# The Big 5 + S&P 495

QPW Perspectives – March 2021

When people think of the stock market there's a good chance that they think of the S&P 500 Index. Its name recognition and the frequency with which it's referenced in news articles and financial media makes it top of mind. The natural tendency for investors is to want to compare their portfolio against it to see how they stack up.

The following discussion explores some basics about what the S&P 500 actually is, when it might be appropriate as a comparison, some of its inherent risks, and when it's definitely not appropriate as a comparison.

**Is the S&P 500 a Good Benchmark?**

This seemingly simple question requires a fair deal of context to answer appropriately for any potential benchmark (see here for a deeper discussion of benchmarks and their use in portfolio management). The short answer is – it depends.

The Standard and Poor's 500 (S&P 500) Index is one of the world's most recognized stock market indices and is designed to be broadly representative of the U.S. large cap investable universe. In the context of a large cap U.S. equity portfolio, this index is generally accepted as the "standard" (no pun intended) for benchmarking purposes.

The underlying securities within the S&P 500 are chosen by Standard & Poor's based on several criteria and are weighted based on their market cap (market value of all shares). The singular objective of the index is to "measure performance" across the U.S. large cap investment universe. There is no deliberate attempt to measure or manage the potential risks within the index – something that is fundamental to portfolio management.

As with any benchmark, the S&P 500 simply serves as a common focal point for investors to look towards and form a baseline for comparison. Differences between the index and the portfolio you are comparing it to must be understood and interpreted.

**The Big 5 + S&P 495**

In its current form, the S&P 500 can be divided into two groups:

- The Big 5
- The S&P 495

The Big 5 consists of the familiar FAAMG stocks (Facebook, Apple, Amazon, Microsoft, Google) and represents the five largest companies in the index, as measured by market capitalization. The S&P 495 represents the other 495 companies in the index.

The Big 5 currently have a combined weight in the S&P 500 of approximately 22%. In other words, 1% of the index constituents (5 out of 500) account for 22% of its total weight – a high level of concentration compared to historical periods. Given this top-heavy reality, the Big 5 are highly influential to overall index performance, for better or for worse. For example, the Big 5 contributed about 10.4% to the total S&P 500 return of 18.4% during 2020 (in U.S. dollars). The S&P 495 contributed about 8.0% collectively. This means that 1% of the index constituents, representing 22% of the index, drove almost 57% of 2020 performance.

As mentioned, the S&P 500 (and any other broad market index for that matter) does not attempt to manage risk within the portfolio – the only objective is to represent the broad market at any given point in time. The S&P 500 is indifferent to the fact that it is currently dominated by a small handful of technology related companies with high valuations. The index has no capacity to recognize rising risks within its composition and adjust accordingly.

| | Market Cap (in Billions USD) | Weight in S&P 500 | Price to Earnings (Last 12 months) | Forward Price to Earnings (Next 12 months) | Price to Sales (Last 12 months) |
|---|---|---|---|---|---|
| Apple | 2,103 | 6.02% | 34.1 | 28.5 | 7.3 |
| Microsoft | 1,794 | 5.13% | 35.4 | 31.4 | 11.8 |
| Amazon | 1,593 | 4.56% | 75.9 | 51.2 | 4.1 |
| Alphabet (Google) | 1,414 | 4.04% | 42.6 | 26.1 | 7.8 |
| Facebook | 811 | 2.32% | 28.3 | 23.1 | 9.5 |
| **Big 5** | **7,715** | **22.1%** | **44.0** | **32.9** | **8.0** |
| **S&P 495** | **27,249** | **77.9%** | **29.0** | **20.2** | **1.5** |
| **S&P 500 Index** | **34,964** | **100.0%** | **32.3** | **23.0** | **3.0** |

Source: Bloomberg, as of March 17, 2021

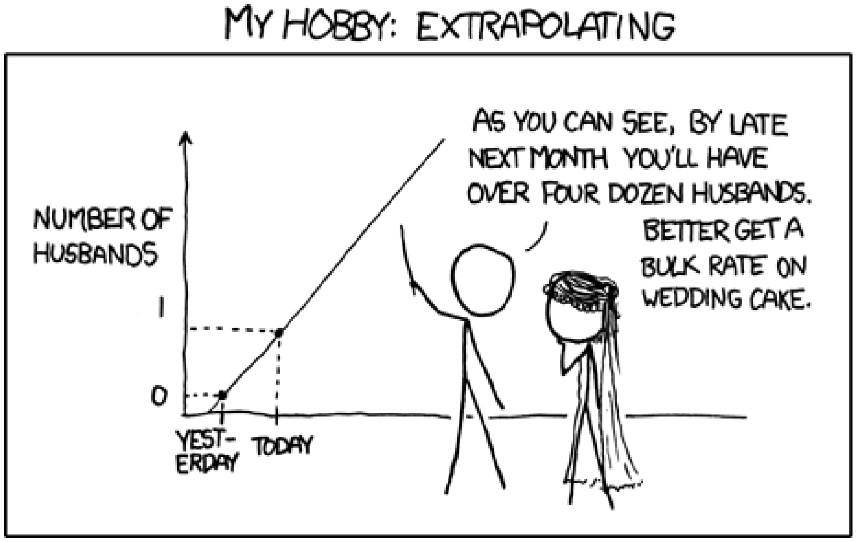
The table above illustrates that the Big 5 are expensive relative to the overall index and the S&P 495 based on all valuation metrics. A forward price to earnings ratio of 32.9 for the Big 5 means that an investor is being called upon to pay $32.90 (price) for $1 of annual profit (earnings). In the absence of growth, a price to earnings ratio of 32.9 implies a 33-year break even period against the purchase price of one share.

Currently, the price to earnings ratio of the Big 5 represents a 63% premium relative to the S&P 495 valuation of 20.2. In order to justify that premium, the Big 5 will need to maintain significant profit growth for an extended period of time. One could argue that a price to earnings ratio of 20.2 is also expensive – but this is an average across 495 stocks providing a broad range of valuations and diversification versus the Big 5.

The inherent risk of the additional premium to own the Big 5 is that reality may not live up to the lofty expectations currently priced in. Any disappointment in this regard may result in a lower valuation premium, which can present itself as price declines or price stagnation as the companies “grow into” their valuations. At the end of the day, overexposure to a small group of companies with elevated valuation levels represents investment risk, regardless of whether or not the companies are fundamentally sound. Overpaying for a great company can result in a poor investment.

As investors, we need to make decisions about what risks we choose to accept in exchange for long term expected returns. This requires assessing available investment options and making probabilistic judgements about what the future may hold. Picking winners like the Big 5 is easy with the benefit of hindsight. The challenge is figuring out who the next winners may be and how to limit the downside risk. Our best-in-class institutional investment managers are extremely diligent in assessing risk and managing downside with the goal of providing attractive long-term risk-adjusted returns over multiple business cycles.

Will the Big 5 continue to be the winners going forward? It’s certainly possible – they are solid companies that may continue to grow profits and outpace expectations going forward. It’s also possible, due to high expectations and expensive valuations for the Big 5, that they underperform as investments in the future. After all, trees don’t grow taller forever. It’s a mathematical fact that maintaining high growth rates gets more difficult the larger something becomes – you can't simply extrapolate from the past and expect the same level of growth to continue indefinitely.




Source: xkcd.com

We believe that it is particularly important at this time to manage downside risk as well as exposure to elevated valuation levels in certain segments of the equity market. As the S&P 500 has continued to grow more concentrated in the Big 5 and the technology sector in general over recent years, its applicability as a benchmark for some portfolios may be less useful in the short term, or will at least require a greater deal of interpretation to understand any differences. If a comparative U.S. equity portfolio does not hold the Big 5 in similar proportion to the index, wider performance differences (positive or negative) relative to the benchmark can be expected.

**Apples and Oranges**

The S&P 500 can be an imperfect but reasonable benchmark for a U.S. equity portfolio as long as the investor understands the differences and risks within it when assessing performance. A U.S. equity portfolio compared against a U.S. equity focused benchmark is an apples-to-apples comparison for the most part. However, due to its popularity and the fact that it is often referenced in the media, investors may find themselves using the S&P 500 as an improper comparison at times – trying to compare an apple to an orange.

Here are a couple of things that are never appropriate to compare against the S&P 500:

- An unrelated or loosely related asset class.

  Example: comparing the S&P 500 Index to the Canadian equity market index (TSX Composite) or to a U.S. equity small cap index.

- A diversified balanced portfolio.

  Example: comparing the S&P 500 Index to your personal balanced portfolio that encompasses various asset classes.

**Personal Benchmarks Matter the Most**

As a private wealth management firm, Quadrant seeks a comprehensive and in depth understanding of our clients and their financial goals and circumstances. In addition to managing investment portfolios, we provide advice and in-depth planning with respect to retirement, estate planning, risk management, taxation, and charitable giving. We believe that all of these important financial matters are intertwined and deserve to be viewed through a holistic wealth planning lens. At the end of the day, the benchmark with the most significance is the personal benchmark – the benchmark that represents whether a client is on track to meet their overall financial goals.

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Quadrant Private Wealth is an independent, comprehensive, integrated wealth management firm committed to your financial well-being and peace of mind. We take the time to understand your complete financial picture. We tie all of your information together, including tax planning, to paint a picture of what your financial future could look like. And we aim to earn your complete confidence in the process.

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