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The Nifty 500?

Index mutual funds attempt to replicate as closely as possible the performance of a chosen stock or bond index. These funds have gotten unprecedented attention in the past few years, primarily because of the performance of the Standard & Poor's 500 index of large US common stocks. The S&P 500, the index that most index funds track, has "beaten" the vast majority of "active" stock managers.

Many active managers view indexing as the fifth horseman of the apocalypse, or at least a threat to their livelihood. Many index investing proponents view active managers as roughly equivalent to Professor Harold Hill in *The Music Man*, a liar and charlatan at best. Sigma uses index funds when we believe it increases the odds of our clients achieving their financial goals. We are troubled, however, by the increasing recent fad of S&P 500 indexing, chasing the returns of the past few years. There are some very good reasons to consider index funds (low expenses, tax efficiency, and "style" purity), but recent performance is not one of them. Our primary concern is that the new index investors don't understand what they are buying.

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The S&P 500 index is capitalization weighted, meaning that the larger the market value of a company's stock, the bigger the influence it has upon the index. Microsoft, the highest valued stock in the US market, has more influence upon the S&P 500 performance than the 130 smallest stocks in the index combined, none of which are "small" in any absolute sense. (If the price of Microsoft stock goes up one percent, and the prices of each of those 130 stocks goes down one percent, the S&P 500 index will go up). The four largest companies combined have a larger market capitalization than all 2000 companies in the Russell 2000 index (a proxy for small capitalization companies) combined.

Some of the "smaller" stocks dwarfed by the market cap giants are Aetna, Alcoa, BankAmerica, Chase, Dow Chemical, Ford, Goodyear, JC Penney, Mobil, Philip Morris and Sears. Call us old fashioned, but we grew up thinking of these as large companies. "Active" managers tend to roughly equal-weight their holdings and will never own 130 times more Microsoft than other names in the S&P 500.

In 1998, the S&P 500 index had a total return of almost 29 percent, but the median stock in the index had a total return of only 3.5 percent and the average stock on the New York Stock Exchange had a *loss* of about seven percent. This is an unusual situation – since small company stocks tend to perform better than

their large cousins over time, the median S&P 500 index stock has tended to do better than the cap-weighted index, not significantly worse.

To better understand the impact of capitalization weighting in an index, consider the Morgan Stanley EAFE index, used as a performance benchmark for foreign stock investors. In 1970, Japanese stocks represented about 15 percent of the EAFE index. In 1988, they represented 65 percent of EAFE. At the end of 1998, they represented about 21 percent. Foreign index investors were putting 15 cents of their dollar in Japan when it was cheap and 65 cents of their dollar in Japan when it was outrageously expensive. Of course, the index doesn't consider the "cheap" or "expensive" qualities of its holdings.

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S&P 500 index investors were putting only 8 percent of their money in the technology sector in 1995 but 21 percent of their money in that sector now after its tremendous run-up. We are not predicting a Japan-like debacle for tech stocks, but most index investors are unaware of these dramatic sector swings. Indexing can be momentum investing, putting the most money in whatever has gone up the most, which may represent the worst value.

More than half of recent mutual fund cash inflow has gone into index funds, (most following the S&P 500 index), chasing its recent performance. The large growth company group that dominates the S&P 500 index is the most expensive area of the market. The 50 largest company stocks in the index sell at a price/earnings ratio more than two-thirds higher than the other 450 stocks, which in turn sell at a hefty premium to smaller company stocks and foreign markets.

We have written before about the "Nifty Fifty" stocks of the early 1970's, a small group of large growth stocks that institutional investors bid up to lofty levels while ignoring everything else. The subsequent bear market cut the major averages in half while decimating even more severely the institutional favorites. While there is validity behind indexing in certain areas of the financial markets, the current indexing enthusiasm runs the risk of repeating the Nifty Fifty error on a larger scale. In the terminal phase of bull markets, the prevalent investing rationale often appears to eliminate the need for thinking. Part of the allure of index investing is the elimination of the need to think – just buy the index and forget about your unique needs, valuation concerns, etc. We do not engage in market prediction, but chasing the S&P 500 because of its recent performance brings to mind the institutional investors in the early 1970's who were throwing money at the Nifty Fifty without really thinking.

If you would to learn more about what index investing really means and how it can fit into a rational investment plan, contact us.