Cap-Weighted Indices, Market Timing and The Stocks People Are Talking About

Any time a stock goes on an incredible run, we inevitably start receiving calls about buying that position. NVIDIA and Bitcoin are recent examples, but every year there is a darling of the market. Most of the companies on the Top 10 lists on the following page have been a market darling at one point or another over the last 30 years. However, timing the entry accurately is incredibly hard and often, by the time everyone is talking about the darling, the opportunity has passed. Furthermore, investing strictly in a handful of securities is risky - what if you do not pick the right ones? If you were lucky enough to get it right, at some point it's time to sell and there are significant tax impacts to consider. A good market cap-weighted index can help address many of these issues.

What is a cap-weighted index and why does Legacy Wealth Management prefer them? A cap weighted index is an index that uses companies' market capitalization (share price times shares outstanding) to determine a company's weighting in that index. The S&P 500 is a market cap-weighted index of the largest 500 companies in the United States. The Russell 2000 and the S&P 600 are market cap-weighted indices of small cap companies. The Dow Jones Industrial Average, on the other hand, is a price-weighted index in which a company's index weighting is calculated based on the share price. There are also equal-weighted indices where every component of an index has the same weight.

All these types of indices in the modern investment world create diversification and trade relatively inexpensively as exchange traded funds (ETF). They are also highly tax efficient for long holding periods. However, the market cap-weighted options create the best chance for momentum and compounding benefits. When a group of stocks performs like those on the right side of the table below, you want the compounding benefits that come along with those extraordinary gains. If you were in an equal-weight index that is rebalanced every quarter, you wouldn't be able to earn as much on the compounding of the returns generated by the true market leaders. With a price index like the Dow, company choices (such as share issuance, stock-based compensation and share repurchases) can impact their weighting in the index and these tend to be much less diversified (the Dow is just 30 stocks). This is not an issue with cap-weighted indices as all those adjustments factor both shares outstanding and current price.

The table below shows part of the reason that cap-weighted indexing is so efficient. The 10 largest stocks in 1994 are listed on the left. They were the cream of the crop and the stocks about which everyone in the 1990's was talking. The conversations around them were much like the conversations currently around the list on the right about the 10 largest stocks at the beginning of this year. However, after a long holding period you'll see over the last 10 years, every one of the stocks on the left underperformed the S&P 500 over the course of the last decade. That's not to say these stocks didn't return gains - they all were positive over the course of the last decade - just not nearly to the level of the S&P 500 index and certainly not to the level of performance of the current top 10. If an investor bought these in 1994, they would have been faced with tough choices about when to sell and how much. This decision would have been amplified by the considerable amount of taxes they would have to pay to liquidate an individual position. Then they would have to guess right about which stock to buy with the proceeds (in hindsight the answer was NVIDIA – but what's the next NVIDIA?) When you own a cap-weighted index, all these adjustments happen behind the scenes within the ETF and minimal taxes are owed along the way. Your portfolio gradually shifts from having the most dollars allocated to Exxon Mobil to Apple or currently to NVIDIA. No buy or sell decisions need to be made or timed appropriately. The stocks that perform well rise to the top of the portfolio and you have more and more exposure to them. Stocks that perform poorly or cease to exist take up less and less weight and are automatically reduced in your portfolio over time all without creating any significant tax impacts, hours of due diligence and valuation research, or any decisional regret from making the wrong choices.

	1/1/1994 Top 10 Holdings	Return over the last 10 years	1/1/2024 Top 10 Holdings	Return over the last 10 years
1	Exxon Mobil	64%	Apple	951%
2	Coca-Cola	107%	Microsoft	1,160%
3	Walmart	230%	Alphabet (Google)	525%
4	Raytheon	97%	Amazon	993%
5	Merck	215%	NVIDIA	28,970%
6	Proctor & Gamble	181%	Meta (Facebook)	663%
7	General Electric	62%	Tesla	1,120%
8	PepsiCo	150%	Berkshire Hathaway	221%
9	IBM	51%	Eli Lilly	1,720%
10	Johnson & Johnson	86%	Visa	456%
S&P 500 growth over the last 10 Years				238%

Source: https://www.finhacker.cz/top-20-sp-500-companies-by-market-cap/ and YCharts
Highlights reflect outperformance over the last 10 years

That's not to say that cap-weighted indices are without drawbacks. They have led to market bubbles in the past as they continue unchecked. The tech bubble in the early 2000's was led by a run in companies that had little to no earnings and made up more than 30% of the market. The current technology sector is similarly weighted but with companies that have significant earnings and cash flows.

At Legacy we combat some of these drawbacks by consistently rebalancing accounts back to their risk tolerances. Rebalancing occurs not only between our stock and bond allocations but also within each asset class. For example, within our US stock holdings we rebalance between large, mid, and small cap-weighted asset classes.

Why is all of this important? When clients call asking if they should add an individual stock to their portfolio, odds are usually that their allocation to that stock has already been significantly growing underneath the indices and managers we already own. NVIDIA for example is currently 7.25% of the S&P 500. As of 1/31/2024, it was also 5.92% of our Goldman Sach GQG Partners Fund. Therefore, a client would own around $4,655 for every $100,000 allocated to stocks within our portfolio (or 4.65%). From an allocation standpoint, the exposure we want to create has happened automatically within the underlying investments.

If you have any questions about the investment portfolio, please reach out to your Relationship Manager; we would be glad to further explain our investment approach in greater detail and how it fits into your personalized financial plan. If you haven't completed a financial plan, we encourage you to work with your Relationship Manager to get one in place.