Index Insights: Understanding What You Own and Evaluating Performance

Indexes play a central role in investing, whether as passive investment tools or benchmarks for evaluating active managers. However, many investors misunderstand what these indexes truly represent. In the case of passive investing, they may believe they are investing in a broadly diversified portfolio, but they are often unaware of the underlying risks they are assuming. This paper aims to highlight the structure, quirks, and hidden risks of major market indexes to help investors make more informed investing and benchmarking decisions. Even passive investors should be more active in understanding what they own.

Benchmarks evolve over time. For example, in 2006, financials represented the largest sector weighting in the S&P 500® at +25%. At present, technology companies make up roughly 30% of the S&P 500®, while sectors such as materials, energy, utilities, and health care together account for only about 10%. These sector weightings shift over time but can lead to unintended concentration risk at any given moment. Additionally, S&P Global and MSCI maintain the Global Industry Classification Standard (GICS), effectively deciding which companies belong to which sectors. Sometimes, companies change sectors. For example, in 2018 GICS decided that Google's parent Alphabet belonged in the Communication sector after 14 years in the technology sector. For this reason, some people might argue that today's large 30% technology weighting in the S&P 500® is potentially understated.

Notably, market capitalization-weighted indexes do not necessarily reflect the relative scale of the economic output of each underlying company. A business with more substantial earnings may have a smaller weighting than a company with a larger market capitalization but weaker fundamentals. This is primarily a result of investors' perceptions of future growth potential and relative opportunity rather than objective earnings power. As Benjamin Graham famously noted, "In the short run, the market is a voting machine, but in the long run, it is a weighing machine."

Indexes such as the S&P 500® are often perceived as broad and diversified, but the reality can differ. Today, the top 10 companies in the S&P 500® comprise approximately 35% of the index's total weight, while the bottom 10 collectively account for less than 0.1%. As a result, investors may not be as diversified as they believe.

Whether investing passively or benchmarking an active strategy, it is critical to understand what is inside the index. Without that knowledge, comparisons and expectations can quickly become misaligned.

Here is a brief overview of several widely followed indices:

S&P 500®
- Most quoted
- **Weighting scheme:** market-cap weighted
- **Purpose:** Represent the 500 largest companies in the US
- **Issue**: The "500" in the name is misleading. Currently, the top 10 holdings make up 35% of the index. Hidden concentration exists across sectors and does not necessarily represent the overall US economy.

S&P 500® Equal Weight
- Often quoted as a measure of the "average stock."
- **Weighting Scheme:** equal across all stocks.
- **Purpose:** Contains the same 500 companies as the traditional S&P 500 but assigns each an equal weighting.
- **Issue:** Tilts toward smaller companies and dramatically changing sector exposures relative to the market-cap weighted S&P 500. Rebalancing results in trimming winners and buying laggards, potentially increasing exposure to lower-quality businesses.

Dow Jones Industrial Average® (“The Dow”)
- *Was* the most common historically, still often quoted
- **Weighting Scheme:** *Price-weighted*
- **Purpose:** Made up of 30 large, “blue-chip” companies, intended to reflect the performance of established industry leaders.
- **Issue:** Companies issue an arbitrary number of shares and split their stock, meaning a small company with a high share price can outweigh the move of a larger company with a low share price, which does not reflect the actual economic scale.

Russell 3000®
- The broadest *US* benchmark.
- **Weighting Scheme:** Market-cap weighted (like the S&P 500)
- **Purpose:** Capture the performance of the broad US equity market, including both large *and* small-cap stocks.
- **Issue:** Intention for broader diversification relative to the S&P 500 is hardly visible in reality, as the top 10 names still comprise an outsized 30% share of the index.

MSCI ACWI (All Country World Index)
- The broadest *global* benchmark
- **Weighting Scheme:** market-cap weighted
- **Purpose:** includes large and mid-cap stocks across 23 developed and 24 emerging markets designed to represent the performance of the global equity market as a whole.
- **Issue:** The US makes up +60% of this index, yet it only makes up approximately 26% of the world’s gross domestic product. This is not necessarily *bad*, but it is essential to recognize that this index reflects the global stock market, not the global economy.

Bloomberg US Aggregate Index (“The Agg”)
- The broadest US fixed-income index
- **Weighting Scheme:** *market-value weighted.*
- **Purpose:** to provide exposure to the entire *investment grade* market, such as Treasuries, agency debt, mortgage-backed securities, corporate bonds, etc…
- **Issue:** Market-value weighting skews exposure toward those companies that issue the most debt. This index includes bonds of all durations and coupon sizes, which can change over time, causing its sensitivity to shifts in interest rates to vary over time.

There is no universally "perfect" index for investing or benchmarking. Each index serves a distinct purpose and has particular biases and construction methods. An appropriate index should be selected based on investment objectives, risk tolerance, and the strategy or manager under consideration.

The key to making more informed investment decisions is fully understanding what is inside the index. Awareness of an index’s composition and structure can help investors set realistic expectations and make better comparisons.

Understanding what you own is the foundation of sound investing and will give you the confidence necessary to stick with your investment approach during tough times. If you have questions about your current investment strategy or how benchmarks align with your goals, we invite you to contact us.