The Magnificent Seven are cheaper than you might think

IAN MCGUGAN

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The outlook for global stock markets in 2024 rests to a surprising extent on seven U.S.-based businesses.

These companies – Alphabet Inc. GOOGL-Q, Amazon.com Inc. AMZN-Q, Apple Inc. AAPL-Q, Meta Platforms Inc. META-Q, Microsoft Corp. MSFT-Q, Nvidia Corp. NVDA-Q and Tesla Inc. TSLA-Q – are commonly known as the Magnificent Seven. Over the past decade, they have provided massive payoffs for investors.

However, their success has reached the point where even optimists have to wonder how much juice can be left in the can. The combined market value of the Magnificent Seven now equals the total value of all publicly listed stocks in Canada, Japan and Britain, according to Torsten Slok, chief economist at Apollo Global Management.

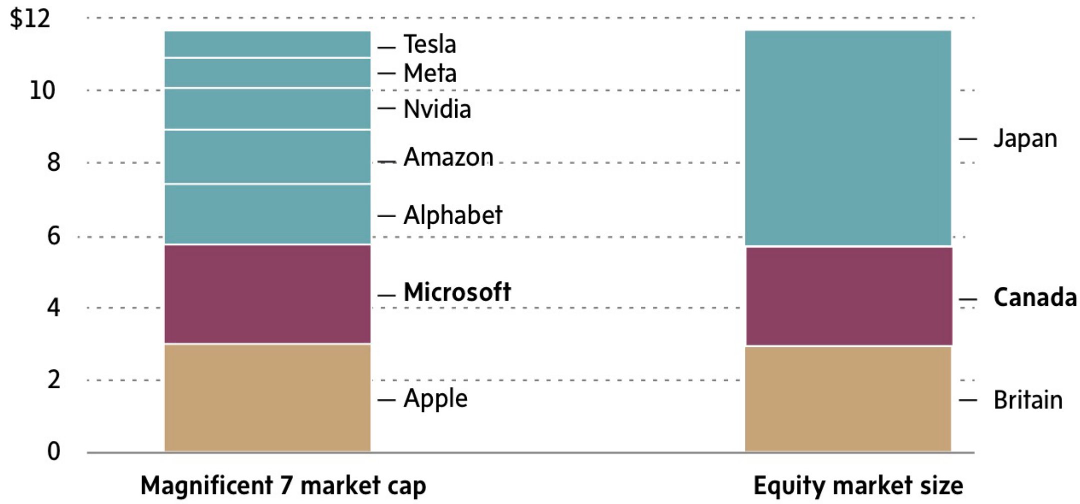
Microsoft by itself is worth more than the entire Canadian stock market. Apple is, too.

The seven superstars make up roughly 28 per cent of the value of the S&P 500 index of big U.S. stocks. They are worth four times as much as the total value of the 2,000 small-cap U.S. stocks in the Russell 2000 index.

Contemplate these numbers and one thing that becomes clear is that how you invest today depends in large part on how you feel about the Magnificent Seven. They tend to divide opinion into two extreme camps.

One Canada = one Microsoft

The Magnificent Seven stocks -- Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla -- are now worth as much as the combined stock markets of Canada, Japan and Britain. Microsoft by itself is as valuable as the entire Canadian stock market. (Market capitalization in trillions of U.S. dollars)



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Bulls will tell you that you can’t afford not to own these high-tech giants at a time when AI is poised to reshape economies.

Bears will argue that companies rarely maintain rapid growth rates year after year. High-flying businesses such as the Magnificent Seven often flame out spectacularly. History suggests you should avoid these tech titans and favour cheaper, more mundane companies instead.

Which of these views makes more sense? My first reaction was to side with the bears and veer away from the Magnificent Seven.

The mad love for these companies evokes past episodes of investor insanity – such as the dot-com bubble of the late 1990s, when Nortel accounted for more than a third of the value of the Toronto Stock Exchange, or the Japanese stock bubble of the 1980s, when Tokyo’s Imperial Palace was supposedly worth more than all the real estate in California.

But the more I looked at the Magnificent Seven, the more rationally priced they appeared to be. Not everyone will agree, but hear me out.

The most common way to value a stock is to look at its share price in comparison with its last year of earnings per share. By this simple standard, the Magnificent Seven look magnificently overvalued. They all have price-to-earnings (P/E) ratios well above the market average. Amazon, Nvidia and Tesla, the worst offenders, sport P/Es north of 70, compared around 22 for the U.S. market as a whole.

The catch, though, is that P/E ratios don't mean much by themselves. You have to adjust them for how fast companies are increasing their earnings. All things being equal, companies such as the Magnificent Seven that are expanding their profits at a breakneck pace should fetch P/E ratios considerably higher than more plodding businesses.

This is where the PEG ratio comes in. It divides a company's P/E ratio by how fast its earnings are growing in percentage terms. (The math here is simpler than it sounds: All it means is that a stock that trades for a P/E of 20 and that is increasing its earnings at 10 per cent a year has a PEG of 2.)

Investors typically regard a cheap stock as one with a PEG ratio around 1. By that standard, many of the Magnificent Seven look to be reasonably priced.

Amazon (a PEG of 1.3), Alphabet (1.3), Meta (1.2) are on the borderline of cheap, while Nvidia (0.7) looks to be a downright bargain, according to calculations this week by Robert Armstrong of the Financial Times.

Microsoft (2.6) and Tesla (2.1) are somewhat pricey by PEG's reckoning but not outrageous. Only Apple (4.6) looks like a true luxury item, perhaps because it's perceived as a superbly managed, ultrasafe defensive stock.

You can, of course, look much deeper than just the PEG ratio. In a report this week, analysts at Man Institute, the British investment group, crunched numbers to look at how much free cash flow the Magnificent Seven are likely to generate over the coming decade and what returns they are poised to produce.

The analysts concluded that Tesla is clearly the most expensive stock in the group, while Alphabet is the cheapest by a hair over Meta. In keeping with that analysis, they expect returns for the Magnificent Seven that range from 3.8 per cent a year for Tesla to 8 per cent a year for Alphabet.

"Our analysis points towards a somewhat boring prediction, which is that these companies in aggregate appear to be valued to produce mid-single digit returns over the next decade," the Man Institute analysts wrote.

Investors may want to ponder that modest conclusion. As the analysts point out, the numbers don't support either extreme of current market opinion.

Barring surprises, the Magnificent Seven no longer look capable of generating huge, market-beating returns. However, they don't seem wildly overvalued either. Maybe, just maybe, the Magnificent Seven are now what they have never been before – entirely average stocks.

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