


# Problems with Capitalizati on Weighted Indexes

**April 2013  
Client Letter**

One of the simplest economics lessons I received came decades ago from my dad. He would tell me to look at copper to gauge the economy. When copper prices are rising, the economy is probably expanding. Falling prices could signal trouble ahead. Dr. Copper is what he



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called the metal because it has a PhD in economics.

Another economic indicator is the stock market. Generally speaking, one would expect a rising stock market to occur during favorable times. Today, with the market near all-time highs, it would be reasonable to assume we have an economy supporting the stock market's rise.

To check in on the U.S. economy, we can take a look at Dr Copper. Certainly, a stock market nearing all-time highs will be confirmed by a decent trend in copper prices.

As can be seen from the chart, the stock market's upward path does not



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correlate with the path of copper, whose prices peaked in February 2011. The price is in a two-year decline from its all-time high. Copper's 28.5% decline since early 2011 puts the metal in an official bear market. So what's the story? Why are stocks soaring while copper is signaling problems?

As I have indicated in previous letters, I believe the stock market is being propped up by the Fed and its current monetary policies. My March 26 letter included a chart showing how well stocks performed after various QE measures.

Copper, on the other hand, is not a buyer of Bernanke's medicine. And copper surely is suspect of



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the five consecutive quarters of GDP decline among euro-area countries. The current recession in the euro area has gone on as long now as the so-called Great Recession did. Unlike the Great Recession, however, Europe's recession may get worse before it gets better. The OECD doesn't believe Greece's economy will grow until the end of 2014.

Combine Europe's woes with slowing economic growth in China, lower economic growth forecasts for India, a Russian economy many expect is already in recession, and a slowing Brazilian economy, and it's hard to have faith in today's bull market.

Our concerns with the



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stock market contribute to our current equity strategy, which emphasizes higher-dividend-paying stocks from the more defensive sectors of the economy.

At our family-run boutique investment company, “simple is sophisticated” has long been one of our basic business tenets. We apply it both to managing our firm and to our investment management process.

## The Price-Weighted Dow Jones Industrial Average

A compelling example of simple is sophisticated in the stock market is the Dow Jones Industrial



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Average. Among the general public, the Dow is the most widely recognized stock market index; but in the institutional investment community, it is widely considered a clunky, flawed, and antiquated index. Those are all fair criticisms. After all, the Dow was created in 1896 by Charles Dow, cofounder of the *Wall Street Journal*. Lacking any high-powered computing power, Mr. Dow decided to take a simple approach to index construction. He calculated an average of the prices of 12 stocks from leading American industries. The calculation could have been done on the back of an envelope.

The Dow Jones Industrial Average is a price-



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weighted index. Companies with higher stock prices are more heavily weighted in a price-weighted index. By example, IBM, with a share price of \$208, gets more than twice the weight of Exxon (\$87 per share), even though Exxon is the world's most valuable publicly traded company. Exxon has a market value of \$385 billion to IBM's \$232 billion.

Most modern stock market indices are weighted by market value. The S&P 500 is a market value or market-capitalization-weighted index. Since Exxon is the most valuable company in the S&P 500, it has the highest weighting in the index.



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## Dow & S&P Have Similar Results

While it may be true that the Dow's index methodology is clunky and antiquated, it has achieved similar results to the more complex market-capitalization-weighted S&P 500. For the 10-year period ending in March, the Dow has compounded at 8.93% versus 8.52% for the S&P 500. Over the last two decades, the Dow has generated a 10% return compared to 8.5% for the S&P—a substantial advantage of over 35% when compounded over 20 years. And despite holding only 30 stocks, the Dow did it with less volatility.

Quite a shocker, is it not?



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A simple average of 30 stocks, almost arbitrarily weighted by price and selected by a small index committee for reputation and popularity, has delivered better risk-adjusted results than a rigorously weighted portfolio of 500 stocks.

Our takeaway is a properly diversified portfolio does not require hundreds of stocks, nor does it require market-value weighting. This basic insight is a major reason the first common stock program we offered to clients at Richard C. Young & Co., Ltd. selected exclusively from Dow companies. As our desire to generate higher-dividend yields and broader diversification grew, we merged the Dow



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program into our current global common stock program—The Retirement Compounders.

## **The Drawbacks of a Capitalization Weighted Index**

Unfortunately, this basic insight has been lost on many investors. There is no denying that for tracking or replicating the market return, a capitalization-weighted index is the way to go. But if you are investing real money, it is vital to understand the drawbacks of a cap-weighted portfolio.

## **Over-Weighting**



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# Overvalued Stocks

Capitalization is a function of price. When prices rise, capitalization rises, and vice versa. Since capitalization-weighted indices are weighted based on the market value of the companies in the index, they necessarily overweight overvalued stocks and underweight undervalued stocks.

As a stock's market value rises, its weight in a cap-weighted index becomes larger. If you go back to the dotcom bubble, the information technology sector grew to account for 35% of the S&P 500 (see chart). In 1999, the top-10 holdings in the SPDR S&P 500 ETF included



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Microsoft, Intel, Cisco, Lucent Technologies, and America Online. Investors who thought they were investing in a broad-based market index had over a third of their money in tech stocks.

This overweighting of overvalued stocks is also apparent at the individual company level. Consider Apple. In the first nine months of last year, Apple shares rose by 73% to \$700 per share. As Apple's stock price rose, so did its weight in the S&P 500. In September of last year, Apple's weight in the S&P 500 was approximately 5%. A little less than seven months later, Apple shares are down almost 45% while the broader market is up about 7%—an almost



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50% difference. Apple's weight in the index has of course fallen with its share price, but that didn't help the investors who bought an S&P 500 index fund in September of last year. According to Research Affiliates, the inefficiencies of market-capitalization-weighted indices can lead to a drag on returns of about 2% per year in developed markets.

## A Lack of Diversification

Another potential drawback of capitalization-weighted funds can occur in certain markets where a handful of names can greatly affect performance. This is most common outside of the United States. Brazil offers a good



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example. The iShares MSCI Brazil ETF is a capitalization-weighted index fund of Brazilian stocks. iShares Brazil's top-four holdings account for over 35% of its portfolio. Investors aren't getting broad diversification by investing in iShares Brazil.

When we craft equity portfolios for clients, we don't weight positions by market capitalization. Like Charles Dow, we favor a simpler approach. We just equal weight all common stock positions at the time of purchase. As the close correlation between the 30 stock Dow and the 500 stock S&P 500 described earlier shows, there isn't much reason to fiddle around with capitalization



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weighting. That is unless your goal is to beat the benchmark.

Beating the benchmark is the sole purpose of many actively managed equity funds. As a result, many mutual fund managers pay close attention to sector, industry, and individual stock weightings. Their investment decisions are often made in relative terms. They are either overweight or underweight a sector or stock. Rarely are these portfolio managers entirely out of a sector or stock. Instead they hug the benchmark weightings.

Our goal isn't to mimic or beat a benchmark. Our goal is to help clients meet their investment objectives. Most often



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those objectives include generating income, saving for retirement, passing assets to future generations, donating money, preserving capital, and appreciating capital. Rarely do investors come to us with the goal of outperforming a specific benchmark.

Since we don't concern ourselves with beating a benchmark, we don't focus obsessively on sector and industry weightings relative to an index. We of course pay attention to the sector and industry weightings in the portfolios we manage, but only to ensure proper diversification. We tend to favor certain sectors and industries in the stock market and avoid others



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altogether.

In your first-quarter holdings report, we have broken down common stocks and equity funds by sector. This enhancement provides a more intuitive presentation of which sectors of the market your portfolio is invested in. By example, your holdings report will reflect the higher concentration in consumer staples and utilities stocks compared to other sectors.

Astute observers will also notice that there isn't a single stock from the technology sector. This is by design. As we've outlined in past letters, technology is not an industry we favor. The barriers to entry are often low, the risk of



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obsolescence is high, and many companies in the sector pay no dividends—a deal breaker for us.

The utility sector is more up our alley. Rather than spend energy forecasting the next product cycle in consumer electronics, we can be relatively sure electricity will remain in demand and be delivered in much the same way it is today for the foreseeable future. We are also relatively confident that consumers will continue to turn the lights on, regardless of the economic environment.

Unlike technology stocks, the barriers to entry in the utility industry are sky-high. Utilities are regulated monopolies. And, as regulated monopolies,



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their returns on investment are set by a local regulator. If a utility makes a capital investment, it is guaranteed a return by the regulator, as long as it executes properly. In many cases, the guaranteed returns are in the double digits—sometimes upwards of 12%. A 12% guaranteed return on investment isn't bad in the land of zero-percent interest rates. And it is much more certain than the pie-in-the-sky return estimates we see for many companies in the technology industry.

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



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investment portfolio.

Sincerely,



Matthew A. Young

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**P.S.** In mid-April, gold bugs got squashed with a nasty two-day blast of selling. In fact, a 9.4% decline on April 15 was the metal's worst one-day drop in 30 years. Gold's rout appeared to have been triggered by a combination of worries over Cypress and other banks becoming sellers of gold, an earlier sale recommendation by Goldman Sachs, and a growing view that stocks



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are currently a better investment than gold.

**P.P.S.** Contributing to gold's volatility included forced selling, where investors who borrowed to buy gold needed to sell in order to raise cash to meet margin calls on those loans. Additionally, gold exchange-traded funds, including the SPDR Gold Trust, saw lots of activity. More than \$1 billion alone flowed out of the SPDR fund on April 12—the third-highest withdrawal on record, according to research firm IndexUniverse.

**P.P.P.S.** Gold's decline was of little concern to us. We include gold as part of our currency component and a hedge against a declining dollar. In today's



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world, the largest central banks are on a money-printing binge to debase their respective currencies. By example, the U.S. is printing at the rate of \$85 billion per month. Japan is a close second, printing \$70 billion per month. If we were to have sold our currency hedge—gold—what would we have bought with the proceeds? More U.S. dollars? Some euros? I don't think so. Investing in hard assets, including gold, is our insurance policy in a world of global money printing.



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