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DOES THE S&P 500 PROVIDE DIVERSIFICATION ANYMORE?
by Evan Campbell, CFA

One of the most common refrains we hear as asset managers is the importance of the S&P 500 as a "global benchmark." The S&P 500 has existed since 1957 and consists of the largest 500 publicly-traded US companies by market capitalization (with a few other requirements besides just size). It is capitalization-weighted, meaning the index is calculated as the sum of the values of its 500 members; a small percentage movement by one large member (for example, Apple) can have a larger percentage impact on the overall value of the index.

In some senses it has become the singular proxy for the US stock market—professionals tend to ignore the Dow, which has only 30 members and has a basically ceremonial role at this point. While there have long been indexes (such as the Wilshire 5000 or the Russell 3000) that are technically broader measures of the US stock market and while the asset management industry may often focus on other measures, the S&P 500 still gets the most attention from the media and public.

Not only does the S&P 500 command the most attention when people talk or think about the US stock market, but also products based on it are among the most widely-held in the world of index funds. All of the top three global ETFs by assets, for example, are S&P 500 index funds, with a total investment of over $1.5 trillion.[1] This does not even count mutual funds or the myriad of other S&P 500 linked products further down the list. This means that the S&P 500's gyrations can have an outsize impact on the net worth of millions of investors at all levels, considering the widespread use of index funds in middle-class retirement accounts.

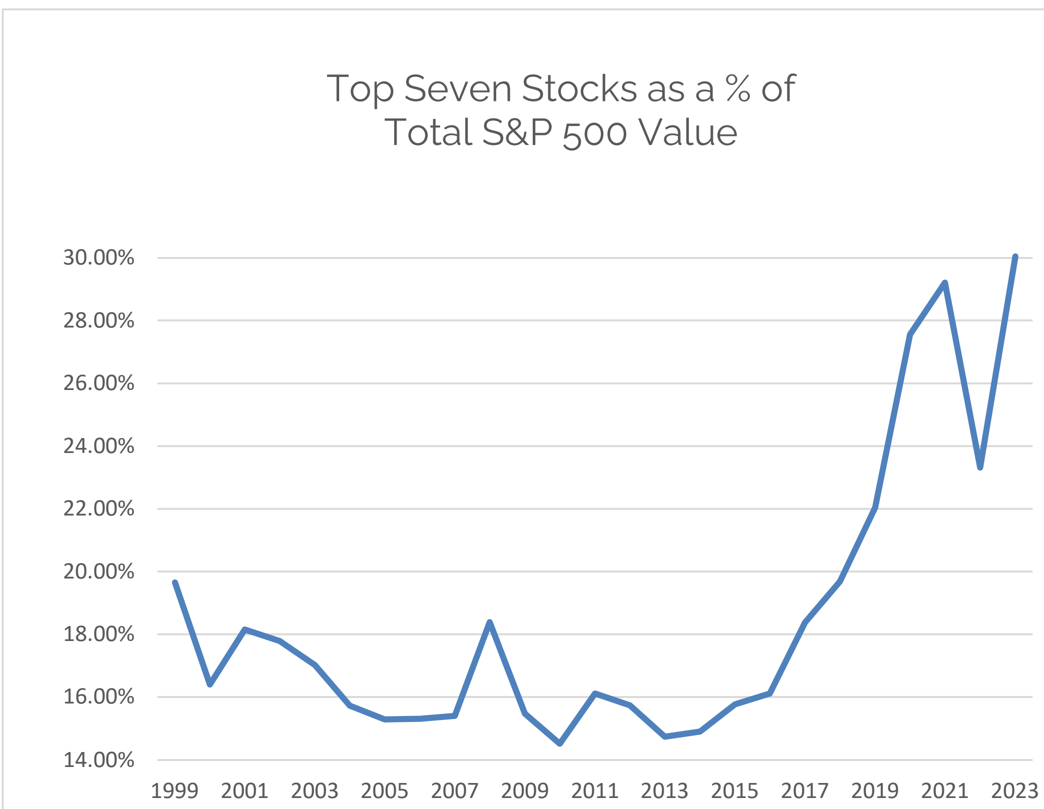
Indexing can be a valuable strategy for many investors; indeed, Warren Buffett has for years recommended that individuals invest mainly (as much as 90/10) in low-cost index funds such as the S&P. His reasoning was more or less sound; the average individual investor lacks

[1] https://etfdb.com/compare/market-cap/, as of 27 July 2024.

the expertise to pick stocks, and instead, investing their surplus in a diversified basket of assets tied to the long term performance of the US economy is in comparison a much better strategy.

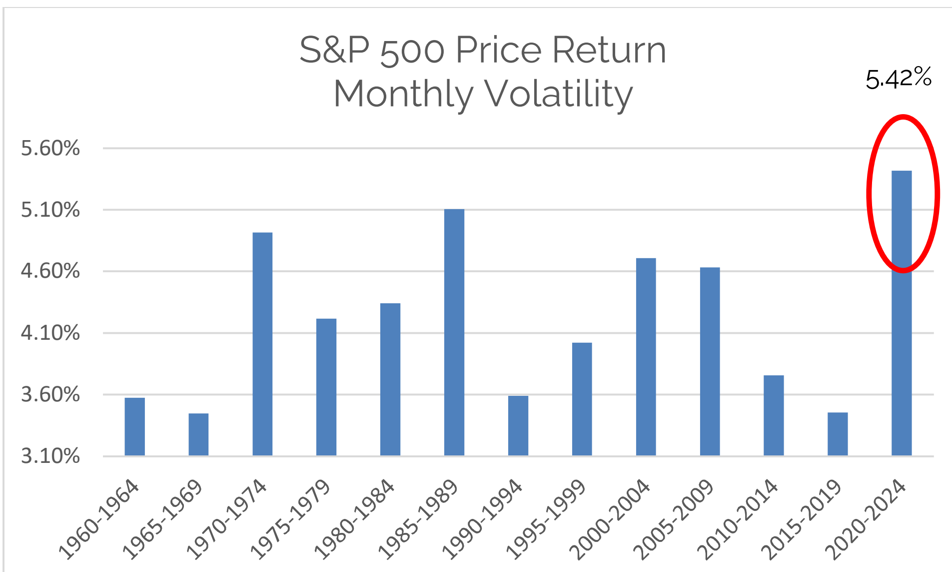
But the key to Buffett's recommendation is *diversification*. Diversification protects investors' capital from the idiosyncratic risks associated with any one, or two, or ten, of their investments, be they publicly traded equities or bonds or real estate. In theory, owning a basket of 500 stocks should achieve this goal nicely. However, remember that the S&P 500 is *capitalization weighted*—as a few companies in recent years have risen in value to dominate American business (and indeed, life), the value of the total index has become more and more concentrated at the top.

Much of the last few years' market news has been dominated by discussion of the "Magnificent Seven"; the stocks whose movements dominate the US stock market and whose gains have far outstripped the wealth creation of the rest of the market. Alphabet, Amazon, Apple, Meta, Microsoft, NVIDIA, and Tesla comprise over 30% of the total value of the S&P 500 as of June 30,2024.[2] Moreover, their gains have comprised an outsized portion of the overall return. In the second quarter of 2024, the movement of these seven stocks represented slightly over 100% of the change in market value of the entire 500.



[2] Data from YCharts and S&P Dow Jones.

As the Magnificent Seven have come to dominate the index, the volatility of the S&P 500 has increased along with it. Taking the period through July 2024 as a full year, the five years since 2020 have seen the highest volatility of monthly returns on the S&P 500 since 1960.[3] Of course, the 2020s contain the volatility of 2020, but it's worth noting that the only periods that come close to the current period's volatility contained the 1987 Black Monday crash and the early 1970s bear market that coincided with the collapse of the so-called "Nifty Fifty." The volatility of the period *excluding 2020* is still 4.80%, exceeding the periods containing both the Great Recession and the Tech Bubble, and coming very close to the 1985-89 and 1970-74 periods.[4]



What this means is that investors in the S&P 500 and its associated index products bear greater risks that their money won't be there when they need it than at almost any time in recent memory. This is a direct consequence of the rapid appreciation of the biggest names in the Index, driven in part by excitement around the potential of Artificial Intelligence. Whatever one's opinion about AI, this index concentration and volatility has had real consequences for investors: in 2022, when the equal-weighted S&P 500 fell 13.1%, the headline S&P declined by 18.1%. Index investors had to withstand the evaporation of nearly a fifth of their capital—those who stayed invested recouped their losses and more, but as we know well,

[3] Volatility is a mathematical measurement of how much an investment's value fluctuates over time. Large increases and large decreases in price have an equal effect on volatility. For this essay we use the standard deviation of monthly returns as a proxy for volatility. Our dataset is available upon request.
[4] Long Term Historical Daily S&P 500 Values available at https://stooq.pl/q/d/?s=^spx

the psychology of withstanding such large losses can lead investors to behave less than optimally, and investors who needed to use their capital at the wrong time suffered.

The *Wall Street Journal* mirrored[5] much of the sentiment expressed here in a piece earlier in 2024. The *Journal* noted the increasing concentration of the index in the financial and technology sectors (as opposed to specific names), concerned that the index would consequently be more sensitive to interest rates than it had been in the past. This is not just a function of how rates might affect corporate earnings or the general economy, but of *valuations*. Since a stock's intrinsic value is the discounted net present value of its future cash flows, the time value of money calculation is the most important component of the valuation. Lower interest rates mean that future cash flows are worth more today; since many large technology companies sell at high price/earnings or price/cash flow ratios, this means that their stock market value is more heavily weighted on future years' earnings. These stocks, which as we have noted make up a third of the index, are thus especially sensitive to interest rates and can experience wild swings when the Fed hikes or cuts rates in response to inflation.

For these reasons we believe the S&P 500 is no longer a suitable global benchmark for equity performance. Benchmarks must be adequately diversified and protect investors' capital from wild swings in value, which the S&P 500 cannot do so long as its top components are global behemoths. Investors who want exposure to broad market trends should therefore seek out alternatives that exhibit actual diversification—where a few names cannot cause sudden, large drops in the value of their capital.

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[5] "The S&P 500 isn't as Diverse as it Used to Be. Here's Why That Matters," *The Wall Street Journal*, 3 July 2024.

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