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## **The Top-Heaviness Problem in Indexation and The Wealth Index**

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*Facts & Figures*  
*and*  
*How They Did It: Tales of the Greatest Investors of All Time*

## **The Top-Heaviness Problem in Indexation and the Wealth Index**

These two normally separate sections have been combined for this issue, since the two categories converge in my discussion of a new approach to the top-heaviness problem in indexation. Let's review the problem. We understand the need for indexation, and we also understand the need for liquidity. The first problem in constructing an index is to provide the customer base enough liquidity for investing sufficient funds in the index. The only recognized approach is that of market capitalization, because that measurement is more or less a guide to the liquidity of the constituent elements of an index. This approach creates a top-heaviness problem, one aspect of which is that if a company is very highly valued in a conventional metric sense, as in having a very high P/E, it has a proportionately larger market capitalization. Therefore, anyone who buys the index would be buying companies that are overvalued.

WisdomTree has attempted to deal with that problem by having what's known as a fundamentally weighted index. The rule is to weight companies in relation to their net income. However, this approach doesn't really solve the top-heaviness problem. For example, if WisdomTree were to create its version of the Spanish ETF, Telefonica would still have a very large weight in the index, because the company is so much more profitable than the average company in Spain.

In his so-called RAFI indices, Robert Arnott has taken a different and more complicated approach by creating a whole series of fundamental factors to alter the company weights, with a view of reducing the impact of any one company, or small group of companies, that might be temporarily overvalued. At the end of the day, however, the companies with the largest market capitalizations generally have the most weight in the index.

Equal-weighting is an interesting approach to overcoming the top-heaviness problem. An equal-weighting approach usually outperforms the market capitalization weighting approach, because it eliminates the P/E bias. It's agnostic for P/E, because it's agnostic for market capitalization, but it has the deficiency of providing low liquidity.

A different approach would be to create a global index that is truly diversified and, at the same time, equally weighted. In order to create an equally-weighted index, it must include enough members with sufficient liquidity, which is possible since there are many large companies in the world today. To that end, I made a list of the wealthiest people in the world, and examined the source of their wealth. If the source was a publicly traded company, I added that company to the list. Of the fifteen wealthiest people in the world,

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the source of wealth for twelve of them came from a publicly traded company. Two of the twelve, Christy Walton and Jim Walton, are heirs of the Wal-Mart founder, so I combined them, as you'll see below. Also, Carlos Slim Helu has two companies, so he's listed twice.

## Wealth Index

<i>(\$ in billions)</i>	Net Worth	Source of Wealth
1) Carlos Slim Helu	\$53.5	Telmex
2) Carlos Slim Helu		America Movil
3) Bill Gates	53.0	Microsoft
4) Warren Buffett	47.0	Berkshire Hathaway
5) Mukesh Ambani	29.0	Reliance Industries
6) Lakshmi Mittal	28.7	Arcelor Mittal
7) Larry Ellison	28.0	Oracle
2) Bernard Arnault	27.5	LVMH
9) Amancio Ortega	25.0	Inditex
10) Christy & Jim Walton	43.2	Wal-Mart
11) Stefan Persson	22.4	Hennes & Mauritz (H&M)
12) Li Ka Shing	21.0	Cheung Kong

Let's compare the companies in the Wealth Index with the 12 largest constituent elements of the S&P Global 100 Index (OOI). As the name suggests, the S&P Global 100 has 100 companies in it, the 12 largest of which I include in the table below. The S&P Global 100 purports to be a global index, because the companies in it are all global multinationals; however, since the constituents are U.S. companies, it isn't really a global index.

Wealth Index	S&P Global 100 (OOI)
1) America Movil	Exxon Mobil
2) Telmex	Microsoft
3) Microsoft	General Electric
4) Berkshire Hathaway	Procter & Gamble
5) Reliance Industries	Nestle
6) Arcelor Mittal	HSBC
7) Oracle	Johnson & Johnson
2) LVMH	IBM
9) Inditex	JPMorgan Chase
10) Wal-Mart	British Petroleum
11) Hennes & Mauritz (H&M)	Chevron
12) Cheung Kong	Pfizer

The most obvious difference between the indexes is that the Wealth Index would be equally weighted, and the S&P Global 100 is market capitalization weighted. I think that if one looked through at the diversity of businesses, one would see that the Wealth Index is

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more diversified by business line than the S&P Global 100 Index. It's certainly more diversified in terms of nation of origin. As a generalization, over the long term, the members of the wealth index have outperformed the members of the S&P Global 100. One possible explanation is that the companies in the Wealth Index are still under the influence of the original patriarchs that created them. Therefore, they have pursued one consistent business strategy for many decades. The S&P Global companies, without exception, are run by professional managers who didn't create the companies, and who perhaps have entirely different agendas for their companies than have the creators of the various companies in the Wealth Index.

There are many who believe that having a large economic stake in an enterprise affects the performance of the enterprise. In the case of the wealth index, in each and every instance there is a large shareholder, or a small group of shareholders, who have an enormous economic stake in the company. The businesses in this group are conducted in such a manner that, over time, the companies earn a higher return on equity than the large constituents in the S&P Global 100. One could extend the list of 12 companies in the Wealth Index yet further to make a large-capitalization index that is equally weighted and globally diversified.