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The S&P 500 Index: Looking Under the Hood

Some Clear Signs of Extremes in Index Construction

We are nine years into a US stock bull market, and volatility has finally returned. If there was ever a time for investors to examine the fundamentals of what they believe, now is that time. In a reflective mood, let's examine some of the fundamentals of investing in stocks and then examine the pros and cons of buying an index, such as the S&P 500. First, let's review two of the classic rules of thumb when investing in a stock:

1. **Know what you own**: Buy a share in a company as if you were buying the whole company. Some fundamental investors seek to know as much about a company as possible. They assess the quality of its products/services; they seek to understand its competitors; they look for "sustainable competitive advantages;" they assess company management, etc.

2. **Pay a fair price or better**: Having decided that you like the business model and you believe in its potential to continue growing, you might decide that it is a "great" company or just a "good" company in an attractive industry. The next step would be to decide what price you are prepared to pay for a share of the company. Warren Buffett famously said that, in his view, "It is better to buy a wonderful company at a fair price than a fair company at a wonderful price." "Wonderful" and "fair" are subjective words, but the idea that an investment is about quality and the price you pay for that quality resonates with us.

"Wonderful" companies don't always make for great investments if you overpay for them. Additionally, we cannot know that a company that seems to be wonderful today will stay that way. We can, however, look back at examples of companies that have delivered strong earnings growth but have had poor relative price performance. Generally, this has been because an investor significantly overpaid when buying the shares.

Purely by way of example, Cisco's share price went from $0.06 at its offering in 1991 to $23 in 1998 (when the company posted earnings of about 20 cents per share). Thus, at the time, investors were paying more than 100 times what the company was making, in anticipation, one presumes, of continued spectacular earnings growth. Cisco's share price subsequently peaked around $70 per share in 2000. Today, Cisco earns around $2.50 per share and its share price is back to around $43, having hit a low of $10 in 2002 (*source: FactSet*). We could debate whether Cisco has been a wonderful company, but hopefully it is easy to see that the price an investor paid had a significant bearing on the investors' experience. If it is still a "wonderful" company (and we are not expressing a view here) then its price seems a lot more "fair" relative to its earnings than it was in the late 1990s.

INVESTING IN THE S&P 500 INDEX: A SUBJECTIVE STUDY

Index investing, or "passive" investing, has become quite a juggernaut. According to the Investment Company Institute, in 2010 the amount of assets invested in index funds was only about one-quarter of the size of the assets invested in actively managed funds; now it is about half the size and growing. The index investors of the 1980s, 1990s, and even the early 2000s tended to be institutional "buy and hold" investors who believed active managers would be unable to do better than the index, net of fees. Today, index funds are some of the most widely held and frequently turned-over products, suggesting that they are now serving active management styles as well as passive. They have also become more significant for retail investors in 401Ks and savings accounts. Given their new-found popularity, it seems reasonable to apply the "wonderful" and "fair" test, and to let investors know what they own.

It seems unreasonable to say that all of the companies in the S&P 500 are wonderful, or even that they are wonderful in aggregate, but let us assume that, taken as a whole, their fundamentals are at least fair. This seems logical to us, given solid long-term historical earnings trends and the fact that US large-cap companies in aggregate tend to have higher structural profit margins than global indexes. So do they sell at a wonderful or even a fair price? At RiverFront, we seek to measure stock asset classes relative to their own long-term trends as one way to assess value. We assume that if an asset class is close to its own trend, then the price is fair.

When we do this for our universe of large cap stocks, we find that (as of the end of February) they are 17% above their 90-year trend line of real total returns. When we then assess all the historical outcomes that have resulted from starting between 10-25% above trend, we find that, over the subsequent five years, the odds of making money are around 70%, in "nominal" terms (nominal meaning before the effects of inflation are factored in). However, adjusting for the impact of inflation on returns, this drops to less than half of the historical outcomes being positive in "real" (inflation-adjusted) terms. This, to us, is less attractive than starting at or below trend, where the results are predominantly positive for subsequent five-year periods in both real and nominal terms. Simply put, we expect US large-cap returns to be positive in absolute terms over the next five years, but lower than average.

Looking Under the Hood: The S&P 500 is diversified among approximately 500 companies, but it is not as balanced as one might expect. **Two sectors, Technology and Financial Services, make up about 40% of the index, and the ten largest stocks make up 20% of the index.** In preferring to buy the index, one is making the assumption that these enormous companies will grow faster than the rest. The law of large numbers suggests otherwise.

RiverFront's View: **RiverFront tends to invest in equities utilizing both passive and active products, applying the mixture of both in an active way according to our views of the fundamental, valuation, and tactical backdrops. In the later stages of a region's bull market, when valuation is less fair, we tend to utilize less market-cap weighted pure "passive" instruments, such as the S&P 500, and more active instruments with specific, granular exposures.**

We try not to see active versus passive as an either/or debate. Rather we seek to judge any investment on its own merits. When analyzing index investments, we want to know what the sector and stock concentrations are and which biases are built in. For example, in a market capitalization weighted index, such as the S&P 500, we need to recognize that it has a momentum bias. As long as the largest components have positive momentum, the index buyer will own more of them. There is no attempt to limit the size of any one company or rebalance the weightings. We recognize that indexes are especially hard to beat in years when the percentage gain is high and easier to beat during bear markets. Thus, an assessment of the length of a bull market can influence our decision. Finally, we continually stress that the decision as to whether or not to own a passive market cap weighted index is itself an active decision, as is any choice about asset allocation or portfolio construction. We seek to use our judgement to come up with a combination of active and passive strategies to meet the objectives of our clients.

Technical analysis is based on the study of historical price movements and past trend patterns. There are no assurances that movements or trends can or will be duplicated in the future.

Technology and Internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market.

Index Definitions

Standard & Poor's 500 Index *(S&P 500) measures the performance of 500 large cap stocks, which together represent about 75% of the total US equities market. It is not possible to invest directly in an index.*