4'3" A NEW RECORD!

My 9 year old son has recently become obsessed with how tall he is and how much he weighs. He feels like he isn't growing fast enough. When measured this weekend, he noted his height (4'3") and said “a new record.” I couldn’t help but think about the headlines from the last week, announcing markets making a new record every day. It seems obvious that when market indexes like the S&P 500 reach a new all-time high, every day they advance further, it is a new record.

Perhaps it is our need to focus on the milestone because we’ve waited so long for it to come. At a time like this of course, pundits want to ask: is this new high the beginning of a new rally or a market top? From an investor’s standpoint, we should ask: do we care?

MARKET INDEXES

Earlier this week, I was giving a presentation about the current market environment and someone asked me about the future of stock returns. I made a comment about the fact that it is difficult to predict what will happen in the next week or even several months. What we do know is that over very long periods of time, the stock market moves higher. Keep in mind that the S&P 500 Index, much like others such as the Dow Jones Industrial Average (DJIA) or Russell 3000, changes over time. The companies represented in the DJIA index in 1980 or 1950 or 1910 are not the same. These indices are meant to represent a cross-section of U.S. public companies and the people who own and market them. The companies who sponsor the indices work hard to make them relevant.

As an example, there is only one company that remains in the Dow Jones index today -- General Electric -- from its construction in 1915. Two others, while no longer in the index remain in business: General Motors and United States Steel. Of course the index only had 12 companies then, not the 30 it has today.
Point being, if you are in the business of marketing an index, people won’t pay licensing fees if it doesn’t stay relevant. That’s why the Dow now includes names like Apple, Cisco, Microsoft and Nike in it.

One of the other things that distinguishes indices from one another is the way they determine how much weight each company's stock should represent in the index. The Dow for example, is a price-weighted index. That means the higher a stock's price, the more weight it has in an index. For example, Goldman Sachs represents over 8% of the index because it has a price of $241.85. Apple is number 10 with a weight of 3.95% due to a price of $113.95. At number 30 is Cisco Systems with a weight just over 1% due to a price of $30.06.

The S&P 500 Index however, uses a market capitalization construction method. This means that each stock in the index is weighted based on the company's market cap (stock price times number of shares outstanding). For example, in the S&P 500, Goldman Sachs, Apple and Cisco have the following market caps and weights respectively: Goldman Sachs ranks 45th, has a market cap of $96.3 bil. and a weight of .47%, Apple ranks first, has a market cap of $617.5 bil and a weight of 3.11%, Cisco Systems ranks 27th has a market cap of $151.5 bil. and a weight of .78%.

The different approaches to index construction mean that the size of a company's position in the index is very different.

PORTFOLIO CONSTRUCTION

There may be a lesson for investors when thinking about index construction. Lesson number 1 is making sure that the companies owned in a portfolio remain relevant. Are these companies driving the economy, representing innovation and beating their competitors? The other lesson learned from index construction is that it can be problematic to put too much weight in the winners. In the case of the DJIA index, the higher a company’s stock price the bigger the weight in the index. This works well on the way up, but leaves a portfolio exposed to more downside risk.

In practice, if you own a portfolio of companies you like, you should be trimming winners on the way up and adding to those investments you have confidence in that may not be doing as well. This type of dynamic rebalancing may produce a better outcome over time.

The other lesson we can learn from indices is that diversification in a stock portfolio can mitigate some risk. Take the S&P 500 Index. There are stocks representing 11 sectors of the economy in the index. When a sector declines in size relative
to the overall index, it may suggest that the group of stocks in that sector is becoming undervalued versus the entire index. When it becomes too large, relative to the rest of the index, it may be overvalued. Take energy. In 2009 the energy sector made up over 14% of the index. As oil prices declined into early 2016, the stocks that made up the energy sector also declined to just over 8% of the index. This was almost 3 percentage points below the long-term average, suggesting that the stocks had become cheaper relative to others in the index.

While new record highs are something to view positively, they don’t necessarily represent much information. However, the details behind what is driving an index to move to all-time highs can provide some insight for investors if we consider the way the index is constructed.

Of course, if you’re 9 and simply not growing as fast as you’d like, then every new high is a meaningful milestone!

As Chief Investment Officer, Brian Andrew leads Johnson Financial Group’s investment strategy to provide consistent, actionable investment solutions for our clients.