

EDITOR'S NOTE

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Is Your Index Fund Too Concentrated?

The S&P 500 index's high level of concentration is having implications for index funds. Vanguard revised its prospectus for its S&P 500 index fund to allow it to no longer be a diversified fund.

While this may seem like something impacting just Vanguard, the ripple extends much further.

Any index fund tracking the S&P 500 now has a high concentration in a small number of stocks. The 10 largest stocks in the S&P 500 accounted for 34.6% of the total index's value at the end of September. Even if we set aside the U.S. Securities and Exchange Commission's (SEC) rules on diversification, it is still a high level of concentration for a broad-based index fund.

Portfolio managers attempting to stay close to the S&P 500 face the same concentration issues. They must either maintain proportionately large holdings in the index's largest companies or otherwise be very creative. The safer ground for a manager who wants to limit their periods of underperformance is to sacrifice diversification and hold those mega-cap companies.

Large-cap growth funds also face concentration issues. The 10 largest positions in the iShares S&P 500 Growth ETF (IVW) account for 60.4% of its total portfolio. The ETF held 237 securities at the end of September, but the impact of most of those other stocks isn't much larger than a rounding error in terms of performance.

Venturing out into a total market fund provides little escape either. The Vanguard Total Stock Market ETF (VTI) has 29.8% of its portfolio allocated to just 10 stocks. Many of the fund's other 3,661 holdings will not move its performance by more than a rounding error.

Good Times While They Last

The temptation is to let the good times roll. The S&P 500 has done well over the past several years. While the valuations of the technology-related companies driving the index upward are expensive, we are not seeing a repeat of the dot-com bubble. The largest companies in the S&P 500 are profitable and are expected to continue growing revenues and profits.

The challenge—as always—is leaving the party before the punch bowl runs dry. No one knows when it will happen, but the pendulum will swing away from the index's current leaders and toward other companies. It's not a question of if, but rather of when.

This is where portfolio diversification comes into play. It increases the odds of being in the right types of stocks and the right types of asset classes at the right time. Diversification allows you to continue riding the momentum of the S&P 500 while having exposure to other categories.

Contributing editors Brian Haughey and Chris Pedersen offer different ideas for diversifying. Haughey looks at using equal-weight funds instead of traditional S&P 500 funds that use a market-capitalization-weighted approach. He also discusses smart beta (factor) strategies that use a different weight scheme. Pedersen looks at combining target-date-fund-like allocations with a small-cap value fund. Their articles appear on pages 7 and 11, respectively.

Improved Data on AAII.com

Last month, AAII switched to using S&P Global Market Intelligence as our financial data provider for stocks. We had previously used LSEG Data & Analytics (formerly Refinitiv).

This enhancement improves the comparability, reliability and overall consistency of the financial data available to you. It impacts the financial ratios, valuation metrics, growth rates and stocks passing particular screens.

The biggest change is how the financial statements are presented. S&P Global attempts to standardize the presentation of financial data. This makes it easier to compare one company to another. LSEG uses as-reported data, which is more subject to the financial decisions made by each company.

Wayne Thorp explains how this change impacts the numbers you see and how it can help you on page 29. I complement Thorp's article with a guide to changes in sector and industry classifications. If you ever wondered why one website lists a company in X industry and why another puts it in Y industry, you will find out why on page 34.

Wishing you prosperity and good health,