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## Diversifying Your Lineup: Don't Bet It All on the Heavy Hitters

February 25, 2025

### Key Takeaways

- The returns for the largest US stocks over the last 10 years were historically strong, driven by above average earnings growth and valuation multiple expansion.
- Repeating this performance is not impossible, but the assumptions needed for another decade like the one we just experienced make the outcome unlikely.
- Diversifying away from the names that drove a significant portion of this historic performance, such as the Magnificent 7<sup>1</sup>, may allow investors to stay aligned with their long-term goals.

At the time of this writing, Opening Day for Major League Baseball is about a month away. There are many things I like about baseball—the history, the nostalgic association with summer, and even the slow pace of play which stands in contrast to the rest of my life (which seems to move faster as the years pass).

The recent success of the Yankees certainly contributes to my joy. After advancing to the World Series last year, my expectations for the team are high. I want that 28th World Series title. While there are plenty of reasons to be optimistic about a team led by Aaron Judge, I must acknowledge that I am letting recent performance anchor my expectations.

While letting past performance guide my expectations for the team I root for is pretty harmless, it can make for bad investing. As a Yankees fan, the worst-case scenario is that I will be a little more disappointed if my team doesn't make a deep postseason run than I would be otherwise. But as an investor, the stakes are much higher. After a period of strong market returns, particularly from a few names in the US, it's worthwhile assessing how past performance may be biasing our go-forward expectations.

### US Stocks Hit it Out of the Park

Over the last 10 years, US stocks have had an incredible run, benefiting from low interest rates alongside new transformative technologies. In fact, for the 10 years ending in 2024, the S&P 500 returned 13% annually, which far outpaced other developed and emerging markets<sup>2</sup>. While there were plenty of winners over this period, much of that handsome return came from just a handful of names—most notably the tech-heavy “Magnificent 7” stocks. The Magnificent 7, also known as the Mag 7, as a group returned about 35% annually over this period.

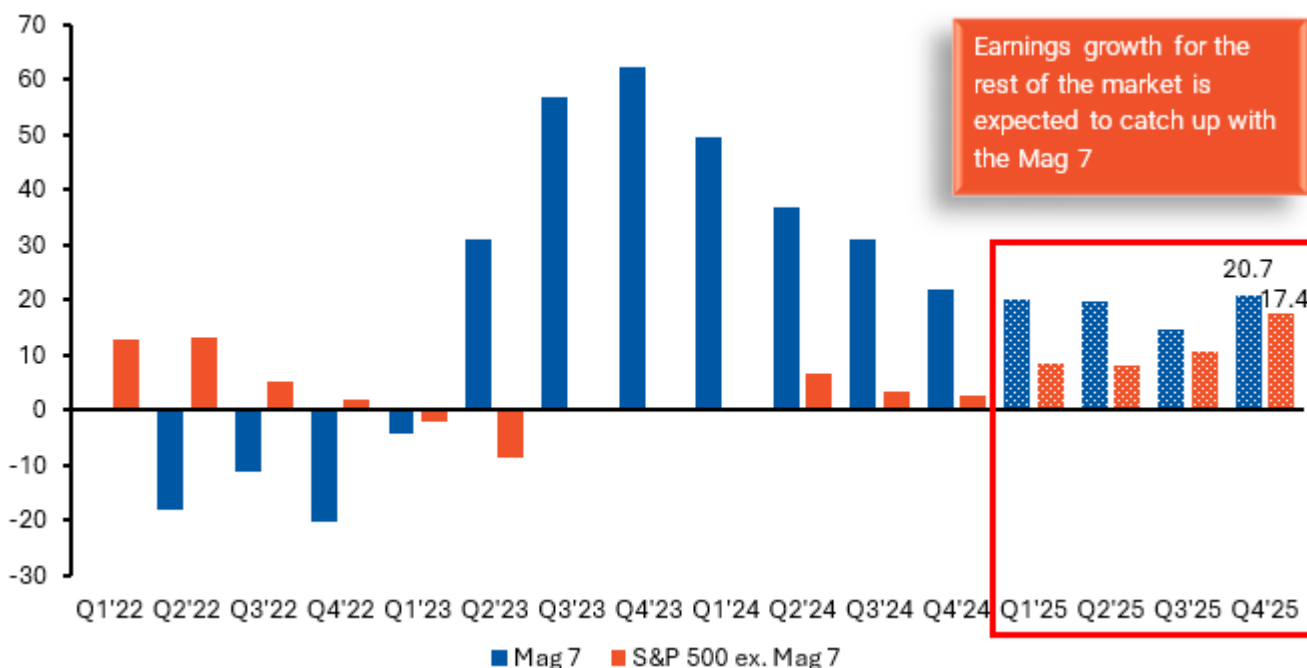
Importantly, though, investing is more about the future than the past. These extraordinary gains have helped propel this group of seven large stocks to new heights such that they represent a very large proportion of some portfolios. Going forward, however, investors should ask themselves: how likely are these stocks to repeat this historically strong performance? To make sound decisions that are aligned with long-term goals and risk tolerance, we must have realistic expectations for the future.

## Swinging for the Fences over the Next 10 Years

Setting realistic expectations is easier said than done, especially when discussing stock returns. Collectively the seven stocks that make up the Magnificent 7 grew earnings from 2015 through 2024 by about 30% a year, an extraordinary feat when compared to the 7% growth of the broader S&P 500. In addition to the rapid pace of earnings growth, valuations – or, how much investors pay for those earnings – grew such that today the average price-to-earnings of the Mag 7 is about 49x compared to 25x for the S&P 500 as a whole. As a result, investors who owned those stocks benefited from both stronger earnings and higher valuations.

But as we mentioned earlier, investing is about the future. So what are expectations for earnings growth and valuations for the Magnificent 7 going forward? First, let's examine earnings growth. Exhibit 1 shows that while the earnings power of the Mag 7 led the market over the last several years, expectations are for the remaining 493 names in the S&P 500 to narrow the gap. By Q4 2025, the Mag 7 are collectively expected to grow their earnings by about 21% versus the rest of the S&P at 17%—still a sizable margin, but much less than what was seen a year or two ago.

**Exhibit 1: Earnings Growth of the Magnificent 7 and the S&P 493 (%)**

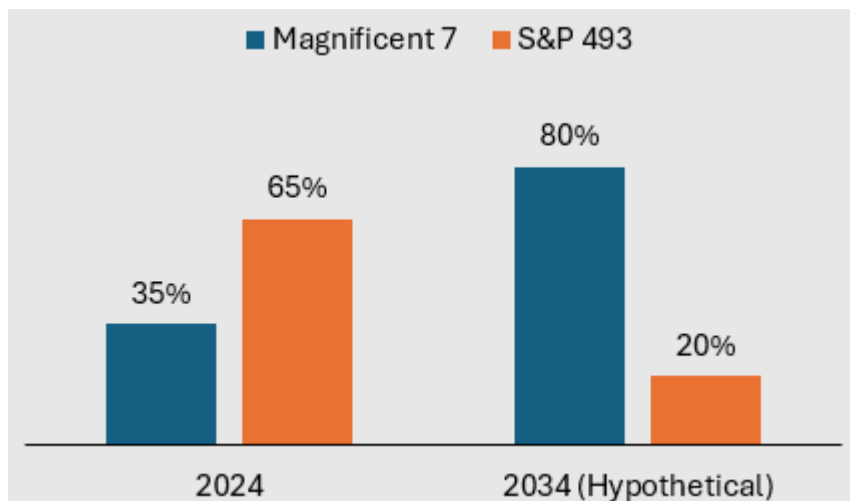


Past performance is not a reliable indicator of current or future results. Indexes are unmanaged and not subject to fees. It is not possible to invest directly in an index. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast or guarantee of future results. Source: Ned Davis Research. Index: S&P 500. Data as of December 5, 2024.

Let's assume that earnings for the Magnificent 7 reaccelerate and grow by the same 30% every year for the next ten years—like they did for the last ten. In order to match the total return of those stocks over the last decade, valuations would also need to expand as they did in the last ten years. In that case, valuations would reach ~70x, compared to the long-term average of the S&P 500 of ~16x.

In this hypothetical scenario, let's also assume that the rest of the S&P 500 grows by its historical rate of about 10%. In that case, we get to an incredibly lopsided market whereby the Magnificent 7 grow from 35% of the S&P 500 (already the highest level of concentration since the 1960s) to a whopping 80% of the market cap of the index. Not impossible but certainly improbable. That outcome would be akin to a pitcher throwing two perfect games—a feat that has never been done by a single player—in back-to-back games.

**Exhibit 2: Market Capitalization Relative to S&P 500, Current and Hypothetical, Assuming Magnificent 7 Continues to Outperform the S&P 493 for the Next 10 Years**

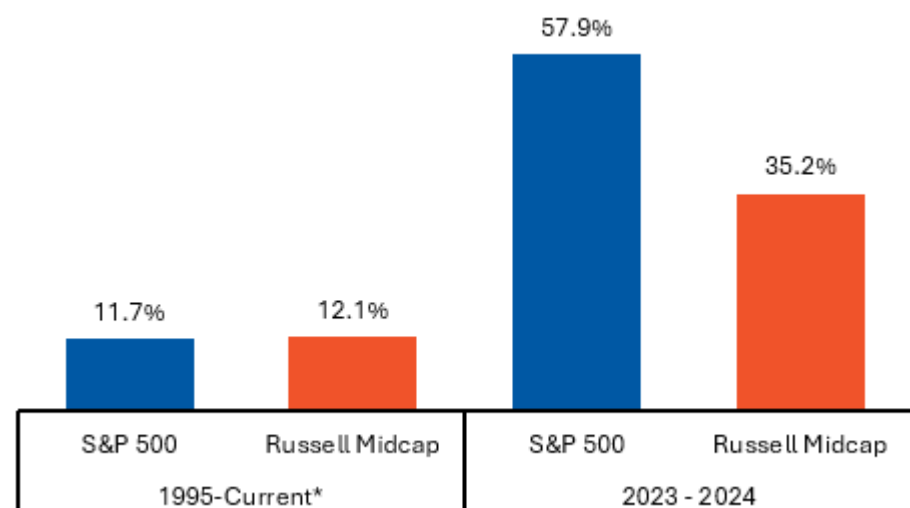


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**The Heavy Hitting Magnificent 7**

Given the high valuations at the top end of the market, it may be prudent to focus on the fundamentals of asset allocation, such as maintaining diversification. After this run, investors may find themselves overweight mega caps and underweight asset classes such as mid caps, small caps, and non-US stocks. For example, mid caps are trading roughly in line with their 20-year average on a forward P/E basis (~16x today vs. 15x for the 20-year average), whereas the S&P 500 today is trading at a premium to the historical average. Historically, a mid-cap allocation has rewarded investors. While they have lagged large caps more recently, Exhibit 3 shows mid caps have actually outperformed large caps since 1995.

**Exhibit 3: S&P 500 vs. Russell Midcap Index**



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## Rounding Third and Bringing It Home

Investors often struggle with what academics call extrapolation bias – a phenomenon whereby individuals tend to overweight the likelihood of recent events continuing. This type of bias can be as simple as: “This stock performed great last year, therefore it will likely perform great next year.” Or, “The Yankees were good last year, this year they will win the World Series” (Fingers crossed).

In order to inoculate ourselves against these types of biases, investors may find it helpful to engage in exercises like those above, which force us to interrogate our assumptions. As such, investors can keep aligned with their long-term goals and risk tolerance.

It's certainly possible that the Magnificent 7 has another magnificent decade. Equities are volatile and their range of outcomes is wide. Yet there is risk in letting extrapolation bias guide our expectations, at the expense of deviating from core principles such as a properly diversified portfolio.

<sup>1</sup> The Magnificent 7 collectively are Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta, Tesla.

<sup>2</sup> Non-US developed markets as represented by the MSCI World ex USA Index. Emerging markets as represented by the MSCI Emerging Markets Index.

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