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How Is The Market Doing?

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The Market

When asked how "the market" is doing, the question invariably refers to the performance of the S&P 500 index. Since its inception in 1957, it has become the de facto barometer for the overall health of global financial markets.

The S&P 500 is also popular with individual investors. Beating the market not only makes us feel smart, it gives us something to brag about during holiday dinners and rounds of golf. The media's fixation on it during times of extreme panic keep eyeballs glued to the television. However, there are three reasons why the S&P 500 is an inappropriate benchmark for most investors.

First, the index is concentrated. It only tracks 505 large cap stocks weighted by size. In fact, just five technology companies (Apple, Amazon, Google, Facebook, and Microsoft) make up more than 23% of the index[1].

Second, the S&P 500 is far too aggressive for most investors. Only those with a strong stomach and a time horizon of at least a decade should hold an all equity portfolio.

Third, consider an investor with a portfolio consisting of 30% large cap stocks and 70% bonds. The S&P 500 would be an inadequate benchmark because the heavy allocation to bonds would almost certainly skew the risk and return comparisons.

Furthermore, any investor with a portfolio designed to generate income should not benchmark themselves against an index that yields around 2% annually and consists of several non-dividend paying stocks.

Think about it this way. If the S&P 500 was down 38% (as it was in 2008), and a money manager benchmarked against the S&P 500 was only down 33%, they would be lauded as a genius. Pension funds and endowments would most likely be begging that manger to take their money.

But would you be happy? Would this make life better? Do your housing, healthcare, and other living expenses rise and fall with the S&P 500 each year? Or would you sit on your couch, head in your hands, sick to your stomach after watching a third of the value of your portfolio disappear?

Sausage Principle

The sausage principle is a theory that states if you love something, never find out how it is made. Anyone with an affinity towards the S&P 500 may want to skip this section because it is time go under the hood.

Most major indices are constructed using objective measures such as company size, profitability, and how long they've been in business. These are *quantitative* and carry no subjectivity with them. The S&P 500 also has a set of rules governing *qualification* to the index. But *inclusion* is a *qualitative* decision, and those who oversee it carry significant influence.

The index is managed by a group of 10 committee members who work for S&P Global. They meet monthly to discuss potential revisions and make changes quarterly. Votes by the index committee are decided by a simple majority, and each member's vote counts equally. While the name of the Chairman is public, the other members' identities are kept secret[2].

S&P Global does not manage this index as an act of public service. This is a for-profit firm that charges handsomely to license the S&P 500, and it generates serious profits. According to its financial filings, S&P Global earned over $830 million in 2018 from the S&P 500 and other indices it manages[5].

Since this is such big business, there is an incentive to treat the S&P 500 as more of a marketing tool than a rules-based index. The more exciting it appears to investors and the media, the higher the likelihood of more licensing fees paid by mutual funds and other financial instruments.

Perhaps this is why the number of stocks that go in and out appears high relative to other indices (half the companies in the index were not in it back in 1999)[6]. During the tech boom of the 1990s, the index was skewed to the tech sector. During the mortgage boom of the 2000s, it was skewed to financials. Neither ended well.

Big investors can also influence the index by placing bets on which stocks might get included over time - raising the price of these stocks. Once a stock gets in, funds that track the index have to then buy that stock, and this coordinated activity only pushes the price higher. The end result is the potential for a lot of expensive stocks in the index.

Simply put, the S&P 500 represents a committee of ten people picking stocks for a product that generates hundreds of millions in licensing fees. Does this sound like something you want to benchmark your financial future against?

Come Prepared

Imagine the opportunity to golf at Augusta National. For those who do not golf (like myself), this is the site of The Masters. Most avid golfers would give up their first-born child to play this legendary course.

Any serious golfer would bring an arsenal of clubs that all serve a unique purpose. A sand wedge is a must (no golfer wants to end up in sand, but they also don't want to risk extra strokes either). A putter will handle the greens, a driver will get off the tee, etc.

The same applies to investing. Here, the driver is the stock market. This tends to hit the ball the farthest and create the most excitement. But seasoned golfers also know what can happen if a driver is off by even a millimeter. The slightest mistake can send the ball towards the moon, and it could take several strokes to get back on track. Hence, it should be used sparingly.

It also takes more than one investment to achieve long-term goals. We need investments that can help us grow our nest eggs over time, but just as important, we need others that can guide us through the sand traps in financial markets.

Managing expectations is equally important. No golfer would expect a sand wedge to hit the ball as far as a driver because a wedge is not designed for distance. Assessing performance involves comparing a wedge shot to other wedge shots, and a drive to other drives.

Similarly, comparing a diversified portfolio of bonds, gold, and other asset classes to an index of 500 U.S. stocks will create unrealistic expectations. This, in turn, risks fueling suboptimal investment decisions.

The Bottom Line

Let me be clear. There is nothing inherently wrong with the S&P 500. It has its flaws but so does every other index out there. My point is that the only investor that should be using the S&P 500 as a benchmark is a money manager who is paid to beat the S&P 500. Nearly every other investor on the planet should use something else.

For example, a retiree with a goal of "not outliving her money" should avoid gauging her performance against an index that can fall by double-digits in the blink of an eye (as we've all seen this year). A more appropriate benchmark for her would be inflation, or more specifically, a rate of inflation that mirrors her lifestyle.

Herein lies the challenge. Everyone is different. Some have the goal of preserving what they've earned while others want to grow it. Some can ignore the volatility in stocks, and others lose sleep over it.

Meaning, there is no benchmark that is appropriate for us all. This is why proper risk assessment and managing expectations is so important. That way, the next time the S&P 500 falls so much in one day that trading is halted, the emotional impact can more closely track the financial one.

The bottom line is that "the market" is no benchmark for those who own diversified portfolios. Ignore the adrenaline rush that comes with a big drive down the fairway because a good score also requires a strong short game.

Sincerely,

Mike Sorrentino, CFA

Chief Investment Officer

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