JENNISON ASSOCIATES

PERSPECTIVES

April 2024

Beyond the Magnificent Seven

US equity market performance in 2023 was dominated by growth stocks, led by a cohort of companies dubbed “The Magnificent Seven:” Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, Tesla. In 2024, many investors are questioning whether this extraordinary performance is sustainable.

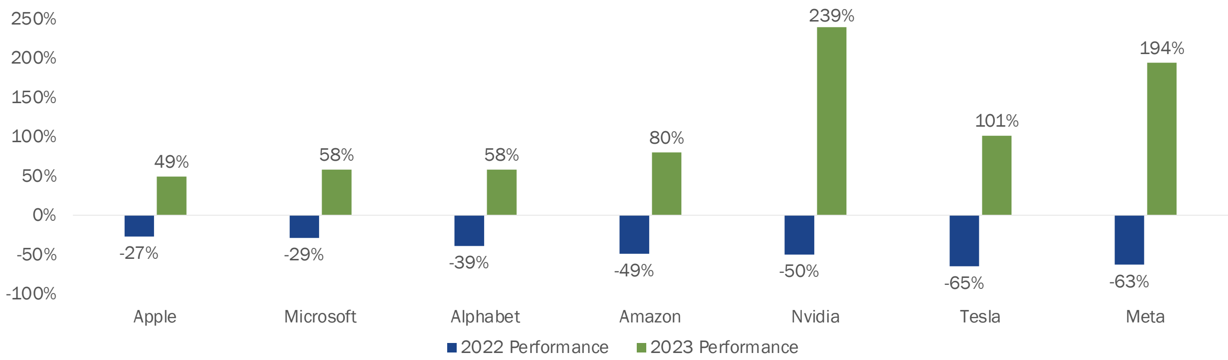
To explore this question, we believe it is important to consider market performance and the macroeconomic environment since 2020. Over the past few years, the markets have endured a number of extraordinary events—a global pandemic, war in the Ukraine, intense conflict in the Middle East, tensions with China, inflation, and an aggressive interest rate tightening cycle.

Persistent inflation drove higher discount rates, leading risk tolerance lower in 2022. Companies with minimal free cash flows and high valuations—as well as companies that benefited disproportionately from unsustainable pandemic trends—underperformed dramatically. Investor sentiment reached a negative crescendo, in our view, as 2022 ended with anxiety and fear eclipsing fundamental considerations.

2023 saw many of the prior year’s underperformers benefit from depressed valuations at the start of the year while near- and medium-term revenue and profit expectations for these companies exhibited stabilization. The significant economic slowdown or possible recession that investors were anticipating failed to occur, adding further impetus to improving investor sentiment. The year ended on an optimistic note as the Federal Reserve left the federal funds rate unchanged and stated the pace of inflation had cooled sufficiently, making further rate increases likely unnecessary. Capital markets rallied vigorously after the announcement.

The extremes in sentiment over the past two years are captured by the performance of the Magnificent Seven in 2022 versus 2023 (Exhibit 1).

Exhibit 1: Magnificent Seven Stock Performance Has Been Volatile



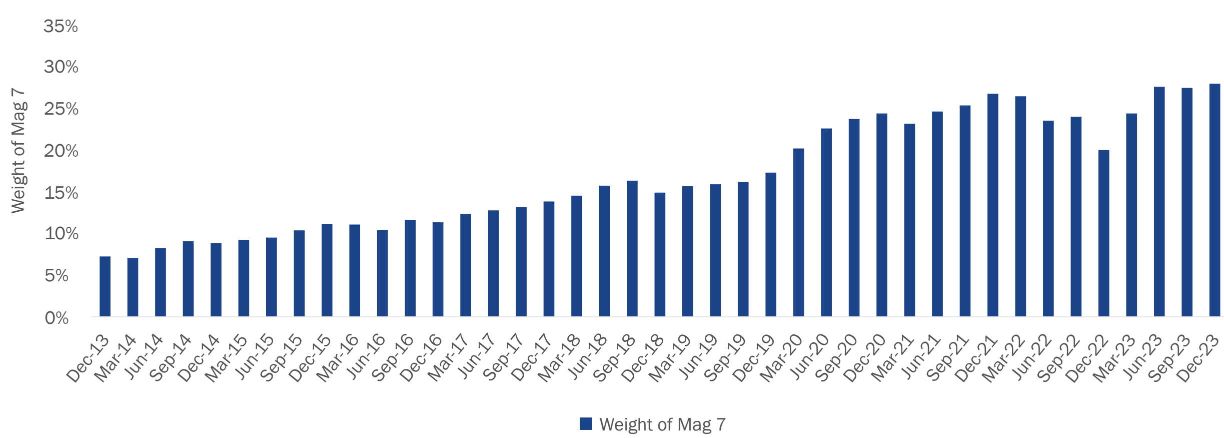
Past performance does not guarantee future results.
Source: Jennison

The growth and fundamental results of the Magnificent Seven exceeded those of most companies in 2023. Investors broadly favored stocks with durable free cashflows and secular growth exposure, characteristics well represented in the Magnificent Seven. As of December 31, 2023, these seven companies accounted for more than a quarter of the S&P 500's market cap and 28% of its projected free cash flow over the next twelve months. The Magnificent Seven have projected EPS and free cash flow growth that is 2–2½ times the rate of the bottom 493 members of the index. By the same comparison, operating margins for the seven are about 1½ times higher than the other 493 (31% versus 20%).

The combined market capitalization of the Magnificent Seven hit an all-time high, constituting 28% of the total S&P 500 Index at the end of 2023. The total market cap of the Magnificent Seven reached 27% (just below its 2023 peak) in the second half of 2021 when Covid-induced trends, business shutdowns, and stay-at-home requirements forced people online to work, communicate, and play. The combined market caps of the Magnificent Seven have been volatile since then, with no dominant trend (Exhibit 2).

Exhibit 2: Not at Extremes for the Magnificent Seven

Combined Weight of the Magnificent Seven as a Percentage of the S&P 500 Index



As of December 31, 2023. Past performance does not guarantee future results.
Source: Jennison, FactSet

Recent performance data shows that investors have been investing in the Magnificent Seven for fundamental reasons. While stock prices for the Magnificent Seven have been rising, their price-to-earnings (P/E) ratios have declined. In contrast, the P/Es for the rest of the market have risen over the same time period. Decomposing the price increases for the Magnificent Seven reveals that the driver of performance was earnings (Exhibit 3). By comparison, the rise of the rest of the S&P 500 Index was reflected in multiples (Exhibit 4).

Exhibit 3: Magnificent Seven Prices Are Being Driven by Earnings

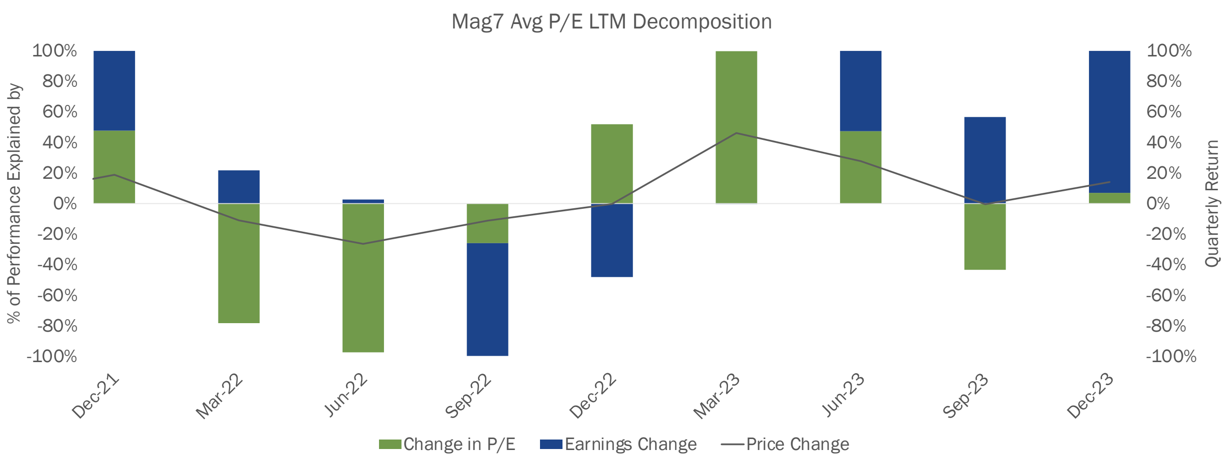
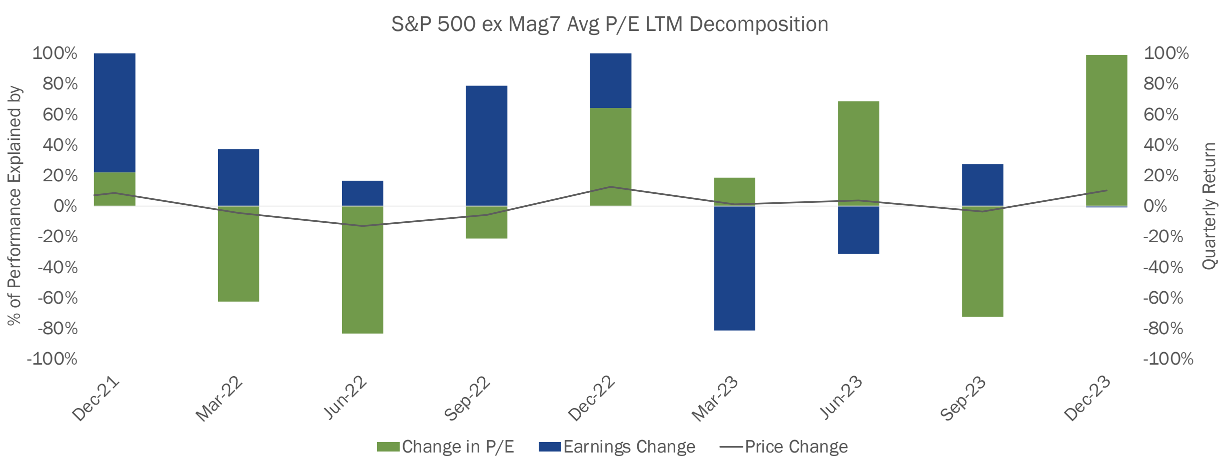


Exhibit 4: The S&P's Rise Reflects Multiple Expansion



As of December 31, 2023. Past performance does not guarantee future results.
Source: Jennison, FactSet

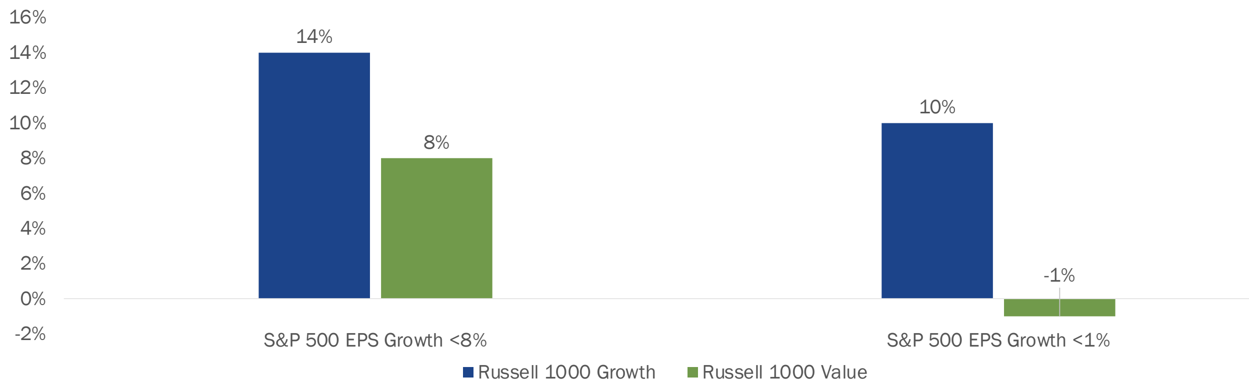
Share price performance of the Magnificent Seven is more fully reflected in current valuations. In any case, the Magnificent Seven is not a monolithic group that rises and falls together. Going forward, the companies face diverging challenges and opportunities, which have been reflected in first quarter 2024 performance.

The Magnificent Seven are not the only options offering growth exposure, and there are other companies, in our view, which represent significant growth opportunities. A review of recent performance of growth companies outside the Magnificent Seven shows that a significant percentage outperform the benchmark each year.

We also note that while economic growth has slowed, we believe this will make companies with genuine growth potential more attractive to investors (Exhibit 5).

Exhibit 5: Growth Stocks Performed Better in Slow or Normal EPS Environment

Growth and Value Average Return in Different Broad Market Earnings Growth Environments



Data from December 31, 1989-December 31, 2023. Past performance does not guarantee future results.
Source: FactSet and Morningstar Direct. The chart was created using annual data for both the Russell returns and S&P EPS Growth.

Seek Tomorrow's Growth

The Magnificent Seven constituents are some of the most successful investment stories of our era, and we believe many of these companies retain extraordinary potential to generate returns in the future. However, we also believe investors today should ask: what are tomorrow's most attractive and durable growth opportunities? Specifically, what are the business models in earlier stages of evolution with large total addressable market potential to exploit? What other emerging leaders can use scale as a competitive advantage to drive rising levels of profitability?

It is an exciting time to be growth investors. We are at the beginning of a secular growth trend that can provide further support for stock prices going forward. The generative AI-driven technological transformation, in our view, will be as significant and long lasting as the advent of the internet and mobile computing. Within the next several years, we expect to see generative AI use cases and applications spread from technology providers and developers to a wide range of industries.

It is early, at this stage, to identify the companies that will develop the next generation of generative AI applications for end users. However, we believe that while there will be disappointments, the companies that enhance their products and services using generative AI can ultimately create significant advantages. We believe this will occur across a range of industries, including healthcare, mobility, luxury, direct-to-consumer ecommerce, finance, and manufacturing.

This thematic backdrop reinforces our belief in taking a long-term perspective on investing. Our experience suggests that growth companies offering differentiated products and services that create real value for society have strong potential to prosper. Furthermore, fundamental research is likely to be critical in identifying these companies. We believe investors with resources, experience, expertise, and skill are best positioned to deliver outperformance over time.

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