



and the Imperfect Index

1. S&P 500 Index

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Despite domestic and geopolitical uncertainty, equity portfolios performed quite well in 2023 as measured by the S&P 500 Index. The market return was largely driven by the seven largest constituents of the S&P 500, also known as the Magnificent Seven. The Magnificent Seven includes: Apple, Microsoft, Alphabet, Amazon, Meta Platforms, Nvidia, and Tesla. These companies account for over twenty-eight percent of the S&P 500 Index and collectively more than doubled in 2023. The spectacular returns concentrated in a few names left the average stock returning less than half of the S&P 500 Index overall. The Magnificent Seven masked the underlying share price weakness of most stocks in the S&P 500 Index. The concentration of returns and weightings raises the question of whether the S&P 500 Index should be dissected for opportunities and imperfections.

S&P 500 Index

This leads us to our next point in which we discuss the construction of the S&P 500 Index and lessons to learn from the evolution of the index. The S&P 500 Index is often referred to as a “passive index,” meaning there is not an active manager changing the constituents of the Index on a regular basis. It may come as a surprise that in any given year there are several changes to the S&P 500 Index. As companies are acquired, merged, or face challenging times, they must be replaced in the index so there remain exactly 500 companies. Over the past decade a shocking 189 companies were added to the S&P 500 Index!

Before we delve into the implications of the 189 additions to the “passive” S&P 500 Index, we should highlight that over 28% of the S&P 500 Index is now in just seven companies, aka the Magnificent Seven. These seven companies are the largest because of their extraordinary performance over the past 15 years. The magnificent seven returns (measured in multiples) since the market peak before the Great Financial Crisis (12/31/2007) through the most recent quarter (12/31/2023) are as follows:

- Apple 32.1x
- Google (Alphabet) 8.1x
- Nvidia 63.4x
- Amazon 32.8x

- Tesla 156.3x (since IPO in 2010) (1.1x since S&P 500 Index inclusion in 2020)
- Microsoft 14.5x
- Meta 12.0x (since IPO in 2012) (6.5x since S&P 500 Index inclusion in 2013)

Usually, we talk about stocks and bonds in percentage terms reserving double digit multiples on investment for only the best Venture Capital hits. In this case, writing about Apple stock's 3,113% return (32.1x multiple) if purchased at one of the worst times in history (right before the financial crisis) through today seems absurd. Thus, we can simply say that an investment in 2007 would today be worth 32.1x as much including dividends (equally absurd you say!). This is a great reminder of how favorable investing in high quality companies can be over long periods of time. (Imagine a game table in Las Vegas that gave you a greater than 50% chance of winning each day, a greater than 65% chance of winning over one year and a nearly 100% chance of winning over multiple decades. You would want to play that game and only that game for as long as you possibly could.) While the magnificent seven have all returned multiples of investment since 2007, the S&P 500 Index has also returned a handsome 4.5x (347%) return over that time frame.

The 189 additions to the S&P 500 Index

Now back to the 189 companies that were added to the S&P 500 Index in the last decade. The 189 additions have been selected by a committee known as the S&P Dow Jones Indices Index Committee (within S&P Global).¹ These additions have to be disclosed before they are added to the index. Thus, the average of those 189 stocks saw a bump immediately before they were added to the S&P 500 Index. On average, those 189 stocks returned 11% over the three month period prior to the announcement date.² As more and more investors allocate a portion of their portfolio to index funds, the newly added stocks see more and more demand for their shares ahead of being included in the index. According to the Investment Company Institute, midway through 2023 there were over \$6.3 trillion dollars invested in S&P 500 Index funds in the United States. As a company is added to the S&P 500 Index there is significant buying power behind that addition.³

Magnificent Seven

The Magnificent Seven stock price appreciation in 2023 reflects their strong fundamentals. These seven companies generally have high margins, low input costs, strong balance sheets, and no unionized labor. Conveniently avoiding the major pitfalls of 2023. Perhaps more importantly, the strong performance from the top seven companies and the outsized weightings of those companies, obfuscates the weakness of the other 493 stocks that are on average still down from the beginning of 2022. After two years of negative returns for the majority of the stocks in the index, perhaps there are some bargains out there for long-term investors.

Conclusion

We can draw a number of conclusions from the above analysis:

1. The S&P 500 Index returns over the next few years will be heavily dependent on the Magnificent Seven.

Fortunately, the majority of the Magnificent Seven have low debt levels, high profit margins, low labor expense relative to revenue, and are cash generative (higher interest rates may boost earnings).

2. The imperfect index will continue to evolve and change despite the passive moniker.
3. Being attentive to potential index inclusions will be ever more important as the size of assets invested in the index grows faster than the index itself.
4. 2023 market returns have been skewed by the Magnificent Seven leaving potential bargains beneath the surface.
5. Finally, investing in high quality companies may pose risks in the near term, but continues to look favorable over extended periods of time.

Endnotes

1. Source: S&P Global
2. Source: Bloomberg Intelligence
3. Source: Investment Company Institute

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