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Built For Marketing: Why The S&P 500 And Dow Are Misleading Investors

GUEST POST WRITTEN BY
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Since the start of the year, the two major U.S. stock market indexes—the Dow Jones Industrial Average and the S&P 500—have (between them) closed at new highs nine times. But do those highs really mean the market is doing better than ever before?

Not necessarily. Human beings pick which stocks to put in these indexes, and their decisions, I fear, are being influenced by marketing. These indexes produce loads of highly profitable licensing fees paid by mutual funds, ETFs and other financial instruments linked to them. Thus the incentives—both direct and indirect—to stimulate investor interest with higher numbers are enormous.

For the average investor, this has three big implications. First, blind historic analysis may not be all that helpful in evaluating the future. Second, if you're using one of these indexes as a benchmark to measure your own (or a money manager's) performance, you may be misled. Third, the many investors who have invested in passively managed funds tracking the S&P 500

index may not be as exposed to broad market movements as they believe. (I'll suggest a way to fix that below.)

Here, some history is useful. The Dow, which dates back to 1896, was created by *Wall Street Journal* editor and Dow Jones & Co. cofounder Charles Dow as an easy way to express market trends. Initially, he added together the closing prices of 12 frequently traded stocks, divided that sum by 12 and printed the result. Over time, as stocks were added or existing ones split or otherwise changed their capital structure, the divisor was changed to allow for continuity. The Dow now contains 30 stocks. It is a price-weighted index, meaning stocks with higher prices have more influence in the index. At $198, Goldman Sachs Group (NYSE: GS) was recently carrying more weight than General Electric (NYSE: GE) with a price of $27.

The S&P 500 was created by Standard & Poor's, now part of McGraw Hill Financial (NYSE: MHFI). It took its current form back in 1957. As its name suggests, the index contains 500 stocks. It, too, depends upon a divisor that is adjusted for certain capital changes. It is market-value-weighted, meaning that stocks with higher market capitalization have more influence. In fact, right now nearly half the total market cap of the 500-stock index comes from just 50 of its stocks. Apple (NASDAQ: AAPL), by market cap the largest stock in the index, holds the dominant position. Apple's weight was recently nearly twice that of the next two largest stocks, Microsoft (NYSE: MSFT) and Exxon Mobil (NYSE: XOM), and 197 times greater than the smallest, Diamond Offshore Drilling (NYSE: DO).

Both the Dow and S&P 500 indexes, and the cash flows from licensing their brands, are now owned by S&P Dow Jones Indexes. That's a joint venture of majority owner McGraw Hill Financial, CME Group (NASDAQ: CME) and News Corp. (NASDAQ: NWS), owner of *The Wall Street Journal*.

Here's the problem. The advent of passive index-linked investing, and the money it generates for the underlying index, has prompted S&P Dow Jones Indexes and McGraw Hill Financial to keep things looking, well, exciting—reapplying fresh lipstick to the pigs, if you will. To me,

rather than being proxies for "the market," these indexes are more promotional tools and investment products.

And make no mistake about it. This is a big business. According to its financial filings, McGraw Hill Financial received more than $500 million of its $5.1 billion in revenue from its indexes division in 2014 and, over the past three years, nearly one-third of its operating profits. That's a lot of skin in the game.

The masters of both indexes go out of their way in published guidance to talk up consistency. The S&P 500 overseers "strive … to minimize unnecessary turnover in index members," one document says, while another insists, "changes are rare" at the Dow.

Yet despite these solemn professions of continuity, it might surprise you to know that both indexes have had a significant amount of turnover within a short period. Some of that is to be expected; big companies go private, like RJR Nabisco; declare bankruptcy, like Lehman Brothers; merge, like Chrysler; or find some other way to no longer exist as publicly traded entities. But hardly all of the index changes result from such external events.

Of the 500 companies that made up the S&P 500 on Dec. 31, 1999, 263 have been replaced. Of the drop-offs, more than a quarter—68—are still in business today, some with long histories. They include Advanced Micro Devices (NASDAQ: AMD) (annual revenues $5 billion), JC Penney (NYSE: JCP) ($12 billion) and KB Home (NYSE: KBH) ($3 billion).

What gives? These kinds of venerable stocks are ideal for inclusion in historical comparisons, because they have been publicly traded for decades and generate substantial revenues. Sure, their stock-price performance has been poor. AMD, for example, is down from $92 in May 2000 to $2 recently. But that's the very reason why they need to be represented in the index. Of course, if they were, the S&P 500 probably wouldn't be at or near an all-time high and maybe investor interest in passive managed funds linked to the S&P 500 might wane. But that would avoid the problem of an index

reflecting the town in Garrison Keillor's "A Prairie Home Companion," where all the children are above average.

The market-cap orientation of the S&P 500 adds a built-in chase-the-herd bias. During the tech boom of the 1990s, the index was skewed toward tech. During the mortgage boom of the 2000s, it was skewed toward financials. We know what happened to those booms.

Consider 1999, the year before the Internet stock bubble burst. Both the S&P 500 and the Dow rose more than 20%. But non-weighted lists of older stocks actually fell 5% for the year—a more realistic picture of what was going on.

Take a look at this heat map below of the Dow's composition. In it, the size of each box represents market capitalization and individual companies are grouped under a larger box showing the Morningstar sector in which they are classified

The Dow is a reasonable collection of businesses. But one of the first things that struck me is that there is only a single basic materials company—DuPont (NYSE: DD)—and no automobile manufacturers. Meanwhile, there are two credit card companies (American Express and Visa), only one of which has a meaningfully long track record as a public company.Are basic materials and automobiles now such an insignificant portion of our economy? And are credit card processors so important that two of them are needed in the index?

The esteemed Bureau of Economic Analysis (BEA) calculates that the industrial sector accounts for 37% of gross domestic product. Yet industrial stocks are less than 20% of the Dow. BEA reckons that financial firms are 18% of GDP, but they make up a full quarter of the Dow. Why is this? Simply put, financials are sexier than

industrials. As recently as 1976, the Dow included far more industrials besides DuPont—Alcoa (NYSE: AA), Bethlehem Steel, Inco and U.S. Steel. Sure, the U.S. economy has shifted away from hard manufacturing. But by as much as the Dow makers think? Is Nike (NYSE: NKE), now a Dow stock, an adequate replacement for all that steel?

A consistent market benchmark must reflect "the good, the bad and the ugly" of the entire stock market universe and not just Wall Street's current darlings. Yet these days the indexes are constructed entirely of them. For pity's sake, published guidelines for the S&P 500 all but admit this:

While stock selection is not governed by quantitative rules, a stock typically is added only if the company has an excellent reputation, demonstrates sustained growth and is of interest to a large number of investors.

Good rep, high growth, wide interest. This, my friends, is the definition of darlings. The road to the poorhouse is paved with companies once considered darlings. Does the name Enron ring a bell?

I don't want to put too fine a point on this, but McGraw Hill Financial doesn't exactly have a clean track record when it comes to acting as an impartial judge. Earlier this year, it and its ratings division agreed to pay a $1.5 billion fine to settle state and federal charges that the company defrauded investors by issuing inflated ratings of pre-crisis mortgage bonds. No wrongdoing was admitted.

Using the stated size and liquidity criteria for S&P 500 inclusion, I queried the database of YCharts, a Chicago-based financial analysis firm, to see how many companies theoretically could qualify for the list. My screen wasn't perfect, but it came up with 835 stocks—hundreds more than are in the index. So that means the committee selecting the stocks has a pretty significant—and subjective—role in deciding the roster, and perhaps, the future course of the S&P 500 Index.

Properly constructed stock market indexes are marvelous investments tools. Unfortunately, the line between unbiased investment statistics and

investment product hype has been crossed and the violation is worse than at any time during my 23 years of investment management.

What's to be done? Investors need unbiased market benchmarks to evaluate the performance of their investments relative to the entire stock market universe, and the investment management industry should act. For example, it could agree on something similar to the Global Investment Performance Standards (GIPS) created by the CFA Institute (of which I am a member) to validate registered investment advisors' performance. These standards could be used to certify the statistical accuracy of an index before it could be considered an official market benchmark. Meanwhile, uniform disclosures could be required, with details about index component changes and calculation methods that could affect its usefulness.

Until that happens, there are some things investors can do to protect themselves from the distortions created by the current leading indexes.

Research index fund investments carefully. Just because it's called an "index" fund doesn't mean you should exempt it from thorough investment analysis. If you buy and hold index mutual funds or ETFs in your portfolio, look closely at how these portfolios are constructed. Investors are often surprised to find out that they don't have even exposure to a large number of companies. Instead, they have heavy concentrations in a few companies and industries that many investors wouldn't consider in a well-diversified portfolio.

Use many different stock indexes. Even Charles Dow believed in following more than one market average to gauge the stock market. For stock market analysis, investors should follow as many as five market indexes that are calculated differently, even if they are not widely used in investment products. I suggest using the indexes calculated by the stock exchanges themselves (such as the NYSE Composite and Nasdaq Composite). I also like Value Line's Market Indexes. FYI: If you still plan to use the DJIA in your analysis, make sure to also follow the Dow 65 composite, which includes transportation and

utility shares. If in implementing an asset allocation strategy you use index funds, consider more than one index fund for each asset class.

Make your own benchmarks. I'm old school and believe in doing my own research. After all, I'm ultimately responsible for the investment success of my clients, and to make investment decisions I need information I can trust. Over the last several years, I constructed my own indexes for common and preferred stocks, real estate and corporate bonds against which I judge performance. In constructing my common-stock index, I opted for the equal-weighted method—the percent price change of each of the 225 stocks in my index is added together and divided by 225—and the exact knowledge of what is in the index. I can honestly say that taking this step has made me a better investor. In today's world it's easy to create your own benchmark.

Trade into total-market funds. I'm not a fan of buying and holding stock market index funds. But, many investors keep a portion of their wealth in them when the stock markets aren't in free fall. If you're sure you should, too, consider a total-stock-market index fund. Vanguard's, started in 1992, contains nearly 3,800 stocks. It has generated an 8.44% return over the past decade, and the expense on a $100,000 investment is a mere $170 per year.

We live in an age of information overload with a constant barrage of news, earnings projections, economic reports, and advice from talking heads streaming over media outlets 24 hours a day. To be a successful investor, you need to filter this information and make decisions based only on information from trusted sources. The key phrase is "trusted sources."

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