Why 500? – by John Augenblick

From amateur investors to seasoned financial advisors, it seems as though everyone wants to compare their portfolio's investment performance to the S&P 500. Comparisons to the S&P 500 are incredibly pervasive in the financial services industry, and in nearly all cases I find these comparisons are completely unjustified.

If your advisor is properly doing his or her job he'll engineer a portfolio of diversified holdings across the U.S. market, developed international markets, and markets in emerging economies. Welcome to 2008, this is not the year 1957 when the S&P 500 was created; this is the global economy that is here to stay. The U.S. stock market now represents less than half of the value of the global market, and the S&P 500 makes up only a portion of the U.S. market.

Keep in mind, owning the S&P 500 does not mean that you own equal amounts of 500 different stocks. It means that you own 500 stocks, but you proportionally own more of the larger stocks and less of the smaller ones. For instance, the largest ten of the 500 stocks in the index make up 20% of the value of the index. Accordingly, the largest 50 companies in the S&P 500 make up roughly 50% of its value. The performance of the index is dominated by just a few of its largest holdings.

Inappropriately, the S&P 500 has been adopted by investors as the benchmark by which they measure portfolio performance. If I was a "hot stock picker" choosing only stocks of gigantic U.S. companies, then it might be appropriate to measure performance against this index. For a diversified portfolio, it is certainly not a useful performance benchmark.

Why in the world would you compare the performance of a beautifully diversified portfolio of 8,000 different stocks from 40 different countries to just a handful of the largest companies in the U.S. market? That just doesn't make any sense. I'm certain I don't need to revisit clichés involving apples and oranges to make my point.

I also struggle with the utility of the S&P 500 as a strategy for building wealth. The S&P 500 is not, in itself, an investment strategy. The S&P 500 is a benchmark. And that benchmark has real world utility, such as measuring the volatility of the U.S. market, comparing the U.S. market to foreign markets, or even comparing stocks to fixed income products.

There are other domestic indexes such as the Russell 3000 or Wilshire 5000 that have risk-return characteristics that are every bit as sound as the S&P 500's and these indexes are much more representative of the broad U.S. market. So why the S&P 500? Its selection seems grossly arbitrary in this context.

I won't continue to feign ignorance over the reason for its use as a performance benchmark or an investment strategy. It was, at one time, the predominant benchmark for the U.S. market and decades of inertia have led to its inappropriate use today. However, as cognizant participants in a global economy we need to broaden our focus and think differently. It is clear that advisors need to stop comparing their clients' portfolios to stocks of gigantic U.S. companies and move forward—the global economy already has.

John R. Augenblick, CFP® is a founding member of Rockwood Wealth Management, an independent financial planning and investment management firm located in New Hope, PA. He is a member of the National Association of Personal Financial Advisors an organization committed to the development of comprehensive financial planning. John can be reached at 267.983.6400.