YOUR BEST PATH
FINANCIAL PLANNING

A Better Alternative To Investing In S&P 500 Index Funds

It may surprise you to learn that I do not advise anyone to invest in S&P 500 Index funds or similar ETFs anymore. The lone exception to this rule is that investors deciding how to invest their 401(k), 403(b), or TSP (Thrift Savings Plan for Federal Employees) funds might not have a better option. Does this mean I recommend active fund management? Not at all. I still believe that passive investing strategies are best for the vast majority of us.

Let's go back for a moment to the creation of the index by Standard & Poor's—a firm in the business of reporting on the markets. In 1957 S&P expanded the previously smaller index to its current size of 500 stocks.[1] The index was never meant to be a guide for investing, rather its purpose was to be an indicator for how the market is doing. To explain the difference that distinction makes I'll need to define a couple of terms.

First, market capitalization (or market cap) is the value of a company that is traded on the stock market, calculated by multiplying the total number of shares by the present share price. Second, the S&P 500 is free-float market cap weighted. That means the market capitalization of each stock only includes the shares that are actively available in the market. So the weight given to each share's price movement is figured by dividing the free float market cap of the stock by the total market cap of the index.

The 500 stocks in the index represent a large percentage of the total wealth of the nation (currently about $22 trillion[2] out of our collective $100 trillion, or approximately 22% of the nation's wealth) and an even larger percentage of the equities market ($22 trillion of $34 trillion[3] or almost 65% of the equities market.) So when reporters say that the S&P 500 went up 1% on a given day, that means that we are approximately 1% richer as a nation in the collective judgment of the markets. Since 1957 the index has done a good job as an indicator as intended.

Then in 1975 the legendary John Bogle founded Vanguard. His idea, first described in his undergraduate thesis at Princeton, was that investing could be simplified and thus made available to far more people and families if an investment house would just create the right product. The first fund Vanguard established was the first "Index" fund and it tracked the S&P 500 Index. Today that fund (ticker symbol VFIAX) and others that copied it are the giants of US equities markets. I'll save writing about Bogle's other huge idea – forming a company owned by its clients – another day. Bogle's ideas helped democratize Wall Street and Vanguard's low costs save investors literally $10 billion a year in a slow revolution that is continuing today.

And yet . . . in June 2018 Vanguard *removed* their S&P 500 Index fund from their employees' 401(k) retirement plan.[4]

Why?

As explained above, in order to reflect the wealth of the investors in the 500 stocks that make up the S&P 500, the index has to be weighted by the market capitalization (number of shares in circulation times the share price) of each of the companies. Today that means that if Apple shares go up $1, it generates more wealth than if Gap Inc. shares go up the same amount because there are more Apple shares in circulation. To capture that in a fund, the manager has to buy more Apple than Gap. The result is that S&P 500 Index funds are more concentrated than you might think. Microsoft, Apple, and Amazon are each over 3% of every S&P 500 Index fund. The top 25 holdings make up over 35% of the funds. For a prudent investor this concentrates too much of your money in a few giant companies that are all moved by many of the same factors.

Ask yourself this. How can a company that is already totally dominant in its industry (or industries) return above-average growth over the years? It is extremely rare. Amazon, dominant in retail, has established a fantastic business in cloud services. I can't think of many similar examples in my lifetime.

But somewhere much lower down in the 500 is the next big thing, a company that will grow tenfold in the next 5 years. If you are in an S&P 500 fund, you will miss most of its growth.

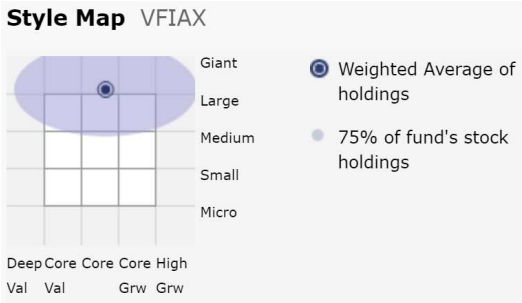
Another way to say it is simply that small-cap stocks outperform large cap stocks over the long run because they have more room to grow.

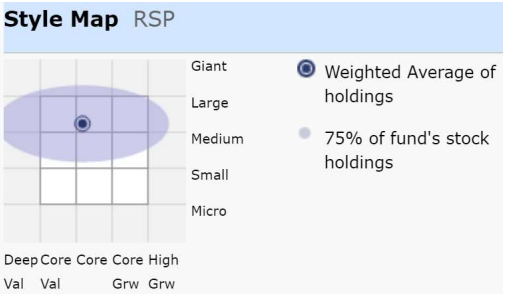
I think there is a better way for most situations.

It's called equal weighting. For example, Invesco's S&P 500 Equal Weight ETF (ticker RSP) introduced in 2003 weighs the stocks in the S&P 500 *equally* instead of by their market capitalization. With this strategy you get exposure to the same companies, the best of American commerce, but without the distortion of market cap weighting. There are over a dozen other similar funds to choose from that equal weight other indexes which may be worth looking into. From RSP's inception, it has outperformed the S&P 500 Index 193.91% to 141.71% as of Jan. 11, 2019.[5] That's a significant difference over a time period that includes bear and bull markets. A $100,000 investment in 2003 would now be worth $52,200 more. Who among us couldn't find a use for that?

Of course, there is no free lunch. Riskiness (volatility) goes up as you move from large caps toward small caps, but if you have a long enough time horizon to have a

significant stake in stocks I think the switch is worth it as you also have a more value oriented tilt with the equal weight fund. That is the result of owning fewer shares of the most expensive stocks (with the highest P/E ratios) and more shares of less expensive stocks (with lower P/E ratios.)





The style maps above show that RSP tilts to smaller capitalization and to value stocks compared to VFIAX (Vanguard's S&P Index fund.) Both of these are characteristics of better performing investments over the long haul.

Notes:

1 https://www.britannica.com/topic/SandP-500

2 http://siblisresearch.com/data/total-market-cap-sp-500/

3 https://www.nasdaq.com/article/us-stock-market-is-biggest-most-expensive-in-world-but-us-economy-is-not-the-most-productive-cm942558

4 http://www.philly.com/philly/business/vanguard-sp-500-retirement-index-fund-20180606.html

5 https://www.google.com/search?sa=X&tbm=fin&q=NYSEARCA:+RSP&stick=H4sIAAAAAAAAAONgecRozi3w8sc9YSm9SWtOXmPU4OIKzsgvd80rySypFJLiYoOyBKT4uHj00_UNK8uTigyqKit5ADkvTRw8AAAA&biw=1645&bih=797#scso=_PkBBXP65DpKq_Qa1rZTIBA2:0&smids=/m/016yss&wptab=COMPARE

I hope you've found this information to be educational and helpful.

Remember that it is my job to assist you. If you have any questions or would like to discuss any matters, please feel free to give me a call.

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As always, I'm honored and humbled by my clients' trust and appreciate the opportunity to serve as their financial advisor.

All the Best!

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