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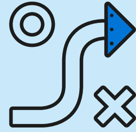
The Magnificent Seven: a concentration conundrum



Ryan Boothroyd
Senior Investment Specialist

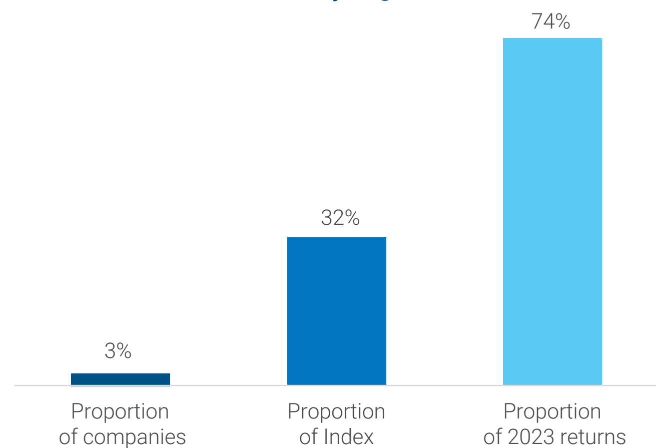
Bigger is better

For investors, the continued success of the US technology sector will come as no surprise. The so-called 'Magnificent Seven'[1] stocks have achieved year after year of impressive share price growth, leaving the rest of the market in the dust.

The scale of the world's largest companies is immense and a historical anomaly. Apple* is as valuable as every company in the UK stock market combined, including heavy hitters like Unilever* and HSBC*. The market value of the Magnificent Seven increased by US$5 trillion in 2023, over 1.5x more than the other 493 stocks in the headline US stock market, the S&P 500, and the equivalent of the French stock market.[2]

It is hard to stress how unusual market conditions are currently, relative to history. Indeed, by most metrics the largest stocks are more dominant than at any point in the past 50 years. The US is the most extreme example, where 3% of its companies make up 32% of the S&P 500 and drove 74% of returns in 2023.[3]

UK stock indices dominated by largest stocks



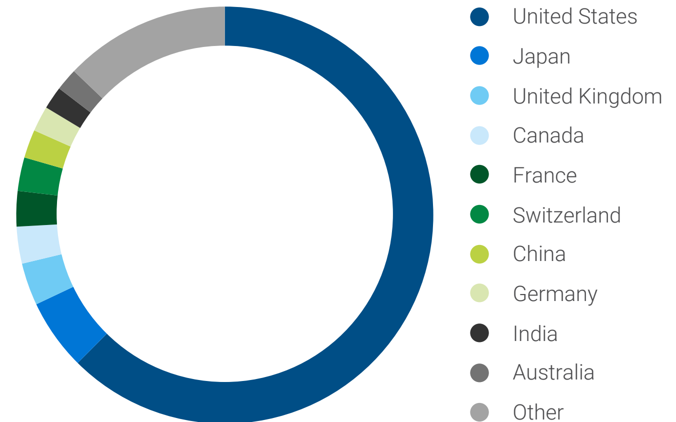
Bloomberg, LGIM, S&P 500 data as at December 2023

Actively passive

A key implication for financial advisers is that investments which appear to offer a diversified solution (such as market-cap weighted index trackers which have more exposure to those markets with the greatest total values) may entail more stock- or sector-specific risks than anticipated. Choosing a passive investment vehicle is an increasingly active decision.

For example, a market-capitalisation weighted global equity index fund can be a core tool for achieving diversified exposure to global stock markets. However, indices are heavily skewed to specific countries, regions and stocks. Is 60% in a single country truly diversified?

Global stock indices dominated by the US



Source: Bloomberg, LGIM as at December 2023

Advisers selecting index funds or products that make extensive use of market-cap weighted building blocks are implicitly choosing to allocate a material proportion of their clients' capital to a small number of US mega cap technology stocks. While this may be considered prudent given recent history, it is an active investment decision that assumes such a trend will continue.

Whatever happened to NTT?

In our view, recent mega cap – companies valued at more than US$200 billion – outperformance is a historic anomaly, not the start of a new era. Stock market dominance rarely persists. The largest index constituents rarely retain their position, and few outperform the broader market. Just ask NTT*, Deustche Telekom* or PetroChina*, all of which were top 10 global companies over recent decades.

Given their scale and dominant market positions, the Magnificent Seven are likely to be a major feature of stock markets for the coming decade. However, history and the balance of probability suggests that we are in an abnormal environment and will eventually revert to something more normal.

We believe advisers can seek to tackle the concentration conundrum in their client portfolios by focusing on products with real diversification and less country-, sector- or stock-specific risk such as fundamentally weighted indices or actively-managed diversified multi-asset portfolios.

1. Alphabet, Amazon, Apple, Meta, Microsoft, NVIDIA and Tesla
2. Source: Bloomberg as at 31 December 2023
3. Source: Bloomberg as at 31 December 2023

***For illustrative purposes only. Reference to a particular security is on a historical basis. The above information does not constitute a recommendation to buy or sell any security.**

Why investors should resist the allure of cash

Isabella Hughes
Investment Specialist

Time horizons

Isn't cash attractive? In recent months, the British public are finding cash accounts more attractive than ever. A combination of higher cash rates of close to 5%, in addition to increased concerns regarding the global economy, have led to a significant increase in investors considering cash as an investment choice, over a widely diversified portfolio of equites, bonds and alternatives.

While we understand the attraction of cash over the short term, it has historically been shown to be highly unlikely that cash will produce returns in excess of a well-diversified multi-asset portfolio over a medium- to long-term time horizon.

Variability

Cash rates are variable, so while they are currently higher than they have been for a number of years, they are subject to change at short notice. Cash rates do not exactly mirror the Bank of England (BoE) base rate although there is a high correlation between the two. The chart below shows the UK base rate over the last 20 years; it has gone through several different regimes over this period. This has meant that investors who relied on the interest earned from a cash investment over the long term have experienced significant fluctuations in the returns received.

UK Bank of England Base Rate (%)

Source: Bloomberg, as at 20/04/2023

The challenges of timing your investment

Investors often feel that they can take advantage of higher cash rates now, and then move into potentially more prosperous asset classes when the time is right. However, is it possible to time this decision? Research shows that an overwhelming majority of investors do not have the ability to time markets.

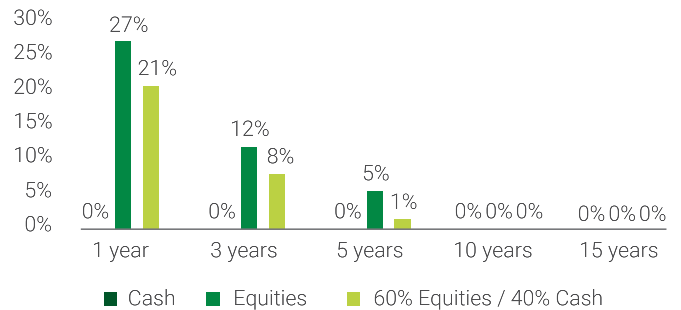
Investors often wait until they see increases in investment markets before they move out of cash. However, as markets are typically leading indicators[4] to future economic activity, it is not always immediately obvious when to move back into the investment markets.

In practice, this means that if investors wait for the clouds to clear, they will most likely have missed out on potential positive returns.

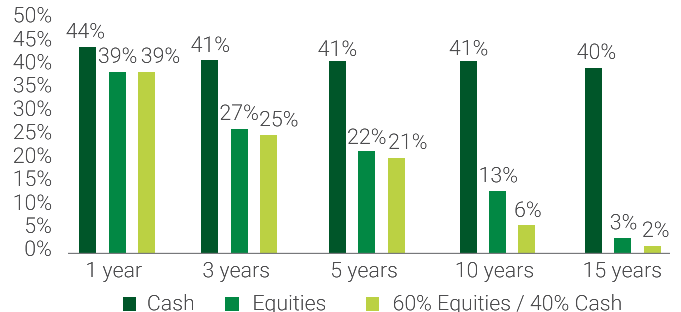
Impact of inflation

The first chart below demonstrates the key attraction of cash, which is the very low historical chance of making a nominal loss[5], whereas equities have on occasion made losses for periods of over five years. It should be noted that the likelihood of equities making such a loss over a sustained period reduces, as illustrated by the fact that there have been no 10-year periods where equities have made a loss in nominal terms.

Historical probability of losses before inflation



Historical probability of losses after inflation



Source: LGIM Bloomberg, as at 29/01/2024.
Covering the period of 13/12/1995 - 29/01/2024

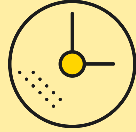
However, in the second chart above we take into account inflation, commonly known as a 'real return'. The picture is very different; while equities can still make a loss after inflation is taken into account, the probability has historically declined with time invested. In contrast, the probability of making a loss from cash after inflation stays broadly constant no matter how long the time horizon.

This reinforces the key point that the likelihood of real returns is a critical factor to be considered when making long-term investment decisions.

4. Leading indicators (markets tend to look forward, so often will react prior to actual changes in economic conditions)
5. Nominal loss means that the value falls without taking into account inflation

Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

Myth busting: Time in the market, not timing the market



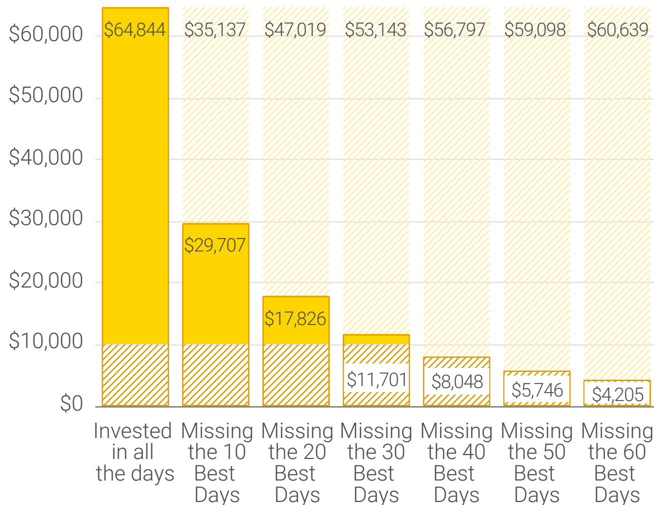
Rebecca Burgess
Investment Specialist

Staying power

The well coined phase "It's not about timing the market, but about time in the market," has been proven correct over the years and it is generally accepted that behavioural biases and panic selling will typically lead to poor investor outcomes.

The chart below suggesting you miss huge potential returns by sitting out the best 10 days of market performance is often cited as evidence that investors should stay invested all the time. While we would urge caution around the framing of these charts, we would advocate for the underlying message, that staying invested over the long-term is prudent for any investor with a long-term horizon.

Value of $10,000 Invested in the S&P 500 (best days)



Source: LGIM Bloomberg, based on daily returns as at 31/12/2003 - 31/12/2023

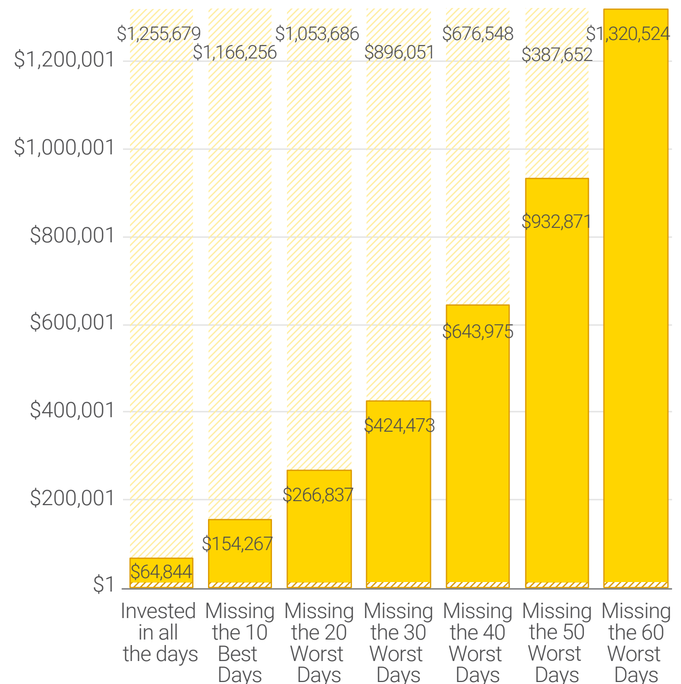
This provides potential advantages such as compounding interest – the effects of the repeated addition of returns to the principal amount invested – reduced impact of short-term market volatility, and ensures participation in historical trend of markets appreciating over time. These charts may appear as though missed days means missing out on substantial gains, but the reality is that the best days for markets often arrive in, or shortly after, periods of prolonged market declines (known as bear markets).

But we know that if investors could time markets, then avoiding the whole bear market period would of course produce the best return. But trying to time the market can be very costly if not done perfectly.

Power-up your portfolio

In our view, investors should not only remain invested over the long-term but also diversify across different asset classes, regions, sectors, and currencies to reduce risk and smooth out returns, thereby reducing days of extreme returns in both directions. Adding new asset classes, such as alternatives like infrastructure where returns are linked to inflation, can help achieve this as seen in 2022 where these allocations helped to insulate investors from the worst equity market returns.

Value of $10,000 Invested in the S&P 500 (missing the worst days)



Source: LGIM Bloomberg, based on daily returns as at 31/12/2003 - 31/12/2023

Power moves

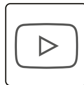
We know we live in an ever-shifting landscape of global risks and opportunities, therefore we argue it is crucial to stay adaptable. It is not just about 'time in the market'. Investing in a dynamic asset allocation portfolio gives the flexibility to respond to market events by changing investments, therefore seeking resilient risk-adjusted returns on an ongoing basis while maintaining the appropriate risk level.

These changes are not led by emotion but are instead part of a robust process for change over the medium and long term. For example, making an adjustment to an UK equity allocation relative to other developed market equity regions following Brexit, or diversifying exposure into new thematic equities such as artificial intelligence. Each asset allocation change aims to enhance the return or mitigate the downside.

Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass. It should be noted that diversification is no guarantee against a loss in a declining market.

Contact us

For further information about LGIM, please visit lgim.com or contact your usual LGIM representative



Key risks

The value of investments and the income from them can go down as well as up and you may not get back the amount invested. Past performance is not a guide to future performance.

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