Magellan – In The Know: Episode 45

Decoding the Magnificent Seven: Profitability, fundamentals, and the future

Announcement (00:00):

The information contained in this podcast is for general information purposes and does not constitute investment advice. You should seek investment advice tailored to your circumstances before making an investment decision.

Host (00:14):

This is In The Know, a monthly investment Podcast brought to you by Magellan Asset Management.

Alan Pullen (00:20):

The key difference is that the companies today are incredibly profitable. They're growing their revenue, they're growing their earnings, they're growing their cashflow, and that has underpinned the performance of these companies, at least to date. Now going forward, who knows, we might become overextended and we could argue there are some elements of the market, some of the Magnificent Seven that have some speculative elements in them. But primarily, it's being driven by earnings and fundamentals. Whereas the dot-com boom was primarily driven by speculation. It was a good old-fashioned speculative boom that eventually collapsed under its own weight.

Host (00:59):

That's Magellan Portfolio manager, Alan Pullen, explaining why he still has confidence in some of the so-called Magnificent Seven companies as others talk of an impending bubble. Welcome to Magellan - In The Know.

(01:18):

The Magnificent Seven soared in 2023 on average delivering returns of more than 100% as investors embraced the promise of generative AI. While the future prospects for AI are exciting, such strong performance from such a narrow group of companies raises the spectre of irrational exuberance and the potential for a big correction. But that's not the case this time around for some companies, thanks to strong underlying fundamentals. In this episode, Alan Pullen is joined by Magellan key account manager, Martin Van Eyk, to dissect the Magnificent Seven. Alan explains why they remain faithful to some while keeping a wide berth from others. It's a fascinating study in what makes some technology-driven companies' excellent long-term investments. First, here's a warm welcome from Martin Van Eyk.

Martin Van Eyk (02:12):

Well, hello and welcome. I'm Marty Van Eyk from Magellan, and today we have the opportunity to delve into the mind of one of our portfolio managers, Alan Pullen. Welcome Al.

Alan Pullen (02:22):

Hi, Marty.

Martin Van Eyk (02:23):

Now to get straight into it, there's been a whole lot of chat recently around the Magnificent Seven and many investors being quite concerned about the possible retreat to some of the good old dot-com days of the past from the early 2000s. What is it that's driving this cause of concern?

Alan Pullen (02:40):

Well, thanks, Marty. Pleasure to be here and great to talk to you about markets today. When we're talking about markets, it's hard to avoid talking about the Magnificent Seven. They really dominated equity markets. Last year, the combined average return of the Magnificent Seven stocks, and here we're talking about of course, Nvidia, Meta, Tesla, Amazon Alphabet, Microsoft, and Apple, on average, they delivered more than 100% return last calendar year. So they were truly magnificent that year. They did drive overall markets, so the S&P 500 delivered around a 26% return for the year. But if you take out those stocks and just consider the other 493 or so, there's actually a few more stocks than 500 in the S&P 500 believe it or not, the rest delivered around 10%. Not bad, but certainly well short of the rest of the market.

(03:34):

In fact, 72% of stocks underperformed the market last year, and that's kind of a record high. When we think about such a narrow market where so few stocks are driving such a large percentage gain in the overall market, that's a very narrow market. And historically, that's been a real warning sign to investors that perhaps markets are becoming overheated, they're unbalanced, and that there is risks ahead. So I don't think it's a surprise that people are focused on, well, given that level of return, does that mean the market is under some sort of risk? It's very similar to what we saw back in that lead up to that dot-com bubble in the early 2000s?

Martin Van Eyk (04:16):

Yeah, well, you can see the similarities there.

Alan Pullen (04:18):

Yeah. The other real correlation, when we think about the early 2000s, well, what was driving that? It was this excitement about a new technology, right? It was the dot-com bubble, the dot-com era. The adoption of the internet was really just broadening out. A lot of people were getting the internet, getting AOL, dialling up. And that created a lot of excitement that there were going to be new business models going to change the world, new profitable business models change the way we live. And those companies underpinning kind of the growth in the dot-com era. So think of your Intel's and your Cisco's, which is building the network equipment. People got very excited about those companies and the future that they had ahead of them. And you go to today, of course, and there's a natural correlation when we think about generative AI.

(05:05):

Again, this is a bit of a revolutionary new technology. It's been in the works for a while, but with the ChatGPT release kind of at the end of '22, really brought home that this technology is real and we think it is real, and it could change a lot of business models, create new opportunities going forward. So again, you have this excitement about a new technology. And the companies underpinning that technology, think of your NVidia's building the chips, the GPU's powering generative AI, think of your Microsoft's and your hyperscale cloud companies, again, there's a lot of excitement about the opportunities that this presents going forward. So I think the correlations are pretty clear to 2000.

(05:51):

The other real correlation is the concentration in the market. I talked about the narrowness in the market of driving returns, but because those large companies have had such high returns and they're so big, the markets are becoming dominated in terms of their share of market capitalization. And again, this is another classic warning sign that perhaps things are a bit unbalanced and there's risks ahead for markets. So back in the early 2000s again, we had those five big technology companies really came to dominate markets. And that was, as I said, Cisco that developed the networking equipment that was going to underpin the growth in the dot-com network going forward. It was like Microsoft back in the day delivering the software. It was IBM, of course, a tech titan from back in history. And those companies came to dominate, those top five companies came to dominate markets accounting for about 20% of the entire S&P 500 at the time.

(06:49):

And you look forward to today, the markets are even more concentrated. So the top seven, the Magnificent Seven companies, as we've talked about, they're now accounting for about 30% of the S&P 500. So they are way more concentrated than we were back in 2000. So that's another classic warning signal. And just to give context to the size and scale of these companies, those seven companies are equivalent to the entire market cap of Canada, Japan, the UK, the kind of the second, third, and fourth-largest equity markets in the world. So they are companies of enormous scale dominating markets.

(07:33):

Just for context, so the entire Australian equity market is about 2.6 billion. So we are smaller than the market cap of Microsoft, for example. So it is remarkable the size of these companies, bigger than entire markets around the rest of the world. So that type of concentration, again, it's even more so that we saw in 2000. It's been generated by this excitement around a new technology. The parallels are really pretty clear to see.

Martin Van Eyk (08:02):

Wow, that really puts it in perspective. Okay, fair enough. It's saying that there are a lot of similarities, but I've heard you at recent functions and around the office arguing about that not being the case and about it not being a repeat of the past. What is your reasoning that sits behind your beliefs that it's not a repeat of the past?

Alan Pullen (08:23):

Yeah, look, the similarities are clear, but we've been pretty clear in our view that this is not a replay of the dot-com boom. It really mostly goes down to fundamentals and the underpinning drivers of what's driven the returns of those companies and where we are in terms of valuation. So the key difference is that the companies today are incredibly profitable. They're growing their revenue, they're growing their earnings, they're growing their cashflow, and that has underpinned the performance of these companies at least to date.

(08:55):

Now going forward, who knows? We might become overextended and we could argue there are some elements of the market, some of the Magnificent Seven that have some speculative elements in them. But primarily, it's been driven by earnings and fundamentals. Whereas the dot-com boom was primarily driven by speculation. It was a good old-fashioned speculative boom that eventually collapsed under its own weight. Now, how do we come to that conclusion? Well, it really goes to looking at the individual companies and the drivers and most importantly, the valuations.

Martin Van Eyk (09:30):

Okay, so talk us through how you look at the valuations or work through those.

Alan Pullen (09:35):

Yeah, absolutely. So we look at the fundamentals here. As you know, we have a deep understanding of the industry. Our analysts know the industry, the suppliers, the customers, and go through a deep detailed modelling of these companies. What I've actually done here for the Magnificent Seven is I've combined all those models together. So basically, I combined revenue, earnings, cashflow, number of shares to look at them as aggregate. How are they performing? I've done that and taken the last six or seven years just as an example of what's been driving these companies.

(10:09):

If I take from 2017 for example, to 2024, our expectations for this yeah, as a combined entity, these companies grew revenue by 17% compound over that period. And they are highly profitable, highly cashflow generative companies, often with net cash balance sheets. So you got very, very low leverage. So that allows them to buy back stock as they're doing this. So that revenue growth has actually turned into 21% compound earnings per share growth over that period.

(10:41):

So that is some remarkable numbers to be delivering this at scale. They estimate deliver almost 400 billion of earnings over the current year, almost 2 trillion of revenue. So simply operating at unprecedented scale. And that is what brings me to the most important difference to 2000, which is those valuations based on those underlying fundamentals. So if I look back to 2000 to some of the big tech companies, the big five companies that were dominating markets in that period, Microsoft, IBM, Oracle, Intel and Cisco, on average, those companies were trading at a forward price earnings ratio. The most basic valuation metric you can get, but one that's kind of everybody can get their head around in the short term. They were trading at more than 80 times forward earnings. You had companies like Oracle and Cisco trading at more than 120 times kind of forward earnings. So this was a classic speculative bubble as I was saying earlier. It was very hard to justify those kind of numbers on the fundamentals. It was just people buying because they were going up. That was the driver at the time. Fear of missing out.

Martin Van Eyk (11:53):

That's not enough reason. You want more than that.

Alan Pullen (11:55):

Yes, we always anchor on valuations here because otherwise you're just a speculator. If you're an investor, you have to have a view of intrinsic value and attempt to purchase companies at a discount to that intrinsic value. And that just went out the window in the dot-com era.

(12:10):

So we fast-forward to today however, and those Magnificent Seven companies are trading on an average forward PE of around 35 times. Now that's not super cheap, that's not a bargain, but that is far from the excesses of the dot-com era because of the strong fundamentals that these companies have been delivering. And we are looking at the future here, and this future is bright for these companies. So once again, if I take those kind of that combined entity and our analysts have crunched the numbers here and they are sober people, they're definitely not prone to irrational, which is kind of what we saw back in 2000, and revenue growth is forecast to be about 11% kind of over the next five years.

(12:57):

And again, given the strong cash flows, the focus that they've had on efficiency and cutting costs, which hasn't been a focus for these companies historically, but we saw for Meta, for example, significantly increase their margins as they started focusing on costs last year, it was a year of efficiency for Zuckerberg as we know. So that revenue growth is translating into about 14% earnings per share growth over the next five years. So that's a pretty solid outlook for those companies.

(13:25):

And when we look at the market as a whole, it's more like mid-single digits. So they are genuinely performing very, very strongly as a combined entity. So that kind of underpins our confidence that the moves so far have largely reflected fundamentals rather than speculative excess as a whole. There might be some elements of speculative excess creeping in. As I said, these companies aren't cheap necessarily, but mostly it's been about fundamentals.

(13:54):

Just given that earnings growth for example, the PE falls to about a forward PE of 21 times by 2027, which is pretty reasonable given there's still going to be very positive outlook for these companies underpinned by the transition to the cloud. Of course, generative AI, I've talked about is a big excitement in markets at the moment. It is not a big contributor to revenue at the moment, but we are starting to see it contribute to revenue for companies like Microsoft, and that outlook is very positive going forward. So the trends underpinning these companies are solid. Our numbers of course could be there's a margin of error there. They could be positive, they could be negative, we could have a recession, what have you in that period, but the underlying fundamental driver is we've got enormous confidence in going forward.

Martin Van Eyk (14:39):

You haven't talked about all of the seven. There's obviously a couple of them that we're not in. Is there a reason that we're not in some of these Magnificent Seven? Do they fall under that speculative component that you were talking about or are there other reasons? What's your thoughts and insights on those?

Alan Pullen (14:55):

Yeah, no, that's a good question. I mean, we've been talking about the Magnificent Gen Seven in aggregate, [inaudible 00:15:02]. But of course, there are seven different companies with seven different drivers. Some of them are related, but quite different drivers for some of these companies. What I really want to be clear, I'm not arguing here. I'm not arguing that all the Magnificent Seven will be great investments going forward. I'm not arguing they're all equal. In fact, we've started to see Tesla, for example, really underperform, really start to struggle this year while other companies like Nvidia continue to rally strongly in the first quarter as the market starts to pay attention to some of the headwinds some of these companies are facing. So yeah, I would argue Tesla doesn't really belong in this group to be honest.

(15:39):

EVs are facing increased competition, low price and fairly good quality competition coming out of China, the EV market. We've seen demand struggle in the US and other developed markets for EVs. And so they're really struggling at the moment to continue to justify their valuation, which is still about 60 times, about 60 times for example, compared that you take that out of the Magnificent Seven, the rest are actually only trading at 30 times. So there are big differences between the individual companies.

(16:10):

And I'm really not arguing. They're all great investments. I'm just arguing that on a whole, the rise of Magnificent Seven has mostly been about fundamentals rather than speculation. But there's certainly speculative elements creeping in, I would say, that was in Tesla and it's probably still in Tesla when we think about some of the valuation there and the headwinds that's facing. Elon Musk is a truly kind of visionary CEO and done some amazing things, but easily distracted is last way to put that.

Martin Van Eyk (16:42):

That's completely fair. Completely fair.

Alan Pullen (16:44):

So it is tough to put those in with that other group.

Martin Van Eyk (16:47):

Well, you heard it here first, the super six now going forward, not the Magnificent Seven, but maybe the super six. Is that the new way to do it? Nvidia is certainly one of those other six that is in that pile. Nvidia, it's fair to say, has certainly been performing quite well. Over the past 12 months, its numbers have been outstanding. We don't hold that in our portfolio. Why does that not make our portfolio? What is it within that stock that doesn't quite cut the mustard?

Alan Pullen (17:14):

That's a really good question. So Nvidia has been an amazing performer. So I talked about the average returns last year. They were obviously the best. They delivered over 200% return last year. They've followed that up with another very strong Q1 this year. So phenomenal performer in terms of its share market performance.

(17:33):

What we do here though is we don't focus on that short term. So they're benefiting a lot in the short term from the undersupply and GPUs. They make the GPUs, the graphics processing units, which are underpinning a lot of this generative AI. Those chips are very effective for training AI and generative AI in particular. So there is a huge under supply of that at the moment and a lot of demand for GPUs, and Nvidia dominates that market. They have the best. They have an operating system around it called CUDA. They're a very good business. We have no doubts about that. It's really about the valuation that we've been struggling with.

(18:11):

So I just looked at our model, our analyst model actually, and I'm going to take you back to 2021. And I'm not picking a bad year here. This was a record year for Nvidia 2021. They delivered $16 billion in revenue and about $4 billion in profit. They had an EBIT margin of 27%, which is pretty good for a chip designer. Remember, they don't actually manufacture these chips, they outsource that. They have to pay for that for companies like TSMC to actually make their chips. So they do have some significant costs in there.

(18:42):

So what we're expecting for 2025 is a revenue of over 105 billion, so that compares to 16 billion from just a couple of years ago and a profit of 55 billion and an EBIT margin of 62%. So there is no denying they have done incredibly well. And if you're looking forward to the next quarter, we know they're still in under supply. So they're still going to have a good quarter. But what we're trying to look forward here is what is the intrinsic value of this company? What's this company going to look like five and 10 years from now? And it's just very hard for kind of a chip company to maintain those kind of margins over the long term. So they've done a tremendous job. They're really well placed, but we're in the currently seeing a real shortage of those GPUs.

(19:31):

And that shortage should be sorted out by capitalism over time, whether it's by them or by competitors. And their biggest customers are in fact the hyperscale cloud platforms. Amazon's AWS, Azure from Microsoft, Google Cloud platform, they're all designing their own chips to run these generative AI as well. So that's not going to be a dominant part of the market in the next quarter. Nvidia is going to do well. But five and 10 years from now, there's a very wide range of outcomes. Just what will the demand be? At the moment, the fabs are building a lot of these GPUs. Not only do they need to build the same amount as they're building this year, but to justify its valuation, which is still around 35 times forward earnings, that actually needs to continue to grow heavily over the next five years. And those margins, which are record margins, as I said, from 27% to 64% just over a few years, they're going to have to maintain that kind of level of margin going forward.

(20:29):

They might do it. We are very positive on generative AI and the opportunities, but just the such big demand at the moment that there's a very wide range of outcomes. And whilst they've done a fantastic job and our estimates of its intrinsic value have indeed risen because of how well they've done, they've executed, it's still quite far below the current share price. So the current share price has just riven way above our estimate of intrinsic value. And that means under our process, we're investors, long-term investors, it doesn't qualify at the moment.

Martin Van Eyk (20:59):

Yeah, that makes complete sense. Okay, so we've talked about a couple of the stocks that aren't in our portfolio. I'm actually really interested in if you could talk about one or two of the companies that you particularly really like that are in our portfolio and are also within that Magnificent Seven.

Alan Pullen (21:16):

Sure. Look, I'm going to talk about one which really clarifies... We started this conversation right about how different this is to the dot-com bubble. And I think one that really brings this home is Google Alphabet. So Google is positioned withheld for a long time. It's been a very successful stock obviously. It dominates search, which is an incredibly profitable industry, $100 billion of earnings, EBIT coming out of Google Services revenue, which is mainly search.

(21:46):

There was fears that that was going to slow down post Covid. It had a big bump in Covid. Everybody went online and there's a lot of advertising and search advertising. But following a slowdown post Covid, that's reaccelerated to 10% plus growth, double-digit growth in Q4 last year. So that business is still performing pretty strongly.

(22:05):

There are a few question marks around what generative AI might mean for search over the long term. Will it change the nature of search? Will people search for things differently on the internet and that impact Google's main business? But we think they're pretty well-placed in that generative AI space. They've got their model Gemini is up there with the best, up there with the latest ChatGPT models and the models coming out of matter and the other big players. They do have the incumbency and the ability to build in those generative search capabilities into their current model. But it's a real risk. It's one we're following, one we're keeping a close eye on. They haven't lost any material market share so far being as tried to put in generative AI into their search results. But it is one thing we are going to continue to monitor.

(22:53):

But really, Google is more than just search. It gets a lot of attention. But when you think about what else they have, YouTube is the leading streaming service globally. So a lot of people would say that's Netflix. We like Netflix, but it is actually not the leader in streaming. Google is through YouTube. They control the Android ecosystem on all non-Apple phones, right? That also protects their moat because they can embed search within there and generative search when it comes, but it also gives them higher revenue, Google Play income. And of course they control the Google Cloud platform, which is the third hyperscale provider after AWS, Amazon. Also love Amazon. After Microsoft Azure. Also love Azure. So we really like the hyperscale cloud providers and generative AI.

(23:40):

We talked about the demand for GPUs right now, but that demand is all going to be run in these hyperscale cloud platforms. And there's only three at scale and there will only be three ex-China just given the scale required and all the tools and platforms required for those. So incredibly good outlook for the Google Cloud platform as well. It's under monetized today. It's margins are around 10% because they did start later than Azure. They started later than AWS, but they're now at a $40 billion run rate. We know they're competitive. They're putting in a lot of generative AI tools in there, and they've got one of the best models. They in fact helped invent generative AI. So Google are rarely well established in this business.

(24:22):

So there are a few concerns over there at search, but Google is much more than just search. And given the value of these other things, if you just take off the Google cloud platform, which is under-monetized, the underlying business is trading at around 15 times forward earnings. So if you think about those huge multiples I said for the big tech companies back in the dot-com era, I think this really emphasises just what a different world we're in at the moment for most of these companies. So that's one we like and we continue to monitor the risks and we might monitor the position size because of that, but really highlights the key differences going forward.

Martin Van Eyk (24:59):

Brilliant. Okay. So to wrap up a little bit for today's session, let's look ahead. I guess I realise there's only so much crystal balling we can do here, but to anticipate potentially what's coming up, where do you see or where do you anticipate these Mag Seven companies unfolding? What's their outlook for the future?

Alan Pullen (25:17):

Well, that's a good question. Of course I won't be able to answer perfectly. The future is unknown.

Martin Van Eyk (25:21):

We want a number. I want a specific number.

Alan Pullen (25:24):

No, the point I'm trying to make here today is not that things are certain sheep, not that every Magnificent Seven stock will deliver, but it is not a bad time to be invested in global equities with a long-term view. I'm not going to try and predict what's going to happen in the next couple of months. That's not what we do. We invest for the long-term. And given the opportunities available to these companies, the valuations are not cheap, but quite reasonable in light of these opportunities. This is a good in place to be over the long-term in selected stocks. As I said, Tesla, [inaudible 00:25:56], Nvidia we like, but the valuation's too high. I talked about Google outstanding valuation. Microsoft and Amazon still incredibly well-placed and we like those companies given on pretty reasonable valuations. And the hyperscale cloud platform, that's not a one or two year story that's going to be growing double digits for a decade.

(26:16):

So the long-term view is generally positive on these companies. I want to broaden out this discussion a little bit more. We've obviously focused on the Magnificent Seven and they were incredible drivers last year, but the market is more than just the Magnificent Seven. There are a lot of great companies out there, and we are seeing good opportunities both companies that will benefit from AI. I think ASML, which is an amazing Dutch company, which actually designs equipment. It's a monopoly equipment maker for the chip industry. So they're also going to benefit from this generative AI business. So there are lots of opportunities outside the Magnificent Seven. There are good reasonable value within the Magnificent Seven.

(26:57):

Just to talk about markets more generally, I think valuations are relatively full. Our base case is for a reasonable macroeconomic outlook for the rest of the year. And in that case, our companies can get on with delivering great earnings, great cashflow, great returns, and that should deliver over time, higher share prices. There will be bumps along the way in the short term, but over the long term, that's what we're investing for the higher fundamental value and profits that these companies are going to deliver over time.

(27:26):

I do think we have a couple of things we want to watch out for in the near term. We want to watch out for inflation. So we just had the march kind of inflation outlook from the US. It was the third-highest kind of miss on inflation in the US. So that might put some pressure on interest rates in the US. That could be a short-term headwind. I think over time we're pretty comfortable at that 4.45% level for the US ten-year bond yield. I think that's a reasonable kind of mid-cycle guide at the moment. So at the moment, we're above that, but we'd consider that more a cyclical risk than a structural risk.

(28:01):

Go back to 2022... I know I'm getting off Magnificent Seven topic, but I do love talking about markets. Go back to 2022, and we had ten-year bond yields rise from 0.5 to over 3. That was a bit of a structural change in interest rates, and that was a real headwind to quality companies because of their long duration growth and their low beta nature. But I think this potential rise in interest rates that we're looking at in the second half is more cyclical in nature. So it likely to have a lesser impact, but yet still could be a headwind to markets.

(28:32):

So potential bumps along the road, but the underlying fundamentals of our companies remain really, really sound. The valuations are fair, not cheap, but they're okay in light of those underlying growth and returns that they're likely to deliver over time. So comfortable in the long term, a little bit wary in the short term, but when you're investing in quality companies like these with our long-term view, we can expect pretty good returns over the long term.

Martin Van Eyk (28:57):

Completely fair enough. There's a few elections as well coming up and a few other bits and pieces as well. So there's always something on the horizon from the macro perspective. So it's great to get your insights on where you feel we're headed. Well, thank you so much for your insights on that, Al. That was really interesting.

Alan Pullen (29:12):

No worries, Marty, anytime.

Host (29:14):

That was Magellan key account manager, Martin Van Eyk, in conversation with Portfolio manager Alan Pullen. We trust you've enjoyed this episode. For more information on previous episodes, visit magellangroup.com.au/podcasts, where you can also sign up to receive our regular investment insights programme. Thanks for listening.