

The S&P 500: Diversified Index?

By Howard Spieler

The Standard and Poor's 500 Index has long been considered a benchmark of performance of fund managers and individual investors alike. The simple fact that the index consists of 500 different stocks from a variety of different sectors implies that the index is a well-balanced, diversified mix including some of the biggest and best performing US companies. A closer inspection of the index, however, reveals that the index is anything but diversified. The primary reason is because the construction of the index is cap-weighted, meaning companies with a larger capitalization make up a larger proportion – and have a greater influence on the movement of the index – than smaller companies. These giant companies have grown such an enormous extent that the index is now a better representation of the top-tier stocks only, not a blend of 500 as some might perceive.

Increased volatility

Does the current volatility of the stock market make you a little uneasy? Does it seem like the market is fluctuating more and more on a daily basis? If so, it is not your imagination. The daily current standard deviation (a true measure of price volatility) of the S&P 500 hovers around 1.18, **40%** greater than its 25-year average of .84. There are many valid reasons that explain why market volatility has reached such an extraordinarily high level. For one, the influx of day traders and momentum players, combined with the proliferation and ease of Internet stock trading has had a huge effect on the stock market. In addition, the publicity of the internet stock mania that has produced outrageous returns for stocks like Amazon.com, Yahoo, Ebay and AOL has attracted more short-term and speculative players to the market. There is one other factor that may also contribute to the growing volatility of many growth and stock mutual funds, and that is the rise of the technology sector in S&P 500 representation.

The technology sector has generated such large returns over the last several years that the market capitalization of many of these companies has grown to some of the largest among all listed stocks. For example, Microsoft has the largest market capitalization among all listed stocks (including any of the thirty Dow components), at approximately \$475 billion. Would you trust your retirement money in the high flying – yet enticing - technology sector? How about your children's college fund? The fact is that these big technology companies have justified their way right up the S&P 500, and probably into your portfolio as well. As of June 30, 1999, technology or technology related stock issues make up close to 25% of the movement in the S&P 500. As mentioned previously, the S&P 500 Index is market-cap weighted, indicating that the larger the capitalization of the stock, the greater representation it probably has in your index fund or growth fund as well. Historically speaking, technology issues are more volatile and prone to greater price fluctuation than most other stocks represented in the S&P. For example, energy stocks were once the largest group represented in the S&P, and their volatility is probably a fraction of the technology sector. The same can be said of the banking, industrial and other sectors that have been emphasized in the past by the Standard and Poor's index.

Top 10 technology stocks listed in the S&P 500:

Company Name	Ticker Symbol	% Weight of S&P*	S&P Defined Sector	Listing
Microsoft	MSFT	4.05%	Computers (Software)	Nasdaq
IBM	IBM	2.09%	Computers (Hardware)	NYSE
Cisco Systems	CSCO	1.84%	Computers (Networking)	Nasdaq
Intel Corporation	INTC	1.76%	Electronics (Semiconductors)	Nasdaq
Lucent Technologies	LU	1.59%	Communications Equipment	NYSE
MCI Worldcom **	WCOM	1.40%	Telecommunications (and Long Distance)	Nasdaq
America Online	AOL	1.07%	Computers (Service)	NYSE
Hewlett-Packard	HWP	.91%	Computers (Hardware)	NYSE
Dell Computer	DELL	.84%	Computers (Hardware)	Nasdaq
Motorola	MOT	.51%	Communications Equipment	NYSE

* As of June 30, 1999. Data courtesy Ned Davis Research.

** MCI Worldcom is listed by Standard and Poor's in the "Telecommunications and Long Distance Services" sector, but is included in this list due to the fact that in addition to providing long distance service they provide global telecommunications as well as internet services.

These 10 technology stocks collectively make up nearly 1/6 (16.06%) of the Index. The technology sector overall generates about 25% of the movement in the index. Isn't the S&P 500 index comprised of 500 stocks, and considered the universal benchmark for a diversified portfolio? Well, it's not! The S&P 500 Index is very heavily weighted towards the large cap stocks, especially the larger technology issues. The same can be said for most of the mutual funds that attempt to match or beat the Index. With so many fund managers, pension funds, institutions and investors chasing the same few stocks, supply and demand tells us that prices will escalate. As stock prices soar, so do P/E Ratios. This could explain why we have an S&P 500 P/E ratio that is twice its historical average. This can also explain why the large cap technology stocks (and their fantastic returns) have helped fuel the great bull market of the 90's.

Top 20 stocks in the S&P 500, regardless of sector:

Company Name	Ticker	% Weight of S&P*	Company Name	Ticker	% Weight of S&P*
Microsoft Corporation	MSFT	4.05	Citigroup	C	1.43
General Electric	GE	3.26	MCI-Worldcom	WCOM	1.40
International Business Machines	IBM	2.09	Coca-Cola Corporation	KO	1.36
Wal-Mart Stores	WMT	1.91	American Intl. Group	AIG	1.29
Cisco Corporation	CSCO	1.84	Pfizer Inc.	PFE	1.26
AT&T	T	1.81	Bristol Myers Squibb	BMJ	1.24
Intel Corporation	INTC	1.76	Johnson and Johnson	JNJ	1.17
Exxon Corporation	XON	1.67	Royal Dutch Petroleum	RD	1.15
Lucent Technologies	LU	1.59	Bank of America	BAC	1.14
Merck and Co.	MRK	1.55	America Online	AOL	1.07

* As of June 30, 1999. Data courtesy Ned Davis Research.

Total of the top 20 S&P 500 Stocks: **34.04%**
 Seven stocks of the top twenty are technology stocks (**35%**)

The return of the Nifty Fifty?

Space constraints do not provide for another chart, but if we extend this analysis to the top 50 S&P 500 stocks, we find that they influence the Index by a whopping **53.74%**. This is reminiscent of the "Nifty Fifty" of the late 1960's and very early 1970's, where the top fifty stocks were known as "no decision stocks" – because they were the most consistent performing stocks in an otherwise fairly narrow marketplace. These fifty stocks kept the indexes rising to higher levels during 1972, while the broad market declined. However, the bear market that started in 1973 eventually ate up the Nifty Fifty – they had further to fall during the prolonged market decline - and the market subsequently remained quiet for years. There are several striking similarities between the Nifty Fifty of the Seventies and Nifty Fifty of the Nineties. Obviously, the high P/E ratios and valuations are one commonality. The failure of the broad market to participate in market advances – if they participate in the advance at all – is another similarity. The absolute dominance of the large cap stocks in 1998 is exemplified by this statistic: The S&P 500, which returned a generous **28.7%** last year, if calculated as a simple average as opposed to a weighted average, would have returned a more modest **12.8%** instead. Is this a warning sign, a flashback to the Nifty Fifty of the Seventies right before a prolonged bear market? Is history destined to repeat itself? Or, should we be grateful that we are in a perfect stock market climate – low unemployment, low interest rates, a growing global economy, a booming domestic economy with little or no inflation, and perhaps, most importantly, a seemingly endless supply of mutual fund and brokerage cash inflows – to keep fueling this bull market. Only time will tell.

Quick facts about the S&P 500

America Online has a greater representation in the S&P (1.07%) than Ford and General Motors combined (1.00%)

The four listed airlines (Southwest, American, Delta and US Airways) have weighting of .29%, or 1/14 of Microsoft

Networking giants Cisco and Lucent (3.43% combined) have more influence than Dow Components Alcoa, Caterpillar, Sears, Eastman Kodak, Boeing, Goodyear, International Paper, Walt Disney Co., General Motors, McDonalds, Minnesota Mining and Manufacturing and United Technologies combined (3.41%)

Any questions or comments feel free to e-mail SandF@Signalert.com

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