Growth Investing Illuminated Part 2: *The Magnificent Seven Perspective*

– Danke Wang, CFA, FRM, Portfolio Manager

The issue of narrow market breadth, dominated by the Magnificent Seven, has become a significant concern for many U.S. equity investors.

Key Takeaways

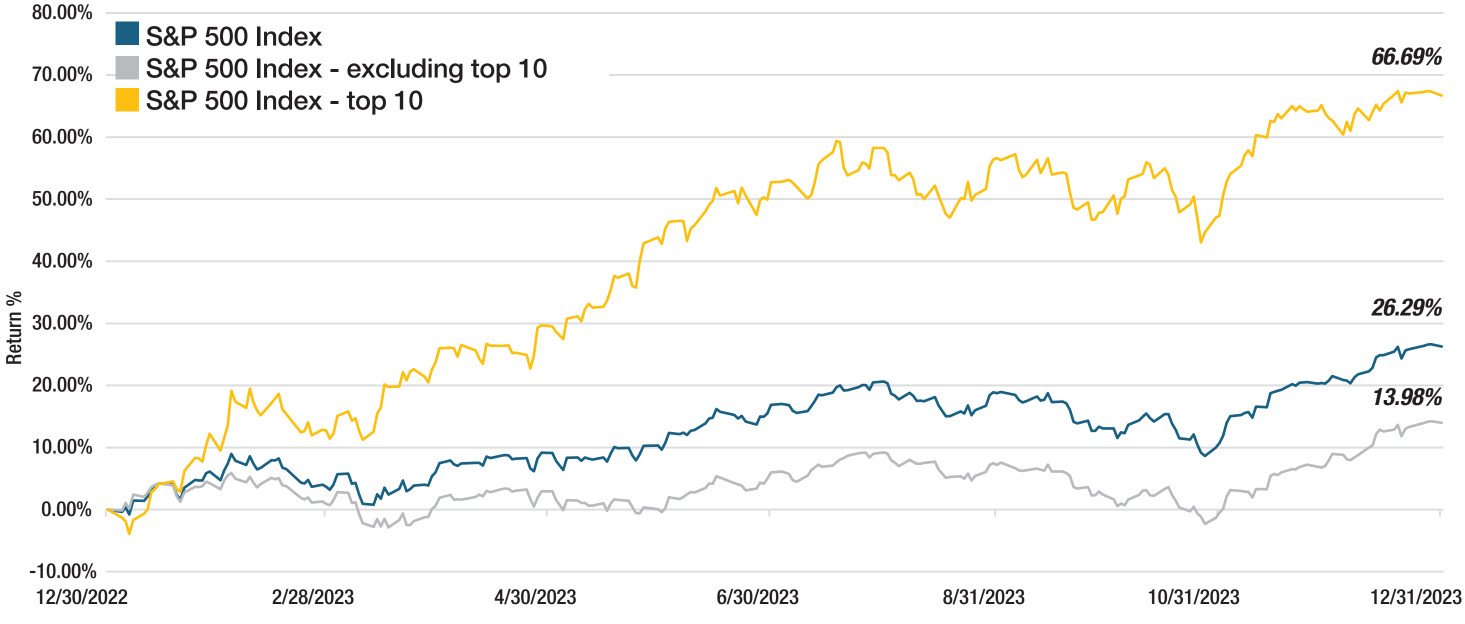
1. Despite concerns over concentration, the Magnificent Seven have consistently outperformed the market, showcasing their high-quality businesses and high growth;
2. The ability to maintain high free cash flow (FCF) margins while achieving substantial revenue growth sets some of those mega-cap stocks apart;
3. Within the realm of high-growth stocks, the combination of high FCF production and above-average growth emerges as a winning formula.

Market Breadth in 2023

Throughout 2023, the ten biggest names within the S&P 500 Index rallied 67% (weighted average), while the rest of the index achieved a modest return of less than 14%. Such a substantial performance gap made 2023 a year with one of the most return concentrations in the past 30 years.

Performance in 2023

12/30/2022 - 12/31/2023

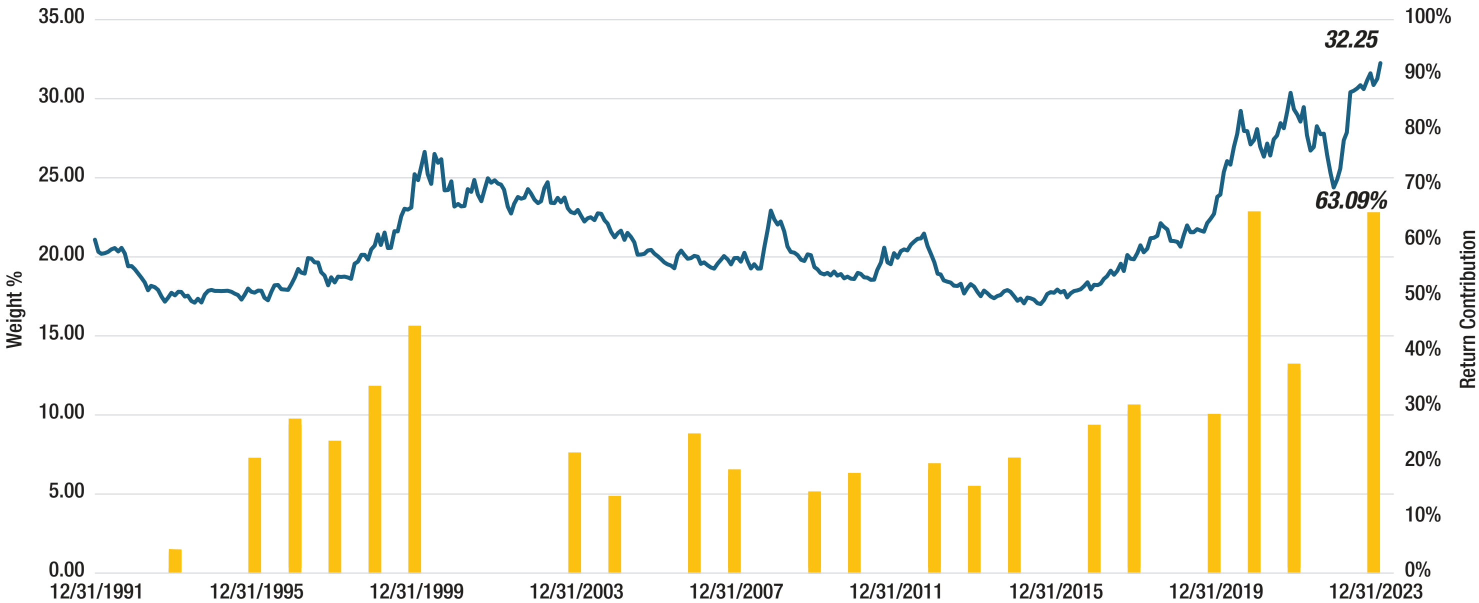


Source: Pacer Advisors, FactSet, Bloomberg

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS. YOU CANNOT INVEST IN AN INDEX.

The top-heavy and unbalanced allocation within the S&P 500 Index also reached the highest level since the tech bubble period. The top ten holdings accounted for more than 30% of the large-cap benchmark at the end of 2023, and that number further increased to more than 32% as of 2/29/2024.

S&P 500 Index Top Ten Stocks, Weighting vs Yearly[1] Performance Contribution
12/31/1991 - 2/29/2024



Source: Pacer Advisors, FactSet
(1)Excluding years when the market return was lower than 5% or the return of the top 10 stocks was negative.

Among the top ten names, the Magnificent Seven: Apple, Amazon, Alphabet, NVIDIA, Meta, Microsoft, and Tesla, demonstrated impressive performance throughout 2023, and rallied 76% (weighted average), constituting 62% of the S&P 500 Index's 26.29% overall return. Consequently, the Magnificent Seven represented 28% of the S&P 500 Index market cap by the end of 2023.

The leadership of the Magnificent Seven can also be seen from their valuations. Presently, the seven names boast an average price-to-earnings (P/E) multiple of 37x. Such robust valuation significantly influences and contributes to the overall valuation of the S&P 500 Index, which has expanded by more than 30% over the course of 2023.

P/E Ratio Over Time, the S&P 500 Index
12/31/1991 - 2/29/2024

Source: Pacer Advisors, FactSet

The narrow market breadth creates a dilemma for investors. Active managers who have lagged the market due to zero or an underweight position in the Magnificent Seven names are grappling with their inner FOMO (fear of missing out). On the other hand, investors who enjoyed the Magnificent Seven rally are now concerned about the sustainability of their market influence. While it is challenging to predict when a broadening of the market will materialize, numerous equity strategists advise investors to reduce their exposure to these top-heavy names and embrace a more diversified approach within the broader market.

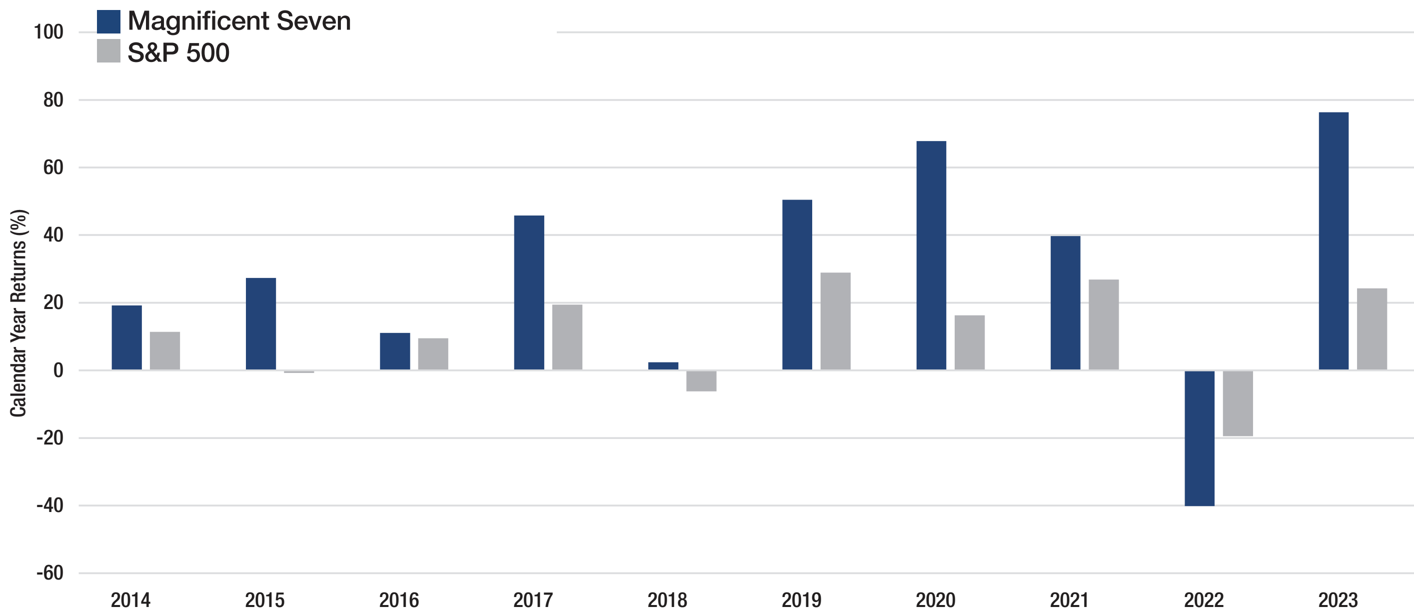
So, what are the implications behind the rally of the Magnificent Seven? And how should investors position their portfolios among those mega-cap names?

The Seven

First, most of the Magnificent Seven names are high-quality businesses. For example, Apple is renowned for its innovative products with a strong brand reputation, loyal customer base, and consistent revenue growth; Microsoft is a global leader in software, cloud computing, and technology solutions; NVIDIA is a key player in the tech sector providing graphics processing units (GPUs) and artificial intelligence (AI) technology, etc.

Over the past decade, the Magnificent Seven stocks have consistently outperformed the broader market, with the exception of 2022 when they failed to surpass the S&P 500 Index due to headwinds from high inflation, which pressured the valuations of these mega-cap stocks.

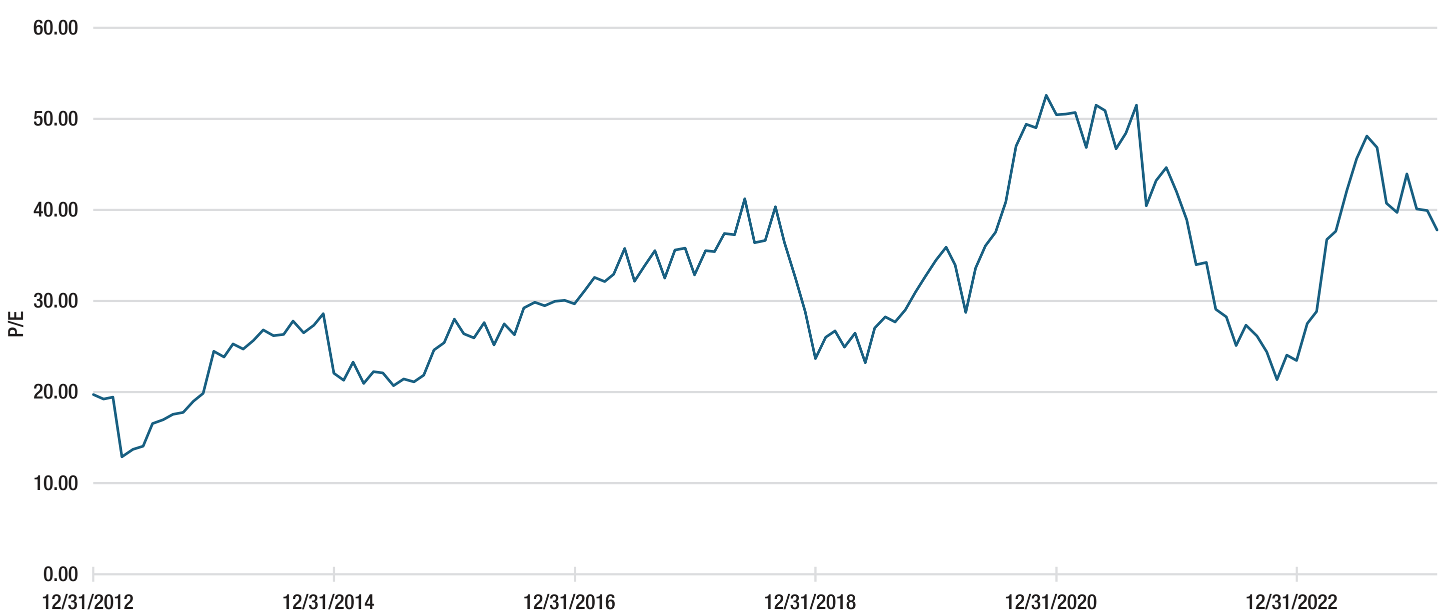
Calendar Year Returns, the Magnificent Seven vs the S&P 500 Index
2014 - 2023



Source: Pacer Advisors, FactSet, Bloomberg

However, in 2023, the Magnificent Seven experienced a notable rally, spurred by bottomed valuations following the previous year's underperformance. Their price-to-earnings (P/E) ratios, averaging 22x initially, were among the lowest levels in recent history compared to the S&P 500 Index. Half of the rally in 2023 can be attributed to multiple expansion, with their P/E ratios increasing on average by 30% over the course of the year.

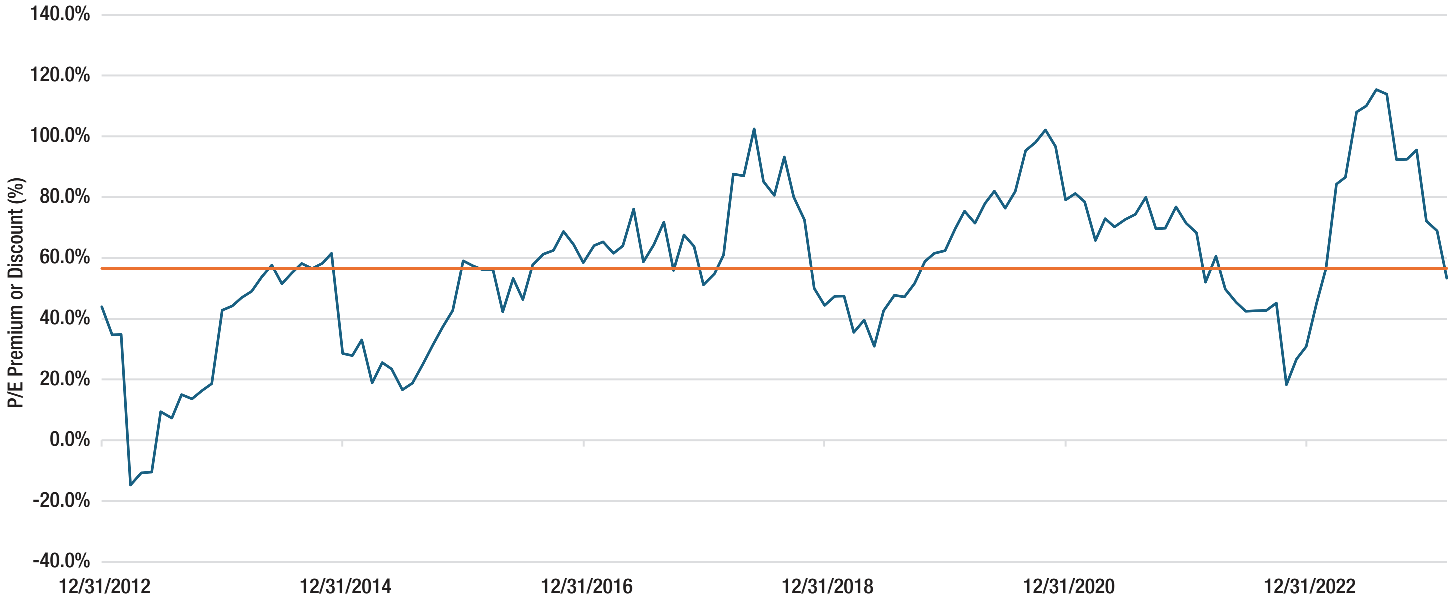
P/E over time, the Magnificent Seven
12/31/2012 - 2/29/2024



Source: Pacer Advisors, FactSet

P/E Premium or Discount, the Magnificent Seven relative to the S&P 500 Index

12/31/2012 - 2/29/2024



Source: Pacer Advisors, FactSet, Bloomberg

Despite trading at a 60% P/E premium over the broader market in the past decade, these rich valuations are substantiated by robust fundamental growth.

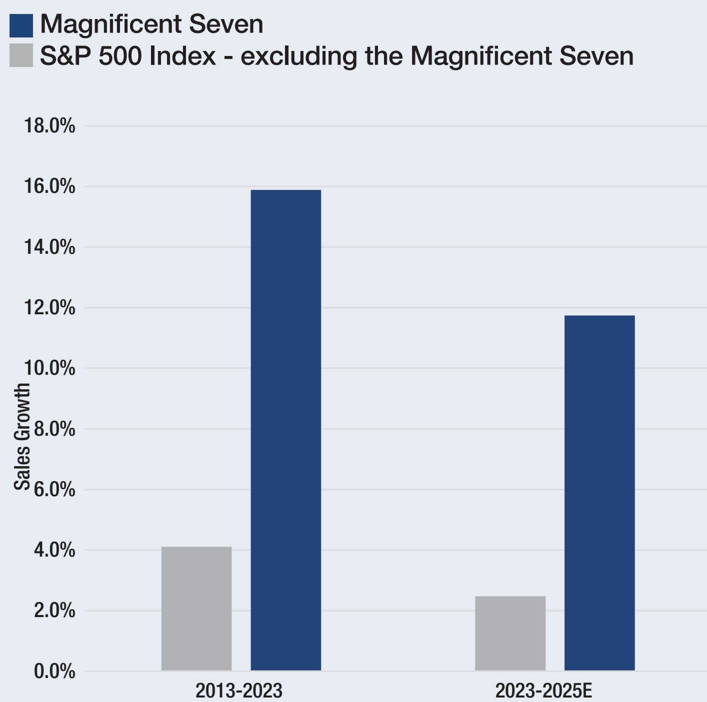
From 2013 to 2023, the Magnificent Seven companies achieved an impressive annual sales growth rate of 15%, significantly outpacing the 4% growth rate from the rest of the S&P 500 Index.

Looking forward to 2025, these companies are projected to maintain a strong growth trajectory, with an anticipated annual growth rate of 11%, surpassing the expected growth rate of less than 3% for the broader market.

Source: Pacer Advisors, FactSet

Annualized Sales Growth

as of 2/29/2024

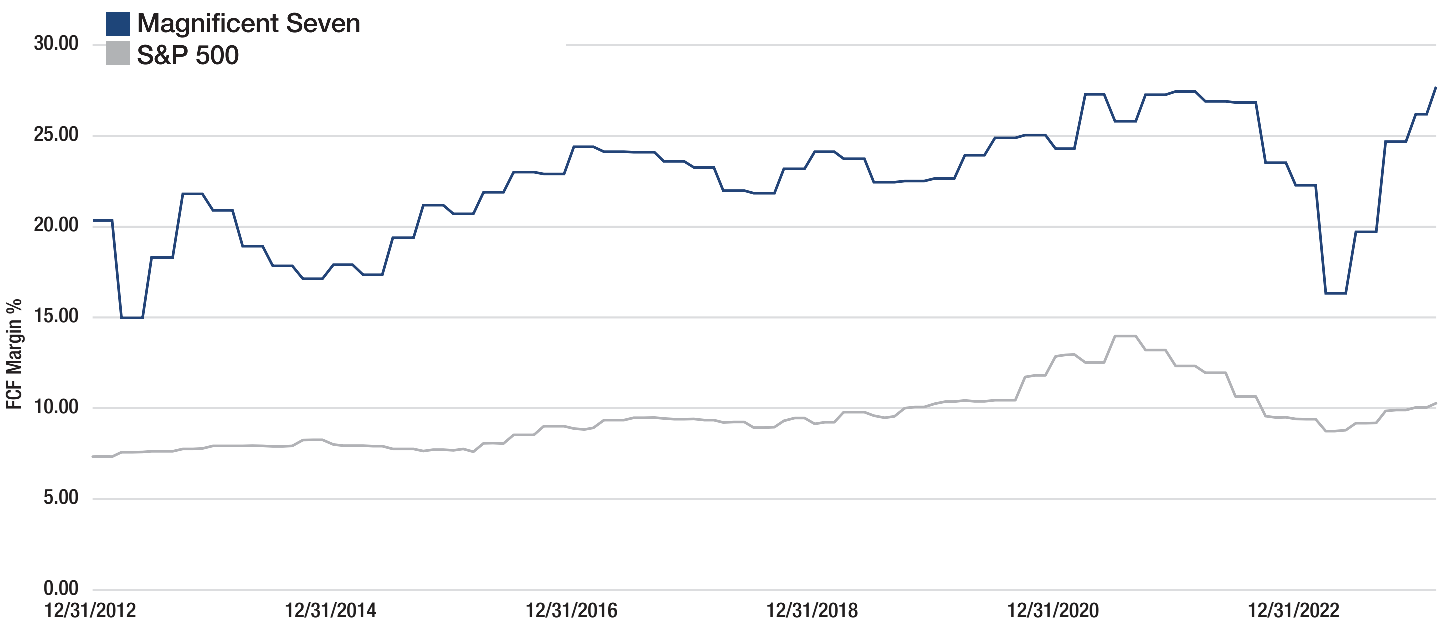


Another distinguishing characteristic of the Magnificent Seven is their exceptional free cash flow generation. As a group, these companies account for approximately 26% of the total free cash flow generated within the S&P 500 Index.

Throughout the past decade, the median free cash flow margins (free cash flow / sales) of these seven companies have exceeded 20% for most of the time, far surpassing the median free cash flow margin of around 10% for the S&P 500 Index during the same period. Notably, aside from Amazon and Tesla, each of these industry giants serves as a veritable fountain of free cash flow, yielding more than 20 cents of cash for every dollar of sales.

Median FCF Margin Over Time

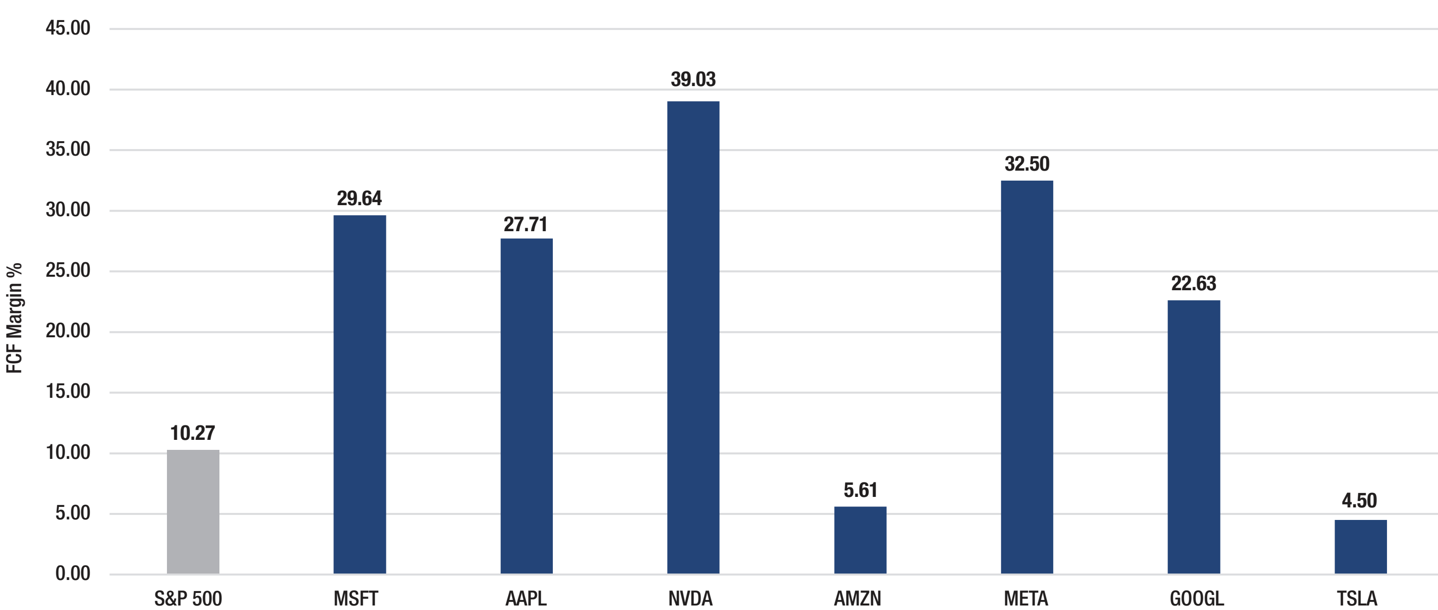
12/31/2012 – 2/29/2024



Source: Pacer Advisors, FactSet

FCF Margin

as of 2/29/2024



Source: Pacer Advisors, FactSet

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The Magnificent Five

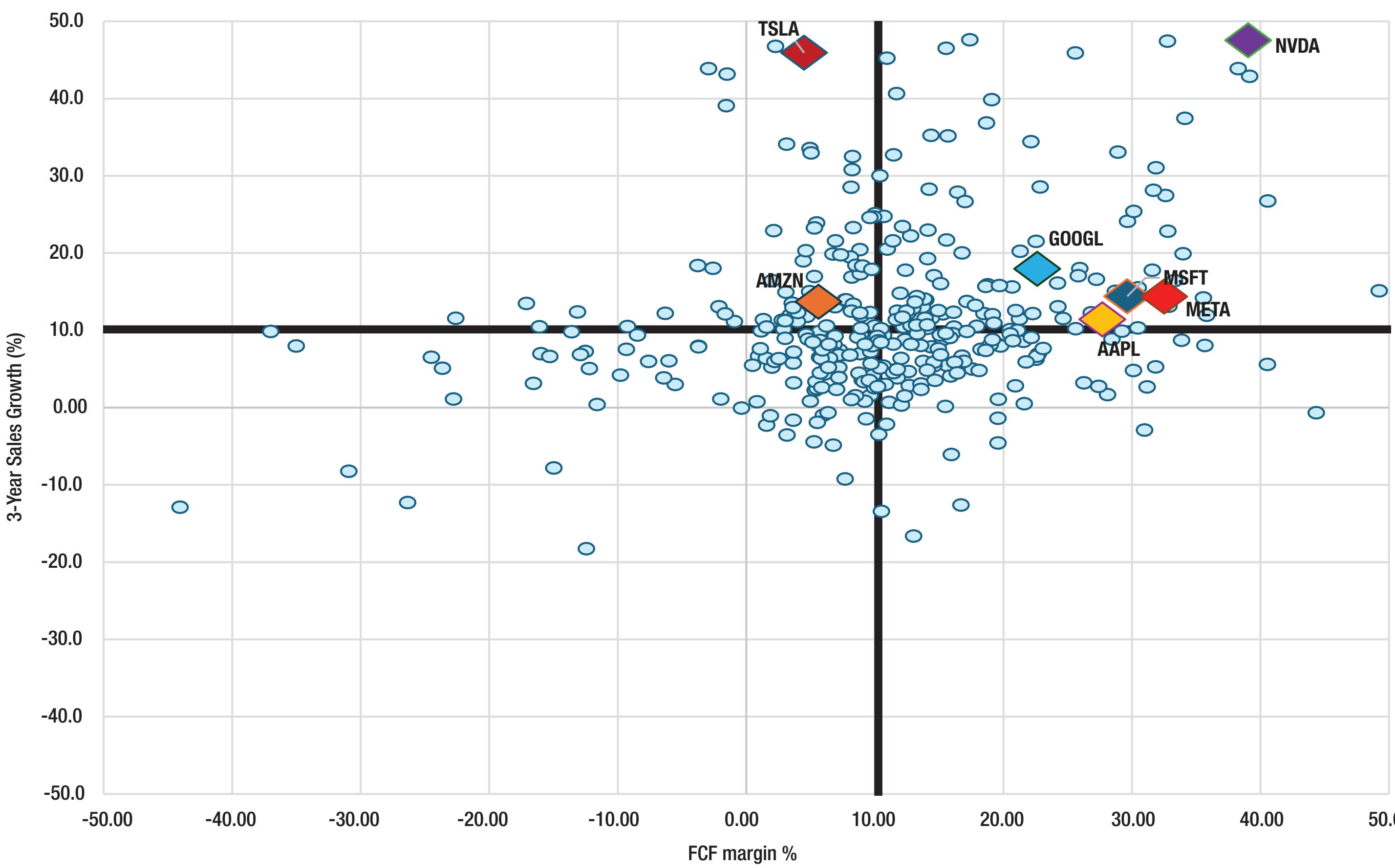
The above analysis unveiled the attractive characteristics of the Magnificent Seven companies; furthermore, it also reveals an intriguing insight.

The growth-profit trade-off is a fundamental concept in business. Traditionally, investors anticipate lower margins from companies experiencing rapid growth, as there's often a perceived trade-off between current profitability and future potential. However, five companies within the Magnificent Seven have defied this conventional wisdom. Apple, Alphabet, NVIDIA, Meta, and Microsoft demonstrate an exceptional ability to sustain high free cash flow margins alongside achieving substantial revenue growth rates. This unique characteristic sets them apart from other businesses where high growth frequently entails sacrificing short-term profitability, as big growers tend to burn through cash in order to expand their market shares.

Achieving both top-line growth and high free cash flow production simultaneously is considered a virtue because it reflects a company's strength and ability to self-finance high growth initiatives, ultimately creating sustainable value for all stakeholders involved.

S&P 500 Stocks, FCF Margin vs Three-Year Sales Growth

as of 2/29/2024



Source: Pacer Advisors, FactSet

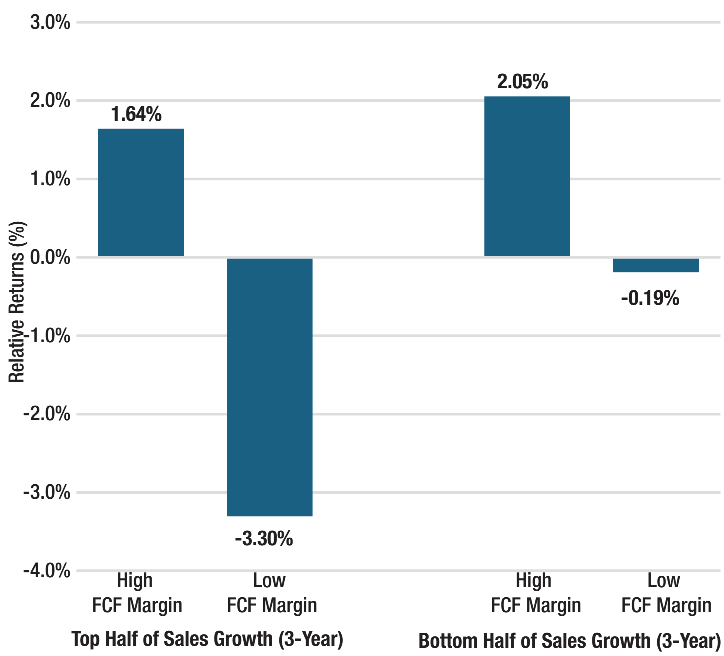
Such advantageous traits, in the end, may translate into superior stock price performance over time. Historically, companies exhibiting both high growth and high profitability tend to deliver higher returns for investors.

To illustrate this idea, we categorize S&P 500 Index companies into four groups based on their three-year sales growth and free cash flow margin, and compare their performance relative to the market.

Looking back to 1991, our observations reveal that companies with higher FCF margins consistently outperformed those with lower margins regardless of their sales growth rates. Notably, companies experiencing high growth rates, but inadequate FCF margins, tended to underperform, highlighting the detrimental effects of insufficient self-funding in high-growth businesses on investor returns.

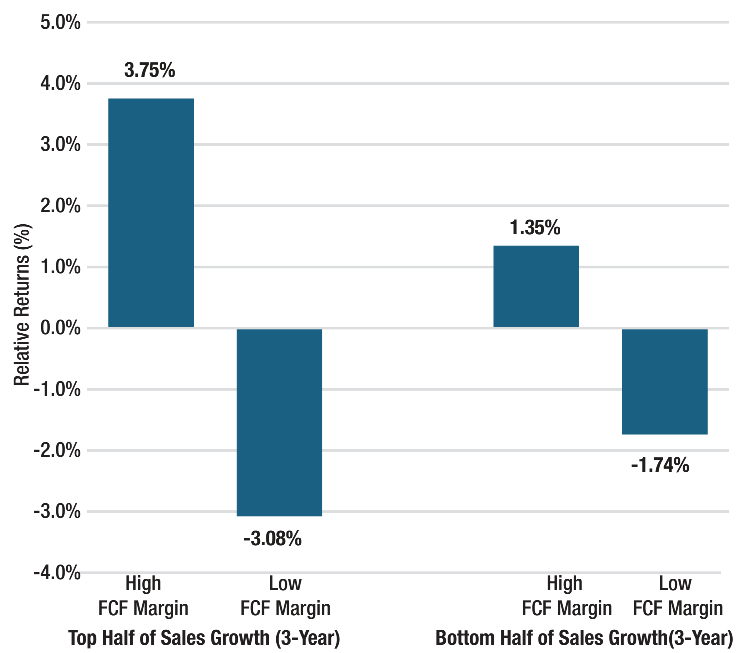
Additionally, in scenarios where FCF production was robust (high FCF margin), top-line growth did not necessarily differentiate stock returns over the long haul.

S&P 500 Stocks, Top and Bottom Half of Sales Growth Stocks Relative Returns by High and Low FCF Margin Groups[2]
12/31/1991 - 2/29/2024



Source: Pacer Advisors, FactSet
(2)Monthly data compounded to Annual Period

S&P 500 Stocks, Top and Bottom Half of Sales Growth Stocks Relative Returns by High and Low FCF Margin Groups[3]
2/28/2014 - 2/29/2024



Source: Pacer Advisors, FactSet
(3)Monthly data compounded to Annual Period

Turning our attention to the last decade, we find that companies exhibiting both high growth and high FCF margins emerge as the top performers. This shift underscores the evolving preferences of investors, likely influenced by the low nominal growth environment post-financial crisis. In this context, the most attractive characteristics for investors lie in companies that deliver significant revenue growth alongside a strong capacity for generating free cash flow.

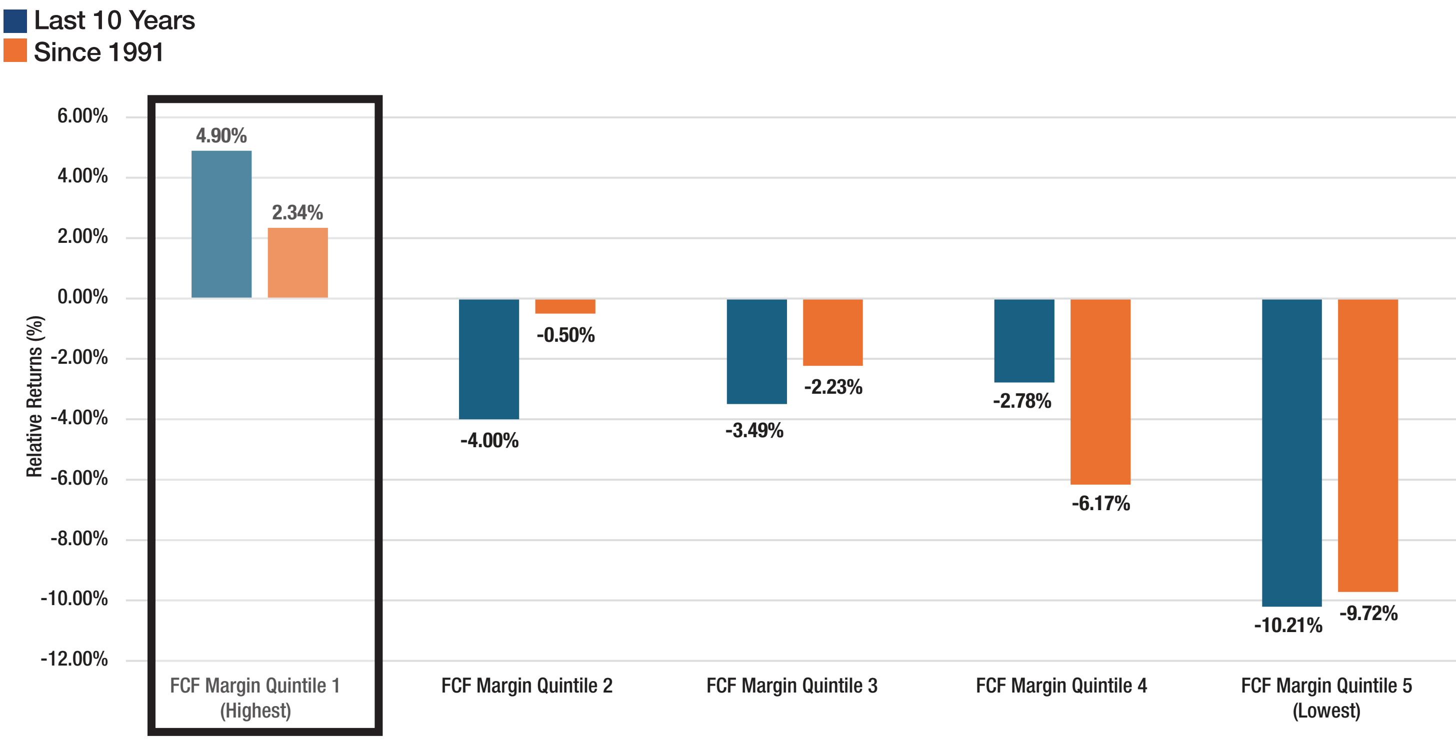
Conversely, companies that exhibit high growth rates, yet fail to maintain adequate FCF margins, continue to lag despite growth being scarce over the past ten years. This serves as a cautionary note, emphasizing the negative consequence of aggressive growth without ensuring sufficient profitability levels.

The Differentiator

In today's market, investors are captivated by the growth trajectory of the Magnificent Seven companies. Nevertheless, FCF production could potentially be a true differentiator for growth investing.

To explore deeper into the significance of high FCF margins among high-growth stocks, we extended our analysis to include companies within the Russell 1000 Index. By measuring the relative returns of companies with the highest sales growth by different FCF margin quintiles, we gained some valuable insights. The results revealed only companies with the highest FCF margin outperformed the market benchmark, while the consequences of lacking FCF production were evident in the underperformance of stocks in the lower margin buckets.

Russell 1000 Stocks, The Top Quintile of Sales Growth Relative Returns by FCF Margin Quintiles[4]
as of 2/29/2024

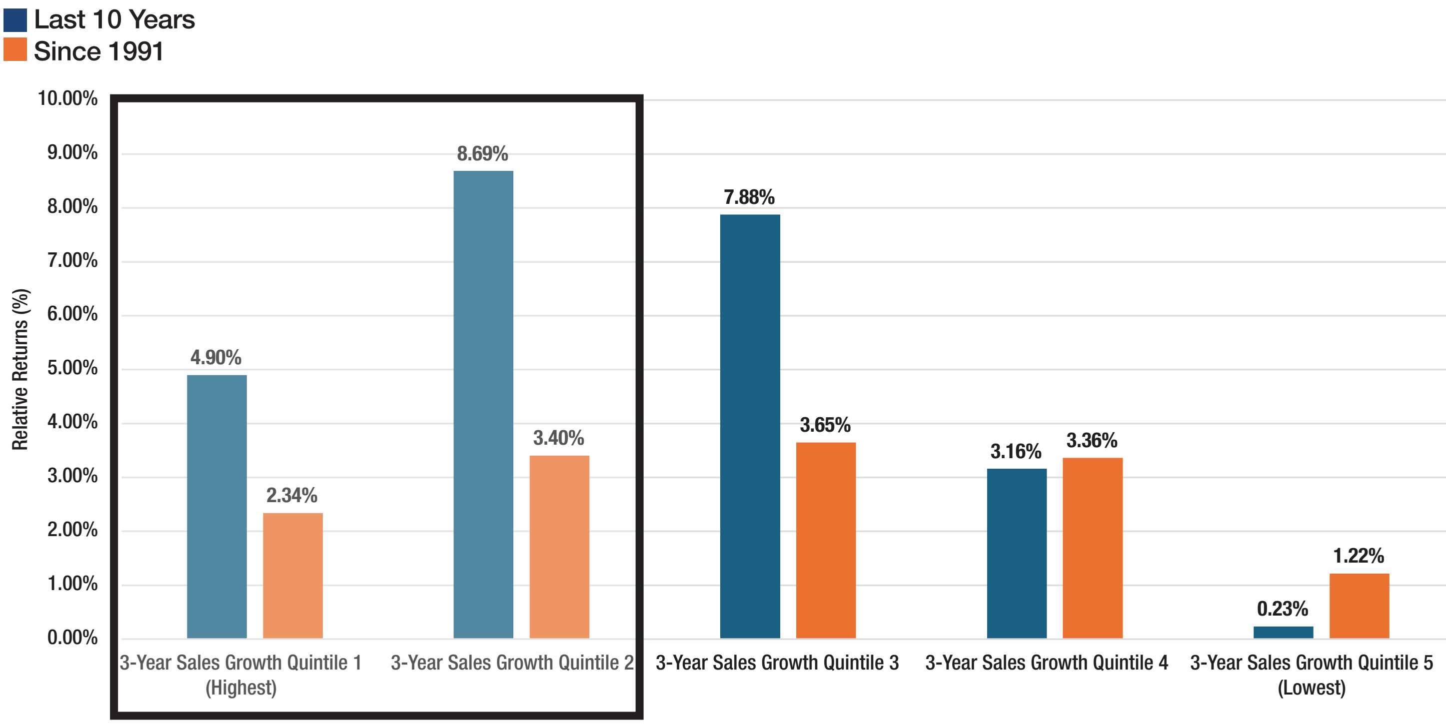


Source: Pacer Advisors, FactSet
(4)Monthly data compounded to Annual Period

Furthermore, within the cohort of companies with the highest FCF margins, the highest sales growth stocks do not necessarily deliver the best performance, while the second quintile does. However, a compelling trend emerges: stocks falling within the first two quintiles of sales growth exhibit stronger relative performance.

This pattern suggests that a combination of high FCF production and better-than-average growth has proven to be a winning formula for investors over the long run, particularly in the past ten years. As investors seek to optimize their portfolios for sustained growth, understanding and leveraging the relationship between FCF margins and sales growth becomes increasingly essential.

Russell 1000 Stocks, The Top Quintile FCF Margin Relative Returns by Sales Growth Quintiles[5]
as of 2/29/2024



Source: Pacer Advisors, FactSet
(5)Monthly data compounded to Annual Period

Our take on growth investing

COWG
Pacer US Large Cap Cash Cows Growth Leaders ETF

The Pacer US Large Cap Cash Cows Growth Leaders ETF (COWG) tracks the Pacer US Large Cap Cash Cows Growth Leaders Index (COWG Index), investing in the highest FCF margin companies within the Russell 1000 Index. Notably, the high free cash flow producers within the Magnificent Seven, Apple, Alphabet, NVIDIA, Meta, and Microsoft, are featured among the index holdings, further solidifying the strategy's focus on companies with profitability, financial health and growth potential.

As of 2/29/2024, holdings within the COWG Index have a median FCF margin of 29% compared to 10% from the market (the S&P 500 Index). Their trailing three-year average sale growth stands at 21% , surpassing the S&P 500 Index's 15%. Additionally, consensus estimates project a forward sales growth rate of 10% for the next two years.

As highlighted in our previous perspective "Growth Investing Illuminated: The "take-one" on FCF Margin", FCF margin has emerged as a pivotal factor for identifying companies with higher growth. By prioritizing companies with robust FCF margins, investors position themselves to capitalize on the financial strength and the growth potential of these firms and potentially achieve better long-term returns.

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Free Cash Flow (FCF): A company's cash flow from operations minus capital expenditures (expenses, interest, taxes, and long-term investments)
Free Cash Flow Margin: the FCF margin is a ratio that compares a company's free cash flow to its sales to understand the proportion of revenue that becomes free cash flow (FCF).
Russell 1000 Index: is a market-capitalization weighted index representing the top 1000 large-cap stocks in the Russell 3000 Index.
S&P 500 Index: The index includes 500 leading companies in the U.S. and covers approximately 80% of available market capitalization.
P/E: price-to-earnings ratio is the ratio for valuing a company that measures its current share price relative to its earnings per share (EPS).

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