



THE DOW IS NOT YOUR BENCHMARK

(And Neither is the S&P 500)

On October 9, when U.S. markets suddenly reflected investors' doubts about our economy's—and equity markets'—growth expectations, the media made hay of the DOW's (hardly historic) one-day decline. It was all DOW, 24/7.

But how much does the DOW mean to prudent investors? Particularly those who are far more broadly diversified than what's represented by its 30 large-cap U.S. stocks?

We think a discussion of media-touted benchmarks like the DOW and the S&P 500 is useful. As wealth managers, we do use benchmarks to help us get our bearings when contextualizing portfolio performance. But we also believe that ultimately, getting our bearings should have more to do with how well our clients are meeting their unique goals and objectives. About this, the DOW has nothing to say.

DOW JONES	16,314.67	+113.25
S&P 500	1,931.34	-0.90
NASDAQ	4,686.50	-47.90
NYSE COMPOSITE	9,857.25	+19.40
DOW COMPOSITE	5,825.39	+45.20
	12,378.57	+38.90

BENCHMARK: TO MEASURE THE PERFORMANCE OF ONE ITEM, RELATIVE TO ANOTHER *SIMILAR* ITEM

Some financial analysts use the acronym SAMURAI to reflect the desired attributes of a proper benchmark: (S)pecified in advance, (A)ppropriate, (M)easurable, (U)ncambiguous, (R)eflective of current investment opinions, (A)ccountable, and (I)nvestable. There's no need to go into each attribute when all we need to focus in on here is one: *Appropriate*.



Here is some background:

The Dow Jones Industrial Average (the DOW) was created in 1896 when Charles Dow picked 12 stocks that he thought were a good representation of the health of the American industrial sector. Literally, these were companies with the words Cotton, Sugar, Cattle, Lead, Iron, Gas, Leather, and Rubber in their names. If the DOW was up, it was largely considered a good day for American industry.

With Charles Dow long gone, a “methodology” has now replaced how stocks are added into the DOW. It states, “While stock selection is not governed by quantitative rules, a stock typically is added only if the company has an excellent reputation, demonstrates sustained growth, and is of interest to a large number of investors.” Does that sound like an investment thesis?

If a money manager told you, “we only pick stocks with an excellent reputation and a large number of investors are interested in them,” would you hire them? We at HH would want considerably more substance to the investment process before investing – and that’s precisely the point. The DOW wasn’t created to be an investment (or a benchmark for that matter); it was created to be an economic indicator.

Furthermore, this index is price-weighted, which means that Boeing has nearly eight times the weight (and thus impact on movement) in the index as Intel, but only because its share price is nearly eight-times higher – even though their sizes are relatively equal. This price weighting concept has no financial or investment reasoning either: It simply made the math easy. Charles Dow could have done it each night in his knickerbockers, by candlelight, with a fountain pen. The DOW is now comprised of 30 stocks and, fun fact, General Electric (GE) was one of the original 12 in 1896 but was only recently removed in June 2018—replaced by Walgreens Boots Alliance. Why was GE replaced? We’ll never know for sure; maybe their reputation isn’t “excellent” anymore?

With these construction constraints, the DOW should only be your benchmark if you were to manage a portfolio with only 30 large cap US stocks. If you think 30 stocks chosen by a panel using relatively opaque selection criteria is an appropriate portfolio for someone’s life savings, then we have a bridge for you to buy as well.

THE S&P 500

Henry Varnum Poor’s company, Poor’s Publishing, introduced their “Composite Index” with just a few stocks in 1923. Poor’s merged with Standard Statistics in 1941 to form Standard and Poor’s (S&P for short); this index was expanded to 500 stocks in 1957.



The methodology for assembling the S&P 500 falls more in line with “modern” portfolio theory (which was largely developed in the 1950s and 1960s). A company’s weight in this index is their market capitalization—the number of outstanding shares times the current market value of those shares—something akin to their overall worth. (For those geeks like us reading this: They transitioned the index to float-adjusted capitalization weighting in 2005.)

While there are some other criteria for inclusion into the S&P 500 (like the unadjusted company market capitalization must be US\$ 6.1 billion or more), it indexes, more or less, the largest 500 companies in the US. What is worth perusing more closely is what this capitalization-weighting scheme means.

You rank each company by their size and then you weight them based on their share of the overall pie. You may think of the S&P 500 as a well-diversified basket of 500 U.S. stocks, but in reality it is more of an aristocracy. The largest 26 companies make up a third of the index, the same weight as the bottom (smallest) 403 companies. The largest nine companies make up almost 22% of the S&P 500—the same weight as the bottom 335.

In fact, the top three companies in the world by capitalization—Apple, Microsoft, and Amazon—make up the same weighting in the S&P 500 as the bottom 228 companies: about 11%. Currently, Apple, the largest company in the world, is so big that this one stock bears the same weight as the bottom 121 companies in this index. Would you put 11% of your liquid net worth in Apple, Microsoft, and Amazon? That’s a heavy tilt towards tech, not to mention a lot of eggs in only three baskets.

What about government bonds? Or corporate bonds? Or municipal bonds? What about small cap stocks? International stocks? Emerging markets? Real estate? Reinsurance? Don’t these things belong in a balanced portfolio as well?

While the S&P 500 is considerably more of a complete basket of stocks than the DOW, we don’t think it is an appropriate alternative to a fully invested and properly diversified portfolio—and neither does the \$257bil invested with CalPERS, nor the \$28bil in the Yale University Investment Fund, nor the \$41bil invested in The Bill and Melinda Gates Foundation. The S&P 500 is only one market and a concentrated one at that.

HOW DID THE MARKET DO TODAY?

We’re often asked, “How did the market do today?” To which the only appropriate answer should be, “which market?” Curt, sure, but while CNBC and Fox News quote the DOW and the S&P 500 incessantly throughout the day, they’re simply facets of the U.S. stock market. There are



many more ways to invest than simply buying U.S. large cap stocks. And, although this asset class has paid well over these last 10 years, keep in mind that we just rolled off the 10-year anniversary of Lehman Brothers' bankruptcy—which set off a dramatic 25% decline in the S&P 500 over the following three weeks in late September 2008.

There is power in diversification. An annually rebalanced 60/40 portfolio would have taken three years to recover from the market peak in October 2007 and would have been back to even in October 2010. The S&P 500 took another year and a half and didn't fully recover until March 2012.

Of course, there are two sides to this issue, given that the S&P 500 has far exceeded the return of the "60/40" blend since March 2012. It continues to trend higher as the new aristocracy of Silicon Valley continues to excel. However, between November 2007 and March 2009, the S&P 500 lost more than half its value. We don't believe our clients are interested in suffering through a 50% decline, particularly those clients who are relying on their portfolio to sustain themselves to and through retirement.

If you're talking about one of the riskiest slices of a portfolio, having these assets decline in value by 50% might be something you can stomach if other pieces in your portfolio are either less impacted, not impacted at all, still doing well, or perhaps, even thriving.

That's why we at HH spend so many resources searching for alternative sources of returns. The objective is to allocate assets to different sources of risk. As we discussed in our Q32016 Quarterly Market View, prudent investing is like building A Bed of Nails. Too much weight on one nail can cause a great deal of damage, but a bed of nails, spread out over a wide range, can greatly assuage discomfort and damage.

Sure, the S&P 500 may be an appropriate benchmark for a large cap US stock manager, but are you a large cap US stock manager? If you're not, then the S&P 500 is not your benchmark, and for that matter, neither is the DOW. Here at HH we believe that the most appropriate benchmarks are your personal goals and objectives, and whether or not you are attaining them. If you are not, perhaps the challenges are a function of spending? Perhaps they're a function of increasing longevity? Regardless, market returns are only a portion of the story. As your Longevity Navigator™, we look to help make sure you have a happy ending.

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