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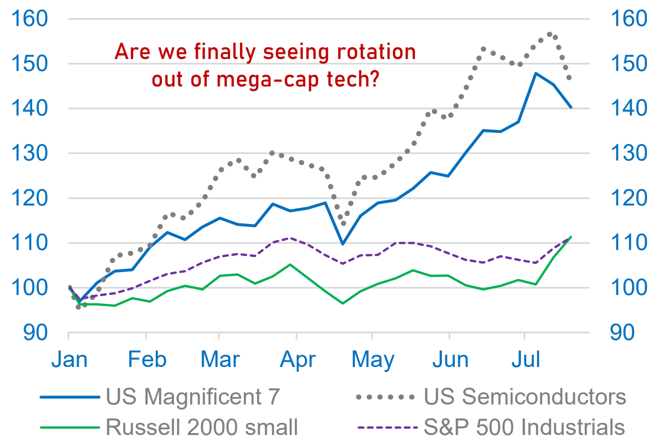
White Paper: Time to fade the Magnificent 7?

Key Messages

1. **Overconcentrated US, global stocks markets are a risk**: The Magnificent 7 stocks make up nearly 36% of the benchmark S&P 500 index, and nearly 23% of the MSCI World index. This record concentration represents a significant stock-specific risk to investor portfolios.
2. **High valuations, over-popularity generally lead to low long-term investment returns**: huge US stock ETF inflows and a surge in Mag 7 valuations to 34x forecast P/E underline the popularity of investing in these mega-cap tech stocks. But historically, highly-valued popular stocks have generated poor long-term returns.
3. **Trying to time the end of a manic phase is very difficult**: the history of previous investment mania suggests that trying to time the end of a manic stock market phase is almost impossible. But reducing exposure to this AI mania allows for greater portfolio diversification.
4. **Abundance of capital invested in AI suggests stiff competition, lower profitability**: investing in the providers of essential AI computing power has been a winning strategy. But it is unclear that companies investing heavily in Artificial Intelligence will earn high returns on investment.
5. **Time to diversify US, global stock portfolios**: We prefer diversification of stock market investment into other areas of the US stock market such as mid- and small-cap stocks. We also advocate investment into stocks outside the US, including Europe and the UK, Japan and Emerging Markets ex China (e.g. South Korea).

Contents

MAGNIFICENT 7, SEMICONDUCTORS AT RISK OF FURTHER FALLS?



Source: BNP Paribas, Bloomberg

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Technology has come to rule our world

The 4 waves of Tech Revolution

Since the 1990s, technology has come to completely dominate both our working and personal lives.

The PC: This technology revolution started with the personal desktop PC and office software applications such as Lotus 1-2-3 and WordPerfect.

Internet and WWW: The widespread adoption of the internet and the world wide web in the late 1990s represented the next step change in the global technology revolution, enabled by the installation of high-capacity global fibre optic networks to carry increasing amounts of internet traffic.

Smartphones: The third step change arrived with the launch of smartphones, particularly the introduction of the first Apple iPhone in 2007. This has led to the widespread adoption of mobile internet access. Today we live in a world where it is increasingly difficult to disconnect from the digital realm, given our addictions to social media and online shopping.

AI: Now we are confronted with a fourth technological revolution, with the growing mania around all things Artificial Intelligence (AI). While AI has existed for several decades, the exponential boom both in data on the internet and in available computing power have laid the foundations for a huge technological advance.

A word of warning: as of August 2023, industry consultancy Gartner already placed Generative AI (e.g. Large Language Models like ChatGPT) at the very top of its Hype Cycle, at the "Peak of Inflated Expectations".

The Rise of the Magnificent 7

The stock market leaders of this AI mania are the largest US technology companies which are very familiar to consumers around the world: Microsoft, Apple, Google (Alphabet), Meta (formerly Facebook) and Amazon. To this list we can add the dominant semiconductor company in the vanguard of providing the necessary computing power for AI learning models, Nvidia.

The so-called "Magnificent 7" technology companies have together grown earnings by nearly 1200% over the last 8 years, averaging 36% earnings growth per year. Over the same period, their share prices have also increased by 1450% cumulatively, or an average of 40% per year.

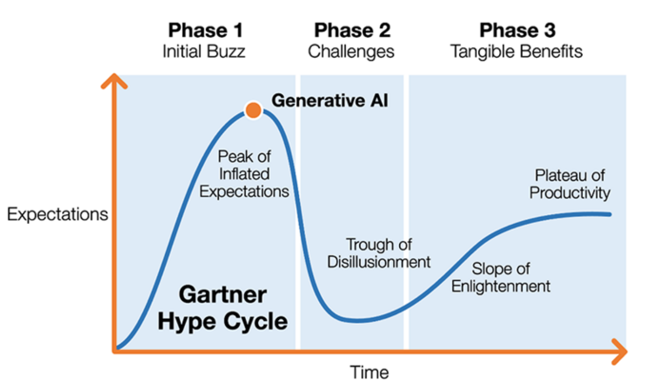
As a result of this prodigious growth in sales, earnings and share prices, these household names together represent 35.5% of the flagship US S&P 500 stock market index. This is a historic high in terms of the concentration of this broad index in such a small handful of companies.

Justified so far by earnings growth, but not by AI

Of these 7 technology companies; the only one which we can say is definitively seeing strong sales and profit growth directly as a result of AI-related spending is Nvidia.

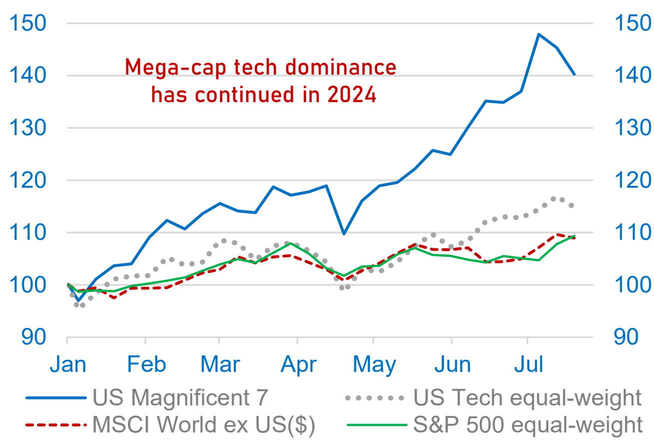
The other 6 members of this club are also posting strong earnings growth and are maintaining extremely high profit margins, but not due to AI but rather to their legacy oligopolistic technology businesses where they are globally dominant.

THE AI HYPE CYCLE IN 2024



Source: Forbes, Adapted from Gartner

NOT JUST ABOUT US TECH: A STORY OF MEGA TECH OLIGOPOLIES



Source: BNP Paribas, Bloomberg.

How much further can this AI mania go?

Predicting the end of mania is dangerous

As with all financial market bubbles and manias, it is always dangerous to try to predict their end. History tells us that these extreme trends can persist for much longer than anyone would think reasonable, due to the persistence of extreme human optimism.

I should make a few, rather obvious points:

- **"Picks and shovels" plays work best:** Only Nvidia is currently making huge profits out of the Artificial Intelligence "gold rush", selling the semiconductor processor chips that are best suited to training large Artificial Intelligence and machine learning models. The other technology companies make their supernormal profits from more traditional technology businesses such as office software, cloud computing, online advertising, and online shopping, rather than anything explicitly AI-based.
- **Expensive valuations point to optimistic profit expectations:** The valuation of these Magnificent 7 companies has risen to elevated extremes at 34x forecast P/E. This is almost double the P/E ratio for the remaining 493 companies in the S&P 500 index, which trade at a much more modest 19x P/E.
- **Has the AI theme become too popular?** The flow of money into these 7 tech stocks has no doubt been amplified by the growth in popularity of Exchange-Traded Funds (ETFs) which track stock market indices such as the S&P 500 and the technology-heavy Nasdaq 100. Investors have followed the strong price momentum in these indices, 60%+ of which was due to the Magnificent 7. As a result, just 4 US-listed ETFs based on the S&P 500 or Nasdaq 100 indices gathered a massive $100 billion in new fund inflows over the first 6 months of this year.

As an investor, treat AI with caution

I am persuaded that AI will have a profound effect on businesses and our personal lives over the next few years. But, judging from the adoption time of revolutionary technologies in the past such as railroads, the radio, the personal PC and even the world wide web, it seems clear that investors are too eager to expect short-term results from these technological shifts. In reality, it takes companies and consumers many years, not months to understand how to best leverage new technologies in their own businesses or lives.

At the same time, I remain sceptical that all these tech companies can make huge new revenues and profits from AI. In general, high profits are generated in industries where there is a scarcity of capital.

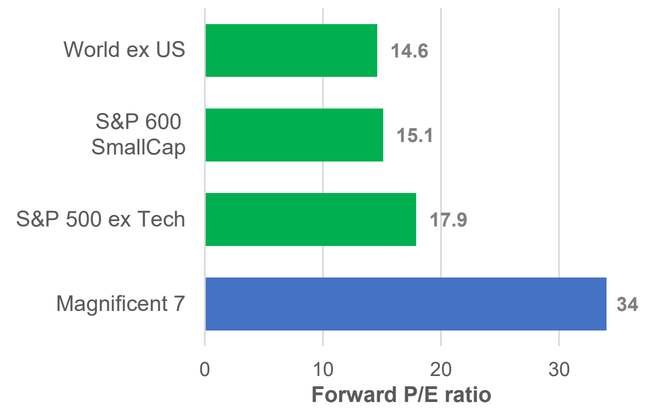
In contrast, we see today huge amounts of capital being invested by both public and private companies into AI. This suggests to me that there will be huge competition between the rival AI models and software of these companies.

So, the ultimate profits that could result from this massive wave of technology investment could prove disappointing for investors, who have built high expectations of huge future AI-related profit growth into current Magnificent 7 share prices.

Time for diversification of stock portfolios

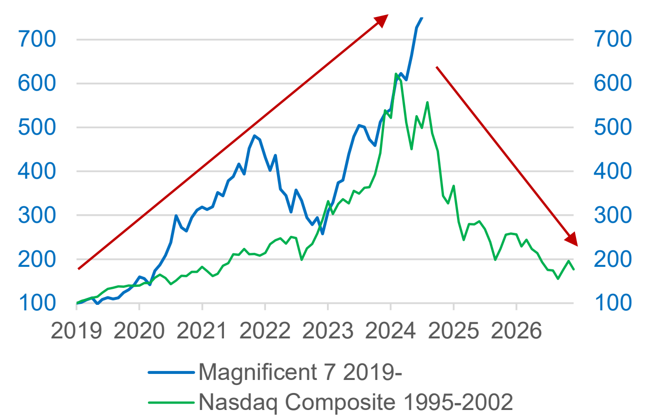
We prefer diversification of stock market investment into other areas of the US stock market such as mid- and small-cap stocks. We also advocate investment into stocks outside the US, including Europe and the UK, Japan and Emerging Markets ex China (with a focus on the technology-heavy South Korean market).

MAGNIFICENT 7 STOCKS VALUED AT NEARLY 2X S&P EX TECH



Source: BNP Paribas, Bloomberg.

LESSONS FROM THE PAST: WHAT GOES UP QUICKLY CAN ALSO COME BACK DOWN



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