THERE IS NO PERFECT INDEX

Be Careful What You Ask For!

Investors have been exposed to various benchmarks or indices over the years. They have learned through different sources, whether it be financial media such as television, financial newsletters or investment professionals, that measuring investment results against an index is appropriate. While benchmarks can serve a very valuable purpose it is imperative that investors understand what a benchmark is, and more importantly, what it is not.

The most widely used indices for measuring the performance of a portfolio of equity securities are those produced by Standard & Poor's (S&P) and Russell. The Dow Jones is quoted on the evening news but has little bearing on the broad markets since that index is comprised of only 30 stocks. This article will concentrate on the Standard & Poor's 500 (S&P 500) index, because this index is one of the most widely accepted benchmarks used to compare equity performance in mainstream financial circles.

The S&P 500 index was originally created and known then as Standard Statistics Company in 1923 when only 233 companies were represented. The S&P 500 in its present form was introduced in 1957 when it was expanded to include 500 of the largest companies in the U.S. According to S&P Dow Jones, more than $22.8 trillion in global assets are benchmarked to the S&P indices (August 2023). Eligibility for inclusion into the index includes companies with market capitalizations of USD $8.2 billion or greater. Understanding this helps an investor know not to try to compare a small or mid-sized company to the S&P 500.

The S&P 500 is maintained by the S&P Dow Jones Indices, a joint venture majority owned by S&P and its components. As a reminder, the S&P 500 is a market capitalization weighted index and rebalances four times each year. Unlike the Dow, which you calculate by just adding up the prices of the component stocks and multiplying by a constant, the S&P 500 is more complex. Instead of adding the constituents' stock prices, the S&P 500 adds the companies' "float-adjusted market capitalization." "Float-adjusted" means counting only the shares available to individuals, excluding those held by management, governments, and other companies.

The only eligible companies are operating companies, not ETFs, ETNs, closed-end funds, Limited Liability Companies, Master or Limited Partnerships, or Royalty Trusts. Real Estate Investment Trusts (REITS) are eligible for inclusion.

Deletions from the S&P 500 are a common practice and can happen at any time during a calendar year. The changes that are made are not easily available for investors who do not know how or where to look for the data after a change has occurred.

Some reasons for deletions in the S&P 500 include companies that have merged with other companies or are acquired. Additionally, if there is a large restructuring, a company may no
longer meet the eligibility criteria. If a company violates one or more of the inclusion criteria, it can be removed if ongoing conditions warrant an index change.

S&P will explain why a company is being removed on their website. In short, changes are made as needed. Investors are invited to visit the web address: www.standardandpoors.com to learn more about the methodology for changes to the index.

The S&P 500 focuses on the largest capitalization segments of the market. To determine the capitalization of a company, simply take the number of outstanding shares of a company stock and multiply it by the share price. As of August 2023, the largest *total* market capitalization in this index was $36.448 trillion. *Source S&P Dow Jones Indices – Slickcharts.

Top Ten Constituents by Index Weight: Data as of 08/22/2023

Microsoft	Information Technology
Apple	Information Technology
Amazon	Information Technology
Meta Platforms A	Information Technology
Alphabet Inc. C	Information Technology
Alphabet Inc. A	Information Technology
Tesla	Information Technology
Nvidia	Information Technology
United Health Group	Health Care

*Information provided for informational purposes only and is not a recommendation of a specific security.

The aforementioned outlines a basic understanding of how the S&P 500 is constructed, and there is another very important factor to consider. This index is comprised of both "growth" and "value" companies, also known as a "core" index. It is imperative to know that these two styles are rarely in favor at the same time. Imagine a pendulum swinging from one extreme to the other. Based on certain market characteristics, one or the other style will be dominant. The challenge is making sure that proper diversification is used to include both styles. In short, a growth company focuses on growing their earnings and typically will reinvest the capital back into the business rather than paying out dividends to the investors. Some growth companies do pay dividends, but that is generally not the emphasis. Value company stocks appear to be selling at a discount to their intrinsic value and more often than not, will pay investors dividends.

The next step in understanding the construction of the index, after growth and value, is that of sector weightings. According to S&P Dow Jones Indices, the S&P 500 sector breakdown for the period ending August 2023 was as follows:

Consumer Discretionary	10.75%
Consumer Staples	6.54%
Energy	4.28%
Financials	12.16%
Health Care	13.17%
Industrials	8.33%
Information Technology	28.78%
Materials	2.27%
Communication Service	8.69%
Utilities	2.55%
Real Estate	2.47%

The percentages held in each sector change as the equities within the sector fluctuate in share price. The committee does not make adjustments to the sector allocations. The market performance of the stocks

in the sector determines the index weight and will be allocated accordingly. Stated another way, the better the performance of the stocks in a sector are doing, the larger the allocation of the index weight. The worse the performance of the stocks in a sector, the smaller the allocation to the sector will become.

As a result of this method of sector allocation, the index will look very different at different times in the investment cycle. The best example of this phenomenon is the technology sector. At the end of 1990, the Information Technology sector represented 6.3% of the S&P 500. After a very strong performance in technology stocks for the next seven years, this allocation index grew to 17.5% by the end of 1998. We all remember how technology stocks did in 1999 and early 2000. As a result of the incredible performance of that sector, even though the size of the sector in the economy had not changed that dramatically, by March 31, 2000, the Information Technology sector weight in the index had increased to an incredible 32.9%! The Information Technology sector has settled back to 28.78% as of August 2023.

To be completely clear on this point, the reason the technology weighting in the S&P 500 increased by more than 5X in aforementioned 10 years was primarily because of the incredible performance of the stocks. Therefore, if investors were expected to compete, and outperform the index, they would have needed to invest approximately one-third of their portfolio in Information Technology. Using the benefit of hindsight, we now know that those stocks were horrifically overvalued.

The result of capitalization weighting causes the index to look very different at various times in history. The moral of this story is that if you want to outperform the market, you must do something different than the market. Timing is not the answer – many investors would have been unwilling to sell tech stocks during their meteoric rise and unfortunately, never saw the crest coming and suffered severe unrealized losses for some period of time. Prudent diversification is crucial.

It is so important for investors to employ the services of a professional investor who can help with goal setting. That leads to what type of investments are appropriate for helping meet those goals and objectives. A seasoned financial advisor will help with setting realistic return expectations to keep investors from experiencing what so many did when the tech bubble burst. A goal analysis should be revisited at least annually to assure that the investments are still appropriate.

Sources: S&P Dow Jones Indices – index_services@spglobal.com; S&P U.S. Indices Methodology August 2017

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The S&P500 is an unmanaged index of 500 widely held stocks. The Dow Jones Industrial Average is an unmanaged index of 30 widely held securities. The Russell 2000 index is an unmanaged index of small cap securities which generally involve greater risks. It is not possible to invest directly in an index. Dividends are not guaranteed and will fluctuate. Companies engaged in business related to a specific sector are subject to fierce competition and their products and services may be subject to rapid obsolescence. There are additional risks associated with investing in an individual sector, including limited diversification.

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