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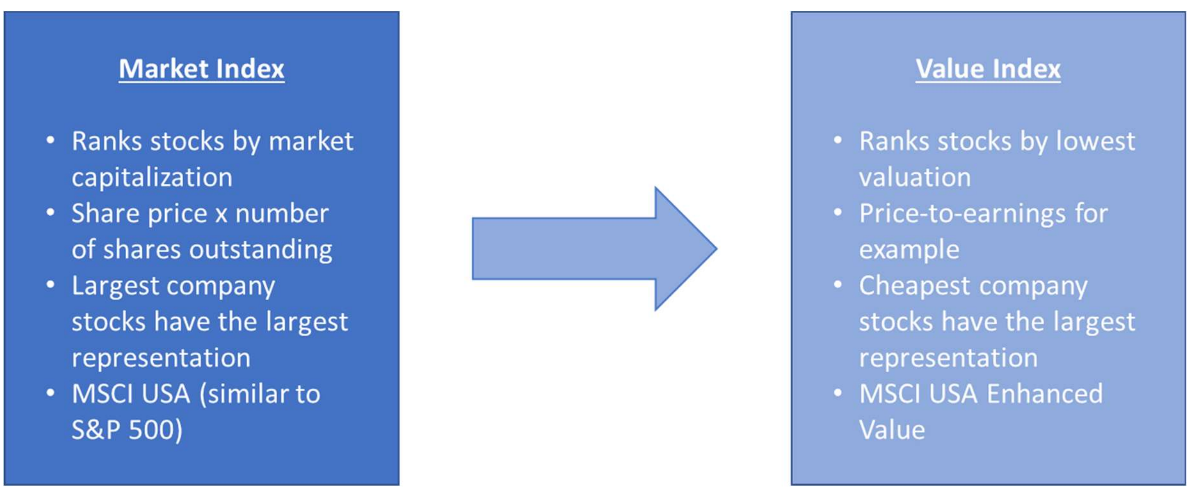
Factor Indexing

Most investors have a general understanding of what the S&P 500 is. After all, it is flashed on CNBC all day every day, along with the Dow Jones Industrial average. Both of these are commonly referred to when one asks “what did the market do today?” As a side note, we at Metric Financial take exception to the Dow being referred to as “the market” since it is a very narrow grouping of 30 stocks representing only one sector. Therefore, for the purposes of this discussion, we will focus on the S&P 500 since that is a broader representation of US large and mid-cap stocks.

The S&P 500 is what is known as a market capitalization weighted index. That means that a stock’s weight in the index is determined simply by multiplying its current share price by the number of shares the company has outstanding. For example, the largest stock in the S&P 500 is Apple because it has a market capitalization of $910 billion, found by multiplying its 4.92 billion shares outstanding by its current stock price of $184.92 (as of 6/28/2018). As a result, the S&P 500 gives investors no other information beyond a company’s stock profile. What if we don’t want to simply own the largest companies? What if we think we can do better by owning companies that are cheaper than the market?

In the past, we would need to hire an expensive active fund manager to find such value stocks for us. Now, however, the wide availability of data and technology innovation allows us to simply screen stocks by certain characteristics, such as low price to earnings. In fact, there are many companies out there that are doing more and more of this, like Standard & Poor’s, MSCI, and FTSE Russell, to name a few. Visually, it looks like this:



This can be done for virtually any characteristic of a company, such as dividend yield, quality of earnings, stock momentum, and so on. It is this process that allows investors to now access the sources of excess return once sought by expensive active mutual funds at meaningfully lower cost. Furthermore, depending on the index, it has the potential for less individual stock risk because this new index will represent a large basket of securities having the characteristic sought, whereas traditional active managers try to guess which ones will do best and select a very concentrated subset.

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