HORIZON KINETICS

Under the Hood: What's in *Your* Index?

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Not Your Grandfather's S&P

While much of the recent market commentary offered by the financial media outlets is focused on the reasonableness (or not) of the market P/E of about 17x and about the reasonableness of that P/E in relation to 'consensus' estimates of corporate profit growth, whether 3% or 6%, it is interesting to note that the largest corporations in the S&P 500 Index do not actually appear to be growing much, if at all. Of the 30 largest companies in the S&P 500, only one-third experienced any revenue growth in 2014, and only one-half had revenue growth of 2% or more. A traditional growth company such as Coca-Cola was negative, Merck was negative, as were IBM, Cisco Systems and General Electric. The aggregate sales growth of these 30 largest U.S. companies was only 4%; exclude just Facebook and Google, and growth was barely above 1%. Perhaps the top tier of the S&P is now too large to grow at a meaningful rate, which has implications for investors in the largest companies; or perhaps it was just a bad year.

There is another question, though, more subtle yet with deep implications for any investor who selects equities, makes asset allocation decisions, or conducts retirement planning or pension plan funding projections. What if the historical returns of the S&P 500, which form the basis for projecting future stock market returns, and therefore powerfully influence the proportion of a pension plan or 401k that will be allocated to stocks or bonds, are not actually representative of what investors are purchasing if they invest in the index today?

12-Month Change in Revenue, 30 Largest S&P 500 Companies

Apple Inc.	6.72%	Coca-Cola	-2.85
Microsoft	11.69	Merck	-6.89
Exxon Mobil	-8.09	Citigroup	-3.30
Johnson & Johnson	5.92	Facebook, Class A	54.69
Berkshire Hathaway	12.12	Google, Class A	19.56
General Electric	-1.69	Google, Class C	19.56
Wells Fargo	1.31	Gilead Sciences	16.72
Procter & Gamble	0.58	PepsiCo, Inc.	1.41
JPMorgan Chase	7.51	IBM	-4.55
Verizon	4.06	Comcast	3.34
Chevron	-4.88	Walt Disney	8.37
Pfizer Inc.	-12.55	Cisco Systems	-3.01
Intel Corporation	-1.19	Wal-Mart	1.52
AT&T Inc.	1.03	Oracle	2.95
Bank of America	1.96	Philip Morris Int'l	-1.32
		Average change:	**4.1%**
		Excluding Facebook & Google:	**1.1%**

Source: Company reports, Bloomberg

The nature of the S&P 500 today – the way the performance is measured – is different than it was before 2005. The difference came about this way: in order to accommodate greater quantities of assets for management in index-based investment products linked to the S&P 500—that is, provide greater liquidity—Standard & Poor's shifted to a float-adjusted weighting system for the index constituents. The necessity grew out of the way indexes are constructed: all positions were weighted based on their total, or gross, stock market values. Once indexation began to be truly popular, though, with truly large inflows of funds, the problem for the index manufacturer was that if 40%, say, of the shares of a company were owned by insiders, there might be an insufficiency of publicly available shares, or float, to accommodate the volume of assets destined to buy those shares without inflating the share price and valuation. In practical terms, float-adjustment means that a company like Oracle or Microsoft would have its weighting in the index reduced by the proportion of inside ownership. The higher the inside ownership, the smaller the weighting would be set, so that there would be a proportionately lower index-based demand for the shares.

The entrepreneurial companies of today, those with substantial inside ownership (such as Tesla or Google) are accorded lower weights in the S&P 500 than would have been the case prior to 2005. Likewise, their impact upon the Index's returns will be lower than they would have been prior to 2005, when they would have been given full weight based upon their stock market capitalization. Therefore, the historical returns of the S&P 500 – upon which our notions of historical rates of return are based – are no longer continuous with or representative of what the S&P 500 is today.

Accordingly, how big would the impact have been on the S&P 500 had the entrepreneurial companies of the past been float-adjusted, as they are today? Here are two examples known to all: Wal-Mart and Microsoft, which span two generations of innovative service and technology business development in the U.S.

Wal-Mart was added to the S&P 500 in August 1982. Its initial weighting was a mere 0.25% Sam Walton died in the first week of April 1992. During that decade, the Wal-Mart stock price appreciated by 28.0x, which translates to over 40% per year, and its Index weighting expanded to 2.0%. Inside ownership in 1982 was 38%, as it was after Sam Walton died. Had the S&P 500 applied its current float-adjusted rules back then, 38% of that truly spectacular return would not have been part of the historical S&P 500 return.

Just two years later, in 1994, Microsoft was added to the S&P 500, at a 0.85% weighting. Insiders owned about 40% of the shares. When Bill Gates announced his departure a dozen years later in 2006, the shares had risen in value 8.3-fold, or by over 19% per year (and the S&P 500 by 9.1% per year, inclusive of dividends). Microsoft's weighting in the Index had expanded to 2.0% (and was as high as 2.6% in 2004). A large part of this return would also have been lost from the S&P 500 had it been float-adjusted at the time. The liquidity-motivated float-adjustment mechanism, even if applied only to these two companies, would have had a measureable negative impact upon the Index's returns. What of the others: the Apples, the Intels, the Hewlett-Packards, the Nikes, the Starbucks, the Schwabs? We believe that the S&P 500 today cannot provide what it did in the past, to the degree that any great future entrepreneurial ventures will find their way into the Index.

As an aside, there is something interesting about the pattern of the Microsoft share ownership. When added to the S&P 500, the share price was about $2.41. At January 1999, when the stock was $44.75, insiders still owned 31% of the shares. By September 1999, near the peak of the Great Technology Bubble, when the shares were $47.50 (when Microsoft's weight in the S&P 500 exceeded 4%), inside ownership had been reduced to 26%, and by early September 2000, the very threshold of the collapse of that bubble, when the stock was $35, inside ownership had dropped to 19%. Today, 15 years later, the shares are only $44.37 – a 1.6% annualized return – and were quite a bit lower than $35 only two years ago. Whether by fortune or perception, insiders were dramatically reducing their holdings going into a decade-plus period of decline and stagnation. What did outsiders do? Had the float-adjusted index weighting method been in place at the time, then as insiders sold, such that the float increased, the Index rules would have increased the Microsoft weighting, and mutual funds and other index investors would have been buying more—*more of what the insiders were selling*.

Although most invest in indexes on the basis of the name on the wrapper, the name doesn't really tell you what's inside. It's not your grandfather's S&P 500.

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