

How Diversified is the S&P 500?

April 2017 Client Letter

In 2015, when the stock market squeaked out a small gain, it was a handful of the most speculative names (the so-called FANG stocks, Facebook, Apple, Netflix, Google) that accounted for the entire return on the S&P 500. If your portfolio didn't include FANG stocks, it might have been down in 2015. Year-to-date, stocks are tracking a similar path, with a handful of names



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driving the lion's share of performance in the S&P 500.

According to Fundstrat Global Advisors, through mid-April, large stocks have powered nearly 53% of the S&P 500's YTD return. Almost a third of that return was driven by only three companies: Apple, Facebook, and Amazon.

How Diversified is the S&P 500?

When you invest in a S&P 500 index fund, it may seem reasonable to assume you are broadly diversified across 500 of America's largest businesses with representation in all major market sectors. While it is true that an investment in



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the S&P 500 provides exposure to 500 stocks in all major sectors, the allocations among those stocks and sectors are not evenly distributed. Far from it.

A problem lies in the S&P 500's market-value-weighting scheme. Constituents with a higher market value are weighted much more than companies with smaller market values. By example, today Apple accounts for 3.65% of the S&P 500. That is about the same weighting as the smallest 100 constituents in the index combined. Looked at another way, every 1% move in Apple shares is about 70 times more important than every 1% move in the 400th largest



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S&P 500 stock.

The S&P 500 weighting scheme also has implications for sector diversification. The largest sector in the S&P 500 is technology, representing about 22% of the index. The smallest sector in the index is telecom, with a 2.4% weighting. While technology is a large and dynamic sector in the economy, technology companies are some of the most susceptible to obsolescence risk, disruption, and failure. According to a study by J.P. Morgan, the technology sector has the highest risk of catastrophic loss, defined as a peak-to-trough decline of 70% with minimal recovery.

If you are in or nearing



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retirement, do you really want tech shares to be your largest investment? And if you are a dividend-focused investor, you may be interested to learn the traditional high-yield sectors of the market including consumer staples, telecom, utilities, and real estate investment trusts make up only 18% of the S&P 500.

The point I want to make is, market-value-weighted indices like the S&P 500 and the ETFs tracking them may not be as diversified as some believe. They also suffer from a bias to overweight expensive stocks and underweight cheaper stocks.



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Dotcom Redux

The weighting distortion and valuation bias of the S&P 500 caused problems for index investors during the dotcom meltdown. At year-end 1999, the top holdings in the S&P 500 had a heavy tech slant. The top five constituents in the index at year-end 1999 were Microsoft, GE, Cisco, Wal-mart, and Intel. The average price-to-earnings ratio of the group was 72X and the average dividend yield was 0.30%.

Today, investors may be looking at a similar problem with the S&P 500. The top five constituents in the S&P 500 are Apple, Google, Microsoft, Amazon, and Facebook. The average P/E of the



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group is 61X (admittedly skewed upward by Amazon) and the average dividend yield is 0.80%. Those five stocks make up around 12.5% of the S&P 500—about the same weighting as the bottom 240 stocks.

Those investing in an S&P 500 based ETF may own a portfolio whose performance is much more reliant on a handful of richly priced technology companies than they realize.

Benchmark against Your Objectives

At Richard C. Young & Co., Ltd., we have long eschewed benchmark-based investing and



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benchmark-based performance comparison. We view benchmarking as an institutional construct where consultants, in conjunction with investment boards, select an asset allocation and pick managers for each asset class. In our view, this isn't a useful format for individual investors. Individuals should worry about their own objectives, risk tolerances, and liquidity requirements, not the performance of an arbitrary group of stocks. By example, the performance of your portfolio relative to the performance of the S&P 500 has no real significance if your objective is capital preservation.



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Dividend- Focused Strategies: A Long History of Success

Many of our clients are investing for retirement or to generate a retirement income. This is partly why our common stock investing strategy is dividend-based—but it's not the only reason. Dividend investing also has a long history of success.

Our Retirement Compounders equity portfolios favor dividend-paying companies with a history of making annual dividend increases. This often keeps us more heavily invested in certain sectors of the market



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(consumer staples, utilities, telecom) and under-invested in others (technology and discretionary), which can make relative comparisons difficult during periods when dividend-heavy sectors are out of favor.

Barron's recently profiled the manager of a dividend fund who expanded on this issue and offered other insight on dividend investing. I've included some of the highlights below.

Consumer staples have been the most consistent dividend growers. I favor companies where demand for the product doesn't have to be reinvented every quarter, such as Kimberly-Clark [KMB], 3M [MMM], and Procter &



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Gamble [PG]. Companies that make consumable products should be the core of any dividend portfolio because they are more likely to keep growing dividends long term than deep cyclicals such as General Motors [GM], which might have a period of dividend hikes, but not for as far as the eye can see. Technology companies didn't offer much in terms of dividends in the past, but that has changed. Texas Instruments [TXN] has become a good dividend payer; it is incredibly well run and under the radar.

P&G has trouble growing, but has raised its dividend consecutively for 60-odd years and wants to keep that record intact. Staples



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are pricey, but find me stocks that aren't! We have owned Travelers [TRV] for a decade. It isn't compelling at current levels, but it's a strong candidate for investment returns over a five-year horizon. It is a wonderful property-and-casualty insurer that increases its dividend and shrinks its market capitalization by buying stock when it is cheap. We love companies that do both.

Payout ratios have caught up to past levels. Companies will continue to increase dividends because investors expect it, but now dividend growth will be more in line with corporate earnings—about 5% to 7% per year. That's still darn good. If you



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graph dividend growth, earnings growth, and stock prices over a 10-, 20-, or 30-year period, the lines will be superimposed. Over any one-year period, though, there is wild divergence.

The only way to make money is to hold stocks for long periods—even better if you buy them when markets are down. If someone needs money within three years, put money in Treasury bills. But young people should put every penny they have in the stock market—not trading, but just buying high-quality stocks and letting compounding work.

From our perspective, there is much to agree with here. Consumer staples are currently our



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most favored sector. These companies have good yields and impressive records of dividend growth. Even when these businesses enter a rough patch, as some might say P&G recently has, consistent dividend increases can help lift share prices. P&G's earnings per share are only a few percent higher than they were in 2010, but since year-end 2010 P&G shares have risen 35% and investors have earned a compounded annual return of over 9%.

During lengthy bull markets as we have today, it can be easy to focus on capital appreciation and overlook the cash generated by a company's stock. I often write about



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dividends as a central theme of our investing strategy, but we also have expectations our holdings will appreciate in value. As was mentioned above in the Barron's piece, if you graph dividend growth, earnings growth, and stock prices over decades, the lines more or less move in tandem. This provides the basis for capital appreciation in dividend-paying stocks. Higher dividends tomorrow don't only mean more income in your pocket, but, most often, they can mean higher share prices.

The market doesn't always go up, of course. After an eight-year bull market, you can be excused for thinking otherwise, but markets do indeed



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experience down years and wicked bouts of volatility. Owning a portfolio of companies consistently paying dividends and increasing dividends helps provide comfort in these environments, both by limiting downside (historically dividend payers fall less than non-dividend payers in bear markets) and providing a basis for recovery (rising dividends lead to rising share prices).

Dividend Payers Most Often Durable Businesses

Why do dividend-paying stocks fall less than non-dividend payers in bear markets? Cash payments



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are one reason, but dividend payers also tend to be more durable businesses than non-dividend payers. In a bear market when investors become risk averse, they flee the least durable businesses with more fervor than the most durable.

Regular dividend payments also help discipline management teams. Theoretically companies not paying a dividend should experience greater earnings growth than those who pay dividends. However, historical record shows dividend payers have experienced higher earnings growth. One possible explanation for this trend is companies making meaningful



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dividend payments force management teams to select only their highest and best returning capital investment projects. Management teams with the flexibility to spend their company's entire earnings stream on whatever they desire may accept marginal projects that destroy value in the end.

Dividend Yield Plus Dividend Growth

When we craft dividend portfolios, we look to combine companies that pay high yields with those which may not pay as high a yield, but have strong dividend growth prospects. AT&T is an example of a high yielder. AT&T is the



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largest telecom company in America. AT&T shares yield 4.9% today. AT&T has a strong record of making annual dividend increases, but dividend growth has been a modest 2.2% compounded annually over the last five years.

Visa, a recent addition to many client portfolios, is a company with a low yield, but strong dividend growth prospects. Visa is the dominant player in the electronic payments industry, with a market share of nearly 60%. Visa connects and clears transactions between banks and merchants. The company's vast network creates a high barrier to entry and a formidable competitive advantage.



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Visa benefits from both increased spending globally and the transition from cash transactions to electronic payments. Cash still accounts for 85% of the world's transactions and 40% of transactions in the U.S. Visa shares yield a below-average 0.8%, but the company has increased dividends at a compounded annual rate of 27% over the last five years. We estimate that Visa will pay well under 30% of its free cash flow as dividends in 2017. Visa's strong dividend coverage means that even if the company were to stop growing today—a highly unlikely prospect—the company could continue to increase its dividend at a 27% compounded annual rate for at least another five



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years.

Have a good month. As always, please call us at (888) 456-5444 if your financial situation has changed or if you have questions about your investment portfolio.

Warm regards,



Matthew A. Young
President and Chief
Executive Officer

P.S. For months, investors have been eager to learn the details of the Trump administration's tax-reform plan. How much will it lower corporate and personal rates? Will the border adjustment tax be included? What about full



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expensing of capital investments and the deductibility of interest? Investors are hoping a bold tax-reform plan will lead to faster economic growth. Fixing the current code may yield benefits, but a better answer may be a flat tax. Dan Mitchell, senior fellow at the Cato Institute, contends that a flat tax would end double taxation schemes like “the death tax,” capital gains taxes, dividend taxes, and more. America’s tax code would no longer discourage capital formation by imposing higher effective tax rates on income saved and invested. Greater savings and investment should lead to faster and more durable growth.

P.P.S. One of the biggest



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and most impactful changes the Trump administration could make to the U.S. economy is with respect to the Federal Reserve. There are three vacant seats at the Fed that Trump could fill. Trump will have the opportunity to replace Chair Yellen and Vice Chair Stanley Fisher early next year. That's five of the seven Fed governors. Within 12 months we could be looking at an entirely new regime for monetary policy. One of the biggest problems with the Fed today is that it has been captured by the academic establishment. Joe Ricketts, founder of TD Ameritrade, recently made the case in a *WSJ* op-ed that the Fed needs more business leaders and



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bankers making policy.
Below are some of his
comments.

Which brings me to the
Federal Reserve. In 2012
Jim Grant, the longtime
financial journalist,
delivered a speech at the
Federal Reserve Bank of
New York. “In the not
quite 100 years since the
founding of your
institution,” he said,
“America has exchanged
central banking for a kind
of central planning and the
gold standard for what I
will call the Ph.D.
standard.”

Ten of the 17 current Fed
governors and regional
bank presidents have
doctorates in economics.
Few have much experience
in the private
economy. Most have spent



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the bulk of their careers at the classroom lectern or in Washington. This is a sea change. In past decades, Fed members and governors frequently had experience in banking, industry and agriculture...

Those who have actually taken risks in the market—as entrepreneurs, business executives or bank chiefs—have unique perspectives on the effects of monetary policy that economists necessarily lack. **These individuals can tell you how a particular policy might affect their decisions, as well as the decisions of those in related industries, and all the knock-on effects that the policy would produce across the**



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economy.

P.P.P.S. Singapore is advertising itself (literally, this is from paid content on CNN) as the country best positioned to turn itself into a “Smart Nation.” According to the ad campaign by the city-state, big data, analytics, and next-gen sensor networks will change how big cities operate, and Singapore will lead the charge. It’s hard not to agree given the list of bullet points the ad proffers to readers about how advanced the small nation is:

- According to the 2016 Global Innovation Index, Singapore is **Asia’s most innovative economy.**
- Singapore was



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ranked as the
**world's top
network-ready
country** in 2015 by
The World
Economic Forum.

- Singapore is the
**world's fastest
broadband nation**
according to Ookla,
and was ranked
the top and fastest-
changing digital
economy by Tufts
University.
- Global
multinationals such
as P&G, Nielsen,
DuPont, GM and
ADM continue to
make Singapore an
important part of
their global
innovation
strategies,
attracted by
Singapore's



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proximity to Asian markets and the ability to tap into the region's future growth.

- Singapore was ranked third out of 50 global cities for having a **“future-ready economy”**—i.e. having the right infrastructure and technology to serve people and grow businesses. That's behind the Californian cities of San Jose and San Francisco, but above the likes of London, Sydney and New York.
- Singapore hosts **regionally significant**



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innovation events
that help develop
the innovation
culture by
providing ideas
and inspiration to
startups, as well as
means for them to
source funding and
market their
products.



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