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OWEN LAMONT'S OBSERVATIONS ON BEHAVIORAL FINANCE AND MARKETS

Magnificent Ignorance about the Magnificent Seven

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Joe Biden is running for re-election in 2024. Never before in U.S. history has any president won a second term. The last time it was attempted, in 2020, incumbent Donald Trump (the youngest president in U.S. history) was defeated. Historians believe this pattern reflects the fact that all U.S. presidents have been from either Delaware or New York City.

I hope you looked at that paragraph and immediately thought "this is total nonsense written by a complete idiot." Now, if you want to be a weasel, you could define "U.S. history" to mean "the period since 2016," in which case the above paragraph is technically correct. But weasel words aside, I hope you reacted with scorn, or perhaps pity, to the above paragraph.

You should react similarly to most stories about the Magnificent Seven stocks.[1] Consider this one:

> *The S&P 500 has never been this top-heavy.*
>
> *The "Magnificent Seven" tech stocks — Apple (AAPL), Alphabet (GOOGL, GOOG), Microsoft (MSFT), Amazon (AMZN), Meta (META), Tesla (TSLA), and Nvidia (NVDA) — make up 29% of the S&P 500's market cap.*
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> *And a chart in Goldman Sachs' 2024 US Equity Outlook shows that's the largest portion of S&P 500 market cap ever dominated by just seven stocks.*[2]

Exhibit 22 in the Goldman Sachs report shows a graph with the top seven S&P stocks at an "all-time high" of 29%, with the graph starting at 1980 with a weight of about 24%, falling to around 14%, and then rising to around 28% since 2020.[3]

Now, if you define "never" as "never since 1980" and "time" to be "the period after 1980," then it is true that the stock market has never been this concentrated and we are at all-time highs, and these statements are technically correct. But those would be weasel arguments made to justify foolish assertions.

The truth is that the U.S. stock market was far more concentrated in the 1950s and 1960s. Looking at Schlingemann and Stulz (2022), for example, we see that:[4]

- In the mid-1950s, just three stocks accounted for about 28% of the market cap of the whole market (Figure 8). Obviously, this implies the market then was much more concentrated than seven stocks being 29% of the S&P 500 today.
- For many decades, the biggest stock in the market was always one of the following three: IBM, AT&T, or GM (Figure 6).

Introducing Owen Lamont, Ph.D.

Senior Vice President, Portfolio Manager, Research

Owen joined Acadian in 2023 and is an expert on behavioral finance. In addition to more than 20 years of experience in asset management as a researcher and portfolio manager, Owen has been on the faculty at Harvard University, Princeton University, The University of Chicago Graduate School of Business, and Yale School of Management. He has published papers on short selling, stock returns, and investor behavior in leading academic journals, and he has testified before the U.S. House of Representatives and the U.S. Senate. Owen earned a Ph.D. in economics from the Massachusetts Institute of Technology and a B.A. in economics and government from Oberlin College.

[1] Any mention of a company in this writeup is for illustrative purposes only and is not a recommendation to buy or sell a specific security

[2] Josh Schafer, "One chart shows how the 'Magnificent 7' have dominated the stock market in 2023," yahoo/finance, November 15, 2023.

[3] "2024 US Equity Outlook: 'All You Had To Do Was Stay'," Goldman Sachs, November 21, 2023.

[4] Schlingemann, Frederik P., and René M. Stulz. "Have exchange-listed firms become less important for the economy?" Journal of Financial Economics 143.2 (2022): 927-958.

- A single stock (AT&T) was 13% of the whole market in 1960 (Table 5), as opposed to today where our largest stock (Apple) is a mere 7% of the S&P 500.
- In terms of employment, concentration was also far higher previously. The authors write, "For 1953, GM is the top firm in market capitalization. It employs 1.39% of non-farm employees. In 2019, Apple's employment contribution is 0.11% (or less than one twelfth GM's employment contribution in 1953)."

With these facts in mind, let us review some absurd claims you might encounter:

- "Due to the Magnificent Seven, low-volatility strategies will not work." No. Low vol worked fine back when a handful of stocks dominated the U.S. stock market. Concentration by itself is perfectly consistent with low vol working.
- "The existence of the Magnificent Seven proves indexing is distorting our markets." No, we had higher concentration before the invention of indexing.
- "The Magnificent Seven is part of a troubling trend of inequality in our winner-take-all society." No. The 1950s and 1960s were a supposed golden age of income equality of U.S. citizens, and that is when stock market concentration was higher.
- "Systematic investing cannot work in a concentrated stock market." Nonsense. Systematic strategies are typically backtested including data before 1980.
- "The market itself takes idiosyncratic bets on big firms, defying the concept of diversification." Well, portfolio analysis and the CAPM were invented in the 1950s and 1960s, and Markowitz, Sharpe, and the whole gang did not seem troubled by high concentration.

Where does the term "Magnificent Seven" come from? Well, it refers to the 1960 film of the same name (later remade in 2016), which was based on the 1954 film *The Seven Samurai*. But let's discuss a different film from 1954, *Magnificent Obsession*. It involves a series of melodramatic events that result in the beautiful widow (played by Jane Wyman, a.k.a. Mrs. Ronald Reagan #1) becoming blind. At the end of the movie, the hero (played by Rock Hudson) has become a doctor and is able to perform brain surgery to restore the widow's sight.

The Magnificent Obsession with the Magnificent Seven is Magnificently Ignorant. While I hope brain surgery won't be necessary, market participants need to open their eyes and look at stock market history.

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