ARE YOUR CLIENTS OVEREXPOSED TO THE MAGNIFICENT 7?

by Henry Pasts, Executive Vice President and Analyst, BTS Asset Management, Inc.

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Why value-centric strategies could outperform in 2024 against the lofty valuations of the top names.

The S&P 500's 26.23% gain in 2023 was largely due to 7 stocks termed the "Magnificent 7" by Wall Street. These names include Apple Inc (AAPL), Amazon Inc (AMZN), Alphabet Inc Class A (GOOGL), Meta Platforms Inc (META), Microsoft Corp (MSFT), Nvidia Corp (NVDA), and Tesla Inc (TSLA).

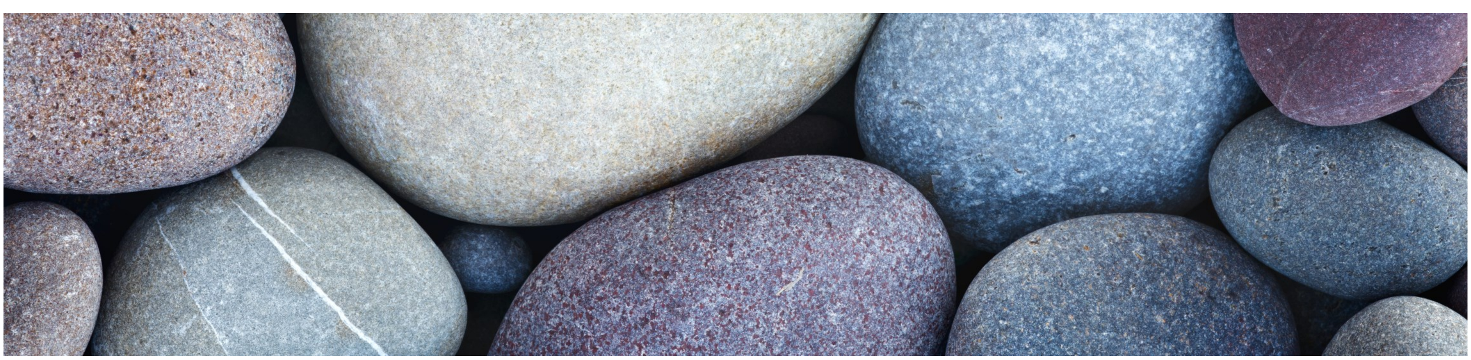
Although these stocks led the market last year, we also have to remember how they contributed to the S&P 500's decline of -18.29% in 2022. Due to the market cap weighted nature of the S&P 500, the Magnificent 7 have made up a huge weight in the S&P 500 over the past two years. At the end of 2022 and 2023, they made up 19.95% and 27.94% of the SPDR S&P 500 ETF Trust, respectively.

Security	SPY Weight on 12/31/2022	2022 Return	SPY Weight on 12/31/2023	2023 Return
Apple Inc	6.02%	-26.62%	7.01%	48.88%
Amazon.com Inc	2.31%	-50.12%	3.44%	80.66%
Alphabet Inc Class A and C	3.09%	-39.59%	3.81%	58.18%
Microsoft Corp	5.54%	-28.60%	6.96%	58.04%
NVIDIA Corp	1.13%	-50.49%	3.05%	238.17%
Tesla Inc	1.02%	-65.40%	1.71%	101.43%
Meta Platforms Inc Class A	0.84%	-64.98%	1.96%	193.48%
Total Weight:	**19.95%**		**27.94%**	

Security	2022 Return	2023 Return
S&P 500	-18.29%	26.23%

Source: Morningstar

Portfolio weights are derived from the SPDR S&P 500 ETF Trust (SPY)



The top Large Core Funds by Assets Under Management (AUM) as of 12/31/2023, also carry significant Magnificent 7 exposure:

Fund	Total Magnificent 7 Exposure %	AUM
Vanguard Total Stock Market	24.04%	1.46 Trillion
American Funds Washington Mutual	10.20%	166 Billion
American Funds Fundamental	14.04%	122 Billion
Strategic Advisers® Fidelity US TtlStk	7.04%	93 Billion
Vanguard Dividend Appreciation	9.71%	88 Billion
Fidelity Total Market	23.98%	83 Billion
Vanguard PRIMECAP	11.08%	71 Billion
Average Weight:	**14.30%**	

Source: Morningstar

On average, the Magnificent 7 make up 14.30% of the biggest Large Core Funds, which means almost 1/7th of a client's portfolio is exposed to extended valuations similar to those at the end of 2021 before growth stocks like the magnificent 7, declined substantially over the course of 2022.

Below are the PE Ratios of the Magnificent 7 at the end of 2021, 2022, and 2023, and their averages. Generally, PE Ratios were the highest at the end of 2021, but Apple Inc, Alphabet Inc Class A, Nvidia Corp, and Meta Platforms Inc all have similar PE Ratios at the end of 2023 that are not too far behind the extended levels of 2021. Taking out the inflated number from Tesla at the end of 2021, the average PE Ratio of the other 6 stocks of the Magnificent 7 was 46.12 at the end of 2021, very close to the end of 2023's average of 47.31.

Security	PE Ratio (as of 12/31/2021)	PE Ratio (as of 12/31/2022)	PE Ratio (as of 12/31/2023)
Apple Inc	29.42	21.27	31.41
Amazon.com Inc	71.37	84.76	71.43
Alphabet Inc Class A	28.98	17.29	25.91
Microsoft Corp	38.47	25.84	36.10
NVIDIA Corp	84.10	50.03	63.45
Tesla Inc	216.48	37.68	79.70
Meta Platforms Inc	24.38	11.35	23.14
Average PE Ratio:	**70.46**	**35.46**	**47.31**
Average PE Ratio without Tesla:	**46.12**		

Source: Bloomberg, note Alphabet Class A shares used for PE Calculation.

With this in mind, even if the Federal Reserve is set to cut interest rates in 2024, value-oriented strategies are better positioned to outperform growth stocks like the Magnificent 7 because their Price-to-Earnings ratios aren't as extended. For example, the Price-to-Earnings ratio of the S&P 500 Value Index was 20.34 as of 12/31/2023, less than half that of the Magnificent 7's average.[1]

Value Oriented Strategies

With Magnificent 7 valuations extended, Dividend Aristocrats, Equity Fortress, and Highest Yielding Equities all offer unique diversification and value propositions against the large-cap and over-allocation risks of the Magnificent 7.

Dividend Aristocrats

Dividend Aristocrats are stocks that have consistently increased their year-over-year dividend payout for many years in a row. The exact number of consecutive years of growth is subjective, but generally 10 consecutive years is considered a minimum. Regardless, the main takeaway is that these stocks have consistently rewarded shareholders by paying out net income and have done so in an increasing manner.

Equity Fortress

Equity Fortress are stocks that have strong balance sheets with large cash holdings that can grow their business and weather economic downturns without taking on excess debt. These stocks are a blend of ‘cash cow’ and ‘wide moat’ stocks that offer value through their strong underlying assets. The internal growth rate is used to evaluate the strength of the ‘fortress’.

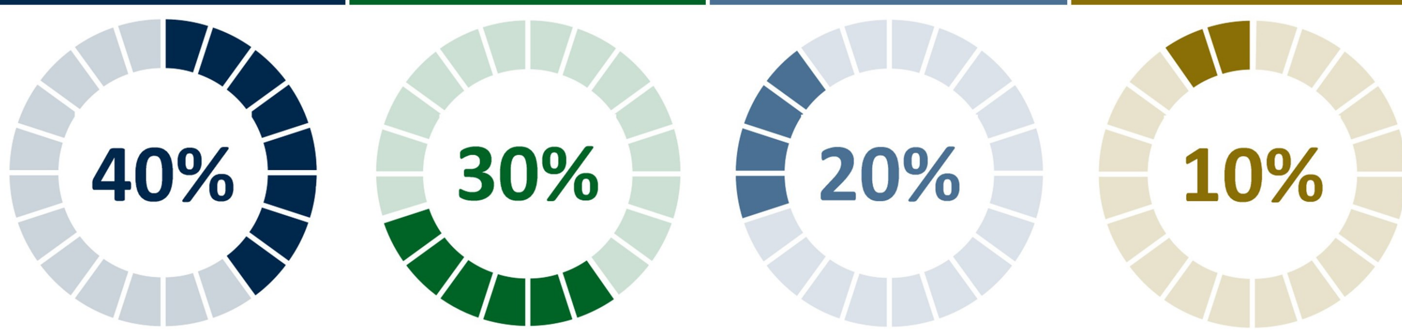
Highest Yielding Equity

Highest Yielding Equities are those stocks that have the highest dividend yields. Dividend Yields are usually compared at the sector level, with the highest yields in each sector being considered Highest Yielding Equities. Dividends can supplement income and be reinvested to buy more shares of the underlying stock.

BTS Enhanced Equity Income

BTS takes the concepts of Dividend Aristocrats, Equity Fortress, and Highest Yielding Equity and adds additional layers of analysis to create a unique blend of income and value that is suitable for when valuations are extended. Some of these additional layers are expanding the universe of securities to the S&P 1500 and analyzing securities across the 11 GICS sectors with a robust fundamental analysis process to narrow down the best securities in each strategy and each sector. A sector overweight process based on comparisons to the historical levels of the sector fundamentals is also used to overweight the top performing sector and eliminate sectors that are performing poorly compared to their historical averages.

BTS Enhanced Equity Income



Dividend Aristocrats	Equity Fortress	Highest Yielding Equity	Covered Call ETFs
Stocks with increasing dividends for a minimum of 10 years* ****Under certain circumstances, the minimum number of years may be less than 10 years.***	***Stocks with strong balance sheets that finance growth internally***	***Stocks with the highest yield in their respective sector***	***Covered Call ETFs to boost income***

There is some overlap between these strategies and the Magnificent 7, as Apple and Microsoft have both increased their dividend for more than 10 years and other companies like Alphabet fall into the definition of an Equity Fortress, but the BTS Enhanced Equity Income portfolio uses the additional layers of sector and fundamental analysis to pick the best valued securities across the different GICS Sectors.

In an environment where valuations are extended, a strong initial equity screens followed by a disciplined fundamental and sector analysis can add diversification and strong value propositions into 2024 and beyond.

Citations:

[1] Source: Bloomberg.

IMPORTANT RISK INFORMATION

Investing in individual stocks and individual stock selection strategies involves inherent risk, including the potential loss of principal. There is no guarantee that a particular individual stock or individual stock selection portfolio will meet its projected value, performance, or objective. The price of individual stocks can fluctuate greatly based on a variety of factors, such as the company's financial health and conditions, industry trends, broader market conditions, and geopolitical events. Unexpected operational and regulatory challenges also can negatively impact the price of a stock. Shares of newer, lesser-known equities might experience greater volatility than well-established firms. Additionally, stocks from emerging sectors or industries may be more susceptible to risks compared to those in established sectors or industries. Economic downturns, like recessions and depressions, or heightened market instability, known as systemic risk, can cause prices to decrease and potentially limit the ability to sell a stock at a desired level, known as liquidity risk. There is no guarantee that an individual stock will continue to pay its dividend. Some individual stocks may be exposed to currency risks, either domestic or foreign, that may result in price declines. Individual stocks with high levels of debt or engaged in loaning or lending businesses are subject to interest rate risk.

The Global Industry Classification Standard (GICS) is an industry taxonomy developed in 1999 by MSCI and Standard & Poor's (S&P) for use by the global financial community. The GICS structure consists of 11 sectors, 25 industry groups, 74 industries and 163 sub-industries into which S&P has categorized all major public companies.

Cash Cow refers to an equity that can generate consistent free cash flow, or the operating cash flow after deducting capex payments and working capital requirements.

Wide Moat refers to an equity that does business in a market or has developed their business in such a way that is difficult for newcomers to easily enter and compete in.

BTS Enhanced Equity Income is BTS strategy currently available at Axos Advisor Services and various UMA/SMA platforms. It consists of 4 strategies, Dividend Aristocrats, Equity Fortress, Highest Yielding Equity, and Covered Calls.

BTS Dividend Aristocrats is a BTS strategy that breaks the largest 1500 U.S. listed equities by Market Capitalization into their 11 GICS Sectors and then filters all securities that have 10-15 years of increasing dividends, based on which sector it is in. BTS may consider a security with less than 10 years of increasing dividends if there are less than 2 securities in any given sector with less than 10 years of increasing dividends. These securities are then run through a proprietary securities selection algorithm that is rule-based in nature and does not change. The top security is then compared against similar historical Dividend Aristocrats in its sector and a historical outperformance is calculated. The top sector is overweighted, and the bottom 2 sectors are eliminated. BTS Dividend Aristocrats and Dividend Aristocrats are used interchangeably and refer to BTS' strategy.

BTS Equity Fortress is a BTS strategy that breaks the largest 1500 U.S. listed equities by Market Capitalization into their 11 GICS Sectors and then filters the top 5-10 securities in each sector based on a proprietary Equity Fortress Model that considers how well the security can finance internal revenue and asset growth without taking on excess debt. These securities are then run through a proprietary securities selection algorithm that is rule-based in nature and does not change. The top security is then compared against similar historical Equity Fortress securities in its sector and a historical outperformance is calculated. The top sector is overweighted, and the bottom 2 sectors are eliminated. BTS Equity Fortress and Equity Fortress are used interchangeably and refer to the BTS strategy.

BTS Highest Yielding Equity is a BTS strategy that breaks largest 1500 U.S. listed equities by Market Capitalization into their 11 GICS Sectors and then filters the top 5-10 securities in each sector based on highest Dividend Yield. These securities are then run through a proprietary securities selection algorithm that is rule-based in nature and does not change. The top security is then compared against similar historical Highest Yielding Equity securities in its sector and a historical outperformance is calculated. The top sector is overweighted, and the bottom 2 sectors are eliminated. BTS Highest Yielding Equity and Highest Yielding Equity are used interchangeably and refer to BTS' strategy.

Covered Call refers to a financial transaction in which the investor selling call options owns an equivalent amount of the underlying security. To execute this, an investor who holds a long position in an asset then writes (sells) call options on the same asset to generate an income stream. The investor's long position in the asset is the cover because it means the seller can deliver the shares if the buyer of the call option chooses to exercise.

Covered Call ETFs refers to exchange-traded funds that deploy Covered Call strategies. BTS uses ETFs that follow S&P 500 and NASDAQ 100 Covered Call strategies in the BTS Enhanced Equity Income portfolio, namely JEPI and JEPQ.

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Performance Sources: ***Morningstar and Bloomberg***

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