THE SEVEN SAMURAI: THE STOCKS THAT SAVED THE MARKET!

A trillion here, a trillion there..

A hat tip to Kurosawa!

- I was planning to finish my last two data updates for 2024, but decided to take a break and look at the seven stocks (Apple, Amazon, Alphabet, Meta, Microsoft, Nvidia and Tesla) which carried the market in 2023.
- While I will use the "Magnificent Seven" moniker attached by these companies by investors and the media, my preference would have been to call them the Seven Samurai.
- After all, like their namesakes in that legendary Kurosawa movie, who saved a village and its inhabitants from destruction, these seven stocks saved investors from having back-to-back disastrous years in the stock market.

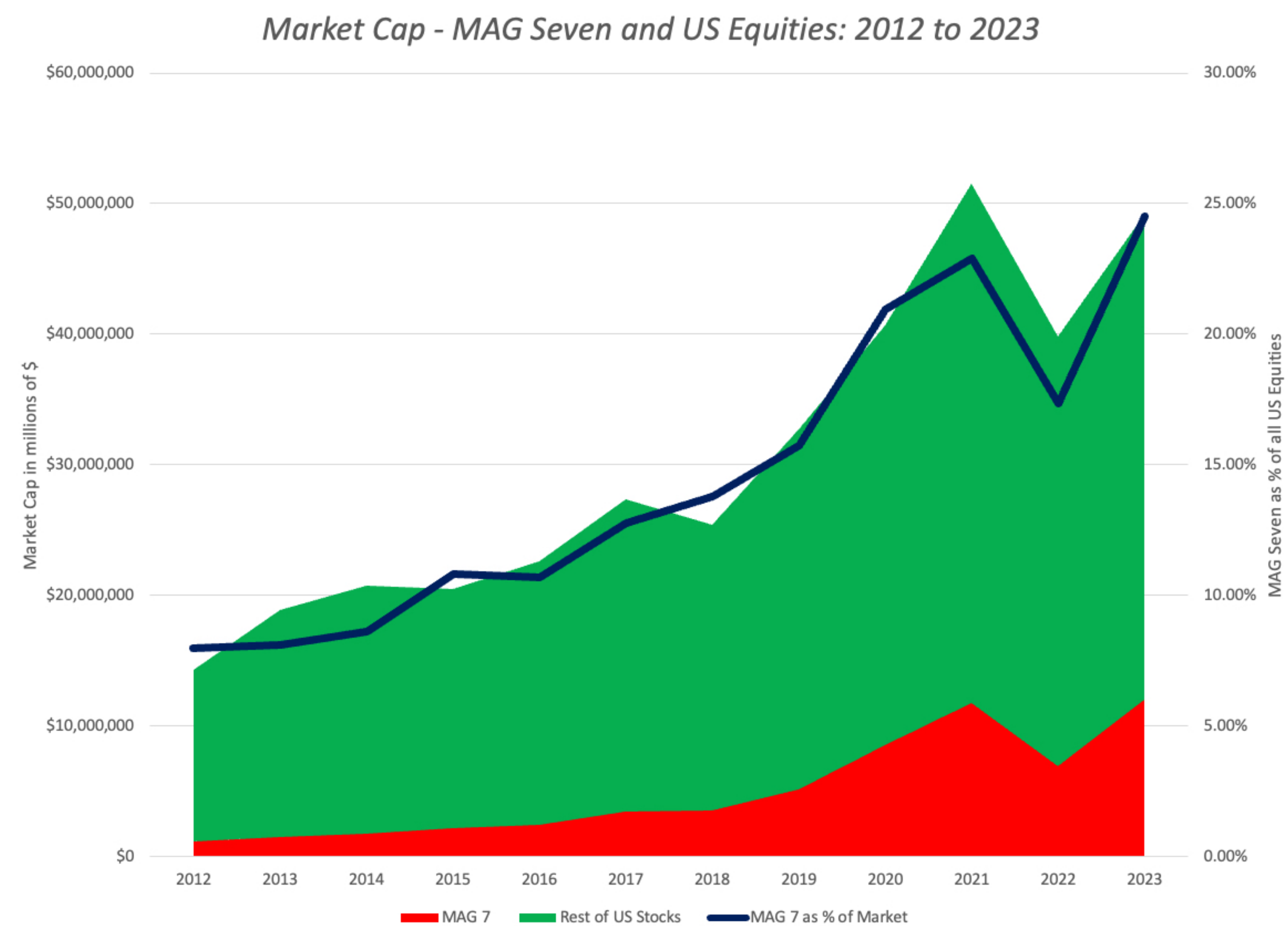
The What?

- It is worth remembering that the Magnificent Seven (MAG 7) had their beginnings in the FANG (Facebook, Amazon, Netflix and Google) stocks, in the middle of the last decade.
- That morphed into the FANGAM (with the addition of Apple and Microsoft to the group) and then to the MAG 7, with the removal of Netflix from the mix, and the addition of Tesla and Nvidia to the group.
- There is clearly hindsight bias in play here, since bringing in the best performing stocks of a period into a group can always create groups that has supernormal historical returns. That bias notwithstanding, these seven companies have been extraordinary investments, not just in 2023, but over the last decade, and there are lessons that we can learn from looking at the past.

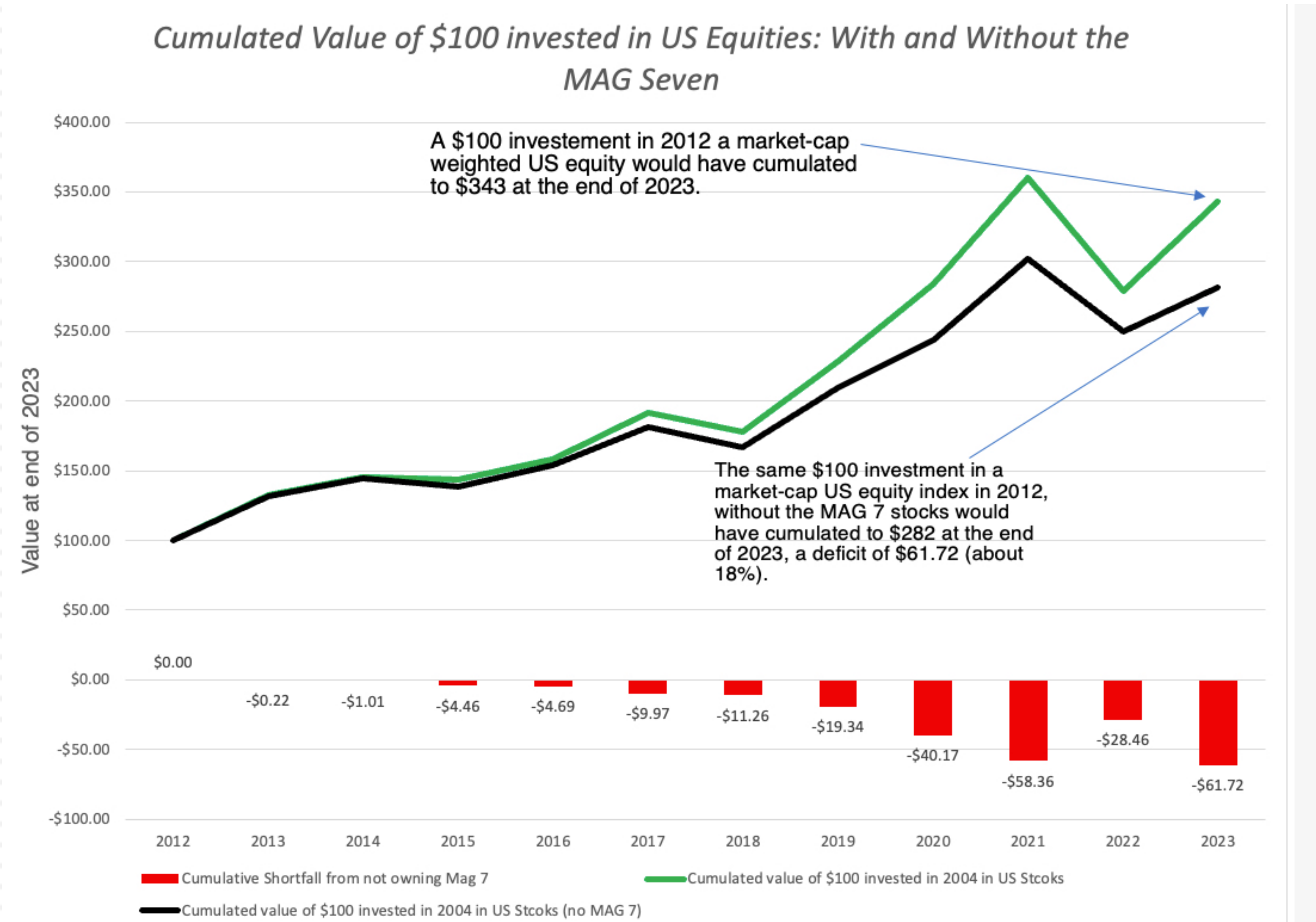
In 2023…

Company Name	*2022*	*2023*	*Change in 2023*	*% Change*
Apple Inc. (NasdaqGS:AAPL)	$2,066,941.80	$2,994,371.30	$927,429.50	44.87%
Microsoft Corporation (NasdaqGS:MSFT)	$1,788,218.40	$2,794,827.90	$1,006,609.50	56.29%
Alphabet Inc. (NasdaqGS:GOOGL)	$1,145,003.90	$1,755,459.00	$610,455.10	53.31%
Amazon.com, Inc. (NasdaqGS:AMZN)	$856,939.00	$1,570,152.60	$713,213.60	83.23%
NVIDIA Corporation (NasdaqGS:NVDA)	$359,650.50	$1,223,193.40	$863,542.90	240.11%
Meta Platforms, Inc. (NasdaqGS:META)	$315,555.20	$910,121.70	$594,566.50	188.42%
Tesla, Inc. (NasdaqGS:TSLA)	$388,971.90	$789,898.40	$400,926.50	103.07%
MAG Seven	$6,921,280.70	$12,038,024.30	$5,116,743.60	73.93%
ALL US Stocks	$39,852,862.75	$49,118,785.36	$9,265,922.61	23.25%
All US Stocks without MAG Seven	$32,931,582.05	$37,080,761.06	$4,149,179.01	12.60%

From 2012 to 2023…



The Cost of not holding the Mag Seven



Exception or the Norm?

- In all of the breathless coverage of the Mag Seven (and FANG and FANGAM) before it, there seems to be the implicit belief that their market dominance is unprecedented, but it is not.
- In fact, equity markets have almost always owed their success to their biggest winners, and Henrik Bessimbinder highlighted this reality by documenting that of the $47 trillion in increase in market capitalization between 1926 and 2019, five companies accounted for 22% of the increase in market value.
- I will wager that at the end of the next decade, looking back, we will find that a few companies accounted for the bulk of the rise in market capitalization during the decade, and another acronym will be created. .

The Why?

- When stocks soar as much as the Mag Seven stocks have in recent years, they evoke two responses.
  - One is obviously regret on the part of those who did not partake in the rise, or sold too soon.
  - The other is skepticism, and a sense that a correction is overdue, leading to what I call knee-jerk contrarianism, where your argument that these stocks are over priced is that they have gone up too much in the past. With these stocks, in particular, that reaction would have been costly over much of the last decade, since other than in 2022, these stocks have found ways to deliver positive surprises.
- Understanding why a group of companies outperformed the market is not just good for understanding, but can help us assess whether they can keep winning.

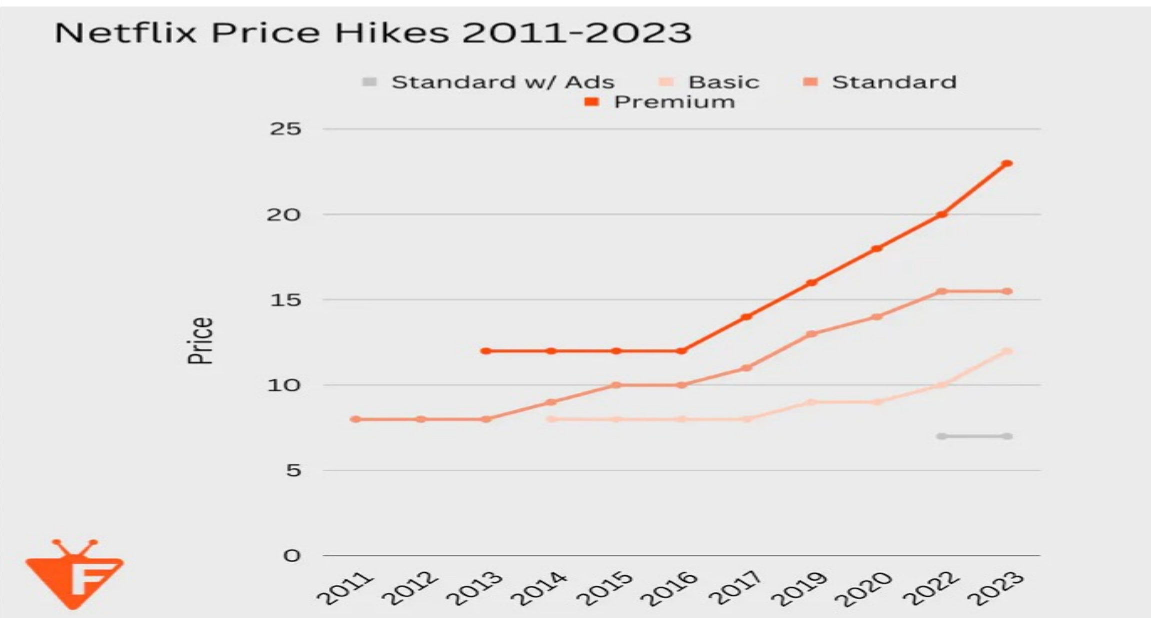
1. Correction/Momentum Story

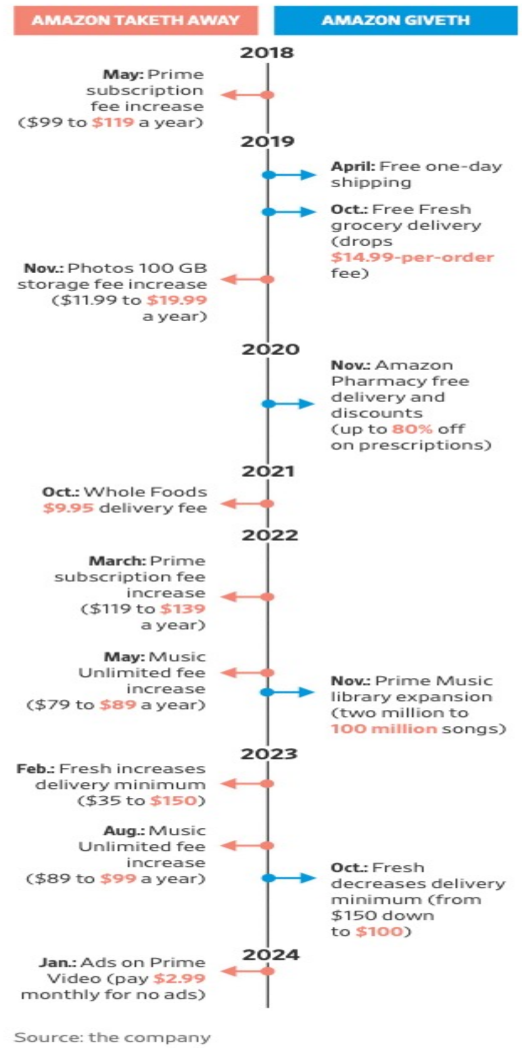
	Market Cap in 2022	Marker Cap in 2023	Change in Market Cap	% Change in Market Cap
Worst Performing Stocks in 2022 (Bottom Decile)	$24,514,556	$33,062,620	$8,548,064	34.87%
Best Performing Stocks in 2022 (Top Decile)	$11,125,462	$11,222,548	$97,085	0.87%
Worst Performing Decile (excluding Mag Seven)	$17,462,047	$20,811,498	$3,349,450	19.18%
Mag Seven	$7,052,508	$12,251,122	$5,198,614	73.71%

2. Payoff to Business Models

- Pricing power and Economic Resilience: Coming into 2023, there were real concerns about whether the big tech companies that had dominated markets for the prior decade had pricing power and how well they would weather a recession. During the course of 2023, the Mag Seven set those fears to rest at least for the moment on both dimensions, increasing prices (with the exception of Tesla) on their products/services and delivering growth.
- Money Machines: The pricing power and product demand resilience exhibited by these companies have manifested as strong earnings for the companies. In fact, both Alphabet and Meta have laid off thousands of employees, without denting revenues, and there profits in 2023 reflect the cost savings:
- Safety Buffers: As interest rates, for both governments and corporates, has risen sharply over the last two years, it is prudent for investors to worry about companies with large debt burdens, since old debt on the books, at low rates, will have to get refinanced at higher rates. With the Mag Seven, those concerns are on the back burner, because these companies have debt loads so low that they are almost non-existent.

a. Pricing Power





b. Profitability

	Alphabet	Amazon	Apple	Microsoft	Meta	Nvidia	Tesla	Mag Seven	S&P 500
Revenues	$307,394	$574,785	$385,706	$227,583	$134,902	$44,870	$96,773	$1,772,013	$16,030,993
Gross Profits	$175,022	$270,046	$173,671	$158,887	$108,896	$31,343	$17,660	$935,525	$3,455,166
Operating Profits	$88,226	$36,852	$118,658	$101,485	$49,006	$20,614	$8,891	$423,732	$2,146,320
Net Profits	$73,795	$30,425	$100,913	$82,541	$39,098	$18,889	$14,997	$360,658	$1,710,249
Gross Margin	56.94%	46.98%	45.03%	69.81%	80.72%	69.85%	18.25%	52.79%	21.55%
Operating Margin	28.70%	6.41%	30.76%	44.59%	36.33%	45.94%	9.19%	23.91%	13.39%
Net Margin	24.01%	5.29%	26.16%	36.27%	28.98%	42.10%	15.50%	20.35%	10.67%
R&D Expenses in 2023	$43,709	$85,622	$29,902	$27,524	$36,911	$7,596	$3,960	$235,224	
R&D Adjusted Margin	32.22%	11.33%	31.77%	46.08%	44.71%	53.44%	11.22%	44.71%	

c. Safety Buffers

	Alphabet	Amazon	Apple	Microsoft	Meta	Nvidia	Tesla	Mag Seven
Total Debt ($ mil)	$29,987	$161,574	$108,040	$111,358	$37,924	$11,027	$5,230	$465,140
Cash ($ mil)	$110,916	$86,780	$180,248	$80,982	$65,403	$18,281	$29,094	$571,704
Net Debt ($ mil)	-$80,929	$74,794	-$72,208	$30,376	-$27,479	-$7,254	-$23,864	-$106,564
Market Cap ($ mil)	$1,776,790	$1,783,903	$2,869,874	$3,055,544	$1,220,659	$1,634,152	$598,454	$43,128,841
Net Debt to Mkt Cap	-4.55%	4.19%	-2.52%	0.99%	-2.25%	-0.44%	-3.99%	-0.25%

3. Winner-take-all Economics

- It is undeniable that as the global economy has shifted away from its manufacturing base in the last century to a technology base, it has unleashed more "winner-take-all (or most" dynamics in many industries.
  - In advertising, which was a splintered business where even the biggest players (newspapers, broadcasting companies) commanded small market shares of the overall market, Alphabet and Meta have acquired dominant market shares of online advertising, driven by easy scaling and network benefits (where advertising flows to the platforms with the most customers).
  - Over the last two decades, Amazon has set in motion similar dynamics in retail and Microsoft's stranglehold on application and business software has been in existence even longer.
  - In fact, it is the two newcomers into this group, Nvidia and Tesla, where questions remain about what the end game will look like, in terms of market share. Historically, neither the chip nor car businesses have been winner-take-all businesses, but investors are clearly pricing in the possibility that the changing economics of AI chips and electric cars could alter these businesses.

What’s next?

Fairly priced or Holdl (Grey)
When your assessment of a company's quality is in sync other investors' perception of its quality, you have fair pricing, where you earn your required return.

Cheap or Buy (Green)
When your assessment of a company's quality is better than other investors' perception of its quality, with greater divergence match up to better buys.

Expensive or Sell (Red)
When your assessment of a company's quality is worse than other investors' perception of its quality, with greater divergence match up to better sells.

Intrinsic Valuations

	Alphabet	Amazon	Apple	Microsoft	Meta	Nvidia	Tesla
Expected CAGR Revenue (next 5 years)	8.00%	12.00%	7.50%	15.00%	12.00%	32.20%	31.10%
Target Operating Margin	30.00%	14.00%	36.00%	45.00%	40.00%	40.00%	13.07%
Cost of Capital	8.84%	8.60%	8.64%	9.23%	8.83%	8.84%	9.17%
Price per share	$145.00	$169.15	$188.00	$405.49	$456.08	$680.00	$185.07
Value per share	$138.14	$155.72	$176.79	$355.88	$445.10	$436.34	$183.75
% Under or Over Valued	4.97%	8.62%	6.34%	13.94%	2.47%	55.84%	0.72%
Internal Rate of Return	8.41%	7.85%	7.89%	8.06%	8.53%	7.18%	9.16%

Assessing Value…

- While all of the companies in the Mag Seven have values that exceed their prices, Tesla and Meta look close to fairly valued, at current prices, Alphabet, Apple and Amazon are within shouting distance and Microsoft and Nvidia look over valued, with the latter standing out as more so.
- It may be coincidence, but these are the two companies that have benefited most directly from the AI buzz, and my over valuation may reflect my lack of imagination on how big AI can get as a business.

And Acting..

- I own all seven of these companies, which may strike you as contradictory, but with the exception of Tesla that I bought just last week, my acquisitions of the other seven companies occurred well in the past, and reflected my judgment that they were undervalued (at the time).
- To the question of whether I should be selling, which would be consistent with my current assessment that these stocks are overvalued, I hesitate for two reasons:
  - I will have to a capital gains tax that will amount to close to 30%, with state taxes included and there is a range on my value, and only one of these seven companies (Nvidia) is clearly out of that range.
  - The second is psychological, since selling everything or nothing would leave me with regrets either way. Last summer, when I valued Nvidia in this post, I found it over valued at a price of $450, and sold half my holdings, choosing to hold the other half. Now that the price has hit $680, I am happy that I did not sell all of my holdings, but I plan to see half my holdings again.

Wrapping up…

- As I noted at the start of this post, the benefit of hindsight allows us to pick the biggest winners in the market, bundle them together in a group and then argue that the market would be lost without them.
- That is true, but it is neither original nor unique to this market. The Mag Seven stocks have had a great run, but their pricing now reflects, in my view, the fact that they are special companies, with business models that deliver growth, at scale, with profitability.
- If you have never owned any of these companies, your portfolio will reflect that choice, and while jumping on to the bandwagon now will not make up for that failure, you should bide your time.
- It is my experience that even the very best companies deliver disappointments, and that markets overreact to these disappointments, simply because expectations have been set so high. It is precisely at those times that you will find that the price is right!