MSFT	63	7	0	70	0.0%
GOOGL	59	16	0	75	0.0%
NVDA	70	7	1	78	1.3%
META	70	8	3	81	3.7%
AAPL	35	17	6	58	10.3%
TSLA	28	16	14	58	24.1%
All Mag 7	404	76	24	504	4.8%

Source: Trivariate Research, LP

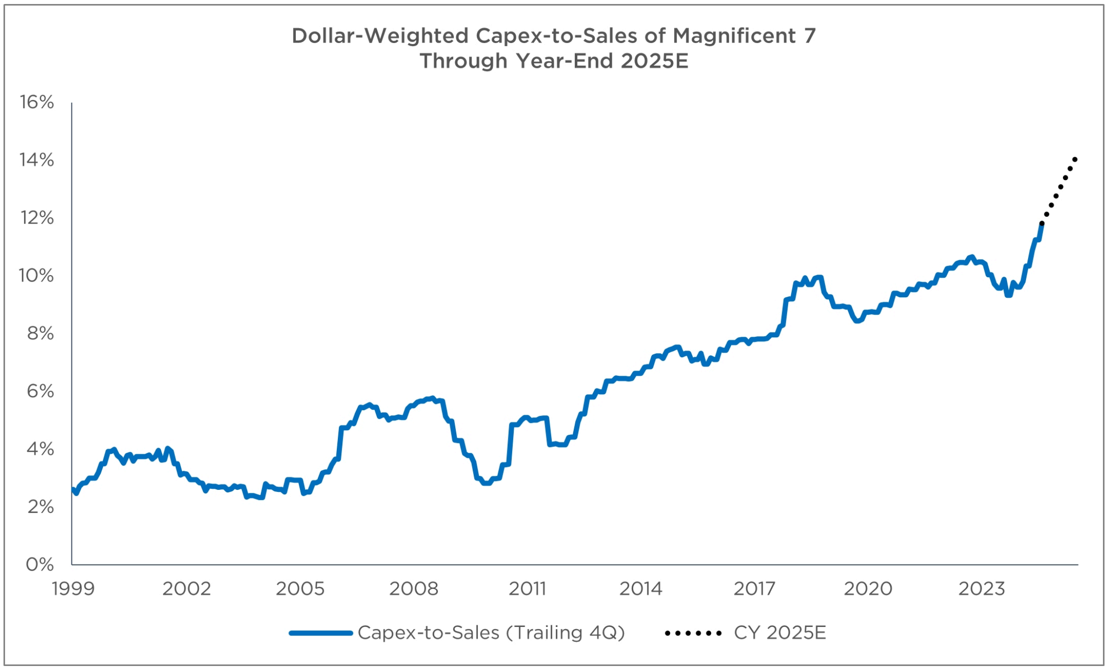
With this group of stocks (the Mag-7) we can't know anything not known by others, that have relatively low company-specific risk, but still can't be replicated, we had previously argued for taking a market-weight aggregate position, opting to not let the group help or hurt portfolio performance. However, we are now changing our mind for several reasons. Firstly, we are apprehensive of the elevated beta-adjusted exposure of the Mag 7 vs. the top 500 US equities excluding the Mag-7. Today, the aggregate exposure of the Mag 7 is 31.3%, or almost a third of the market cap opportunity is Mag-7. However, on a beta-adjusted basis the current exposure of the Mag-7 is 44.7% (see below). This means that a portfolio manager who owns in market-weight all the Magnificent 7 stocks has nearly half their fund's beta-adjusted exposure in these stocks! This remains near highs of the last 25 years.



Source: Trivariate Research, LP

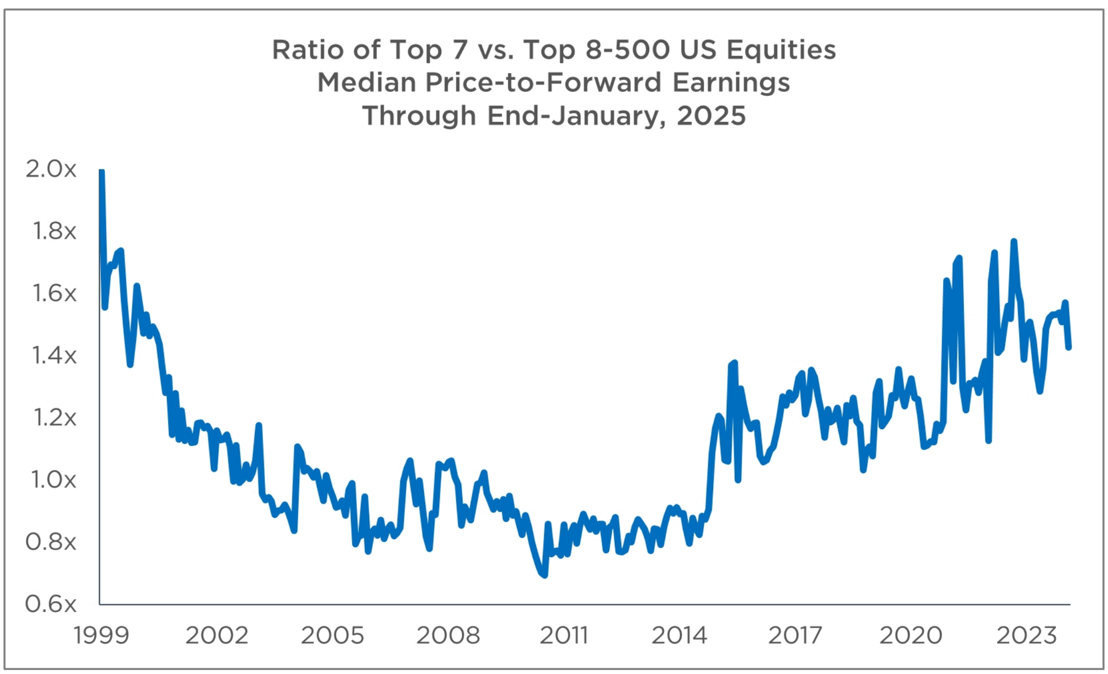
At the same time that the beta has grown to 25-year highs, capital intensity has also evolved. Since 2011, the capital spending-to-sales of the Magnificent 7 has continued to grow. The eye-catching numbers from this week's earnings include the guidance for $75 billion in capital spending from Alphabet (Ticker: GOOGL) and over $100 billion from Amazon (Ticker: AMZN). Taking the management commentary and guidance on capital spending and dividing it by the consensus revenue forecasts indicates capital spending-to-sales will be 14.5% by the end of 2025, far higher than any previous period in history (see below). Clearly there is ample debate on the timing and potential for return on this capital spending. Investors seem to believe different stories for different stocks at the moment. When META announced its higher capital spending plans, the market went up, as if the management is "innocent until proven guilty." At least for the time being, investors believe that META will generate high return on that capital spending as they are seen as an AI-beneficiary at present. GOOGL on the other and is "guilty until proven innocent" when it comes to their capital spending as investors extrapolate their own use of Perplexity and ChatGPT as reasons their capital spending is more defensive and less likely to generate high return. There is no question either way that the high capital spending will continue to come under increasing scrutiny until investors can better understand the return on today's massive investments.

The Mag 7 Capital Intensity Is Materially Expanding



Source: Trivariate Research, LP

As the betas and capital intensity have both grown, the market has simultaneously chosen to expand the relative valuation. While we do not like leading with valuation-based arguments, the relative price-to-forward earnings of the Magnificent 7 vs. stocks 8-500 in the S&P500 is at a 42% premium, toward the upper end of the 25-year range. The high beta and increasingly high capital intensity combined with the elevated valuation of the Magnificent 7 is, in our judgment, an increasing cause for concern.



Source: Trivariate Research, LP

Conclusion: Normally, this kind of valuation, beta, and capital spending would be accompanied by a highly certain future revenue growth and the expectation of sustained stability of that growth. However, today's outlook seems increasingly tenuous given the disruptive nature of AI and the rapidly changing landscape of Software development. Investors should be lowering their exposure to the basket of AI stocks, at least to the point where their beta-adjusted exposure is equal to the raw weight. NVDA has a beta of 2.2 and TSLA 2.17. Starting by lowering their raw weights is likely the best initial risk-management move.

Important Disclosures

Analyst Certification

The analysts, Adam Parker, Maxwell Arnold, Chang Ge, Colin Cooney and Ryan McGovern, responsible for the preparation of this research report certifies that: all the views expressed in this research report accurately reflect the research analyst's personal views.

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