RIA Advice

From Magnificent 7 To A New Team: Conquering Bandwagon Bias

As investors cheer on the Magnificent 7, some football fans are forging new allegiances in hopes of rooting for the coming Super Bowl champion. The task isn?t easy. Recent favorites like the Bills and Bengals are fighting to make the playoffs. Indeed, a few fans of those teams will jump on the recently popular Dolphins or Lions bandwagon. Others may stick with the dependable Eagles, Chiefs, and Forty Niners.

Stock market investors and football fans are not that different. As 2023 ends, professional and amateur investors start thinking about what stock or investment theme bandwagon to jump on for the coming year.

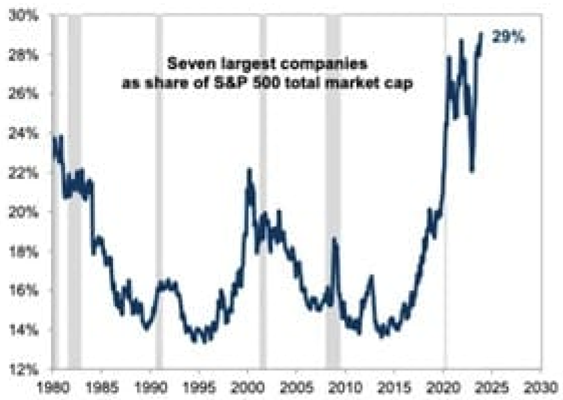
This year, the Magnificent 7 stocks are the odds-on favorites to win the stock market Super Bowl. While hats off to those profiting from the Magnificent 7, we must look ahead. To do so, we must appreciate the bandwagon bias harbored in our mindsets and not let it cloud our vision of the future.

Bandwagon Bias Of 2023

Bandwagon bias is a psychological phenomenon that happens when people do something because others are doing it already. Often called following the herd in market parlance, the bandwagon bias forces many investors into decisions they ultimately regret.

This year?s most popular investment bandwagon is the Magnificent 7, comprised of Apple, Microsoft, Google, Tesla, Nvidia, Amazon, and Meta. The graphs below, courtesy of Goldman Sachs, and our table show these 7 stocks gained 71% this year to date, while the remaining 493 stocks added a mere 6%. The outperformance pushed up their contribution to the S&P 500 to nearly 30%. Lastly, the sharp increase in stock prices led to even more extreme valuations for the group.

Exhibit 22: Share of largest seven companies' market cap in S&P 500 is at an all-time high



Source: Compustat, Goldman Sachs Global Investment Research

Exhibit 23: The Magnificent 7 have led the index higher in 2023

Source: FactSet, Goldman Sachs Global Investment Research

	Share of the S&P 500	P/E	P/S	P/B	YTD Return (%)
Apple	7.42%	31.33	7.79	48.07	48.11
Microsoft	7.18%	35.76	12.58	12.46	54.49
Amazon	3.45%	75.63	2.70	8.18	72.57
Nvidia	3.03%	61.16	25.51	34.35	218.05
Google (GOOG	3.85%	25.68	5.65	6.16	51.22
Meta	1.91%	28.46	6.52	5.79	167.55
Tesla	1.74%	77.32	7.96	14.28	95.01
Weighted Avg.		42.80	9.89	22.33	81.94

The Magnificent 7 are fundamentally stronger companies than the aggregate of the S&P 500. Per Goldman Sachs, revenues for the Magnificent 7 are expected to grow by 8% more than the S&P 500. At the same time, net margins are forecasted to be around 21% for the next two years. Such is double the S&P 500.

Is their share price outperformance justified? Yes. However, if the prices outperformed their fundamentals, as may likely be the case, it will now be much harder for a repeat performance in 2024.

Nvidia Vs. Albemarle

To help appreciate what may lie ahead, we compare Nvidia to Albemarle. Nvidia is up 230% year to date. As a result of the stock surge, Nvidia?s investors are paying a 250% premium for Nvidia?s earnings versus those of the S&P 500. Nvidia?s earnings will undoubtedly grow faster than the market for a while, but by how much and for how long? Can they avoid competition and margin pressures while keeping sales elevated long enough to justify the premium?

The world?s largest lithium producer is in quite the opposite shoes. Despite strong demand for lithium from electric vehicles (EV) and a projected shortfall of lithium to meet growing EV needs, Albemarle investors only demand a price to earnings of five, about one-fifth of the S&P 500. Its shares are down about 30% year to date.

Despite the significant value in Albemarle compared to Nvidia, investors continue to chase Nvidia and sell Albemarle. Comparing them does not endorse owning Albemarle or selling Nvidia, but they show how markets can be very inefficient.

Narratives Drive Markets

As we highlight with Nvidia and Albemarle, in the short run, narratives and bandwagons of investors drive individual stocks and markets, regardless of whether the narrative makes sense.

Only a few months ago, the popular narrative in the bond market warned that massive U.S. Treasury issuance was responsible for pushing yields higher. Well, such issuance has continued unabated, but yields have fallen precipitously. Despite the reality of the situation, as outlined in Context and Facts Expose Bearish Narratives, the narrative reinforced a growing bandwagon, resulting in higher yields. Today, the narrative and bandwagon are limping along.

Such is the nature of bandwagons. This year, the Magnificent 7 was the bandwagon to be on. It?s easy to assume that what worked in 2023 will work in 2024. That may be the case. Or it may be the case for the first four months. While the narrative is strong, it can fade quickly, like the bond narrative.

Understanding our bias toward owning the Magnificent 7 allows us to make rational decisions when the narrative changes. Lingering on yesterday?s bandwagon can be dangerous. Just ask those short bonds on the Treasury issuance narrative.

Equally important, renting, not owning, a bandwagon allows us to shift to the winning theme more quickly.

For example, since early November, small-cap stocks have handily beat the S&P 500 and Magnificent 7. These stocks are interest rate sensitive. Ergo, the more dovish Fed stance should help these relatively beaten-down stocks more than the less interest rate-sensitive large-cap stocks. Small-cap stocks may or may not be the winning bandwagon for 2024.

Summary

The graphic below shows that the Super Bowl tends to have different teams vying for the trophy each year. Some helmets appear more often than others, but there are few consecutive champions.

Such is like investing. The Callan Periodic Table of Investment Returns below ranks investment performance by year for key indices. As you will notice, there is no predominant winner year in and year out.

The Callan Periodic Table of Investment Returns

Annual Returns for Key Indices Ranked in Order of Performance (2003–2022)

2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Emerging Market Equity 55.82%	Real Estate 37.96%	Emerging Market Equity 34.00%	Real Estate 42.12%	Emerging Market Equity 39.38%	U.S. Fixed Income 5.24%	Emerging Market Equity 78.51%	Small Cap Equity 26.85%	U.S. Fixed Income 7.84%	Real Estate 27.73%
Small Cap Equity 47.25%	Emerging Market Equity 25.55%	Real Estate 15.35%	Emerging Market Equity 32.17%	Dev ex-U.S. Equity 12.44%	Glbl ex-U.S. Fixed 4.39%	High Yield 58.21%	Real Estate 19.63%	High Yield 4.98%	Emerging Market Equity 18.23%
Real Estate 40.69%	Dev ex-U.S. Equity 20.38%	Dev ex-U.S. Equity 14.47%	Dev ex-U.S. Equity 25.71%	Glbl ex-U.S. Fixed 11.03%	Cash Equivalent 2.06%	Real Estate 37.13%	Emerging Market Equity 18.88%	Glbl ex-U.S. Fixed 4.36%	Dev ex-U.S. Equity 16.41%
Dev ex-U.S. Equity 39.42%	Small Cap Equity 18.33%	Large Cap Equity 4.91%	Small Cap Equity 18.37%	U.S. Fixed Income 6.97%	High Yield -26.16%	Dev ex-U.S. Equity 33.67%	High Yield 15.12%	Large Cap Equity 2.11%	Small Cap Equity 16.35%
High Yield 28.97%	Glbl ex-U.S. Fixed 12.54%	Small Cap Equity 4.55%	Large Cap Equity 15.79%	Large Cap Equity 5.49%	Small Cap Equity -33.79%	Small Cap Equity 27.17%	Large Cap Equity 15.06%	Cash Equivalent 0.10%	Large Cap Equity 16.00%
Large Cap Equity 28.68%	High Yield 11.13%	Cash Equivalent 3.07%	High Yield 11.85%	Cash Equivalent 5.00%	Large Cap Equity -37.00%	Large Cap Equity 26.47%	Dev ex-U.S. Equity 8.95%	Small Cap Equity -4.18%	High Yield 15.81%
Glbl ex-U.S. Fixed 19.36%	Large Cap Equity 10.88%	High Yield 2.74%	Glbl ex-U.S. Fixed 8.16%	High Yield 1.87%	Dev ex-U.S. Equity -43.56%	Glbl ex-U.S. Fixed 7.53%	U.S. Fixed Income 6.54%	Real Estate -6.46%	U.S. Fixed Income 4.21%
U.S. Fixed Income 4.10%	U.S. Fixed Income 4.34%	U.S. Fixed Income 2.43%	Cash Equivalent 4.85%	Small Cap Equity -1.57%	Real Estate -48.21%	U.S. Fixed Income 5.93%	Glbl ex-U.S. Fixed 4.95%	Dev ex-U.S. Equity -12.21%	Glbl ex-U.S. Fixed 4.09%
Cash Equivalent 1.15%	Cash Equivalent 1.33%	Glbl ex-U.S. Fixed -8.65%	U.S. Fixed Income 4.33%	Real Estate -7.39%	Emerging Market Equity -53.33%	Cash Equivalent 0.21%	Cash Equivalent 0.13%	Emerging Market Equity -18.42%	Cash Equivalent 0.11%

2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Small Cap Equity 38.82%	Real Estate 15.02%	Large Cap Equity 1.38%	Small Cap Equity 21.31%	Emerging Market Equity 37.28%	Cash Equivalent 1.87%	Large Cap Equity 31.49%	Small Cap Equity 19.96%	Large Cap Equity 28.71%	Cash Equivalent 1.46%
Large Cap Equity 32.39%	Large Cap Equity 13.69%	U.S. Fixed Income 0.55%	High Yield 17.13%	Dev ex-U.S. Equity 24.21%	U.S. Fixed Income 0.01%	Small Cap Equity 25.52%	Large Cap Equity 18.40%	Real Estate 26.09%	High Yield -11.19%
Dev ex-U.S. Equity 21.02%	U.S. Fixed Income 5.97%	Cash Equivalent 0.05%	Large Cap Equity 11.96%	Large Cap Equity 21.83%	High Yield -2.08%	Dev ex-U.S. Equity 22.49%	Emerging Market Equity 18.31%	Small Cap Equity 14.82%	U.S. Fixed Income -13.01%
High Yield 7.44%	Small Cap Equity 4.89%	Real Estate -0.79%	Emerging Market Equity 11.19%	Small Cap Equity 14.65%	Glbl ex-U.S. Fixed -2.15%	Real Estate 21.91%	Glbl ex-U.S. Fixed 10.11%	Dev ex-U.S. Equity 12.62%	Dev ex-U.S. Equity -14.29%
Real Estate 3.67%	High Yield 2.45%	Dev ex-U.S. Equity -3.04%	Real Estate 4.06%	Glbl ex-U.S. Fixed 10.51%	Large Cap Equity -4.38%	Emerging Market Equity 18.44%	Dev ex-U.S. Equity 7.59%	High Yield 5.28%	Large Cap Equity -18.11%
Cash Equivalent 0.07%	Cash Equivalent 0.03%	Small Cap Equity -4.41%	Dev ex-U.S. Equity 2.75%	Real Estate 10.36%	Real Estate -5.63%	High Yield 14.32%	U.S. Fixed Income 7.51%	Cash Equivalent 0.05%	Glbl ex-U.S. Fixed -18.70%
U.S. Fixed Income -2.02%	Emerging Market Equity -2.19%	High Yield -4.47%	U.S. Fixed Income 2.65%	High Yield 7.50%	Small Cap Equity -11.01%	U.S. Fixed Income 8.72%	High Yield 7.11%	U.S. Fixed Income -1.54%	Emerging Market Equity -20.09%
Emerging Market Equity -2.60%	Glbl ex-U.S. Fixed -3.09%	Glbl ex-U.S. Fixed -6.02%	Glbl ex-U.S. Fixed 1.49%	U.S. Fixed Income 3.54%	Dev ex-U.S. Equity -14.09%	Glbl ex-U.S. Fixed 5.09%	Cash Equivalent 0.67%	Emerging Market Equity -2.54%	Small Cap Equity -20.44%
Glbl ex-U.S. Fixed -3.08%	Dev ex-U.S. Equity -4.32%	Emerging Market Equity -14.92%	Cash Equivalent 0.33%	Cash Equivalent 0.86%	Emerging Market Equity -14.57%	Cash Equivalent 2.28%	Real Estate -9.04%	Glbl ex-U.S. Fixed -7.05%	Real Estate -25.10%

The Callan Periodic Table of Investment Returns conveys the strong ***case for diversification*** across asset classes (stocks vs. bonds), capitalizations (large vs. small), and equity markets (U.S. vs. global ex-U.S.). The Table highlights the uncertainty inherent in all capital markets. Rankings change every year. Also noteworthy is the difference between absolute and relative performance, as returns for the top-performing asset class span a wide range over the past 20 years.

A printable copy of The Callan Periodic Table of Investment Returns is available on our website at ***callan.com/periodic-table/***.

Bandwagon bias can be good as riding the hot theme or group of stocks helps investors grow their wealth. Unfortunately, jumping on a market bandwagon too late can come with steep costs.

As we enter 2024, be open to the possibility that last year?s winners will not take the crown this year.

We don?t know what will replace the Magnificent 7 or when, but we will be sure to keep our bias in check and stay open to new ideas.